Romania

Fiscal Council

Annual Report

2022

Note:

The 2022 Annual Report was approved by the Chairman of the Fiscal Council, according to art. 56, para. (2), letter d) of Law no. 69/2010, after being adopted by the members of the Council through vote, on July 31, 2023.

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List of abbreviations

CEE	Central and Eastern Europe
CPI	Consumer Price Index
DESI	Digital Economy and Society Index
EAFRD	European Agricultural Fund for Rural Development
EAGF	European Agricultural Guarantee Fund
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EDP	Excessive Deficit Procedure
EMFF	European Maritime and Fisheries Fund
ESA 2010	European System of National and Regional Accounts 2010
ESA 95	European System of Accounts 1995
EU	European Union
FC	Fiscal Council
FRL	Fiscal Responsibility Law no. 69/2010
FS	Fiscal Strategy
GCB	General consolidated budget
GDP	Gross Domestic Product
GEO	Government Emergency Ordinance
HICP	Harmonized Index of Consumer Prices
IMF	International Monetary Fund
MIEP	Ministry of Investments and European Projects
MF	Ministry of Finance
MFF	Multiannual Financial Framework
MTO	Medium-term objective
NAFA	National Agency for Fiscal Administration
NBR	National Bank of Romania
NCFI	National Centre for Financial Information
NCSP	National Commission for Strategy and Prognosis
NIS	National Institute of Statistics
NREF	Non-reimbursable external funds
NRRP	National Recovery and Resilience Plan
OP	Operational Program
pp	percentage points
RRF	Recovery and Resilience Facility
SGP	Stability and Growth Pact
SME	Small and Medium Enterprises
SSC	Social Security Contribution
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact)

TUEF	Temporary unavailability of European funds
VAT	Value Added Tax
WB	World Bank

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I. Summary

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

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

In 2022, Romania's economy registered a real GDP growth of 4.7%. In line with the trends in previous years, the economic activity was significantly supported by household consumption, tempered however by the negative pace of real wage growth. Additionally, investment expenditures had an upward dynamics, the percentage contribution of gross fixed capital formation to economic growth being substantially higher than in 2021.

Romania's economy grew by 4.7% in real terms in 2022. Although the economic activity decelerated compared to 2021, when real GDP increased by 5.8%, the growth recorded was above expectations. On the demand side, household consumption had the biggest contribution to the positive dynamics of real GDP (3.6 pp), followed by gross fixed capital formation (1.9 pp) and public administration consumption (0.5 pp). The positive impact of these elements was diminished by the negative contribution of the change in inventories (0.6 pp) and of the net export of goods and services (0.7 pp). On the supply side, the added value from the information and communications sector (1.3 pp contribution to GDP growth), from retail and wholesale trade (1.2 pp), from the professional, scientific and technical activities sector (0.9 pp), along with the added value from constructions (0.7 pp) and from real estate transactions (0.7 pp) had the highest contributions to the real GDP growth. Their effect was partially counterbalanced by the contribution of the agriculture, forestry and fishing sector (-0.5 pp) and industry (-0.5 pp).

2022 was characterized by high inflation and an increase in the current account deficit, which reached 9.3% of GDP at the end of the year. Thus, the average of the external deficits recorded in the last 3 years is significantly above the alert threshold of 4% established by the European Scoreboard. The Romanian economy is characterized by high

2022 was characterized by high inflation, which evolved on an upward trajectory, especially in the first semester. At the end of the year, the inflation rate reached 16.35%. Also, the price increase measured by the GDP deflator was at a substantially higher level than the one anticipated in the 2022-2024 FS, namely at 13.4%, compared to 5.8%. The current account deficit continued its upward trend, increasing to 9.3% in 2022 (+2.1 pp compared to 2021), with a reduction to 52.2% (from 67% in 2021) of its coverage from non-debt generating flows (the balance of equity participations related to foreign direct investments, including reinvested profit and capital transfers from European funds). It

levels of the twin deficits, which involve major challenges for the economic stability of the country.

should be noted that the average of the current account deficits recorded in the last 3 years is 7.2% of GDP, far exceeding the 4% alert threshold set by the European Scoreboard, which highlights a major external macroeconomic imbalance and high vulnerability in the face of shocks. However, we must take into account the fact that the Covid-19 pandemic had a major influence on the deficits and the dynamics of the EU economies. The Romanian economy is characterized by high levels of the twin deficits, which involve major challenges for the economic stability of the country and call for fiscal consolidation.

The labour market had a positive evolution, with the average number of employees increasing in 2022 by 1.5% compared to the previous year, while the ILO unemployment rate remained at 5.6%. The average gross wage continued its upward trend from previous years, exhibiting a nominal increase of 10.6%, compared to 2021, but, against the background of high inflation, the real wage decreased by 2.2%.

The evolution of non-governmental credit entered a downward trajectory, registering a reduction of 3.6% in real terms compared to the previous year, due to the decrease of loans granted in lei. The real decrease in non-governmental credit is explained by the increase in the price of credit, given the rise of reference interest rates to moderate inflationary pressures. In 2022, data on the labour market revealed an average number of employees of 5,170 thousand people (+1.5% compared to the previous year), as well as an ILO unemployment rate of 5.6%, similar to the one recorded in 2021. The average gross wage across the economy was 6,120 lei (+10.6% compared to 2021), the average net wage was 3,801 lei (+11.3%) and the real wage registered a decrease of 2.2%, given an average annual inflation of 13.8%.

The two budget revisions carried out during 2022 operated a substantial increase in budget revenues, based on a more rapid dynamics of the nominal GDP, determined by the inflation above expectations, and on additional revenues from overtaxing the electricity and natural gas producers. However, the additional revenues did not lead to a decrease in the nominal budget deficit, being fully allocated for increases in expenditure aggregates; there were even additional increases in public expenditures. This situation

The general consolidated budget for 2022 was based on a macroeconomic evolution scenario with a real GDP growth of 4.6% and a GDP deflator of 5.8%. Considering Romania's placement in the excessive deficit procedure, the 2022-2024 FS projected the return of the budget deficit, in ESA 2010 terms, below the reference level of 3% of GDP by 2024.

The two budget revisions carried out during 2022 operated a substantial upward adjustment – unprecedented in the history of revisions evaluated by the FC since 2010 – for both budget revenues and expenditures. The increase in budget revenues had two main sources: the more rapid dynamics of nominal GDP, compared to previous estimates (due to high inflation), and the additional revenues from overtaxing the electricity and natural gas producers. However, the additional revenues did not lead to a decrease in the nominal budget deficit, being fully allocated for increases in expenditure aggregates; there were even additional

complicated the budget consolidation process, considering that part of the additional revenues in 2022 is temporary or due to the favourable cyclical dynamics of the economy, while a significant part of the increase in expenditures constitutes permanent expenditures.

increases, especially at the level of social assistance, other transfers, goods and services and interest expenditures. This situation complicated the budget consolidation process, considering that part of the additional revenues in 2022 is temporary or due to the favourable cyclical dynamics of the economy, while a significant part of the increase in expenditures constitutes permanent expenditures.

The 2022 budget execution revealed a deficit of 80.8 billion lei (according to the national methodology), 3.8 billion lei above the target assumed in the initial budget (77 billion lei). As a share of GDP, the cash deficit recorded a level that was marginally lower than the one initially programmed (5.72% compared to 5.84%), due to the increase in nominal GDP above the estimates taken into account when elaborating the initial budget. According to the European methodology, the budget deficit was 6.2% of GDP, close to the level projected in the initial budget (6.24% of GDP). Although the budget deficit decreased by about 0.9 pp of GDP compared to the previous year, the structural deficit decreased by only 0.4 pp of potential GDP, to 5.8%, confirming the tendency to allocate cyclical and/or temporary revenues for financing permanent expenditures.

Investment expenditures represented 5.1% of GDP in 2022, 0.1 pp above the 2021 level. The Fiscal Council appreciates that, through a large absorption of the European funds made available to Romania, a high level of investments can be maintained in the coming years.

In 2022, investment expenditures represented 5.1% of GDP, 0.1 pp above the level recorded in the previous year, but under the circumstances of a nominal GDP dynamics of 19.3%. The nominal increase compared to 2021 was 13.3 billion lei, this being spread across all investment components, as follows: projects with financing from external non-reimbursable post-accession funds (+8.4 billion lei), projects with financing from the amounts representing non-reimbursable financial assistance and loans related to the NRRP (+0.9 billion lei), while sources from the domestic economy increased by about 4 billion lei. Given that Romania is the recipient of a significant volume of European funds intended for investments, maintaining public investments at a high level, through an improved absorption of EU funds, is essential to eliminate infrastructure gaps, simultaneously with increasing the quality of programming and implementation of investment projects.

The Fiscal Council advocates for the intensification of efforts regarding the implementation of

Considering the limited progress of the reform in the field of public investments management, the Fiscal Council advocates for increased transparency and a better prioritization of public

reform measures in the field of public investments in order to use as much as possible the significant volume of European funds allocated through the 2021-2027 Multiannual Financial Framework and the NRRP. European funds can play a key role in mitigating the contractionary effect of the necessary correction of the structural budget deficit.

investments, for a higher efficiency of allocating and spending public money, as well as for the increase of investments in research, development and innovation, in physical and digital infrastructure. In this regard, achieving a higher absorption of the European funds allocated through the 2021-2027 Multiannual Financial Framework and the NRRP is an essential condition for a significant increase in public investment expenditures in the following period. Implementing the reforms stipulated by the NRRP can support the acceleration of the investment process, allowing a higher rate of economic growth. Thus, European funds can play a key role in mitigating the contractionary effect of the necessary correction of the structural budget deficit, an aspect reiterated by the FC in its analyses.

Romania has a very low level of budget and tax revenues relative to its GDP, ranking second to last in the EU in 2022, similar to the 2016-2021 period.

Romania's budget revenues, according to the ESA 2010 methodology, stood at 33.5% of GDP in 2022, well below the European average of 46.5% (a difference of 13 pp), denoting one of the lowest levels in the EU, being followed only by Ireland. Tax revenues (including social security contributions) remained at 27.2% of GDP in 2022, Romania continuing to be in the penultimate place, with a gap of 13.7 pp compared to the EU average (40.9% of GDP). Romania's share of tax revenues (including social security contributions) in GDP is significantly below that of other countries with similar economies, such as Slovenia (36.4%), Poland (35%), Czechia (34.7%) and Hungary (34.5%). Compared to Bulgaria, the share of budget revenues in GDP is lower by 5 pp, and that of tax revenues by 3.4 pp. This unfavourable situation is also the effect of the large-scale fiscal relaxation after 2016, which resulted in the reduction of budget revenues as a share of GDP in 2022, compared to 2015, by 2 pp (in the EU27 they increased by 0.3 pp) and that of tax revenues by 0.8 pp (in the EU27 they increased by 0.5 pp).

The positioning of Romania at the bottom of the ranking, in terms of budget revenues as a share of GDP, is also the effect of an insufficiently modernized tax administration apparatus, with slow reforms and, often, only partially implemented. At the same time, from the perspective of the digital economy and society

The positioning of Romania at the bottom of the ranking, in terms of budget revenues as a share of GDP, is also the effect of an insufficiently modernized tax administration apparatus, with slow reforms and, often, only partially implemented. If, at the central level, the simplification and improvement of the administrative apparatus for the collection of taxes has succeeded to some extent, at the local level efforts must still be made in this direction. The reform of the National Agency of Fiscal Administration through digitalization, stipulated in the NRRP, starts from recognizing that, in order to correct the budget deficit, there is a need for the rapid

index, in 2021 Romania remained in the last position among the 27 EU member states.

The Fiscal Council appreciates that sustained efforts are needed towards increasing investments in the tax administration infrastructure, especially in the digital one, which have the potential to improve the functioning of public institutions, with effect on increasing tax revenues.

improvement of collection efficiency and of the relationship with taxpayers. The reform plan is built on two directions – increasing voluntary compliance through the development of digital services and improving tax administration processes, including through the implementation of integrated risk management. From the perspective of the digital economy and society index, according to the Report prepared by the EC in 2022, Romania remained in 2021 in the last position among the 27 EU member states. In the structure of the 4 major axes of the index, Romania ranked last in digital public services (the same as in the previous year), human capital (down from the 26th place) and the integration of digital technology (down from the 25th place), respectively in the 15th place in terms of connectivity (down from the 10th place). The Fiscal Council appreciates that sustained efforts are needed towards increasing investments in the tax administration infrastructure, especially in the digital one, which have the potential to improve the functioning of public institutions, with effect on increasing tax revenues.

In 2022, there was a relative improvement in the use of the contingency reserve fund from the perspective of total expenditures. Thus, compared to the previous year, total allocations from the contingency reserve fund decreased by 20.8%, supported by the reduction of transfers to the local administration (-36%), while the amounts allocated for the central administration increased by 7.1%.

2022 was marked by the war in Ukraine, with repercussions both in economic and humanitarian terms, many of the Government decisions regarding allocations from the contingency reserve fund being intended to provide support and humanitarian assistance to foreign citizens or stateless persons in special situations, coming from the armed conflict in Ukraine. It can be observed, however, that some amounts from the contingency reserve fund continue to be used outside the framework established by the Public Finance Law no. 500/2002, respectively for expenditures that cannot be categorized as urgent or unforeseen and that should have been taken into account when projecting the state and local budgets. In 2022, 3.6 billion lei were allocated from the contingency reserve fund (representing 0.7% of the total expenditures of the general consolidated budget, respectively 0.25% of GDP), of which 1.7 billion lei to the central administration and 1.9 billion lei to the administrative-territorial units. Compared to the previous year, total allocations from the contingency reserve fund decreased by 20.8%, supported by the reduction of transfers to the local administration (-36%), while the amounts allocated to the central administration increased by 7.1%.

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reiterating the recommendation regarding the explicit specification of the expenditures that can be covered from the contingency reserve fund, together with higher transparency, including through periodic reporting to Parliament of the amounts spent from the contingency reserve fund.

In 2022, there was a decrease in the ratio between personnel and social assistance expenditures, and budget revenues as a result of recording public revenues above expectations determined, among other factors, by high inflation. It should be noted that covering permanent expenditures with cyclical, temporary revenues poses additional risks to the sustainability and stability of public finances.

Starting from 2016, with the implementation of the new Fiscal Code, which led to a large-scale fiscal relaxation (translated into the reduction of budget revenues), the discretionary increases in permanent expenditures have intensified, resulting in a pronounced rigidity of the public expenditures' structure. In 2022, there was a decrease in the ratio of personnel expenditures to total budget revenues, from 33.9% to 29.6%, Romania being overtaken by Malta (30.8%), which thus moves in the first position at EU level. Also on a downward trend is the ratio between social assistance expenditures and budget revenues, with a decrease of 0.4 pp in 2022 compared to 2021. This fact is due to an increase beyond expectations in revenues determined, among other factors, by high inflation. It should be noted that covering permanent expenditures with cyclical, temporary revenues poses additional risks to the sustainability and stability of public finances. Therefore, keeping these rigid expenditures under control is imperative.

In 2022, personnel and social assistance expenditures represented 85.3% of tax revenues (including social security contributions). Reducing the structural budget deficit requires increasing the level of tax revenues, as well as caution regarding the increase of permanent expenditures.

After the peak reached in 2020, when personnel and social assistance expenditures represented 94.7% of tax revenues (including social security contributions), respectively 25.4% of GDP, in 2021 the share of these expenditures in tax revenues (including social security contributions) and in GDP decreased, reaching 89.4% and, respectively, 24.2%. The trend continued in 2022, when the share of personnel and social assistance expenditures fell to 85.3% of total tax revenues and to 23.2% of GDP. In 2022, this improvement was driven by an increase in tax revenues (including social security contributions) of around 19.4%, while personnel and social assistance expenditures increased by only 6%. Given that budget revenues in 2022 were influenced by higher-than-expected inflation and the overtaxing of electricity and natural gas producers, reducing the structural budget deficit requires increasing the level of tax revenues, as well as caution regarding the increase of permanent expenditures.

In 2023, the macroeconomic picture indicates a deceleration of

In 2023, the macroeconomic picture indicates a deceleration of economic activity, compared to the previous year, given the

economic activity, compared to the previous year, given the persistence of certain adverse effects. The EC anticipates an economic growth of 3.2% for Romania in 2023, above the IMF projection of 2.4%. The NBR forecasts the annual CPI inflation rate at 7.1% at the end of 2023.

persistence of certain adverse effects. The war in Ukraine, with negative effects on the prices of raw materials and energy, the high inflation rate, but also the worsening of financing conditions on the international market will contribute to the slowdown of the economic activity. In its spring forecast, published recently[1], the EC anticipates an economic growth of 3.2% for Romania in 2023 – above the IMF forecast of 2.4%. The determining factors of the upward trajectory of the GDP are expected to be private consumption (also supported by the indexation of wages and pensions, as well as government support schemes, including for energy) and gross fixed capital formation (the increase of investments being supported by the anticipated absorption of the funds allocated by the EC both through the MFF and the NRRP). The NBR's latest projections place the annual CPI inflation rate at 7.1% at the end of 2023. The downward trend in the inflation rate is due to an accelerated moderation in energy prices, accompanied by a slower attenuation of adjusted CORE2 prices.

Although the projected economic growth for 2023 was slightly overestimated, this is offset by an underestimation of the GDP deflator over the forecast horizon. In conclusion, the nominal GDP projection has a high level of plausibility.

In its opinion issued on the budget draft for 2023 and the 2023-2025 Fiscal Strategy, the FC considered that the real economic growth was slightly overestimated, aggregating into an overall optimistic evolution, but being compensated by an underestimation of the GDP deflator over the forecast horizon. In conclusion, the FC considered that the nominal GDP projection had a high level of plausibility. This observation is reinforced by the latest available data showing that, for 2023, the Government's economic growth forecast of 2.8% could undergo revisions in the context of very high uncertainty, with a higher likelihood of a downward revision, while risks regarding the GDP deflator forecast indicate the possibility of slightly higher values.

The 2023 budget draft targeted a budget deficit of 4.4% of GDP both according to the cash methodology and the European methodology. Taking into account a prudent evaluation of revenues and expenditures, the FC assessed, in its opinion regarding the budget

The 2023 budget draft targeted a budget deficit of 4.4% of GDP both according to the cash methodology and the European methodology. The deficit adjustment was expected to be achieved partially through the increase of budget revenues, due to the projected macroeconomic framework, the fiscal policy measures adopted, the NRRP projects and the amounts expected to be received from improving collection efficiency / reducing tax evasion (estimated by the MF at 8.7 billion lei), and, on the expenditure

[1] European Economic Forecast - Spring 2023, Bruxelles, May 2023.

draft for 2023, that the budget is compatible with a cash deficit of about 5.7% of GDP, being necessary for future budget revisions to identify adjustment measures in order to reach the deficit target.

side, through decreasing subsidies in nominal terms and by increases in personnel, goods and services, social assistance and interest expenditures at a slower pace than the projected dynamics of nominal GDP. Taking into account a prudent evaluation of revenues and expenditures, the FC assessed, in its opinion regarding the budget draft for 2023, that the budget is compatible with a cash deficit of about 5.7% of GDP. Under these conditions, the FC emphasized that future budget revisions must identify adjustment measures in order to reach the deficit target, as there are major risks regarding the continuation of budget consolidation.

The medium-term budget deficit adjustment is projected to be mainly achieved through a reduction of budget expenditures, while for budget revenues a marginal increase is estimated. The FC questioned the realism of this approach, appreciating that, in the absence of credible measures to increase tax revenues, the balance of risks is tilted in the direction of recording higher-than-expected medium-term deficits. The FC emphasizes that the fiscal consolidation process calls for a significant increase in tax revenues, this objective representing a problem of economic security and national solidarity, in order for the public budget to be able to cope with very large current and future needs.

The medium-term budget deficit adjustment (2024-2026) is determined, according to the projections from the Convergence Programme, mainly by a reduction in the share of public expenditures in GDP by 1.2 pp (from 38.3%, in 2023, to 37.1%, in 2026), while the share of public revenues is projected to increase by only 0.3 pp of GDP (from 33.9% in 2023 to 34.2% in 2026). In its opinion on the 2023-2025 FS, the FC questioned the realism of this approach, appreciating that, in the absence of credible measures to increase tax revenues, the balance of risks is tilted in the direction of recording higher-than-expected medium-term deficits.

The FC reiterates that the fiscal consolidation process calls for a significant increase in tax revenues, which are at an unacceptable low level in relation to the needs of Romania and compared to other EU member states. In this regard, it is necessary to remove exemptions and loopholes from the current legislation, as well as to increase the efficiency of revenue collection by discouraging tax optimization and reducing evasion. It should be borne in mind that such measures have a significant distributional impact, so their implementation may face difficulties and the opposition of certain interest groups.

The increase in tax revenues, however, represents a problem of economic security and national solidarity so that the public budget can cope with very large current and future needs. Considering that public health and education are chronically underfunded, that the current military and geopolitical context calls for increased defence spending, and that the severe impact of climate change requires state intervention during difficult times, significant increases in tax revenues are a pressing necessity, a priority in economic policy.

Considering the budget execution for the first six months of 2023, which recorded a budget deficit of 2.3% of GDP, as well as the measures adopted after the approval of the initial budget, including the wage increases granted, the FC assesses that the 2023 budget deficit will probably be above 6% of GDP, in the absence of corrective measures. At the same time, the FC emphasizes the importance of a rapid adoption of such measures, given the short time in which they can produce effects on the 2023 budget execution.

The budget execution for the first six months of 2023 recorded a budget deficit of 2.3% of GDP, about 0.63 pp higher compared to the same period of the previous year, caused by the slower dynamics of certain revenue categories (in relation to the evolution of the relevant macroeconomic bases, but also compared to the levels anticipated in the initial budget), as well as by the increase beyond expectations of certain categories of expenditures relative to the targets set in the initial budget. It should also be mentioned that the budget execution in the second half of the year will be affected by the wage increases granted after the adoption of the annual budget laws, while the measures adopted through GEO 34/2023 appear insufficient to ensure the continuity of the fiscal consolidation process.

Under these circumstances, compared to the assessment from its opinion on the budget draft, the FC is revising upward the deficit projection for the current year, estimating that it will probably be above 6% of GDP, in the absence of corrective measures. The need for the adoption of corrective measures was signalled by the FC in its opinion on the budget draft, but now the importance of their rapid adoption must be emphasized, considering the short time in which they can produce effects on the 2023 budget execution.

II. Macroeconomic framework in 2022

The year 2022 was dominated by a series of events with significant economic impact. The unprecedented rise of the inflation rate, the magnitude of geopolitical tensions dominated by the outbreak of the war in Ukraine, the energy crisis, and China's zero-Covid-19 policy led to an amplification of uncertainty across most economies. In a context of inflation rates well above central banks' targets and far beyond expectations, monetary authorities embarked on a cycle of tightening interest rates, marking the end of the period of accommodative monetary conditions, characterized by near-zero or even negative interest rates and central bank asset purchase programs. Under these circumstances, the dynamics of global economic activity has been modest in 2022, with a more pronounced deceleration in the second half, as most developed economies registered modest growth.

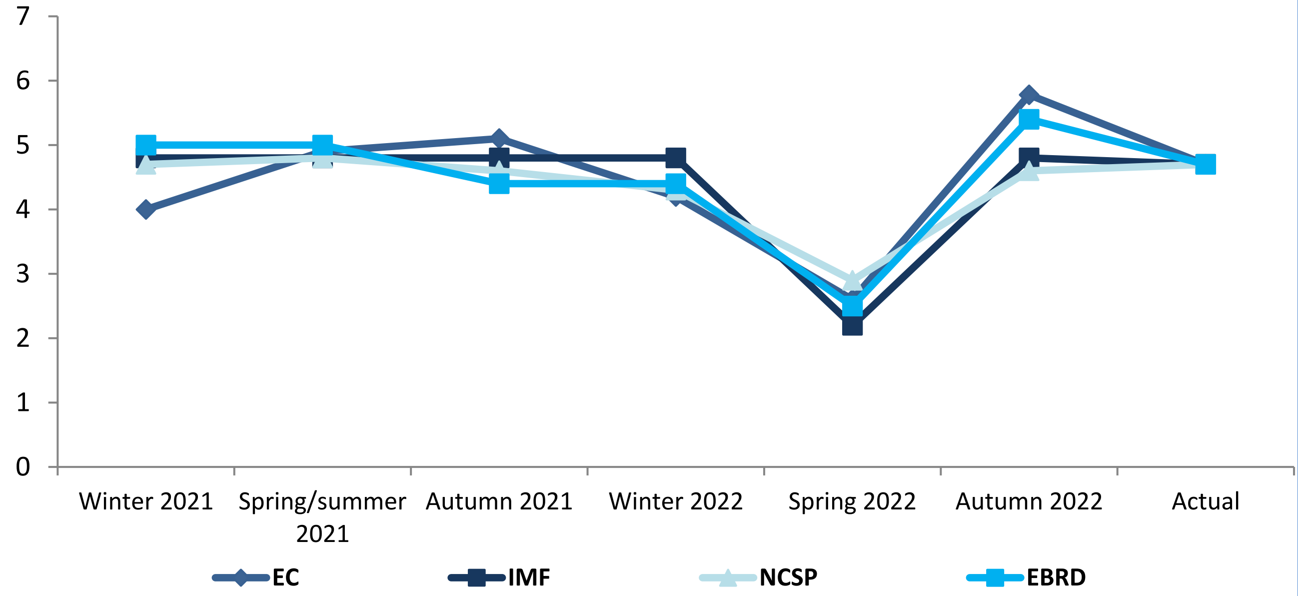
In Romania, despite unfavourable external conditions, the real economic growth reached 4.7% in 2022[2]. Although economic activity decelerated compared to 2021, when real GDP grew by 5.8%, the growth exceeded expectations. Consistent with trends from previous years, on the demand side, the economic activity was significantly supported by household consumption, although tempered by the annual negative growth rate of real wages. Additionally, investment expenditures, carried out by both the private and public sectors, exhibited an upward trajectory, as the contribution of gross fixed capital formation to economic growth was significantly higher than in 2021. The positive dynamics of household consumption and investments was partially offset by the negative contribution of net exports and inventory changes. On the supply side, the value added from the information and communication sector and retail and wholesale trade had the highest contributions to real GDP growth (more than 1 pp each). Meanwhile, the agriculture, forestry and fishing, as well as industry had negative contributions to GDP growth.

Within the EU, Ireland (9.4%), Malta (7.1%) and Portugal (6.7%) recorded the highest rates of real GDP growth, while Germany (1.8%), Slovakia (1.7%), Finland (1.6%) and Luxembourg (1.5%) experienced slower dynamics and Estonia recorded a negative evolution (-1.3%). According to the real GDP growth criterion, in 2022, Romania (4.7%) ranked 11th among the 27 EU member states, with the average real GDP growth across the EU being around 3.7%, similar to that in the Eurozone[3].

[2] According to the GDP preliminary estimates, published by the NIS on April 7, 2023

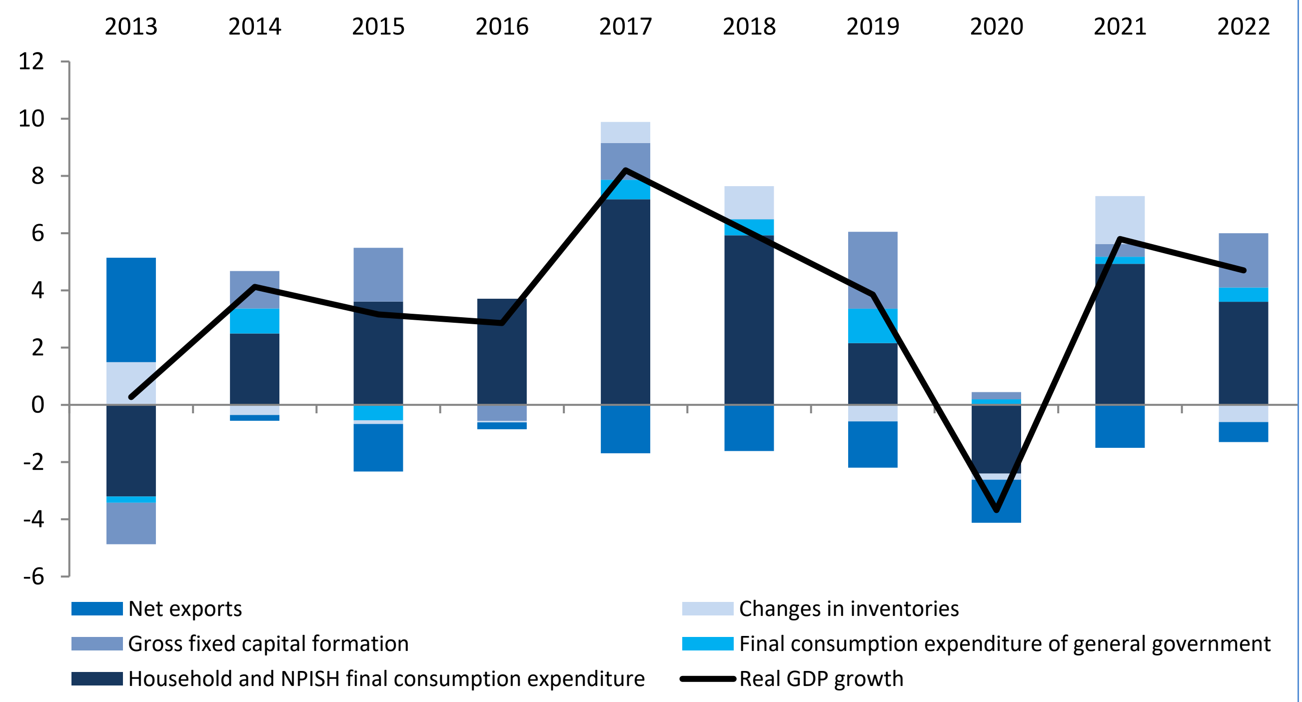
[3] According to the GDP preliminary estimates, published by the Eurostat and accessed on July 25, 2023.

Figure 1: The evolution of economic growth forecasts for 2022



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

Figure 2: Contributions to real GDP growth



Source: Eurostat, Fiscal Council's calculations

From the analysis of *Figure 1*, it can be noticed that the forecasts made in 2021 by the international financial institutions (EC, IMF and EBRD) anticipated an economic growth ranging between 4% and 5.1% for 2022. The IMF's forecast indicated a growth of 4.8%, similar to the NCSP's projection. The 2021 EC's forecasts indicated growth rates of 4.0% and 5.1%. In the context of the war in Ukraine and the higher-than-expected inflation rate, by the end of the first half of 2022, the forecasts were revised downward, with the upper bounds of projected growth by international financial institutions ranging between 2.2% and 2.9%. As the statistical data for 2022 accumulated and economic activity showed resilience beyond expectations, the forecasts were revised upward, varying between 5.8% (EC's forecast) and 4.7% (NCSP's forecast). In the end, the real GDP growth rate stood at 4.7%, closely aligned with the NCSP's and IMF's projections.

On the demand side (see *Figure 2*), household consumption had the largest contribution to the positive dynamic of economic activity (+3.6 pp), along with gross fixed capital formation (+1.9 pp) and government consumption (+0.5 pp). It is noteworthy that, compared to 2021, the contribution of household consumption to GDP growth decreased by 1.3 pp. This evolution was driven by the negative annual growth rate of real wages, more pronounced in the second half of the year, as well as the rising interest rates, which tempered the pace of growth in non-governmental credit. The moderation in household consumption was offset by the dynamic of gross fixed capital formation, its contribution to GDP growth increasing from 0.4 pp in 2021 to 1.9 pp in 2022. The growth in public investments was supported by the acceleration of investments financed from both domestic funds and external grants. Between October and December 2022, investments financed from domestic funds and external grants increased by 119% and 64%, respectively, compared to the January - September 2022 period. Relative to 2021, investments financed from domestic funds grew by 15%, while those from external grants grew by 30%. The changes in inventories – historically characterized by significant variations – had a negative contribution to economic growth (-0.6 pp). Consistent with its pattern from recent years, the net export of goods and services (-0.7 pp) maintained a negative contribution to economic growth.

On the supply side, the sectors of the national economy had mixed contributions. Thus, on one hand, the following economic sectors supported the GDP growth:

- retail and wholesale trade (+1.2 pp), with a weight of 18.7% to GDP formation, driven by increased sales;
- information and communication sector (+1.3 pp), with a weight of 6.6% to GDP formation, due to a 20% increase in value added generated by this sector, supported by the acceleration of digitalization processes;
- construction sector (+0.7 pp), with a weight of 6.3% to GDP formation, driven by a more pronounced growth in the engineering construction segment;
- real estate transactions (+0.7 pp), with a weight of 7.4% to GDP formation;
- professional, scientific and technical activities; administrative and support service activities (+0.9 pp), with a weight of 7.1% to GDP formation;
- entertainment, cultural and recreational activities; household repair services and other services (+0.2 pp), with a weight of 2.6% to GDP formation;
- net taxes on products (+0.5 pp), with a weight of 9.0% to GDP formation.

Conversely, agriculture, forestry, and fishing, as well as industry, had a negative contribution to GDP growth. Specifically:

- agriculture, forestry and fishing (-0.5 pp), with a weight of 4.5% to GDP formation, due to the high prices of raw materials and unfavourable weather conditions;
- industry (-0.5 pp), with a weight of 22.5% to GDP formation, amid the economic slowdown in Germany, Romania's main trading partner, and the significant increase in energy prices.

In 2022, inflationary pressures were high. The inflation rate followed an upward trajectory, more pronounced in the first semester, starting from an inflation rate of 8.35% in January and reaching 15.05% in June. In the second half of the year, the inflation rate stabilized around 15-16%. Thus, in December 2022, the inflation rate was 16.35%. The average inflation in 2022 was 13.8%, from 5.1% in 2021, significantly exceeding the central bank's target of 2.5% +/- 1 pp, and surpassing the population's expectations.

The 2022-2024 Fiscal Strategy envisaged inflation at 4.7% in December 2022 and at an average rate of 6.5% throughout the year. The differences compared to the recorded values were +11.65 pp and +7.3 pp, respectively. The persistent and higher-than-expected increase of prices has its roots in two main factors. Firstly, due to the war in Ukraine and the restrictions imposed on Russia, the prices in the energy sector escalated rapidly[4]. Secondly, during the last three quarters of the year, the inflation rate was significantly impacted by the rise in food prices, attributed to the conflict in Ukraine, as well as adverse weather conditions[5]. The effect of price increases in the energy sector has been partially mitigated by government support schemes. As these increases have gained amplitude and became persistent, they have been reflected in the prices of non-food goods and services, as well as in inflationary expectations. Furthermore, despite the elevated inflation being sustained by supply shocks, the resilience of demand has amplified inflationary pressures. Similar developments have been recorded at the GDP deflator level – which measures the dynamics of prices for the entire economy, not just for final goods and services – which was anticipated to be 3.9% for 2022 (in the 2022-2024 Fiscal Strategy), while the actual value greatly exceeded the forecast, being 13.5%.

In the first part of the year, the inflation rate followed a strongly upward trajectory, reaching a level of 10.15% by the end of the first quarter. This trajectory persisted into the second quarter, with the inflation rate reaching 15.05% in June. In the last two quarters of the year, the inflation growth rates stabilized, indicating a moderation of inflationary pressures and the attainment of a plateau. By the end of the third quarter of 2022, inflation recorded a value close to 15.9%, and by the end of the year, it

[4] In Europe, in 2022, the annual growth of oil prices was positive every month, with growth rates ranging between 12% and 81%, with a peak in May 2022 when the price reached $126 per barrel, compared to $69 per barrel in May 2021. Under these conditions, in Romania, in 2022, the annual growth of fuel prices reached a peak of 54% in June, according to the National Bank of Romania's Inflation Report from February 2023.

[5] Considering that Russia and Ukraine have significant shares in the global market for wheat, sunflower seeds and oil, corn and barley, in March 2022, the global price index of corn increased year-on-year by 37%. This trend continued throughout 2022, with a peak year-on-year growth of 43% in November. Similarly, the global price index of wheat increased year-on-year by 69% in March 2022. In Romania, according to the National Bank of Romania's Inflation Report from February 2023, the annual variation of agricultural prices in the domestic market exhibited growth rates ranging from 22% to 47% in 2022, with a peak reached in April.

reached a value of 16.4%. In the first half of the year, the energy crisis, amplified by the Russia-Ukraine conflict, and transmitted through production costs, as well as tensions in the agri-food market were the main driving factors of high inflation. Specifically, at the end of the first semester, the contribution of the increase in prices of electricity, natural gas, fuels, and food to the total inflation was about 70%. Government support schemes partially mitigated the effects of rising prices in the energy sector[6]. The transmission of the effects of these shocks into production costs has led to an acceleration of inflationary pressures within the economy. This trend was more visible in the last two quarters, when prices in the energy sector moderated, while prices of food products, non-food items and services continued to rise rapidly. Under these circumstances, it can be mentioned that the adjusted Core2 inflation rate has consistently increased throughout the year: 7.1% at the end of the first quarter; 9.8% at the end of the second quarter; 11.9% at the end of the third quarter, and 14.6% at the end of the year.

In the view of high of inflationary pressures, the NBR continued the cycle of tightening monetary conditions that began in 2021. Thus, in 2022, in all eight meetings of the Board members, the central bank increased the reference interest rate. In the initial meetings, the rate hike was 0.25 pp, followed by increments of 0.50 pp. As price increases intensified, monetary policy became more restrictive and the rate hike was 1 pp in the July meeting. The last meeting, held in November, brought a 0.50 pp increase in the key interest rate. Consequently, the monetary policy rate rose from 1.75% at the beginning of the year to 6.75% at the end of 2022. With respect to the minimum reserve requirement (MRR) rate, it was maintained at 8% for liabilities in national currency, while for foreign currency liabilities, the MRR rate stood at 5%.

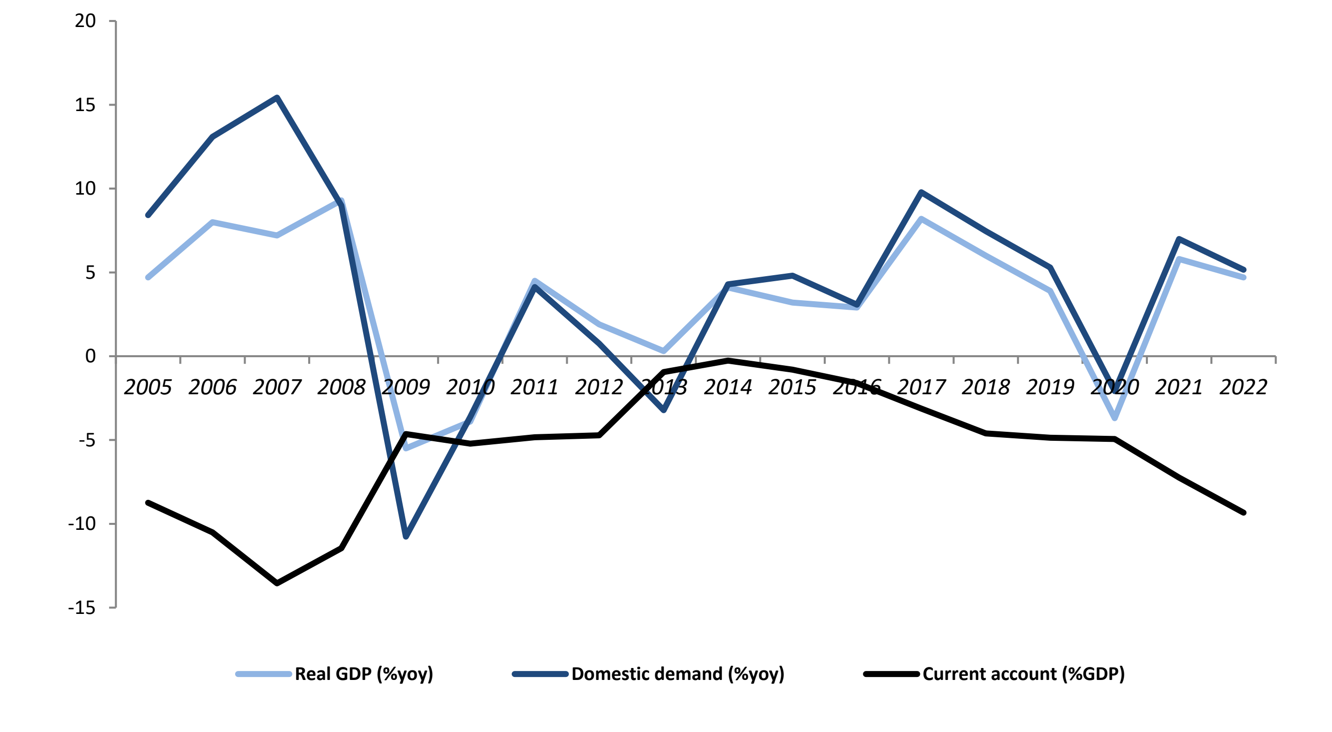
The current account deficit[7], as an indicator of Romania's external position, recorded a consistent increase throughout 2022, reaching 9.3% of GDP by the end of the year. This represents a significant growth of 2.1 pp compared to the previous year. An important role in this development was played by the deterioration of the terms of trade, likely around 1.5% of GDP, due to a more pronounced increase in import prices compared to export prices. The deepening trajectory of the current account deficit over the past few years raises questions about the evolution of external imbalances and competitiveness. The European Scoreboard sets an alert threshold when the average current account deficit over the last 3 years exceeds 4% of GDP. For Romania, this average reached 7.2% of GDP in 2022, surpassing the 4% of GDP level in each of the last three years. As such, the Romanian economy is characterized by a high level of twin deficits, posing significant challenges to the country's economic stability. It is worth noting that, unlike the years when the budget deficit exceeded the current account deficit[8], in 2022, the current account deficit was larger by around 3.6 pp compared to the budget deficit.

[6] In the absence of government support schemes, according to calculations made by NBR, by the end of the second quarter, the inflation rate would have been 21%.

[7] Data source: NBR, interactive database.

[8] For example, in the years 2009-2010, 2013-2014, 2016 and 2020.

Figure 3: The evolution of real GDP, domestic demand and current account balance between 2005-2022



Source: NBR, Eurostat, Fiscal Council's calculations

The increase in the current account deficit was primarily determined, similarly to the previous year, by a significant deepening of the balance of goods and services deficit, from 13.7 billion euros in 2021 to 19.8 billion euros in 2022 (+44.5%). This dynamic was exclusively driven by the unfavourable evolution of the goods balance, its deficit increasing by 9.2 billion euros, from 23.1 billion euros in 2021 to 32.3 billion euros in 2022, while the services balance acted in the opposite direction, its surplus expanding by 3.1 billion euros, from 9.4 billion euros in 2021 to 12.5 billion euros in 2022. The primary income balance also contributed to the widening of the current account deficit, while the secondary income balance remained in surplus. Consequently, the primary income balance exhibited a deficit increase of 3.9 billion euros, from 4.8 billion euros in 2021 to 8.7 billion euros in 2022. The secondary income balance registered a growth of 0.8 billion euros, from a surplus of 1.1 billion euros in 2021 to 1.9 billion euros in 2022.

Analysing the evolution of the current account from the perspective of the savings-investment balance, the savings rate as a proportion of GDP decreased by 0.9 percentage points in 2022, reaching 17.4% of GDP, while the investment rate increased by 1.2 pp to 26.7% of GDP. This explains the increase of the current account deficit by 2.1 pp between 2021 and 2022, from 7.2% to 9.3% of GDP.

The financing of the current account deficit (of 26.6 billion euros) was predominantly achieved through the financial account of the balance of payments (16.2 billion euros) and, to a lesser extent, through contributions from the capital account (7.0 billion euros). Within the financial account, foreign direct investments (in the form of equity participation, including net reinvested profits, as well as debt instruments) hold a significant share in the available financing. Thus, direct investments increased between 2021 and 2022 by 0.8 billion euros (+9%), from 8.8 billion euros to 9.6 billion euros. Given the deepening of the current account deficit, its coverage through non-debt-generating flows (considered to be the balance of the capital account and, from the financial account, only "Equity Participation of a direct investment nature, including reinvested earnings") decreased to 52.2% in 2022, from 67% in the previous year.

In 2022[9], Romania's gross external debt increased by 5.8% compared to the previous year, reaching a level of approximately 145 billion euros by the end of December. Its share in GDP decreased by 6 pp compared to December 2021, reaching a level of 50.6%. It is noteworthy that the share of external debt in GDP gradually declined from 2013 to 2022 (except for 2020, when it increased by 8.5 pp compared to 2019), in contrast to the 2010-2012 period, when the indicator reached a peak of 73% in 2010. On the other hand, it is expected that the trend of accelerating the growth rate of external debt, initiated in 2020, will continue in the coming years.

The analysis of debt structure by maturities reveals that, out of the total external debt, at the end of 2022, 67.5% was represented by long-term debt. The share of this category has decreased from 71.4% in 2021, considering that, in nominal terms, long-term debt increased by only 0.2%, from around 97.5 billion euros to 97.7 billion euros. A more accelerated growth rate can be noticed for short-term external debt, which increased by 7.8 billion euros (+19.9%), reaching a level of 46.8 billion euros. Thus, its share in the total external debt increased by 3.8 percentage points, to 32.5% in 2022. Consequently, the trend of reshaping the external debt by maturity continues, characterized by the reduction of the long-term debt share (which was around 80% during the 2013-2014 period), in favour of short-term external debt. In 2022, this resulted in a long-term external debt share below 70%, marking a decline from the previous year.

In 2022, the evolution of long-term debt was primarily driven by an increase in the volume of government borrowing (+2.9 billion euros), as well as the volume of cash and deposits (+0.8 billion euros) and debt securities (+1.3 billion euros) held by deposit-taking institutions, excluding the central bank. These increases were offset by a decrease in the volume of debt securities (-4.4 billion euros).

The analysis of debt structure by institutional sectors reveals that direct external public debt decreased by 1.5 billion euros by the end of 2022 compared to 2021, following a decrease in the volume of bond issuances carried out by the Ministry of Finance on foreign markets. Consequently, the proportion of external public debt to total external debt diminished from 61.6% in 2021 to 58.3% in 2022. Given that the proportion related to the external debt of the central bank remained unchanged in 2022, accounting for 3.5% of the total external debt, the share of external private debt within the total direct external debt increased from 34.9% in 2021 to 38.2% in 2022.

[9] Data source: NBR, interactive database.

The evolution of non-governmental credit[10] has entered a descending trajectory, recording a year-on-year decrease of 3.6% in real terms in December 2022 (in nominal terms, non-governmental credit increased by 12.1%). The component denominated in local currency saw a real decrease of 8.4%, whereas loans in foreign currency (converted into local currency) accelerated significantly, exhibiting a real increase of 8.9%. The real decline in non-governmental credit is attributed to the rising costs of credit, in line with the increases of reference interest rates aimed at mitigating inflationary pressures. The increase in foreign currency loans was driven by the growing demand from the non-financial sector, influenced by the interest rate differential between the national currency and the euro, as well as the fact that the ECB initiated its reference interest rate hike cycle later in comparison to the NBR. Government programs continued to support the evolution of credits granted to the non-financial sector, as the share of state-guaranteed loans in total loans provided to non-financial companies increased by around 7 pp compared to the previous year. Conversely, the share of loans granted through the "New Home" program in total mortgage loans continued to decrease[11], as the allocated budget for the program was reduced to 1.5 billion lei. The evolution of household loans in local currency reveals a year-on-year real decrease of 7.8% (in nominal terms, +7.3%) in 2022. Household loans in foreign currency (converted into local currency) experienced a significant real decline of 23.1% during the same period, which corresponds to a nominal contraction of 10.5%. Loans in local currency provided to non-financial companies and non-monetary financial institutions decreased by 9.3% in real terms (+5.6% in nominal terms), while loans in foreign currency (converted into local currency) increased by 23.1% in real terms (+43.3% in nominal terms).

The non-performing loan ratio continued its downward trend from previous years, reaching a value of 2.65% in December 2022, compared to 3.35% in December 2021. The provision coverage ratio reached 68.2% at the end of 2022, up from 68% in 2021 – well above the European average of 43.4%. Also, from a macroprudential perspective, there is comfortable liquidity in the banking system, with the liquidity requirement coverage standing at 209.1% by the end of 2022. Additionally, the credit-to-deposit ratio for households and non-financial corporations was around 70%, highlighting issues with credit absorption both for business and households. For companies, the generating factor is denoted by the decapitalization problems of the real sector, which also lead to the lack of bankable economic agents in the economy. At the household level, the strong sub-unitary ratio between credits and deposits reflects the high-income inequality – one of the highest in the EU – which also reduces the appetite for bank loans, as well as the creditworthiness of potential borrowers.

In 2022, labour market data indicated a slight increase in the average number of employees to 5,170 thousand people[12] (+1.5% compared to the previous year), as well as an unemployment rate according to the ILO methodology of 5.6%, similar to that of 2021. The average gross wage across the entire economy was 6,120 lei[13] (+10.6% compared to 2021). The average net wage was 3,801 lei (+11.3%

[10] Data source: NBR, interactive database.

[11] According to the Financial Stability Report of the National Bank of Romania, December 2022.

[12] According to the NCSP spring forecast of May 2023.

[13] According to the NCSP spring forecast of May 2023.

compared to the previous year), while the real wage exhibited a decrease of 2.2%, given an average annual inflation rate of 13.8%.

Considering the obligation of the Fiscal Council to include in its annual report an *ex-post* evaluation of the macroeconomic and budgetary forecasts contained in the Fiscal Strategy that is the subject of the report (according to art. 61 of the FRL), *Table 1* presents the main macroeconomic forecasts from the FS 2022-2024 compared to the actual values achieved in 2022, according to the latest available data. It is noteworthy that the accuracy of the forecasts from the Fiscal Strategy needs to be evaluated by considering the exceptional circumstances of 2022, during which numerous extreme events overlapped and uncertainty was elevated.

Table 1: Main macroeconomic indicators in 2022 (Fiscal Strategy forecast versus actual values)

	Fiscal Strategy 2022-2024	Actual values 2022
	%, change, year on year	
Gross domestic product		
GDP (mil. lei)	1,317,267	1,409,784
Real GDP	4.6	4.7
GDP deflator	5.8	13.4
GDP components		
Final consumption	4.1	5.2
Private consumption expenditure	4.5	5.5
Government consumption expenditure	2.7	4.3
Gross fixed capital formation	9.3	8.0
Exports of goods and services (volume)	5.4	9.6
Imports of goods and services (volume)	7.2	9.9
Inflation		
December 2022	4.7	16.4
Annual average	6.5	13.8
Labour market		
ILO unemployment rate (end of period)	5.1	5.6
Average number of employees	2.0	1.5
Net average wage	8.9	11.3

Source: NCSP, Eurostat, MF

The analysis of the differences between the estimated values in the FS 2022-2024 and the actual values reveals that these were primarily determined by the significantly higher and persistent price growth, well above the authorities' expectations. Thus, in 2022, the nominal GDP was about 7% higher compared to the FS 2022-2024 forecasts, driven by a GDP deflator and an average annual inflation rate significantly higher than the initial estimates, while real economic growth remained very close to the level estimated in the FS 2022-2024 (4.7% compared to 4.6%). Regarding the main components of GDP, one can notice actual growth rates higher than the forecast for final consumption (+1.1 pp), exports of goods and services (+4.2 pp) and imports of goods and services (+2.7 pp), and lower for gross fixed capital formation

(-1.3 pp). On the labour market, the differences between the estimated and actual values are smaller: +0.5 pp in the case of the ILO unemployment rate, -0.5 pp in the case of the average number of employees' growth rate, and +2.4 pp in the case of net wage growth dynamics. The differences between forecasted and recorded values, more pronounced in the case of nominal indicators, once again highlight the surprise effect of inflation.

III. Fiscal policy in 2022

III.1. Main features of the fiscal-budgetary policy in 2022

After the budget deficit decreased to 6.73% of GDP in 2021, according to the cash methodology, and to 7.12% of GDP in ESA terms, 2022 was marked by several significant shocks – the onset of the conflict in Ukraine, increases in energy prices and accelerated inflation – which posed significant challenges for Romania's fiscal-budgetary policy. The main features of the fiscal-budgetary policy in 2022 are further summarized below and detailed subsequently in this report:

- The budget construction for 2022 envisioned a target deficit of 5.84% according to the cash methodology (-0.89 pp compared to the previous year), and 6.24% of GDP according to the ESA 2010 methodology (-0.88 pp compared to the previous year). The projected reduction in the deficit was supported by the following elements: an increase in budget revenues, mainly due to the *ex-ante* consideration of sums amounting to 10.65 billion lei derived from an anticipated improvement in collection efficiency / reduction of tax evasion. This was coupled with a decrease in budget expenditures resulting from a freeze on the majority of salaries in the public sector and lower growth rates in relation to the nominal GDP dynamics for expenditures related to goods and services, social assistance and other transfers. At that time, the FC assessed that there were not sufficient credible adjustment measures to achieve the assumed target. Based on a cautious approach to revenues and expenditures, the 2022 budget was evaluated as compatible with a cash deficit of around 7% of GDP (equivalent to 7.5% of GDP according to European methodology).
- The analysis of the medium-term budget projection indicated that the consolidation process for the 2023-2024 period was predominantly anticipated to be achieved through reducing budget expenditure. The FC raised questions regarding the realism of this approach, emphasizing that it is not feasible for this consolidation to occur solely through constraining public expenditures while simultaneously providing a critical mass of essential public goods.
- The draft of the first budget revision for 2022 operated a substantial nominal increase – unprecedented in the history of revisions evaluated by the FC up to that point – both in total budget revenues (+31.7 billion lei, representing +7.2%) and expenditures (+34.9 billion lei, representing +6.8%). As a result, the budget deficit stood 3.2 billion lei above the initial target. Expressed as a percentage of GDP, the projected level of the budget deficit remained at 5.84%, due to an increase in the forecast of nominal GDP by 55.2 billion lei. The significant revision in budget revenues was driven by an upward revision of nominal GDP dynamics (due to higher-than-expected inflation) and additional revenues from the overtaxing of electricity and natural gas producers. The increase in budget expenditures, compared to the parameters approved in the draft budget, was primarily driven by additional spending on social assistance, other transfers and interest payments. Analysing the updated coordinates of revenues and expenditures, the FC's opinion on the first budget revision indicated 7% of GDP as a plausible budget deficit target.

- The second budget revision of 2022 occurred under unfavourable circumstances, with particularly severe implications for the Romanian economy: an energy crisis intertwined with the complex transition to green energy, disruptions in production and supply chains, widespread high inflation, exacerbated effects of climate change, the ongoing pandemic and, ultimately, the war in Ukraine. Compared to the previously approved budget parameters, this revision aimed at a minor increase in both revenues and expenditures (+0.9 billion lei), though significant changes occurred in their structure. The budget deficit remained unchanged in nominal terms but, expressed as a percentage of GDP, it was expected to decrease to 5.74% of GDP, due to an increase in the projection of nominal GDP by 23.7 billion lei. Regarding revenue levels, the second revision marked an estimate close to that of the first adjustment, as revenues far above previous expectations – particularly non-tax and corporate income taxes – counterbalanced the reduction of other revenue categories, especially VAT and funds related to the National Recovery and Resilience Plan (NRRP). On the expenditure side, the FC's assessments made during the first revision were confirmed, highlighting inadequate allocations for expenditures with goods and services, and social assistance. Although the FC maintained its previous evaluation regarding the need for additional allocations to these expenditure aggregates, it noted that aligning with the newly proposed budget deficit target was feasible given the significant under-execution of total investment expenditures in the first 10 months of the year. This under-execution made it unlikely to achieve the proposed targets for these expenditures, but it had a favourable impact on the budget balance.
- The 2022 budget execution, according to the cash methodology, resulted in a deficit of 5.72% of GDP, very close to the projection from the second budget revision, and 6.2% of GDP according to the ESA 2010 methodology (0.04 pp below the target set in the initial budget). These values confirmed the evaluation of the FC, as expressed in its opinion on the second budget revision, regarding the improved fiscal outlook for 2022 due to a higher-than-anticipated nominal GDP dynamic. This improvement led to higher tax revenues (including social security contributions) and to an increase in non-tax revenues, particularly driven by developments in the energy sector, surpassing the budgeted levels.
- Furthermore, the FC emphasized in its analyses that the process of budget consolidation is crucial for Romania due to reasons of stabilizing the level of public debt, reducing internal and external vulnerabilities, maintaining stability of the national currency, safeguarding macroeconomic balances and improving the country's credit rating. Postponing this process through measures affecting the structural deficit, relying solely on the continuation of favourable cyclical economic trends and the positive fiscal effects of inflation, is not a viable option.

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

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

a) an ex-post evaluation of the macroeconomic and budgetary forecasts set out in the fiscal strategy and the annual budget to which the annual report corresponds, including the reporting, where applicable, of any persistent deviations in the same direction of macroeconomic forecasts compared to actual data, which were recorded over a period of at least 4 consecutive years;

b) an assessment of objectives, targets and indicators set out in the fiscal strategy and annual budget to which the annual report corresponds;

c) an assessment of the Government's compliance with the principles and rules of this law during the previous budget year;

d) opinions and recommendations of the Fiscal Council aimed at improving the conduct of fiscal policy during the current year, according to the principles and rules of this law.

In the characterization of the fiscal-budgetary policy for 2022, the following will be analysed: the initial budget for 2022, the budget revisions made during the year and the execution of the budget.

1. The initial budget for 2022

According to the provisions of art. 26, paragraphs (1) and (2) of the FRL, by July 31 of each year, the Ministry of Finance (MF) has the obligation to submit to the Government the Fiscal Strategy for the next 3 years, accompanied by the law for the approval of the ceilings specified in the fiscal-budgetary framework. The Fiscal strategy for the period 2022-2024 was sent simultaneously with the budget proposal [14], which involved an identical fiscal-budgetary framework for 2022 in the two above-mentioned documents. Under these circumstances, the obligation of the Fiscal Council to evaluate in the annual report the objectives, targets and indicators established by the Fiscal Strategy and by the budget is reduced exclusively to an *ex-post* analysis of the projections included in the initial budget. Therefore, monitoring the *ex-ante* compliance with the rules regarding the limits established for the budgetary indicators provided for by the law on ceilings being, similar to the situation in previous years, irrelevant. Even though the FRL stipulates at art. 33 (c) the possibility of revising the fiscal-budgetary framework defined by the FS in the event of a change in the scope of the general consolidated budget, a significant worsening of the forecast of macroeconomic indicators or a change of Government, considering the repeated non-compliance with the legal calendar for the elaboration and approval of the FS in recent years, the Fiscal Council notes that the perpetuation of this situation reduces the relevance of the ceilings established for budgetary indicators and undermines the guiding role that a medium-term fiscal strategy must have for the budget, as it (the FS) remains recurrently dependent on short-term objectives.

[14] On 17 and 19 December 2021, respectively, the Ministry of Finance submitted to the Fiscal Council the project of the general consolidated budget for the 2022-2025 period, the report on the macroeconomic situation for 2022 and its projection for the 2023-2025 period, the Fiscal Strategy for the 2022-2024 period, the project of the state budget law for 2022, the statement of reasons and the project of the social security budget law for 2022, the statement of reasons and the project of the law for the approval of the ceilings of certain indicators specified in the fiscal-budgetary framework for 2022.

The FS for the 2022-2024 period established for 2022 a cash budget deficit of 5.84% of GDP, respectively a decrease of 1.29 pp of GDP compared to the level of 7.13% of GDP estimated at that time for 2021[15]. Expressed in ESA 2010 terms, the 2022 budget deficit was projected at 6.24% of GDP, down by 1.79 pp compared to the level assessed by the Ministry of Finance for 2021. The level of structural adjustment was 1.6 pp, from 7.31 % to 5.71% of potential GDP. The general consolidated budget for 2022 was based on a macroeconomic evolution scenario that estimated a real GDP growth of 4.6%, a GDP deflator of 5.8% and an average annual inflation rate of 6.5%.

In the medium term, considering Romania's placement in the excessive deficit procedure (EDP)[16], the FS projected the return of the budget deficit in ESA 2010 terms below the reference level of 3% of GDP by 2024 (namely, 2.9%)[17].

In its opinion[18] regarding the *budget law for 2022*, the FC appreciated that the construction of the initial budget, as well as of the medium-term budgetary framework associated with it indicated a change in the conduct of the strongly expansionary fiscal-budgetary policy of recent years towards a sustainable trajectory of public finances. Among the aspects mentioned by the FC are the following:

- According to the cash methodology, the planned reduction of the 2022 budget deficit to 5.84% was the result of increasing public revenues by 0.83 pp of GDP, simultaneously with the reduction of public expenditures by 0.46 pp of GDP.
- The increase in collection efficiency / the reduction of tax evasion was indicated as the main source for the increase in the share of tax revenues in GDP, against which the FC expressed doubts in considering it at that time, by virtue of the prudence principle. Thus, the FC estimated a revenue gap compared to the targets stated in the initial budget of approximately 12.15 billion lei (0.92% of GDP).
- The planned reduction of the expenditures share in the GDP aimed at freezing the majority of salaries in the public sector and moderate growth rates in nominal terms, lower than the dynamics of nominal GDP, for the expenditures on goods and services, social assistance and other transfers. The FC estimated an additional need for budget allocations of 1.9 billion lei for social assistance expenditures and at least 2 billion lei for interest expenditures (cumulatively, an under-budgeting of expenditures of at least 0.3% of GDP).
- The ambitious target for investment expenditures (6.7% of GDP, the maximum level since 2009 up to that time) was noteworthy, as well as the share of amounts from NRRP in total investment expenditures (approximately 12% in 2022).

[15] The 2021 budget execution registered a cash deficit of 6.73% of GDP, based on the latest GDP data published by Eurostat (April 2022).

[16] Triggered in April 2020, following the exceeding in 2019 of the reference level of 3% of GDP for the budget deficit expressed in European standards.

[17] The calendar is established by the EC within the framework of the EDP, taking into account the suspension of fiscal rules at EU level in the 2021-2023 period.

[18] http://www.fiscalcouncil.ro/FC%20opinion%20budget%202022%20and%20fiscal%20strategy%202022-2024.pdf

- Based on a prudent approach of revenues and expenditures, the FC considered the budget construction for 2022 compatible with a cash deficit of around 7% of GDP (equivalent to 7.5% of GDP according to the European methodology), due to insufficient credible measures of budget adjustment that could lead to the achievement of the of 5.84% of GDP target.
- The FC emphasized the fact that the main structural fiscal-budgetary policy measures, adopted by the Government with the aim of reducing the deficit, targeted public expenditures, while the increase in public revenues was projected based only on the anticipated improvement in tax collection efficiency.

2. The two budget revisions during 2022

The first budget revision (approved by GEO no. 19/2022) stipulated a substantial nominal increase – unprecedented in the history of revisions evaluated by the FC from 2010 until that moment – both for public revenues (+31.7 billion lei, representing +7.2%) and expenditures (+34.9 billion lei, representing +6.8%), the budget deficit being 3.2 billion lei above the initial target. Expressed as a percentage of GDP, the projected level of the deficit remained unchanged compared to the initial budget construction, namely 5.84% of GDP, as a result of the nominal GDP projection increase by 55.2 billion lei.

The large-scale revision of public revenues had two main sources: the upward revision of nominal GDP dynamics (on the background of high inflation, the projection of the GDP deflator being increased from 5.8% to 12.2%) and the additional revenues from the surcharge on electricity and natural gas producers.

By categories of public revenues, positive revisions compared to the levels projected in the initial budget (net of the impact of swap schemes) occurred in the vast majority of items, as follows:

- *Fiscal revenues*: +21.2 billion lei, with the main changes at the level of the following components:
  - *Corporate income tax*: +4 billion lei, revision that took into account the increase in the projection for nominal GDP dynamics from +10.7% (at the time of the initial budget) to +16.2%;
  - *Personal income tax*: +1.7 billion lei, revision that took into account the change of the forecast that underpinned the elaboration of the initial budget regarding the relevant macroeconomic aggregates, respectively for the average number of employees from +2% to +1.4% and for the average gross salary earnings from +8.7% to +10.4%, as well as the impact of the income tax measures, adopted through GO 16/2022, assessed by the Ministry of Finance at +0.3 billion lei for 2022;
  - *Other taxes on income, profits and capital gains*: +0.13 billion lei;
  - *Property taxes*: -0.4 billion lei;
  - *VAT*: +5.1 billion lei, based on the projected improvement of VAT collection (taking into account that the *ex-ante* inclusion of additional amounts based on the projected increase in collection efficiency is not compatible with the principle of fiscal responsibility, the FC appreciated, in its opinion formulated on the occasion of the first budget revision for 2022[19],

[19] http://www.fiscalcouncil.ro/FC%20Opinion%20on%20the%20First%20Budget%20Revision%20for%202022.pdf

that it was probable to register a revenue gap of about 5 billion lei at the level of VAT revenues);
  - *Excise duties*: -1.9 billion lei, confirming the FC assessment on the initial budget draft which indicated an oversizing of this budgetary aggregate (the FC also assessed the new projected level as being oversized relative to the execution in the first semester, which recorded a degree of achievement of the revised target of only 45.7%);
  - *Other general taxes on goods and services*: +11.1 billion lei, increase compatible with the evolution of revenues from the tax on additional income obtained as a result of the deregulation of prices in the natural gas sector, respectively from the tax applied to the additional income made by electricity producers;
  - *Tax on the use of goods, on the authorization of the use of goods or on the performing of activities*: +0.7 billion lei, the new projection incorporating the increase in revenues from gambling taxes and the maintenance of estimates regarding the collection in 2022 of the revenues related to the exploitation of radio frequencies in the new frequency bands harmonized at European level for 5G broadband terrestrial mobile communications systems;
  - *Tax on foreign trade and international transactions*: +0.4 billion lei;
  - *Other fiscal taxes*: +0.3 billion lei.
- *Social security contributions*: +1.6 billion lei, having as the relevant macroeconomic base the aggregate wages in the economy, the dynamics of which was revised from +10.9% to +11.9% (the new level of social security contributions, proposed by the budget revision, was seen by the FC as overstated in relation to the execution in the first semester, which recorded a degree of fulfilment of the revised target of only 48.3%, the FC estimating a revenue gap of around 1.5 billion lei at the level of this budgetary aggregate);
- *Non-fiscal revenues*: +7.2 billion lei, revision incorporating the upward evolution of oil royalties (due to the increase in oil and natural gas prices) and dividends related to the 2019 and 2020 financial years paid out by CEC BANK;
- *Capital revenues*: +0.4 billion lei;
- *Sums received from the EU/other donors on account of payments made and pre-financing related to the 2014-2020 financial framework*: +1 billion lei, revision that occurred as a result of the increase in the amounts transiting the general consolidated budget intended for the pre-financing of projects from the non-governmental sector in the event of temporary unavailability of European funds, this increase being largely counterbalanced by the decrease in the amounts related to European funds for agriculture (-2 billion lei), and structural and cohesion funds (-1 billion lei).

The increase in public expenditures, compared to the parameters approved in the initial budget, was mainly determined by additional expenditures with social assistance, other transfers and interest. The upward revision of previous estimates (amounts net of the impact of swap schemes) occurred in almost all major expenditure categories, as follows:

- *Personnel expenses*: +2.8 billion lei, of this amount 1.6 billion lei representing the additional personnel expenditures of the state budget, and 1.2 billion lei the additional personnel expenditures of the general centralized budget of the administrative-territorial units (the increase in personnel expenditures was not negligible, requiring a strict control of them and putting into question if the limit set by the budget revision would be respected);

- *Goods and services*: +2.8 billion lei, mainly as a result of supplementing the amounts related to the national social health insurance fund (+2 billion lei) and the general centralized budget of the administrative-territorial units (+1.5 billion lei), partially offset by the reduction of the ceiling for goods and services expenditures at the state budget level (-0.5 billion lei). Considering that this budgetary aggregate proved difficult to control in the past, as well as taking into account the execution in the first semester of 2022, the FC estimated that an additional need of around 3 billion lei was likely;
- *Interest*: +4.4 billion lei, an important increase that occurred due to the rise in public debt and interest rates at which new loans were contracted, highlighting the fact that the initial ceiling was undersized (aspect noted by the FC in its opinion on the initial budget);
- *Subsidies*: +2.9 billion lei, mainly for the financing of the electricity and natural gas price compensation scheme (+2.5 billion lei);
- *Transfers between public administration units*: +0.5 billion lei;
- *Other transfers*: +6 billion lei, mainly being supplemented the amounts related to green certificates with special destination (+1.7 billion lei), allocations to the Environmental Fund (+1.5 billion lei), transfers to enterprises within state aid schemes (+1.1 billion lei), Romania's contribution to the EU budget (+0.8 billion lei) and transfers to the National Investment Company (+0.7 billion lei);
- *Social assistance*: +10.9 billion lei, a substantial increase as a result, mainly, of supplementing allocations for the settlement of medical leaves (+2.5 billion lei), granting a one-off support in July in the case of pensions lower than or equal to 2,000 lei (+2.3 billion lei), supplementing the amounts for compensating electricity and natural gas prices (+1.5 billion lei), respectively supplementing the amounts for the payment of state military pensions (+0.4 billion lei), highlighting the fact that the initial ceiling was significantly undersized (aspect noted by the FC in its opinion on the initial budget). Considering the budget execution for the first semester of 2022, the FC assessed in its opinion regarding the first budget revision that an additional requirement of about 3 billion lei was plausible;
- *Projects with financing from non-refundable external post-accession 2014-2020 funds*: +1.9 billion lei, an increase mainly due to the upward revision of the amounts transiting the general consolidated budget intended for the pre-financing of projects of the non-governmental sector in the event of the temporary unavailability of European funds (about +4 billion lei), partially counterbalanced by the reduction of the amounts related to European funds for agriculture (-2 billion lei), and structural and cohesion funds (-0.1 billion lei);
- *Other expenditures*: +0.6 billion lei;
- *Projects financed from the amounts representing the non-refundable financial assistance related to NRRP*: +0.1 billion lei;
- *Projects financed from the amounts related to the loan component of NRRP*: +1 billion lei;
- *Contingency reserve fund*: +1 billion lei;
- *Capital expenditures*: +0.6 billion lei.

Total public investment expenditures, from internal and external sources, were increased by 3.2 billion lei (+3.7%) compared to the level provided for in the initial budget (maintaining the level of 6.7% of GDP, in the context of the upward revision of the nominal GDP projection), with the main source being the increase in capital expenditures, investment transfers and NRRP-related amounts. Following this increase, the programmed level of investment expenditures was 37.8% higher (+25.1 billion lei) compared to the 2021 execution.

In the opinion formulated by the FC on the occasion of the first budget revision for 2022, it assessed, on the revenue side, the probability of a revenue gap compared to the targets specified in the revision project of about 9 billion lei (0.66% of GDP) and, on the expenditure side, an underestimation of about 6.2 billion lei (0.45% of GDP) – assuming that the data transmitted by the MF regarding the impact of the measures in the energy sector was realistic. Consequently, the FC estimated that the plausible budget deficit to be reached, according to the cash methodology, was around 7% of GDP (compared to 5.84% of GDP in the revised budget projection). At the same time, the FC pointed out that an underestimation of the expenditures regarding the energy compensation scheme would lead to a considerable increase in the deficit.

The second budget revision[20] (approved by GEO no. 160/2022) includes, compared to the previously approved budgetary parameters, a small increase in total revenues and expenditures of the GCB (+0.9 billion lei each), the budget deficit thus remaining unchanged in nominal terms (as a percentage of GDP, the budget deficit was estimated to decrease to 5.74% of GDP, due to an increase in the nominal GDP projection by 23.7 billion lei).

By categories of budget revenues, more sizeable adjustments of the levels projected in the first revision (net of the impact of swap schemes) were registered in the following categories:

- *Fiscal revenues*: -2.3 billion lei, the main changes being:
    - *Corporate income tax*: +1.6 billion lei, the revision taking into account the increase in the projection for nominal GDP by 23.7 billion lei (about 1.7%) compared to the estimate from August 2022;
    - *VAT*: -1.6 billion lei, the new target for 2022 being 22.5% higher than the amounts collected in 2021;
    - *Excise duties*: -0.7 billion lei, confirming the FC's previous assessment regarding the overestimation of this budgetary aggregate (the FC assessed, in its opinion on the second budget revision for 2022[21], that the new projected level was also slightly oversized, considering as probable a revenue gap of about 0.5 billion lei compared to the new target);
    - *Tax on the use of goods, on the authorization of the use of goods or on the performing of activities*: -1.3 billion lei, the decrease in the estimated revenue being determined by the approval of Government Decision no. 1139/2022, which set the collection in 2022 of 1.1 billion

[20] The comparisons have as reference the budget revision adopted by the Government, and not the revision project on which the FC issued an opinion; between the two there are some minor differences, namely total revenues and expenditures are higher by about 0.4 billion lei in the budget revision adopted by the Government.

[21] http://www.fiscalcouncil.ro/FC%20opinion%20second%20budget%20revision%202022.pdf

lei in revenues related to the exploitation of radio frequencies in the new frequency bands harmonized at European level for 5G broadband terrestrial mobile communications systems, compared to the initial estimate of 2.5 billion lei;

- *Social security contributions*: -0.08 billion lei, maintaining the estimate was surprising, given that the proposed target was equivalent to a growth rate compared to the previous year of around 11.1%, while the execution at 10 months recorded a 10% growth rate;
- *Non-fiscal revenues*: +6.7 billion lei, the source of the revision being, according to the MF, the evolution of collections from oil royalties, dividends related to the 2021 financial year, interest revenues and payments from the NBR's net income. It should be noted that this revision of non-fiscal revenues was the main source of the improvement of the fiscal-budgetary position in 2022;
- *Sums received from the EU/other donors on account of payments made and pre-financing related to the 2014-2020 financial framework*: +1.95 billion lei;
- *Sums related to non-refundable financial assistance allocated for NRRP*: -5.8 billion lei, due to the delays in starting the projects compared to the initial estimates.

Thus, the second revision recorded an estimate close to the first revision, given that revenues far above initial expectations – in particular, non-fiscal revenues and corporate income tax – counterbalanced the reductions in other revenue categories – especially VAT and amounts related to NRRP. In its opinion regarding the second budget revision, the FC assessed as likely the materialization of a revenue gap of around 3 billion lei (0.21% of GDP), down from the previous estimated revenue gap of 9 billion lei.

On the expenditure side, there was an increase of about 0.9 billion lei, compared to the parameters approved at the first revision, the following adjustments (net of the impact of swap schemes) for the main expenditure categories being operated:

- *Personnel expenses*: +0.3 billion lei, mainly as a result of additional allocations to the Ministry of Education;
- *Goods and services*: +1.5 billion lei, mainly as a result of supplementing the amounts related to the budget of institutions financed entirely and/or partially from own revenues (+1.1 billion lei), respectively to the national social health insurance fund (+0.5 billion lei), to which was added the impact of the reduction of the swap-type compensation scheme (+0.5 billion lei, effect on expenditures without swap), these changes being partially counterbalanced by the reduction of the ceiling for goods and services expenditures at the state budget level (-0.5 billion lei);
- *Interest*: +4.5 billion lei, the increase being the result of three main factors, namely the increase in the stock of public debt, the increase in interest rates at which new loans are contracted, respectively the reopening of older issues of government securities by offering a discount to the nominal value (so that the yield of these issues reflects the current interest rates on the market);
- *Transfers between public administration units*: -0.4 billion lei, mainly as a result of the increase in the swap-type compensation scheme;
- *Other transfers*: -0.5 billion lei, the decrease being mainly found at the level of the budget of institutions financed entirely and/or partially from own revenues, respectively of the state budget;
- *Projects with financing from non-refundable external funds*: -0.1 billion lei;

- *Social assistance*: +1.7 billion lei, mainly as a result of supplementing the allocations for the benefits granted to families and children (+1.1 billion lei) and those to the centralized general budget of administrative-territorial units (+0.6 billion lei);
- *Projects with financing from non-refundable external post-accession 2014-2020 funds*: -0.5 billion lei, revision due to the reduction of expenditures related to projects financed from structural and cohesion funds (-1.8 billion lei), partially counterbalanced by the upward revision of the amounts transiting the general consolidated budget intended for pre-financing non-governmental sector projects in case of temporary unavailability of European funds;
- *Other expenditures*: +1.1 billion lei, of which 0.5 billion lei to cover the payment titles issued by the National Authority for Property Restitution;
- *Projects financed from the amounts representing non-refundable financial assistance related to NRRP*: -7 billion lei; respectively, from the *sums related to the loan component of the NRRP*: -0.6 billion lei, decreases that appeared in the context of delays in the start of projects compared to the initial estimates;
- *Contingency reserve fund*: +0.9 billion lei;
- *Capital expenditures*: +1.3 billion lei, increase mainly determined by the additional allocations to the National Company for Road Infrastructure Administration (+2.3 billion lei), to which the impact of the reduction of the swap-type compensation scheme is added (+0.4 billion lei, effect on expenditures without swap), these changes being partially counterbalanced by the decrease in the amounts allocated to the budget of institutions financed entirely and/or partially from own revenues (-1.2 billion lei) and to the state budget (-0.2 billion lei).

Total public investment expenditures, from internal and external sources, were reduced in planning by 4.6 billion lei (about -5%) compared to the level estimated at the first revision, due to the reduction of the amounts allocated through the NRRP, partially compensated by the additional allocations for projects with financing from non-refundable external post-accession funds, capital expenditures and other investment-type transfers. Following this decrease, the programmed level of investment expenditures was lower by around 1.5% (-1.3 billion lei) compared to the value stated in the initial budget, but remained significantly higher (+20.6 billion lei, representing +30.9%) compared to the 2021 execution.

The second budget revision confirmed the FC's assessments, formulated on the occasion of the first revision, regarding the insufficiency of allocations for the expenditure on goods and services and those on social assistance. The FC maintained its previous assessment regarding the need for even higher additional allocations at the level of the two expenditure aggregates of about 2.5 billion lei (0.18% of GDP). However, the FC estimated that it is possible to fall within the projected amount for GCB's total expenditures, given the significant under-execution of investment expenditures (the amounts actually spent are likely to be lower than the budgeted ones). Thus, the FC assessed as plausible the new target proposed for the cash budget deficit of 5.74% of GDP.

Moreover, the FC emphasized the improvement of the fiscal perspective for 2022, improvement that was based on both the higher-than-anticipated dynamics of the nominal GDP, which involved higher fiscal revenues (including social security contributions) and the very large increase (compared to the budgeted levels) of non-fiscal revenues, especially as a result of developments in the energy sector.

3. Compliance with fiscal rules in the budget programming process

Romania is subject of the excessive deficit procedure (EDP)[22] that started prior to the triggering of the temporary derogation clause from the Stability and Growth Pact (SGP), whereby the budgetary rules were suspended in the 2020-2023 period[23] to give the member states the necessary leeway to implement appropriate measures to manage the difficult situations generated by the evolution of the pandemic, the increase in energy prices, the war in Ukraine, with important budgetary consequences.

On June 18, 2021, the Council adopted the recommendation within the EDP that established that Romania should put an end to the excessive deficit situation by 2024 at the latest, the new deadline for its correction allowing a gradual effort and a balance between budgetary consolidation and economic recovery. According to the EC recommendation, in order to meet the deadline, Romania should reach a deficit target of 8% of GDP in 2021, 6.2% of GDP in 2022, 4.4% of GDP in 2023 and 2.9% of GDP in 2024.

Considering the above, the assessment of compliance with fiscal rules is made exclusively through analysing the changes of the ceilings established by Law no. 312/2021 following the exemptions established on the occasion of the budget revisions during 2022.

It should be noted that Law no. 312 from December 24, 2021 for the approval of the ceilings of certain indicators specified in the fiscal-budgetary framework for 2022 established the limit of the cash deficit at 5.84% of GDP for 2022, corresponding to a deficit in ESA terms of 6.23% of GDP, close to the target for 2022 according to the EC recommendation of June 2021 within the EDP (6.2% of GDP). By derogation from the provisions of art. 6, 7 and of art. 26 para. (3) from the FRL, Law no. 312/2021 did not specify the adjustment path towards the medium-term budgetary objective of -1% of the gross domestic product, stating however that the adjustment of the structural balance continued in 2022, the structural deficit being estimated at 5.71% of potential GDP and projected on a downward trend (4.18% in 2023 and 2.88% in 2024, according to the same law[24]).

Table 2 shows the ceilings of the main indicators established by Law no. 312/2021 and, respectively, through the two budget revisions carried out during 2022. The figures in italics represent the values of the indicators as a percentage of GDP recalculated with updated GDP data (Eurostat, April 2023), respectively, 1,412.5 billion lei, compared to 1,317.3 billion lei (estimated level in the initial budget).

[22] Following the exceeding in 2019 of the threshold of 3% of GDP, on the recommendation of the Commission from March 4, 2020, the Council decided on April 3, 2020 to apply EDP for Romania, with the recommendation to reduce the excessive deficit by 2024.

[23] In May 2022, the EC extended for another year the activation of the derogatory clause that allows the temporary exceeding of the limits set out in the SGP, due to the uncertain economic context created by the war in Ukraine.

[24] In the 2022-2025 Convergence Program, the estimates for the structural balance were -5.4% (2022), -3.8% (2023), -2.6% (2024) and -2.8% (2025).

Table 2: Nominal ceilings for GCB balance, total and personnel expenditure									
	Law no. 312/2021			GEO no. 19/2022			GEO no. 160/2022		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
mil. lei	**-76,983.0**	**457,969.4**	**115,407.0**	**-80,154.0**	**491,765.6**	**118,156.9**	**-80,154.0**	**496,185.8**	**118,416.2**
% of GDP initial budget	**-5.84%**	**34.8%**	**8.8%**	**-5.84%**	**35.8%**	**8.6%**	**-5.74%**	**35.5%**	**8.5%**
% of GDP budget execution	*-5.45%*	*32.4%*	*8.2%*	*-5.67%*	*34.8%*	*8.4%*	*-5.67%*	*35.1%*	*8.4%*

** Excluding financial assistance from the EU and other donors*
Source: MF, Eurostat

The two budget revisions established, by way of derogation from the ceilings law, new increases in the nominal limits, compared to the initial budget, for almost all the indicators specified in the fiscal-budgetary framework (in line with the evolution, during 2022, of the revenue and expenditure aggregates).

This practice reflects the persistence of some major weaknesses in the construction of public budgets in Romania, confirming the arbitrariness in the reallocation of funds to some categories of expenditures, at the expense of national fiscal rules that can be easily evaded, limiting the role they should play in the orientation of the medium-term fiscal-budgetary policy. It can be stated, following over time the budget revisions by which derogations are made from the fiscal rules established by the FRL and the ceilings of the budgetary aggregates are redefined, that when a rule is in danger of not being respected, what is being modified is the rule, not the behaviour.

As can be seen from the table above, *the first budget revision* (GEO no. 19/2022) brought the increase in the nominal ceiling of both *total expenditures (excluding financial assistance from the EU and other donors)* (+33.8 billion lei) and *personnel expenditures* (+2.8 billion lei), while the *budget deficit* limit increased by 3.2 billion lei, compared to the initial budget for 2022. As a share of GDP, the budget deficit remained at 5.84%, as a result of the increase in the nominal GDP projection in the interval between the initial budget and the first revision. The share of total expenditures in GDP increased to 35.8%, from 34.8%, while the share of personnel expenditures in GDP experienced a slight decrease, from 8.8% (as set in the ceilings law 312/2021) to 8.6%, due to the upward revision of the GDP at the time of the first budget revision.

The second revision (GEO no. 160/2022), compared to the first, increased the ceiling of *total expenditures (excluding financial assistance from the EU and other donors)* by 4.4 billion lei, that of *personnel expenditures* by approximately 0.3 billion lei, maintaining constant the nominal ceiling for the *budget deficit* (80.2 billion lei). As a share of GDP, all these indicators registered a slight decrease (generated by the positive revision of GDP by 23.7 billion lei), namely: total expenditures (excluding financial assistance from the EU and other donors) from 35.8% to 35.5%, personnel expenditures from 8.6% to 8.5%, respectively the budget deficit from 5.84% to 5.74%.

If the indicators expressed as a share of GDP are recalculated considering the updated GDP value from April 2023 (last row of *Table 2*, in italics), there is an increase in the *budget deficit* from 5.45% of GDP in the initial budget, to 5.67% of GDP in the first and second revisions, respectively the successive increase in the share of *total expenditures (excluding financial assistance from the EU and other donors)* from 32.4% (in the initial budget) to 34.8% (first revision) to 35.1% (second revision). *Personnel expenditure* as a share of updated GDP increases from 8.2% (in the initial budget) to 8.4% (first and second revisions).

The nominal ceiling of the primary deficit was maintained at the first budget revision (57 billion lei), decreasing to 51.4 billion lei in the second budget revision for 2022. It should be noted that the public debt ceiling, expressed as a share of GDP (indebtedness ratio), remained unchanged throughout the year, namely 49.8%, as stated in Law 312/2021.

Even though the derogatory clause was extended until the end of 2023, it does not suspend the SGP procedures, but allows the deviation from the budget requirements that would normally apply, and the commitments assumed by Romania towards the EC, regarding the reduction of the budget deficit below the level of 3% of GDP (in ESA 2010 terms), remain valid.

4. The budget execution

The results of the budget execution (including the swap scheme) indicate a budget deficit of 80.8 billion lei (according to the national methodology), 3.8 billion lei above the target from the initial budget (77 billion lei). As a percentage of GDP, the cash deficit registered a marginally lower level than originally planned (5.72% compared to 5.84%). According to the ESA methodology, the budget deficit was 6.2% of GDP, slightly below the level projected in the initial budget (6.24% of GDP).

The difference between the nominal levels of the budget deficit according to the two methodologies can be explained by elements that act in both directions, respectively some that affect only the budget deficit according to the national methodology, and others only the one according to the European methodology. Thus, the main elements that explain the gap between the deficit according to ESA 2010 and the one according to the national methodology were represented by: differences in the treatment of interest expenditures (about +12 billion lei), differences between recorded expenditures and payments made on behalf of the EU (+5 billion lei), revenues from property treated as super-dividends (-4.3 billion lei), amounts granted to the Oltenia Energy Complex (-2.9 billion lei), registration of the National Authority for Property Restitution compensation titles (-2.3 billion lei), cash-ESA differences between the amounts granted for the compensation of invoices related to the consumption of electricity and natural gas (-2.4 billion lei), deferred taxes (-1.2 billion lei), differences between issued and paid executory titles (-0.7 billion lei), differences resulting from operations with gas emissions certificates (-0.3 billion lei) etc.

The 2022 budget execution (excluding the swap compensation scheme[25]) reveals that both GCB's total revenues and expenditures significantly exceeded the initial budget estimates. *Table 3* presents the evolution of the main budgetary aggregates during 2022 in cash standards.

[25] In execution it amounted to 1,058.21 million lei, above the initially projected level (850 million lei).

Table 3: The evolution of the main budgetary aggregates during 2022 (billion lei)				
	Initial budget	First revision	Second revision	Budget execution
Total revenues, of which	**439.1**	**471.2**	**472.0**	**459.1**
Tax revenues	210.6	231.9	229.6	230.1
Social security contributions	139.5	141.2	141.1	139.3
EU funds	59.0	60.5	56.9	48.4
Total expenditures, of which:	**516.1**	**551.3**	**552.2**	**539.9**
Current expenditure, of which	477.4	511.1	510.6	501.9
Projects from EU funds*	60.8	63.3	55.7	49.7
Capital expenditures	38.7	40.3	41.6	40.5
Budget deficit	**-77.0**	**-80.2**	**-80.2**	**-80.8**

Source: MF

Note: Amounts without swap compensation schemes

** Amounts without the loan component of NRRP*

Total budget revenues, net of the impact of swap compensation schemes, were 20 billion lei above the initial estimate. In terms of structure, developments beyond expectations were recorded for *tax revenues* (+19.5 billion lei) and *non-fiscal revenues* (+10.6 billion lei), given a growth rate of the economy and of the labour market clearly higher than the forecast for the macroeconomic indicators that underpinned the initial budget, plus the additional revenues from overtaxing electricity and natural gas producers. Developments below initial expectations were recorded at the level of *social security contributions* (-0.2 billion lei) and *amounts from European funds* (including *amounts received from the EU for operational programs financed under the convergence objective*, as well as *amounts related to non-refundable financial assistance allocated for NRRP*), for which the non-realization compared to the initial program was 10.6 billion lei.

In the structure of *tax revenues*, significant increases were recorded compared to the initial provisions at the level of the following items: *corporate income tax* (+5.1 billion lei, as an effect of nominal GDP growth), *VAT* (+2.3 billion lei, mainly due to the favourable dynamics of consumption in nominal terms) and *personal income tax* (+2.2 billion lei, considering the evolution above the initial estimates for the labour market indicators).

The level of public expenditures exceeded the initially programmed amount by 23.8 billion lei. The main expenditure aggregates that registered significant increases were: *social assistance* (+13.9 billion lei, due to insufficient initial budgeting, but also to some one-off measures in the case of pensions lower than or equal to 2,000 lei), *interest* (+9.2 billion lei, following the increase in public debt and interest rates at which new loans are contracted), *goods and services* (+5.9 billion lei, as a result of the initial under-budgeting and partially justified by the impact of the higher than expected increase in prices), *subsidies* (+5.4 billion lei, as an effect of the electricity and natural gas price compensation schemes), *personnel expenditures* (+2.3 billion lei, as a result of additional allocations for the state and local budgets), *capital expenditures* (+1.8 billion lei, mainly for supplementing allocations to the National Company for Road Infrastructure Administration). There were significant reductions in *expenditures related to projects* *financed from the amounts representing non-refundable financial assistance related to NRRP* (-10 billion lei), *expenditures related to projects financed from non-refundable external funds* (-4 billion lei), *expenditures related to projects financed from non-refundable external post-accession 2014-2020 funds* (-1.1 billion lei), as well as allocations from the *contingency reserve fund* (-1.2 billion lei).

Table 4 presents the evolution of public revenues and expenditures from the perspective of the national methodology (cash), expressed as a share of GDP. Compared to the previous year, in 2022 the budget deficit in GDP decreased by 1.01 pp, explained by the increase in the share of public revenues in GDP by 0.58 pp and the decrease in the share of public expenditures in GDP by 0.43 pp.

The GCB revenues that had the most favourable evolution were: *tax revenues* (+0.64 pp), *non-fiscal revenues* (+0.60 pp) and *amounts received from the EU for payments made* (+0.09 pp), while decreases occurred in the case of *social security contributions* (-0.84 pp).

At the level of *tax revenues*, increases compared to the previous year were recorded for *corporate income tax* (+0.20 pp, given the growth of the economy in nominal terms) and *personal income tax* (+0.02 pp, due to the improvement of labour market indicators), the *property taxes* decreasing as a share of GDP (-0.07 pp). With regard to consumption taxation, the most significant decrease was in *excise duties* (-0.40 pp), *VAT* collection decreasing by 0.02 pp, while for the sub-component *other taxes on goods and services* there was an increase of 0.90 pp.

On the GCB expenditure side, compared to the previous year, the most important reduction was recorded in *personnel expenditures* (-1.09 pp of GDP, under the conditions of maintaining a prudent salary policy in the public sector, with an increase (+5.17%) below the dynamics of nominal GDP (+19%)). Other budgetary expenditures that decreased, as a share of GDP, are *goods and services* (-0.25 pp) and *social assistance* (-0.06 pp).

Increases compared to 2021 were registered for *interest expenditures* (+0.55 pp, due to the increase in financing needs and borrowing costs), *subsidies* (+0.55 pp, increase generated by energy price compensation schemes), *projects funded from non-refundable external post-accession funds* (+0.11 pp) and *capital expenditures* (+0.06 pp).

Table 4: The evolution of public revenues and expenditures (cash methodology, % of GDP)										
	2009	2015	2016	2019	2020	2021	Initial budget 2022	Budget execution 2022	Initial budget 2022-2021	Budget execution 2022-2021
Total revenues	**29.6**	**32.8**	**29.4**	**30.3**	**30.4**	**31.9**	**31.1**	**32.5**	**0.3**	**0.58**
Tax revenues (without SSC)	16.4	19.4	17.8	14.8	14.2	15.7	14.9	16.3	0.6	0.64
Personal income tax	3.5	3.7	3.6	2.2	2.3	2.4	2.2	2.4	0.0	0.02
Corporate income tax	2.0	1.9	2.0	1.7	1.5	1.7	1.5	1.9	0.1	0.20
Property tax	0.6	0.8	0.8	0.6	0.6	0.6	0.5	0.5	0.0	-0.07
VAT	6.5	8.0	6.8	6.2	5.7	6.7	6.5	6.6	0.6	-0.02
Excise duties	2.9	3.7	3.5	3.0	2.9	2.9	2.7	2.5	-0.1	-0.40
SSC	9.0	8.1	8.0	10.5	10.5	10.7	9.9	9.9	-0.3	-0.84
Non-fiscal revenues	3.1	2.7	2.3	2.6	2.3	2.2	2.1	2.8	-0.2	0.60
Donations	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.00
Amounts received from the EU for payments made	0.4	2.4	1.0	2.4	3.3	3.2	3.5	3.3	-0.2	0.09
Total expenditures	**36.6**	**34.2**	**31.6**	**34.9**	**40.0**	**38.7**	**36.5**	**38.2**	**-1.0**	**-0.43**
Personnel expenditures	8.8	7.3	7.5	9.7	10.4	9.4	8.2	8.3	-1.1	-1.09
Goods and services	5.3	5.7	5.4	5.0	5.4	5.4	4.7	5.1	0.0	-0.25
Interest	1.1	1.3	1.3	1.1	1.4	1.5	1.4	2.1	0.0	0.55
Subsidies	1.4	0.9	0.9	0.7	0.8	0.7	0.9	1.3	0.3	0.55
Projects funded from non-refundable external post-accession funds	0.5	3.4	0.8	2.6	3.3	3.5	4.7	3.6	0.5	0.11
Social assistance	12.0	10.7	10.7	10.8	13.1	12.4	11.4	12.3	-0.7	-0.06
Capital expenditures	4.1	2.6	2.5	2.9	3.1	2.8	2.7	2.9	0.2	0.06
Budget balance	**-6.95**	**-1.45**	**-2.2**	**-4.59**	**-9.61**	**-6.73**	**-5.45**	**-5.72**	**1.32**	**1.01**

Source: MF, FC's calculations

Note: Amounts without swap compensation schemes

Table 5 shows the evolution of public revenues and expenditures in ESA 2010 standards[26], expressed as percentages of GDP.

Table 5: The evolution of public revenues and expenditures (ESA 2010, % of GDP)								
	2009	2015	2016	2019	2020	2021	2022	Changes 2022/2021
Total revenues	**30.4**	**35.5**	**32.5**	**31.6**	**32.3**	**32.7**	**33.5**	**0.8**
Indirect taxes, of which	10.2	13.3	11.5	10.5	10.3	10.7	10.7	0.0
VAT	6.3	8.1	6.5	6.2	6.1	6.4	6.7	0.3
Excise + custom duties	3.9	5.2	5.0	4.3	4.2	4.3	4.0	-0.3
Direct taxes, of which:	5.9	6.6	6.5	4.8	4.7	5.1	5.9	0.8
Personal income tax	3.3	3.7	3.7	2.3	2.4	2.4	...	...
Corporate income tax	2.3	2.3	2.3	2.1	1.9	2.2	...	...
SSC	9.7	8.1	8.9	11.2	11.8	11.3	10.6	-0.7
Other current revenues	1.5	2.0	1.6	1.8	1.8	1.5	1.9	0.4
Amounts from the EU	0.4	2.7	1.4	1.1	1.6	1.9	2.3	0.4
Total expenditures	**39.9**	**36.0**	**35.0**	**36.0**	**41.5**	**39.8**	**39.7**	**-0.1**
Intermediate consumption	6.0	5.9	5.7	5.6	5.9	6.1	5.8	-0.3
Compensation of employees	10.3	7.8	9.1	11.2	12.1	11.1	9.9	-1.2
Interest	2.0	1.6	1.4	1.0	1.2	1.1	1.2	0.1
Social assistance	12.7	11.5	11.7	11.8	13.4	13.2	13.4	0.2
Subsidies	1.1	0.4	0.3	0.4	1.0	0.5	1.2	0.7
Other current expenditures	1.7	2.4	1.4	1.4	2.1	2.3	2.0	-0.3
Gross fixed capital formation	5.8	5.2	3.7	3.5	4.6	4.2	4.2	0.0
Budget balance	**-9.5**	**-0.5**	**-2.5**	**-4.3**	**-9.2**	**-7.1**	**-6.2**	**0.9**

Source: Eurostat

The fiscal consolidation initiated in 2010 in order to correct the existing major imbalances in the position of public finances was characterized by an alert pace, Romania succeeding in a relatively short period of time to reduce the budget deficit according to ESA 2010 from 9.5% of GDP in 2009 to 0.5% of GDP in 2015. Between 2016-2019, the lax fiscal policy led to the reversal of this trend, registering an important increase in the budget deficit compared to 2015, against the background of a massive decrease in revenues (by 3.9 pp in 2019). Thus, 2019 marked the crossing of the 3% of GDP threshold (the deficit was 4.3%), Romania being placed in the EDP in April 2020. The impact of the fiscal measures taken in 2020 to mitigate the social and economic effects in the context of the outbreak of the pandemic further

[26] The data contained in this table is not fully comparable with that in *Table 4*; the differences come from the different scope of coverage under the two standards, ESA 2010 and the national standard.

accentuated the budgetary imbalance, the GCB deficit (as a share of GDP) being close to the level reached in 2009. 2021 marked the economic recovery, against the backdrop of government support measures and the improvement of the health situation, and, compared to the previous year, budget revenues advanced marginally (+0.4 pp of GDP), while total expenditures decreased by 1.7 pp of GDP, recording a deficit of 7.1% of GDP, 2.1 pp of GDP below the level reached in 2020.

In 2022, budget revenues recorded a share of 33.5% of GDP. The most significant increases, compared to 2021, were for: *direct taxe*s (+0.8 pp of GDP), *other current revenues* and *amounts from European funds* (+0.4 pp each). Revenues from *VAT* advanced by 0.3 pp of GDP, growth "cancelled" by the decrease of the same size (-0.3 pp) in revenues from *excise duties* and *customs duties*, which translated into maintaining the share of indirect taxes in GDP at the level of 2021, namely 10.7%. At the same time, a reduction can be noticed in the share of *social security contributions* (-0.7 pp, the GDP increase exceeding the aggregate wage increase in the economy).

The share of public expenditures in 2022 was 39.7% of GDP, 0.1 pp less than the previous year. The most significant decrease was recorded in the *compensation of employees* (-1.2 pp of GDP, under the circumstances of a nominal growth rate of personnel expenditures significantly lower than that of nominal GDP), followed by the decrease of *intermediate consumption* and *other current expenditures* (-0.3 pp of GDP each). Increases were recorded in expenditures with *subsidies* (+0.7 pp), *social assistance* (+0.2 pp) and *interest* payments on contracted loans (+0.1 pp). *Gross fixed capital formation* stagnated in the 2021-2022 period, with a share of 4.2% pf GDP in each of the two years.

The budgetary situation of our country is particularly complicated. On the one hand, the war in Ukraine (which implies increased funding needs for defence), the challenges deriving from the energy transition and climate change put additional pressure on the public budget, and, on the other hand, it is absolutely necessary for Romania to continue the process of budget consolidation, for reasons of stabilizing the level of public debt, reducing internal and external vulnerabilities, stability of the national currency and defence of macroeconomic balances, improvement of the country's rating.

Under these conditions, it is absolutely necessary that the budget consolidation process also includes measures to increase tax revenues, which are at an inadmissible low level relative to Romania's needs, as well as compared to EU benchmarks, the budget correction not being able to be achieved exclusively through reducing public spending.

The implementation of a rigorous multi-year plan for fiscal consolidation and the efficient use of European funds made available to Romania constitute the basis for a gradual adjustment, which minimizes the associated economic and social costs and boosts sustainable economic growth in accordance with the EU programs in the field of digitalization, support of the circular economy, reducing dependence on conventional energy sources in the common effort to ensure the "greening" of European economies.

III.3. The structural budget balance in Romania

The signing and ratification by Romania of the Treaty on Stability, Coordination and Governance within the Economic and Monetary Union (TSCG) in 2012 established a fiscal-budgetary framework based on rules, with the objective of achieving a maximum structural deficit of 1% of potential GDP[27] in the case of Romania. The provisions of TSCG and Directive No. 85/2011 were integrated into the national legislation, by amending Law No. 69/2010 (FRL) in December 2013. This integration led to the imposition of limitations on medium-term budget planning, as governed by the new rule for the structural budget deficit[28] outlined in the TSCG. These changes began to take effect with the preparation of the 2015 budget. Theoretically, once the medium-term objective (MTO) was achieved in 2015, the fiscal consolidation process initiated in Romania in 2010 could be considered completed. However, this constraint no longer functioned after 2015. **Since 2016 there has been a deliberate and large-scale deviation from the 1% rule for the maximum level of the structural deficit. During the 2017-2019 period, Romania was twice subject to the significant deviation procedure from the MTO – the preventive arm of the SGP – and, since March 2020, is the only EU member state placed under the excessive deficit procedure – the corrective arm of the SGP.** The EC's recommendation for Romania is to follow a credible and sustainable fiscal adjustment trajectory by achieving a budget deficit of 4.4% of GDP in 2023 and 2.9% of GDP in 2024[29].

It should be noted that defining the target in terms of the structural deficit involves an effective deficit objective, adjusted based on the position of the economy within the economic cycle. Thus, when the output gap is positive, the compliance with the structural deficit target of 1% of GDP requires lower effective deficit levels, as the cyclical component[30] of the budget balance is positive. The structural budget balance, although reflects more accurately the fiscal position of an economy, presents a series of disadvantages, the most significant one being related to the uncertainties associated with its estimation. Therefore, the value of the structural balance is dependent on the level of the output gap, calculated based on the potential GDP level, which is an unobservable measure, often subject to more or less significant revisions, depending on the updates in statistical data and methodology used. For example, the output gap estimates for Romania, presented in the FC Annual Report for 2021, have been

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

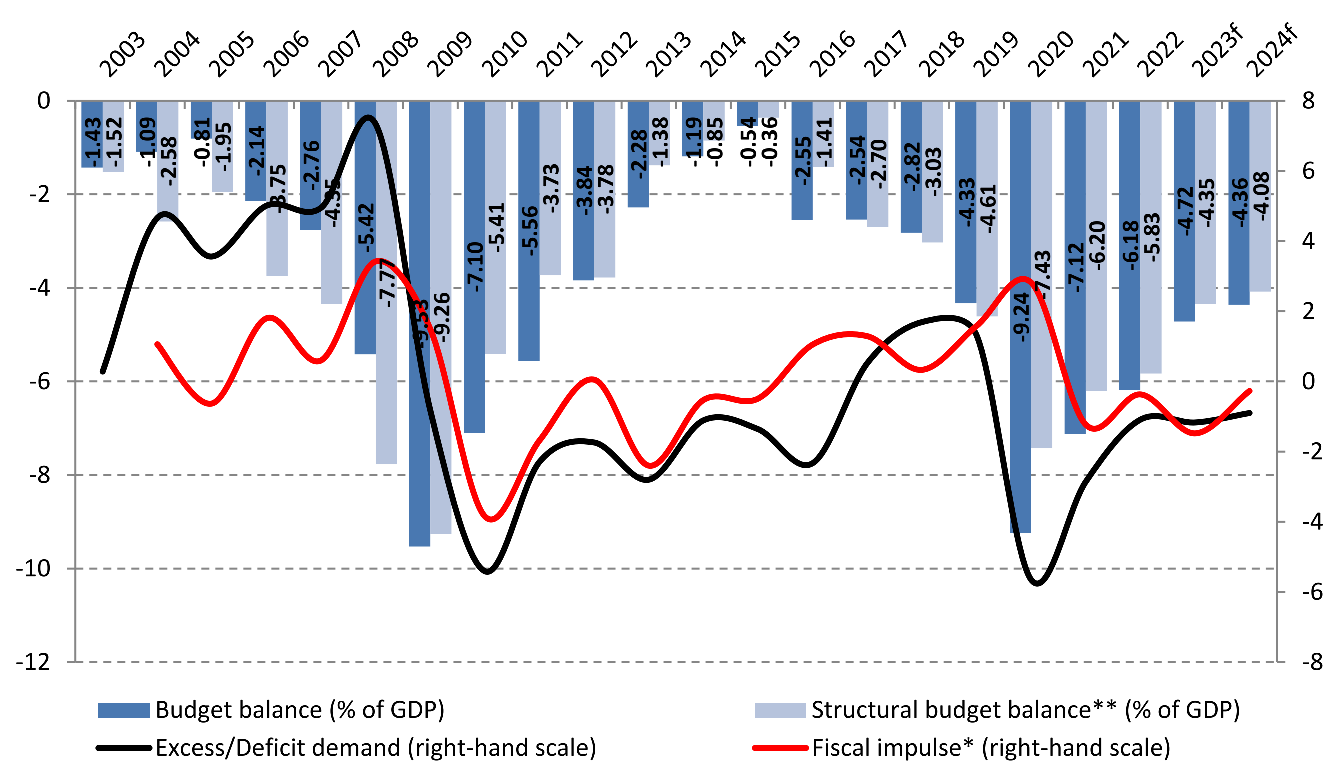
[28] It is calculated by subtracting from the actual budget balance the cyclical component of the budget deficit and the one-off and temporary measures. For details, see http://www.fiscalcouncil.ro/annualreport2012.pdf, pp. 45-57.

[29] https://eur-lex.europa.eu/legal-content/RO/TXT/?uri=CELEX:52021DC0530

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

revised from -4.76% for 2020, -2.52% for 2021, and -3% for 2022 (AMECO, June 2022) to -5.65% for 2020, -2.86% for 2021, and -1.09% for 2022 (AMECO, June 2023).

Figure 4: Structural deficit, fiscal impulse and the excess demand



*Defined as variation in the structural balance (% of GDP) (+ stimulus effect, - contractionary effect)

** For the period 2003-2009, the data refers to the cyclically adjusted budget balance

Source: AMECO, FC's calculations

The evolution of the structural deficit, fiscal impulse, and excess demand (presented in *Figure 4*) reveals how, in the period from 2003 to 2022, Romania mainly employed a pro-cyclical fiscal-budgetary policy[31]. The discretionary policy of intense, but useless and counterproductive stimulation of the economy during periods of pre-crisis expansion (2006-2008 and 2017-2019), as well as the restraint during the periods when the economy operated below potential (2010-2015 and 2021-2022) have amplified the fluctuations of the economic cycle through its pronounced pro-cyclical character. Therefore, the beneficial and stabilizing action of the automatic stabilizers was cancelled out.

During the period from 2009 to 2015, the structural budget deficit decreased from 9.3% of potential GDP in 2009 to 0.4% in 2015, with an average adjustment rate of 1.5 pp per year. Given the high starting level in relation to financing constraints, it was necessary to swiftly adopt radical measures in 2010 and 2011. Fiscal consolidation was achieved with an average annual adjustment rate of 3 pp, primarily focusing on expenditures. However, from 2016, this process was suddenly reversed, following the implementation of the new Fiscal Code, which led to a significant fiscal relaxation. Concurrently,

[31] Except for the years 2005, 2009, 2012, 2016 and 2020.

significant permanent expenditure increases (salaries and pensions[32]) were legislated. Maintaining the expansionist character of the fiscal policy, under the conditions of a positive output gap starting from 2017, as well as deliberately evading the rules established by TSCG and FRL, regarding the maintenance of the structural deficit target, contributed to a rapid deterioration of the public finances. In 2019, the budget execution ended with an ESA deficit of 4.3% of GDP, significantly exceeding the allowed limit of 3%. Consequently, Romania entered the excessive deficit procedure in March 2020 and this status was even maintained in the context of activating the general escape clause of the SGP.

The outbreak of the COVID-19 pandemic occurred when Romania had a structural deficit of around 4.6% of potential GDP at the end of 2019, the highest in the EU. This limited the manoeuvring space that Romania had to address the negative effects of the pandemic, 2020 ending with a structural deficit of 7.4%[33] of potential GDP. In the context of adverse cyclical developments[34] caused by the pandemic, the fiscal-budgetary policy in 2020 was countercyclical and had a strong stimulative character (fiscal impulse of 2.8 pp). This was driven by the measures adopted to support the economy, population and the healthcare sector through increases in expenditures (such as pension point and child allowance hikes) and tax reductions, decided prior to the pandemic (elimination of the excise duties surcharge and the tax on banking assets).

2021 brought a reduction of the budget deficit to the level of 7.1% of GDP, according to the ESA 2010 methodology. This fall was driven by the recovery of the macroeconomic environment and the better-than-expected collection of budgetary obligations related to 2020, which had been deferred for payment by economic agents. These favourable developments would have allowed for a more substantial reduction in the budget deficit compared to the recorded level. However, the additional revenues were allocated entirely to increases in expenditure aggregates, leading to further spikes in budget spending. As a result, although the budget deficit decreased by 2.1 pp in 2021, compared to the previous year, the pace of adjustment for the structural deficit was only 1.2 pp, from 7.4% in 2020 to 6.2% in 2021.

In 2022, the fiscal consolidation process continued, as the budget deficit fell to 6.2%, according to the ESA 2010 methodology. However, relative to 2021, the reduction of the budget deficit was smaller (2.1 pp in 2021, compared to 0.9 pp in 2022). Also, the pace of adjustment for the structural deficit was only 0.4 pp, decreasing from 6.2% to 5.8%. Similar to 2021, the contractionary fiscal impulse overlapped with a deficient demand. The deceleration of the fiscal consolidation process was primarily driven by the complex context of 2022, marked by the energy crisis, constraints in supply chains, the war in Ukraine, as well as the high and persistent inflation rates. Furthermore, 2022 witnessed a substantial upward revision of budget revenues compared to the initial estimations, attributed to higher-than-expected inflation and additional proceeds from the over-taxation of electricity and natural gas producers.

[32] Starting with 2017, *ad-hoc* increases of the pension point were legislated (+65% between 2017-2020).

[33] According to the AMECO database. It should be noted that the level of structural deficit is identical in the EC's assessment with that of the cyclically-adjusted deficit.

[34] According to EC, from an excess demand of 1.3% of potential GDP in 2019, to a deficient demand of 5.65% in 2020.

However, this revenue surplus was surpassed by the increase in budget expenditures, particularly in areas related to social assistance, interest payments, other transfers, goods and services.

The budgetary construction for 2023 envisaged a deficit target of 4.4% of GDP, according to the ESA 2010 methodology, a level below the 3% of GDP threshold being projected for 2024. According to the MF, this evolution is deemed compatible with a 2.9 pp reduction of the structural deficit by 2026. However, at the end of the forecast horizon, a deviation of 1.7 pp from the medium-term objective still remains[35]. In 2023, according to the MF, the fiscal consolidation process is supported, on the revenue side, by fiscal policy measures, most of which act in the direction of restricting exceptions and optimization loopholes in the tax regime, by *ex-ante* considering additional sums gained from improving tax collection and by accelerating the absorption of European funds (especially those allocated through the NRRP). On the expenditure side, the consolidation process is the result of reducing subsidies in nominal terms while the projected dynamics, in nominal terms, for social assistance, goods and services, personnel, and interest expenditures is lower than the anticipated nominal GDP growth rate. At the same time, it is worth noting that the medium-term budgetary consolidation process is substantially projected on the expenditure side.

In its analyses, the FC emphasized the particularly difficult fiscal situation in which Romania finds itself, illustrated by the insufficient level of budget revenues in relation to expenditures, as well as by the size of the structural and external deficits. Given the complicated international context and the overlap of crises faced by both Romania and the EU, a combination of macroeconomic measures is needed to try to avoid entering recession, which implies the gradual implementation of the budget consolidation process. The FC emphasized that this consolidation cannot be achieved only on the expenditure side because critical areas (such as public health and education) are chronically under-funded, the military conflict on the borders calls for increased defence and security spending, the high inflation rates have significantly lowered the purchasing power, especially in the case of low-income people, and the impact of climate change and the energy transition require strengthening the capacity of the state to intervene in very complicated moments.

Thus, the budgetary consolidation by increasing tax revenues represents a problem of economic security and national solidarity so that the public budget can cope with very large current and future needs. In this sense, FC appreciates that Romania can obtain a considerable increase in budget revenues through better collection and by reducing the multitude of exceptions and loopholes found in the current fiscal regime[36].

[35] According to the 2023-2026 Convergence Program.

[36] For a more in-depth analysis of the need to increase tax revenues in Romania and the search for solutions to achieve this goal, please consult the study “Budgetary consolidation and higher fiscal revenues – A vital need for Romania’s stability and economic security”, carried out by a Working Group under the coordination of the Fiscal Council (http://www.fiscalcouncil.ro/Analiza_sistem_fiscal%20EN%2031%20mai.pdf).

III.4. Budget revenues

GCB's revenues, net of the swap compensation schemes for outstanding obligations against the budget (in the amount of 1.06 billion lei), increased in 2022 by 21.1% (+80.5 billion lei) compared to the previous year under the impact of a significant increase in nominal GDP, due to high inflation (the GDP deflator reaching 13.4%), overtaxing electricity and natural gas producers and increase in non-tax revenues (especially oil royalties and dividends received, including those paid by CEC BANK related to the financial years 2019 and 2020). Thus, budget revenues stood at 459.1 billion lei (representing about 32.5% of GDP), which denotes an increase of 0.6 pp compared to the level of 31.9% of GDP recorded in 2021. This evolution was supported by the increase in the share of *fiscal revenues* (+0.6 pp), *non-fiscal revenues* (+0.6 pp) and *amounts received from the EU* (+0.2 pp), partially counterbalanced by the evolution of *social security contributions* (-0.8 pp).

Fiscal revenues registered increases mainly at the level of *other taxes on goods and services* (+0.9 pp, on account of revenues from overtaxing electricity and natural gas producers) and *corporate income tax* (+0.2 pp, being supported by the nominal GDP dynamics), their impact being partially counterbalanced by the decrease in the share of *excise duties* (-0.4 pp) and *property taxes* (-0.1 pp). Regarding *social security contributions* (-0.8 pp), the decrease in their share in GDP reflects the faster dynamics of nominal GDP (+18.7% relative to 2021) compared to that of wage across the economy (about +13% relative to 2021). Last but not least, the evolution of the *amounts received from the EU* (+0.2 pp) reflects the increase of the amounts related to the 2014-2020 Multiannual Financial Framework by 3.8 billion lei, of the non-reimbursable financial assistance allocated through the NRRP by 0.2 billion lei and of the pre-financing granted to the non-governmental sector in the event of the temporary unavailability of European funds by 6.1 billion lei, while the funds intended for agriculture[37] decreased by 2.3 billion lei. It should be noted that the last two categories represent European funds whose recipient is the private sector, with a symmetrical impact on revenues and expenditures, these only transiting the general consolidated budget.

Compared to the initial budget projection, GCB revenues collected in 2022, net of swap compensation schemes, recorded a substantial increase of around 20 billion lei (representing +1.4 pp of GDP). This favourable evolution was due to significantly exceeding the initial projections in the case of *fiscal revenues* (+1.4 pp) and *non-fiscal revenues* (+0.8 pp), partially counterbalanced by the failure to meet the programmed level for *the amounts received from the EU* (-0.8 pp), while the share of *social security contributions* registered a level close to that provided for in the initial budget. It should be noted that exceeding the revenue targets proposed in the initial budget is mainly due to the same factors mentioned previously: the upward revision of nominal GDP dynamics (as a result of higher inflation than the initial projections, the budget being built on the assumption of a deflator of 5.8%, well below the actual level of 13.4%), additional revenues from overtaxing electricity and natural gas producers and the realization of non-fiscal revenues above expectations (the more favourable evolution of oil royalties

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

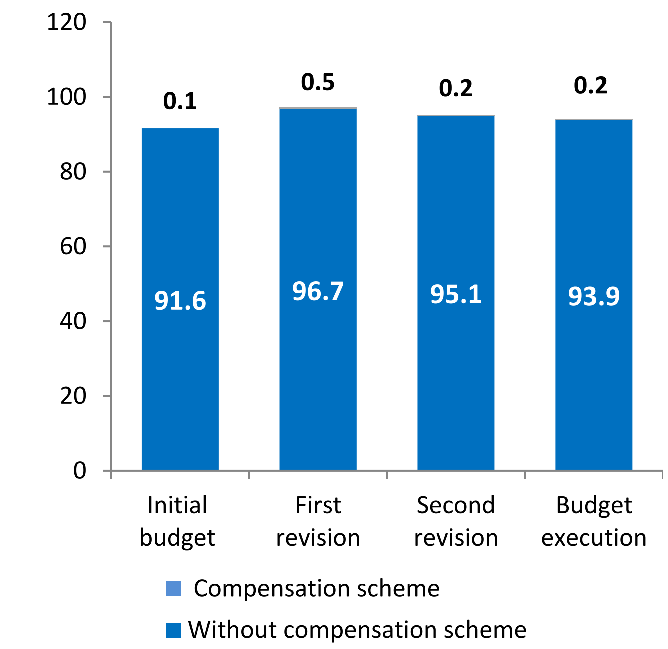
being justified by the increase in oil and natural gas prices, while dividends were boosted by the distribution of over 85% of the net income of CEC BANK, related to the years 2019 and 2020, in accordance with the agreement on the increase of the bank's equity).

In the case of *fiscal revenues*, exceeding the initial projection is mainly due to *other taxes on goods and services* (+1 pp, as a result of additional revenues from overtaxing electricity and natural gas producers), to the *corporate income tax* (+0.4 pp, given the nominal GDP growth above initial estimates), to the *personal income tax* (+0.2 pp, this aggregate also benefiting from a more favourable evolution of the labour market compared to the initial estimates) and to the *VAT* (+0.2 pp, under the conditions of a more rapid dynamic of the population's consumption compared to the initial projection). Non-fulfilment of the share in GDP established by the initial budget was mainly recorded at the level of *excise duties* (-0.2 pp, FC warning in its opinion on the draft budget for 2022 that this aggregate was oversized), of the *tax on the use of goods, on the authorization of the use of goods or on the performing of activities* (-0.1 pp, as a result of the decrease in the amounts collected in 2002 from auctioning the 5G broadband radio frequencies) and of *property taxes* (-0.1 pp). The revenue category that recorded the largest non-fulfilment of the target set by the 2022 budget is represented by the *amounts received from the EU* (-0.8 pp), mainly as a result of the non-realization of the amounts related to the non-reimbursable financial assistance allocated through the NRRP (- 8.6 billion lei, given the delays in starting the projects).

III.4.1. VAT and excise duties

VAT revenues, in cash standards, net of the impact of swap compensation schemes, recorded a level of 93.9 billion lei in 2022, being 2.3 billion lei above the level provided for in the initial budget. The adjacent graph shows the evolution of the revenues and the compensation schemes programmed in the initial budget and on the occasion of the budget revisions, compared to the values actually recorded in the budget execution.

Figure 5: VAT revenues in 2022 (billion lei)



Source: MF (cash standards)

The first budget revision operated a large-scale positive revision of this budgetary aggregate (+5.1 billion lei), the main factors that could have justified it being represented by the increase in the forecast for the final consumption of households, compared to the initial estimates, and the target of 1 billion lei set by the MF for the improvement of VAT collection. In its opinion on the first budget revision, the FC considered that the elements mentioned above were not sufficient to justify the revision carried out and assessed as likely the manifestation of a revenue gap at the level of VAT.

The second budget revision confirmed the assessment of the FC from the first revision, operating a decrease in VAT revenues by 1.6 billion lei. However, taking into account the budget execution from that moment, as well as the macroeconomic forecasts available, the FC estimated that the VAT receipts continued to be overestimated by about 1 billion lei. The final 2022 execution confirmed the FC opinion, the level of VAT revenues being 1.2 billion lei lower than the estimates from the second revision.

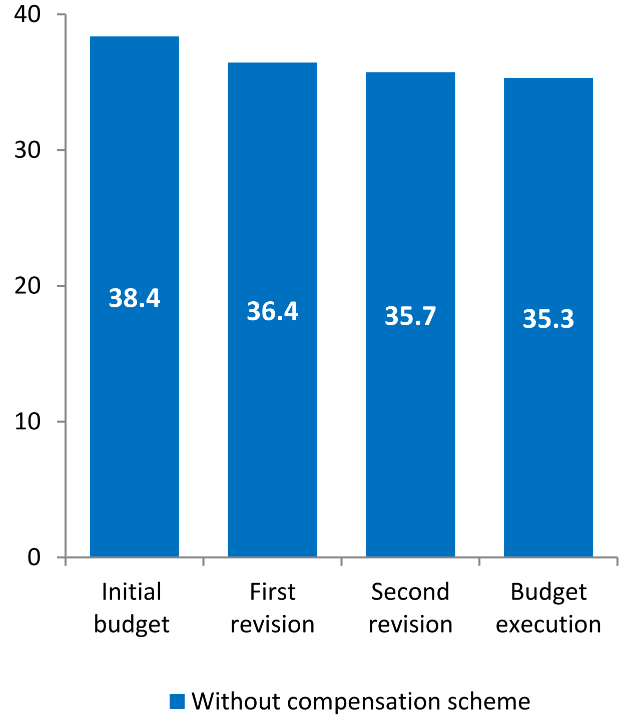
Considering that the level programmed in the initial budget for VAT revenues also included the amount of 7.2 billion lei due to an expected increase in collection efficiency, it should be noted that exceeding the level programmed by the execution of this budgetary aggregate does not confirm the materialization of the target for increasing collection efficiency. The main factor that boosted the evolution of VAT revenues in 2022 was the increase well above the initial estimates of the relevant macroeconomic base (represented by the final consumption of population, excluding self-consumption and the rural market component). Thus, against the background of high inflation, the relevant macroeconomic base increased in 2022 by 21.2%, far exceeding the 10.9% dynamic estimated at the time of drafting the budget, a fact that would have justified an increase in VAT revenues by about 8-9 billion lei compared to the programmed level. Consequently, the fact that the execution of VAT revenues was only 2.3 billion lei above the level programmed in the initial budget shows the failure to meet the target of 7.2 billion lei additional revenues from increasing collection efficiency.

It should be noted that the FC has drawn attention on numerous occasions that it is not prudent to include *ex-ante* in the budget construction some additional revenues on the account of increasing collection efficiency. *Ex-ante* quantification of the possible revenues generated by the efforts to increase tax collection is not possible, as there is no performance history that can substantiate such calculations. Moreover, the analysis of budget executions in recent years shows that the targets for increasing collection efficiency set in the initial budgets or on the occasion of budget revisions have never been reached. Therefore, the additional revenues from improved collection can be included *ex-post* in the budget construction, but only after their amount can be assessed with a high degree of confidence and there are sufficient indications of the emergence of a trend in reducing tax evasion, which would amount to a permanent nature of these revenues.

Compared to the previous year, the level of VAT revenues, net of swap compensation schemes, increased by 18.6% (+14.7 billion lei). In order to investigate the performance of VAT collection, an *ex-post* projection of this budgetary aggregate was made in order to compare it with the actual achievements. Thus, starting from the 2021 budget execution of VAT revenues (adjusted with the volume of obligations deferred for payment by economic agents in 2020 and reimbursed in 2021), the 21.2% increase in final consumption expenditure of the population was applied (excluding self-consumption and the rural market component) and the negative effect of some fiscal policy measures implemented in 2022 was taken into account (increasing the ceiling for applying the 5% VAT rate to the purchase of housing, reducing the VAT on thermal energy and firewood, with a total impact estimated by the MF at about -0.9 billion lei). Under the impact of these factors, the *ex-post* projection of VAT revenues for 2022 is around 91-92 billion lei, while the actual execution recorded a level of 93.9 billion lei. These results confirm the existence of a favourable difference of around 2-3 billion lei which could suggest an improvement in the collection of VAT revenues, but far below the level programmed in the 2022 budget.

Revenues collected from **excise duties**, net of the impact of swap compensation schemes, reached 35.3 billion lei in 2022, this level being about 3.1 billion lei lower than the estimate from the initial budget. Thus, the initial program provided for excise duties in the amount of 38.4 billion lei, taking into account a forecasted growth of the macroeconomic base (final consumption of the population in real terms) of 4.6%. In its opinion on the draft budget, the FC assessed that the programmed level of excise revenues was oversized in relation to the forecasted evolution of the relevant macroeconomic base. The first budget revision confirmed the FC's assessment, adjusting downwards the target set initially by about 1.9 billion lei, simultaneously with the adoption of measures to increase excise duties on tobacco and alcohol (impact estimated by the MF at 0.5 billion lei for 2022) and with the establishment of a target of 1 billion lei for the improvement of excise duty collection. Considering the budget execution from that moment, the FC assessed that the programmed level of excise revenue was still excessive. The second budget revision confirmed the FC assessment again, reducing this budget aggregate by 0.7 billion lei, while the actual execution recorded a level that was 0.4 billion lei lower than the projection from the second revision.

Figure 6: Excise duty revenues in 2022 (billion lei)



Source: MF (cash standards)

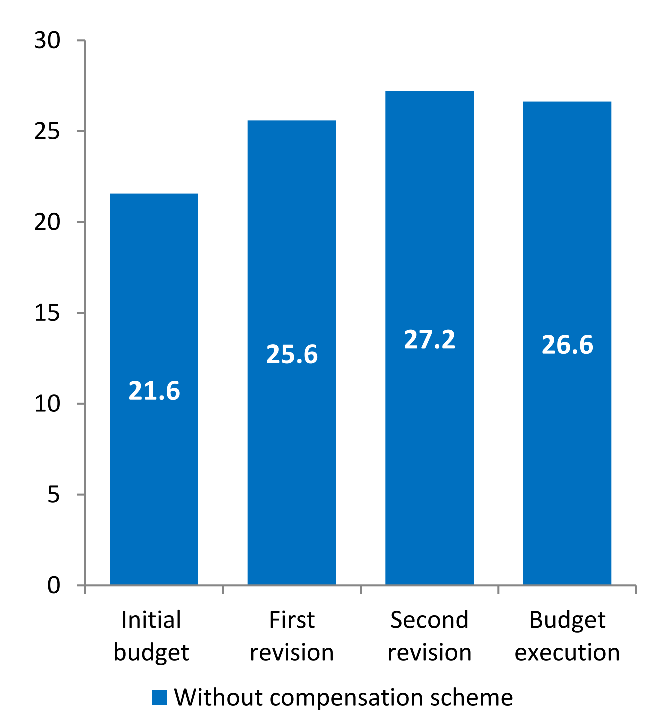
Compared to the previous year, the revenues collected from excise duties increased by only 0.8 billion lei (+2.4%) given a 6.8% advance in the final consumption of the population in real terms and the increase, from August 1, 2022, of the level of excise duty on alcohol and tobacco products (from 563.97 lei/1,000 cigarettes to 594.97 lei/1,000 cigarettes). Because excise duties are presented in an aggregate manner in the budget construction, which does not allow to study the impact of a change in a single category, it is of interest to carry out an analysis of their structure. Thus, with a share of 50.1% in total excise revenues (similar to the previous year), excise duties on energy products continue to represent the most important component of this revenue category, while excise duties on tobacco products are in second place, with a share of 45.3% (a marginal decrease compared to the level of 45.6% recorded in the previous year). Revenues from excise duties on alcohol, distillates and alcoholic beverages remained at around 4.5% of total excise revenues, while the rest of the categories continued to be below 1%.

Analysing the changes relative to 2021 at the level of each product category, it is found that excise duties on energy products increased by only 2.4% (+0.4 billion lei), a pace significantly lower than the dynamics of the relevant macroeconomic base (+6.8%), to which is added the increase in consumer prices communicated by the NIS (+3.6%, for the period October 2020 - September 2021). Excise duties on tobacco products increased by only 1.9% (+0.3 billion lei), an increase lower than the MF estimates regarding the impact of the increase in excise duties on tobacco products and alcohol, while excise duties on alcohol, distillates and alcoholic beverages increased by only 2.6% (+0.04 billion lei), also a dynamics significantly lower than the one of the relevant macroeconomic base combined with the increase in consumer prices. In conclusion, given that all the main categories of excise duties have recorded much lower increases than would have been expected according to macroeconomic developments and fiscal policy measures adopted, a deterioration in the collection of excise duties is noted during 2022, which may suggest a decrease in collection efficiency.

III.4.2. Direct taxes

Revenues from **corporate income tax** in cash standards, net of the impact of compensation schemes, amounted to 26.6 billion lei, representing an increase of 6.6 billion lei (+33%) compared to 2021, but also exceeding by about 5 billion lei the estimates from the initial budget. Thus, the initial program set the target for corporate income tax at 21.6 billion lei, given that the relevant macroeconomic base (nominal GDP) was anticipated to increase by 10.7%. This level was revised upwards on the occasion of both budget revisions (+4 billion lei at the first revision, respectively +1.6 billion lei at the second revision), as the nominal GDP projection exceeded the initial estimates, in the context of the high inflation recorded in 2022. In its opinion on the second budget revision, the FC estimated, considering the budget execution from that moment, that it was probable to register a revenue gap of about 0.5 billion lei.

Figure 7: Corporate income tax revenues in 2022 (billion lei)



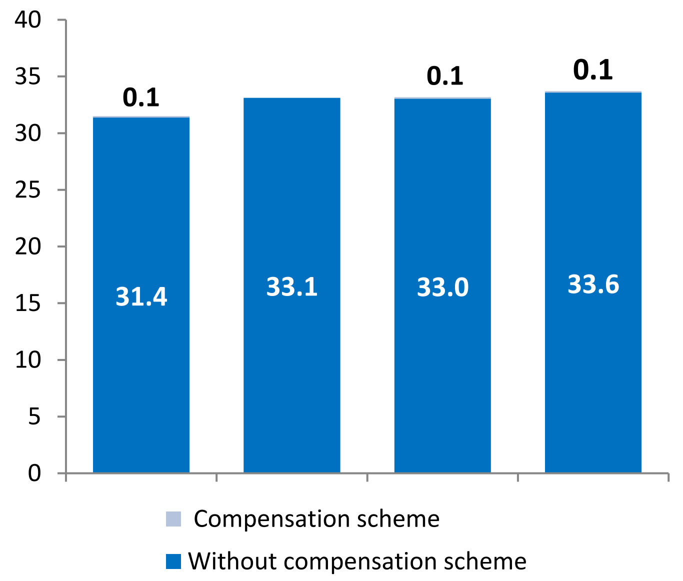
Source: MF (cash standards)

The final execution of this budget aggregate confirmed the FC assessment, recording a value of 0.6 billion lei lower than the level estimated at the second revision.

The strong upward evolution of corporate income tax revenues compared to the previous year (+33%, representing +6.6 billion lei) was significantly more pronounced than the dynamics of the relevant macroeconomic base (nominal GDP, which grew by only 18.7%). Thus, starting from the 2021 budget execution of the corporate income tax (adjusted with the volume of obligations deferred for payment by economic agents in 2020 and reimbursed in 2021), the 18.7% increase in nominal GDP was applied while also taking into account the negative effect of some fiscal policy measures implemented in 2022 (increasing the deduction limit of adjustments for the depreciation of receivables registered according to accounting regulations, with a total impact estimated by the MF at around -0.3 billion lei). Under the impact of these factors, the *ex-post* projection of corporate income tax revenues for 2022 is around 22-23 billion lei (the actual execution recording a level of 26.6 billion lei), which could suggest an improvement in collection efficiency.

An analysis of the structure of this budgetary aggregate shows that the biggest impact was exerted by the corporate income tax paid by economic agents from the non-financial sector (this representing the main component of the corporate income tax, with about 92.5% of total revenues), which increased by 5.6 billion lei (+29.3%) compared to the previous year. On the other hand, the corporate income tax paid by commercial banks increased by about 1 billion lei (+106.1%), as a result of recording very high profits in the banking system, against the background of high inflation that caused interest rates to rise. Given that the corporate income tax paid by economic agents from the non-financial sector (category that represents the overwhelming majority of the total revenues from corporate income tax) grew rapidly, far exceeding the dynamics of the nominal GDP, the conclusions formulated above, regarding a possible improvement in collection efficiency during 2022, are confirmed.

Figure 8: Personal income tax revenues in 2022 (billion lei)



Source: MF (cash standards)

Revenues from **personal income tax**, according to cash standards, stood at 33.6 billion lei, exceeding by 2.2 billion lei the budgeted level at the beginning of 2022. Thus, the initial program set the revenues at 31.4 billion lei based on an estimated increase in the average number of employees by 2%, respectively a 8.7% rise in the average gross salary. This level was revised upwards on the occasion of the first budget revision (+1.7 billion lei), taking into account the more favourable developments of the labour market, compared to the initial estimates. In its opinion on the first budget revision, the FC assessed the new target as plausible considering the budget execution for the first semester of 2022. The second revision operated a marginal decrease of this aggregate (-0.1 billion lei), while the final execution of personal income tax revenues was 0.6 billion lei higher than the estimates from the second revision.

Compared to the previous year, revenues from personal income tax increased by 20.1% (+5.6 billion lei), the dynamics of this category exceeding the increase in the wage across the economy (about 12.3%). Thus, starting from the budget execution of 2021 (adjusted with the volume of obligations deferred for payment by economic agents in 2020 and reimbursed in 2021), extrapolating with the dynamics of the average number of employees and the average gross salary in 2022 (+1.5%, respectively +10.6% according to the latest available data) and considering the negative effect of some fiscal policy measures implemented in

2022 (estimated by the MF at around -0.1 billion lei), all would justify a level of personal income tax revenues of about 31 billion lei, while the actual execution stood at 33.6 billion lei. Therefore, this aggregate recorded a revenue surplus in 2022 of about 2-3 billion lei.

In order to investigate the source of this surplus, an analysis of the structure of the personal income tax revenues was carried out. The payroll tax (which represents 67.6% of the revenues related to this budgetary aggregate) had a slower dynamic than the wage across the economy, recording an increase of only 10.5% (+2.1 billion lei) compared to the previous year, which does not seem to indicate an increase in collection efficiency. The revenue surplus highlighted above is the result of faster increases in other components of this budgetary aggregate. Thus, revenues from the dividend income tax (weight of 13.5% in total revenues) increased by almost 80% (+2 billion lei) as an effect of massive dividend distributions before the increase of the tax rate from 5% to 8%, starting with January 1, 2023. The revenues from the income tax on pensions (weight of 7.4% in total revenues) also increased by 25.1% (+0.5 billion lei), as well as revenues established on the basis of the single declaration (weight of 7.9% in total revenues) by 32.3% (+0.6 billion lei), thus contributing to the revenue surplus registered at the level of the entire aggregate. Concluding the analysis of the main components of the personal income tax, it is found that the dynamics of this revenue category is rather the result of the evolution of the dividend income tax and other component taxes, no signs of improvement in collection efficiency being observed.

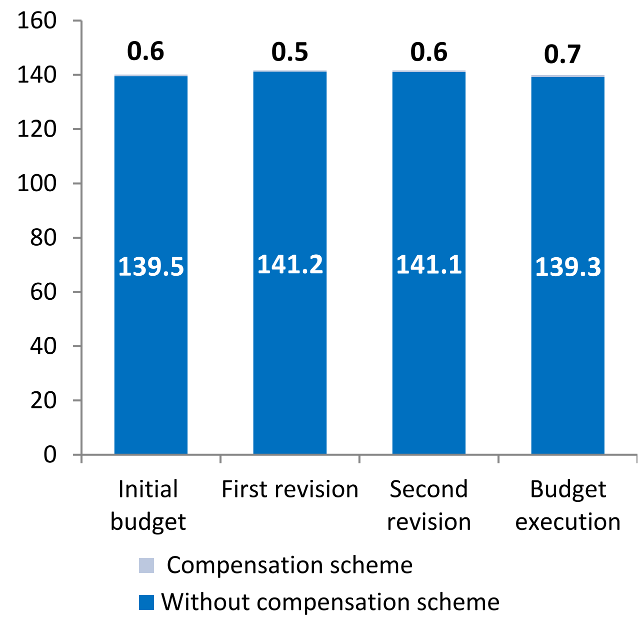
III.4.3. Social security contributions

SSC revenues in cash standards, net of compensation schemes, stood at 139.3 billion lei at the end of 2022, about 0.2 billion lei below the estimates in the initial budget, given that the average number of employees increased by 1.5%, compared to the initial projection of +2%, and the average gross salary increased by 10.6%, compared to the initial projection of +8.7%. It should be noted that the initially budgeted amounts included the favourable impact of the adopted fiscal policy measures (enforcing healthcare contributions on pensioners with monthly revenues over 4,000 lei[38], with a total impact estimated by the MF at around 0.6 billion lei), but also a target of 2.5 billion lei for improving collection efficiency. On the other hand, the enforceable titles paid during 2022 must also be taken into account, including Law 85/2016 on the payment of salary differences due to teaching staff in state education for the period October 2008 - May 13, 2011, GEO 114/2018 on the payment of salary rights established in favour of staff from public institutions and authorities, which became enforceable between January 2019 and December 2021, as well as GEO 75/2020 regarding the recalculation of salaries for police officers from the structures of the Ministry of Internal Affairs and for military personnel in activity. The planned value of the enforceable titles for 2022 was around 2.5 billion lei, while the actual payments stood only at 1.7 billion lei, which led to a decrease in SSC revenues, compared to the programmed level, by almost 0.3 billion lei.

[38] The measure was declared unconstitutional by the Constitutional Court of Romania, at the end of 2022, the amounts withheld being reimbursed in monthly installments between March 1, 2023 and February 28, 2024 (according to GEO 4/2023).

Analysing the projection of SSC revenues during 2022, the first budget revision adjusted them upwards by 1.7 billion lei, taking into account the more alert dynamics of the wage across the economy compared to the initial estimates, as well as the adopted measures regarding the change in the way that SSC is calculated for individual part-time work contracts, respectively the decrease of payments from legal entities for disabled persons who are not employed. The second revision operated a marginal decrease (-0.1 billion lei) of SSC revenues. In its opinions on both budget revisions, the FC assessed that the budget execution of this aggregate was lower than the proposed targets and considered as probable the manifestation of a revenue gap in the case of SSC. The budget execution at the end of 2022 confirmed the FC's assessments, registering a level of SSC revenues lower by 1.8 billion lei compared to the one estimated at the second revision.

Figure 9: Social security contributions revenues in 2022 (billion lei)



Source: MF (cash standards)

Relative to the previous year, SSC revenues, net of compensation schemes, increased by 12.2 billion lei (+9.6%) in 2022, mainly due to the positive evolution of the wage across the economy. For a more detailed analysis of the performance of revenues related to this budgetary aggregate, an *ex-post* projection will be carried out starting from the 2021 budget execution (adjusted with the volume of obligations deferred for payment by economic agents in 2020 and repaid in 2021). Extrapolating the starting point with the dynamics of the relevant macroeconomic bases in 2022 (+1.5% average number of employees, respectively +10.6% average gross salary) and taking into account the fiscal policy measures adopted (considering both the measures included in the initial budget, as well as those implemented during the year, the total impact is about +0.7 billion lei, according to MF estimates), a level of revenues of about 140-141 billion lei appears justified, which is slightly higher than the one recorded in the effective budget execution of 2022 (139.3 billion lei). Given that this is a small-magnitude difference, there are no clear indications to suggest a worsening in the collection of SSC revenues during 2022.

In order to more accurately reflect the SSC dynamics during the 2019-2022 period, the table below shows the adjusted series of this budgetary aggregate[39], as well as its gross series obtained by removing adjustments related to swap compensation schemes and transfers to Pillar II.

[39] Taken from each year's budget execution.

Table 6: Social security contributions (million lei)					
		Budget execution 2019	Budget execution 2020	Budget execution 2021	Budget execution 2022
Adjusted series	**1**	**111,473.5**	**112,250.7**	**127,493.4**	**139,920.2**
Swap	2	464.3	552.4	396.6	664.8
Pillar II	3	8,487.3	8,912.2	9,768.6	10,986.6
Gross series*	**4=1-2+3**	**119,496.5**	**120,610.5**	**136,865.4**	**150,241.9**
*out of which enforceable titles		668.0	537.9	461.5	577.5

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

Thus, if the gross series is taken into account, it can be seen that, in 2022, SSC revenues amounted to about 150 billion lei, exceeding the 2021 revenues by 9.77% (+13.4 billion lei), the dynamics being slightly more alert than the increase in SSC revenues from the budget execution (+9.75%), because the gross series also includes transfers to Pillar II, which had a more accelerated advance (+12.5%). Eliminating the impact of enforceable titles from the gross series, SSC revenues increased in 2022 compared to the previous year by 9.72% (+13.3 billion lei), due to a marginal increase in payments related to this category.

III.5. Budget expenditures

Budget expenditures, net of the impact of swap compensation schemes (amounting to 1.06 billion lei), recorded a 17.6% increase compared to the previous year (+80.9 billion lei), reaching nearly 540 billion lei by the end of 2022. Given the significant nominal GDP growth (+18.7%, driven by a deflator of 13.4%), the share of budget expenditures in GDP decreased by approximately 0.5 pp, namely from 38.7% to 38.2% of GDP. In 2022, all categories of expenditures showed significant upward trends: *projects with financing from non-reimbursable external funds* (+442.7%), *subsidies* (+108.2%), *interest* (+61.8%), *payments made in previous years and recovered in the current year* (+47.9%), *capital expenditures* (+21.5%), *other expenses* (+21.0%), *projects with financing from post-accession non-reimbursable external funds 2014-2020* (+19.6%), *social assistance* (+18.4%), *goods and services* (+13.4%), *other transfers* (+6.2%) and *personnel* (+5.2%).

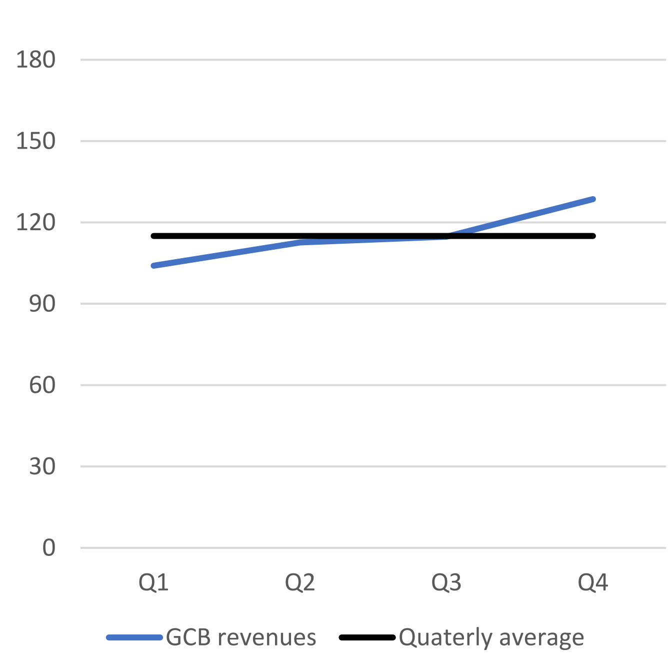
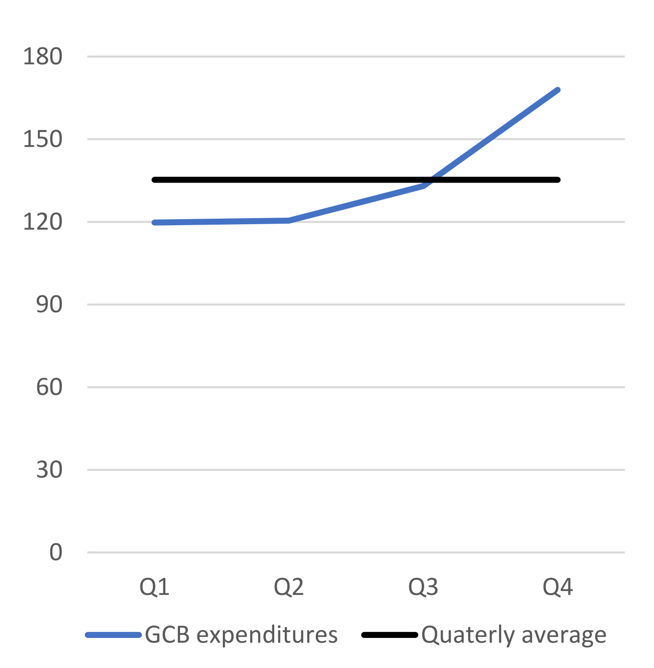
The decrease in the share of budget expenditures in GDP was mainly driven by the decrease in the share of *current expenditures* (-0.5 pp) and *other transfers* (-0.2 pp). Within current expenditures, the most significant reductions in the share of GDP were observed in the case of *personnel expenditures* (-1.1 pp) and *expenditures with goods and services* (-0.3 pp), which experienced growth rates lower than nominal GDP. The evolution of these aggregates was partially offset by the dynamics of *interest expenditures* (+0.5 pp, in the context of increased public debt volume and interest rates at which new loans were contracted) and *subsidies* (+0.5 pp, mainly for financing the compensation/capping scheme for electricity and natural gas prices). In contrast, the other expenditure aggregates showed marginal changes in their share of GDP compared to the 2021 budget execution.

Compared to the allocations established in the initial budget for 2022, GCB expenditures reached a substantially higher level, exceeding the budgeted amounts by 23.8 billion lei (+4.6%), equivalent to 1.7 pp of GDP. Overruns were recorded in the majority of expenditure aggregates: *social assistance* (+1.0 pp), *interest* (+0.6 pp), *goods and services* (+0.4 pp), *subsidies* (+0.4 pp), *other transfers* (+0.2 pp), *personnel* (+0.2 pp), *other expenditures* (+0.1 pp) and *capital expenditures* (+0.1 pp). It should be noted that, although the budget revisions made throughout 2022 marked an unprecedented upward adjustment of revenues in the history of revisions evaluated by the FC, these were fully allocated to increases in expenditure aggregates, leading even to additional increases in budget expenditures. Some of these increases were driven by the inadequacy of funds allocated in the initial budget for certain expenditure categories, a point highlighted by the FC in its opinion on the 2022 budget project. On the other hand, the main category of expenditures that did not meet the levels envisaged in the 2022 budget is represented by *projects financed from the amounts representing non-refundable financial assistance related to the NRRP* (-0.7 pp), an unfavourable situation caused by delays in initiating projects that resulted in a lower absorption of funds allocated through NRRP compared to the initial planning.

Similar to previous years, the analysis of the quarterly execution of budget expenditures[40] shows that they were concentrated in the final quarter of 2022. However, the share of the fourth quarter in total annual expenditures is marginally lower compared to 2021 (31% relative to 31.5%). Thus, total expenditures in the fourth quarter of 2022 amounted to approximately 167.9 billion lei (compared to 145 billion lei in the fourth quarter of 2021, representing a substantial increase of about 15.8%), being 26.3% higher than the level from the third quarter of 2022 (compared to a 38.8% increase in expenditures in the fourth quarter relative to the third quarter of 2021).

Analysing the evolution of expenditure structure in the fourth quarter of 2022 compared to the previous quarter, a significant acceleration is observed in several categories of expenditures: *capital expenditures* surged by 143.2%, respectively a contribution of 35.9% to the total increase Q4/Q3, *expenditures related to projects with financing from 2014-2020 post-accession non-reimbursable external funds* increased by 99.6%, respectively a contribution of 31.9% to the total increase Q4/Q3, *expenditures related to projects with financing from non-reimbursable external funds* also rose by 54.1%, respectively a contribution of 0.2% to the total increase Q4/Q3. Additionally, *expenditures on goods and services* increased by +34.6%, respectively a contribution of 17.2% to the total increase Q4/Q3. The combined contribution of the other categories of budget expenditures to the total increase in the fourth quarter compared to the previous quarter was only 14.9%. Notable among these are *personnel expenditures*, which contributed 4.1% (+4.9% compared to Q3), *subsidies* with a contribution of 3.3% (+20.6% compared to Q3) and *interest expenditures* with a contribution of 0.9% (+4.1% compared to Q3).

[40] Including the swap scheme.

Figure 10: Quarterly evolution of GCB revenues in 2022 (billion lei)	Figure 11: Quarterly evolution of GCB expenditures in 2022 (billion lei)
	

Source: MF (cash standards)

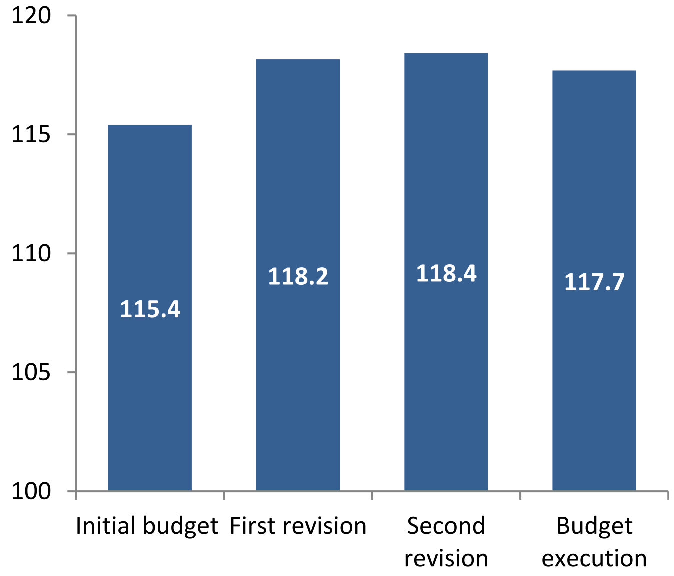
The concentration of expenditures in the final quarter of the year highlights significant deficiencies in the budget planning process, especially concerning public investment expenditures (capital expenditures and European funds), even though the principle of prudence could partially justify postponing certain expenditures until the point when the budget revenue projection has a lower degree of uncertainty. On the other hand, in 2022, the quarterly evolution of budget revenues indicates that they were largely realized in the final quarter of the year, albeit to a slightly lesser extent compared to the previous year (with a share of 28% in total annual revenues compared to 28.8% in 2021, representing an increase from the previous quarter of about 12%, compared to 16.3% in 2021). The FC reiterates the recommendation from previous years regarding the reduction of quarterly volatility in the execution of budget expenditures.

III.5.1. Personnel and social assistance expenditures

The execution of **personnel expenditures** recorded an increase of 2.3 billion lei compared to the level programmed in the draft budget for 2022. Initially estimated at 115.4 billion lei, their final value reached 117.7 billion lei, respectively 8.3% of GDP.

The forecasted evolution of personnel expenditures during 2022 recorded an excess compared to the ceilings defined by *Law no. 312/2021 for the approval of some indicators specified in the fiscal-budgetary framework for 2022*. Thus, on the occasion of the first budget revision, this expenditure aggregate was increased by approximately 2.75 billion lei (+2.4%), while the nominal GDP was revised upwards by 55.2 billion lei (+4.2%) compared to the estimates from the initial budget. In the second budget revision, personnel expenditures increased by 0.26 billion lei (+0.22%) compared to the previous budget iteration and by 3 billion lei (+2.61%) compared to the initial budget. At the same time, the level of nominal GDP was 78.9 billion lei (+5.99%) above the one estimated at the time of drafting the initial budget.

Figure 12: Personnel expenditures in 2022 (billion lei)



Source: MF (cash standards)

On the occasion of the first budget revision, the FC mentioned that the additional amounts allocated to personnel expenditures were directed mainly to the payment of salary rights established by court decisions and administrative acts, respectively to the granting of salary increases in education. Moreover, considering that the increase in personnel expenditures was not negligible, the FC emphasized the need for tight control, falling within the ceiling set by the budget revision entailing risks.

In the second budget revision, the FC mentioned that the increase in personnel expenditures was determined by additional allocations to the Ministry of Education, partially offset by the reduction in allocations to other ministries.

Compared to 2021, personnel expenditures increased by 5.8 billion lei, respectively by 5.17%. In 2022, there was an increase in the amounts paid on account of court rulings regarding the payment of salary differences for some categories of public employees. Thus, it can be noted that, in 2022, the enforceable titles paid (1,687 million lei) were higher than those paid in the previous year (1,348 million lei). Also, at the level of newly issued enforceable titles, an increase of 98.87% is observed in 2022 (2,460.6 million lei) compared to 2021 (1,237.3 million lei), so the amount recorded in 2022 will continue to affect the cash execution of the following years.

Table 7: Enforceable titles issued/paid on the account of the court decisions regarding the payment of salary differences for certain categories of public employees, million lei											
		2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**Total**
Enforceable titles issued, including Law no. 85/2016	Central administration (State budget)	3.8	82.3	1,599.4	67.4	996.9	1,461.6	2,812.3	1,163.3	2,340.5	11,067.6
	Local administration	1,614.4	1,064.1	2,094.3	20.3	0.0	0.0	10.3	74.0	117.1	6,442.7
	Social security budget	5.5	12.2	7.6	1.2	0.0	0.9	0.0	0.0	3.0	73.3
	Total	**1,623.6**	**1,158.5**	**3,701.2**	**88.9**	**996.9**	**1,462.5**	**2,822.6**	**1,237.3**	**2,460.6**	**15,123.0**
Enforceable titles paid, including Law no. 85/2016	Central administration (State budget)	1,531.7	1,234.6	363.1	476.2	80.8	999.7	1,551.5	1,314.6	1,652.9	9,678.4
	Local administration	2,447.2	2,806.1	544.6	705.0	79.2	947.7	17.5	31.4	33.8	8,071.5
	Social security budget	59.3	0.0	0.6	0.6	0.6	4.2	2.4	2.3	0.5	167.2
	Total	**4,038.2**	**4,040.7**	**908.4**	**1,181.8**	**160.6**	**1,951.6**	**1,571.5**	**1,348.3**	**1,687.2**	**16,229.9**

Source: MF

The average gross salary (*Figure 13*) in the public sector reached 7,297 lei/month in 2022, 4.18% higher than in 2021, surpassing by 17.4% the one in the private sector, which stood at 6,216 lei/month (increasing by 13.52% compared to the previous year). Considering quarterly averages, the average gross monthly salary in the public sector for the fourth quarter of 2022 recorded a level of 7,377 lei, 3.69% more than in the same period of 2021, while the salary in the private system was 6,594 lei, up by 14.8% compared to the fourth quarter of 2021.

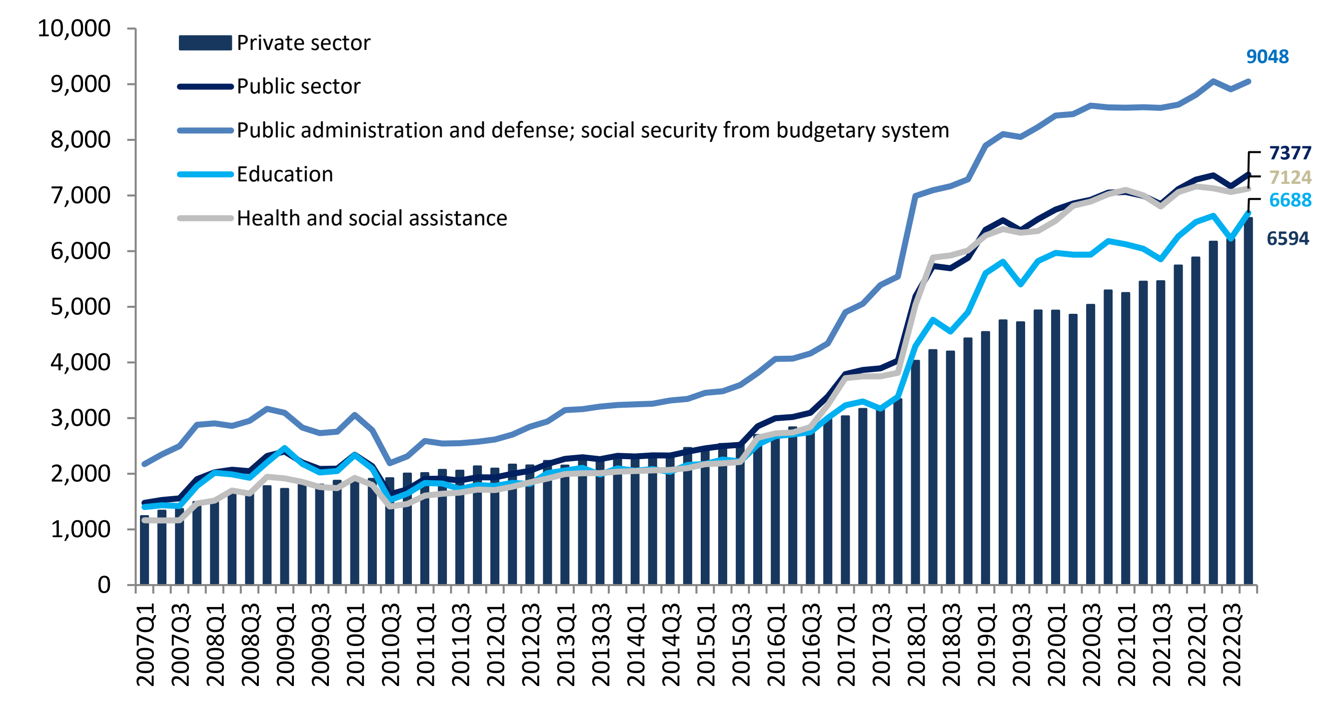
Taking into account the fields of activity of the public sector, the three most important by weight had the following evolution of the average gross salary in quarter IV of 2022 compared to quarter IV of 2021: in public administration and defence it increased by 4.82%, in education by 6.72%[41], and in healthcare by 0.89%.

After an increase by 165,600 people registered in the period 2005-2008, the total number of employees in the public sector decreased by 119,534 people between December 2008 and December 2022, to a level of 1.28 million (*Figure 14*). Practically, most of the staff reduction took place in the period 2009-2011, when the number of employees in the public sector decreased by about 180,000, while in the period 2012-2014 the decrease was about 9,540 positions. The adjustment registered in the period 2009-2022 occurred especially at the level of local executive authorities (-34,395 positions), the Ministry of Internal Affairs (-21,287 positions), other institutions financed entirely from own revenues (-12,353

[41] This increase comes mainly as a result of granting outstanding salary rights in education, following errors in the calculation of the amounts owed to employees in this sector.

positions), the Ministry of Finance (-8,886 positions), the Ministry of National Defence (-6,256 positions), the Ministry of Agriculture and Regional Development (-4,865 positions). On the other hand, during the same period, increases were recorded at the level of the healthcare system, including the Ministry of Health (+28,379 positions), the Ministry of Justice (+3,137 positions), the General Secretariat of the Government (+2,167 positions), the Ministry of Investments and European Projects (+1,560 positions) and the Ministry of Labour and Social Solidarity (+1,108 positions).

Figure 13: Average gross earnings in the private and public sectors between 2007-2022 (lei/month)

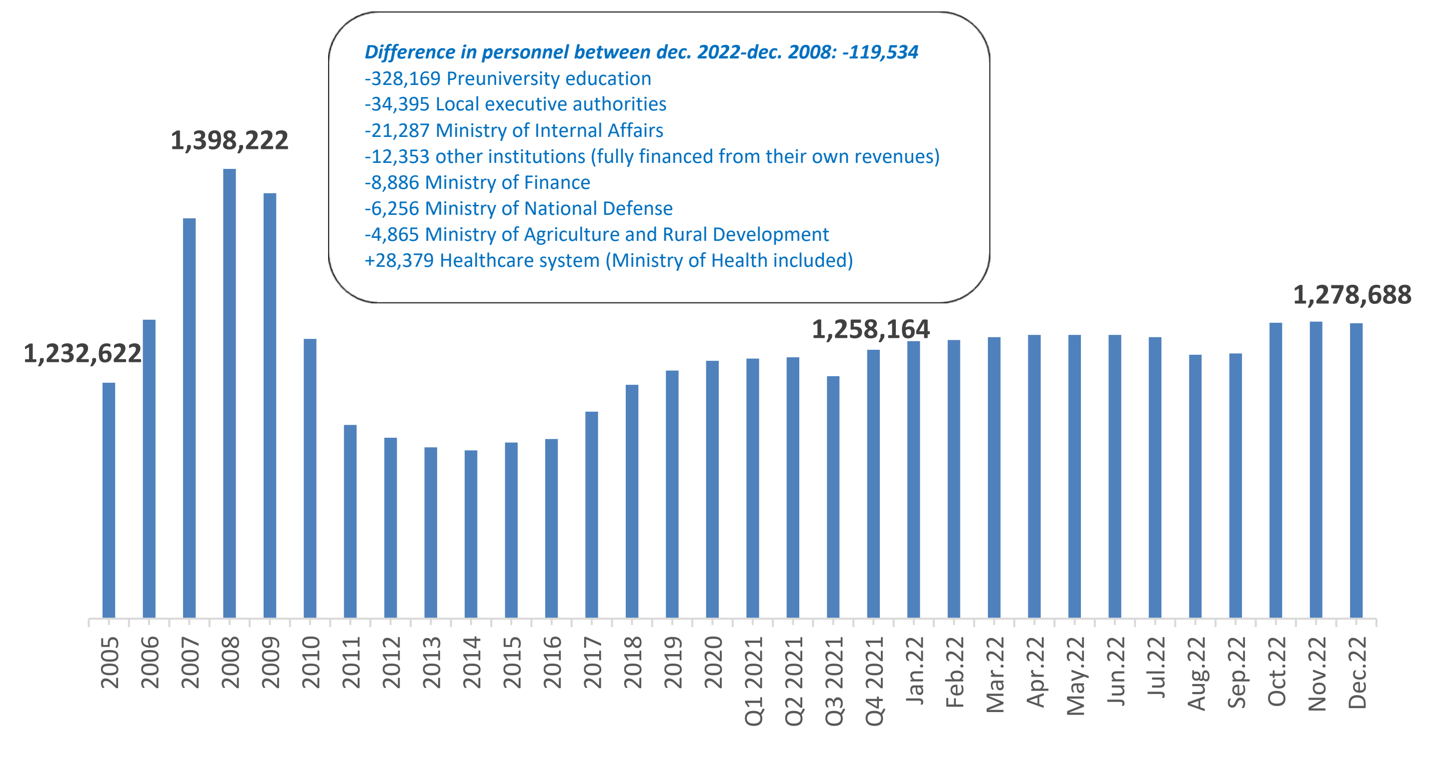


Source: NIS, FC's computation

At the same time, it should be mentioned that, in 2022, the growth rate of the number of employees was higher than the one recorded in the previous year, namely 1.3% (+16,370 people) compared to 1.02% (+12,694 people). Staff increases were registered especially at the level of the healthcare system, including the Ministry of Health (+6,109 positions), the Ministry of Education (+4,331 positions), the Ministry of Internal Affairs (+4,046 positions) and the Ministry of Finance (+446 positions)). On the other hand, the most important staff reductions were registered at the level of the Ministry of National Defence (-2,445 positions) and institutions fully financed from the social security budgets (-973 positions).

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

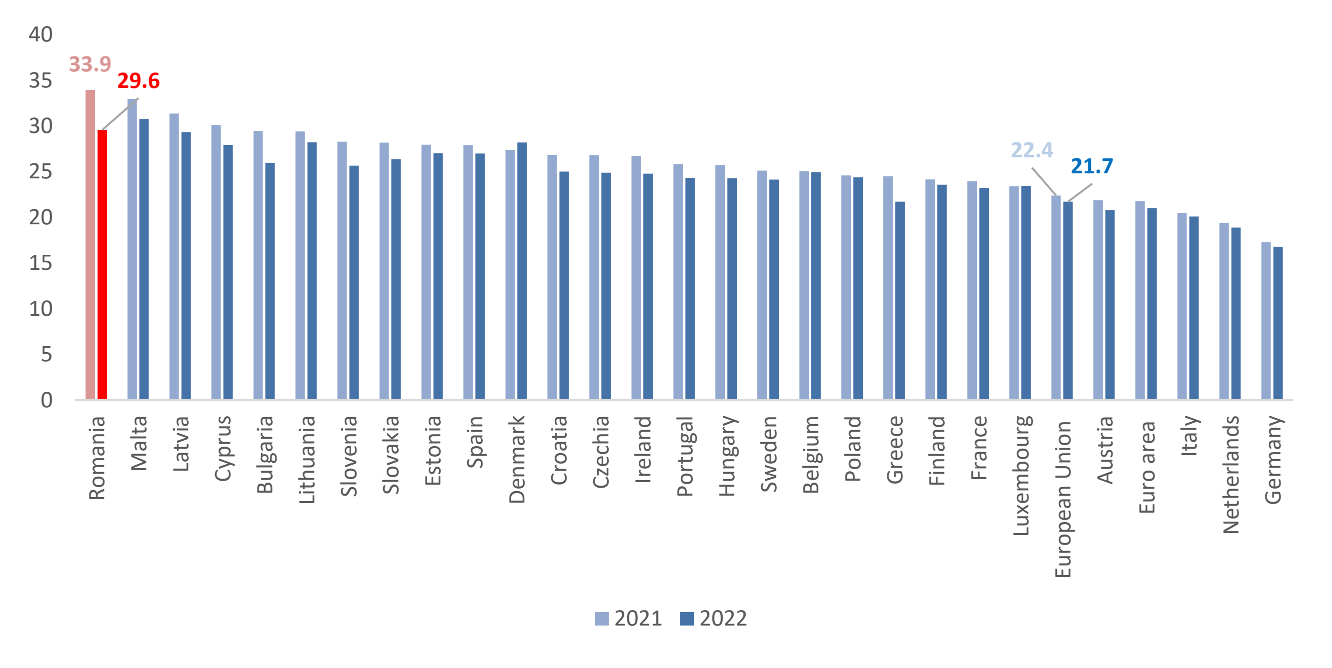
Figure 14: The evolution of public sector employment between 2005-2022



Source: MF

Regarding the ratio between public sector personnel expenditures and total budget revenues (*Figure 15*), according to ESA 2010 standards, in 2022, there is a decrease in this indicator compared to the previous year, Romania being overtaken by Malta (30.8%), which thus moves to the first position at EU level. Analysing the data from recent years, Romania ranked first of the 27 EU countries between 2018 and 2021. If until 2009 Romania was placed in the first half of the ranking, in terms of the ratio of personnel expenditures to total budget revenues (8th position in 2008 and 10th in 2009), in 2011, as a result of fiscal consolidation measures initiated in the middle of 2010, Romania dropped to the 19th position out of 27. In 2013, Romania reached the 17th position, due to salary recoveries and increases for certain categories of public employees, but in 2015 it ranked 20th out of 27, given a slight increase in budget revenues while personnel expenditures remained constant as a percentage of GDP. Starting with 2016, the situation changed and Romania climbed steeply to 10th place, reaching second place in 2017 and, since 2018, occupying the first position.

Figure 15: Personnel expenditures as a share of total budget revenues in EU27 countries

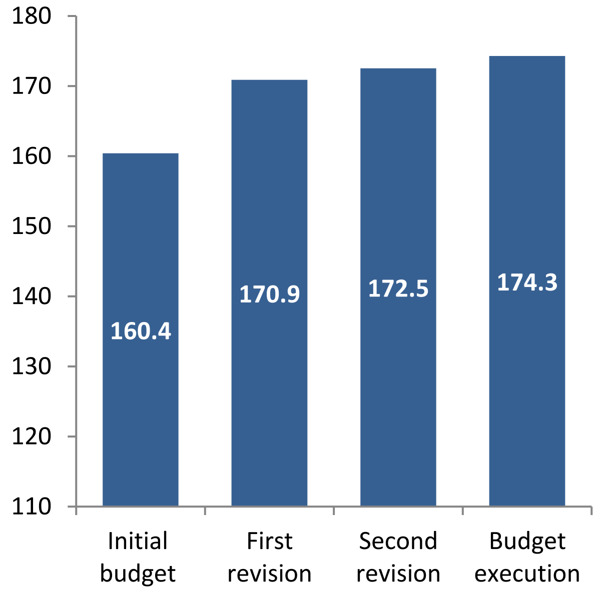


Source: Eurostat

Note: Given the change in the statistical treatment of special pensions by Eurostat, they are included in revenues from social security contributions and in personnel expenditures without an actual collection/payment taking place. Accordingly, in order to avoid double recording, the expenditures on special pensions have been removed from social security contributions and from personnel expenditures.

In 2022, **social assistance expenditures** recorded a level higher than the one envisaged in the initial budget, being revised upwards on the occasion of both budget revisions, mainly because they were underestimated in the initial budget, while also accounting for the increase in allocations for the settlement of medical leaves, granting a one-off support in July in the case of pensions less than or equal to 2,000 lei, supplementing the amounts for compensating electricity and natural gas prices, as well as supplementing the amounts for the payment of state military pensions. Consequently, despite being estimated at 160.4 billion lei in the 2022 budget, the actual execution of social assistance expenditures, net of swap compensation schemes, stood at 174.3 billion lei, 8.7% (the equivalent of about +13.9 billion lei) more than in the initial program.

Figure 16: Social assistance expenditures in 2022 (billion lei)



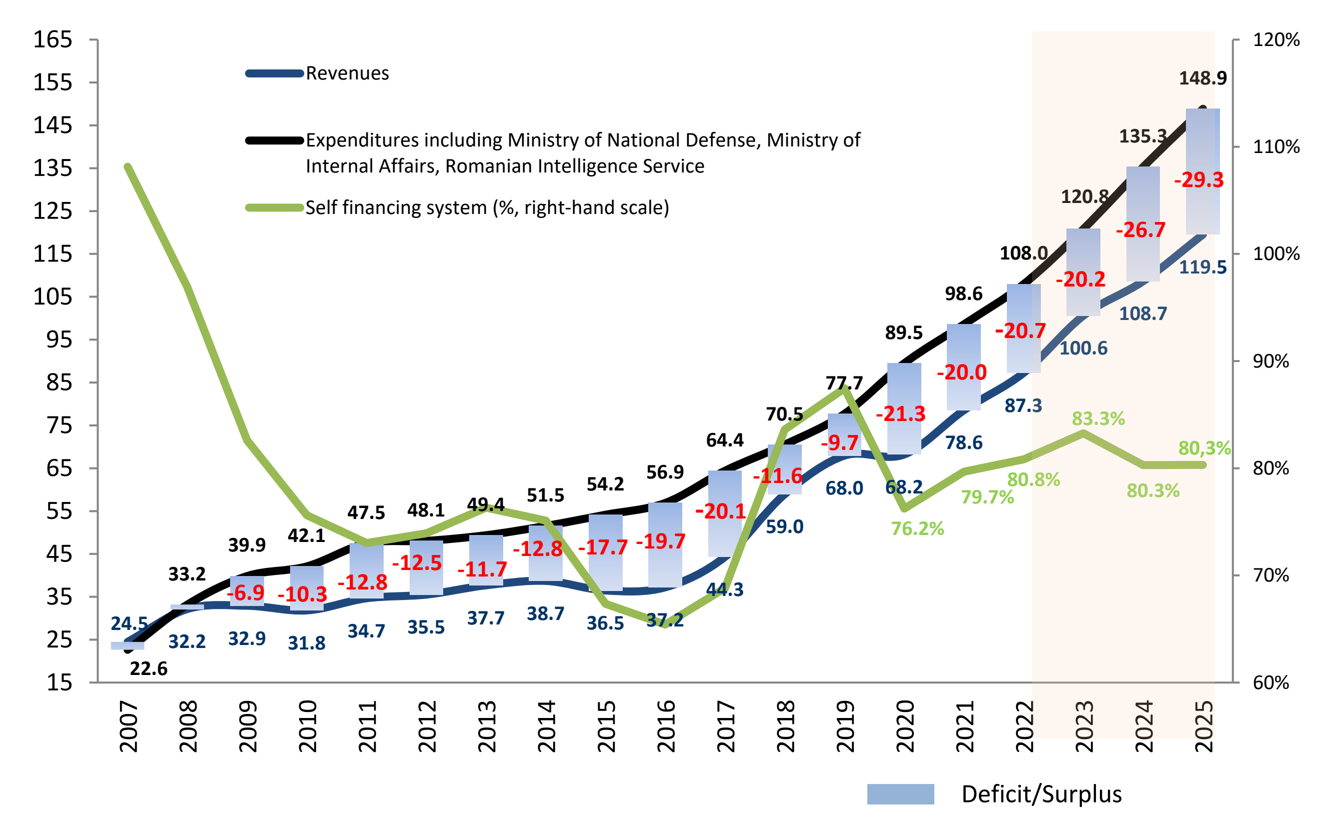
Source: MF (cash standards)

Starting from 2009, the deficit of the social security budget, including special/service pensions, has deepened significantly, reaching 20.7 billion lei in 2022 (*Figure 17*). In 2018, it was significantly reduced, dropping to 11.6 billion lei, mainly as a result of the adoption of fiscal measures regarding the resettlement of the taxation structure of income from salaries, pensions, independent activities and copyrights by transferring contributions from the employer to the employee.

Thus, although the total contribution rates apparently decreased from 39.25% to 37.25%, the transfer of contributions from the employer to the employee determined a significant increase in the gross salary, practically leading to an increase in the level of taxation through social security contributions by about 13.9%. In addition to the increase in labour taxation through SSC, the decrease of the deficit in 2018 is also explained by the reduction in the contribution rate to Pillar II of pensions (from 5.1% in 2017 to 3.75% in 2018). In 2019, the deficit of the social security budget continued to decrease, reaching the value of 9.7 billion lei, as a result of the increase in the number of employees in the economy. However, in 2020, the deficit of the social security budget deepened significantly both due to the increase in pensions and to the unfavourable evolution of revenues, as a result of the recession generated by the pandemic.

The estimates for the following years, according to data from the 2023-2025 Fiscal Strategy, show that the deficit of the social security budget will decrease slightly in 2023, registering a level of 20.2 billion lei, and will deepen significantly in the next two years, up to 29.3 billion lei in 2025. In its opinion on the draft budget for 2023, the FC drew attention to the fact that there are still risks regarding this expenditure aggregate, due to higher pensions of those who retire in 2023, compared to those who retired previously. At the same time, social expenditures (salaries, pensions and other social benefits), which in the European context, as a percentage of GDP, do not seem excessive, can be overwhelming relative to domestic tax revenues.

Figure 17: The evolution of revenues and expenditures from the social security budget (billion lei)



Source: MF (cash standards)

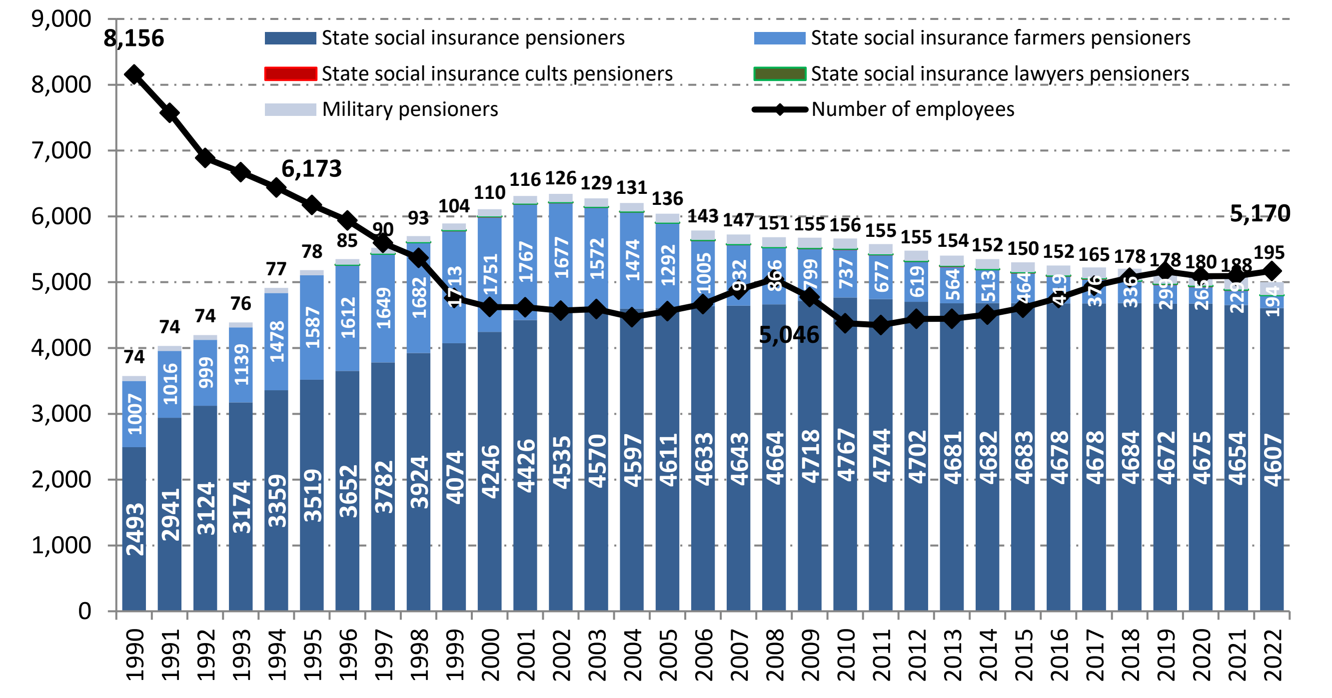
Note: In addition to the expenditures of the social security budget, military pensions were also included for the 2016-2022 period. According to Law no. 223/2015, since January 1, 2016 the necessary funds for paying military pensions and other social security rights due to military pensioners are provided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

The deficit, expressed as a percentage of GDP, decreased from 2.29% in 2011 to 1.92% in 2014, followed by an increase in 2015 to 2.48%, then by a significant decrease in 2018, to 1.20% of GDP, and in 2019, to 0.92%. The downward trend of the deficit as a share of GDP was reversed in 2020, its level reaching 1.99% of GDP, in the context of the economic contraction determined by the COVID-19 pandemic, but also of the significant increase in social assistance expenditures (by 15.15%), while the collected revenues remained relatively constant compared to 2019. In 2021, the deficit entered a slightly downward trend, reaching 1.69%, which was also maintained in 2022, when it reached 1.47%, and the projection for next year indicates a continuation of the reduction of the deficit to 1.27%. In 2024 it is expected to increase, followed by a relative stagnation in 2025[42] (1.52% and 1.53%).

[42] According to the growth assumptions presented by the Ministry of Finance in the 2023-2025 Fiscal Strategy.

The social security budget started recording deficits due to an excessive increase in its expenditures between 2007 and 2009 (+75.8%) and in the context of a favourable dynamics of SSC revenues in the period preceding the financial crisis, as a result of the economic boom, when it was anticipated that this trend would be kept in the following years. However, a significant part of the increase in SSC revenues turned out to be cyclical, with subsequent developments disproving the optimistic forecasts that underpinned the substantial increase in the pension point. The self-financing of the system decreased steeply from 111.8% in 2006 to 73.02% in 2011, reaching its historical minimum in 2016 (65.4%) and remaining close to it in 2017 (68.84%). In 2018, the self-financing capacity registered a slight recovery, reaching 83.6%, and the growth continued in 2019, to 87.5%. In 2020, there was a significant reduction in the degree of self-financing of the system, its value being 76.24%, followed by a slight increase to 79.68% in 2021 and then to 80.83% in 2022. The estimate for 2023 is more optimistic, self-financing being projected at 83.27%, while for the following years (2024 and 2025) it is expected to decrease to 80.3%.

Figure 18: The evolution of the number of pensioners versus the number of employees (thousand persons)



Source: NIS, except for the number of employees in 2021 and 2022, for which the source is NCSP, Spring Forecast 2023

The decision to increase permanent expenditures, such as those related to pensions, should take into account the trend of SSC revenues, as well as the forecasts regarding the employees-to-pensioners ratio, especially since, given the accentuation of the demographic aging phenomenon, on January 1, 2018 the elderly population aged 65 and over outnumbered the young population aged 0-14 (3,596 thousand versus 3,042 thousand people), according to NIS data. At the same time, it became evident the need to find an indexation rule that would ensure the long-term sustainability of the social security budget instead of the discretionary approach of the past.

The ratio between the number of taxpayers and the number of beneficiaries (*Figure 18*) has decreased very strongly in the last 30 years, from 2.28 employees per pensioner in 1990 to just 1.03 in 2022, with the number of state social security pensioners trending upwards, while the number of employees was trending downwards, especially until 1999-2002. Projections of the European Commission[43] estimate that this ratio will decrease to 0.74 employees per pensioner by 2050.

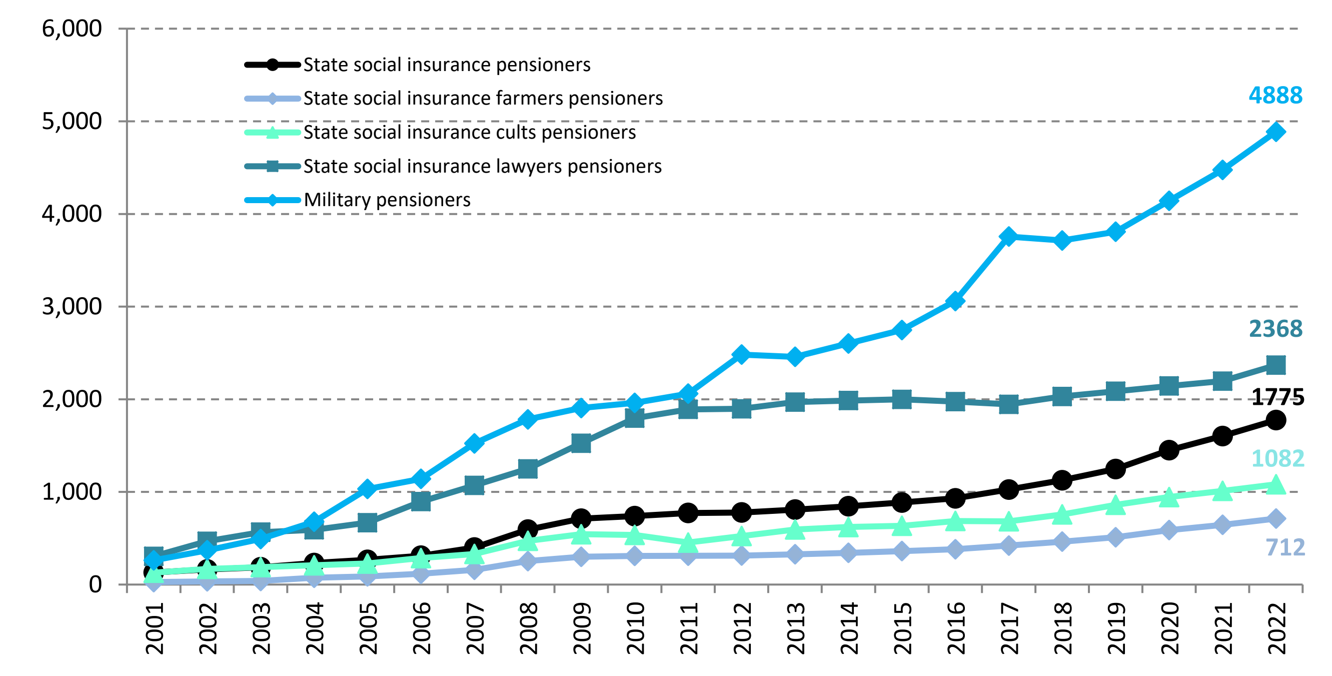
2022 marked significant developments in the aggregate of social assistance expenditures, on the occasion of both budget revisions. In the first budget revision, the aggregate was increased by 10.5 billion lei, this increase being due in particular to: supplementing the allocations for the settlement of medical leaves, granting a one-off support in July in the case of pensions less than or equal to 2,000 lei, supplementing the amounts for compensating electricity and natural gas prices, respectively supplementing the amounts for the payment of state military pensions. The FC had warned in its opinion on the draft budget for 2022 that the initial ceiling for this budgetary aggregate was significantly undersized. In the second budget revision of 2022, social assistance expenditures were supplemented by 1.6 billion lei, mainly as a result of the increase in allocations for the payment of benefits granted to families and children and those to the centralized general budget of administrative-territorial units.

The FC appreciates that the recurrent and large-scale overruns of the amounts provided for this budgetary aggregate signal deficiencies in budget programming and a lack of control in the management of social assistance expenditures.

According to NIS reports, in 2022, the average monthly pension (*Figure 19*) was 1,855 lei, up by 11.3% compared to the previous year, given the increase of the pension point to 1,586 lei in January 2022, from 1,442 lei. Pensions paid from the social security budget stood at an average level of 1,775 lei, and those corresponding to agricultural pensioners at 712 lei on average. At the same time, the pensions granted to the military reached an average monthly level of 4,888 lei, an increase of 413 lei (9.2%) compared to 2021. The average monthly pension corresponding to beneficiaries from the defence, public order and national security system recorded an increase of about 150% between 2010 and 2022. In the same period, the average monthly pension for pension beneficiaries from the social security budget increased by about 140%.

[43] According to *The 2021 Ageing Report: Economic and Budgetary Projections for the EU Member States (2019-2070)*, https://economy-finance.ec.europa.eu/publications/2021-ageing-report-economic-and-budgetary-projections-eu-member-states-2019-2070_en#files

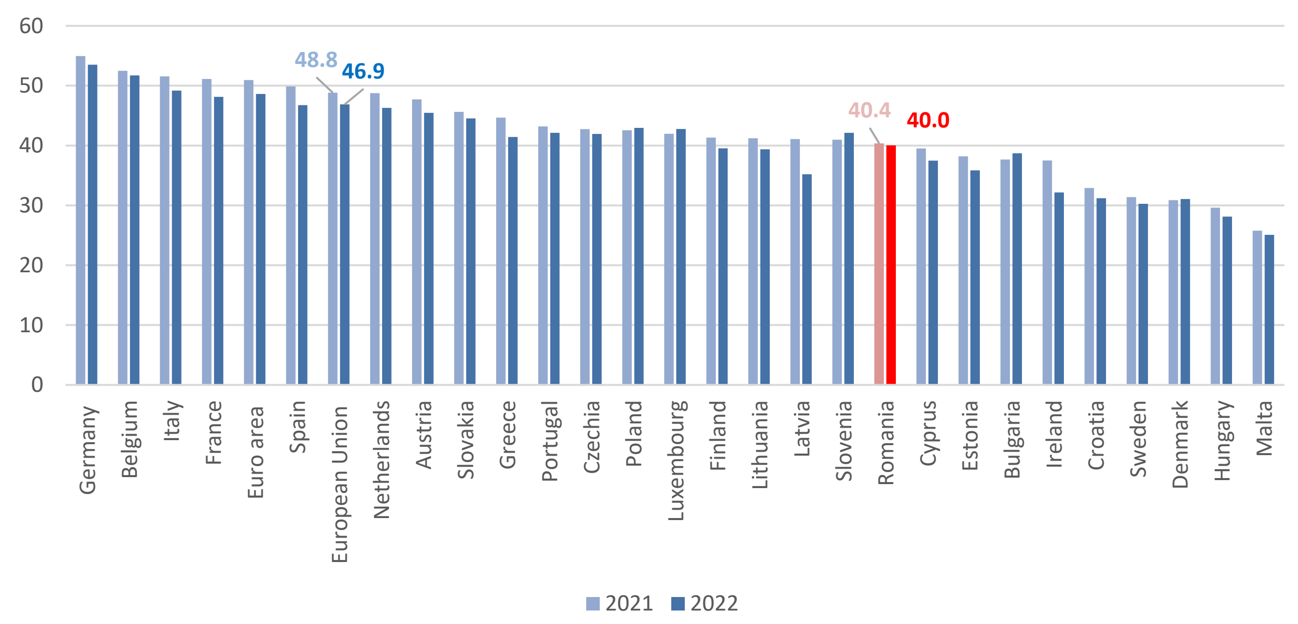
Figure 19: The evolution of the average pension (lei) between 2001-2022



Source: NIS

In 2022, Romania was 3 positions higher in the ranking of EU member states according to the share of social assistance expenditures in total budget revenues (*Figure 20*), respectively the 17th position, while in 2021 it occupied the 20th position. The share of social assistance expenditures in total budget revenues decreased in 2022 by 0.4 pp, compared to the previous year, a decrease determined by the slower growth rate of this category of expenditures relative to the growth rate of budget revenues.

Figure 20: Social assistance expenditures as a share of total budget revenues in EU27 countries



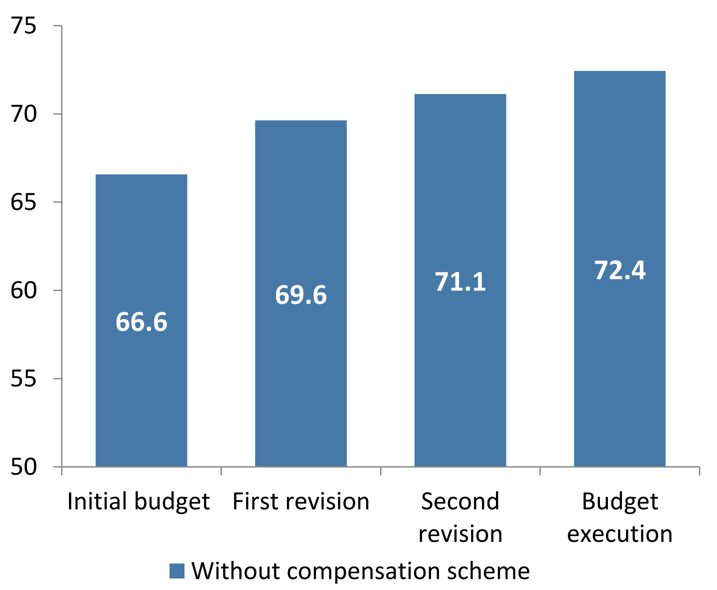
Source: Eurostat

Note: Given the change in the statistical treatment of special pensions by Eurostat, they are included in revenues from social security contributions and in personnel expenditures without an actual collection/payment taking place. Accordingly, in order to avoid double recording, the expenditures on special pensions have been removed from social security contributions and from personnel expenditures.

III.5.2. Goods and services expenditures

The execution of expenditures on **goods and services** recorded a higher level, both compared to the one envisaged in the initial budget (+5.8 billion lei) and relative to the values projected in the two budget revisions carried out during the year, driven by high inflation in 2022 and as a result of measures to combat the effects of the pandemic. Initially projected at 66.6 billion lei, the final execution of this aggregate reached a level of 72.4 billion lei, which is 2.8 billion lei higher than the value estimated in the first budget revision and 1.3 billion lei higher than the value from the second budget revision.

Figure 21: Goods and services expenditures in 2022 (billion lei)



Source: MF (cash standards)

Expressed as a percentage of GDP, expenditures on goods and services decreased by 0.3 pp compared to 2021, reaching a level of 5.1% of GDP. Relative to the 2021 budget execution (63.9 billion lei), this expenditure category (net of swap compensation schemes) was projected to increase by about 2.7 billion lei, according to initial budget estimates.

Throughout 2022, the budget allocation was increased on the occasion of both budget revisions. In the first budget revision, carried out in August 2022, the amount of expenditures on goods and services was revised upwards by 3 billion lei, representing a 9.3% increase over the nominal level of this aggregate in 2021 (the growth rate from 2020 to 2021 was 12.5%, and from 2019 to 2020 was 7.2%). However, in the first six months of 2022 the growth rate of this budgetary aggregate was 14.3% compared to the same period of the previous year. The FC noted the substantial increase in this expenditure category, partially justified by an unexpectedly high inflation rate, as well as by the inadequate amounts allocated in the initial budget. However, the FC assessed that the conducted revision was insufficient, likely requiring an additional allocation of around 3 billion lei. In fact, the FC had already pointed out in its opinion on the initial budget that compliance with the proposed level for 2022 would have been possible only given a tight control of expenditures on goods and services, a control that had not operated efficiently in 2021.

During the second budget revision, expenditures on goods and services were once again revised upwards. The successive increases in expenditures on goods and services through both budget revisions, although partially justified by the high inflation in 2022, confirmed the risks highlighted by the FC in its opinions. Furthermore, considering the execution in the first 10 months, the limit set by the second revision appeared to be insufficient, the FC estimating an additional need of around 1.5 billion lei.

The final execution of expenditures on goods and services confirmed the FC's assessment from the second budget revision, reaching a level of 72.4 billion lei, which was 1.5 billion lei higher than the value projected in the second revision. According to the accompanying note to the general consolidated budget execution for 2022, this budgetary aggregate experienced an increase of 17.1% at the level of local budgets and of 9.3% at the level of the National Health Insurance Fund compared to the previous year.

The expenditures on goods and services have proven to be difficult to control, a situation that is similar to previous years. Thus, during the periods 2011-2013 and 2017-2021, the execution of expenditures on goods and services (net of swap compensation schemes) exceeded the initially budgeted level or even the revised upward limits set during budget revisions. In contrast, the period 2014-2016 was characterized by a different situation, where the final execution recorded a lower level of expenditures compared to the last budget iteration.

The FC highlights a chronic lack of transparency in projecting this expenditure aggregate, particularly regarding the assumptions that underlie its trajectory. The reasons behind significant revisions made throughout the year are not explained in the documents accompanying budget iterations. These explanations are all the more necessary as changes are often substantial and have the potential to impact the achievement of the budget deficit target or the compliance with fiscal rules. The FC advocates for a budget planning process that encompasses all expenditures within this category in the draft budget, along with an appropriate breakdown of fund allocations, as well as comprehensive explanations during budget revisions regarding potential increases in this expenditure category. Improved transparency could serve as a good starting point in optimizing expenditures on goods and services, but this should be accompanied by a comprehensive reform of the public procurement system.

III.5.3. Public investment expenditures

Investment expenditures include, according to the budget classification, *capital expenditures* (non-financial assets), *projects financed from post-accession non-reimbursable external funds*, *expenditures related to reimbursable financing programs*, *capital transfers* and *other transfers of an investment nature* and, starting with 2022, the *projects financed from the amounts representing non-refundable financial assistance related to the NRRP*, respectively the *projects financed from the amounts related to the loan component of the NRRP*. Within this chapter, the structural analysis of this budgetary aggregate complies with the above definition.

In the initial budget construction of 2022, investment expenditures, in cash standards, were estimated significantly above the value from the 2021 program (by 26.4 billion lei), respectively at 88.4 billion lei, including the amounts related to the swap compensation scheme. The financing structure was designed in favour of internal sources of financing (*capital expenditures and other investment-type transfers* accumulating 54% of the total, 6 pp above the share of the initial budget of 2021), with external sources representing 46% of the total (compared to the 52% share of the initial 2021 budget). This evolution can also be explained by the fact that 2022 is the penultimate year in which amounts can be absorbed through the MFF 2014-2020, which calls for additional expenses related to the co-financing of ongoing projects. The FC consistently supports increasing the share of European funds in the financing structure of public investments, taking into account the general economic context characterized by uncertainty, which calls for increased efficiency in the allocation of domestic funds.

In execution, the increase compared to the previous year was 13.3 billion lei (at a level of 72.5 billion lei), respectively a 22% increase in nominal terms[44]. In terms of structure, compared to the previous year, the advance was made on account of all components, respectively: *projects with financing from post-accession non-refundable external funds* (+8.4 billion lei), *projects with financing from the amounts representing non-refundable financial assistance and loans related to NRRP*[45] (+0.9 billion lei), while internal sources were higher by about 4 billion lei compared to 2021. Thus, in 2022 the ratio between internal and external sources[46] of financing public investment expenditures was again larger than 1, after in the previous year it was smaller than 1 for the first time since 2015[47].

[44] More than the GDP growth in nominal terms, which was around 19.3%.

[45] This aggregate appears for the first time in 2022.

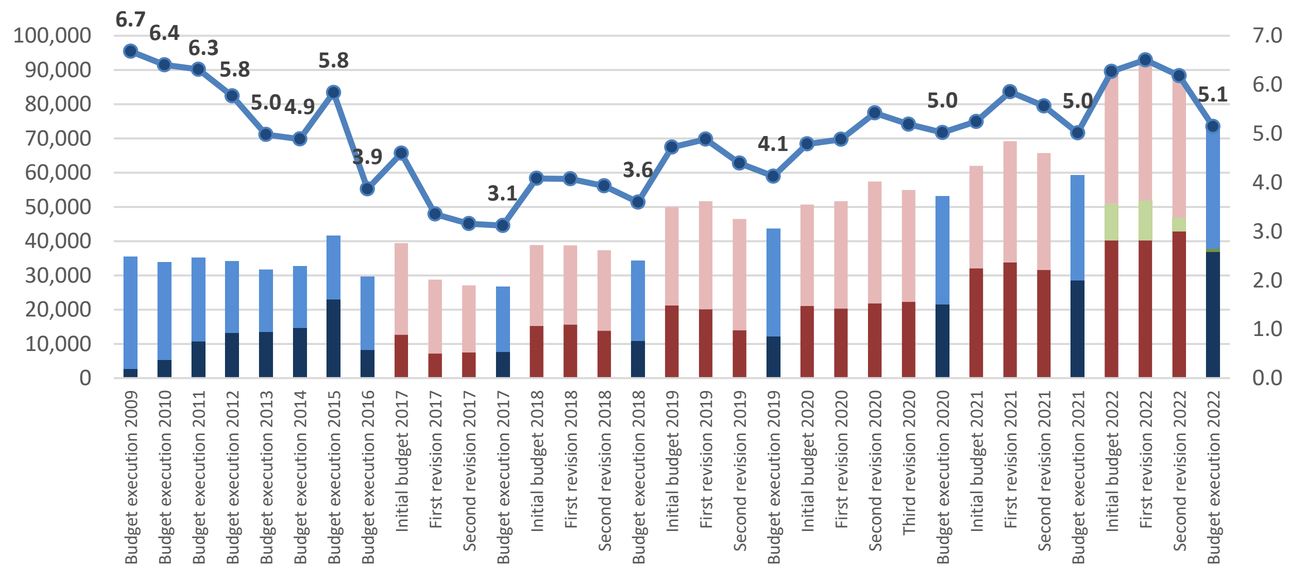
[46] Starting with 2022, this category also includes *projects with financing from the amounts representing non-refundable financial assistance and loans related to NRRP.*

[47] Respectively 108% from 99% in 2021, 134% in 2020 and 235% in 2019. In 2015, which marked a maximum degree of absorption of European funds (2007-2014 MFF), the ratio was 74%.

The share of investment expenditures in GDP reached 5.1% in 2022, 0.1 pp above the level recorded in the previous year (5%), representing an advance of approximately 1.5 pp compared to the average of the 2016-2019 period, but still below the average of the 2009-2015 period (5.8% of GDP) by 0.7 pp.

The evolution of this budgetary aggregate from the perspective of the comparison between the actual execution and the values planned in the initial budget, or established on the occasion of budget revisions, is illustrated in *Figure 22* for the period 2017-2022, the execution results for the period 2009-2016 being also presented. In recent years, a high volatility of forecasts regarding public investment expenditures has been observed, the execution results being lower than the estimates from the initial budgets (with the exception of 2020) and, without exception, than the estimates from the revisions.

Figure 22: Investment expenditures between 2009-2022



Source: MF (cash standards)

The evolution in 2022 does not deviate from this trend, with a gap of 15.9 billion lei between execution and the level programmed in the initial budget, of which the largest non-realization, of 9.7 billion lei, was in the amounts related to NRRP, followed by projects with financing from post-accession non-refundable external funds (-3.4 billion lei) and the amounts related to own and borrowed funds (-2.7 billion lei). Compared to the estimate from the first budget revision, the difference was -19.2 billion lei, due to a massive failure to realize investments from the NRRP (-10.8 billion lei), followed by a non-execution at the level of own and borrowed funds of about 5 billion lei, respectively of 3.4 billion lei at the level of post-accession non-refundable external funds. Between the execution and the level proposed in the second revision, operated in November, the gap decreased compared to the first revision, but remained at alarming levels (-14.6 billion lei, approximately 1% of GDP), generated mainly by the failure to meet the target for projects financed from post-accession non-refundable external funds (-5.96 billion lei), followed by own and borrowed funds (-5.5 billion lei) and amounts related to the NRRP (-3.2 billion lei). The FC appreciates the intention to finance an important part of public investment expenditures from external funds (considering the very low level of tax revenues in Romania), but major non-achievement of investment targets (over 1 pp of GDP), such as those from 2022, shows deficiencies in the budgeting process, which can make the budget consolidation mission difficult, taking into account the need for prioritization, given the constraint of the current fiscal space.

Also, the quarterly distribution of the share of investment expenditures in total execution shows high volatility, fluctuating from 11.1% in the first quarter, to 17.4% in the second quarter, to 24.5% in the third quarter, and to 47.1% in the last quarter. Practically, in the last 3 months of the year, investment expenditures were 2.7 times higher than the average of the previous three quarters. Considering the fact that, in previous years, the same pattern has also manifested systematically, this practice questions the efficiency of the budget programming process from the perspective of managing investment projects and establishing the criteria for their implementation in accordance with their importance and utility.

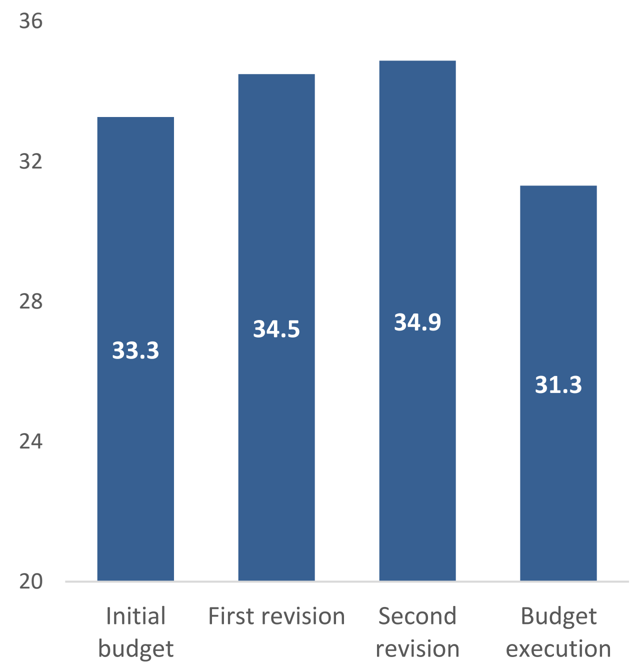
Next, the evolution of the main components of investment expenditures during 2022 is presented (summed up, they represent about 95% of the total) by comparing the execution levels with those programmed in the initial budget and in the two budget revisions, illustrated in *Figures 23*, *24* and *25*.

In 2022, *capital expenditures* for public investments [48] were projected in the initial budget at a level of 33.3 billion lei, excluding the impact of swap compensation schemes. Compared to the amounts spent in 2021, this level represents an increase of 5.1 billion lei.

The final execution recorded a level that was 2 billion lei below the program established in the initial budget of 2022 (-6%).

The two budget revisions operated during the year proposed successive increases in capital expenditures (+1.2 billion lei, respectively +0.4 billion lei), unlike public investment expenditures, which were supplemented on the occasion of the first budget revision (+3.3 billion lei), but were later reduced by 4.5 billion lei on the occasion of the second budget revision.

Figure 23: Capital expenditures in 2022 (billion lei)



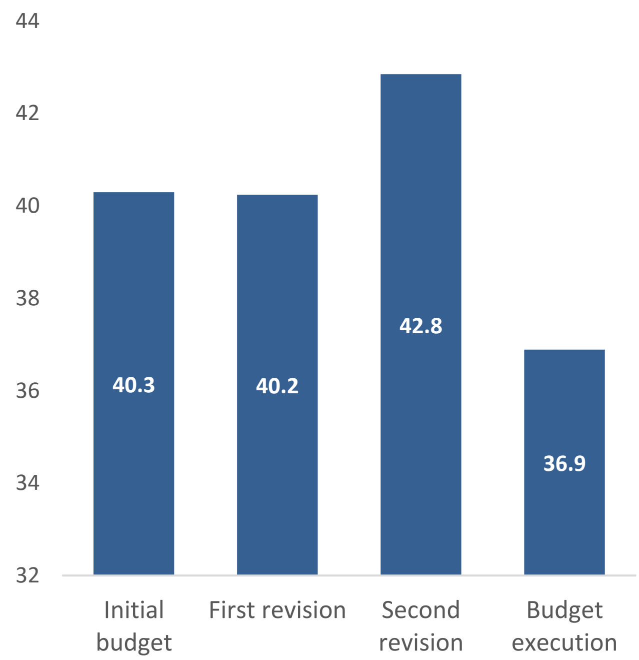
Source: MF (cash standards)

[48] They represent the main component of capital expenditures from the GCB (which also include capital transfers and inventories).

In its opinion regarding the first budget revision, the Fiscal Council noted that the increase in this category of expenditures was mainly found at the level of the state budget, respectively of the administrative-territorial units. As for the second revision, the FC stated that the increase was mainly determined by supplementary allocations to C.N.A.I.R., to which was added the reduction of the swap compensation scheme, these changes being partially counterbalanced by a decrease in the amounts allocated to institutions fully and/or partially financed from own revenues and to the state budget.

The projects financed from post-accession non-reimbursable external funds (NREF) intended for public investments were projected in the initial budget of 2022 at a higher level than in the program of the previous year (+8.2 billion lei), respectively by 11.8 billion lei above the level recorded in the budget execution of 2021. The final execution of 2022 registered a non-realization of 3.4 billion lei compared to the budgeted level, the program achievement rate reaching 91.5%. However, this represents an increase compared to the previous year, when it was 88.7%. Compared to the 2021 execution of NREF projects intended for public investments, in 2022 there was an increase by 8.4 billion lei. In what concerns the total amounts related to the 2014-2020 Multiannual Financial Framework, the increase compared to 2021 was of about 8.12 billion lei.

Figure 24: Projects financed from post-accession NREF in 2022 (billion lei)



Source: MF (cash standards)

Box 1: Changing the scope of budget revenues and expenditures for projects funded by non-reimbursable external funds during the 2016-2022 period

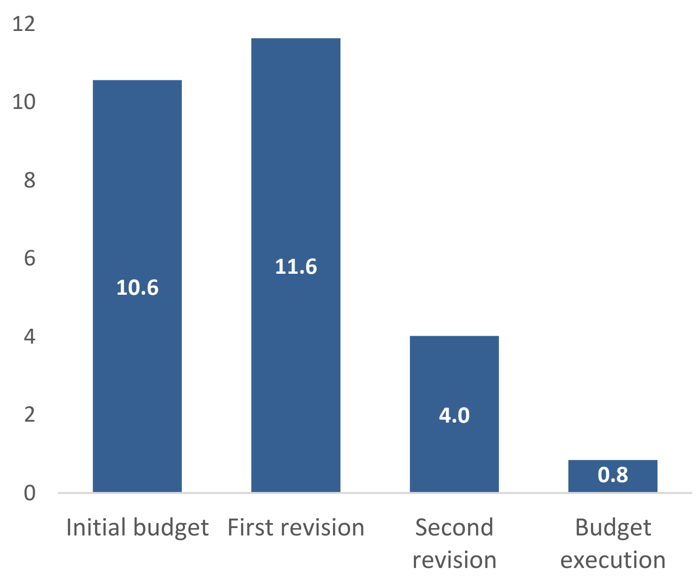
Starting with 2016, the category of *projects financed from post-accession non-reimbursable external funds (NREF),* most of which is intended for investments, also includes funds for agriculture, which in previous years were not included in NREF, considering that these funds are allocated to the private sector. Since 2017, in addition to funds for agriculture, in this category have been included, according to art. 10 of GEO no. 40/2015, the amounts representing funds intended for pre-financing of non-governmental projects in case of temporary unavailability of European funds (TUEF). Thus, in 2022, out of the total of 60.4 billion lei related to projects financed from post-accession NREF 2014-2020, 21.7 billion lei were allocated to payments for agriculture (respectively EAGF and EMFF related to the 2014-2020 Multiannual Financial Framework) and 7.9 billion lei for TUEF. From the difference of 38.7 billion lei, representing structural and cohesion funds whose final beneficiary is the state, 36.9 billion lei (95%) were allocated to investment expenditures. In 2015, which recorded the maximum absorption of the amounts related to the 2007-2013 Multiannual Financial Framework, NREF totalled 24.6 billion lei (of which 0.5 billion lei related to the 2014-2020 Multiannual Financial Framework), 23 billion lei being allocated for investment expenditures (94% of the total post-accession NREF). We mention that, from the perspective of the ESA 2010 methodology, only the structural funds whose final beneficiary is the state are relevant, the amounts intended for agriculture and the pre-financing granted to the non-governmental sector not being included in the public administration sector. Moreover, the fact that amounts intended for agriculture and TUEF are transiting the GCB makes it practically impossible, at an aggregate level, to compare the data from the budget execution for the 2016-2023 period with the flows of European funds from the 2007-2013 Multiannual Financial Framework.

The projects financed from the amounts representing non-refundable financial assistance and loans related to the NRRP were estimated in the initial budget of 2022 at a level of 10.6 billion lei.

On the occasion of the first budget revision, these amounts were increased to the level of 11.6 billion lei, the loan component having the most important contribution to the increase (about 1 billion lei).

At the second budget revision from 2022, this category of expenditures was significantly reduced, by 7.6 billion lei, due to delays in starting the projects compared to initial estimates. Therefore, as the projects are implemented, the amounts related to the NRRP will be recorded both on the revenues and expenditure side.

Figure 25: The evolution of expenditures with projects financed from the amounts representing non-reimbursable financial assistance and loans related to the NRRP in 2022 (billion lei)

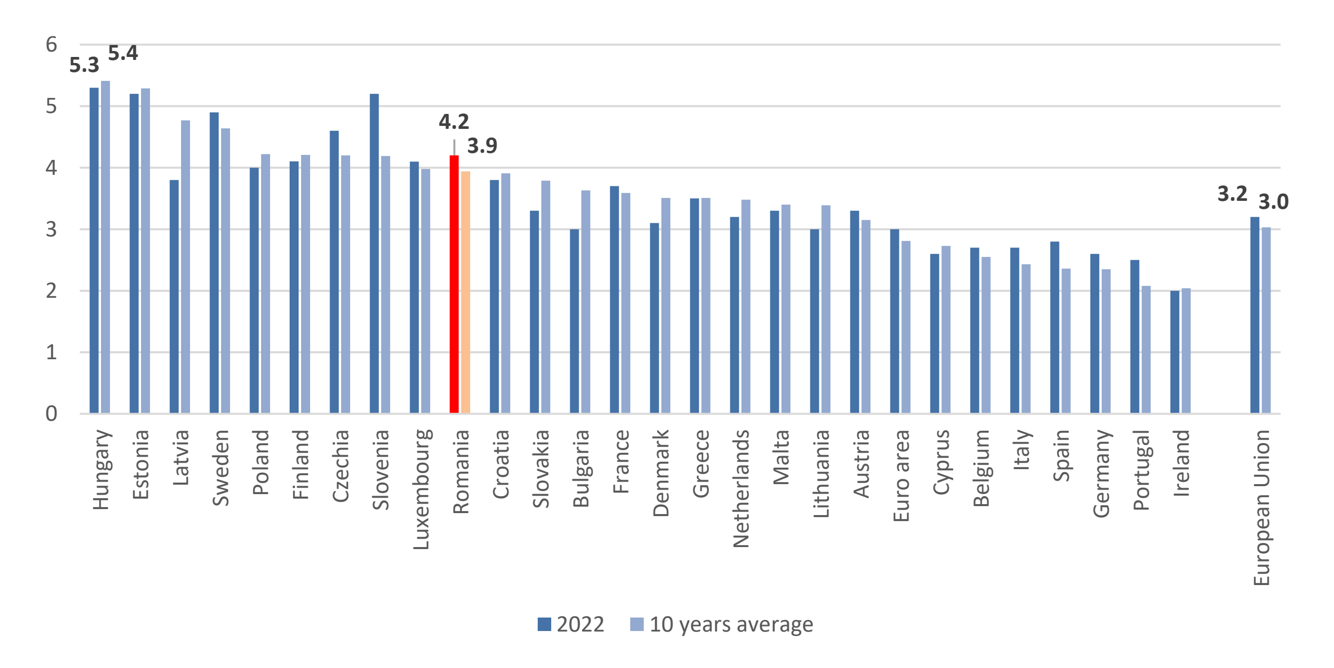


Source: MF (cash standards)

According to the data on the execution of the GCB, the expenditures with projects financed from the amounts representing non-refundable financial assistance and loans related to the NRRP stood at just 0.8 billion lei, approximately 7.5% of the initially budgeted amount. The Fiscal Council draws attention to the fact that an additional impact on the deficit can be exerted by the amounts related to the loan component of the NRRP, to the extent that it is not possible to accommodate them by restricting other categories of expenses and/or by increasing budget revenues. An important constraint, however, is represented by the current very limited fiscal space.

An analysis of the efficiency of investment spending over the last 10 years reveals an unsatisfactory result for our country compared to the evolution of the indicator in other EU member states. Given that Romania had, in the last decade, one of the highest shares of capital expenditures in GDP compared to the EU average, the infrastructure is insufficient, both in terms of quantity and quality, signalling a low efficiency of public investment expenditures. Thus, in the period 2013-2022, the share of capital expenditures in GDP (*Figure 26*) placed Romania in the first half of the ranking (10th place in the EU27), respectively with a 10-year average of 3.9% of GDP, approximately 1 pp above the EU27 average. Compared to the first ranked, Hungary, the gap is 1.5 pp, and compared to the second ranked, Estonia, it is 1.4 pp. The gap decreases at the level of 2022 (-1.1 pp compared to Hungary and -1 pp compared to Estonia).

Figure 26: Capital expenditures in 2022 and the 10-year average (% GDP, ESA 2010)



Source: Eurostat

The analyses developed in recent years by the EC and various international financial institutions[49] show that, systematically, the quality of infrastructure in Romania is among the lowest in Europe, especially in critical sectors, such as road, rail and energy infrastructure, due to the modest results recorded by most state-owned enterprises – the main infrastructure providers in these areas – and to the lack of progress in restructuring loss-making enterprises. According to the most recent FC analysis[50] regarding the performance of state-owned companies, the rate of new investments (% of total assets) in these companies has had a fluctuating evolution over time and, although increasing in recent years (7.2% in

[49] For example, *Assessment of the infrastructure governance* (World Bank, 2020), *Global Competitiveness Report* (World Economic Forum, 2019), *Romania Diagnostic* (Milatovic and Szczurek, 2020) etc.

[50] http://www.fiscalcouncil.ro/SOE%202021%20EN%2017.04%20final.pdf

2021, 5.3% in 2020, 5.8% in 2019 compared to 1.3% in 2018 or 4.7% in 2015), it is still at a level well below the average of the pre-crisis period (about 12%).

In *the EC Country Report* [51], it is stated that regional disparities remain high, especially as a result of the labour productivity gap between them. At the same time, it is also stated that the less developed regions find it more difficult to recover the development gaps, given that they lack important assets, such as adequate transport infrastructure or a highly qualified workforce, also facing the phenomenon of depopulation. Regarding the transition to a green economy, the EC report shows that progress is being made in implementing reforms related to sustainable transport, decarbonization or road safety. Also, in this report reference is made to the *EIB Investment Survey*[52] from 2022, which states that, in Romania, 71% of respondents believe that the local business environment is negatively influenced by the quality of transport infrastructure, in contrast to 48% of respondents at the EU level.

Also, the *Report prepared by the OECD* in 2022[53] mentioned the precarious state of the transport infrastructure, its quality being at a very low level. The study shows that, compared to countries that have similar institutional arrangements (a centralized model), the difficulties in infrastructure development in Romania denote problems in the implementation of specific investment projects. The OECD report points to factors that contributed to this situation: the low degree of absorption of European funds (along with substantial time and cost overruns), the low quality of the preparation of investment projects with economic impact, inefficiency in the preparation, prioritization and implementation of projects, frequent changes in legislation and the poor governance of state-owned enterprises in the field.

In 2022, the investment revival of the last two years has continued, the share of public investments in GDP being above the average of the last 10 years, namely 5.1% compared to an average of 4.5% of GDP (but still below the value recorded in 2015, of 5.8% of GDP). Compared to a 10-year average of the share of investments in budget revenues of 14.4%, in 2022 they represented 15.7% (compared to 17.8% in 2015, the only value higher than that of 2022 in the last 10 years). Given the significant volume of European funds that Romania benefits from[54], increasing public investments through improved absorption is essential to eliminate infrastructure gaps, simultaneously with increasing the quality of programming and implementation of investment projects.

Considering that there is plenty of space to improve the efficiency of spending public funds allocated to investments, the Government initiated a reform process regarding the management of public investments in the 2013 - March 2014 period[55].

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[51] https://economy-finance.ec.europa.eu/system/files/2023-05/RO_SWD_2023_623_en.pdf

[52] https://www.eib.org/en/publications/online/investment-survey-european-union

[53] *OECD Economic Surveys*: Romania 2022.

[54] 31 billion euros from the cohesion policy related to the Multiannual Financial Framework 2021-2027, to which NRRP resources are added: 12.1 billion euros in grants and 15 billion euros in the form of loans.

[55] In accordance with the requirements of the new legal framework, before approving the budget, the Ministry of Finance is obliged to present to the Government the list of prioritized significant public investment projects to be

- In this sense, a technical assistance contract on *"Improving the management of public investments"* was signed with the WB, with the aim of improving the process of preparation, selection and strategic prioritization of public investment projects, which was completed in December 2015. During 2016, the recommendations for improving the selection process of public investments and strengthening the role of the Public Investment Evaluation Unit in the related legislation have been implemented (GEO no. 88/2013[56], GD no. 225/2014).
- Starting with 2017 there are applicable the provisions of *Decision no. 907/2016* regarding the elaboration stages and the framework of the technical-economic documentation related to investment objectives/projects financed from public funds, in order to eliminate the deficiencies of the investment process, to optimize financing and the achievement of investment objectives and to increase the efficiency of the use of public funds.
- By *Decision no. 363/2018 for the modification and completion of the Methodological Norms regarding the prioritization of public investment projects*, new clarifications have been brought to the procedure for prioritizing new investments, but additional efforts are needed for the prioritization of public investment projects and their preparation.
- *Romania's General Transport Master Plan (GTMP)*, adopted in 2016, represented an important step towards improving the implementation of strategic investments in road and railway transport infrastructure, the *2014-2030 GTMP Implementation Strategy* constituting the general framework for the prioritization and implementation of infrastructure projects. Until now the application of the GTMP registers a very slow pace of progress.
- *Romania's National Recovery and Resilience Plan (NRRP),* approved by the EC in September 2021, represents an anchor for strengthening the potential for economic growth, through the implementation of the package of investments and reforms carried out in accordance with the country-specific recommendations, being coordinated at the national level by the Ministry of Investments and European Projects. The *NRRP* is based on six pillars (green transition, digital transformation, smart growth, social and territorial cohesion, health and institutional resilience and policies for the next generation) and includes measures on sustainable transport, education, health, renovation of buildings and digitalization of the public administration. The reforms in the *NRRP* include regulatory changes aimed at boosting zero-emission road transport, improving road safety and encouraging modal shift to railways and inland waterways.

The investment revival from 2020 which, in the context of the temporary shutdown of some production capacities and of an extremely high level of uncertainty, significantly contributed to mitigating the economic contraction, showed the positive effect of a sustained dynamic of productive investments. Considering this aspect, the Fiscal Council pleads for the acceleration of efforts regarding the implementation of real reform measures in the field of public investments in order to make the most of

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financed through the state budget, these being selected according to opportunity, economic and social justification, financial affordability, the remaining period until completion, the commitments undertaken by Romania with international financial institutions.

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

the opportunity to access European funds allocated through the 2021-2027 Multiannual Financial Framework and through the NRRP for the implementation of reforms that address Romania's acute investment priorities.

The Fiscal Council pleads in favour of the firm application of the legal framework regarding the management of public investments and appreciates that extremely limited progress has been made regarding the reform in this area, decisive steps being necessary to increase transparency in the process of prioritizing public investments and to improve the efficiency of the allocation and spending of public money. Such steps are: the streamlining of the public procurement process, the resumption of the corporate governance reform in state-owned companies, strategic planning in the field of investments (directing them to key policy areas and strengthening the prioritization of public investment projects), the consultation of the private sector when adopting measures that have an impact on it and creating a legal institutional framework for evaluating the impact of legislative regulations in the field.

The Fiscal Council appreciates that a good prioritization of investments, their orientation towards research, development and innovation activities in strategic areas, in the physical infrastructure and especially in the digital one, can contribute to the reduction of regional disparities and to the improvement of productivity and long-term growth of the Romanian economy.

In this sense, a better absorption of European funds from the 2021-2027 Multiannual Financial Framework and access to the resources available through the NRRP are prerequisites for the upward investment trend of the last two years to be significantly accentuated in the medium term, allowing a rapid economic growth in parallel with the adjustment of the budget deficit according to Romania's commitment within the EDP.

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

In accordance with art. 30 of the Public Finance Law no. 500/2002, with subsequent amendments and additions, **the contingency reserve fund** at the Government's disposal and **the intervention fund** at the Government's disposal are included in the state budget.

The contingency reserve fund at the Government's disposal is allocated to main authorizing officers of the state budget and local budgets, based on Government decisions, for financing urgent or unforeseen expenditures arising during the budget exercise. The allocation of amounts from the contingency reserve fund at the Government disposal, for local budgets, is done by increasing the amounts subtracted from some state budget revenues or the transfers from the state budget to local budgets for investments partially financed by external loans, as the case may be.

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 expenditures 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.

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. Therefore, a level of the contingency reserve fund that is too low might be insufficient to cover unforeseen expenditures, while an oversized fund might grant too much power for the authorities to spend excessively, without the Parliament's approval.

The intervention fund at the Government's disposal is allocated to main authorizing officers of the state budget and local budgets, based on Government decisions, for the financing of urgent expenditures in order to remove the effects of natural calamities and support the impacted persons. Unlike the possible destinations of allocations from the contingency reserve fund, which leave room for interpretation, in the case of the intervention fund, they are clearly specified by the law, the opportunity of the existence of such fund being justified. Over the course of the year, this fund can be supplemented from the reserve fund, depending on the needs regarding the provision of the amounts necessary to eliminate the effects of natural calamities.

The present section of the report analyses the use of the two funds during 2022, based on the Government decisions published in the Official Gazette of Romania, by which sums are allocated to authorizing officers and destinations.

If 2021 marked a return of the economy after the large-scale economic and social impact associated with the outbreak in 2020 of the pandemic caused by the SARS-CoV-2 virus, 2022 was characterized by the war in Ukraine, with repercussions both economically and humanitarian, many of the Government decisions regarding allocations from the contingency reserve fund at the Government's disposal being intended to provide support and humanitarian assistance to foreign citizens or stateless persons in special situations, originating from the area of the armed conflict in Ukraine.

It can be observed, however, that some amounts from the reserve fund continue to be used beyond the framework established by the Public Finance Law no. 500/2002, respectively for expenditures that cannot be categorized as urgent or unforeseen and should have been taken into account when establishing the state budget and local budgets, such as:

- payment of current and capital expenditures for some administrative-territorial units;
- organizing in Bucharest the 21st edition of the International Telecommunications Union Plenipotentiary Conference;
- measures for the operation of centralized systems for supplying thermal energy to the population;
- payment of salary rights established by enforceable titles in favour of the staff of the High Court of Cassation and Justice;
- ensuring the payment of social security rights from the public pension system which is borne from the state social security budget;

- purchase of a building in the municipality of Timișoara for carrying out the activities of the Timiș School County Inspectorate and the House of the Didactic Corps.

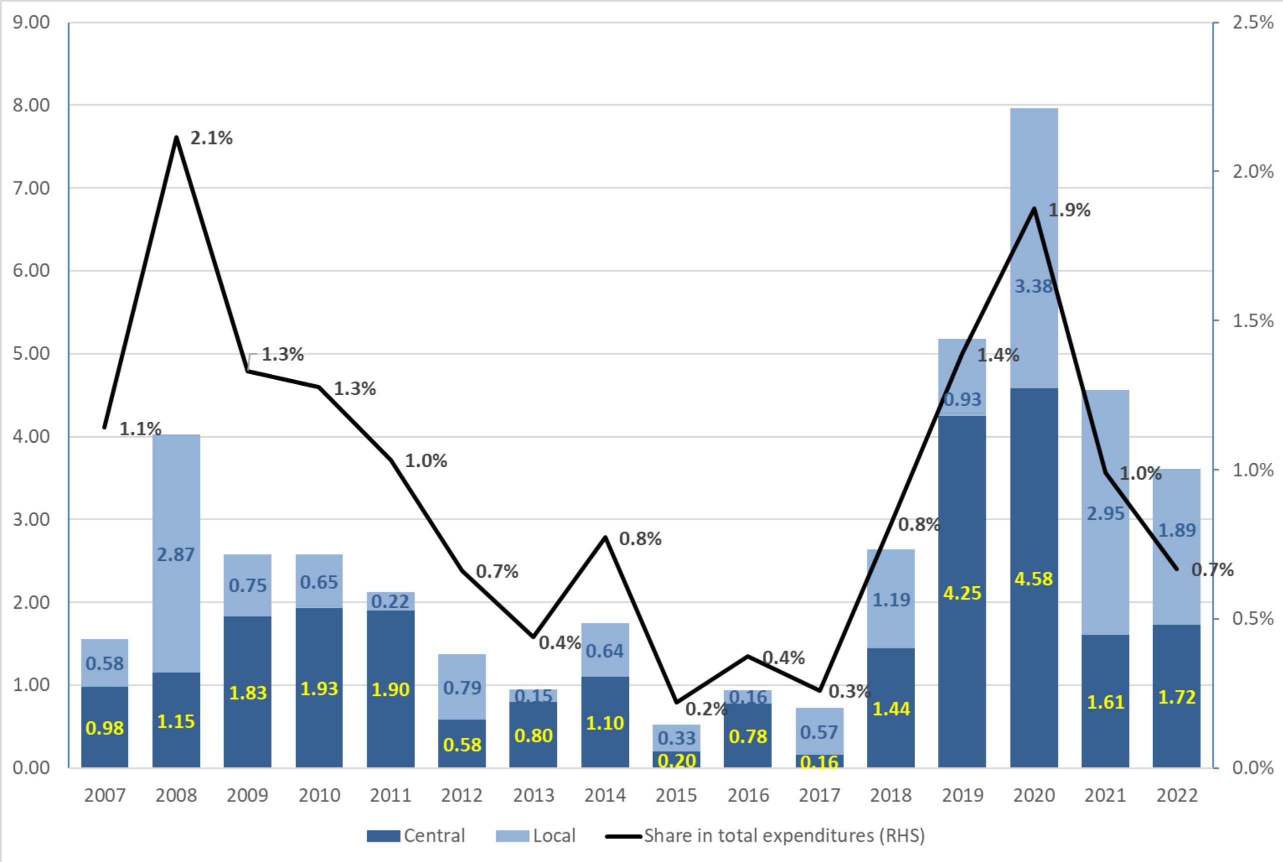
In 2022, 3,611 million lei were allocated from the contingency reserve fund, representing 0.7% of the total expenditures of the general consolidated budget, respectively 0.25% of GDP. Of these, 1,725 million lei were allocated for the central administration and 1,886 million lei for the administrative-territorial units.

Compared to the previous year, there is a decrease in total allocations from the contingency reserve fund (-20.79%) due to the reduction of transfers to the local administration (-36%), while the amounts allocated for the central administration increased by 7.07%.

Thus, 2022 registered a decrease of 0.3 pp in the share of the amounts used from the contingency reserve fund in total public expenditures compared to the previous year (from 1% in 2021 to 0.7% in 2022), the reasons being, on the one hand, the decrease in allocations, and, on the other hand, the increase in total expenditures (denominator effect). Referring to the average of the 2013-2022 period (10 years), 0.8%, we observe an improvement, and in 2022 the share of allocations from the contingency reserve fund in total public expenditures is closer to the minimum of the range (0.2% in 2015) than to its maximum (1.9% in 2020).

The evolution of the amounts allocated from the contingency reserve fund at the Government's disposal and their share in total public expenditures is shown in *Figure 27*.

Figure 27: Total contingency reserve fund allocations (billion lei)



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

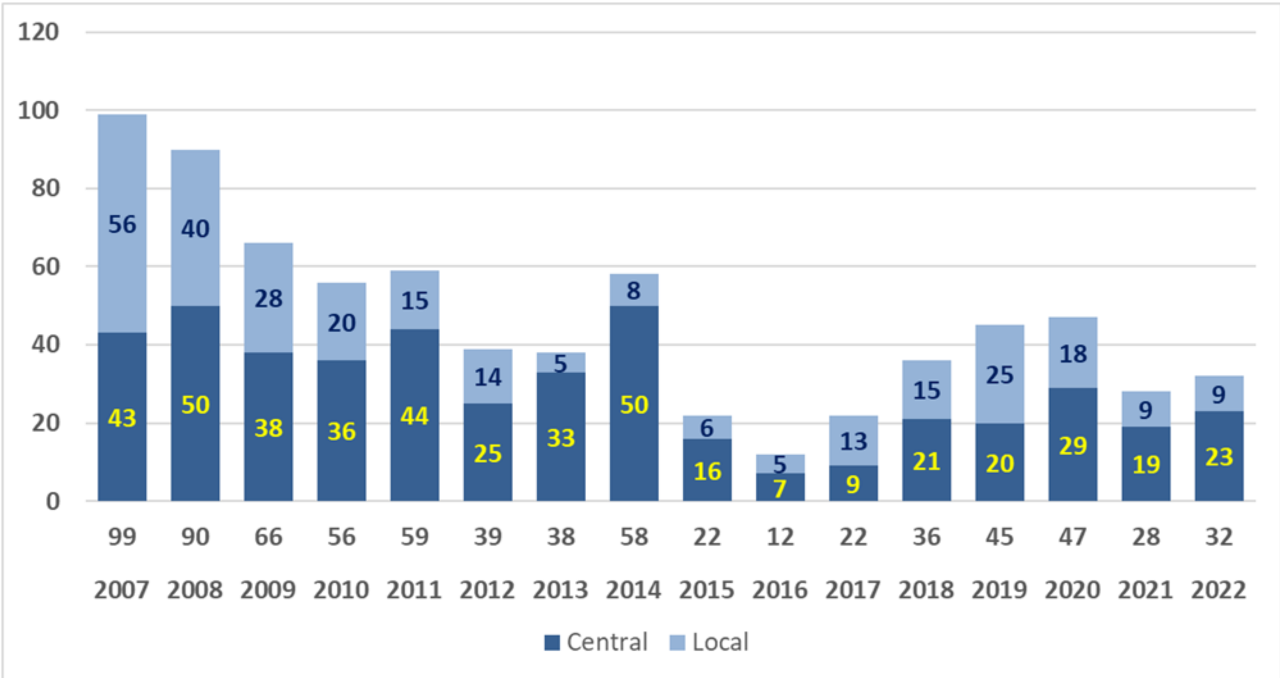
In 2022, 32 decisions were adopted by the Government in order to allocate some amounts from the contingency reserve fund, compared to 28 decisions in 2021 (see *Figure 28*).

It is noteworthy that the tendency from previous years to engage almost half of the total expenses from the contingency reserve fund towards the end of the year is maintained, 9 out of the 32 decisions being approved in December, allocating 1,652.4 million lei, representing approximately 46% of the allocations of the whole year (this practice makes it 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).

6 out of the 9 Government decisions adopted in December were for allocations to the central administration, in the amount of 624 million lei, of which 498 million lei were intended for the Ministry of Labour and Social Solidarity (the main beneficiary, for that matter, of the contingency reserve fund in 2022), to ensure the payment of social security rights from the public pension system which is borne from the state social security budget and to ensure the payment of home heating aids and the energy supplement related to the consumption of solid and/or oil fuels.

The 3 Government decisions adopted in December for allocations from the contingency reserve fund to the local administration consisted of additional amounts subtracted from VAT to balance local budgets (approx. 1,029 million lei).

Figure 28: Number of Government decisions regarding contingency reserve fund allocations



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

In 2022, the main beneficiary of the contingency reserve fund remained the *local authority* (*Figure 29*), to which 1,886.67 million lei were allocated, namely 52.2% of the total, a decreasing proportion compared to the previous year, when the administrative-territorial units received 64.7% of the total (in absolute amount, 2,948.36 million lei). The allocation ratio changed in favour of the central administration which receives amounts higher by 113.82 million lei from the contingency reserve fund. Therefore, 47.8% of the total is allocated to the central administration, compared to 35.3% of the total in the previous year.

From the perspective of the allocations from the contingency reserve fund at the Government's disposal in 2022, directed towards the central authority, the main beneficiaries were:

- *Ministry of Labour and Social Solidarity*, 13.8% of the total allocations (497.9 million lei), to which, through two Government decisions, both issued in December, the budget was supplemented to ensure the payment of social security rights from the system public pensions that are borne from the state social security budget (196 million lei) and to ensure the payment of home heating aids and the supplement for energy related to the consumption of solid and/or oil fuels (301.9 million lei);
- *Ministry of Internal Affairs*, 12.3% of the total (442.6 million lei), mainly for the provision of support and humanitarian assistance to foreign citizens or stateless persons in special situations,

coming from the area of the armed conflict in Ukraine and for the settlement of food and accommodation expenses for persons hosting foreign citizens or stateless persons in special situations, coming from the area of the armed conflict in Ukraine;

- *Ministry of Transport and Infrastructure*, 5.9% of the total (214.3 million lei), the largest part of the amount, namely 200 million lei, being directed to repair and maintenance works for the public railway infrastructure within the premises of Constanța Port;
- *Ministry of Foreign Affairs*, 4.2% of the total (152.5 million lei), 50 million lei being used to provide non-refundable financial assistance to the Republic of Moldova, and the rest intended to pay instalments related to Romania's annual contribution to European Peace Facility (EPF), pillar II;
- *General Secretariat of the Government*, 4% of the total (143.3 million lei), for civil compensations, transfers to public institutions, heating, electricity and transport;
- *Ministry of Regional Development and Public Administration*, 3.9% of the total (140 million lei), for measures regarding the operation of the centralized heat energy supply systems for the population.

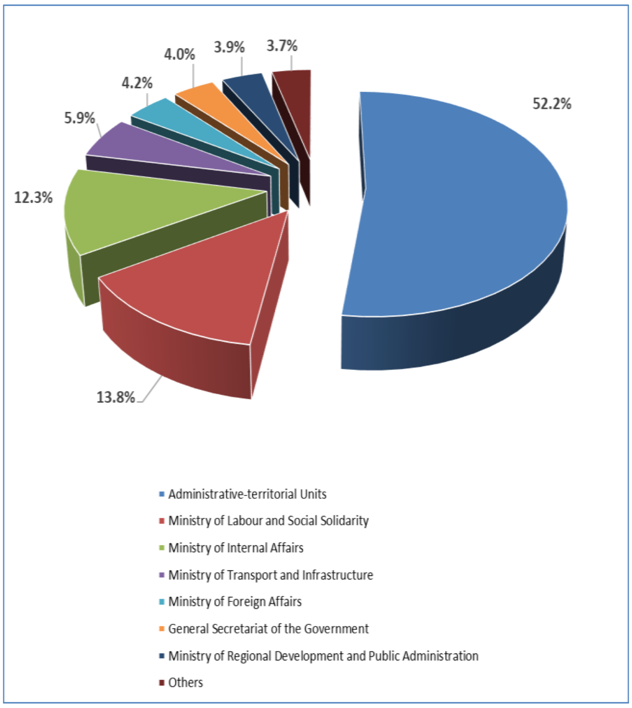
It should be noted that the Ministry of Health, which in 2021 received 23.5% of the total allocations from the contingency reserve fund (1,071.5 million lei), in 2022 is no longer among the main beneficiaries, its budget being supplemented only once, by 1.5 million lei.

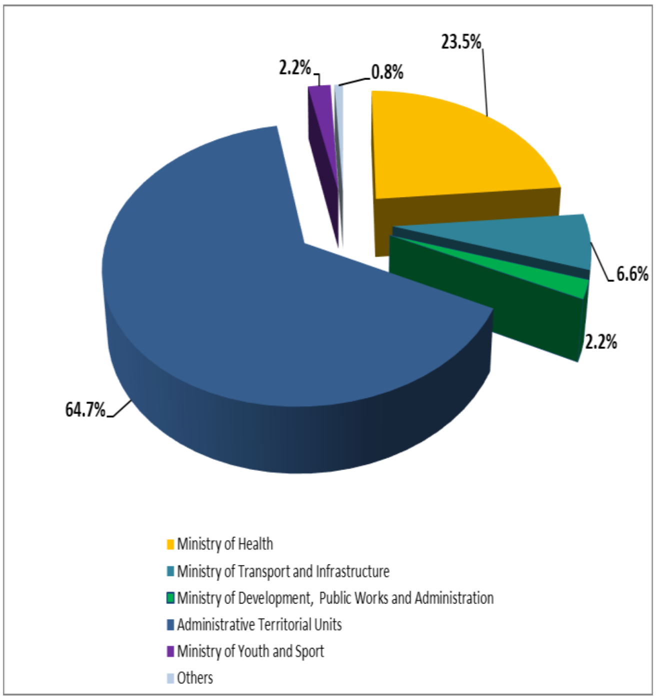
For local authorities, allocations from the contingency reserve fund in 2022 were made in all cases by increasing the amounts subtracted from VAT, and the main destination was to balance local budgets. Apart from that, 66.8 million lei were directed to financing the Pilot program for granting food support to pre-schoolers and schoolchildren from 150 state pre-university education units, in the second semester of the 2021-2022 school year, and 2.8 million lei for the financing of maintenance emergency works at the dam of the Tăul Mare reservoir.

Similar to the situation in previous years, the Fiscal Council notes the lack of transparency for the destination of allocations from this fund, the nonexistence of explicit identification criteria for the expenditure that can be made from the contingency reserve fund, the absence of Parliamentary control, the absence of clear criteria and procedures of its use, exclusively for destinations according to the law. Thus, considering the evolution in recent years of the amounts spent from this fund that are not allocated for urgent or unforeseen situations, the Fiscal Council advocates for the amendment of the legislation that establishes how to use the contingency reserve fund in order to set clear criteria and procedures for its use, exclusively for destinations related to unforeseen and urgent situations that cannot be predicted in the budgetary allocation process.

Figure 29: The beneficiaries of the contingency reserve fund (% of total allocations)

2022	2021





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

Considering the best international practices in this field, as well as the conclusions formulated by the Romanian Court of Accounts in its annual reports[57], the Fiscal Council reiterates its recommendation from the previous reports regarding the explicit identification of expenditures that can be made from the contingency reserve fund and a higher transparency, including through reporting on a regular basis to the Parliament about the use of this fund and the amounts actually spent.

It is worth noting that, despite the recommendations made by the Romanian Court of Accounts to combat the recurring use of a significant share of the contingency reserve fund for expenditures largely driven by underestimating the need for budget allocations at the time of drafting the budget, and that are not intended for urgent or unforeseen situations[58], in Law no. 317/2022 of the state budget – by way of derogation from the provisions of art. 30 para. (2) from Law no. 500/2002 –, certain amounts from the contingency reserve fund are committed for:

– funding the Local Development National Program, including stage II (beneficiary – Ministry of Regional Development and Public Administration);

[57] *Public Report for year 2021* – in Romanian (https://www.curteadeconturi.ro/en/publications/64-audit-reports).

[58] In the *Public Report for year 2021*, the Romanian Court of Accounts notes that the initial budget provisions of the contingency reserve fund were increased 8.5 times during the year, and 87.3% of the allocations were made by way of derogation from the law (in comparison with 66.8% in 2020). Of the total contingency reserve fund, 15.6 mil. lei remained unused.

- funding the compensation for the consumption of electricity and natural gas (beneficiary – Ministry of Energy);
- funding some current and capital expenditures related to payment obligations that cannot be made from the approved budget (beneficiary – newly established ministries);
- organizing in Bucharest the 21st edition of the International Telecommunications Union Plenipotentiary Conference, between September 26 and October 14, 2022 (beneficiary – main authorising officers of the state budget);
- employment stimulation and payment of salary claims (beneficiary – Ministry of Labour and Social Solidarity, to the unemployment benefits budget).

In 2022, the allocations from **the intervention fund** were much lower than in the previous year, namely 11.2 million lei, compared to 563.8 million lei in 2021. Their destinations, established according to the provisions of the Public Finances Law no. 500/2002, were for works to restore the local infrastructure affected by natural disasters and for the settlement of the expenses necessary to remove the state of risk caused by the current critical hydrological situation through emergency dredging operations on the Danube River and other specific works. It should be noted that both Government decisions aimed at using the intervention fund led to its supplementation from the contingency reserve fund.

III.5.5. Arrears of the general consolidated budget

At the end of 2022, a year marked by multiple shocks – energy crisis, disruption of production and supply chains, widespread high inflation, exacerbated effects of climate change, the pandemic, and last but not least, the war in Ukraine –, the *arrears of the general consolidated budget*[59] reached 282.6 million lei, by 110.5 million lei higher than in December 2021 (when they stood at 172.1 million lei).

Regarding the situation of *total outstanding payments with a delay of less than 90 days*, which do not fall under the arrears' category according to Public Finance Law no. 500/2002, after experiencing a decrease in the previous year, to a level of 1,238.2 million lei, in 2022 they increased to 2,185.0 million lei (+946.7 million lei, or +76.5%).

The GCB's total outstanding payments (0-360 days) at the end of December 2022 reached a value of 2,467.5 million lei, compared to 1,410.3 million lei at the end of the previous year. The increase from 2021 was mainly localized at the level of the social security budget (+614.4 million lei, representing a 210% increase) and of the local budgets (+401.3 million lei, representing a 44.4% increase). As a matter of fact, the GCB's total outstanding payments are predominantly found at the level of local budgets (1,305.8 million lei, representing 52.9% of the total) and of the social security budget (907.0 million lei, representing 36.8% of the total).

[59] According to the Public Finance Law no. 500/2002 with subsequent amendments and additions, *overdue payments older than 90 days*, calculated from their due date, are considered *arrears*.

The *GCB' arrears (90-360 days) to the private sector companies* amounted to 276.7 million lei, compared to 168.9 million lei at the end of the previous year (+107.8 million lei, or +63.8%). These arrears are predominantly located at the level of local budgets.

The following table shows the quarterly evolution of the stock of *total outstanding payments of the GCB* (*arrears and overdue payments with a delay of less than 90 days*) overall and for each budget category (state budget, local budgets and social security budget), compared to the previous year.

Table 8: Quarterly evolution of GCB outstanding payments (0-360 days) in 2022 (million lei)

	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022
State budget	**213.2**	**136.4**	**181.0**	**204.7**	**254.7**
Under 90 days	190.1	113.3	163.6	187.3	236.7
Over 90 days	4.3	6.9	2.2	3.1	3.8
Over 120 days	9.6	6.4	4.2	3.4	4.4
Over 360 days	9.1	9.8	10.9	10.9	9.8
Local budgets	**904.5**	**912.4**	**1,009.8**	**1,569.2**	**1,305.8**
Under 90 days	755.5	760.1	824.3	1,274.0	1,041.3
Over 90 days	56.3	57.1	69.7	120.6	62.7
Over 120 days	57.8	54.3	68.9	130.9	163.4
Over 360 days	34.9	40.9	46.8	43.7	38.5
Social security budget	**292.6**	**14.8**	**8.8**	**31.6**	**907.0**
Under 90 days	292.6	14.8	8.8	31.6	907.0
Between 90 and 360 days	0.0	0.0	0.0	0.0	0.0
Total outstanding payments	**1,410.3**	**1,063.6**	**1,199.6**	**1,805.4**	**2,467.5**
Under 90 days	**1,238.2**	**888.2**	**996.8**	**1,492.9**	**2,185.0**
Over 90 days	60.6	64.0	72.0	123.7	66.4
Over 120 days	67.4	60.8	73.1	134.2	167.8
Over 360 days	44.0	50.7	57.7	54.6	48.3
Total arrears (90-360 days)	**172.1**	**175.4**	**202.8**	**312.5**	**282.6**

Source: MF

Overall, a significant reduction of *GCB outstanding payments (90-360 days) to the private sector* is notable over the past 9 years (from 3.8 billion lei in 2012 to under 0.3 billion lei in 2022), primarily attributed to the implementation of EU Directive no. 7/2011 on combating late payment in commercial transactions (transposed into national legislation by Law no. 72/2013), as well as to the positive impact of other legislative measures aimed at reducing the stock of arrears: GEO no. 29/2011 for regulating payment arrangements, GEO no. 3/2013 which restricted the ability of local authorities to contract new loans strictly for clearing arrears and GEO no. 12/2013 which introduced a mechanism for settling reciprocal payment obligations.

From the concerning perspective of the current global economic situation, characterized by persistently high inflation and geopolitical instability, the FC deems it necessary to pay great attention to the potential increase in the stock of arrears, given the deteriorating fiscal situation compounded by pressures stemming from rising defence expenditures and the costs of adapting to climate change.

III.6. Public debt

In 2022, interest expenditures, in cash standards, increased by almost 11.1 billion lei (+61.8%) compared to the previous year. Considering a nominal GDP growth of 18.7%, the share of interest expenditures in the GDP rose from 1.5% to 2.06%. This evolution is due, on the one hand, to a rapid increase in the public debt stock in recent years (+31.7% in 2020, +18% in 2021, and +17% in 2022), driven by Romania's growing financing needs, including those resulting from the impact of the COVID-19 pandemic. On the other hand, this development is also attributed to a significant rise in interest rates.

Public debt, measured according to the ESA 2010 methodology, increased by 89.1 billion lei (+15.4%) in 2022 compared to the previous year, while its share in the GDP decreased by 1.4 pp, from 48.6% to 47.2%. From the perspective of the national methodology[60], public debt increased by approximately 125.6 billion lei (+18%). Given the higher nominal GDP growth, its share in GDP decreased by 0.4 pp, from 58.8% in 2021 to 58.4% in 2022. The slightly decreasing trajectory of public debt was supported by the evolution of the budget deficit, which, although still at a high level (5.72% of GDP according to the national methodology), was adjusted by 1 pp of GDP during 2022.

The average interest paid on public debt[61], measured according to the national methodology, followed an upward trend in 2022, following a 0.7 pp decrease in 2021. Specifically, it increased from 3.1% in 2021 to nearly 4.2% in 2022. This upward trend was driven by a significant rise in interest rates, considering that, in the context of high and persistent inflation, central banks initiated a cycle of increasing key interest rates in 2022.

From the perspective of the ESA 2010 methodology, in 2022, interest expenses experienced a smaller increase (+3.6 billion lei, representing +26.8%), compared to the national methodology. The difference between the two approaches can be explained by the reopening of older government bond issuances with a significant discount to their nominal value[62]. In cash terms, this amount is fully recorded as interest expenditures, while according to the ESA methodology, it is gradually amortized over the entire lifespan of the loan.

[60] Public debt, according to the national methodology, includes, in addition to the public debt according to the European methodology, the debt guaranteed by the Government, as well as loans from the general account of the State Treasury.

[61] Calculated as the ratio between the current year's interest expenses and the public debt balance at the end of the previous year.

[62] Discounts on the nominal value of government bonds are provided when older issuances are reopened and these bonds have lower yields compared to the market yield at the time of reopening. The purpose of applying these discounts is to bring the yield of these bonds in line with the prevailing market yield.

The cost of borrowing in national currency (see *Figure 30)* registered a positive development between 2014-2016 due to the inclusion, beginning with July 2014, of the bonds issued by the Romanian Government in the calculation of the GBI-EM Global Diversified index series by JP Morgan, the extension of the average maturity of public debt, the accommodative monetary policy conducted by the central bank, the achievement of a BBB- rating from Standard & Poor's in May 2014[63], but also due to a liquidity surplus in the financial markets. However, starting with 2017, there was a reversal of this trend, characterized by an increase in the cost of obtaining new loans in national currency. This upward trajectory intensified notably in 2018 due to the significant inflation growth. 2019 marked a slight reduction (between 0.1 and 0.4 pp) in the cost of borrowing new resources in national currency for most of the considered maturities. A similar trend can also be noticed in 2020, with reductions averaging 0.5 pp, due to the implementation of quantitative monetary policies by central banks. This influence was particularly evident through the substantial decrease in benchmark interest rates, the injection of liquidity into the banking system and asset purchases. In 2021, there was a further decrease in the cost of borrowing resources in national currency. This reduction can be noticed for most of the yields, with an average decrease of 0.5 pp. The most significant decreases, of 1 pp, were recorded for maturity periods of 6 and 12 months. However, a yield increase of around 0.5 pp for maturity periods of 5 and 10 years can also be seen. In 2021, similar to 2020, accommodative monetary conditions anchored sovereign yields: the central bank continued to inject liquidity through repo operations, conducted two interventions to purchase government securities from the secondary market, and maintained the key interest rate at 1.25% during the first three quarters. In the last quarter of 2021, due to the rapid rise in inflation, the central bank raised the key interest rate in two successive meetings, by 25 basis points each time. The decreasing trend in yields, which had been noticed over the past years, was strongly reversed in 2022. The cost of taking new loans in national currency increased significantly. On average, there was an approximate rise of 5 pp for bonds with maturities of 12 months, 2 years, 3 years, and 4 years, and an increase by about 3.5 pp for bonds with maturities of 5 and 10 years.

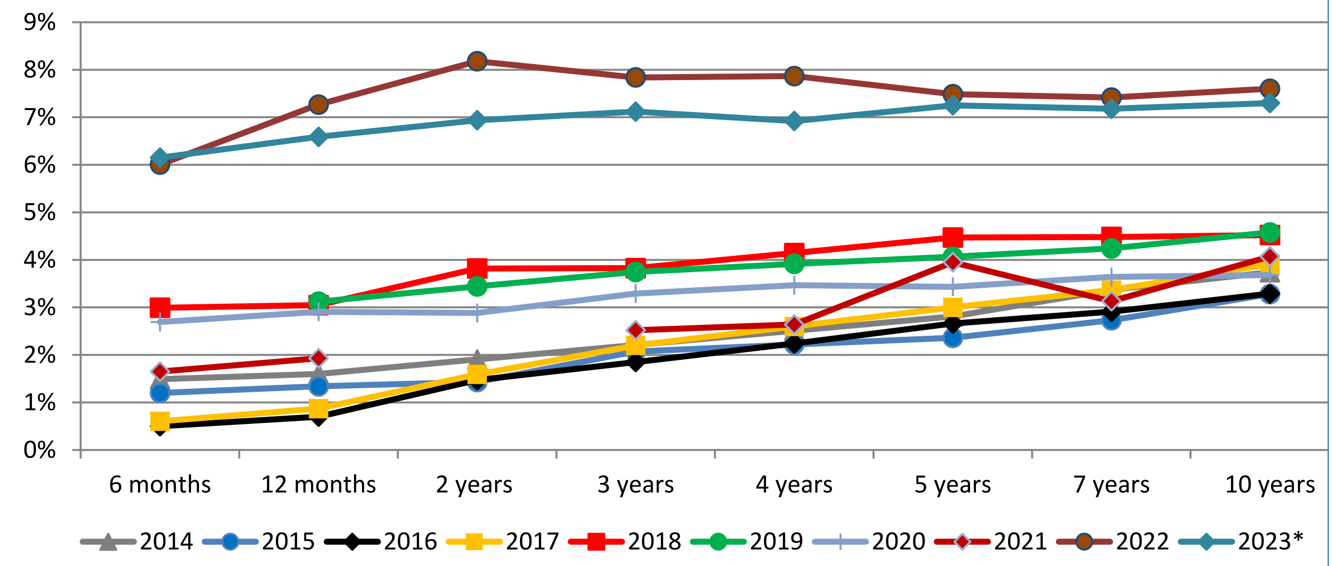
The evolution of sovereign bond yields, denominated in local currency, was significantly influenced by the rapid increase in the inflation rate and its persistence, as well as the elevated geopolitical uncertainty. In December 2022, the annual inflation rate reached 16.35%, compared to 8.2% in December 2021. In light of these circumstances, the central bank increased the key interest rate by 5 pp, from 1.75% at the beginning of the year to 6.75% at the end of the year. Liquidity remained accommodative, as the NBR conducted repo operations during the first three quarters of the year[64]. Additionally, the central bank intervened in the secondary market to purchase government securities in March and May[65].

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

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

[65] According to the NBR Bulletin from January 2023.

Figure 30: The yield curve for government bonds, issued in domestic currency between 2014 – July 31, 2023



*Source: NBR (*July 31, 2023)*

In 2022, the issuance of debt in foreign markets followed an upward trend, both in terms of volume and borrowing costs. Specifically, in 2022, there were four bond issuances denominated in euros, totalling €6.1 billion, and four issuances denominated in dollars, totalling $4.45 billion. This contrasts with the issuance activity in 2021, when there were four bond issuances denominated in euros totalling €7 billion. Borrowing costs for debt raised from foreign markets have increased amid restrictive monetary policies and a tightening climate in international financial markets. In 2022, the yield of the euro-denominated bond issuance with a maturity of 12 years, which was the only issuance in 2022 with comparable maturity and currency to those in 2021, was 3.8%, relative to 2.1% in 2021. Yield increases were more pronounced for issues launched in the last three quarters of the year. For instance, the yields for 4 and 7-year maturities were 5.1% and 6.7%, respectively.

Regarding the structure of public debt[66], in 2022, the share of central government debt increased slightly (97.5% of the total, compared to 97.3% in 2021), while the share of local government debt decreased (2.5% of the total, down from 2.7% in the previous year). Government bonds maintained their position as the primary instrument of government public debt in 2022, accounting for 32.8% of the total (down from 35.4% in 2021). They were followed by Eurobonds at 30.6% (down from 31.3% in 2021), government loans at 16.5% (up from 14.4% in 2021), retail bonds issued through the Tezaur Program at 3.3% (compared to 2.5% in 2021), and treasury bills at 0.6% (compared to 0.9% in 2021). Meanwhile, loans from the general account of the State Treasury slightly increased to 12.8% (up from 12.0% in 2021). In terms of currency structure, there was a marginal increase in the share of loans denominated in national currency, rising from 52.7% in 2021 to 53.8% in 2022. There was also a slight increase in the

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

share of loans denominated in US dollars, which grew from 6.3% in 2021 to 6.8% in 2022. Conversely, there was a decrease in the share of debt denominated in euros, dropping from 38.1% in 2021 to 36.7% in 2022.

The value of government bonds issued in the domestic market in national currency increased by approximately 22.3% in 2022, compared to 2021. In terms of the maturity structure of these bond issuances, it can be noticed a trend of borrowing resources for longer terms. Specifically, there was an increase in bonds with maturities exceeding 10 years, accompanied by a decrease for short-term maturities. Thus, treasury bills with maturities of up to 1 year represented 6.8% of the value of new loans contracted in 2022, compared to a share of 15.4% recorded in 2021. It is noticeable that the proportion of financing for longer periods has significantly advanced compared to the 2009-2012 period (the share of treasury bills with maturities of up to 1 year was 65% in 2009). Bonds with maturities between 1 and 5 years represented 26.8% of the value of new loans contracted in 2022, a slight decrease from the 28.3% share recorded in 2021. Bonds with maturities between 5 and 10 years had a share of 52.7% in 2022 (an increase from the 44.8% level in 2021), while those with maturities exceeding 10 years accounted for 13.7% in 2022, representing a 2.2 pp increase from the 11.5% share in 2021. In 2022, the average residual maturity of newly issued government bonds in national currency on the domestic market increased to 7 years, compared to 5.9 years in 2021 and 5.1 years in 2020. The extension of the maturity of government debt highlights a strategic move towards longer-term maturities. This strategy helps reduce vulnerability to short-term interest rate fluctuations and to potential challenges in refinancing maturing loans.

In the context of ending the accommodative monetary conditions, the bid-to-cover ratio for government bonds issued in the national currency decreased from 1.75 in 2021 to 1.55 in 2022, reflecting a decline in demand, while still remaining relatively high. The decline in the ratio was more pronounced for short-term maturities (the ratio for treasury bills decreased from 1.89 in 2021 to 1.58 in 2022) and medium-term maturities (the ratio for bonds with maturities between 1 and 5 years decreased from 1.71 in 2021 to 1.48 in 2022), while the ratio remained relatively constant (1.73) for bonds with maturities exceeding 10 years.

The evolution of the public debt as a share of GDP can be analysed starting from the following relationship[67], derived from the budget identity:

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

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

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

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

where y_t - real GDP growth rate at time t, i_t – interest rate at time t, and π_t – inflation rate at time t.

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

The year 2022 recorded a moderate decrease (-1.4 pp) in the share of public debt as a percentage of GDP (see *Figure 31*). Using the dynamics equation presented above, it can be noticed that the primary deficit significantly contributed towards an increase of the share of public debt in GDP (+5 pp), while the stock-flow adjustment has marginally contributed in the same direction (+0,1 pp)[68]. However, the other factors have reversed the impact of the primary deficit and of the stock-flow adjustment: real economic growth (-2.1 pp, as strong economic growth was maintained) and the real interest rate (-4.4 pp, in the context of accelerated inflation). As can be noticed, the primary deficit had the most significant contribution to the dynamics of public debt in the context of a budget balance of -6.2% of GDP, driven by supportive measures adopted to mitigate the adverse effects of rising energy prices. Moreover, from the perspective of the primary balance, Romania underperforms within the EU, as it had the highest primary deficit among the member states in 2022 (*Figure 32*). Furthermore, Romania only managed to reduce the primary balance by 1 pp (from -6% of GDP in 2021 to -5% of GDP in 2022), representing the smallest adjustment among EU member states with negative primary balances. In 2022, the economic growth of 4.7% overlapped with a negative real interest rate (-10.4%, in the context of a high and persistent inflation), which led to a negative value for λ_t and, consequently, to a favorable impact on the dynamics of public debt expressed as a percentage of GDP. Thus, the effect of the high budget deficit was counteracted by the real economic growth rate, combined with the presence of a negative real interest rate.

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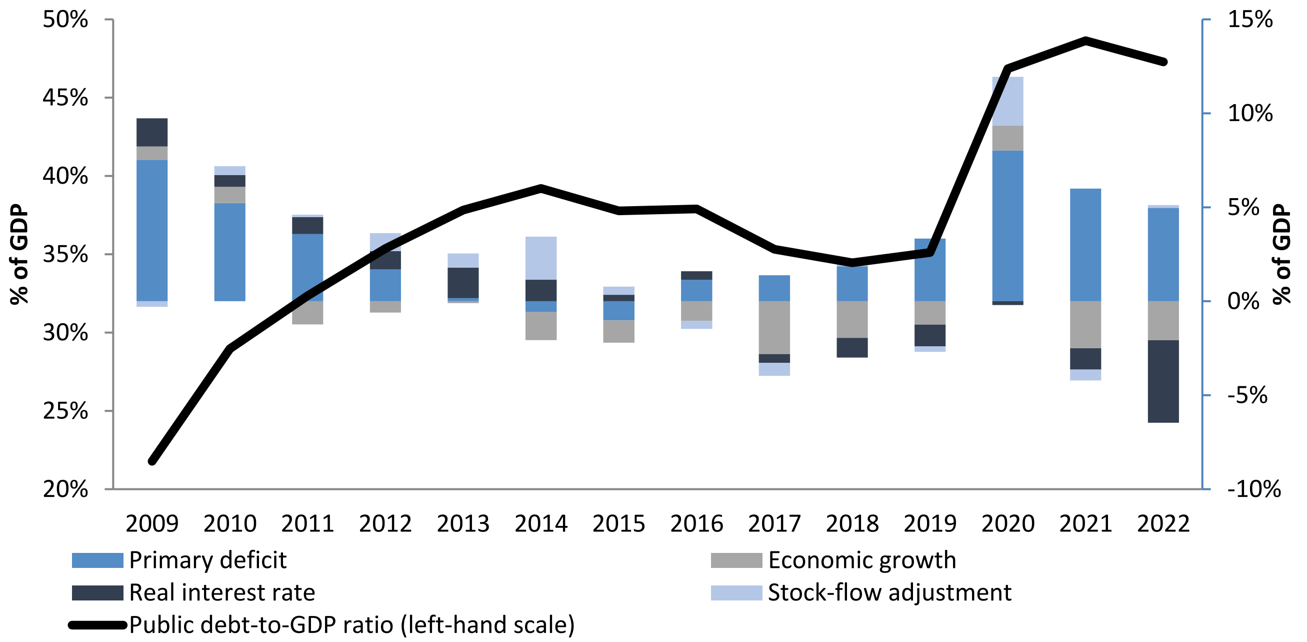
[68] The stock-flow adjustment has an unfavourable, yet relatively small contribution to the increase in the share of public debt to GDP. This contribution results from several factors with significant impacts that have acted in opposing directions. Thus, the increase in available liquidity reserves in the State Treasury, additional loans for financing projects from EU funds until the actual receipt of funds, the collection of contributions related to the current year in the following year, as well as higher interest expenses due to reopening older government bond issuances, have led to a rise in public debt. These elements were partially offset by the granting of super-dividends paid by state-owned companies, the balance of EU funds, as well as the sale of emission certificates that remained undistributed.

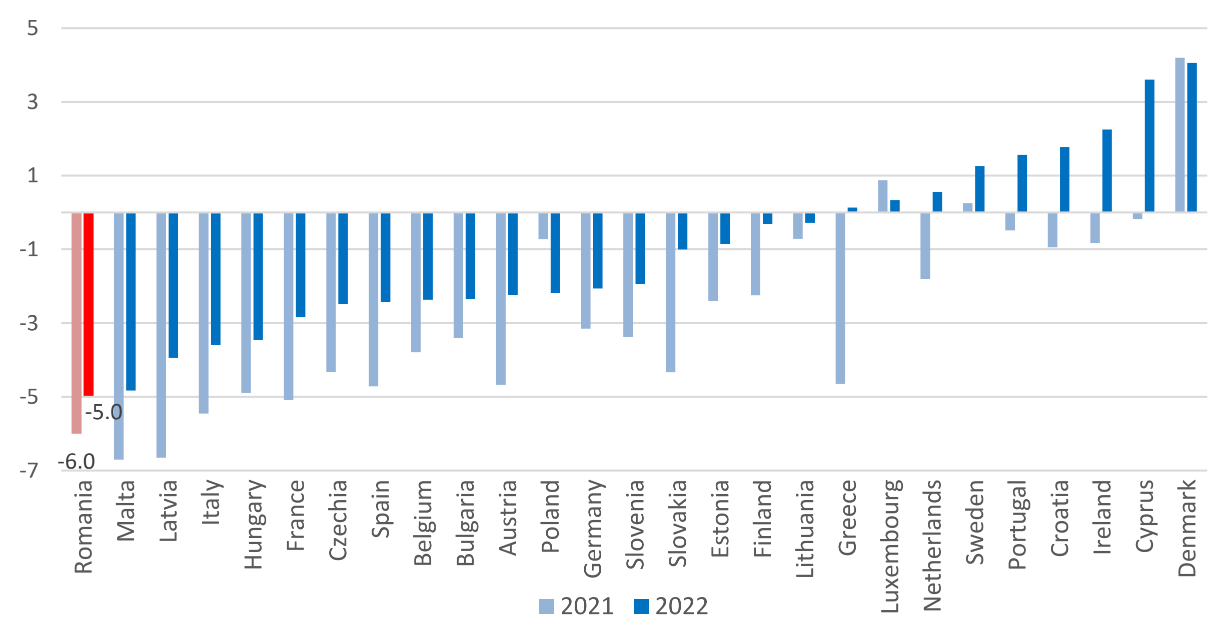
Figure 31: Contributions to changes in the public debt-to-GDP ratio for the 2009-2022 period



Source: Eurostat, Fiscal Council's calculations

Analysing the level of public debt at the end of 2022, it must be noted that it remained above the alert threshold of 45% of GDP, set by the FRL. Thus, it is necessary for the MF to present a report justifying the increase in public debt and proposing measures to maintain it at a sustainable level. The justification is not an issue given that, amidst the COVID-19 pandemic, the share of public debt in GDP rose by 11.7 pp in 2020 compared to 2019, and by approximately 1.8 pp in 2021 compared to 2020. However, the alert signal remains relevant considering the high structural budget deficit. Nonetheless, a positive aspect is that the ratio of public debt to GDP decreased in 2022 compared to 2021 (by 1.4 pp). Considering a scenario in which the budget deficit targets of 4.4% (for 2023) and 2.95% (for 2024) are achieved, and a favourable differential between the real economic growth rate and the financing cost, represented by the real interest rate, is maintained, it is expected that the ratio of public debt to GDP will continue its downward trend. However, adverse events in recent years have demonstrated that the impact of severe overlapping shocks, with risks that could materialize simultaneously, can lead to an accelerated increase in public debt due to a sudden reversal in the relationship between economic growth and the real interest rate.

Figure 32: Primary balance in EU member states, in 2021 and 2022 (% of GDP, ESA 2010)



Source: Eurostat

An additional constraint is related to the high level of public debt compared to the depth of the domestic financial sector and the limited capacity to absorb an additional stock of public debt at the current level of financial intermediation. Thus, at the end of 2022, Romania's public debt to bank assets ratio was approximately 95% (compared to around 90% in the previous year), while bank exposure to the government sector relative to bank assets (banks are the main holders of public debt in the domestic market) is about 21% (down from 25% in 2021). The levels of these indicators are among the highest in the EU. This situation has the potential to lead to increased dependence on non-resident investors, which is associated with a higher vulnerability to interest rate and exchange rate shocks, to changes in risk appetite in the global financial markets, and to potential sovereign rating changes.

IV. The absorption of EU funds

The EU Multiannual Financial Framework (MFF) for the 2021-2027 period (1,074 billion euros) and the Next Generation EU instrument (750 billion euros)[69], totalling 1,824 billion euros and representing the largest package of financial assistance in the history of the Union, is intended to support the recovery of member states' economies after the shock of the pandemic in 2020, as well as the achievement of the EU's long-term priority objectives, mainly the green and digital transition.

This is a budget for exceptional times, marked not only by the pandemic, which has become a recurring threat, but also, in the last part of 2021, by an unprecedented surge in energy, fuel and raw material prices. The impact of the outbreak of the war in Ukraine in 2022 has further exacerbated the situation, leading to pronounced inflationary effects on the global economy. Despite being of a somewhat reduced magnitude, the persistence of these effects is still felt in 2023.

This unfavourable international context, under the pressure of multiple crises, at maximum levels of uncertainty and instability even regarding the near future, severely challenges the economic, monetary, fiscal and social policies of governments, including within the EU space.

For Romania, European funds represent a key financial resource for economic and social development, both in terms of investment strategy and public finance sustainability. It is of vital importance for Romania to take advantage on this historic opportunity, benefiting from the European Union's allocation of nearly 80 billion euros (31 billion euros from the Cohesion Policy[70] and around 20 billion euros from the Common Agricultural Policy under the EU's 2021-2027 MFF). In addition to these, there are 12.1 billion euros in grants and 15 billion euros in loans through the Recovery and Resilience Facility (RRF), the most significant financial instrument within the Next Generation EU (NGEU) framework.

The lessons drawn from previous financial exercises, which resulted in relatively low absorption rates compared to other EU member states, highlight the vital importance of concerted efforts to enhance administrative capacity both at the central and local levels. These efforts serve as essential prerequisites for maximizing the utilization of European funds during the 2023-2027 period.

This achievement would lead, in terms of macroeconomic stabilization, to amplifying the contribution of investments to both potential and real GDP growth, as well as to maintaining internal and external financial balances. On the real economy side, it would support the implementation of structural reforms, directly and indirectly contributing to the progress of fiscal consolidation. This is particularly crucial in a period when Romania faces significant challenges arising from the impact of external factors and the volatility of the international economic, financial and geopolitical environment. European financial

[69] Documents approved by the European Parliament in December 2020 and February 2021.

[70] European Commission (2022). *EU Cohesion Policy: €31.5 billion for Romania's economic, social and territorial cohesion, competitiveness and green and digital transition in 2021-2027*, EC Press Release, Brussels, July 25, 2022.

resources can play a key role in mitigating the contractionary effect of the necessary correction of the structural budget deficit. The FC has reiterated this essential aspect in numerous analyses.

Absorption of structural and cohesion funds from the 2014-2020 MFF

The EU's cohesion policy aims to alleviate economic and social disparities between regions, promotes convergence between member states, supports the increase of their competitiveness and level of employment.

In the 2014-2020 MFF, in order to achieve the objectives of the cohesion policy, Romania was allocated structural and cohesion funds of around 24.1 billion euros divided among six operational programs (OP): Regional OP, Large 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 and the SME Initiative OP), but in October 2018 the integration of the SME program into the Regional OP was approved, benefiting from a reallocation of over 150 million euros.

Analysing the data available for May 2023 (see *Table 9*), an improvement in the absorption rate of European funds, relative to the results recorded by the FC in March 2022, is observed[71]. Thus, compared to the situation at that time, the absorption rate (including pre-financing) has increased by 26 pp, from 53% to 79% of the total allocated structural and cohesion funds for the 2014-2020 MFF. At the level of operational programs, it is noted that the average growth rate is 24 pp, with a tendency to equalize absorption rates among them.

The most significant improvements in absorption rates occurred in the case of the Competitiveness OP (from 31.6% in 2022 to 71% in 2023) and the Human Capital OP (from 54.6% in 2022 to 85.3% in 2023), while the absorption rate for the Technical Assistance OP recorded the lowest increase in the past year (from 72.8% in 2022 to 81.2% in 2023), due to an already high absorption level in the previous year.

Among the other three operational programs, an above-average increase was recorded for the Large Infrastructure OP (from 56.3% in 2022 to 84.3% in 2023), while for the Regional OP (from 54% in 2022 to 70.7% in 2023) and the Administrative Capacity OP (from 52.1% in 2022 to 72.8% in 2023), the increases were below the average absorption rate of the other programs.

[71] See the *2021 Annual Report of the Fiscal Council*, July 2022. http://www.fiscalcouncil.ro/FC%20Annual%20Report%202021.pdf

Table 9: Structural funds absorption by operational program for the 2014-2020 MFF as of May 2023 (million euro)						
	Total allocations 2014-2020 (cumulative)	Payments 2023			Absorption rate 2023	Absorption rate excluding pre-financing 2023
		Total, out of which:	Pre-financing	EU refunds		
Regional	6,860.0	4,853.1	397.6	4,455.5	70.7%	64.9%
Large Infrastructure	9,338.6	7,872.0	804.3	7,067.7	84.3%	75.7%
Competitiveness	2,379.8	1,689.5	378.2	1,311.2	71.0%	55.1%
Human Capital	4,596.1	3,922.4	413.3	3,509.1	85.3%	76.3%
Administrative Capacity	563.6	410.1	46.8	363.3	72.8%	64.5%
Technical Assistance	332.8	270.3	16.4	253.9	81.2%	76.3%
Total	**24,070.8**	**19,017.3**	**2,056.6**	**16,960.7**	**79.0%**	**70.5%**

Source: EC, Fiscal Council's calculations

Table 10 provides an analysis of the situation in Romania compared to other EU member states in Central and Eastern Europe based on data available as of May 2023. The vast majority of these states (including Romania) received larger allocations of structural and cohesion funds for the 2014-2020[72] period compared to the previous financial exercise, with exceptions being represented by Czechia (22.7 billion euros compared to 26.5 billion euros), Slovenia (3.3 billion euros compared to 4.1 billion euros) and Hungary (22.5 billion euros compared to 24.9 billion euros). It is worth mentioning the case of Latvia, which, due to additional allocations in 2021 for the 2014-2020 MFF, exceeded the allocations from the previous financial exercise (4.6 billion euros compared to 4.5 billion euros).

On the other hand, when comparing the received allocations per capita[73], it is observed that Romania ranks second to last, with approximately 1,207 euros per inhabitant, surpassing only Bulgaria (1,098 euros per inhabitant). At the opposite pole, eight out of the eleven analysed states have allocations of over 2,000 euros per inhabitant, with the highest values recorded by Estonia (2,814 euros per inhabitant) and Slovakia (2,638 euros per inhabitant).

[72] Compared to previous editions of the FC's annual report, the allocation for the 2014-2020 MFF has been revised due to additional allocations through React-EU.

[73] The population as of January 1, 2014 (the beginning of the 2014-2020 MFF), according to data provided by Eurostat.

Table 10: Absorption of structural funds for the 2014-2020 MFF – comparison with other EU Member States as of May 2023					
	Total allocations 2014-2020	Payments 2023	Absorption rate 2023	Total allocations 2014-2020 /inhabitant	Total payments/ inhabitant 2023
	billion euro	billion euro	%	euro	euro
Bulgaria	8.0	6.0	75.2	1,098.4	825.7
Czechia	22.7	20.0	88.1	2,157.1	1,901.4
Croatia	9.1	6.0	65.7	2,146.3	1,409.4
Estonia	3.7	3.5	94.4	2,813.6	2,656.4
Latvia	4.6	3.6	78.5	2,318.6	1,819.6
Lithuania	7.0	6.6	94.0	2,389.5	2,245.3
Poland	78.8	72.6	92.2	2,072.6	1,910.0
Romania	**24.1**	**19.0**	**79.0**	**1,206.7**	**953.4**
Slovakia	14.3	10.7	74.8	2,638.2	1,973.4
Slovenia	3.3	3.0	89.4	1,619.0	1,446.6
Hungary	22.5	19.9	88.3	2,280.9	2,014.3

Source: EC, Eurostat, Fiscal Council's calculation

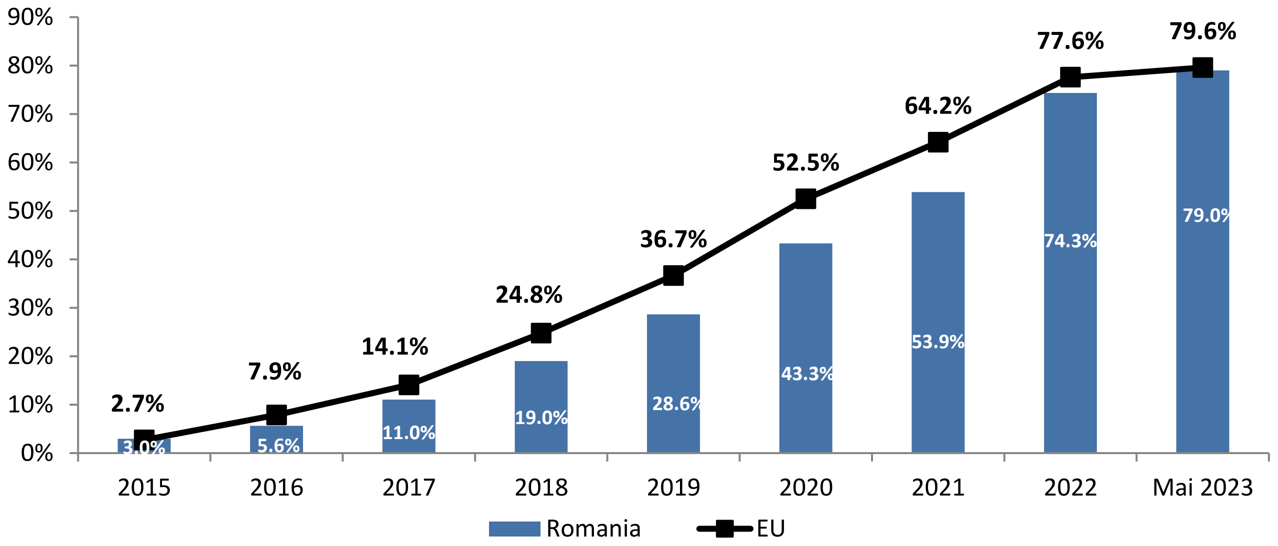
Note: The absorption rate is calculated on the basis of interim payments and pre-financing.

From the perspective of the absorption rates of structural and cohesion funds recorded in May 2023, Romania has climbed three positions compared to the previous year (reaching the 7th place), with an absorption rate of 79%, surpassing Croatia (65.7%), Slovakia (74.8%), Bulgaria (75.2%) and Latvia (78.5%). The average for the entire sample is 83.6%. The countries with the highest absorption rates included in the analysis are Estonia (94.4%), Lithuania (94%), Poland (92.2%) and Slovenia (89.4%). An important aspect to note for Romania is the significant improvement of its absorption rate during the past year, ranking first in terms of relative growth, with an increase of 26 pp. The following countries are Estonia, with an increase of 18.9 pp, and Czechia, with an increase of 18.8 pp.

The reduction of the gap compared to EU member states can also be observed from the analysis of the evolution of absorption rates of structural and cohesion funds in Romania, compared to the EU average[74] (see *Figure 33*). Thus, the 2014-2020 MFF started with difficulties both in Romania and at the EU level, due to the delayed finalization of the legislative, institutional and functional framework. As a result, the beginning of the period saw low absorption rates, with Romania being close to the European average. However, starting in 2016, an unfavourable gap compared to the EU average emerged and continued to widen until 2021, when it reached nearly 10.3 pp. In the last two years, however, the gap compared to the EU average has significantly decreased, so that by May 2023 it narrowed down to just 0.6 pp.

[74] In the years 2021, 2022 and 2023, excluding the United Kingdom.

Figure 33: Evolution of EU funds absorption rate: Romania versus EU average, 2015 – March 2023 (2014-2020 MFF)



Source: EC, Fiscal Council's calculations

However, given that the structural and cohesion funds allocated for the 2014-2020 MFF can be spent until the end of 2023, following the n+3 rule, the results regarding their absorption rate, both in comparison with the EU average and with other member states in the region, raise questions about the persistence of difficulties in absorbing European funds by Romania in the first years of the MFFs and the potential impact thereof on the 2021-2027 MFF.

Cohesion policy according to the 2021-2027 MFF

The absorption of non-reimbursable European funds from the MFF 2021-2027 represents a top-priority objective of utmost national interest in the short, medium and long term. It constitutes an essential financial resource for the sustainable development of the economy, yielding a range of positive and catalytic effects such as reducing regional disparities, poverty and social exclusion, facilitating the green and digital transition, developing a sustainable transportation network, making infrastructure investments, enhancing firm competitiveness, research and innovation capacity, improving the quality of education and healthcare systems, enhancing water and waste management systems etc.

The European Union's cohesion policy for the 2021-2027 period pursues five key priorities, namely:

- **A smarter Europe**, through innovation, digitalization, economic transformation and support for SMEs;
- **A greener Europe**, with zero carbon emissions, through investments in energy transition, renewable energy development and combating climate change;
- **A more connected Europe**, through the development of strategic transport and digital networks;
- **A more social Europe**, by supporting job quality, education, skills, social inclusion and equal access to the healthcare system;

- **A Europe closer to its citizens**, through locally-led development strategies and sustainable urban development.

Under the EU's Cohesion Policy for the 2021-2027 period, Romania has been allocated European funds totalling around 31 billion euros (in addition to a national contribution of 13.6 billion euros). According to the Partnership Agreement with the EU for the 2021-2027 MFF, adopted by the EC in July 2022[75] (a delay primarily caused by the impact of the pandemic at the EU level, as well as by the extended negotiation with the EC of the preliminary versions of the Agreement submitted by Romanian authorities), **8 national operational programs** will be funded (Sustainable Development OP, Transport OP, Smart Growth, Digitalization and Financial Instruments OP, Inclusion and Social Dignity OP, Health OP, Education and Employment OP, Technical Assistance OP, Just Transition OP), as well as **8 regional operational programs**.

In the context of the challenging fiscal consolidation timeline between 2022 and 2024, agreed upon with the EC within the excessive deficit procedure, as well as the pressure exerted, particularly by external factors, on the country's economic and financial stability, the importance of absorbing European funds becomes even more pronounced in order to alleviate the strain on the public budget. Considering the unfavourable trend in absorption rates observed in previous financial exercises, especially in the beginning years of the programming periods, partially mitigated by the n+3 rule, accelerating the pace of European fund absorption is an urgent necessity for the implementation of the 2021-2027 MFF[76].

Given the limited progress in implementing the country-specific recommendations of the EC, including those issued in May 2023[77], efforts to improve the absorption of European funds should primarily focus on: enhancing economic governance efficiency, strategically planning investments in key areas, increasing administrative capacity for project management, prioritizing large-scale projects and expediting their implementation, improving the efficiency of the public procurement system and ensuring predictability in the legislative and institutional framework.

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[75] European Commission, *EU Cohesion Policy: €31.5 billion for Romania's economic, social and territorial cohesion, competitiveness and green and digital transition in 2021-2027*, Press release, Brussels, July 25, 2022.

[76] The execution of Structural and Cohesion Funds (SCF) for the 2021-2027 MFF reached only 3.27 million euros as of May 31, 2023 (SCF reimbursements, excluding pre-financing), which would practically represent an absorption rate close to zero. It should be noted that the current MFF only began in the latter part of 2022 (Ministry of Finance, *Evolution of Financial Flows between Romania and the European Union*, May 31, 2023). https://mfinante.gov.ro/documents/35673/920747/BFN_2023_05_31.pdf

[77] European Commission, *Recommendation for a COUNCIL RECOMMENDATION on the 2023 National Reform Programme of Romania and delivering a Council opinion on the 2023 Convergence Programme of Romania*, COM(2023) 623 final, Brussels, 24.5.2023.

The National Recovery and Resilience Plan

As previously mentioned, to counter the extremely severe economic and social impact of the COVID-19 pandemic, the EU launched the NGEU plan, which includes the facility of the RRF, approved at European level on February 12, 2021. This mechanism provides member states with grants of up to 312.5 billion euros and loans of up to 360 billion euros to support reforms and investments[78].

The change of the geopolitical context in the spring of 2022, with Russia's invasion of Ukraine, and the economic impact of escalating energy prices, have brought to the forefront the importance of EU's energy security. In order to address this significant challenge and reduce dependence on gas, coal and oil imports from the Russian Federation, the EC launched the REPowerEU plan in May 2022. This plan aims to secure the necessary financial resources for additional investments amounting to 210 billion euros, through complementary measures alongside those funded by the RRF[79], including their incorporation into NRRPs[80].

[78] It should be noted that, unlike the Cohesion Policy, projects funded through the RRF cannot be extended beyond the end of the period, nor can they be phased. Therefore, it is necessary for them to be completed by August 2026.

[79] https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/european-green-deal/repowereu-affordable-secure-and-sustainable-energy-europe_en

[80] All EU member states are required to revise their NRRPs by including a new chapter concerning the reforms and investments related to REPowerEU. These revised plans must be submitted to the EC and they may also include other proposals for modifications or funding. Between January and June 2023, a total of 12 countries have submitted their revised national plans to Brussels, with 7 of them already being validated by the EC. In the case of Romania, apart from the REPowerEU chapter, the NRRP revision involves challenging negotiations with the EC regarding a reduction in grants by 2.1 billion euros, adjusting investment prices and infrastructure projects due to increases in material and labour costs (estimated at around 2.2 billion euros), as well as changes to milestones and targets based on the invocation of objective circumstances. This pertains to discussions surrounding the elimination or replacement of the 9.4% of GDP ceiling for pension expenditures. For the latest official information available on the status of negotiations with the EU as of mid-May 2023, please refer to the following link on the Ministry of Investments and European Projects' website: https://mfe.gov.ro/concluziile-vizitei-de-lucru-la-bruxelles-ce-a-obtinut-ministrul-marcel-bolos-in-urma-discutiilor-cu-reprezentantii-comisiei-europene/.

Thus, Romania is facing exceptional opportunities, with the 31 billion euros allocated within the cohesion policy for the 2021-2027 MFF being supplemented by 27 billion euros through the RRF facility, of which 12.1 billion euros are in the form of grants[81] and 14.9 billion euros in the form of loans[82].

Accessing the RRF facility for Romania is carried out through the **National Recovery and Resilience Plan** (NRRP), a strategic document that outlines national reform priorities and investment areas. This plan was approved by the EU Council in October 2021. Key principles in the development of the NRRP were guided by the priorities set for member states during the European Semester (Country-Specific Recommendations). According to EU regulations, a minimum of 37% of the total amounts related to the NRRP have been allocated for measures to achieve climate objectives, while a minimum of 20% for the realization of digitalization objectives.

In Romania's case, the NRRP has aligned national objectives with EU priorities through a package of public investments and reforms organized into six pillars:

(i) **Green transition – 15.314 billion euros** (Component 1: Management of the water and sewage system – 1.462 billion euros; Component 2: Reforest Romania and protect biodiversity – 1.173 billion euros; Component 3: Waste management – 1.239 billion euros; Component 4: Sustainable Transport – 7.620 billion euros; Component 5: Fund for the Renovation Wave – 2.200 billion euros; Component 6: Energy – 1.620 billion euros);

[81] According to Article 11(1) of the Regulation establishing the RRF (The European Parliament and the Council of the EU*, REGULATION (EU) 2021/241 of 12 February 2021 establishing the Recovery and Resilience Facility*, L 57/17, Official Journal of the European Union, 18.2.2021), the allocation of grants to each EU member state was calculated according to a methodology where 70% of the amount is based on population and the inverse proportionality ratio with GDP per capita, and 30% takes into account the real GDP variation in 2020 and the aggregated real GDP variation in the period 2020-2021, based on the EC's fall 2020 forecasts. According to Article 11(2) of the Regulation, allocations for each EU member state were to be recalculated (by the end of June 2022) based on the EC's spring 2022 estimates of the actual results of the real GDP variation in 2020 and 2021. Under these conditions, the initially allocated amount for Romania through non-reimbursable grants from the RRF was 14.2 billion euros, calculated based on the EC's estimation of a 5.2% contraction in real GDP in 2020 and a recovery of 3.3% in 2021 (European Commission, *European Economic Forecast Autumn 2020*, November 2020), assuming a situation where the pandemic-induced GDP decline would not have been recovered in the following year. The actual results for Romania were better than anticipated, with a 3.7% decrease in real GDP in 2020, which was lower than the EC's estimates, and an economic growth of 5.9% recorded in 2021, ensuring the recovery of the decline (European Commission, *European Economic Forecast Spring 2022*, May 2022). As anticipated (Darvas Z., *How has growth changed what countries get from the European recovery fund?*, Bruegel Blog, February 17, 2022), in Romania's case, the application of the provisions of Article 11(2) of the Regulation led to a decrease in the amount corresponding to the 30% share, from 4 billion euros to 1.9 billion euros, and the total amount allocated to Romania in grants decreased from 14.2 billion euros to 12.1 billion euros (European Commission, *RRF: Update of the maximum financial contribution*, Commission note to the Council and European Parliament, June 30, 2022).

[82] Moreover, there would be an additional 1.4 billion euros from REPowerEU, following the completion and inclusion of this chapter in the NRRP, which has been open for public consultation since March 2023 (https://mfe.gov.ro/consolidarea-sistemului-energetic-national-mipe-lanseaza-in-consultare-publica-capitolul-repowereu-care-va-aduce-romaniei-14-miliarde-de-euro-pentru-independenta-energetica/).

(ii) **Digital transformation – 1.884 billion euros** (Component 7: Government cloud and digital public systems – 1.884 billion euros);

(iii) **Smart, sustainable and inclusive growth – 3.014 billion euros** (Component 8: Fiscal reforms and pension system reform – 0.456 billion euros; Component 9: Support for the private sector, research, development and innovation – 2.558 billion euros);

(iv) **Social and territorial cohesion – 2.549 billion euros** (Component 10: Local fund for green and digital transition – 2.1 billion euros; Component 11: Tourism and culture – 0.449 billion euros);

(v) **Health and institutional resilience – 2.811 billion euros** (Component 12: Health – 2.450 billion euros; Component 13: Social reforms – 0.196 billion euros; Component 14: Reform of the public sector, increasing the efficiency of justice and strengthening the capacity of social partners – 0.165 billion euros);

(vi) **Policies for the next generation, children and youth, such as education and skills – 3.605 billion euros** (Component 15: Education – 3.605 billion euros).

Although there were delays in operationalizing the necessary organizational structures for initiating the implementation of the NRRP, which would ensure functions such as evaluation, management and control, contracting, authorization and expenditure payment, as well as in signing financing agreements with beneficiaries, by the end of May 2022, the Ministry of Investment and European Projects (MIEP) submitted the first payment request to the EC under the NRRP, amounting to nearly 3 billion euros, of which around 2 billion euros from the grant component and 0.9 billion euros from the loan component[83]. This payment request included all supporting documents regarding the achievement of the 21 milestones/targets for the fourth quarter of 2021, mainly related to reforms and investments in the fields of energy efficiency, digital transformation, justice and anti-corruption efforts, support provided to the private sector and the audit and control system related to the RRF. Following the examination of these documents, as well as additional clarifications requested, in September 2022, the EC published a positive preliminary assessment of the payment request[84] and, after obtaining the opinion of the Economic and Financial Committee, authorized the disbursement of the first instalment of financial support – excluding pre-financing – amounting to 2.6 billion euros (1.8 billion euros from the grants component and 0.8 billion euros from the loans component) in October 2022[85].

In mid-December 2022, with a delay of approximately two months, MIEP submitted to the EC the second payment request, amounting to 3.2 billion euros (2.6 billion euros excluding pre-financing)[86], containing over three thousand supporting documents related to the achievement of a total of 51 milestones and targets for the first and second quarters of 2022. These documents pertain to reforms and investments

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[83] https://mfe.gov.ro/pnrr-a-fost-transmisa-comisiei-europene-prima-cerere-de-plata-in-valoare-de-3-miliarde-euro/

[84] https://commission.europa.eu/system/files/2022-09/c_2022_6711_1_annexe_en.pdf

[85] https://economy-finance.ec.europa.eu/news/commission-disburses-first-payment-eu26-billion-romania-under-recovery-and-resilience-facility-2022-10-27_en

[86] https://ec.europa.eu/commission/presscorner/detail/en/mex_22_7792

in the fields of the electricity market, energy efficiency of buildings, digitalization, decarbonization, good governance, interoperability of databases for reducing bureaucracy, government cloud and sustainable mobility.

Although the typical evaluation period for payment requests by the EC is approximately two months, the EC only made its preliminary evaluation of Romania's second payment request public at the end of June 2023[87]. The validation process of certain milestones (primarily milestones 97, 114, 129, 133, 430, 213, assessed as not being satisfactorily achieved) was hindered by the response time to clarifications requested by EC experts, as well as the requirement for additional evidence during inter-service technical consultations. Following these consultations and discussions with EC services, Romanian authorities made certain corrections and adjustments, including the urgent adoption of normative acts falling under these milestones[88]. Observing that milestones 129 and 133 (in the energy sector, related to the construction of new electrolysis capacities and high-efficiency natural gas cogeneration) were not satisfactorily met, the EC's evaluation is only partially positive, triggering a payment suspension procedure for these two milestones (preliminary estimated amount of around 53 million euros). A period of 6 months was granted to fulfil them, during which the EC will engage in active dialogue with Romanian authorities. Consequently, the EC transmitted its preliminary evaluation to the Economic and Financial Committee, which issues an opinion within four weeks. Upon receiving this opinion, through the committee of comitology, the EC makes the final decision regarding the payment instalment to Romania (excluding payments related to the two unfulfilled milestones). Considering the duration of these EC procedures across EU member states, the average time between the publication of the preliminary evaluation and the final decision on authorization and payment is approximately two months. As a result, in Romania's case, the transfer of the 2.6 billion euros corresponding to payment request no. 2 is expected to take place in August or, more likely, in September 2023.

Under these circumstances, the third payment request, amounting to 3.1 billion euros, related to the fulfilment of 79 milestones and targets with deadlines in the third and fourth quarters of 2022 (noting that as of June 19, 2023, 16 milestones had not been achieved[89]), was not submitted by the end of June 2023, as per the initial schedule. This delay, also conditioned by the completion of the NRRP revision and the inclusion of the RePowerEU chapter, likely until September 2023, will result in delays in the preliminary evaluation process by the EC, as well as in the endorsement of the request by the Economic and Financial Committee. Consequently, the authorization and disbursement of the third instalment are

[87] https://ec.europa.eu/commission/presscorner/detail/en/ip_23_3496

[88] For example, milestone 114 pertains to the adoption of a Decarbonization Law that outlines a phased elimination of lignite and coal-based power plants. In order for this milestone to be considered achieved, the EC requested the incorporation of an exception into GEO 108/2022 regarding the postponement of decommissioning 660 MW of lignite-based electricity generation capacities and placing them in a state of preservation for a period of 3 years, starting from June 2023. In response to this requirement, the Government of Romania passed GEO 14/2023 to address this matter.

[89] https://economedia.ro/exclusiv-cate-jaloane-a-indeplinit-romania-din-cererile-de-plata-nr-3-si-4-din-pnrr-care-trebuie-depuse-in-acest-an-cele-mai-importante-restante-noua-lege-a-salarizarii-unitare-noua-lege-a-pensi.html

not expected to occur until the end of 2023, likely to be postponed to 2024. This delay will deprive Romania of a significant foreign exchange inflow for this year, which could have contributed significantly not only to respecting the NRRP's assumed timetable, but also to covering the external financing needs and improving the fiscal-budgetary parameters of 2023.

Furthermore, the application of the continuity rule in Romania's case, which implies that payment request no. 4, amounting to 2.8 billion euros and related to the fulfilment of 49 milestones with deadlines in the first and second quarters of 2023[90], originally scheduled for submission in December 2023, cannot be submitted until after the EC's final decision regarding the payment of the third instalment, likely not earlier than the first part of 2024. This situation jeopardizes the adherence to subsequent deadlines for submission/validation of the fulfilment of milestones and targets outlined in the NRRP[91], as well as the requirements to implement the plan by August 2026. Such a scenario would disrupt the entire calendar of financial flows associated with the NRRP, exposing Romania to the risk of temporary payment suspensions[92] and having direct and collateral effects on the financial-budgetary stability of Romania and on the costs of financing internal and external imbalances, against the backdrop of foreseeable constraints imposed by the implementation of the new economic and fiscal governance framework of the EU in 2024[93].

Such risks are also highlighted by the EC in the country report on Romania within the context of the European Semester – Spring Package 2023, published at the end of May. Given that credit rating agencies rate Romania at the lowest level of the investment grade category[94], underscoring the significant macroeconomic importance of the NRRP and of the complete and timely implementation of the envisaged measures, including for mitigating external and fiscal vulnerabilities, as well as for reducing the financing costs of deficits, the report notes that due to weak governance and limited administrative capacity, there is a risk of significant delays in the plan's implementation. This risk is

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[90] As of June 19, 2023, only 5 milestones had been achieved, and among the pending ones were milestones 201 and 202, related to completing the analysis of expenditures in the healthcare and education sectors, as well as to adopting a multiannual strategy and a timetable for a systematic analysis of expenditures in all sectors.

[91] https://gov.ro/ro/guvernul/sedinte-guvern/briefing-de-presa-la-finalul-edintei-de-guvern-sustinut-de-ministrul-investitiilor-i-proiectelor-europene-marcel-bolo-i-de-purtatorul-de-cuvant-al-guvernului-dan-carbunaru-briefingul-va-fi-transmis-pe-canalele-oficiale-ale-guvernului

[92] For the Payment Suspension Methodology according to RRF regulations, see: European Commission Recovery and Resilience Facility: *Two years on. A unique instrument at the heart of the EU's green and digital transformation*, Communication from the Commission to the European Parliament and the Council, COM(2023) 99 final, Brussels, 21.2.2023.

[93] In the Report of the Ministry of Finance on the *Budget Execution for the first quarter of 2023*, published at the end of April, it is stated that the largest discrepancy between the planned level and actual payments occurred at the level of projects financed from the NRRP, both from the grant component and the loan component. It is specified that the main authorizing officers are required to make all efforts to accelerate project implementation and recover the recorded gap.

[94] European Commission, *In-depth review for Romania*, 2023 European Semester – Spring Package, Commission Staff Working Document, SWD(2023) 642 final, Brussels, 24.5.2023.

explicitly referenced in relation to the extended evaluation of the second payment request and the revision of the NRRP[95].

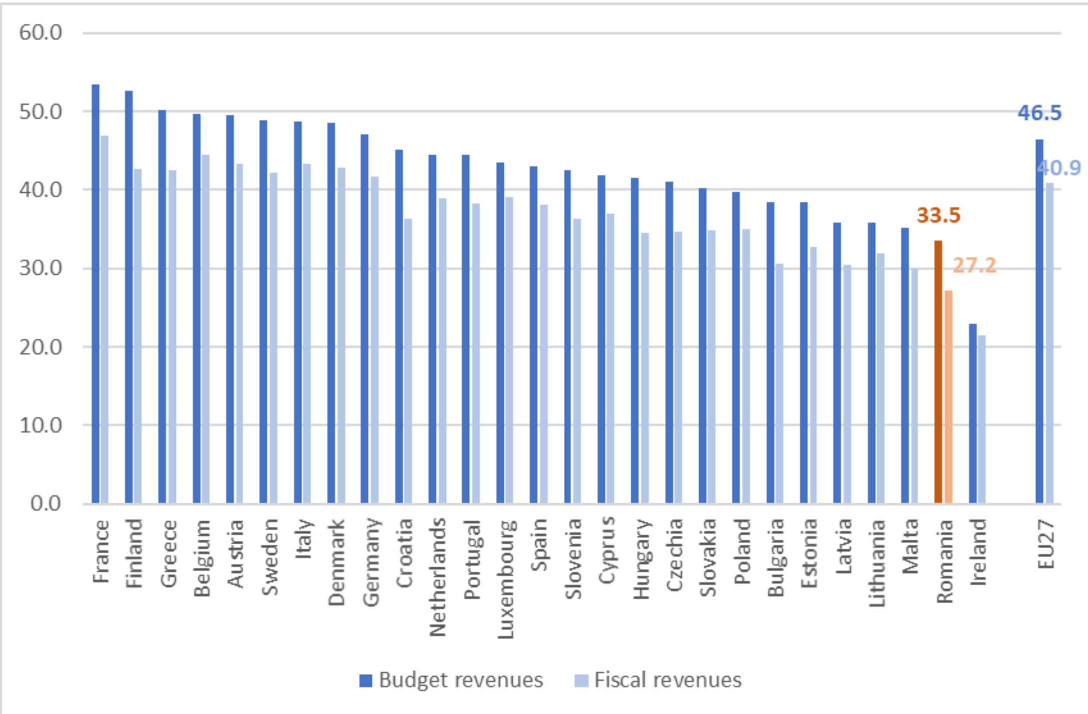
[95] European Commission, *2023 Country Report – Romania*, Commission Staff Working Document SWD(2023) 623 final, Brussels, 24.5.2023.

V. Tax collection and the structure of budget expenditures – international comparisons

V.1. Tax collection in Romania – international comparisons

Romania recorded in 2022, according to the ESA 2010 methodology, a share of budget revenues in GDP of 33.5%, well below the European average of 46.5% (difference of 13 pp), one of the smallest relative to EU member states, followed only by Ireland. The level of fiscal revenues (taxes and social security contributions) remained at 27.2% of GDP in 2022, Romania still being in the penultimate place, with a gap of 13.7 pp relative to the EU average (40.9% of GDP). Analysing the evolution of these indicators compared to the previous year, the gap that separates Romania from the EU27 average experienced a slight decrease, both in the case of budget revenues (from 14.1 pp in 2021 to 13 pp in 2022) and in the case of fiscal revenues (from 14 pp to 13.7 pp).

Figure 34: Budget revenues and tax revenues in 2022 (% of GDP, ESA 2010)



Source: Eurostat

Note: Tax revenues include social security contributions

The share of fiscal revenues in GDP recorded by Romania in 2022 is significantly below that recorded in other countries with similar economies, such as Slovenia (36.4%), Poland (35%), Czechia (34.7%) and Hungary (34.5%). Compared to Bulgaria, the share of budget revenues in GDP is lower by 5 pp, and for fiscal revenues, by 3.4 pp.

This unfavourable evolution is also the effect of the large-scale fiscal relaxation that started in 2012 through the implementation of the new Fiscal Code, which resulted in the reduction of the share of budget revenues in GDP in 2022, compared to 2015, by 2 pp (at EU27 level, they increased by 0.3 pp), and that of tax revenues by 0.8 pp (for the EU as a whole, the share increased by 0.5 pp).

From the perspective of the structure of fiscal revenues, Romania's share of indirect taxes in total fiscal revenues remains in 2022 higher than the European average (39.3% compared to 32.8%), but below the level recorded by Hungary (51.6%), Bulgaria (51.6%) and Croatia (51.2%).

The share of social security contributions in fiscal revenues reached a level of 39%, above the EU average of 34.2% – we observe a tendency towards the EU average, the gap decreasing from 7 pp in 2021 to 4.8 pp in 2022. Based on this indicator, Romania ranks sixth in the EU27 (compared to 4th in 2021), after Czechia (46.1%), Slovenia (43.4%), Slovakia (42.7%), Germany (41.2%) and Poland (39.1%).

Regarding direct taxes, Romania has one of the lowest shares in tax revenues in the EU[96], this however increasing to 21.7% in 2022 compared to 18.8% in 2021, now being 11.3 pp below the EU27 average, compared to 13.5 pp in 2021.

The structure of budget revenues in Romania is predominantly oriented towards indirect taxes and social security contributions – together they represent 78.3% of tax revenues, the 6th place in the EU, surpassed by Czechia (78.7%), Slovenia (78.8%), Bulgaria (79.1%), Hungary (80%) and Croatia (81.3%). Instead, it can be noted that at the European level there is a tendency to balance the weight of direct taxes, indirect taxes and social security contributions (respectively, an EU average of 33%, 32.8% and 34.2%).

According to a recent study from 2022[97], lower fiscal revenues in Romania compared to similar economies in the EU can be attributed to the following three factors: (i) low level of the collection rate; (ii) exemptions and loopholes that reduce the taxable base and preferential regimes for certain sectors of activity / categories of taxpayers; (iii) tax rates in some cases below EU ones.

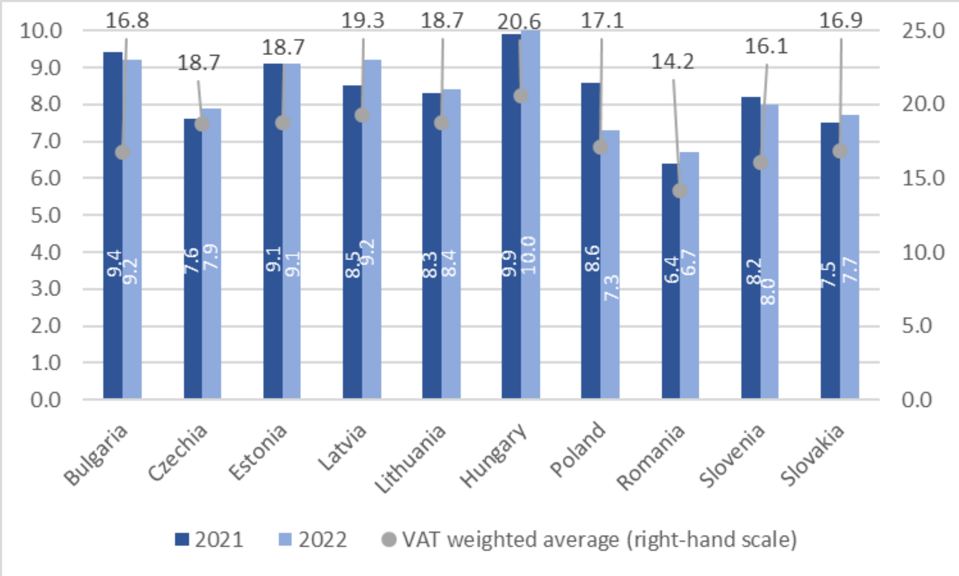
Next, a brief analysis is presented from the perspective of the collection of VAT revenues and social security contributions in Romania relative to CEE countries.

Compared to similar CEE economies, it can be seen that Romania has an unsatisfactory level of VAT revenue collection in relation to GDP (*Figure 35*) – it is also true that the level of the weighted average VAT rate is the lowest among CEE countries. Similar to the previous years, in 2022 Romania ranked last among CEE countries from the perspective of VAT revenues relative to GDP and the level of the weighted average VAT rate.

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

[97] *Budget Consolidation and Higher Fiscal Revenues – A Vital Need for Romania's Stability and Economic Security* (2022, http://www.fiscalcouncil.ro/Analiza_sistem_fiscal%20EN%2031%20mai.pdf)

Figure 35: VAT revenues in 2022 compared with the previous year (% of GDP)



Source: EC, Eurostat

At a weighted average VAT rate of 14.2% (compared to a legal rate of 19%), Romania collected about 6.7% of GDP from VAT, 1.3 pp of GDP away from Slovenia, which collected 8% of GDP at a weighted average VAT rate of 16.1% – Slovenia was chosen for comparison because, from the group of CEE countries, it is the closest to Romania in terms of weighted average VAT rate.

It is worth noting the very good performance of Bulgaria, with an economy structure relatively similar to that of our country and a weighted average VAT rate of 16.8%, which collected 9.2% of GDP, being surpassed only by Hungary, with 10 % of GDP – but at a much higher weighted average VAT rate (20.6%) –, being equal to Latvia – but at a weighted average rate of 19.3%, the second highest after Hungary, among the analysed countries – and surpassing countries that benefit from a higher average VAT rate, such as Lithuania, Estonia or Czechia.

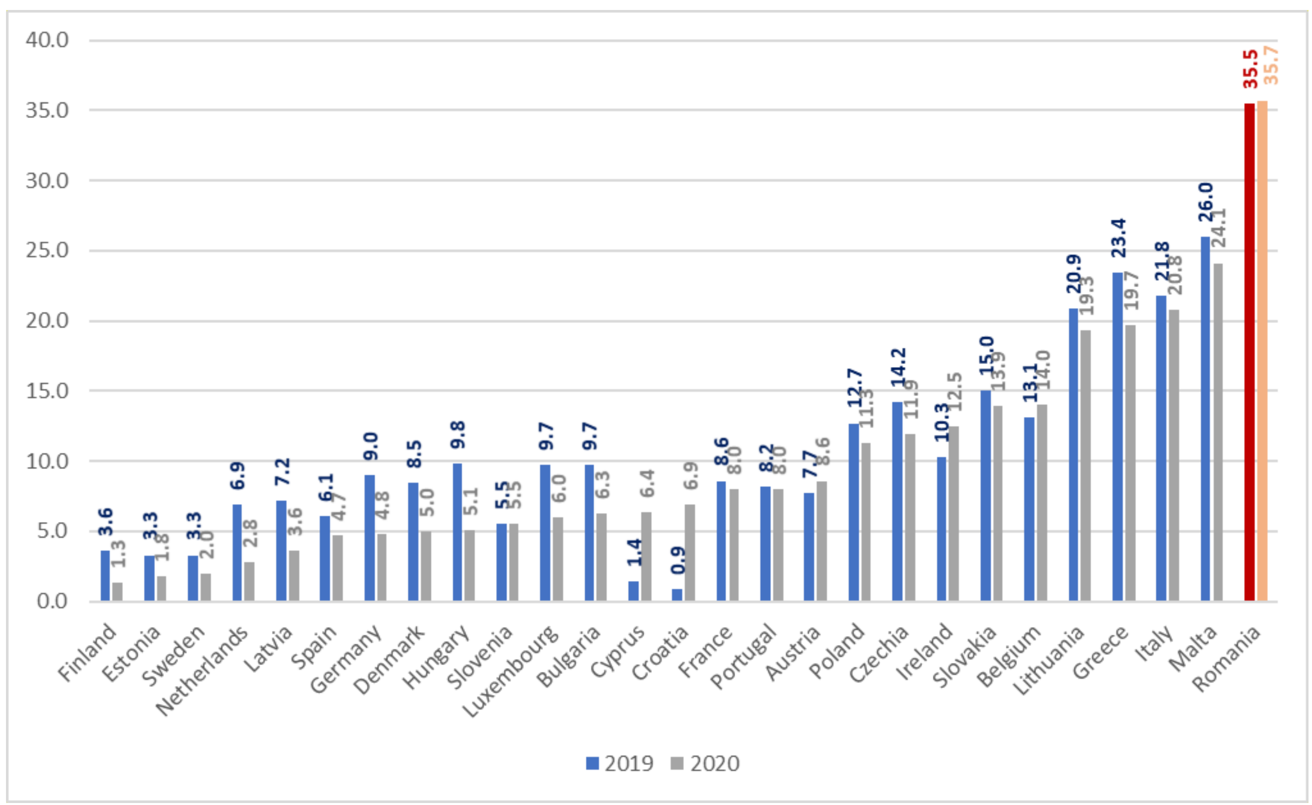
The modest VAT revenues in comparison to CEE countries are also the result of an extremely high level of the VAT gap[98], an indicator that measures the effectiveness of measures to ensure compliance with VAT legislation. It is calculated as the difference between the VAT revenues theoretically estimated to be collected (VTTL, amounts owed by economic agents, in conditions of full compliance) and those actually collected by the tax administration. According to the most recent evaluations (December 2022) from the EC's annual study[99] on this indicator, a level of VAT collection deficit of 7.4 billion euros was estimated for Romania in 2020, respectively, a share of 35.7% of theoretical revenues to be collected,

[98] The calculation of the VAT gap is based on a common methodology for all EU states. It is determined in relation to the amounts remaining in the budget after reimbursements and tax amnesties, including accessories. It includes: non-compliance with payment, tax fraud, tax evasion, tax optimization, errors of registration. It does not include the influence of fiscal policy (the deficit resulting from application of reduced quotas and exemptions' regime).

[99] https://op.europa.eu/en/publication-detail/-/publication/030df522-7452-11ed-9887-01aa75ed71a1

the highest value in the EU and CEE (*Figure 36*). Compared to the previous year, the deficit in Romania deepened by 0.2 pp while in the EU as a whole it decreased by 1.9 pp (to 9.1% from 11%). Estonia recorded a revenue gap reported to VTTL of only 1.8% (from 3.3% in 2019), Bulgaria of 6.3% (from 9.7% in 2019), Hungary of 5.1% (from 9.8% in 2019), Poland of 11.3% (from 12.7% in 2019), Czechia of 11.9% (from 14.2% in 2019) and Slovakia of 13.9 % (from 15% in 2019).

Figure 36: VAT Gap (% VTTL)



Source: EC, VAT Gap in the EU Report 2022

The huge VAT gap in Romania (almost four times higher than the EU average) is mainly determined by the poor digitalization of NAFA. Modern solutions, specific to digital transformation, which have been applied for many years by most EU states, have been implemented in Romania only partially and with long delays (connecting cash registers to NCFI or e-Invoice servers only from 2021).

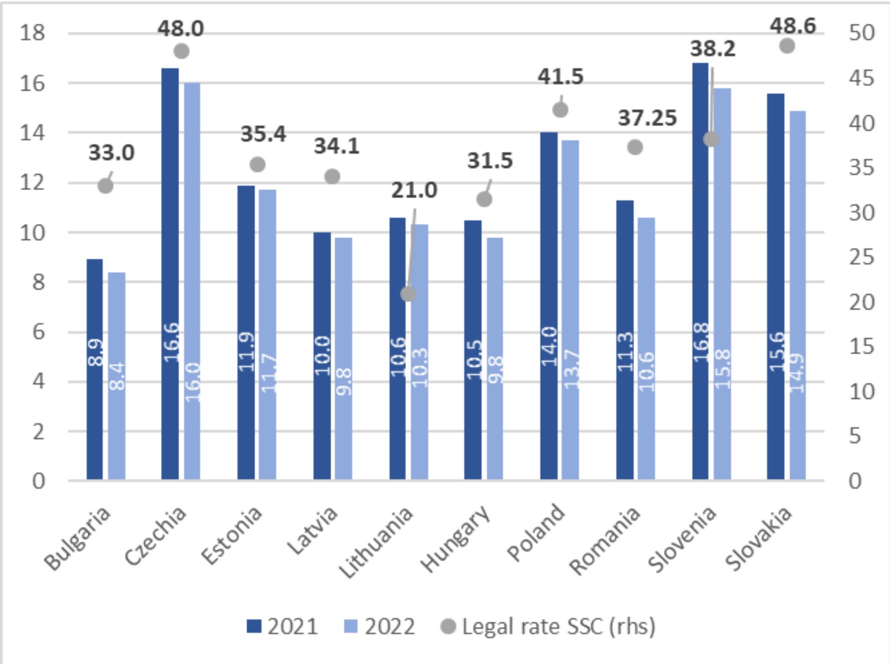
Regarding the revenues collected from social security contributions (SSC) paid by employees and employers (expressed as a share of GDP), compared to the same set of countries, Romania is positioned towards the bottom of the ranking, with a low level of collection compared to the legal SSC rate (*Figure 37*).

In 2022, SSC revenues decreased compared to the previous year (-0.7 pp of GDP), registering a level of 10.6% of GDP, but at an equivalent legal rate of 44.7%[100] (level corresponding to the legal rate of 37.25% adjusted with the increase in the tax base to make possible the comparison with the other countries).

[100] Level calculated to adjust the legal rate with the increase in gross wages following the transfer of social contributions from the employer's responsibility to the employee's starting with 2018.

Given that this equivalent tax rate is the third largest among the analysed countries (after Slovakia and Czechia), the collected revenues are superior only to Lithuania (SSC revenues of 10.3% of GDP, in the context of a legal rate of only 21%), Hungary (9.8% of GDP, but at a legal rate of 31.5%), Latvia (with 9.8% of GDP, at a legal rate of 34.1%) and Bulgaria (8.4% of GDP, but at a legal rate of 33%).

Figure 37: Social security contributions revenues in 2022 (% of GDP)



Source: EC, Eurostat

On the other hand, Slovenia (revenues of 15.8% of GDP) and Estonia (11.7% of GDP) surpassed Romania, although their legal SSC rates are lower than Romania's.

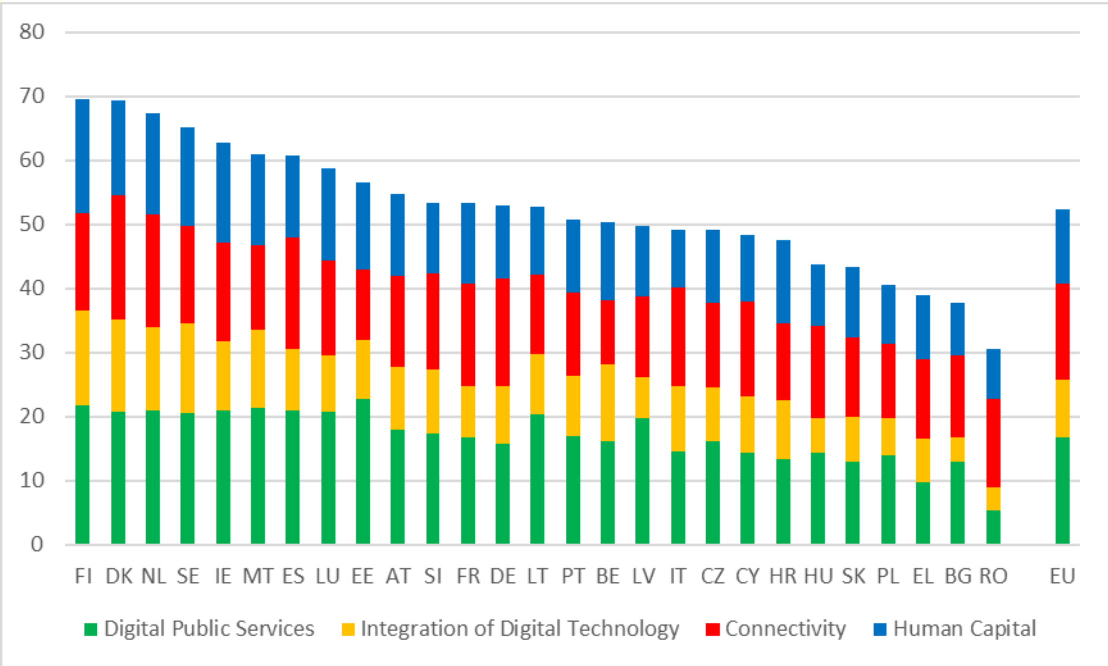
Compared to Poland, which collected about 13.7% of GDP from SSC, the equivalent legal rate in Romania is higher by 3.2 pp, and compared to Czechia, which leads this ranking with SSC revenues of 16% of GDP, the equivalent legal rate in Romania is 3.3 pp lower.

The position at the bottom of the ranking from the perspective of budget revenues as a share of GDP in recent years is not only the effect of an expansionist fiscal policy, but also of an insufficiently modernized fiscal administration apparatus, with slow and partial reforms. If, at the central level, the simplification and improvement of the administrative apparatus for tax collection has succeeded to some extent, at the local level efforts must still be carried out in this direction.

The NAFA reform, through digitalization provided for in the NRRP, starts from the recognition that, in order to correct the budget deficit, there is a need for the rapid improvement of public revenues collection and of the relationship with taxpayers. The reform plan focuses on two directions – increasing voluntary compliance by developing digital services (priority digital interaction, through VPS (Virtual Private Space) and by using pre-filled forms, where possible; creating the mechanism for assessing taxpayers' satisfaction in their relationship with NAFA and for consulting them permanently) and the improvement of tax administration processes, including through the implementation of integrated risk management (reducing the level of non-compliance, among other things, by interconnecting the IT systems of the Ministry of Finance/NAFA with the corresponding ones of the European Commission and with those of the tax administrations in EU member states).

From the perspective of the digital economy and society index (DESI, see *Box 2*), according to the 2022 EC Report[101], Romania remained in the last position among the 27 EU member states. In the structure of the 4 main axes of the DESI composite index (*Figure 38*), Romania is ranked last in *digital public services* (the same as in the previous year), *human capital* (down from the 26th place) and *integration of digital technology* (down from the 25th place), respectively on the 15th place in terms of *connectivity* (down from the 10th place).

Figure 38: DESI composite index for 2022



Source: *EC, Digital Economy and Society Index (DESI) 2022*

[101] https://digital-strategy.ec.europa.eu/en/policies/desi. The data is for 2021.

Box 2: Digital Economy and Society Index (DESI)

The DESI report monitors global digital performance in the EU, tracking the progress made by member states towards a digital economy and society, being the analysis tool for the evolution of digital competitiveness within the European semester. From 2021 the DESI composite index has 4 major axes (instead of 5 axes in the 2014-2020 period), in line with two policy initiatives with a major impact on digital transformation in the coming years: the Recovery and Resilience Mechanism and the Compass for the Digital Decade.

The 4 main axes, together with their sub-components, are:

- *human capital* (at least basic digital skills, above basic digital skills, at least basic digital content creation skills, ICT specialists, female ICT specialists, enterprises providing ICT training, ICT graduates);

- *connectivity* (overall fixed broadband usage, at least 100 Mbps fixed broadband usage, at least 1 Gbps broadband usage, fast broadband (NGA) coverage, fixed very high capacity network (VHCN) coverage, fibre to the premises (FTTP) coverage, 5G spectrum, 5G coverage, mobile broadband usage, broadband price index);

- *integration of digital technology* (SMEs with at least a basic level of digital intensity, electronic information sharing, social media, big data, cloud technology, AI, ICT for environmental sustainability, e-Invoices, SMEs in online sales, e-Commerce turnover, cross-border online sales);

- *digital public services* (e-Government users, pre-filled forms, digital public services for citizens, digital public services for businesses, open data).

It should be noted that, in the 2022 DESI Report, 11 out of these sub-components measure the objectives set in the Digital Decade.

The 2022 DESI Report includes a detailed analysis of digital policies at the level of each member state, providing an overview of progress in the digitalization of the economy and identifying key areas for action given that a good e-governance is crucial for achieving sustainable development.

Regarding the structure of the *digital public services* axis, Romania constantly presents a low performance compared to the other member states, all indicators in this field being well below the EU average. Thus, 17% of Romanian *online* users actively interact with e-government services, compared to the EU average of 65%, and the score for the *pre-filled forms* indicator is 19, compared to the EU average of 64. Regarding *digital public services for citizens*, the score is 44 (EU average: 75) and *for businesses* is 42 (EU average: 82). The report highlights for Romania that the lack of interoperability of IT systems in the public administration is a chronic problem, despite the advance during the pandemic. For the *open data* sub-component, we observe a tendency towards the European average (Romania – 76%, EU – 81%).

In what concerns the structure of the *human capital* axis, Romania has a score below the EU27 average for most sub-indices, with two exceptions: the number of *ICT graduates* (6.7% compared to the European average of 3.9% – here the data refers to 2020) and the number of *female ICT specialists* (26% compared to the European average of 19.1%). On the other hand, the shortage of *ICT specialists* (sub-index value of 2.6% compared to the EU average of 4.5%) and the very small number of *enterprises* *offering ICT training* (sub-index value of 6% compared to the average EU of 20% – here the data also refers to 2020) limit the country's ability to innovate and take advantage of digital transformation. Also from the perspective of *at least basic digital skills* in terms of digital and software knowledge, Romania is far away from the EU average, with a value of 9% (EU average: 26%).

Analysing the *integration of digital technology* by enterprises, a large part of the indicators are far below the EU average: 22% of SMEs have *at least a basic level of digital intensity* (EU average: 55%), 17% of enterprises issue *electronic invoices* (EU average: 32%) – here the data refers to 2020 –, 11% use *cloud* services (EU average: 34%) and only 5% of enterprises analyse *large volumes of data (big data)* – here also the data refers to 2020. Romania ranks above the EU average for the percentage of *businesses using ICT for environmental sustainability* (68% compared to an EU average of 66%).

Regarding the *connectivity* axis, Romania is above the EU average in terms of: use of services of *at least 100 Mbps fixed broadband* (57% of households, compared to 41% of households in the EU), use of services of *at least 1 Gbps* (8.98% of households, compared to 7.58% of EU households), *fast broadband (NGA) coverage* (93% of households, compared to 90% of EU households), *fixed very high capacity network (VHCN) coverage* (87% of households, compared to 70% of households in the EU) and *fibre to the premises (FTTP) coverage* (87% of households, compared to 50% of households in the EU). The *broadband price index* places us first in the EU with a score of 97, compared to the EU average of 73 – out of a maximum of 100 points, where 100 means the lowest prices. Romania, Lithuania, Poland and Bulgaria have the lowest prices for broadband connection; at the opposite pole, with the highest prices, are Belgium (the most expensive country from this point of view), Croatia and Greece.

The Authority for the Digitalization of Romania (ADR) identified the following barriers to the digitalization of the public sector[102]: the lack of an efficient and effective IT architecture; lack of IT systems for central public institutions; the small number of specialists in e-government and the absence of a coordinated and effective legislative and procedural framework. ADR developed the public policy in the field of e-government for 2021-2030, adopted on June 3, 2021, with the main objective of increasing the number and quality of electronic public services in Romania, having an impact, among others, on the degree of tax collection.

The NRRP includes measures for issuing a number of 8.5 million electronic identity cards (which will allow, on the one hand, authentication for the use of online public services, and, on the other hand, the electronic signature), with an allocated amount of 200 million euros – in Romania there is no electronic identification system, essential for online interactions. Investments financed through the NRRP also aim at the online provision of essential public services and the development of a unified framework for the government cloud[103].

In conclusion, the tax administration is at an early stage in terms of digitalization, with unfavourable results from the perspective of budget revenues, placing Romania in the penultimate position in the EU.

[102] https://www.adr.gov.ro/wp-content/uploads/2021/04/ADR-Barierele-Digitalizarii-mediului-public-si-privat-din-Romania.pdf

[103] https://digital-strategy.ec.europa.eu/en/policies/desi-romania

The situation becomes even more problematic if we refer not only to the obligation to reduce the budget deficit provided by the EDP under the current conditions of geo-political instability (the war in Ukraine, the energy crisis etc.), but also to the challenges related to the transition to a new type of economy, which has to respond to issues related to the exodus of human capital, the energy transition and climate change.

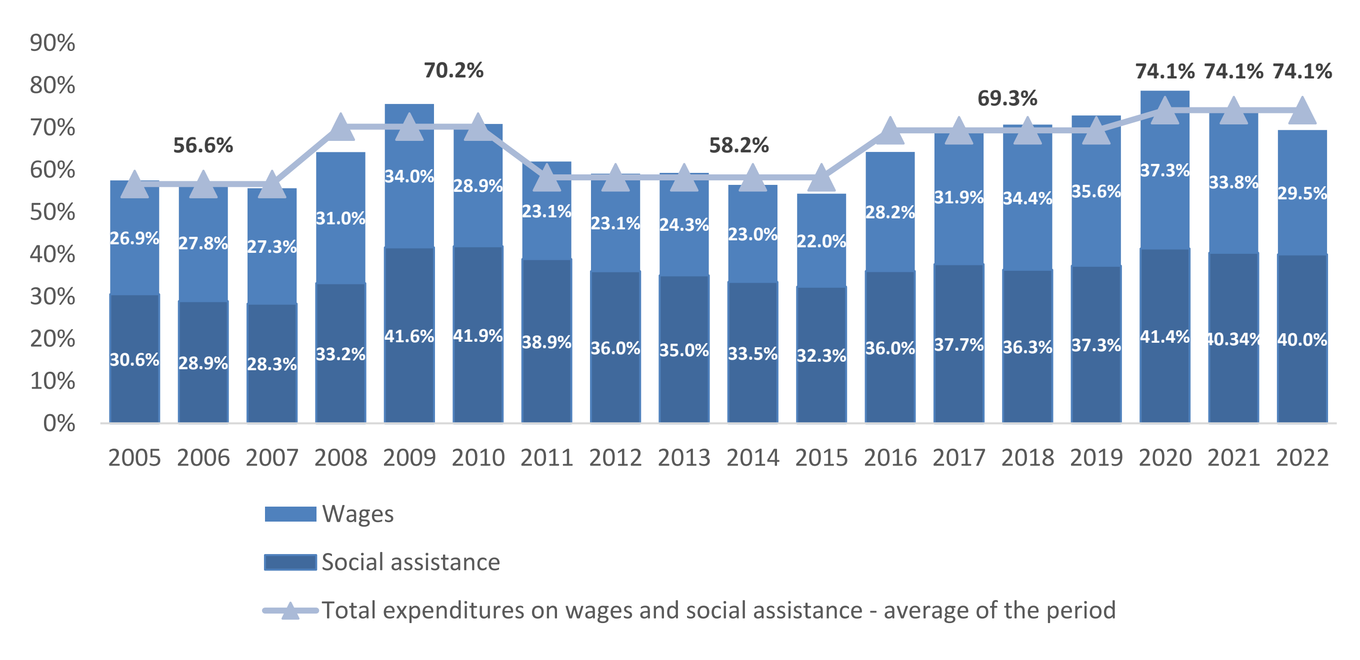
As the FC has repeatedly pointed out, intense efforts are needed to increase investments in fiscal infrastructure and, especially, in digital technology. The access to the resources made available to Romania through the Recovery and Resilience Mechanism represents the opportunity through which these objectives can be achieved in the coming years, allowing the capitalization of new innovative economic models to face future challenges that derive from the need for budgetary correction, assumed in the EDP, for improvement of financial creditworthiness and for sustainability of public finances.

V.2. Public expenditures – structure and sustainability

The structure of budget expenditures in Romania is characterized by the dominance of expenditures on salaries and social assistance (pensions, social benefits etc.). Although their relative importance was significantly reduced between 2011 and 2015, as a result of the fiscal consolidation process, with 2015 representing the minimum of the analysed period, the 2016-2020 period saw a strong reversal of this evolution (*Figure 39*). Thus, at the end of 2020, the share of expenditures on salaries and social assistance in budget revenues was higher by approximately 24 pp compared to 2015. Moreover, the level recorded in 2020 (78.7%) represented the peak of the analysed period. Starting from 2021, a downward trend can be noticed for the share of expenditures on salaries and social assistance in total budget revenues. Thus, in 2021, their share in total budget revenues decreased by 4.5 pp compared to the peak recorded in 2020. In 2022, this path continued and the share of expenditures on social assistance and salaries in total budget revenues recorded a decrease of 4.8 pp compared to the previous year, reaching a value of 69.4%.

This evolution can be explained by the fact that, although these categories of expenditures registered a nominal increase, compared to the previous year, with a 6% increase in the case of personnel expenditures and a 21% increase for social assistance expenditures, budget revenues grew at a faster pace (+22%). Therefore, the downward trend for the share of expenditures on salaries and social assistance in total budget revenues was primarily due to the slower growth rate of personnel expenditures, as the difference between the growth rates of revenues and social assistance expenditures was minor. Under these circumstances, it should be underlined that the share of personnel expenditures in total budget revenues for the year 2022 (29.5%) is below the average of the 2008-2010 period (31.4%), while the share of social assistance expenditures (40%) is above the average of the 2008-2010 period (39%). Compared to the fiscal consolidation period between 2011 and 2015, the shares of personnel and social assistance expenditures in total budget revenues are above the averages of 23.1% and, respectively, 35.1%, as the expansionary fiscal policy, implemented during the 2016-2020 period, has cancelled out the personnel and social assistance expenditures adjustments from the 2011-2015 period. It should be noted that the decrease of the share of social assistance expenditures in total budget revenues was of small magnitude in 2022. Compared to 2021, the ratio of social assistance expenditures to total budget revenues decreased by only 0.3 pp, while the ratio of personnel expenditures to total budget revenues declined by 4.3 pp.

Figure 39: The evolution of social assistance and personnel expenditures as a share of total budget revenues (ESA 2010, %)

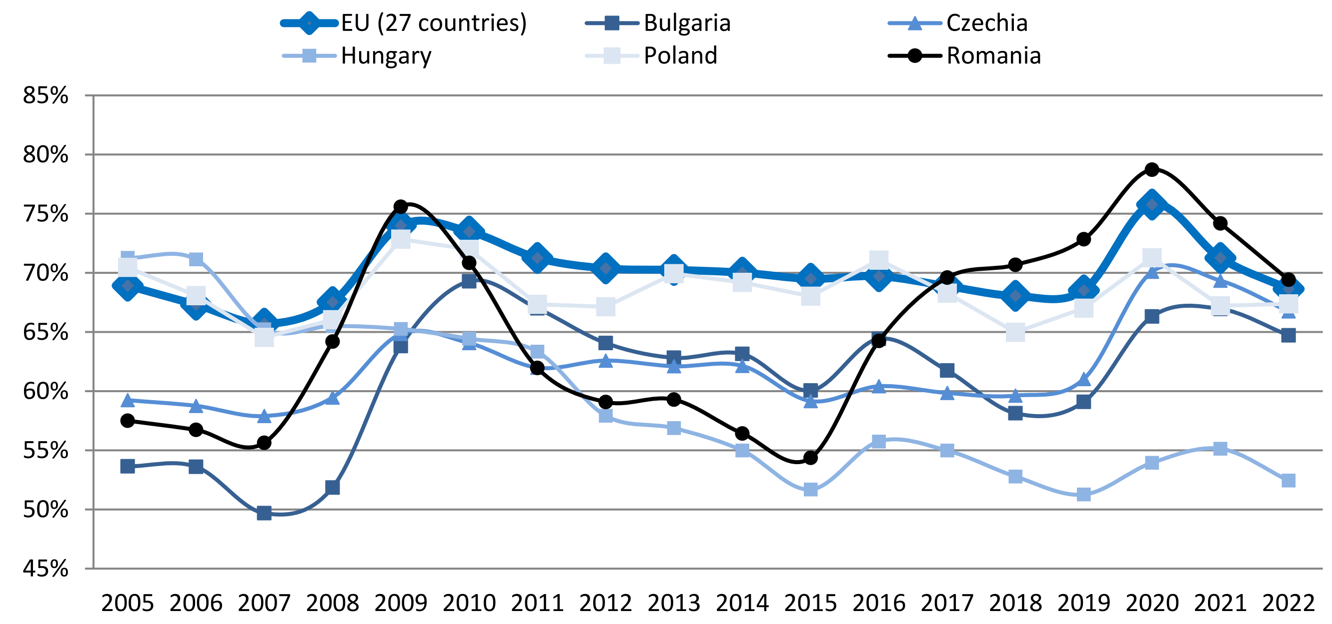


Source: Eurostat

Note: Given the change in the statistical treatment of special pensions by Eurostat, they are included in revenues from social security contributions and in personnel expenditure without an actual collection/payment taking place. Accordingly, in order to avoid double recording, the expenditure on special pensions has been removed from social security contributions revenues and from personnel expenditure.

Starting from 2018, the change in the tax regime of wages by transferring contributions from the employer to the employee determined a significant increase in the gross salary, which was equivalent to an increase in the contribution to the social security system. These measures, in addition to the reduction of the quota transferred to Pillar II, have contributed to the substantial improvement of the system's self-financing capacity in the last two years. However, the share of this category of expenditures in total revenues remains very high, compared to other EU member states. Therefore, considering the ensuring of medium and long-term sustainability of public finances, it is important that any future increase in public personnel expenditures to be done in line with the evolution of economic activity and, in particular, with productivity gains. In this sense, the 2016-2020 period saw a trend of rapid increase in public personnel expenditures with growth rates significantly higher than the nominal GDP advance and, especially, compared to the growth rate of total budget revenues from this period. This trend is reversed in 2021 and 2022, as personnel expenditures increased at a slower pace compared to the growth of budget revenues. However, their share in total revenues remains high.

Figure 40: The share of personnel and social assistance expenditures (including pensions) in total budget revenues in EU27 and CEE between 2005-2022



Source: Eurostat

Note: Given the change in the statistical treatment of special pensions by Eurostat, they are included in revenues from social security contributions and in personnel expenditure without an actual collection/payment taking place. Accordingly, in order to avoid double recording, the expenditure on special pensions has been removed from social security contributions revenues and from personnel expenditure.

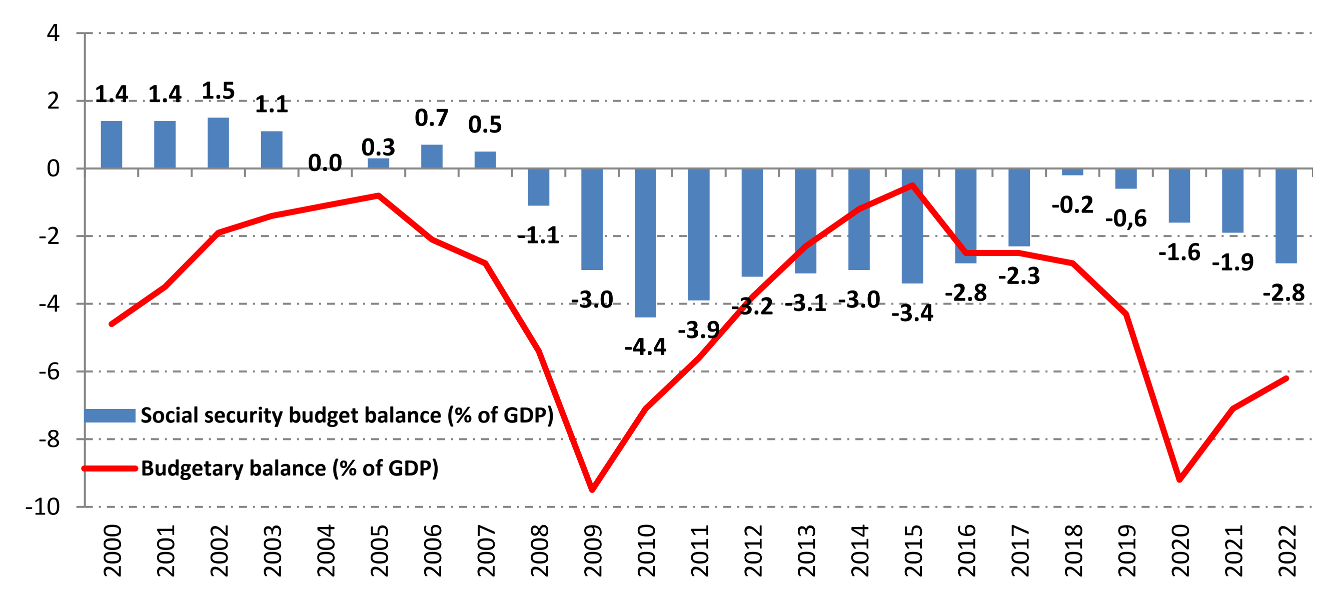
After a relatively stable evolution compared to budget revenues before 2007, expenditure on salaries and pensions advanced at a rapid pace during 2008-2009[104]. With a value of 75.6% in 2009, Romania has recorded the highest share of expenditure on salaries and social assistance in total budget revenues at the level of CEE countries, even exceeding the EU27 average (*Figure 40*). After the implementation of the fiscal consolidation program, their share decreased significantly during the 2013-2015 period, being reduced to a lower level than the other CEE countries, except for Hungary. However, starting from 2016, this trend was reversed and, against the background of aggressive increases in salaries in the public sector and pensions, Romania has registered between 2018 and 2020 the highest values in the region for the ratio of expenditures on salaries and social assistance to budget revenues (70.7% in 2018, 72.8% in 2019 and 78.7% in 2020) while also surpassing the EU27 average. Since 2021, a downward trend can be noted for the share of expenditures on salaries and social assistance in total revenues. Thus, in 2021, this indicator decreased to 74.2% and, in 2022, to 69.4%. However, Romania remains the country with the highest ratio of expenditures on salaries and social assistance in total budget revenues among the CEE countries, being 2 pp higher than the next ranked country, Poland, and 17 pp higher than the last

[104] With an average share in total budget revenues of 70%.

ranked country, Hungary. Additionally, this indicator is 0.8 pp above the EU27 average, which reached 68.6% in 2022.

Regarding the evolution of the social security budgets (pensions, unemployment and health), it can be noticed that, if in the 2000-2007 period they were characterized by a relatively level balance or even a surplus, after 2008 they went into deficit. Furthermore, they have come to represent an important component of the total deficit, between 62% and 92% in the 2010-2017 period (*Figure 41*). In 2019, the deficit of the social security systems represented 14% of the total budget deficit. However, in 2018 this deficit was considerably reduced as a result of the fiscal measures adopted to reset taxation, embodied in the increase of taxation through social security contributions (reaching 7% of the total budget deficit). In 2020, the deficit increased by 1 pp compared to 2019, representing 17% of the total budget deficit. The increasing path for the deficit of social security systems can be also noticed in 2021 and 2022, reaching values of 1.9% and, respectively, 2.8% of GDP. Under these circumstances, in 2022, the deficit of the social security budget reached a share of 45% of the total budget deficit, an increase of 18 pp compared to the previous year. It is worth mentioning that, in 2022, although the overall budget balance improved by 0.9 pp of GDP in ESA terms, the balance of social security budgets worsened by 0.9 pp of GDP. This signals a systemic problem for Romania, accentuated by the persistence of a negative demographic growth rate and the ongoing trend of population emigration.

Figure 41: Social security budget balance (pensions, unemployment and health) and total budget balance (ESA 2010, % of GDP)



Source: Eurostat

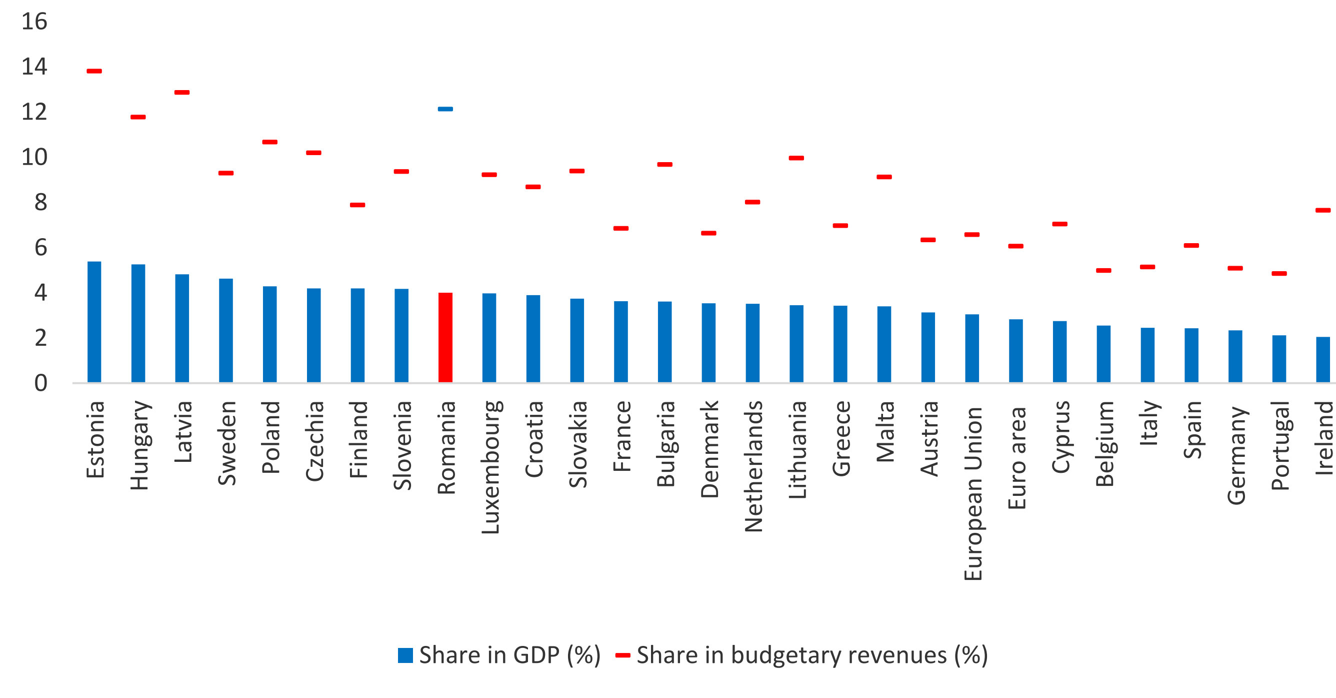
Note: Data according to ESA 2010 – the differences from the figures in the reports for the years 2010-2015 are due to the transition from ESA 95 to ESA 2010 methodology.

In 2022, investment expenditures remained at the same level as in the previous year (4.2% of GDP). Compared to 2020, when investment spending reached a peak after 2015, the percentage is lower by

0.4 pp. Compared to 2015[105], public investment spending as a percentage of GDP is 19.2% lower, corresponding to a 1 pp difference. From the perspective of this indicator, in 2022, Romania ranked 6th in the EU27 (compared to 8th in 2021) and held an intermediate position among the CEE countries, ahead of Bulgaria (ranked 19th) and Poland (ranked 9th), but behind Hungary (ranked 1st) and Czechia (ranked 5th).

As a share of budget revenues, public investment expenditures were lower by 0.5 pp compared to the previous year and with 2.1 pp lower than in 2015. In 2022, within the EU27, in terms of the ratio of investment expenditures to budget revenues, Romania ranked 3rd, after Estonia and Hungary, a position similar to the ranking which considers the average investment expenditures over the 2012-2022 period (*Figure 42*). Considering the context of rising commodity prices and Romania's development needs, it is expected that the allocation for this budgetary aggregate to be supported by the funds allocated through the National Recovery and Resilience Plan and the Multiannual Financial Framework.

Figure 42: The share of investment expenditures in GDP and in total budget revenues (2012-2022 average)



Source: Eurostat

[105] 2015 was the first year after 2008 in which public investment spending was on the rise as a percentage of GDP compared to the previous year, given that this year represented the deadline for the absorption of European funds related to the 2007-2013 financial framework.

VI. 2023 – Macroeconomic and fiscal perspectives

VI.1. Macroeconomic framework

In 2022, the Romanian economy had a real economic growth of approximately 4.7%, building upon the recovery that started in 2021. This recovery was characterized by increased consumer and investor confidence in the economy, as highlighted by the higher contributions of both final consumption (4.1 pp to economic growth) and, notably, gross fixed capital formation (1.9 pp to economic growth)[106]. Among the factors that contributed to these developments, we can mention the still accommodative monetary policy – despite the increase of the monetary policy rate, the real interest rate remains negative – and a lenient fiscal policy, reflected in the size of the deficit, despite a slight structural fiscal adjustment last year. Additionally, the improved external demand also contributed to economic growth Romania, similar to other CEE countries, being among the most open economies in terms of external trade. Other key factors behind the favourable developments in gross value added in the economy include: (i) a relative easing of disruptions in supply and production chains; (ii) a relative decrease in commodity prices, such as oil, gas, electricity, metals, and agricultural products, both in international markets and domestically; (iii) the relocation of some production activities from other geographical areas to Europe; (iv) a significant contribution from European funds within the Multiannual Financial Framework, as well as from the NRRP, combined with a focus on green transition policies; (v) favourable financing conditions, which, despite some deterioration – including rising costs, reduced volumes and greater risk selectivity – remained relatively favourable even for emerging economies, such as Romania, which face additional imbalances and vulnerabilities.

For the global economy, the latest forecast by the IMF[107] anticipates that the GDP will increase by 2.8% in real terms throughout 2023. However, this growth rate represents a significant slowdown compared to the previous year, when the real economic growth was 3.4%, as well as compared to the earlier projection of 2.9% (January 2023 update of the World Economic Outlook). This deceleration is primarily due to persistent adverse shocks caused by several factors: the war in Ukraine (especially the issues concerning commodity and energy prices and disruptions in trade), the effects of new COVID variants in some economies, and the worsening of international financing conditions, due to the central banks' response to the rising inflation that has deviated significantly from their targets. In the IMF's forecast, the structure of growth among countries reveals different trends and, overall, the growth is expected to

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[106] The growth of 4.7%, according to the **expenditure** approach, was determined by **final consumption** (4.1 pp**),** **gross fixed capital formation** (1.9 pp), **net exports** (-0.7 pp), and **changes in inventories** (-0.6 pp). According to the **production** approach, the annual economic growth of 4.7% was attributed to: the **services** sector – with a cumulative contribution of 2 pp – especially professional, scientific, and technical activities, as well as real estate transactions; the **IT** sector (1.3 pp), **trade** (1.2 pp), **constructions** (0.7 pp) and **net taxes on products** (0.5 pp), partially offset by negative contributions in **agriculture** and **industry** (-0.5 pp each).

[107] World Economic Outlook – April 2023, https://www.imf.org/en/Publications/WEO/Issues/2023/04/11/world-economic-outlook-april-2023

be slow and uneven. Most of the developed countries (90% of them) are anticipated to have lower economic growth in 2023, compared to the previous year (1.3%, compared to 2.7% in 2022). In contrast, emerging and developing countries are expected to maintain a similar growth pace as in the previous year (3.9% growth in 2023, compared to 4.0% in 2022). Among developed countries, the highest growth rates are projected for the United States, Canada, and Japan (with growth rates of 1.6%, 1.5%, and 1.3%, respectively). This contrasts with the Eurozone, which is expected to have a 0.8% GDP increase in 2023 (compared to a 3.5% GDP increase in the previous year). The high pace of economic growth in emerging and developing economies is largely due to the strong growth anticipated in China and India (real GDP growth rates of 5.3% and 5.2%, respectively). This is partially offset by slower developments in countries like Russia, Brazil, and Mexico (growth rates of 0.7%, 0.9%, and 1.8%, respectively), as well as countries in the Middle East and North Africa (largely significant producers of commodities, especially energy) – where aggregate GDP variations are estimated at 3.1%.

The IMF anticipates a relatively similar, albeit slightly higher, real GDP growth rate for 2024, compared to the 3% forecast for the current year. The growth is unevenly distributed, driven by a slight acceleration in growth in both developed countries (at 1.4%) and emerging economies (at 4.2%). In the EU and the Eurozone, there is a strong upward trend in growth, the projected economic growth rates in 2024 being 1.6% (up from 0.7% in 2023) and 1.4% (up from 0.8% in 2023), respectively. CEE countries are expected to have a much faster dynamic (2.5% in 2024, up from 1.2% in 2023). However, the IMF's forecast highlights a high and increasing level of uncertainty in the projections. Adverse risk scenarios are considered, especially regarding financing conditions, and these are deemed relevant and relatively plausible.

The most recent forecast of the EC, the 2023 spring forecast[108], published in May 2023, estimates a real GDP growth of 1% for the EU27[109] and 1.1% for the Eurozone (compared to a growth of 3.5% for both in 2022). The EC anticipates for 2024 an acceleration in the growth rate to 1.6% for the EU27 and to 1.7% for the Eurozone. Compared to the EC's provisional 2023 winter forecast, published in February, the economic growth in the latest forecast is higher for both the EU and the Eurozone in 2023 (0.2 pp higher). The economic scenario and the underlying assumptions take into account several factors: (i) a more favourable starting point, represented by a better-than-expected economic growth in the first quarter of 2023 and a smaller contraction in the last quarter of the previous year; (ii) lower energy prices; (iii) mitigated supply-side constraints; (iv) increased business confidence; (v) the impact of the recovery and resilience plans promoted by the EU, reflected in increased investments despite anticipated tighter monetary conditions; (vi) a relatively tight labour market; (vii) an improvement in terms of trade (as a result of lower commodity prices) reversing the negative effect from the previous year; (viii) a recovery in consumption in 2024 after the inflationary shock dissipates, which is currently eroding purchasing power, this recovery also reflecting an improvement in the terms of trade; (ix) the persistence of the

[108] European Economic Forecast, Spring 2023, https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/economic-forecasts/spring-2023-economic-forecast-improved-outlook-amid-persistent-challenges_en, May 14, 2023.
[109] United Kingdom (UK) not included.

current conditions on the labour market, marked by high tension due to high labour demand and a significant gap between the level of specialization in the labour supply and demand. These assumptions, generally favourable in effect, are accompanied by other anticipated developments/incorporated as assumptions in the projection: (x) fiscal adjustment in 2023 and 2024, which will reduce aggregate demand, driven by a reduction in the level of support provided to economies to overcome the energy crisis, but also by moderating inflation – which, all else being equal, leads to higher tax revenues – which is equivalent to a structural adjustment; (xi) fiscal consolidation offset, to some extent, in some countries, by higher spending due to past inflation indexing; (xii) a more favourable international economic environment, represented by the recovery of economic activity in Asia, in particular, leading to an improvement in the current account of the balance of payments for EU27 countries.

Although the changes in the EC's spring projection, compared to the winter forecast, are relatively small in terms of the main variables, the situation is different when it comes to risks. These risks are seen as more likely and with a more pronounced negative effect: (i) the persistence of inflation is one of the determinants of negative risks; (ii) an increase in risk aversion in international capital markets and a more restrictive monetary policy could lead to slower economic developments; (iii) fiscal policies more expansionary than projected could reignite inflation, leading to a stronger response from monetary policy; (iv) lower prices for energy and raw materials could help reduce inflation, with positive effects on real aggregate demand; (v) the war initiated by Russia in Ukraine could increase, through its consequences, the persistent uncertainty in the current macroeconomic projections. The EC considers that the current risk balance is tilted towards more adverse scenarios than the baseline, with the risks being judged as less unfavourable in the previous forecast (from February).

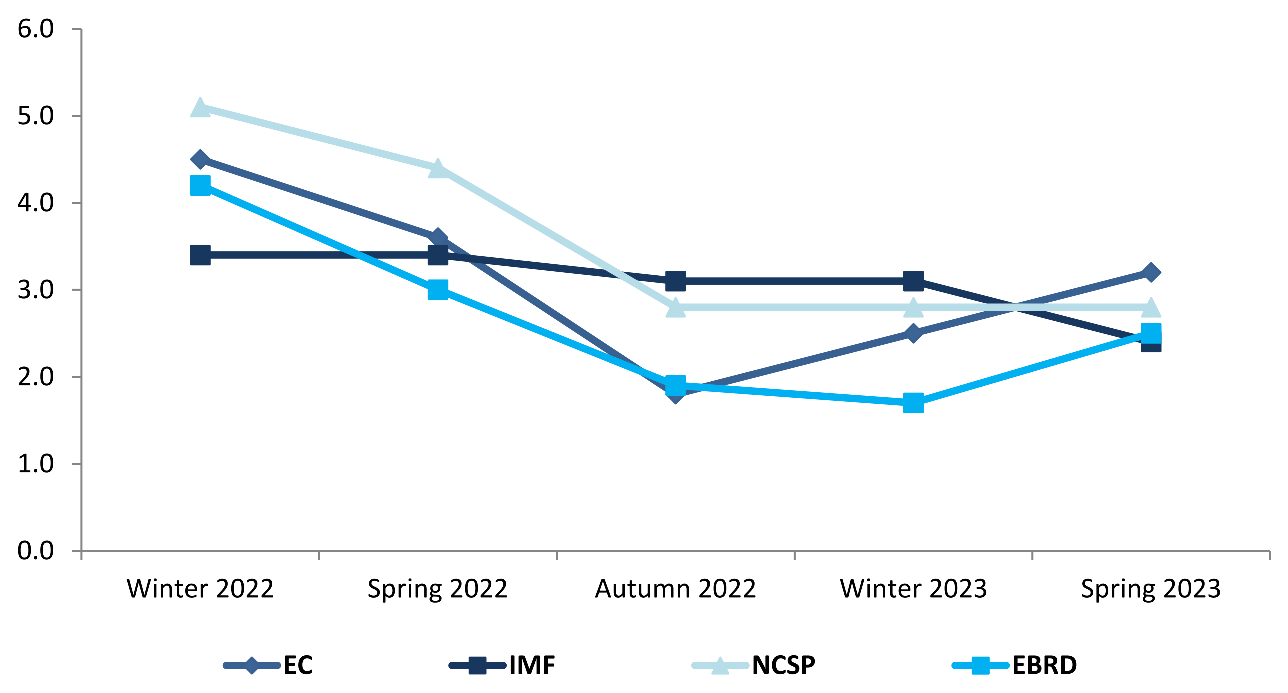
Regarding the growth forecasts for EU27 member states for the current year, the EC estimates, in the spring forecast, faster growth rates for Ireland (5.5%), Malta (3.9%), Romania (3.2%), Greece and Portugal (2.4% each), and Cyprus (2.3%). The lowest GDP growth rates are expected in countries like Sweden (a contraction of 0.5%), Estonia (a contraction of 0.4%), Czechia, Germany, and Finland (0.2%), and Denmark (0.3%). The projection indicates that the dispersion of GDP per capita in euro in European countries could increase, given different starting points and despite the convergence of economic growth rates, which will widen the gap between countries and regions within the projection horizon. The pace of economic growth in 2024 is expected to increase or remain high in most European countries (with an aggregate dynamic of 1.7%, up by 0.7 pp compared to the previous year), especially in Ireland (the growth rate decreases by 0.5 pp to 5%), Malta (at 4.1%, up by 0.2 pp), Romania (at 3.5%, an increase of 0.3 pp compared to 2023), Estonia (at 3.1%, an increase of 3.5 pp), and Hungary (at 2.8%, an increase of 2.3 pp from the previous projection year). The countries with the lowest projected economic dynamics in 2024 are Italy (1.1%, a decrease of 0.1 pp compared to the previous year), Sweden (also at 1.1%, but an increase of 1.6 pp from 2023), the Netherlands (at 1.2%, a deceleration of 0.6 pp), Germany (growth of 1.4%, 1.2 pp higher than in 2023), and Belgium (also at 1.4%, but with an annual dynamic increase of only 0.1 pp). EC's assessments of future economic growth should be judged considering the high uncertainties in this forecast round.

In 2023, from the perspective of inflation development, expressed through the Harmonized Index of Consumer Prices (HICP), it is estimated that it will reach very high values, 6.7% for EU27 and 5.8% for the Eurozone, both in comparison to the inflation from the previous year (3.1% in EU27 and 2.8% in the Eurozone) or in comparison to historical data, as well as in comparison to the Eurozone's inflation target and the specific targets of each non-member country. It is noteworthy that even in the current forecast, emerging countries within the Eurozone, but especially those outside it, have higher HICP levels than other states. These differences arise from both a stronger impact of adverse, mostly supply-side, shocks on prices within each country and from different policies and economic structures, including exchange rate regimes and the degree of transmission of exchange rate variations. This differentiation also affects countries from the perspective of internal balance and resilience, as represented by price dynamics. Regarding HICP inflation, the largest difference among EU27 countries, in the current year's forecasts, lies between the anticipated inflation for Hungary (16.4%), Czechia (11.9%), Poland (11.7%), Slovakia (10.9%), and Romania (9.7%), on the one hand, and that projected for Luxembourg (3.2%), Belgium (3.4%), Cyprus (3.8%), Spain (4%), and Greece (4.2%), on the other hand.

From the perspective of economic growth for Romania, in the spring forecast, the EC anticipates a growth of 3.2% in 2023 – above the IMF's forecast of 2.4% – followed by an acceleration to 3.5% in the following year (3.7% in the IMF projection). The determining factors for the upward trajectory of GDP over the next two years are expected to be private consumption (supported by wage and pension indexation, as well as government support schemes, including in the energy sector) and gross fixed capital formation (the investment increase is also supported by the anticipated absorption of funds allocated by the EC through both the Multiannual Financial Framework and the NRRP). Net exports are expected to have a negative contribution to economic growth, despite the forecasted gradual adjustment of the external imbalance (represented by the trade deficit and the current account deficit – the latter is expected to remain at approximately 8% of GDP over the projection horizon). The adjustment of external deficits occurs as a result of an improved external environment (external demand) and the effects of European funds and allocations from the NGEU program. On the one hand, the still high inflation in 2023 is forecasted to reduce households' purchasing power and moderate economic growth, while, on the other hand, in 2024, the anticipated inflation level decrease will contribute to an acceleration in the pace of the economy. Rising interest rates and the effect of uncertainty could be offset by investments from European resources (Multiannual Financial Framework and NRRP). The risks within the projection are assessed to lean towards lower economic growth values (which could be driven by slower absorption and delays in the NRRP and the Multiannual Financial Framework, leading to reduced investments), inflation could be higher (due to significant wage pressures), and the budget deficit could increase due to higher allocations associated with the super-election cycle in 2024.

For 2023, the initial forecasts of the EC, the IMF, and the EBRD indicated an economic growth above potential for Romania, which was expected to accentuate the excess of domestic demand. The downward evolution of these forecasts, to a level in the immediate proximity of the growth potential or even below it, occurs due to the impact of deteriorating external conditions (both in terms of external demand and financing conditions). It is also influenced by the tightening of monetary policy, high inflation, which erodes the purchasing power, and optimistic expectations regarding fiscal adjustment.

Figure 43: 2023 economic growth forecasts for Romania



Source: EC, IMF, NCSP, EBRD

The realization of these worsening forecasts for 2023 can be noticed in the GDP data for the first quarter of 2023, the provisional version (2). Thus, the new data confirms an annual economic growth rate of 2.4% (approximately half the rate for the previous quarter - the fourth quarter of 2022, which was 4.7%), while the GDP growth in the current quarter (the first quarter of 2023) compared to the previous one (the last quarter of 2022) was only 0.2%, marking an almost stagnation of the economy. This data confirms the significantly deteriorated forecasts from the autumn of 2022. However, the data structure (in this slowdown, for example, according to the expenditure approach, the changes in inventory represent the most important factor, historically, this being a proxy for developments that are subsequently allocated to other components such as consumption, investments, net exports) does not provide sufficient information to assess whether the factors considered by the mentioned forecasts are reflected in the published data.

In the context of significant twin deficits (a current account deficit of 9.3% and a fiscal deficit of 6.2%, according to European methodology, in 2022), Romania's economy is particularly vulnerable to changes in the attitude of financiers, as reflected by the financial markets. This attitude, in turn, depends largely on the performance of the public sector, its commitment to a consolidation path that would also help reduce the large external deficit.

Considering the necessary fiscal adjustment in 2023, the following elements are relevant: (i) the nominal GDP will not grow as rapidly in 2023, compared to 2022, and inflation (which has identical observational effects to a structural adjustment), both through the denominator effect and through the increase in macroeconomic bases, will not contribute as significantly to deficit reduction; (ii) the lower economic growth in 2023, already noticeable in the data for the first quarter of 2023, will close the excess demand in the medium term, exposing, with the disappearance of the cyclical component (which adjusted the *headline* deficit), a very high structural deficit; (iii) the 6 months budget execution reveals a relatively high deficit of 2.3% of GDP in national methodology, raising questions about the realization of the Fiscal Council's opinion at the time of approving the 2023 budget (and the 2023-2025 Fiscal Strategy) regarding a deficit larger than projected, while the gap between the deficit target and recent forecasts seems to indicate the implausibility of the targeted deficit without clear, firm consolidation measures adopted rapidly (in order to have an effect in the latter part of 2023); (iv) adjustments in expenses to achieve the deficit target are no longer possible at the levels seen in previous years, because expenditure aggregates are under pressure from inflation and inherent indexation, are constrained by the electoral year of 2024, and investments have to remain high, in order to absorb funds from the NRRP and considering that Romania is in the T+3 year of the Multiannual Financial Framework which, historically, is the year when Romania absorbs most of the allocated European funds – therefore, reducing co-financing expenditures is not an option; (v) the measures adopted up to this point (Government Emergency Ordinance 34 of May 15, 2023) are insufficient to guarantee a fiscal adjustment trajectory for this year and the ones to come.

Regarding the forecasts for the external deficit (current account balance) and the budget deficit, the latest EC's forecast anticipates adjustment trajectories for both. The current account balance is expected to decrease to a deficit of 7.6% of GDP in 2023 and 7.4% in 2024, as the budget deficit is projected to reach 4.7% and 4.4% in 2023 and 2024, respectively, all figures being computed according to the European methodology.

According to the Inflation Report published by the NBR in May 2023, the CPI[110] annual inflation rate will reach 7.1% at the end of 2023, continuously decreasing from a peak of 15.1% at the end of February 2023. By the end of 2024, the projected value is 4.2%. The downward trajectory of headline inflation is attributed to a rapid moderation of energy prices, "especially due to substantial base effects associated with price increases in the same period of the previous year – mainly caused by the outbreak of the war in Ukraine – and, to a lesser extent, as a result of schemes to cap and compensate electricity and natural gas tariffs." This is accompanied by a slower easing of prices related to the adjusted CORE2 index, which reflects both increased persistence and the slow effect of more restrictive monetary policy, which responds only to second-round effects of other prices on CORE2 prices. The Inflation Report assesses that "after two years in which energy prices recorded exceptionally large dynamics, they will register a negative annual rate at the end of the current year, equivalent to a correction of about 4.5 pp of their contribution to the annual CPI inflation compared to December 2022. Under these conditions, the pace of CPI disinflation will be particularly brisk in the second quarter of 2023, and it will subsequently moderate." The projection for adjusted CORE2 inflation in 2023 reflects the developments described

[110] Computed according to the national methodology. It is different from the HICP inflation rate calculated according to the European methodology.

above, reaching a level of 9.3% at the end of the year. Although decreasing to 4.8% towards the end of 2024, the core inflation rate still remains high, reflecting "the persistence of inflationary pressures associated with significant increases in production costs for companies that began in 2021 and intensified throughout 2022 (especially those related to energy and other raw materials, as well as labour costs), their transmission into the final prices of goods being facilitated by exceptionally favourable demand conditions. One of the consequences was the maintenance of high profit margins for companies over the past two years." The report also specifies that the positive deviation of GDP is only slowly absorbed towards the end of the forecast period, which is one of the factors behind the slow disinflation of the adjusted CORE2 index through the functional relationship represented by the Phillips curve. Furthermore, the report states that "reflecting the influence of all the determinants mentioned above, starting from high levels, inflation expectations will follow a downward trajectory until the projection horizon. A relatively faster reduction in inflationary pressures, especially in 2024, is anticipated for imported goods prices, reflecting the projected dynamics of non-energy HICP inflation in the Eurozone."

The most recent statistical data published by the National Institute of Statistics (NIS), specifically for the first quarter of 2023, indicates a quarter-on-quarter growth (seasonally adjusted data) of 0.2%, rapidly decelerating from 1% in both the third and fourth quarters of 2022. The slower pace of growth can be explained, on the production side, by the dynamics of the industry (which is in contraction), the null contribution of agriculture to economic growth, while the rest of the sectors have positive, but limited contributions. According to the expenditure approach, the strong performance in the first quarter of the year of final consumption and gross fixed capital formation, as well as the return of net exports of goods and services to a positive contribution to GDP, are partially offset by the negative evolution of inventory changes (which historically is allocated to other components of GDP in subsequent data revisions). The main determinant of economic growth is consumption, with investments and net exports playing a smaller role. This is confirmed by the high level of the current account deficit (8.3 billion euros in the first 5 months of 2023), although adjusted compared to the same period the previous year (a reduction of 16.7%). This adjustment is largely explained by the surplus in the services account (which increased by 40.4% in the first 5 months of 2023, compared to the same period in 2022) and, only partially, by the adjustment in the deficit of goods, which is only 9.7% lower. These adjustments are somewhat offset, to a lower extent, by a higher deficit in the primary income account (+37.4%) and a lower surplus in the secondary income account (-24%). The evolution of real wages in the economy (+4.6% year-on-year in May 2023[111]) and real pensions in the first quarter of the year (+10.5% year-on-year[112]), as well as positive developments in trade and services[113], and construction[114], also confirm the economic growth structure mentioned above.

[111] NIS press release No. 177/July 12, 2023.

[112] NIS press release No. 146/June 14, 2023.

[113] NIS press release No. 185/July 19, 2023.

[114] NIS press release No. 184/July 19, 2023.

The Fiscal Council's opinion regarding the 2023 budget draft and the 2023-2025 Fiscal Strategy states that the projected values of real growth are slightly overestimated ("sensitively close to the upper edge of a probable range of evolution") and paints an overall optimistic trend ("these slightly higher increases each year reinforce each other, accumulating, towards the end of the projection, systematic positive deviations that lead to a higher GDP level – contributing to higher budget revenues, but also to a denominator effect on the indicators computed as a share of GDP (deficit, debt, etc.) – both of which have favourable effects on fiscal-budgetary aggregates"). However, they are offset by an undervaluation of the GDP deflator over the projection horizon (both in 2023 and in the 2024-2025 period; "all of these lead to the opposite conclusion regarding the deflator, in contrast to the one regarding real GDP, in this case, possible systematic errors leading, *caeteris paribus*, to a lower nominal GDP level"). "Considering the size of these systematic deviations (positive for real GDP and negative for its deflator), it can be considered that at both the annual and overall interval levels, these possible systematic deviations compensate for each other, leading to the conclusion of a nominal GDP projection – FC considers – with a high level of plausibility, given all the economic information available at the current moment."

The latest information indicates that for 2023, the government's economic growth forecast of 2.8%, both in the initial budget draft and in the winter forecast of NCSP (published on January 26), as well as in the spring forecast (published on May 5), is prudent, but could undergo revisions given the very high uncertainty – with a higher probability of downward revisions. The GDP deflator projection for 2023, which was 8.2% in the NCSP's autumn forecast, was successively raised to 9.1% (in the winter 2023 forecast) and then to 9.7% in the spring forecast. The risks to the evolution of this indicator can be considered slightly inclined – taking into account all the available information – toward slightly higher values. Thus, the nominal GDP's evolution reveals risks that offset each other.

For the coming years, the NCSP's combined forecast regarding the real economic growth and the dynamics of the deflator also remains relatively plausible, despite a considerable acceleration compared to 2023 and relatively high values of the indicators. These assessments start from an assumption of a smooth trajectory of the economy, which does not consider and cannot consider the rapid, large-scale developments caused by the changing geopolitical context, changes in financing conditions, events that could affect European grant flows and those related to NRRP. Furthermore, even in the absence of these shocks, NCSP's updated forecast could benefit – similarly to FC's previous observations – from greater transparency regarding the determinants of future economic growth (including by clarifying the assumptions made regarding the use of NRRP funds) and, implicitly, the detailed internal saving–external balance correlations for the public and private sectors, linked to the evolution of financing conditions.

VI.2. Fiscal framework

The 2022 budget execution recorded a GCB deficit of 5.72% of GDP (according to the cash methodology), respectively 6.2% of GDP (according to the ESA 2010 methodology), while the initial budget had set a deficit target of 5.84% of GDP according to the cash methodology, and 6.24% of GDP according to the ESA 2010 methodology. The outcomes are marginally positive compared to the initial planning, but it should be noted that the revisions operated during 2022 involved a significant nominal increase both in budget revenues and expenditures, driven by higher-than-expected inflation, additional revenues from overtaxing the energy sector and increased spending on social assistance, interest, subsidies, goods and services. Thus, the fact that the budget deficit, expressed as a percentage of GDP, stood below the initial target is not due to a reduction in its nominal value, but rather to the faster growth rate of nominal GDP.

In its opinions and analyses on the revisions operated throughout 2022, the FC emphasized that the fiscal consolidation process cannot solely rely on favourable cyclical economic trends and inflation. The FC also highlighted that the low level of tax revenues, as share of GDP, is insufficient to support sustainable development and ensure the provision of essential public goods. Moreover, high inflation will inevitably lead to an erosion of purchasing power, negatively impacting economic activity, and will require an increase in budget expenditures, exerting additional pressure on the budget.

Romania is facing a highly challenging fiscal situation, as indicated by data from 2022. This situation is characterized by insufficient budget revenues (approximately 33.5% of GDP) relative to the EU average of around 46.5% of GDP. Romania also has the lowest level of tax revenues in the EU, excluding Ireland (27.2% of GDP in Romania compared to an EU average of 40.9%). Additionally, there is a high structural deficit (5.8% of potential GDP) and an elevated external deficit (current account deficit of 9.3% of GDP).

In this context, the draft budget for the year 2023 aimed at a deficit target of 4.4% of GDP, according to the cash methodology, representing a decrease of 1.32 pp compared to the previous year's level. The deficit target, according to the ESA 2010 methodology, was also set at 4.4% of GDP, denoting a reduction of 1.8 pp compared to the level recorded in 2022. The planned reduction of the deficit was expected to be achieved partially through increased budget revenues, driven by the projected macroeconomic framework, changes in fiscal policy, NRRP projects and amounts considered from the improvement in collection efficiency/reduction of tax evasion (estimated by the MF at 8.7 billion lei). On the expenditure side, the reduction was intended to be realized through nominal decreases in subsidies and lower growth rates, compared to the projected dynamics of nominal GDP, for personnel, goods and services, social assistance and interest expenditures. In its opinion on the draft budget for the year 2023 and the Fiscal Strategy for 2023-2025, the FC noted the following main issues:

- The elaboration of the budget occurred in a complex domestic and international context, marked by the war in Ukraine, the energy crisis, high and persistent inflation, tightened financing conditions and ongoing supply chain tensions. In this environment, characterized by economic slowdown and heightened uncertainty, the formulation of economic policies demands resource mobilization, prioritization, solidarity and responsibility.

- The FC highlighted that the surprise inflation has supported the budget execution in 2022 and has limited the share of public debt in GDP. However, this effect is only temporary. In the absence of prudent fiscal policy, the impact of high inflation will reverse and negatively impact the budget.

- In these circumstances, to ensure sustainable economic development, the FC emphasized the need for an appropriate mix of policies: a restrictive monetary policy to anchor inflation expectations, a prudent fiscal policy focused on budget consolidation and economic policies that support production.

- Furthermore, given that Romania has been under the excessive deficit procedure for several years and has committed to bringing the budget deficit below 3% of GDP by 2024, the process of budget consolidation is inevitable.
- Following the analysis of the draft budget for the year 2023 and adopting a cautious approach, the FC estimated that there was a likelihood of lower revenues by approximately 11.3 billion lei, relative to the assumed targets, representing about 0.7% of GDP. On the expenditure side, the FC identified an additional need for allocations totalling at least 9 billion lei, equivalent to about 0.6% of GDP.
- Taking into account the evaluation of revenue and expenditure projections, the FC assessed that the budget drafted for the year 2023 was compatible with a deficit of around 5.7% of GDP. In this context, the FC emphasized that future budget revisions need to identify adjustment measures in order to comply with the deficit target, the continuation of the budget consolidation process being challenged by significant risks.
- To mitigate these risks, a significant increase in tax revenues is necessary, supported by the removal of exemptions and loopholes from the current legislation, as well as by improving collection efficiency through discouraging tax optimizations and reducing tax evasion.
- According to the medium-term fiscal-budgetary framework, budget consolidation between 2024 and 2026 is anticipated to be primarily achieved through cuts in budget expenditures. However, the FC has questioned the feasibility of this approach. In the absence of credible policies that support medium-term fiscal-budgetary consolidation through increased tax revenues, the FC noted that the balance of risks leaned towards the possibility of recording higher deficits than those projected for the upcoming years.
- The FC has highlighted that the negative fiscal impulse of budget consolidation can be offset by a massive absorption of European funds. Therefore, the NRRP, together with the resources available through the MFF, are of extraordinary importance, as they can serve as a vital instrument for facilitating fiscal-budgetary consolidation by supporting a higher level of economic activity than the one induced by a negative fiscal impulse and the tightening of monetary policy. Additionally, they can also contribute to balancing Romania's external account.

The budget execution for the first six months of 2023 revealed a relatively high budget deficit (2.3% of GDP), which is approximately 0.63 pp higher compared to the same period in the previous year. This was caused by slower dynamics in certain revenue categories (compared to the relevant macroeconomic and to the levels projected in the initial budget) and by higher-than-expected increases in certain expenditure categories compared to the targets set in the initial budget. It is worth mentioning that the execution in the second half of the year execution will also be affected by salary increases granted in certain sectors (such as education, healthcare, defence etc.), with a budgetary impact estimated by the MF at around 4 billion lei for 2023. At the same time, the measures adopted through GEO 34/2023 appear to be insufficient to ensure the continuity of the fiscal-budgetary consolidation process.

Despite these developments, the latest estimates from the MF, as outlined in the 2023-2026 Convergence Program, maintain the budget deficit target for the year 2023 at 4.4% of GDP, both according to the cash methodology and the European methodology, without presenting additional adjustment measures to achieve this target. Thus, the Convergence Program 2023-2026 stipulates that the deficit target will be achieved through a decrease in the share of permanent expenditures in GDP, coupled with an increase in the share of revenues, based on the accelerated absorption of European funds. The EC, in its Spring 2023 Forecast, projects a deficit of 4,7% of GDP for the current year, slightly higher than the target stated in the Convergence Program. The gap between the EC's and MF's projections for 2024 is even larger (1.4 pp), the MF anticipating a rapid decrease in the ESA deficit to 3% of GDP, while the EC's forecast is 4.4% of GDP. Regarding the structural budget balance, the MF forecasts an adjustment of 2.1 pp of potential GDP in 2023 and 1.3 pp of potential GDP in 2024. On the other hand, the EC estimates a decrease of 1.5 pp of potential GDP in the structural budget deficit in 2023, followed by a 0.2 pp adjustment in 2024.

In the medium term (2024-2026), according to the projections from the Convergence Program, the adjustment of the budget deficit from 4.4% of GDP to 2.9% of GDP is mainly determined by a decrease in the share of budget expenditures in GDP by 1.2 pp (from 38.3% in 2023 to 37.1% in 2026). Meanwhile, the share of budget revenues is projected to increase by only 0.3 pp of GDP (from 33.9% in 2023 to 34.2% in 2026). In its opinion on the Fiscal Strategy for 2023-2025, the FC questioned the realism of this approach and noted that without credible measures to increase tax revenues, the balance of risks leaned towards the possibility of recording higher deficits than those projected in the medium term.

It should be noted that the budget execution for the first six months of 2023 has confirmed the FC's assessment, expressed in its opinion on the draft budget, which estimated the cash deficit for the current year at around 5.7% of GDP, despite the assumed target being 4.4% of GDP. Moreover, considering the unfavourable evolution of the budget execution and assuming that corrective measures are not adopted, the FC is revising upwards its deficit projection for the current year and estimates that it will likely exceed 6% of GDP. The need for adjustment measures was highlighted by the FC in its opinion on the draft budget. However, now it is vital to emphasize the importance of swiftly adopting such measures, given the limited time left for them to have an impact on the 2023 budget execution.

The fiscal-budgetary consolidation is vital and urgent for Romania, and postponing its implementation by relying on favourable cyclical economic trends and the positive fiscal impact of inflation is not a viable option. The FC emphasizes, as it has done in most of its opinions and in other analyses[115], that fiscal-budgetary consolidation requires a significant increase in tax revenues. These revenues are currently at an unacceptable low level in relation to Romania's current and future needs, as well as compared to other EU member states. In this regard, it is necessary to eliminate exemptions and loopholes in the current legislation, and also enhance collection efficiency by discouraging tax optimization strategies and reducing tax evasion. It is important to note that such measures can have a significant distributive

[115] Also refer to the study "Budget Consolidation and Higher Fiscal Revenues – A Vital Need for Romania's Stability and Economic Security", conducted by a Working Group under the coordination of the Fiscal Council (http://www.fiscalcouncil.ro/Analiza_sistem_fiscal%20EN%2031%20mai.pdf).

impact, which might lead to difficulties in their implementation and opposition from certain interest groups.

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Appendix – Glossary of terms

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

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

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

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

Arrears of the general consolidated budget – 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 a result of contractual terms' violations.

Automatic disengagement – part of the budgetary 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 – tools for self-regulating the economy with the aim of reducing economic fluctuations; for example: taxation in proportional percentage rates, social benefits for unemployment.

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

Balance of the general consolidated budget – indicator computed as the difference between total public revenues and total public expenditures.

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

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

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

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

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

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

Classification by function – the classification of expenditures based on their destination, in order to assess public funds allocations.

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

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

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

Consolidation – the operation of eliminating transfers between two component budgets of the general consolidated budget, in order to avoid their double accounting.

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

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

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

Countercyclical fiscal policy – fiscal policy behaviour 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 to a country exceed exports of goods, services and transfers from that country; in this case, that country becomes a net debtor to the rest of the world.

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

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

Cyclically adjusted budget balance – the balance of the general consolidated budget, net of the cyclical component. It is a measure of the fundamental trend in the budget balance.

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

Disinflation – the process of reducing inflation.

Economic classification – the classification of expenditures based on their economic nature and effect.

ESA 2010 methodology (*European System of National and Regional Accounts*) – accounting reporting framework used internationally for a systematic and detailed description of an economy (region, country or group of countries), or its components and relationships with other economies. The main difference between ESA 2010 methodology and the cash methodology is that revenues and expenditures are recorded in "accrual" system (based on commitments, not actual payments as in the cash system). ESA 2010 methodology replaced 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 committing themselves to take measures to encourage competitiveness, employment and consolidation of public finances.

European Agricultural Guarantee Fund – European funds for the implementation of support measures for farmers.

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

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

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

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

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

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

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

Expansionary fiscal policy – fiscal policy behaviour that has an accelerating effect on aggregate demand growth and may lead to an amplification of inflationary pressures.

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

Fee – amount paid as remuneration for services provided by an economic agent or a public institution.

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

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

Fiscal Compact – part of the Treaty on Stability, Coordination and Governance signed on March 2, 2012 by all EU member states, except for the United Kingdom and Czechia. The treaty is aimed at strengthening fiscal discipline by introducing an automatic correction mechanism and stricter surveillance. The fiscal compact establishes a requirement for national budgets to be in balance or in surplus. This criterion is 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 posed to long-term public finance sustainability are low, the structural deficit may reach a maximum level of 1% of GDP.

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

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

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

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

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

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

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

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

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

GDP deviation – an indicator that measures the difference between the actual GDP of an economy and its potential GDP. It is also known as output-gap.

General consolidated budget – the set of budgets (provided in art. 1 para. (2) of Law 500/2002 on Public Finances, to which local budgets are added), aggregated and consolidated to form a whole.

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

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

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

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

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

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

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

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

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

Nominal variables – variables expressed in current prices.

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

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

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

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

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

Primary balance of the general consolidated budget – the difference between total budget revenues and expenditures, excluding the interest payments with regard to public debt.

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

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

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

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

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

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

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

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

Relevant macroeconomic basis – macroeconomic aggregate on which proceeds from a certain category of budget revenues depend.

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

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

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

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

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

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

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

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

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

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

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

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

Tax – compulsory and non-refundable levy, without immediate and direct compensation, charged by a public authority with the purpose of financing public goods and services.

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

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

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