Romania

Fiscal Council

Annual Report

2017

Note:

The Annual report for 2016 was approved by the Chairman of the Fiscal Council, according to article 56, paragraph (2), letter d) of Law no. 69/2010, after being adopted by the members of the Council through vote, on June 11, 2018.

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List of abbreviations

CEE	Central and Eastern Europe
CEF	Connecting Europe Facility
CF	Cohesion Fund
COTS-RMS	Commercial Off the Shelf - Revenue Management System
CPI	Consumer price index
EAFRD	European Agricultural Fund for Rural Development
EAGF	European Agricultural Guarantee Fund
EC	European Commission
ECB	European Central Bank
EBRD	European Bank for Reconstruction and Development
EDP	Excessive Deficit Procedure
EMFF	European Maritime and Fisheries Fund
ERDF	European Regional Development Fund
ESA 2010	European System of National and Regional Accounts 2010
ESA 95	European System of Accounts 1995
ESF	European Social Fund
EU	European Union
FC	Fiscal Council
FRL	Fiscal Responsibility Law No 69/2010
FS	Fiscal Strategy
FSA	Financial Supervisory Authority
GCB	General consolidated budget
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GEO	Government Emergency Ordinance
IBRD	International Bank for Reconstruction and Development
HICP	Harmonized Index of Consumer Prices
IMF	International Monetary Fund
LIOP	Large Infrastructure Operational Programme
MEF	Ministry of European Funds
MPF	Ministry of Public Finance
MTO	Medium-term objective
NAFA	National Agency for Fiscal Administration
NBR	National Bank of Romania
NCSP	National Commission for Strategy and Prognosis
NIS	National Institute of Statistics

NMS CEE	New Member States from Central and Eastern Europe
NMS 10	10 new EU member states (excluding Croatia)
NPISH	Non-profit institutions serving households
NRDP	National Rural Development Programme
NREF	Non-reimbursable external funds
NRP	National Reform Programme
NSVFSA	National Sanitary Veterinary and Food Safety Authority
OECD	Organization for Economic Co-operation and Development
OMPF	Order of the Minister of the Public Finance
OP	Operational Programme
OPFMA	Operational Programme for Fisheries and Maritime Affairs
PADP	Operational Program for Assistance to Disadvantaged People
pp	Percentage points
RAMP	Revenue Administration Modernization Project
SGP	Stability and Growth Pact
SIEF	Structural and Investment European Funds
SME	Small and Medium Enterprises
SSC	Social Security Contribution
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact)
TUF	Temporary Unavailability of European funds
VAT	Value added tax
VPS	Virtual Private Space
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 aims to support the Government and the Parliament in designing and implementing the fiscal policy and to promote the transparency and sustainability of public finances.

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

The year 2017 recorded the highest rate of growth for the Romanian economy in the post-crisis period, its structure being mainly based on consumption. Economic growth was accompanied by a rebound in inflation and a significant deepening of the current account deficit, largely financed by foreign direct investment. The labor market reached the lowest unemployment rate in the past two decades and was characterized by significant wage increases.

In 2017, Romania's economy continued its upward trend from the previous years, reaching the highest level of post-crisis economic growth. The gross domestic product (GDP) increased by 6.9% in real terms, its value being 17.5% higher than the one recorded in 2008. The main contribution to economic growth was provided by the final consumption expenditure of the population (+6.4 percentage points - pp) which was supported by indirect taxes cuts and wage increases in the public and private sectors. A positive impact was also generated by the gross fixed capital formation (+1.1 pp), but the dynamics of this factor was affected by the significant reduction of public investment for the second consecutive year. In terms of supply, it should be noted that GDP growth was supported by all the sectors of the national economy, excluding constructions, the most important contributions belonging to industry and commerce. Economic growth was accompanied by a rebound in inflation which returned to positive territory after two consecutive years of falling prices and reached the level of 3.32% at the end of the previous year. On the other hand, the price increase across the entire economy, as measured by the GDP deflator, stood at 5.3% in 2017. Stimulated by the rapid increase in domestic demand, the current account deficit deepened significantly from 2.09% of GDP in 2016 to 3.35% of GDP in 2017, being largely financed by foreign direct investment. The economic growth was recorded in the context of a moderate increase in the non-governmental credit (+2.3% in real terms, compared to the previous year). The labor market had a favorable evolution, with the average number of employees rising to 4.9 million persons (+3.5% compared to 2016), while the unemployment rate reached 4.9%, the lowest level in the past two decades. The gross average earnings per economy was 3,256 lei, up 15.9% compared to 2016, driven mainly by the increase of 24.6% in public sector earnings.

In 2017, the fiscal policy continued to deviate from the MTO, the budget deficit expressed as a percentage of GDP was slightly below the initial target but close to the 3% threshold, while in nominal terms the targets were exceeded marginally, according to both cash and ESA 2010 methodologies. The majority of national fiscal rules have been systematically evaded since the FRL was drawn up in 2010 and beginning with 2016 the structural deficit rule has also been violated. Despite the fact that Romania has become the subject of a significant deviation procedure, in 2017 the structural deficit worsened compared to the previous year, by 1.2 pp of GDP.

The general consolidated budget (GCB) for 2017 was based on a budget deficit target of 2.96% of GDP in cash terms, or 2.98% of GDP according to the European System of National and Regional Accounts 2010 (ESA 2010), rising from the 2016 levels as a result of continued fiscal loosening. Thus, there was again a deliberate deviation from the medium-term budgetary objective (MTO), which sets a structural budget deficit of maximum 1% of GDP, the structural deficit for 2017 being estimated at 2.91% of GDP at that time. The final budget execution was in line with the target deficit, both according to the cash methodology (2.83% of GDP deficit) and to the ESA 2010 methodology (2.92% of GDP deficit) while, according to the latest European Commission (EC) estimates, the structural deficit deteriorated to 3.3% of GDP from 2.1% in 2016. Moreover, although EC warned Romania on May 22, 2017 concerning the significant deviation from the MTO, with the recommendation to initiate a structural adjustment of 0.5% of GDP during the year, the first budget revision did not follow the recommendation and has massively supplemented budget expenditure, in particular wages and social assistance allocations. In fact, almost all fiscal rules were violated in 2017, including the one referring to the GCB deficit in nominal terms, except for the rule referring to the GCB deficit as a percentage of GDP, this being due to a GDP advance of 43.1 billion lei relative to the one that was considered when elaborating the budget draft. Amendments to the 2017 budget have been adopted in breach of the rules prohibiting the increase of GCB and primary deficit ceilings, personnel expenditure, with the exception of EU funds and total public expenditure during the fiscal year.

Romania remains in the trap of pro-cyclical fiscal policies by maintaining the expansionary fiscal stance that started in 2016, despite the positive output gap recorded in 2017, which leads to the vulnerability of public finances. During 2016 and 2017 the cumulative fiscal impulse was strongly positive, amounting to 3.1 pp of GDP, which exceeded significantly the limits imposed by the MTO.

Since 2006, Romania has pursued a strong pro-cyclical fiscal policy, stimulating intensively but unnecessarily and counterproductively the economy during the expansion periods (2006-2008) and slowing down during the periods when it operated under potential (2010-2015), thus, contributing to the amplification of the economic cycle fluctuations and to the deepening of the imbalances accumulated in the economy. The fiscal consolidation process that took place between 2010 and 2015 has been partially reversed by maintaining an expansionary fiscal stance during 2016 and 2017, contributing to the vulnerability of public finances. Consequently, assuming a reversal of the economic cycle, fiscal policy will not be able to stimulate the economy due to the lack of fiscal space, creating the premises for undertaking structural adjustment measures during recession. The cumulative fiscal impulse of the period 2016-2017 amounted to 3.1 pp of GDP and, considering the current projections of budgetary aggregates for 2018 and 2019, fiscal policy will maintain its expansionary character, the fiscal impulse being forecasted at approximately 0.7% GDP in both years, even if this implies that the structural deficit allowed by the MTO will be exceeded by more than 3 pp of GDP.

The tax efficiency index declined overall in 2017, compared to the previous year, mainly due to discretionary fiscal policy measures. Following the tax cuts from recent years, the tax revenues continued to decline as a percentage of GDP, ranking Romania as the second to last among EU countries.

The tax efficiency index decreased notably in the case of personal income tax (from 0.8 to 0.74), mainly due to discretionary fiscal policy measures, as well as in the case of corporate income tax (from 0.22 to 0.19), this evolution requiring a more in-depth analysis of the budgetary impact of the 2017 Fiscal Code. On the other hand, the tax efficiency index recorded marginal changes for value added tax (VAT - a decrease from 0.71 to 0.7) and social security contributions (SSC – an increase from 0.71 to 0.72). In what concerns the revenues from excise duties, although they registered a decrease of about 350 million lei relative to 2016, this is mainly due to the temporary reduction of the excise duty on fuels without indicating a deterioration in the efficiency of tax collection. Analyzing the impact of tax cuts in recent years, they have contributed to the erosion of tax revenues, leading to a level of just 25.7% of GDP in 2017 (including SSC). Therefore, from the perspective of this indicator, Romania continues to rank on the second to last place among the countries in the European Union (EU), with a gap of 14.2 pp relative to the EU average of 39.9% of GDP. Moreover, this gap has increased significantly in the last two years, its level being 11.5 pp in 2015 and 13.1 pp in 2016. Analyzing the structure of tax revenues, it is noted the prevalence of indirect taxation in Romania, to a greater extent than in the EU, which is likely to support long-term economic growth, direct taxation having a larger discouraging effect on the mobilization of the production factors.

The need for increasing performance in the area of tax collection efficiency remains significant. Thus, it is recommended to hasten the implementation of the tax administration reform that was initiated in 2013.

In 2013, an extensive process of reforming the Romanian tax administration was launched in collaboration with the World Bank (WB) and the Fiscal Council notes an improvement in the efficiency and simplification of the tax collection administrative apparatus, both in terms of decreasing the number of financial administrations (although Romania still has more financial administrations *per capita* when compared to the average of other new EU member states) and the ease with which the taxes are paid (Romania has advanced 8 positions in the *Paying taxes 2018* ranking compared to the previous edition). The tax administration reform seems to have led to positive results but below the established targets, so, the WB assessments draw attention to the high risk of failing to achieve the project objectives. Consequently, it is recommended to accelerate the implementation of the tax administration reform in Romania which has the potential to generate significant positive effects in the long run.

Personnel and social assistance expenditures, expressed as a percentage of budget revenues, have returned to their pre-crisis levels as a result of rapid increases during 2016 and 2017. Moreover, similar to 2009, Romania recorded in 2017 the highest level of personnel and social assistance expenditures

After a rather stable evolution before 2007, personnel expenditures and pensions relative to budget revenues have advanced at a rapid pace in 2008-2009, reaching a peak of 75.9% in 2009. In that year Romania recorded the highest level of personnel and social assistance expenditures, as a percentage of total budget revenues, among Central and Eastern European (CEE) countries and surpassed the EU28 average. Following the implementation of the fiscal consolidation program, their share declined significantly over the period 2013-2015, falling to a lower level than CEE countries, except for Hungary. But Romania has started to reverse this trend in 2016 and, following the aggressive increase of pensions and wages in the public sector

relative to budget revenues (70%) among CEE countries, while at the same time exceeding the EU28 average(68.2%).

during 2017, it recorded again (similar to 2009) the highest level of personnel and social assistance expenditures (70%) among CEE countries which is, as well, above the EU28 average (68.2%). Moreover, the developments from 2018 seem to strengthen the upward trend of 'mandatory' expenditures relative to total budget revenue, which will substantially complicate the coordinates of future fiscal policy.

The public investment expenditures, expressed as a percentage of GDP, continued on a downward trend in 2017 and reached the lowest level of the 2012-2017 period, decreasing from 3.87% of GDP in 2016 to 3.11% of GDP in 2017.

Compared to the last five years, public investment expenditures, expressed as a percentage of GDP, registered the lowest level in 2017, being 1.95 pp below the average of the 2012-2016 period. Compared to the previous year, they decreased by 2.8 billion lei, (-0.76 pp of GDP), 2017 being the second consecutive year of declining public investment expenditures. Compared to the initial budget, investment expenditures were lower by 12.7 billion lei (1.48% of GDP respectively), the deviation being much higher compared to the previous year. This development is attributable to the constraints of fiscal policy in 2017 which, faced with major pressures from budget expenditures, especially personnel and social assistance, resorted to the massive reduction of public investment as a way to maintain the budget deficit below the 3% of GDP threshold.

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

It may be appreciated that some improvements have been made in 2017 regarding the management of public investment, with large infrastructure projects being evaluated and included on a priority list, monitored by a specialized unit inside the Ministry of Public Finance (MPF), while the assigned prioritization scores are to be reflected in the budgets proposed by each ministry. On the other hand, weak strategic planning and the reversal of the corporate governance reform in state-owned companies act as a deterrent on public investment growth.

Public debt, expressed as a percentage of GDP, declined significantly in 2017 despite the large budget deficit, mainly due to high economic growth,

Public debt, measured according to ESA 2010 methodology and expressed as a percentage of GDP, declined significantly from 37.4% in 2016 to 35%. This decrease was supported by real economic growth (-2.41 pp), the real interest rate (-0.61 pp) and the stock-flow adjustment (-0.98 pp), while the primary deficit contributed to the increase of the public debt to GDP ratio by 1.6

but also due to temporary factors reflected by the stock-flow adjustment. According to EC projections, public debt is expected to increase gradually in the near future.

pp. Between 2018 and 2021, according to the baseline scenario, public debt is projected to progress gradually from 35% in 2017 to 38.1% at the end of the interval and, under unfavorable scenarios, public debt could exceed 40% of GDP. The forecast is based on EC projections for economic growth, budget deficit and the GDP deflator, which are more adverse than the projections from the 2018-2021 Convergence Program. If the latter projections are taken into account, public debt in the baseline scenario is forecasted to reach 33.3% of GDP at the end of 2021.

Romania's performance regarding the absorption of European funds, taking into account only structural and cohesion funds, is modest, with a rate of only 9.3% so far, ranking second to last among NMS CEE. Compared to the EU average, Romania has a 6.06 pp gap that is set on an upward trend. Timely preparation of projects and enhanced administrative capacity to plan and manage European funds are essential factors for increasing the absorption rate.

The 2014-2020 programming period was characterized by a slow start not only in Romania, but also in other EU Member States, due to delays in finalizing the European legislative framework and such delays are expected to have a greater impact on countries that lack experience and administrative capacity. Romania's performance in terms of absorption of European funds allocated under the 2014-2020 multiannual financial framework, taking into account only structural and cohesion funds, is modest so far. Thus, Romania ranks second to last among new EU Member States from Central and Eastern Europe (NMS CEE) with an absorption rate of just 9.34%, surpassing only Croatia which stands at 8.52%, while the absorption rates registered by Lithuania, Estonia, Poland and Hungary are approximately twofold. Moreover, compared to the EU average, Romania has a 6.06 pp gap, rising from 2.24 pp in 2016. Slow preparation of new projects, fragmented mechanisms for their selection and prioritization, inefficiencies in the management of public investments as well as the lack of strategic planning in the medium and long term are factors that contribute to maintaining a low absorption rate of European funds.

The budget projections for the year 2018 and the medium-term framework associated with it institute, similar to the previous year, a deliberate and sizeable deviation from the fiscal rules enshrined in

The budget projections for the year 2018 and the medium-term framework associated with it institute, similar to the previous year, a deliberate and sizeable deviation from the fiscal rules enshrined in both the national legislation and European Treaties ratified by Romania, establishing a massive slippage from the requirements of the preventive arm of the Stability and Growth Pact (SGP). Although Romania is subject to a significant deviation procedure from the MTO that was triggered in June 2017, which

both the national legislation and European Treaties ratified by Romania

recommends a structural adjustment of at least 0.8 pp of GDP for 2018, according to the 2018-2021 Convergence Program for the current year it is estimated that the structural deficit will deepen by 0.4 pp of GDP compared to the previous year. Thus, the convergence towards the MTO is expected to start in 2019, but without specifying precisely the measures that will be taken in order to achieve this result.

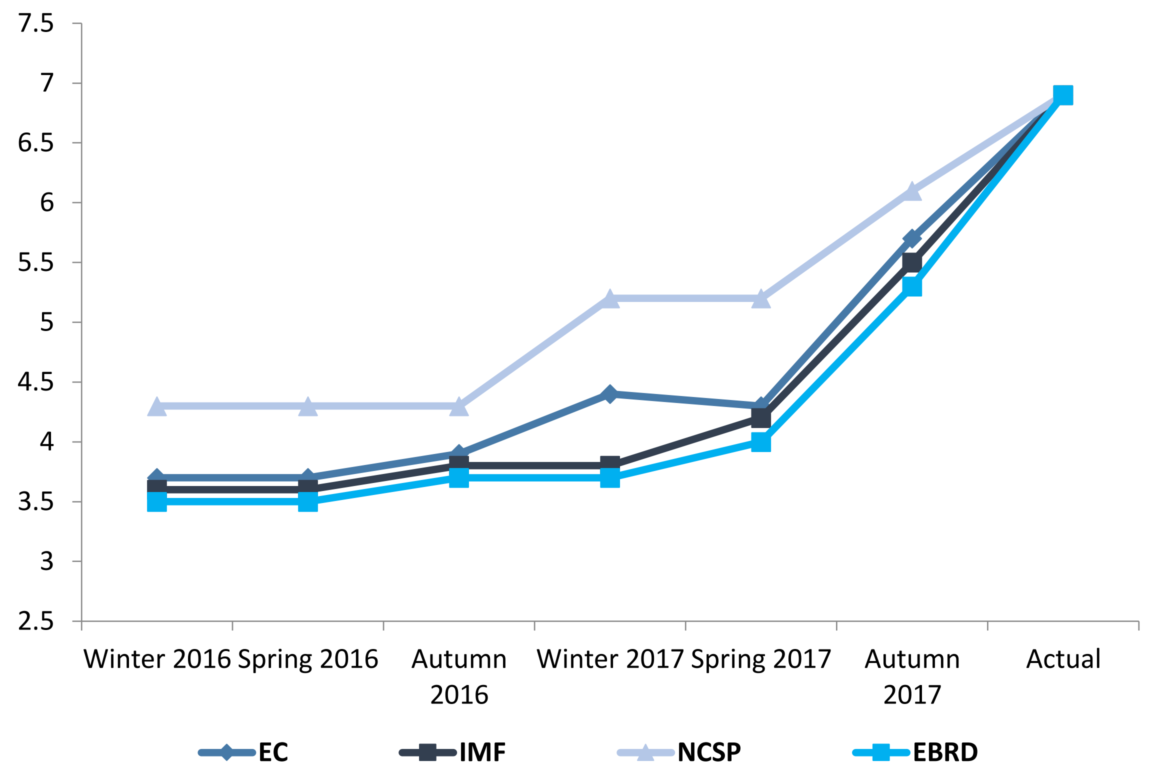
The risk balance associated with the projected budget deficit is tilted on the negative side. The risk of re-entering the excessive deficit procedure appears to be significant if the current policies are maintained.

In its opinion on the Draft Budget, the Fiscal Council identified a high probability of a negative income gap generated by an optimistic estimate of the GDP growth rate and of the VAT revenues (through the ex-ante projection of the impact associated with the measures taken by The National Agency for Fiscal Administration - NAFA – in order to improve collection and with the introduction of VAT split). Moreover, the Fiscal Council also identified at that time an underestimation of the social assistance expenditures by at least 3 billion lei, taking into account their execution in the last quarter of the previous year. Based on the budgetary execution in the first quarter of the current year, the Fiscal Council appreciates that there is a high risk of falling short from the projected VAT revenues, as well as overrunning significantly the projected expenditures for social assistance, personnel, goods and services. In the context of maintaining the current fiscal policy parameters, the 2018 risk balance appears to be significantly leaning towards exceeding the 3% target for the budget deficit, requiring corrective measures concerning either income or expenditures in order to avoid entering the excessive deficit procedure (EDP).

II. Macroeconomic framework in 2017

In 2017, Romania's economy continued its upward trend from previous years, reaching the highest level of post-crisis economic growth. GDP increased by 6.9% in real terms, surpassing significantly the 4.8% growth recorded in 2016 and positioning the Romanian economy in the second place among EU countries, behind Ireland. Thus, after a period of successive increases since 2011, the real GDP in 2017 is 17.5% higher than in 2008 when the peak value of the pre-crisis period was recorded.

Figure 1: The evolution of economic growth forecasts for 2017



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

Analyzing the graph above, it can be noted that the real GDP growth rate in 2017 significantly exceeded both the more prudent forecasts made by EC, IMF and EBRD and the more optimistic projections of NCSP. This upward trend was felt across the entire EU which recorded the highest growth rate in the last 10 years amid the transition from the post-crisis recovery to the boom phase[1]. Thus, compared to the 5.2% initial forecast of the NCSP, which was considered when drafting the budget for 2017, the effective economic growth was 1.7 pp higher, creating the conditions for improving the results of the budget execution.

In terms of expenditures, the main contribution to the economic growth registered in 2017 was provided by the household final consumption expenditure which accounted for 6.4 pp of the total growth of 6.9%. In real terms, household consumption advanced by 10.1% compared to 2016, being supported by increases in disposable income through indirect tax cuts (the reduction of the standard VAT rate to 19% as of January 1, 2017) and wage increases in the public and private sectors. A positive but smaller impact came from the gross fixed capital formation which contributed 1.1 pp to real GDP growth. Thus, investment returned on an upward trend but its dynamics (a real growth of 4.7%) was still lower compared to the projections from the 2017-2019 Fiscal Strategy due to the significant reduction in public investment for the second consecutive year. It is expected that investment may gradually recover supported by a progress in the implementation of projects financed by European funds. Government consumption exerted a very small but positive influence (+0.1 pp), based on a real increase of 0.7% compared to the previous year. In what concerns net exports, it had a negative contribution to economic growth (-0.7 pp) due to higher imports dynamics (real growth of 11.3%, stimulated by the expansion of private consumption) as compared to exports (real growth of 9.7%). In conclusion, after analyzing GDP growth from an expenditure perspective, it can be noticed that the economic expansion in 2017 was almost entirely based on consumption.

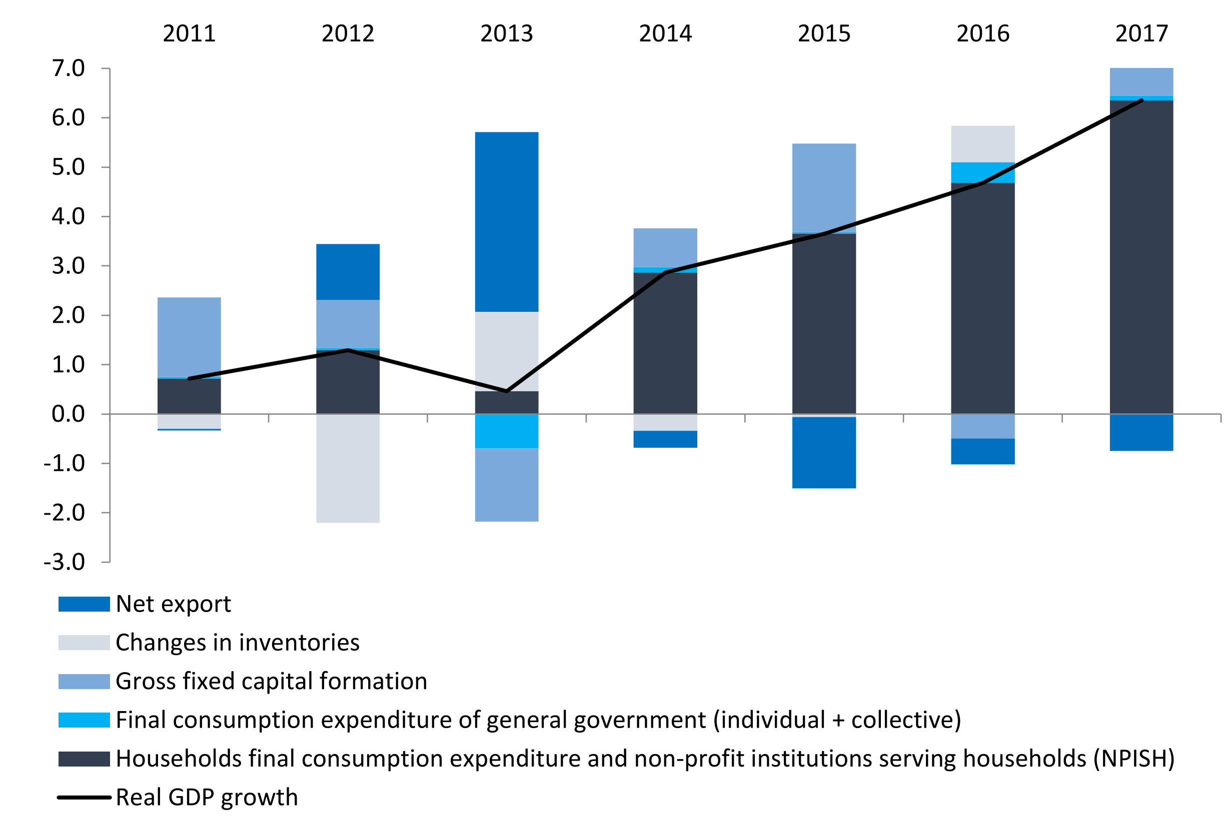
In terms of supply, GDP growth was supported by almost all sectors of the national economy[2], with the most important contribution being made by industry (+1.9 pp), this sector also having the largest share in GDP formation (24.2%), followed by wholesale and retail; repair of motor vehicles and motorcycles; transport and storage; hotels and restaurants (+1.5 pp) with a share of 18.6% in GDP formation, by professional, scientific and technical activities; activities of administrative services and support services (+0.7 pp) with a share of 6.9% in GDP formation, by agriculture, forestry and fishing (+0.7 pp) with a share of 4.4% in GDP formation and by the information and communication sector (+0.6 pp) with a share of 5.1% in GDP formation. The other branches contributed less than 0.5 pp to GDP growth, but only the construction sector had a small negative contribution (below 0.1 pp) while having a weight of 5.9% in GDP formation. Overall, the gross value added by the entire economy contributed 6.2 pp to economic growth, the remaining difference until 6.9% corresponding to net taxes on products. Compared to 2016, industry and agriculture returned among the top contributors to GDP growth, while services retained a strong

[1] According to the European Economic Forecast, Spring 2018.

[2] According to the National Institute of Statistics (NIS) press release from April 5, 2018, http://www.insse.ro/cms/sites/default/files/com_presa/com_pdf/pib_tr4e2017_2.pdf.

contribution to economic activity through the following sectors: wholesale and retail components; repair of motor vehicles and motorcycles; transport and storage; hotels and restaurants; professional, scientific and technical activities; activities of administrative services and support services; information and communication.

Figure 2: Contributions to economic growth



Source: Eurostat, Fiscal Council's calculations

After two consecutive years of falling prices, the inflation rate measured using the consumer price index (CPI) returned to positive territory as early as January 2017, reaching 3.32% at the end of the year. Thus, inflation re-entered the 1.5% - 3.5% range associated with the 2.5% target and significantly exceeded the 1.9% level taken into account in the 2017-2019 Fiscal Strategy. The inflation rate remained positive throughout 2017, ranging between 0.05% and 3.32%[3], while its annual average was 1.34%, close to the level of 1.4% projected in the 2017-2019 Fiscal Strategy. Eliminating the temporary effects of reducing the standard VAT rate, the adjusted CPI inflation rate stood at 4.1% in December 2017. It also remained positive throughout 2017, ranging from 1% to 4.1 %, while its average value was 2.28%. The price increase across the entire economy, as

[3] According to the Inflation Reports from May 2017, August 2017, November 2017 and February 2018, published by the National Bank of Romania (NBR).

measured by the GDP deflator, reached 5.3% in 2017 and the sizeable difference between the deflator and the average inflation of 1.34% can be attributed to price increases affecting government consumption (+19%) and gross capital formation (+5.7%).

Quarterly analysis shows that the annual inflation rate has returned to positive territory since the beginning of 2017, so that in March it has already recorded an increase of 0.72 pp compared to December 2016. This evolution occurred as a result of the gradual elimination of the statistical effect produced by the reduction of the standard VAT rate from 24% to 20% (January 2016), coupled with a series of external developments that have affected the prices of fuels and food products. On the other hand, the elimination of certain taxes and indirect tax cuts slowed down inflation. The second quarter of 2017 saw the consolidation of positive inflation, with a 0.67 pp gain in June compared to the end of the first quarter. The surge can be attributed to an increase in the production costs of the companies (their transmission to the final prices being facilitated by the expansion of the aggregate demand) as well as to the evolution of the prices for energy (natural gas and electricity) and food products. The annual inflation rate continued its upward trend in the third quarter, reaching 1.77% in September, which corresponds to an increase of 0.92 percentage points compared to June. At the same time, in September 2017 the inflation rate entered the variation range associated to the 2.5% target set by the NBR. The trajectory during the third quarter is largely explained by the same factors that influenced it during the second quarter, additional effects being generated by the rise in the international oil price and by the increase of the excise duty on fuels. The fourth quarter marked the acceleration of the inflationary phenomenon, the level of 3.32% recorded in December 2017 being 1.55 pp above the end-September value and close to the upper limit of the variation range (1.5% - 3.5%). The surge in inflation was due to shocks that affected the prices of fuel, electricity and agri-food products amid continued growth in companies' production costs. At the same time, the excess of aggregate demand continued to favor the transmission of shocks to consumer prices. It must be mentioned that an important part of these developments was unanticipated, so that the annual inflation rate exceeded by 0.6 pp the level projected by the NBR. In conclusion, the inflation rate grew almost continuously during 2017, the minimum value being recorded in January and the peak in December. Nevertheless, apart from the surge recorded in the fourth quarter, the evolution of inflation was largely anticipated on the basis of macroeconomic developments.

The NBR Board of Directors maintained the monetary policy interest rate at 1.75% throughout 2017, while the annual inflation rate re-entered the 1.5% - 3.5% range associated with the 2.5% target in September. However, in just three months it rose sharply and at the end of the year it was close to the upper end of the range. In what concerns the minimum reserve requirements, the rate applicable to foreign currency liabilities was reduced from 10% to 8% in May 2017, being now aligned with the rate applicable to domestic currency liabilities which remained unchanged throughout 2017. The reduction of the minimum reserve requirements is part of the process that seeks to align this mechanism with the standards and practices of the European Central Bank (ECB).

In what concerns the external position, 2017 witnessed an increase in the current account deficit[4] which reached 3.35% of GDP from 2.09% in 2016. Thus, it deepened by over EUR 2.7 billion (approximately 77%) compared to 2016, while GDP recorded a growth of 10.7%. The increase in the current account deficit is largely due to a deterioration in the balance of goods and services from a deficit of EUR 1.58 billion in 2016 to a deficit of EUR 3.98 billion in 2017 (the situation was generated exclusively by the balance of goods, its deficit being EUR 2.61 billion higher). A smaller contribution came from the primary income balance[5], the deficit of which increased by EUR 0.49 billion, while the secondary income balance[6] exercised a minor positive influence, increasing its surplus by EUR 0.14 billion. In nominal terms, exports of goods and services continued to grow at around 11% in 2017 (EUR +7.7 billion), supported by a favorable economic climate across the EU which is the main trading partner of Romania. Although the growth rate of exports was substantial, it is still surpassed by imports which advanced by 14.2% compared to 2016 (EUR +10.2 billion), boosted by the expansion of domestic demand.

Analyzing the changes in the current account balance in terms of difference between the saving and the investment rate, it can be seen that the saving rate continued its downward trend from previous years, decreasing by 0.82 pp of GDP in 2016, while the investment rate grew by 0.44 pp compared to 2016. Thus, the evolution of both rates contributed to the increase of the current account deficit. Comparing these results with those of 2007, when the highest current account deficit of the 2005-2017 period was recorded (13.45% of GDP), the deficit from 2017 was achieved through the reduction of the investment rate by more than 6.5 pp, while the saving rate advanced by about 3.5 pp.

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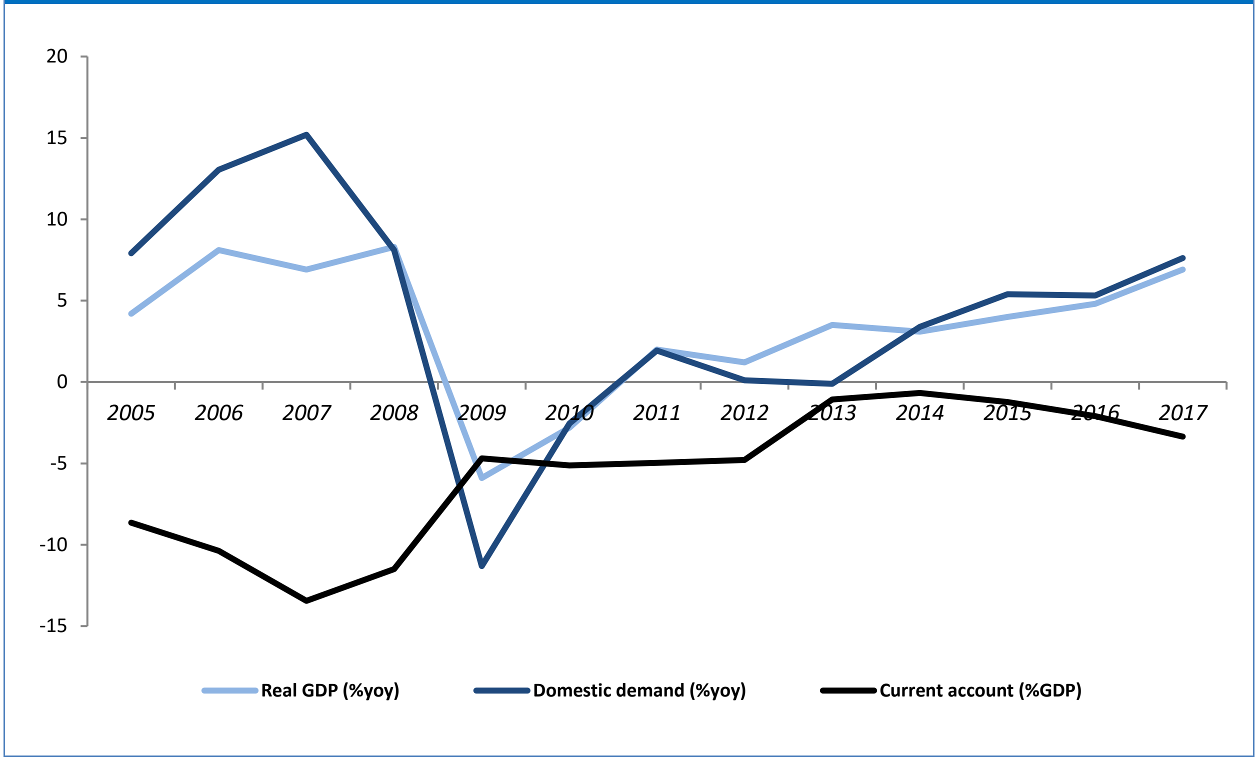
[4] According to BPM6 standards (the balance of payments manual developed by IMF), the terminology of the current account components changed. Thus, the primary income balance and the secondary income balance replaced the income and transfers balance.

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

[6] The secondary income balance shows the redistribution of income, i.e. the situation in which the resources employed for current purposes are provided by a state without repayment. Personal transfers and current international aid can be mentioned as examples of such operations.

Figure 3: The evolution of the real GDP, domestic demand and current account, 2005-2017



Source: NBR, Eurostat, Fiscal Council's calculations

Direct investment of non-residents in Romania recorded a level of EUR 4.58 billion in 2017, this value representing an increase of 1.37% compared to 2016. Although this increase is a minor one, the recorded level is significant above the average of the 2010-2015 period. On the other hand, the direct investment of non-residents is still much lower compared to the pre-crisis period (the average annual foreign direct investment in 2007-2008 was about EUR 8.37 billion). In terms of net foreign direct investment[7], it also recorded a slight increase of 1.47% compared to the previous year[8], reaching EUR 4.59 billion. Thus, it can be seen that net foreign direct investment financed around 73% of the current account deficit.

Romania's external debt increased in nominal terms by 0.61% in 2017, compared to the previous year, and reached EUR 93.48 billion, but diminished significantly as a percentage of GDP, from 54.7% to 49.8%, supported by the strong upward GDP dynamics. Thus, following the gradual reduction of the external debt to GDP ratio, the current level represents a significant improvement over the 2010-2012 period when the indicator stood at around 75%. In what

[7] Net foreign direct investment represents the total investment of non-residents in the domestic economy from which the residents' investment abroad is deducted.

[8] The 2016 net foreign direct investment of EUR 3.86 billion, stated in the 2016 Annual Report of the Fiscal Council, underwent a significant revision to EUR 4.52 billion.

concerns the medium and long-term external debt, it accounted for 73.4% of the total external debt at the end of 2017 (i.e. EUR 68.61 billion), its weight being lower than the one recorded at the end of 2016 (approximately 75%). Short-term external debt increased by 6.9% to EUR 24.86 billion (representing 26.6% of total foreign debt compared to 25% in 2016). Over the past few years, there was a slight tendency of restructuring the external debt by maturity, reflected in the reduction of medium and long-term debt, coupled with increases in the short-term debt. The decline in long-term debt in 2017 was the result of a decrease in private debt and non-residents' deposits. On the other hand, direct external public debt increased from EUR 31.75 billion at the end of 2016 to EUR 33.1 billion by the end of 2017. This increase was mainly due to the two issues of Eurobonds on the international financial markets, from April and October 2017, through which the Romanian government obtained a total financing of EUR 2.75 billion with maturities of 10 years (EUR 2 billion) and 18 years (EUR 0.75 billion) [9].

In 2017, the dynamics of non-governmental loans remained in positive territory, registering a 2.3% increase in real terms compared to the previous year. Similar to 2016, domestic currency denominated loans continued their upward trajectory, rising by 12.25% in real terms, while foreign currency denominated loans continued to lose ground, decreasing by 10.4% in euro equivalent. The dynamics of lending activity can be attributed to factors such as: the increase of disposable income (due to indirect tax cuts and the elimination of certain taxes, also being supported by wage increases in the public and private sectors), the favorable evolution of the labor market (manifested through the reduction of the unemployment rate, coupled with an increase of average earnings and of the minimum guaranteed wage) and low interest rates (although it should be noted that, beginning with September 2017, ROBOR increased rapidly having a significant impact on the cost of loans granted at a variable interest rate). At the same time, during 2017 credit institutions showed a tendency to tighten the access of non-financial corporations and households to loans (mainly consumer loans, the conditions for mortgage loans being slightly eased in the third quarter), while the demand for loans had a mainly upward trend, especially in the case of non-financial corporations which displayed an increasing demand for 9 consecutive quarters[10]. The ratio of non-performing loans continued its downward trend from previous years, reaching 6.4% compared to 9.62% in December 2016. Also, from a macro prudential point of view, there is a comfortable level of liquidity in the banking system, the loans/deposits ratio of the non-governmental sector consolidating its position below the 100% threshold (76.8% in December 2017, compared to 80.3% in December 2016).

The positive evolution of the lending activity in 2017 can be attributed only to the dynamics of household loans (+4.3% in real terms), while corporate loans recorded a slight decrease (-0.8% in

[9] According to public debt data, available on the MPF website.

[10] According to the quarterly Bank Lending Surveys published by the NBR.

real terms). In the case of household loans, the advance was caused exclusively by those granted in domestic currency (+17.4% in real terms), while loans in foreign currency declined by 13.5% in euro equivalent. The decrease in corporate loans was determined by the downward trend of the foreign currency component (-8.8% in euro equivalent), while loans in domestic currency registered positive dynamics (+6.1% in real terms).

Stimulated by economic growth, the labor market recorded a positive evolution in 2017, the average number of employees rising to 4,925 thousand people[11] (+3.5% compared to 2016), supported by an increase in the number of employees in both the private (+3.9%) and the public sector (+1.8%)[12]. Thus, the unemployment rate dropped to 4.9% (from 5.9% in 2016), this being its lowest level during the last 20 years[13].

In 2017, the gross average monthly wage per economy was 3,256 lei (+15.9% compared to 2016), while the net average monthly wage stood at 2,373 lei (+16% compared to the previous year)[14]. Taking into account the average annual inflation of 1.3%, the increase in real wages was slightly lower (+14.5%). The positive dynamics of the average wage per economy was mainly supported by the evolution of public sector earnings (+24.6% in nominal terms), several salary increases for employees paid from public funds being enacted during 2017 (mainly in the areas of defense, public order and national security, health, education and public administration). On the other hand, wages increased in the private sector as well (+13.7% on average) due to excessive demand relative to existing supply. Last but not least, another factor that influenced the dynamics of the gross average wage per economy was the increase of the guaranteed minimum wage from 1,250 lei in May 2016 to 1,450 lei as of February 2017.

[11] According to the NCSP forecast from April 2018.

[12] The public sector is determined by summing the following sectors: public administration, defense, education, health and social assistance. The private sector is approximated by removing the public sector from the values recorded for the entire economy.

[13] According to the European Economic Forecast, Spring 2018.

[14] According to the NCSP forecast from April 2018.

Table 1: Macroeconomic indicators in 2017 (Fiscal Strategy forecast versus effective)		
	Fiscal Strategy 2017-2019	**Effective 2017**
	- % yoy -	
GDP		
GDP (million lei)	815,195.0	858,332.8
Real GDP	5.2	6.9
GDP deflator	2.2	5.3
GDP components		
Final consumption	6.2	8.5
Private consumption expenditure	7.2	10.1
Government consumption expenditure	1.8	0.7
Gross fixed capital formation	7.2	4.7
Exports (volume)	5.6	9.7
Imports (volume)	8.5	11.3
Inflation rate		
December 2016	1.9	3.3
Annual average	1.4	1.3
Labor market		
Unemployment rate (end of period)	4.3	4.9
Average number of employees	4.3	3.5
Gross average wage	11.2	15.9

Source: NCSP, Eurostat, MPF

III. Fiscal policy in 2017

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

According to article 61, para. (2) of the FRL, the Fiscal Council's Annual Report must contain "*an analysis of the fiscal policy implemented during the previous year compared to the objectives that were set out in the Fiscal Strategy and the annual budget*" and will include:

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

b) An assessment of objectives, targets and indicators set out in the Fiscal Strategy and annual budget to which the Annual Report corresponds;

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

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

According to article 26, para. (1) of the FRL, until July 31 of each year, the MPF is required to submit to the Government the Fiscal Strategy for the next 3 years accompanied by the draft law approving the ceilings specified in the fiscal framework. The Fiscal Strategy for the period 2017-2019 was elaborated and approved in January 2017, at the same time with the draft budget proposal for 2017, which implies that both documents set out an identical fiscal framework for 2017. Under these circumstances, the obligation of the Fiscal Council to assess in its Annual Report the objectives, targets and indicators established through the Fiscal Strategy and the annual budget is reduced to an *ex-post* analysis of the projections set out in the draft budget, the *ex-ante* assessment of the compliance with the rules regarding the limits defined for the budgetary indicators stipulated by the Law of ceilings being in this situation irrelevant. The Fiscal Council draws attention to the perpetuation of this situation over the past 4 years, with the Government issuing the Fiscal Strategy or an updated version of it together with the draft budget for the respective year, which is not likely to create an efficient budgetary planning based on *ex-ante* compliance with fiscal rules.

The GCB for 2017 was based on a macroeconomic forecast scenario with an economic growth estimated at 5.2% in real terms, while the deficit target was projected to 2.96% of GDP according to cash standards (increasing from 2.4% of GDP in 2016), respectively to 2.98% of GDP according to ESA 2010 methodology. Due to an increase in the positive output gap, maintaining the budget deficit close to the 3% ceiling involved a deterioration of the structural deficit which recorded a significant deviation from the MTO of 1% of GDP, in addition to the one registered in 2016 as a result of fiscal relaxation measures. Therefore, the structural deficit was 2.57% of GDP in 2016 and deepened further in 2017 to 2.91% of GDP, supported by new fiscal relaxation measures.

The final budget execution was in line with the deficit target, the budget deficit standing at 2.83% of GDP, or 24.26 billion lei (compared with a projection of 24.1 billion lei) according to the cash methodology, while the nominal GDP was 43.1 billion lei higher compared to the initial budget forecast. According to ESA methodology, the budget deficit stood at 25.02 billion lei (2.92% of GDP) which is slightly lower than the target expressed as a percentage of GDP but higher in nominal terms. The difference between the budget deficit computed according to the two methodologies can be explained by elements that act in both directions, namely those that are accounted for only in the national methodology while others are included only in the European methodology. Thus, the main elements that explain the gap of 0.76 billion lei between the ESA 2010 and the cash deficit are as follows: dividend distribution by state-owned companies from previously accumulated reserves that only affect public debt according to the European methodology (+2.5 billion lei gap between the ESA 2010 and the cash deficit), payments in advance for the purchase of military equipment that will be recognized only at delivery according to the European methodology (-2.7 billion lei gap between the ESA 2010 and the cash deficit), payments regulated by the Law 85/2016 that were already recorded in the ESA execution for 2016 (-1.2 billion lei gap between the ESA 2010 and the cash deficit), differences in the treatment of interest expenses, the ones according to the European methodology being higher (+1.2 billion lei gap between the ESA 2010 and the cash deficit), differences between the compensation decisions established by the National Authority for Property Restitution which were set at 1.35 billion lei, while only 0.97 billion lei were actually paid (+0.33 billion lei gap between the ESA 2010 and the cash deficit). In conclusion, although there were elements with a significant impact on the budget deficit according to just one of the methodologies, they cumulatively canceled each other. It must be highlighted that the decision to demand to state owned companies to distribute additional dividends from the reserves accumulated in previous years did not influence the ESA 2010 budget deficit which is relevant for the evaluation of fiscal rules at the European level. The contribution of state-owned companies to the GCB balance was a positive one in 2017 (approximately 2.33 billion lei), increasing by 0.84 billion lei compared to the previous year.

In terms of fiscal policy rules, the 2017 nominal ceilings for the GCB balance, the primary balance, total expenses (excluding revenues from post-accession EU funds, pre-accession funds and financial assistance from other donors) and personnel expenditure were established by Law no.

5/2017[15] (see *Table 2* below). The budget execution revealed non-compliance with the ceilings for all the above mentioned elements and it should be noted that the ceilings have not been met even ex-post, as happened in the previous year, although the nominal GDP was well above the preliminary forecast (+43.1 billion lei) and public investment expenditures registered a massive drawback of 12.7 billion lei compared to the initial budget. Thus, in 2017 the fiscal rules were violated both ex-ante in the process of drafting the budget, including the two budget revisions, and ex-post, mainly due to an increase in personnel expenditure (+5.7 billion lei).

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

	Law no. 5/2017			Budget execution 2017		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
million lei	**-24,100.00**	**256,535.20**	**63,884.00**	**- 24,260.66**	**258,787.50**	**69,620.47**
% of GDP budget draft	*-2.96%*	*31.5%*	*7.8%*			
% of GDP provisional data for 2017	*-2.81%*	*30.0%*	*7.5%*	*-2.83%*	*30.2%*	*8.1%*

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

Source: MPF

The first budget revision, approved at the beginning of September 2017, rectified upward both GCB revenues (+1.7 billion lei) and expenditures (+2.35 billion lei) compared to the initial budget, leading to an increase of 644.5 million lei in the projected deficit (from 24.1 to 24.74 billion lei). Compared to the ceilings stipulated by Law no. 5/2017, the Fiscal Council noted that almost all of them were exceeded[16], except for the one referring to the GCB balance as a percentage of GDP which was maintained inside the limits of the initial projections due to an increase in the forecast for nominal GDP[17]. Thus, the rule defined by article 12, letter a) of the FRL, which states that "*the GCB balance and the personnel expenditure of the GCB, expressed as a percentage of GDP, cannot*

[15] The Law on the approval of ceilings for certain indicators specified in the Fiscal Strategy which entered into force on February 19, 2017 until December 31, 2017.

[16] Overruns of the ceilings for: *GCB deficit* by 0.64 billion lei, *primary deficit* by 0.15 billion lei, *personnel expenditure* by 5.1 billion lei and in the case of *total expenditure excluding financial assistance from the EU and other donors* by 2.8 billion lei.

[17] Given the evolution of GDP during the first semester of 2017, its forecast was raised by 21.9 billion lei, allowing for the GCB deficit to be maintained at 2.96% of GDP.

exceed the annual ceilings that were set out in the Fiscal Strategy for the first 2 years covered by it", was partially respected. However, for all the other budgetary aggregates, the amendments made by the first budget revision are in contradiction with the fiscal rules established by the republished FRL. Thus, for personnel expenses, the provisions of article 12, letter a) (for the level expressed as a percentage of GDP) and letter c) (for the nominal level) and of article 17, para. (2), which prohibits the increase in personnel expenditure on the occasion of budget revisions, were violated. For the total GCB expenditures, excluding financial assistance from the EU and other donors, a lack of compliance with the fiscal rules was observed in the case of article 12, letter c), as well as article 24 of the FRL, which allows for an increase in total GCB expenditure (excluding financial assistance from the EU and other donors) during budget revisions only when it is made for the service of public debt or for the payment of Romania's contribution to the EU budget[18]. The provisions of article 26, para. (5), which reaffirms the mandatory ceilings established by law for next year's budget, were also violated. Moreover, although **in June 2017 the EC warned Romania that it was subject to a significant deviation from the MTO, with the recommendation to initiate a structural adjustment of 0.5% of GDP during 2017**, the Romanian authorities did not follow this recommendation and, in September 2017, operated an increase in the GCB expenditure with the occasion of the first budget revision, thus, continuing to violate the corrective mechanism established by article 14 of the FRL. In order to implement the revision, GEO no. 63/2017 for amending the 2017 state budget stipulated the necessary derogations from the aforementioned fiscal rules and redefined the ceilings set by Law no. 5/2017 in line with the revised levels of the budgetary aggregates.

GCB revenues, including the swap scheme amounting to 1.4 billion lei, were revised upward[19] by about 1.7 billion lei, despite a sizeable decrease of *tax revenues* (-2.1 billion lei) and a reduction of approximately 490 million lei of the programmed inflows from *European post-accession funds for the 2014-2020 multiannual financial framework*, but being supported by increases in *non-tax revenues* (+3.35 billion lei) and *social contributions* (+1.6 billion lei), based on the budget execution for the first 7 months of 2017, as well as taking into account changes in the level and structure of the swap scheme[20]. Eliminating the impact of the swap scheme, the following

[18] In this case, the exceeding of the ceiling appears to be partially justified by *interest expenses* (+494 million lei) and by *Romania's contribution to the EU budget* (+990 million lei).

[19] It should be noted that, at the time of drafting its Opinion on the first budget revision, the Fiscal Council received from MPF data that was subsequently amended (when GEO no. 63/2017 was approved). Therefore, the data from this analysis is slightly different compared to the Opinion of September 13, 2017.

[20] In the initial budget the swap scheme was estimated at 1,592.7 million lei and it was allocated entirely to *VAT* revenues. The first budget revision reduced it by 167.7 million lei and allocated it mainly to *social contributions* (+716 million lei), to *corporate and personal income tax and capital gains* (+709 million lei) and only 297 million lei to *VAT*.

revenue aggregates underwent significant revisions compared to the initial budget: *non-tax revenues* (+3.35 billion lei), *social contributions* (+0.9 billion lei), *excise duties* (+0.45 billion lei), coupled with reductions in *corporate income tax*[21] (-1.9 billion lei) and in the *taxes on the use of goods, the authorization of the use of goods and conducting activities* (-0.53 billion lei). In what concerns the seemingly minor revision of the *amounts received from the EU for payments made and pre-financing*, taking into account the very poor execution up to that point, it is important to mention that it masked a significant downward revision of structural funds (-4.44 billion lei, from 9.64 billion lei to 5.2 billion lei) which was partially offset by an increase in the funds allocated to *EU payments for agriculture* (+1.49 billion lei) and by recording the *amounts intended to pre-fund non-governmental sector projects in the case of temporary unavailability of European funds* in the GCB, based on article 10 of GEO no. 40/2015 (+2.46 billion lei). It should be noted that the last two categories generated a symmetric impact on revenues and expenditures, but the reduction in structural and cohesion funds, of which the state was the final beneficiary, led to a significant decrease in co-financing and ineligible expenses (of approximately 8.4 billion lei). As the Fiscal Council had already explained in the opinion on the draft budget for 2017, from the perspective of the ESA10 methodology only structural funds whose final beneficiary is the state are relevant, while the amounts for agriculture and pre-financing to the non-governmental sector are not included in the public administration budget. Moreover, recording these amounts in the GCB makes it virtually impossible to compare data from 2017 with previous years (for the payments granted under article 10 of GEO no. 20/2015) and with the European funds received under the 2007-2013 multiannual financial framework.

GCB expenditures, excluding the swap scheme, increased by 2.52 billion lei mainly due to the significant increase of *personnel expenditure* by 5.1 billion lei (because they were initially underestimated, but also under the impact of certain wage increases decided after the approval of the initial budget) and of *social assistance expenditure* by 3.3 billion lei (validating the warning issued by the Fiscal Council in its opinion on the annual budget law, concerning a possible underestimation of at least 2 billion lei). The evolution of these budgetary aggregates revealed serious shortcomings regarding the budgetary planning process and the recurrent violation of the fiscal rules which do not allow the increase of personnel expenditure during the year. Confirming again the underestimation of aggregates in the initial budget, identified by the Fiscal Council in its opinion from January 2017, *other transfers* were increased by 0.7 billion lei (in order to accommodate the initial underestimation of Romania's contribution to the EU budget with almost

[21] A reduction of 2.4 billion lei in the corporate income tax owed by non-bank economic agents came as a result of underestimating the impact of changing the micro-enterprise regime at the beginning of 2017 by generalizing the turnover tax rate of 1%, coupled with a significant increase of the application ceiling from an annual turnover of 100,000 euros to 500,000 euros.

1 billion lei) and *interest expenses* by about 0.5 billion lei (determining the increase of the primary deficit).

These expenditure increases were partially offset by a massive reduction in *investment expenditure* of 10.66 billion lei (driven by a decrease of 5.5 billion lei in investment projects financed by European non-reimbursable funds, a reduction of 130 million lei in allocations related to investment programs financed with repayable funds and a decline of 5 billion lei in capital expenditures - mainly those related to co-financing of projects from European structural funds following the significant downward revision of structural and cohesion funds by over -4.4 billion lei) and in *goods and services expenditure* (-1.5 billion lei, which was surprising given a positive evolution in the first 8 months of 2017 compared to 2016, the warning of the Fiscal Council proving again to be pertinent taking into account that their execution was higher even when compared to the level from the initial budget). Article 12, letter e) must be added to the aforementioned violations of the fiscal rules, its provisions prohibiting the use of approved and unused budget allocations for current expenditure during the year, given that the increase in total expenditure has occurred simultaneously with a massive reduction in investment expenditure.

The second budget revision, approved in November 2017, estimated an increase of GCB revenues by 0.38 billion lei and of GCB expenditures by 0.6 billion lei, compared to the first budget revision, the deficit being projected to increase by 224 million lei to a level of 24.97 billion lei (exceeding by 868 million lei the ceiling defined in Law no. 5/2017). Thus, the proposed revision required derogations from the provisions stipulated at article 12, letters a) - c), article 17, para. (2), article 24 and article 26, para. (4) and (5) of the republished FRL, as well as from the provisions stipulated at article 2, para. (2) and article 3, para. (5) and (6) of Law no. 5/2017, thereby sanctioning the non-compliance with most fiscal rules except for the GCB balance expressed as a percentage of GDP. The second budget revision supplemented *personnel expenses* by another 0.63 billion lei, exceeding the nominal ceiling defined in Law no. 5/2017 by 5.7 billion lei and the ceiling expressed as a percentage of GDP by 0.5 pp of GDP (although the GDP estimate increased by 27.3 billion lei compared to the time when the Law on ceilings was drafted). It also supplemented by 0.86 billion lei (compared to the first revision) the overrun of the ceiling for *total expenditure, excluding financial assistance from the EU and other donors*, the gap towards the ceiling established by Law no. 5/2017 being of +3.6 billion lei. In addition, it is also noted the non-compliance with the ceiling defined by Law no. 5/2017 for the GCB primary balance (by 0.55 billion lei), as the downward revision of interest expenses (-181 mil. lei compared to the first revision) was accompanied by increases in other expenditures, without an equivalent reduction of the GCB deficit.

Thus, the 2017 second budget revision violated the provisions of article 12, letters a) - c), article 17, para. (2), article 24 and article 26, para. (4) and (5) of the republished FRL, providing for appropriate exemptions from the aforementioned fiscal rules and redefining the ceilings of Law no. 5/2017. As in the case of the first budget revision, the rule stipulated by article 12, letter e) was also violated because the additional reduction of investment expenditure (by another 1.7 billion lei compared to the first budget revision) was accompanied by an increase of the current expenditures, respectively of the total level of expenditures by 0.6 billion lei.

Compared to the first budget revision, **GCB revenues**, excluding the swap, were revised upward by 377 million lei based on increases in *tax revenues* (+17.8 million lei), in *social contributions* (+484 million lei) and in *non-tax revenues* (+189 million lei) that were partially offset by a reduction of revenues related to *EU funds for the 2014-2020 multiannual financial framework* (-225 million lei). The categories of tax revenues that have changed compared to the estimates of the first budget revision were represented by: *corporate income tax* (-311 million lei), *excise duties* (+143 million lei, due to the reintroduction of the additional excise duty on fuels in September 2017) and *personal income tax* (+86 million lei). Regarding the relatively low downward revision of the *amounts received from the EU for payments made and pre-financing for the 2014-2020 multiannual financial framework*, it masked the reduction of the *amounts intended to pre-fund non-governmental sector projects in the case of temporary unavailability of European funds*, based on article 10 of GEO no. 40/2015 by 724 million lei (symmetric impact on revenues and expenditures), simultaneously with the increase of *structural and cohesion funds whose final beneficiary is the public sector* by 500 million lei. The Fiscal Council warned that the end-October execution stood at less than 56%[22] of the level estimated for the end of the year, so, convergence towards that target would have implied a massive acceleration of inputs in the remaining two months. The execution at the end of the year confirmed this problem, the revenues of this budgetary aggregate being only 17 billion lei (compared to the estimated 21.36 billion lei).

Eliminating the influence of the compensation scheme for budget arrears, **GCB expenditures**, were revised upward by 600 million lei, compared to the first budget revision, by increasing *current expenses* while reducing *investment*. The main categories of expenditures that have changed compared to the estimates of the first budget revision were represented by: *social assistance* (+1.39 billion lei, due to allocating insufficient funds compared to the execution of social assistance rights and state military pensions for the first 10 months), *personnel expenses* (+0.63 billion lei, due to underestimating the amounts granted by court decisions for the payment of certain wages), *goods and services* (+0.45 billion lei, in line with the execution for the first 10 months), *the reserve fund* (+0.34 billion lei, by derogating[23] from the provisions of article 30, para.

[22] 11.9 billion lei for the first 10 months of 2017, while the end-of-year estimate was 21.36 billion lei.

[23] This concerns the possibility of allocating amounts from the reserve fund for social assistance, for the national contribution and ineligible expenditure of projects funded by non-reimbursable funds, for subsidies to support agricultural producers and for other categories of expenditures that cannot be classified as "urgent or unforeseen".

(2) of the Law no. 500/2002 on public finances which regulates the use of this fund). *Investment expenditures* were reduced by 1.77 billion lei[24] due to a decrease of 2.44 billion lei for projects financed by domestic sources (mainly capital expenditures), coupled with an increase of 0.7 billion lei for projects financed by the EU. The additional expenditures did not come as a result of new legislative measures, but by underestimating state budget expenditures related to military pensions and child allowances, and local budget expenditures related to the payment of indemnities to disabled people who renounce their attendant and to the child protection system.

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

- the lack of compliance with the annual ceilings set for the general government deficit, the primary deficit, the total expenditure and personnel expenditure, these being often violated *ex-post*;
- the frequent violation of the ban on increasing total expenditure and personnel expenditure during budget revisions;
- the Fiscal Strategy has not been developed on time (July 31);
- usually, the measures to reduce taxes are not accompanied by coherent compensation measures (such as increasing the tax base, rising other taxes or reducing expenditures);
- the structural deficit rule (MTO of -1% of GDP) has been violated since 2016.

The Fiscal Council observes the breach of almost all fiscal rules in 2017, except for the one referring to the GCB deficit as a percentage of GDP, and ascertains their *de facto* inoperability. Thus, when elaborating the two budget revisions for 2017, the Government stipulated in the corresponding GEOs the necessary derogations from the fiscal rules set by the FRL and readjusted the ceilings from Law no. 5/2017 in line with the revised levels of budgetary aggregates.

The weak constraints of the "auxiliary" rules (linked to the budget deficit), illustrated by the ease and frequency with which they are ignored, undermines the integrity and consistency of the rule-based fiscal and budgetary framework and prevents at least two benefits envisaged by the legislator:

[24] The annual estimate from the second revision is 8.3% lower compared to the previous year, while the initial budget estimated an increase of 33% in investment expenditures compared to 2016.

- if the "auxiliary" tax rules had been fully operational, they would have contributed to the coherence of the fiscal-budgetary framework according to the principles of transparency and stability established by law. They would have motivated the decision-makers to fully include the relevant information in the initial budgetary construction, and would have led to increased predictability of budget parameters, discouraging the adoption of ad hoc measures;
- if the rule concerning the nominal ceiling of budgetary expenditures had been operational, there would have been a real-time compliance mechanism with the benchmarks for the structural balance, limiting deviations from them, when cyclical developments are more favorable than anticipated (as is the case with Romania at present).

The Fiscal Council notes the continued inoperability of the rule-based fiscal and budgetary framework stipulated by the republished FRL, as well as by the European Treaties signed by Romania. Moreover, the concerns about the conduct of fiscal policy in Romania and the deliberate circumvention of European treaties in the field are shared by the EC, Romania being already subject to a *significant deviation procedure from the MTO* triggered in June 2017. The Recommendation of the European Council from June 16, 2017, aimed at correcting the deviation from the adjustment path so that the MTO could be achieved, required a structural adjustment of 0.5% of GDP in 2017. Because the recommendation was ignored by the Romanian authorities, on December 5, 2017 the Council revised the adjustment to 0.8% of GDP for 2018.

Besides, the fact that the budget deficit was close to 3% of GDP, given that the economy is in the upward phase of the economic cycle, corresponds to a pro-cyclical fiscal policy which, considering the inevitable reversal of the economic cycle, will lead to the impossibility of stimulating the economy (due to the lack of fiscal space), creating the premises for adopting structural adjustment measures during recession (Romania had such an experience during 2010-2013). Moreover, recent economic literature[25] identifies significantly higher levels of fiscal multipliers in the recession period and low values during the expansion period, which means that the benefits in terms of additional short-term economic growth due to pro-cyclical fiscal relaxation are lower than the costs of an inevitable fiscal consolidation in the downward phase of the economic cycle. In addition, the Fiscal Council considers that maintaining or enrolling even on a moderate upward path of the public debt-to-GDP ratio during the boom phase masks the accumulation of vulnerabilities that will materialize in an (inevitable) downward phase of the economic cycle. It should be noted that, in the case of Romania, there is an additional constraint concerning the relatively high size of public debt compared to that of the domestic financial sector, implying a

[25] Auerbach, A. and Y. Gorodnichenko, ”*Fiscal Multipliers in Recession and Expansion*”, NBER Working Paper 17447, September 2011.

limited capacity to absorb an additional stock of public debt, the exposure to the government sector versus the total assets of local banks (the main holder of public debt in the domestic market) being among the highest in the EU. In fact, in the 2018 Country Report[26], the EC warns Romania that it has high risks related to medium-term debt sustainability, being one of the few EU countries where debt is projected to increase by 2028 while also having the highest growth rate among Member States. The calculations were based on the assumption of preserving current policies, characterized by the maintenance of high budget deficits and structural primary deficits. Taking also into account the costs generated by population ageing, the debt-to-GDP ratio is projected on an upward path, exceeding the 60% benchmark by 2028. The recommendations made to Romania by the EC aim at a consistent fiscal and budgetary effort, starting in 2018, in line with the requirements of the preventive arm of the SGP and ensuring the full application of the rule-based fiscal framework.

The evolution of the key budgetary aggregates during 2017, according to cash standards, is presented in *Table 3*.

Table 3: The evolution of the key budgetary aggregates during 2017 (billion lei)

	Initial budget	First revision	Second revision	Budget execution 2017
Total revenues	**253.1**	**255.0**	**255.4**	**250.6**
Tax revenues	230.0	232.3	233.0	232.6
Social Contributions	69.8	70.7	71.1	71.1
EU funds	22.3	21.8	21.6	17.1
Total expenditure, of which:	**277.2**	**279.7**	**280.3**	**274.9**
Current expenditure, of which:	252.2	260.3	262.3	256.5
Projects from EU funds	24.1	23.5	23.3	18.7
Capital expenditure	25.1	19.4	18.0	19.6
Budget balance	**-24.10**	**-24.74**	**-24.97**	**-24.26**

Source: MPF

Note: Amounts without the compensation schemes.

The results of the budget execution (including the swap scheme) in the fiscal year 2017 indicate a budget deficit in cash standards which is 0.16 billion lei higher than the forecast of the initial

[26] Country Report Romania 2018, https://ec.europa.eu/info/sites/info/files/2018-european-semester-country-report-romania-en.pdf.

program (+0.02% of GDP), as revenues were 2.9 billion lei below the initial expectation and expenditures decreased by 2.74 billion lei compared to the values estimated in the initial budget.

On the revenues side, net of the swap compensation schemes, the difference from the estimated amount to be collected was -2.5 billion lei, mainly due to the very poor absorption of European funds[27] (-5.2 billion lei compared to the initial estimation), but also as a result of lower than expected revenues from *taxes on corporate income, personal income and capital gains* (-2.2 billion lei[28]) and on the *use of goods, the authorization of the use of goods and conducting activities* (-0.56 billion lei). Revenues above expectations were recorded for *non-tax revenues*, by 2.82 billion lei above the initial estimate (which recorded a massive upward adjustment during the first budget revision as a result of the extraordinary distribution of dividends by the state-owned companies on the basis of GEO no. 29/2017), for *social contributions*, by 1.32 billion lei higher than the initial estimate (in line with salary increases and the payment of certain court decisions), for *VAT* (+0.76 billion lei) and for *excise duties* (+0.55 billion lei) as a result of reintroducing the additional excise duty on fuels, as of September 15, and supported by the economic growth which performed above expectations.

Regarding the execution of budget expenditures, their amount diminished by 2.4 billion lei compared to the initial estimates, the main categories that registered decreases being: *capital expenditures* (-5.5 billion lei), *projects financed from 2014-2024 non-reimbursable external post-accession funds* (-5.4 billion lei) and *subsidies* (-0.96 billion lei). An increase above expectations was recorded by *personnel expenses* (+5.7 billion lei, as a result of the initial underestimation, but also because of the salary increases decided after the approval of the initial budget) and by *social assistance expenditures* (+4.1 billion lei, mainly due to insufficient funds allocated in the initial budget and less as a result of new legislative measures).

[27] Including the funds belonging to the 2014-2020 multiannual financial framework.

[28] Mainly due to the *corporate income tax* (-2 billion lei).

Table 4: The development of budgetary expenditure and revenue according to ESA 2010, %GDP										
	2009	2011	2012	2013	2014	2015	2016	2017	Changes 2017 to 2016	Changes 2017 to 2009
Total revenue	**30.5**	**33.9**	**33.6**	**33.2**	**33.6**	**35.0**	**31.6**	**30.5**	**-1.2**	**-0.1**
Tax revenue	16.3	19.1	18.9	18.6	18.9	19.8	17.7	16.3	-1.4	0.0
Indirect taxes, out of which:	10.3	13.0	13.1	12.7	12.7	13.2	11.3	10.3	-1.0	0.0
VAT	6.3	8.6	8.2	8.1	7.6	8.1	6.5	6.2	-0.3	-0.1
Excise and custom duties	4.0	4.4	4.8	4.5	5.0	5.1	4.8	4.1	-0.7	0.1
Direct taxes, out of which:	6.0	6.1	5.8	5.9	6.2	6.6	6.5	6.1	-0.4	0.1
Personal income tax	3.5	3.4	3.6	3.5	3.6	3.7	3.7	3.6	-0.2	0.1
Corporate income tax	2.3	1.9	1.7	1.7	1.8	2.0	2.0	1.7	-0.3	-0.6
Social contributions	9.7	9.0	8.7	8.6	8.5	8.1	8.8	9.3	0.6	-0.4
Other current revenue	1.4	1.5	2.0	2.1	2.1	2.1	1.6	1.6	0.0	0.2
Total expenditure	**39.7**	**39.3**	**37.2**	**35.4**	**35.0**	**35.8**	**34.6**	**33.4**	**-1.2**	**-6.3**
Intermediate consumption	6.1	5.8	6.0	5.7	5.7	5.7	5.3	4.9	-0.5	-1.2
Compensation of employees	10.4	7.8	7.8	8.1	7.7	7.7	8.9	9.7	0.8	-0.7
Interest payments	1.4	1.6	1.7	1.8	1.6	1.6	1.5	1.3	-0.2	-0.1
Social assistance	12.8	13.2	12.1	11.7	11.5	11.5	11.5	11.6	0.1	-1.2
Subsidies	1.1	0.9	0.7	0.5	0.5	0.5	0.4	0.4	0.0	-0.6
Other current expenditure	1.8	2.1	2.5	1.9	2.3	2.5	1.8	2.1	0.3	0.4
Gross fixed capital formation	6.2	7.9	6.4	5.7	5.6	6.4	5.1	3.3	-1.8	-2.9
Budget balance	**-9.2**	**-5.4**	**-3.7**	**-2.1**	**-1.3**	**-0.8**	**-3.0**	**-2.9**	**0.1**	**6.2**

Source: Eurostat

The fiscal consolidation initiated in 2010, in order to correct the existing major imbalances regarding the public finances position, was characterized by a fast pace, Romania managing to reduce the budget deficit (according to ESA 2010 standards) in a relatively short period of time, from 9.2% of GDP in 2009 to 0.8% of GDP in 2015. However, 2016 and 2017 marked a reversal of this trend, with a significant increase in the budget deficit as compared to 2015, amid a massive decline in revenues (by 4.5 pp in 2017 compared to 2015), thus, partially reversing the results of the fiscal consolidation process.

In 2017, budget revenues were by 1.2 pp of GDP lower than in the previous year and by 0.1 pp of GDP below the level of 2009, as a result of the significant decrease of tax revenues compared to 2016 which was caused by the negative evolution of indirect taxes (-1 pp of GDP) and of the direct ones (-0.4 pp of GDP). Thus, following the fiscal relaxation measures brought by the new Fiscal Code, the *VAT revenues* were below those from 2009 and the *excise duties* were heavily affected by the temporary cancellation of the additional excise duty on fuels (-0.7 pp of GDP compared to the previous year). The *corporate income tax* recorded a consistent decrease compared to the previous year (-0.3 pp of GDP) and especially as compared to 2009 (-0.6 pp of GDP), partially as a result of the changes made to the regime of micro-enterprises. *Social contributions* recorded an increase of 0.6 pp of GDP compared to the previous year, but were 0.4 pp of GDP below 2009 levels.

The significant fiscal adjustment compared to 2009 was achieved almost exclusively at the level of budget expenditures, which are 6.3 pp of GDP below the level of 2009, due to decreases registered by the following categories: *gross fixed capital formation* (-2.9 pp of GDP), *intermediate consumption* (-1.2 pp of GDP), *social assistance* (-1.2 pp of GDP), *compensation of employees* (-0.7 pp of GDP), *subsidies* (-0.6 pp of GDP) and *interest payments* (-0.1 pp of GDP). On the other hand, *other current expenditures* increased by 0.4 pp of GDP. Compared to the previous year, budget expenditures declined by 1.2 pp of GDP, due to decreases registered by the following categories: *gross fixed capital formation* (-1.8 pp of GDP), *intermediate consumption* (-0.5 pp of GDP) and *interest payments* (-0.2 pp of GDP). The categories of budgetary expenditures that registered increases compared to 2016 were: *compensation of employees* (+0.8 pp of GDP), *other current expenditures* (+0.3 pp of GDP) and *social assistance* (+0.1 pp of GDP). In essence, the fiscal adjustment between 2009 and 2017 was mainly made at the expense of investment, personnel and social assistance expenditures. However, the decrease of personnel and social assistance expenditures was partially reversed during the last two years, especially the *compensation of employees* which was 2 pp of GDP higher in 2017 compared to 2015.

Table 5: The development of budgetary revenue and expenditure according to cash methodology (% of GDP)												
	2009	2011	2012	2013	2014	2015	2016	Initial budget 2017	Execution 2017	Changes initial budget 2017 to 2016	Changes 2017 to 2016	Changes 2017 to 2009
Total revenue	**30.8**	**32.1**	**32.4**	**31.4**	**32.0**	**32.6**	**29.4**	**29.5**	**29.3**	**0.1**	**-0.1**	**-1.5**
Tax revenue	17.1	18.5	19.1	18.7	18.6	19.4	17.9	16.5	16.3	-1.4	-1.6	-0.8
Personal income tax	3.6	3.4	3.5	3.6	3.5	3.7	3.6	3.5	3.5	-0.1	-0.1	-0.1
Corporate income tax	2.1	1.8	1.8	1.7	1.8	1.9	2.0	1.9	1.7	-0.1	-0.3	-0.4
Property tax	0.7	0.7	0.7	0.7	0.9	0.8	0.8	0.6	0.6	-0.2	-0.2	-0.1
VAT	6.7	8.5	8.5	8.1	7.6	8.0	6.8	6.1	6.2	-0.7	-0.6	-0.5
Excise duties	3.1	3.4	3.4	3.3	3.6	3.6	3.6	3.0	3.1	-0.6	-0.5	0.0
Social contributions	9.4	9	8.7	8.5	8.6	8.0	8.0	8.1	8.4	0.1	0.4	-1.0
Non-fiscal revenue	3.3	3.2	3.1	2.7	2.6	2.7	2.4	2.2	2.5	-0.2	0.1	-0.8
Donations	0.6	0.1	0.1	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.6
Amounts received from the EU for payments made	0.4	1.1	1.3	1.4	1.7	2.4	0.9	2.6	2.0	1.7	1.1	1.6
Total expenditure	**38.0**	**36.3**	**34.8**	**33.8**	**33.7**	**34.1**	**31.8**	**32.3**	**32.2**	**0.5**	**0.4**	**-5.8**
Personnel expenditure	9.2	6.8	6.8	7.3	7.5	7.3	7.5	7.4	8.1	-0.1	0.6	-1.1
Goods and services	5.5	5.6	5.8	6.1	5.8	5.7	5.4	4.7	4.7	-0.7	-0.7	-0.8
Interest payments	1.2	1.6	1.8	1.7	1.5	1.3	1.3	1.2	1.2	-0.1	-0.1	0.0
Subsidies	1.4	1.1	1	0.8	0.9	0.9	0.9	0.8	0.7	-0.1	-0.2	-0.7
Projects financed from post-accession grants	0.5	1.9	2.2	2.2	2.2	3.4	1.3	2.9	2.3	1.6	1.0	1.8
Social assistance	12.5	12	11.2	10.7	10.7	10.7	10.8	10.3	10.8	-0.5	0.0	-1.7
Capital expenditure	4.3	4.1	3.2	2.8	2.6	2.5	2.5	2.9	2.3	0.4	-0.2	-2.0
Budget balance	**-7.2**	**-4.2**	**-2.5**	**-2.5**	**-1.7**	**-1.5**	**-2.4**	**-2.8**	**-2.8**	**-0.4**	**-0.4**	**4.4**

Source: MPF

Note: Amounts without the compensation schemes.

According to the cash methodology, relative to the previous year, in 2017 the budget deficit deteriorated by 0.4 pp of GDP, revenues registered a slight decrease of 0.06 pp of GDP while expenditures increased by 0.36 pp of GDP. Compared to 2016, *tax revenues* had the worst evolution (-1.56 pp of GDP) amid new fiscal relaxation measures introduced in 2017. The main categories of tax revenue affected by these measures are: *VAT* (-0.56 pp of GDP, as a result of a 1 pp reduction in VAT rate since January 1, 2017), *excise duties* (-0.5 pp of GDP, as a result of eliminating the additional excise duty on fuels between January 1 and September 14, 2017), *corporate income tax* (-0.28 pp of GDP, as a result of changes to the micro-enterprise regime) and *taxes on property* (-0.18 pp of GDP). These unfavorable developments were partially offset at the aggregate level of budget revenues by a much higher level of *amounts received from the EU* (+1.08 pp of GDP), as well as from *social contributions* (+0.35 pp of GDP) and *non-tax revenues* (+0.15 pp of GDP). On the expenditure side, compared to the previous year, there were significant reductions in *goods and services* (-0.67 pp of GDP), *capital expenditure* (-0.22 pp of GDP), *subsidies* (-0.18 pp of GDP) and *interest payments* (-0.12 pp of GDP). However, they were counterbalanced by increases in expenditures related to *projects financed from post-accession grants*[29] (+0.98 pp of GDP) and *personnel expenses* (+0.61 pp of GDP).

Further, this chapter will include an analysis of the structural budget balance in Romania, given that the fiscal targets are defined primarily in terms of structural deficit, followed by a detailed examination on the developments of the main budgetary aggregates of revenues and expenditures. Finally, it will conclude with an assessment of the public debt dynamics and its determinants based on a medium-term projection.

III.2. The structural budget balance in Romania

In 2012, Romania signed and ratified the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) which stipulates a rule-based fiscal framework, the target for the structural deficit of Romania being set at a maximum of 1% of GDP[30]. The provisions of TSCG and of the Directive no. 85/2011 were incorporated into domestic law by amending the FRL in December 2013, so, beginning with 2015, the medium-term budgetary planning has been constrained by the new rule for the budget deficit. However, while in 2015 the structural deficit

[29] It should be noted that, similar to the absorption of EU funds, the increase in expenditures related to projects financed from post-accession grants is caused entirely by payments for agriculture.

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

stood below the 1% of GDP target, since 2016 there has been a deliberate and sizeable deviation from this rule.

In theory, after reaching the MTO between 2013 and 2015, the fiscal consolidation process initiated in 2010 has been completed without the need for further tax adjustments. However, it should also be considered that defining the target in terms of structural deficit implies a corresponding deficit target that is adjusted according to the position of the economy within the economic cycle. Therefore, once the output gap becomes positive, complying with the 1% of GDP target is equivalent to recording budget deficits that are actually lower than this level[31] (because the cyclical component of the budget balance will be positive).

Despite the fact that it conveys the fiscal stance of an economy much clearer, the structural budget balance presents a number of disadvantages, the most important one being related to the uncertainties associated with its estimation. Thus, the structural balance is dependent on the output gap which, in turn, is computed based on potential GDP, an unobservable variable that is often subject to more or less significant revisions depending on adjustments concerning the statistical data and the estimation methodology. Compared to the 2016 Annual Report of the Fiscal Council, the output gap was revised significantly by the EC from 0% (2016), 0.7% (2017) and 0.8% (2018) in the 2017 Spring Forecast, to -1.5% (2016), 1.2% (2017) and 1.4% (2018) in the 2018 Spring Forecast.

The draft budget for 2017 targeted an overall deficit of 2.98% of GDP, according to the ESA 2010 methodology, corresponding to a structural deficit of 2.91% of GDP that was equivalent to a deterioration of about 0.34 pp of GDP compared to the 2016 structural deficit which, at that time (January 2017), was estimated at 2.57% of GDP. The budget execution for 2017[32] indicated an actual deficit of 2.91% of GDP, compared to 2.97% of GDP in 2016, while the structural deficit deteriorated further, reaching 3.3% of GDP according to the latest EC estimates. Thus, it was 0.4 pp of GDP higher than originally anticipated, due to a more favorable evolution of the economic cycle reflected by a growth rate that exceeded initial forecasts. Moreover, the 1.2 pp of GDP deterioration of the structural balance was much higher than anticipated, partially due to the EC revisions of the output gap, the level for 2016 being 1.5 pp lower relative to initial projections. This revision was equivalent to reducing the 2016 estimate of the structural deficit to 2.1% of GDP from 2.6% of GDP.

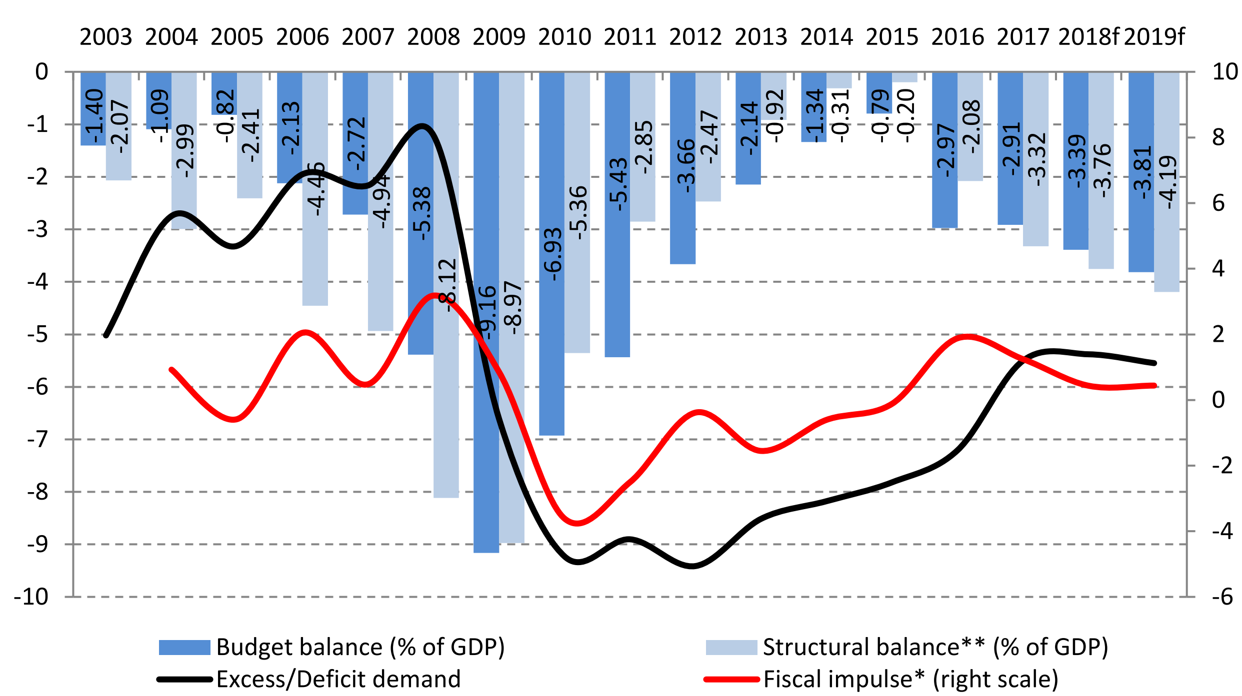
Romania has pursued a strong pro-cyclical fiscal policy between 2006 and 2015, stimulating intensively but unnecessarily and counterproductively the economy during the expansion period

[31] For example, complying with the OTM in 2017 would have implied an actual budget deficit of at most 0.6% of GDP.

[32] Published in April 2018 by Eurostat.

(2006-2008) and slowing down when it operated below potential (2010-2015), thus, contributing to the amplification of the economic cycle fluctuations and to the deepening of the imbalances accumulated in the economy (see *Figure 4*). Basically, the pro-cyclicality of the fiscal policy during the pre-crisis economic boom has exhausted the required fiscal space to stimulate the economy during the recession that followed and the need to reduce the budget deficit during the crisis (primarily due to funding constraints) led, inevitably, to maintaining the pro-cyclicality of the fiscal policy. Consequently, the automatic, beneficial and stabilizing action of the cyclical deficit (the automatic stabilizers) was canceled by the pro-cyclical discretionary policy.

Figure 4: Structural deficit, fiscal impulse and 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, Fiscal Council`s calculations

Over the period 2009-2015, the structural budget deficit declined sharply, from around 9% of GDP to 0.2%, and at a fast pace, the average rate of adjustment being around 1.7 pp per year until 2014. At the same time, it should also be considered that the starting level was high and required the rapid adoption of decisive measures in order to ensure the sustainability of fiscal policy. It is worth mentioning that this adjustment was made predominantly in 2010 and 2011 when the structural budget deficit decreased by an average of over 3 pp per year, the fiscal consolidation being mainly carried out on the expenditure side through reforms concerning the wages in the public sector, the public pension system and budget programming. On the revenue side, the most important measure was to increase the standard VAT rate from 19% to 24%, starting in July 2010.

The fiscal consolidation conducted between 2010-2015 has been partially reversed and in a steep manner since 2016 as a result of the new Fiscal Code, which implies a broad loosening of the fiscal policy, while simultaneously regulating significant increases in spending, especially for wages and pensions. This development is in **flagrant contradiction with the FRL's fiscal principles and rules, as well as with the European fiscal governance treaties signed by Romania.**

Thus, during 2016-2017 the fiscal policy stance became expansionary with a strong positive fiscal impulse, amounting to 3.1 pp of GDP, that exceeded significantly the limit imposed by the MTO. **Between 2018 and 2019, the fiscal policy will maintain its expansionary character, with the fiscal impulse forecasted at about 0.7% of GDP in both 2018 and 2019, even if this implies exceeding the limit imposed by the MTO for the structural deficit by more than 3 pp of GDP**. It should also be noted that the MPF projection included in the 2018-2021 Convergence Program differs significantly from that of the EC, anticipating structural deficits of 3.3% for the current year and 2.8% of GDP for 2019. These differences arise both as a result of different estimates of the actual budget deficit but also due to a lower output gap in the MPF projection.

Continuing the expansionary fiscal stance that started in 2016 and carried on throughout 2017-2018, despite a positive output gap since 2017, leads to maintaining the pro-cyclicality of fiscal policy and weakens the position of public finances in the face of shocks which may require corrections during difficult economic times. Moreover, considering that the public debt at the end of 2017 stood at a significantly higher level than in 2008 (35% of GDP compared to 12.4%), there is a clear lack of fiscal space to stimulate the economy during recession while there may even be risks to the sustainability of public debt. Besides, such a policy is in flagrant contradiction with the rules established by the TSCG and the FRL, effectively giving up the maintenance of the structural deficit target for the period 2016-2019. Additionally, the adjustment path to the MTO is not specified, a situation that has persisted for the last two years, and the automatic correction mechanism, stated by the law, is not currently functional.

III.3. Budgetary revenues

GCB revenues, without the impact of the compensation schemes (amounting to 1,206.8 million lei), increased in 2017 by 12.31% (corresponding to an absolute increase of 27.46 billion lei) compared to the previous year. Thus, budget revenues registered a value of 250.61 billion lei, representing 29.2% of GDP, this weight being the minimum of the 2006-2017 period. Compared to 2016, the share of budget revenues in GDP remained almost unchanged[33], this evolution being the result of a reduction in the share of *tax revenues* (-1.56 pp), coupled with increases in the shares of *social contributions* (+0.28 pp), *non-tax revenues* (+0.18 pp) and the *amounts received from the EU for payments made and pre-financing*[34] (+1.2 pp).

In the case of tax revenues, significant reductions in the share of GDP were registered by the following categories: *VAT* (-0.53 pp, due to the decrease of the standard VAT rate from 20% to 19%), *excise duties* (-0.44 pp, due to the temporary cancellation of the additional excise duty on fuels), *corporate income tax* (-0.31 pp, a surprising evolution given the high economic growth in 2017, several possible causes being highlighted throughout this chapter), *taxes on property* (-0.15 pp), *personal income tax* (-0.14 pp) and *taxes on the use of goods, the authorization of the use of goods and conducting activities* (-0.08 pp). On the other hand, slight increases in their share of GDP, compared to the previous year, were recorded by *other taxes on goods and services* (+0.07 pp) and by *other taxes on corporate income, personal income and capital gains* (+0.03 pp). It should be noted that the overall evolution of tax revenues was influenced by the continuation of fiscal relaxation measures, such as: the decrease of the standard VAT rate by another percentage point to 19%, the temporary cancellation of the additional excise duty on fuels which affected the proceeds of the first three quarters (the additional excise duty was subsequently restored in two stages: September 15 and October 1, 2017) and the elimination of the special constructions tax. In what concerns social contributions, their positive evolution was stimulated by the wage increases in the public and private sectors, while the advance of non-tax revenues was significantly influenced by the extraordinary distribution of dividends by state-owned companies, representing at least 90% of their net profit in the previous year, coupled with a supplement of about 1.5 billion lei from accumulated reserves, distributed at the request of the majority shareholder.

Although the upward trend in the amounts received from the EU seems to indicate an acceleration in the absorption of European funds, the indicator should be interpreted with

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[33] A negligible decrease of 0.07 pp was recorded. Thus, it can be said that both 2016 and 2017 mark the lowest level of budget revenues, expressed as a percentage of GDP, over the last decade.

[34] Throughout this chapter, revenues from EU funds are cumulated for the 2007-2013 and the 2014-2020 multiannual financial frameworks.

caution. Thus, out of the approximately 17 billion lei belonging to this budgetary aggregate, only about 4.6 billion lei are structural funds, the difference being represented by European funds allocated for agriculture[35] (almost 12 billion lei) and amounts intended for pre-financing non-governmental sector projects in the case of temporary unavailability of European funds, according to article 10 of GEO no. 40/2015 (about 0.4 billion lei). As the fiscal Council had already stated in several of its opinions[36], only structural funds whose final beneficiary is the state are relevant, while the amounts for agriculture and pre-financing of the non-governmental sector are not included in the public administration budget. Moreover, recording these amounts in the GCB raises issues of data comparability with previous budget executions, as well as with historical flows of European funds.

Compared to the projections of the initial budget, revenues in 2017 were down by about 2.5 billion lei (approximately -1%), corresponding to a reduction of almost 0.3 pp of GDP, mainly due to a performance below expectations of the *EU funds related to the new multiannual financial framework* (-0.59 pp of GDP) and of the *tax revenues* (-0.18 pp of GDP). These unfavorable developments were partially offset by the evolution of *non-tax revenues* (+0.33 pp of GDP versus the initial projection, due to the supplementary dividends paid by state-owned companies from their reserves) and *social contributions* (+0.15 pp of GDP compared to the initial projection, as the increase in gross earnings exceeded the NCSP forecast).

In the case of tax revenues, their weak performance compared to initial estimates is mainly due to *corporate income tax* (-0.23 pp of GDP versus the initial projection, its performance being well below expectations) and to *taxes on the use of goods, the authorization of the use of goods and conducting activities* (-0.06 pp of GDP compared to the initial projection). On the other hand, the categories that registered better dynamics compared to their planned level include *VAT* (+0.09 pp of GDP versus the initial projection) and *excise duties* (+0.06 pp of GDP versus the initial projection). In what concerns the under-performance of the amounts received from the EU (approximately -5 billion lei compared to the initial projection), this is due almost exclusively to the downward revision of structural funds, changes in the amounts allocated for agriculture and the pre-financing of the non-governmental sector being small and of opposite signs, thus, their overall impact being almost null.

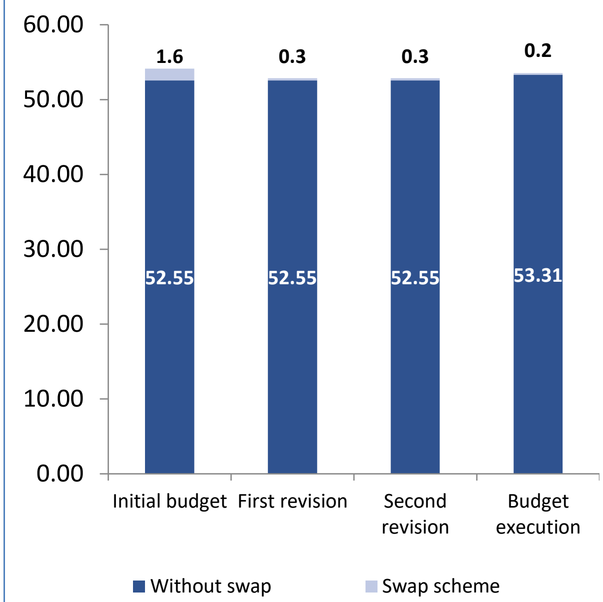
[35] Funds granted through the European Agricultural Guarantee Fund (EAGF), the European Agricultural Fund for Rural Development (EAFRD) and the European Maritime and Fisheries Fund (EMFF).

[36] *Fiscal Council's Opinion on the State Budget Law, the Social Insurance Budget Law for 2017 and the Fiscal Strategy for 2017-2019* and *Fiscal Council's Opinion on the Draft Budget Revision for 2017 and the Half-Year Report Regarding the Economic and Budgetary Situation*, available at www.consiliulfiscal.ro.

III.3.1. VAT and excises

VAT revenues, without the impact of the swap compensation schemes, registered a level of 53.31 billion lei in 2017, according to the cash methodology, exceeding by about 758 million lei the amount stipulated in the draft budget. This evolution is justified by a growth rate above expectations of the relevant macroeconomic base (final consumption of households, excluding self-consumption and NPISH[37]), which increased by 12.4%, compared to the forecast of only 8.9% considered in the development of the draft budget for 2017, creating the premises of even higher revenues than those actually recorded. On the other hand, the effect of the gradual reduction of the standard VAT rate from 24% to 19% can be noticed in the GDP share of this budget aggregate, which has fallen from 8% in 2015 to 6.21% in 2017.

Figure 5: VAT revenues in 2017 (billion lei)



Source: MPF

Figure 5 shows the evolution of VAT revenues and compensation schemes projected by the draft budget and amended by the budget revisions, compared to the actual figures of the budget execution. Thus, the two budget revisions did not significantly alter the projected VAT revenues (net of swap), which amounted to around 52.55 billion lei[38], while the final execution recorded an increase of about 1.5%. More significant changes are observed in the compensation scheme, which, according to the initial projection, would have supplemented the VAT revenues by about 1.6 billion lei. However, following the first revision, the swap scheme was amended to only 0.3 billion lei, while the actual proceeds amounted to 0.24 billion lei, representing about 15% of the initial program.

Compared to the previous year, VAT revenues (net of swap) advanced by 3.74% (an increase of 1.92 billion lei). This development can be explained by two factors that acted in opposite directions: on one hand, the reduction of the standard VAT rate from 20% to 19% had a negative effect on the revenues that were collected while, on the other hand, the significant increase of the relevant macroeconomic base has exerted a positive influence on this revenue category. In order to provide a first indication of the effectiveness of VAT collection, it is relevant to develop an ex-post projection

[37] Non-profit institutions serving households.

[38] Analyzing the second budget revision, the Fiscal Council evaluated that there were no reservations concerning the realization of these revenues.

of this budgetary aggregate and compare it with the actual execution. Thus, the increase recorded by the households final consumption expenditure (+12.4%) was applied to the 2016 VAT revenues[39](net of swap) and the result was adjusted to take into account the impact of discretionary measures (the most important one being the reduction of the standard VAT rate from 20% to 19%). Although MPF estimated the budgetary impact of this measure at -2,200 million lei, the Fiscal Council revised this level to -2,541 million lei, taking also into account the loss of revenues resulting from the elimination of the additional excise duty on fuels. This initial estimate was further amended with the actual increase of the households final consumption expenditure and with the subsequent reintroduction of the additional excise duty on fuels, the final budgetary impact of the discretionary measures being estimated at around -2.5 billion lei. As a result, the ex-post projection of the VAT revenues for 2017 amounts to approximately 54.5 billion lei, while the actual execution stood at only 53.3 billion lei, the unfavorable difference of about 1.2 billion lei indicating a possible deterioration in the effectiveness of taxation.

Further, the effectiveness of VAT revenue collection will be assessed based on the ratio between the implicit tax rate[40] and the weighted average tax rate. Regarding the latter, it should be noted that, starting with the Annual Report for 2015, the weighted average VAT rate[41] was determined, which is a change in methodology compared to the 2010-2014 Annual Reports of the Fiscal Council, so, the results presented here are not comparable to those from the above-mentioned editions. It should also be noted that the weights used to determine the weighted average VAT rate are those of the harmonized index of consumer prices (HICP), which is the only available source for international comparisons, although they represent only an approximation of the weighted average VAT rate for the entire economy. Thus, given that the goods and services subject to the reduced VAT rate have a higher weight in the consumer basket, it is expected that the weighted average VAT rate for the entire economy will be higher than the estimate of the Fiscal Council, the efficiency of taxation being overstated to a certain extent.

Figure 6 shows the evolution of the implicit tax rate and of the VAT taxation efficiency index for Romania, using as tax base both the final consumption of households and NPISH (right-hand scale, in blue) and the final consumption of households and NPISH excluding self-consumption (right-hand

[39] The starting point of the extrapolation was adjusted by -700 million lei, as a result of VAT receipts recorded in January 2016 (belonging to December 2015 when the standard VAT rate was 24%).

[40] Defined as the ratio between the actual income collected for a given type of tax and the corresponding macroeconomic tax base.

[41] The standard VAT rate has been used previously but, beginning with 2015, it was replaced by the weighted average VAT rate which takes into account the effect of the reduced rates. It is determined based on the weights of various categories of goods and services in the consumer basket, while also taking into account the timing of the legislative changes that affect VAT rates.

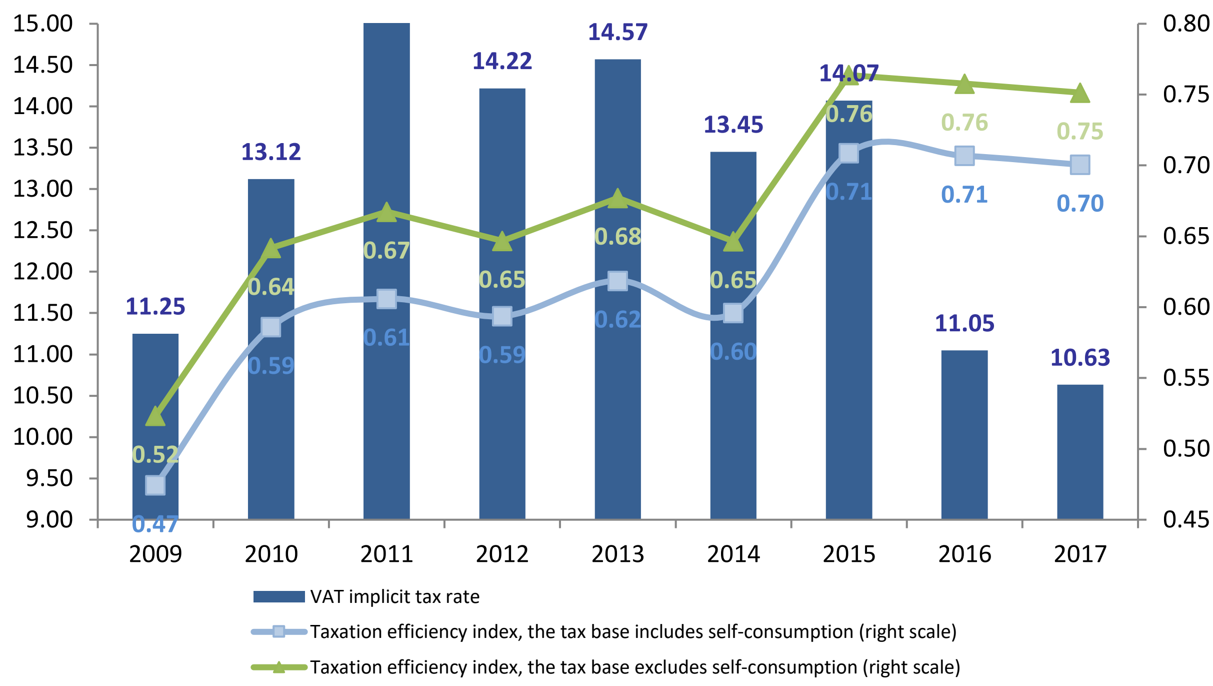
scale, in green). The decision to evaluate the effectiveness of VAT revenue collection by excluding self-consumption and the farmers' market from the tax base is justified by the fact that these components have an important dimension in the case of Romania, the results for the taxation efficiency index being higher by 7% to 10% compared to the situation in which they were computed based on the total final consumption of households and NPISH. According to the methodology described above, the VAT taxation efficiency in Romania registered a slight decrease in 2017 compared to the previous year (-0.82% when excluding self-consumption from the tax base, -0.89% if self-consumption is included in the tax base), this outcome being already anticipated by the comparison between the ex-post projection of this budgetary aggregate and the actual receipts.

At the same time, it should be mentioned that in 2017 there was a relatively large difference between the evolution of VAT revenues according to the ESA 2010 methodology[42] (which registered an increase of about 8%) while, according to the cash methodology, they grew by only 3.74%. The gap originates from the significant upsurge in investments in December 2015, this being the deadline for spending European funds belonging to the 2007-2013 multiannual financial framework. The phenomenon generated a steep fall in VAT receipts in 2016 (according to the ESA 2010 methodology) while, according to the cash methodology, the decrease was alleviated by the fact that the VAT for December 2015 was collected in January 2016. In 2017, this atypical evolution was overcome and VAT revenues, according to both methodologies, were slightly above 53 billion lei. Consequently, we witnessed a reversal of the previous evolutions: VAT revenues, according to the ESA 2010 methodology, which had suffered an important reduction, appreciated significantly, while VAT revenues, according to the cash methodology, whose decrease had been alleviated by the proceeds of January 2016, recorded a more modest increase.

Analyzing the evolution of the VAT taxation efficiency index (see *Figure 6*), it can be noticed that, after a period of relative stability between 2010 and 2014, 2015 marked a substantial improvement in the effectiveness of revenue collection, reaching the peak of the post-crisis period. The index suffered minor decreases during 2016 and 2017 in the context of a 5 pp reduction in the standard VAT rate (from 24% in 2015 to 19% in 2017) while the applicability of the reduced VAT rates (9% and 5%) has been extended. The aforementioned measures have led to a drop in the weighted average VAT rate from 18.42% in 2015 to 14.15% in 2017. In this respect, it should be noted that the reduction in VAT rates during 2016 and 2017 (materialized by significant decreases of both standard and weighted average rates) has not led to an improvement in taxation efficiency and, implicitly, in voluntary compliance.

[42] Which is used to determine collection efficiency indices.

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



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

Comparing the taxation efficiency for VAT in 2017 among the NMS CEE countries, the index of 0.7[43], recorded by Romania, is significantly lower than ones registered in Estonia (0.98), Slovenia (0.94), Hungary (0.93), Bulgaria (0.89) and the Czech Republic (0.86). Thus, Romania collected 6.2% of GDP in VAT revenues in 2017 (according to the ESA 2010 methodology), compared to 9.5% of GDP in Hungary, 9.3% of GDP in Bulgaria and Estonia, 8% of GDP in Slovenia and 7.7% of GDP in the Czech Republic. At the same time, the weighted average VAT rate was 20.7% in Hungary, 18.8% in the Czech Republic, 18.6% in Estonia, 17% in Bulgaria and 16.3% in Slovenia, while Romania registered a weighted average VAT rate of only 14.1%. In the taxation efficiency ranking, Romania retained the eighth position in 2017, the only countries that recorded a lower efficiency, according to the methodology of this study, being Latvia and Lithuania. On the other hand, as a direct consequence of the 5 pp decrease of the standard VAT rate (from 24% to 19%), beginning with 2016 Romania has the lowest weighted average VAT rate compared to the other

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

NMS CEE countries, standing by about 2 pp below Slovenia, which occupies the penultimate position.

The taxation efficiency index should be interpreted taking also into account the structural differences between the analyzed economies, given that the higher percentage of rural population in Romania is reflected in a bigger size of self-consumption and the farmers' market (non-taxable), which has an impact on the value of this index, as shown in *Figure 6*. Thus, the conclusion of a study developed by Aizenmann and Jinjarak (2005)[44], that examined a panel of 44 countries between 1970 and 1999, was that the effectiveness of VAT collection is inversely proportional to the share of agriculture in GDP and directly proportional to the degree of urbanization and to the degree of openness of the economy – all three variables having an unfavorable influence in the case of Romania. It should also be noted that the current methodology for calculating the taxation efficiency index, although taking into account the impact of reduced VAT rates, does not include the impact of other GDP components that are subject to VAT (a part of intermediate consumption and of gross fixed capital formation in the case of VAT non-payers who do not have the right to deduct).

Table 6: Taxation efficiency - VAT

Country	Weighted average VAT rate (%)			Implicit tax rate* (%)			Taxation efficiency index**			Rank		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
BG	17.1	17.0	17.0	14.3	15.1	15.1	0.84	0.89	0.89	4	3	4
CZ	18.8	18.8	18.8	15.5	15.8	16.2	0.82	0.84	0.86	5	5	5
EE	18.8	18.6	18.6	17.7	17.7	18.2	0.94	0.95	0.98	1	1	1
LV	19.4	19.5	19.5	12.8	13.3	13.1	0.66	0.68	0.67	9	9	9
LT	19.3	19.2	19.3	12.3	12.2	12.3	0.64	0.63	0.64	10	10	10
HU	21.7	21.8	20.7	19.5	18.7	19.2	0.90	0.86	0.93	3	4	3
PL	17.1	17.1	17.3	12.0	12.2	13.0	0.70	0.72	0.75	7	7	6
RO	18.4	14.6	14.1	13.1	10.3	9.9	0.71	0.71	0.70	6	8	8
SI	16.5	16.4	16.3	15.5	15.4	15.2	0.94	0.94	0.94	2	2	2
SK	18.7	17.1	17.1	12.5	12.2	12.8	0.67	0.72	0.75	8	6	7

Source: EC, Eurostat, Fiscal Council's calculations

* Calculated as a ratio between "VAT revenues" (ESA code D211REC) and "Households and NPISH Final Consumption Expenditure" (ESA code P31_S14_S15). In the case of Romania, the revenues for 2014, 2015 and 2016 include additional receipts due to implementing the compensation

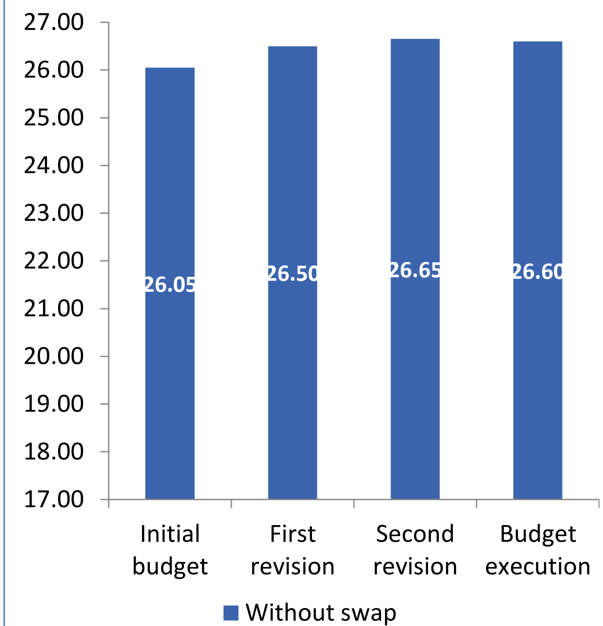
[44] Aizenmann J., Jinjarak Y, "The Collection Efficiency of the Value Added Tax: Theory and International Evidence", National Bureau of Economic Research Working Paper no. 11539, August 2005.

scheme for clearing arrears (+157 million lei in 2015, +287 million lei in 2016 and +236 million lei in 2017).

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

Excise revenues amounted to 26.6 billion lei (3.1% of GDP) in 2017, surpassing the estimate from the initial budget by 552.79 million lei, the two revisions gradually increasing the projections for this aggregate: the first to 26.5 billion lei, the second to 26.65 billion lei. The revision was motivated by the restoration of the additional excise duty on fuels in two steps (on September 15 and October 1, 2017), and the fact that the actual proceeds were close to the estimate from the second revision confirms the Fiscal Council's consent to the feasibility of the revisions. Compared to the previous year, the revenues collected from excise duties were down by 353 million lei (representing a decrease of about 1.3%), this evolution being attributable to the temporary cancellation of the additional excise duty on fuels.

Figure 7: Excise revenues in 2017 (billion lei)



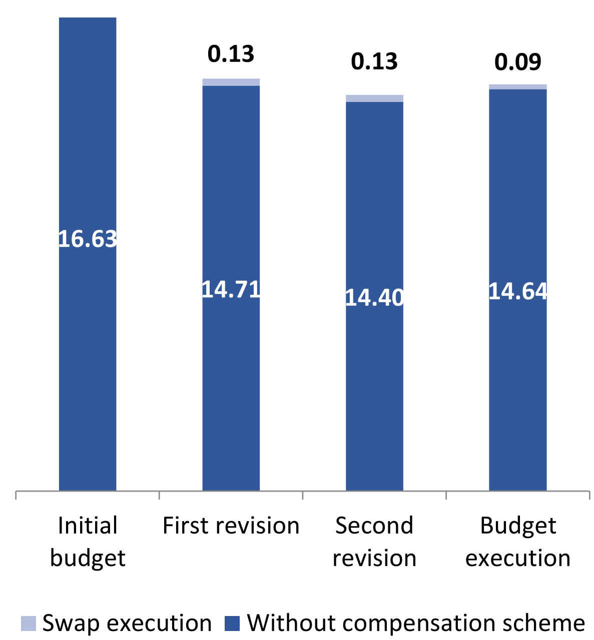
Source: MPF

Considering that only the aggregate amount of excise duties is presented in the budget, which does not allow to study the impact of changing a single category, it is of interest to carry out an analysis of the structure of excise revenues. Thus, in 2016 and in 2017, more than 55% of the revenues came from excise duties on fuels, about 35-40% represented excise duties on tobacco products, less than 5% came from excise duties on alcohol, distillates and alcoholic beverages, while the rest of the categories were below 1%. Given the significant share of excise duties on fuels in total revenues, the cancellation of the additional excise duty was expected to have a significant impact, MPF estimating a revenue decrease of 2,886 million lei. However, amid the reinstatement of the additional excise duty in the autumn of 2017, corroborated with the significant advance of the relevant macroeconomic base (final consumption expenditure of the population increased in real terms by almost 10%, while retail of automotive fuel in specialized stores by approximately 8%), the revenues from excise duties on fuels decreased only by about 900 million lei (approximately 6%). On the other hand, the increase of the excise duty from 430.71 lei/1,000 cigarettes in 2016 to 435.58 lei/1,000 cigarettes in 2017 contributed to the advancement of excises on tobacco products by almost 500 million lei (5.3%). Thus, the developments of the two main excise categories justify the upward revisions of this budgetary aggregate (subsequently confirmed by the actual execution), the decline that was anticipated initially being alleviated over the course of 2017. At the same time, from the perspective of excise taxation efficiency, it appears that it has remained relatively constant.

III.3.2. Direct taxes

The revenue from corporate income tax according to cash standards, in amount of 14.64 billion lei, without the compensation schemes, registered a significant decrease of 5% compared to 2016, being lower than the estimates of the initial budget (by about 2 billion lei, respectively 12%). Although the initial program forecasted revenue from corporate income tax in amount of 16.63 billion lei, this level was revised drastically at the first budget revision following the low achievement level of the initial program at the end of the first semester (about 90%), corroborated with a performance below expectations in July. The second revision reduced the level of this budgetary aggregate by another 300 million lei, but the final execution was close to the values estimated at the first revision.

Figure 8: Corporate income tax, 2017 (billion lei)



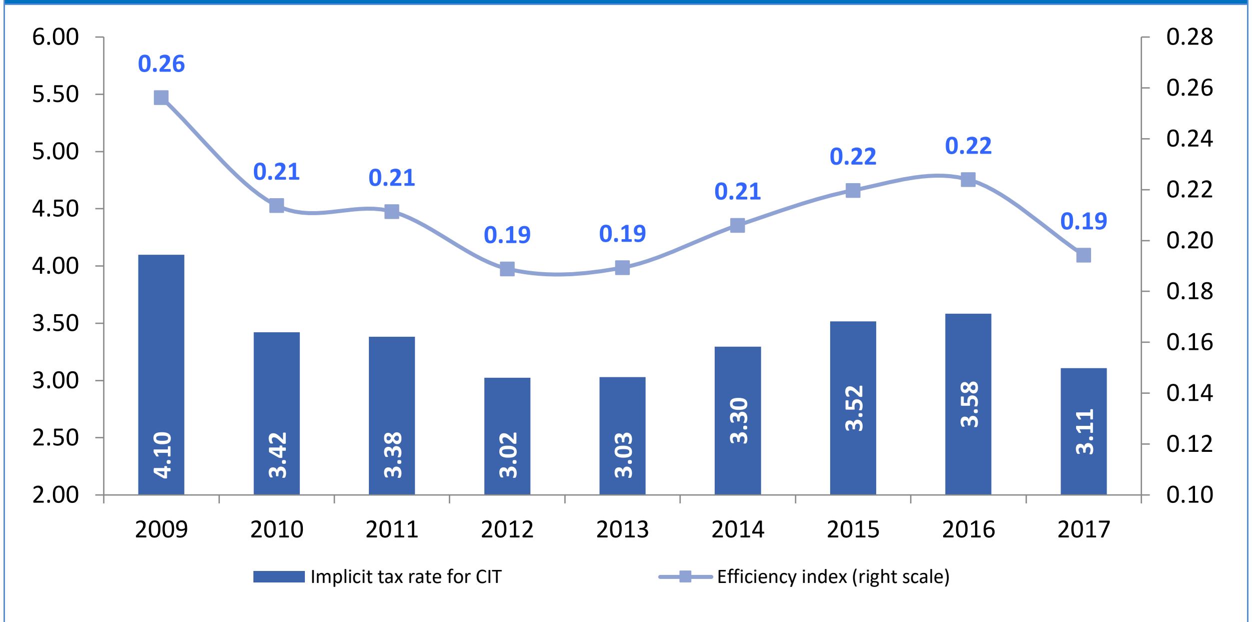
Source: MPF

The negative evolution of this budgetary aggregate appeared as surprising in the context of the high economic growth from 2017, as well as on the basis of the initial projections about the revenue from the corporate income tax. Ever since the first budget revision, the Fiscal Council highlighted a factor that could contribute in explaining this phenomenon: the possible underestimation of the budgetary impact of modifying the microenterprises regime (the income ceiling up to which a firm is considered to be a microenterprise has been increased from the equivalent of 100,000 euros in 2016 to 500,000 euros starting 1st January 2017), given the uncertainties about the behavior of companies that, under certain conditions could opt either for the corporate income tax or for the microenterprise income tax, as well as under the circumstances in which the financial impact was estimated on the basis of the financial statements of the economic agents at the end of 2015 (for reasons of data availability). This factor could also be compounded by important salary increases across the economy with a potential negative effect on companies' profits, as well as the introduction, as of 1 January 2017, of the specific tax for firms in the tourism and food sectors that practically replaced the corporate income tax, the budgetary impact of this measure being unclear so far, but potentially negative.

Given the fact that the causes that led to a significant reduction in corporate tax revenue have not been clearly identified, the Fiscal Council recommends a thorough investigation of this evolution in order to subsequently take the necessary corrective measures.

The level of the efficiency index of the corporate income tax (based on ESA 2010) showed a significant reduction in the period 2009-2012. After the resumption of economic growth in 2011, the efficiency index seems to have stabilized, followed by an upward trend, its level in 2016 being the highest since 2010. However, amid the reduction in corporate tax revenues comparative to 2016 (-4.8% according to cash standards, respectively -4% according to ESA 2010), the year 2017 marked the return of the efficiency tax index to a downward trend. Furthermore, its value of 0.19 cancels out the progress registered in the previous years, standing at the minimum level of the period 2012-2013. The evolution of corporate tax revenue appears even more surprising as the relevant macroeconomic base (gross operating surplus) recorded an advance of 10.6% in 2017. Thus, including in terms of taxation efficiency, it is recommended a thorough analysis of the causes that have led to a significant reduction of the corporate income tax receipts.

Figure 9: Implicit tax rate and efficiency tax index for corporate income tax in Romania



Source: Fiscal Council's calculations

Compared to the other NMS CEE states, Romania remains on the ninth position in 2017, this being the last position in ranking in the context of not including Poland[45]. Estonia (0.21) and Lithuania (0.22) are the countries closest to Romania, while Hungary (0.56[46]) and Bulgaria (0.51) occupy the first places, far away from the other states included in the analysis. At the level of the year 2017, there was a general downward trend in the efficiency of corporate tax collection, five of the ten countries registering reductions in the efficiency index, while two others have recorded stagnant values.

Table 7: Taxation efficiency – corporate income tax

Country	Legal corporate income tax			Implicit tax rate*			Taxation efficiency index**			Rank		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
BG	10.0	10.0	10.0	4.6	4.6	5.1	0.46	0.46	0.51	1	1	2
CZ	19.0	19.0	19.0	6.7	7.0	7.0	0.35	0.37	0.37	2	2	3
EE	20.0	20.0	20.0	5.4	4.7	4.2	0.27	0.24	0.21	4	7	8
LV	15.0	15.0	15.0	3.7	4.1	3.8	0.24	0.27	0.25	5	5	5
LT	15.0	15.0	15.0	3.2	3.5	3.3	0.21	0.24	0.22	9	8	7
HU***	19.0	19.0	9.0	4.2	5.6	5.0	0.22	0.30	0.55	7	4	1
PL	19.0	19.0	19.0	3.6	3.7	NA	0.19	0.19	NA	10	10	NA
RO	16.0	16.0	16.0	3.5	3.6	3.1	0.22	0.22	0.19	8	9	9
SI	17.0	17.0	19.0	3.9	4.3	4.5	0.23	0.25	0.24	6	6	6
SK	22.0	22.0	21.0	7.4	7.1	6.7	0.34	0.32	0.32	3	3	4

Source: EC, Eurostat, Fiscal Council's calculations

* Calculated as the ratio between "direct taxes paid by enterprises" and "gross operating surplus" (ESA code B2A3G).

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

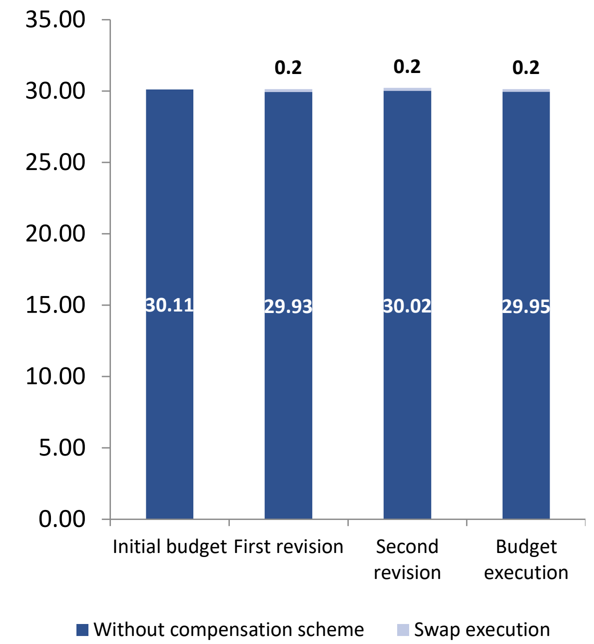
*** Compared to the previous report, local taxes were not taken into account in determining the standard rate of corporation tax.

[45] Poland was not included in the raking of 2017 due to unavailability of data on the gross operating surplus.

[46] Given that since 2017, Hungary has a substantially reduced corporate income tax (9% in 2017 compared to 19% in 2016), and revenue for the year 2017 reflect also the realization of some revenues from the corporate income tax computed on the old tax rate of 19% (the result of a fiscal facility granted to the companies who allowed them to postpone the payment of corporate income tax), it is expected that the substantial advance of the taxation efficiency index will be only temporary.

The receipts from the personal income tax in cash standards, in amount of 29.95 billion lei, had an upward evolution compared to 2016, registering an increase of about 8.2% (about 2.27 billion lei). The dynamics of this budgetary aggregate reflects an increase of 15.9% of the average gross wage in the economy (which exceeded the initial forecast of 11.2%[47]), but also the increase of the average number of employees by only 3.5% (in context of an estimated increase of 4.3%). Compared to the initial program, the two budget revisions brought minor changes, and the final execution recorded values close to those originally planned (99.5% against the initial estimates). This situation was anticipated in the Fiscal Council's Opinions on the two rectifications, the budgeted levels for this aggregate being considered feasible.

Figure 10: Personal income tax, 2017 (billion lei)



Source: MPF

Given that the dynamics of the average gross wage and the average number of employees in the economy showed a high potential for increasing the receipts from personal income tax, it is appropriate to conduct a more detailed analysis on the evolution of the main components of this budgetary aggregate. Thus, revenue from the wage income tax (with a weight of about 83% from the total revenue) evolved in tandem with the relevant macroeconomic base, registering an increase of 19.4% (over 4 billion lei in absolute terms) compared to 2016. On the other hand the receipts from the dividend tax (with a weight of about 5% from the total revenue) decreased by almost 16% (-270 million lei) compared to the previous year. This evolution was anticipated in the Fiscal Council annual report for 2016, where it was mentioned that the reduction of the dividend tax rate from that moment has modified the behavior of the firms in the sense that they granted dividends far more than the usual levels. Although the immediate consequence was represented by the improvement in the budgetary impact of tax rate cuts, the Fiscal Council noted that this

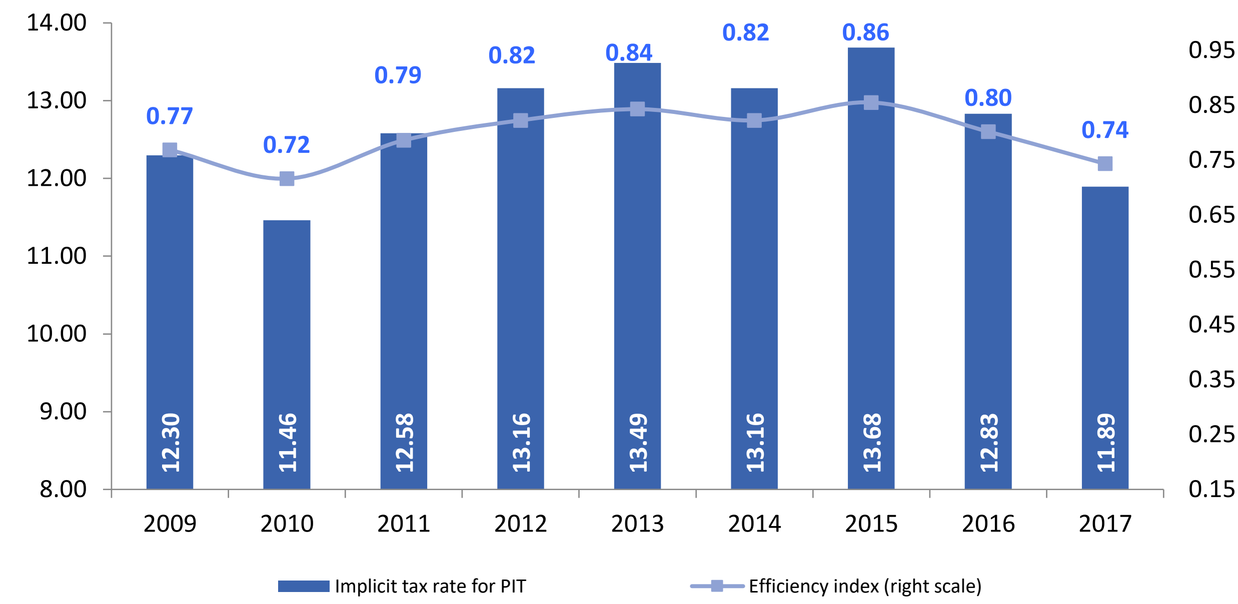
[47] However, it should be noted that the initial projection relating to the salaries advance didn't include either the minimum salary growth to 1,450 lei per month, starting 1 February 2017, or the significant increase of the public sector salaries decided on the occasion of the elaboration of the budget draft.

behavior can only be a temporary one, and the loss of revenue initially calculated will be seen in the years to come.

On the other hand, in the year 2017 a series of fiscal policy measures have been adopted with a negative impact on the revenue collected from personal income tax. Thus, the receipts from the pensions income tax registered a decrease of over 650 million lei (-35.5%) on the basis of tax exemption for pensions lower than 2,000 lei. At the same time, the proceeds from the transfer of real estate assets included in personal income tax receipts decreased by almost 400 million lei (about -90%) in the context of introducing a non-taxable ceiling of 450,000 lei for revenues obtained as a result of transferring the property right. In conclusion, corroborating the significant advance of the income tax revenues from wages with the decrease of the receipts from the others categories mentioned above, it may be appreciated that the evolution of this budgetary aggregate does not raise doubts relating to the possible deterioration of the collection efficiency during the year 2017.

According to ESA 2010 standards, the revenue from personal income tax reached 30.5 billion lei in 2017, those registering an increase of 7.7% compared to the previous year. Although the dynamics of the receipts from personal income tax, expressed in cash terms, is higher (+8.2%), both are well below the one of the relevant macroeconomic base (gross wages in the national accounts, from which social insurance contributions paid by employees were deducted) which increased by 16.2%. As mentioned above, the revenue from the personal income tax was negatively affected by a series of discretionary measures adopted in 2017, as well as the delayed impact of the dividends tax rate cuts. In consequence, the taxation efficiency index for personal income tax registered an important decrease in year 2017, reaching the level of 0.74. However, removing the unfavorable influence of the discretionary measures and the dividends tax rate cuts, the taxation efficiency index would be 0.78, in moderate decline against 2016. Thus, it can be remarked a reversal of the improvement trend observed since 2011, but the efficiency index evolution is significantly affected by the discretionary fiscal policy measures.

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



Source: Fiscal Council's calculations

The decrease of the collection efficiency index for personal income tax can also be observed in comparison with the others NMS CEE[48] states. Thus, Romania dropped two positions in the ranking compared to previous year (from the fourth place to sixth place), after Latvia and Lithuania. The first two positions are occupied by Hungary and Bulgaria (which remained in the top during the last three years), followed at distance by Estonia. A constant evolution can also be noted in the bottom of the list, Slovenia and Slovakia occupying the last places in each of the last three years. On the whole ranking it may be observed an increased disparity of the taxation efficiency index, the difference between the first and last placed being over 50 pp.

[48] There is no data available regarding the gross wages in the national accounts for Poland in 2017.

Table 8: Taxation efficiency – personal income tax												
Country	**Legal personal income tax* (%)**			**Implicit tax rate** (%)**			**Taxation efficiency index*****			**Rank**		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
BG	10.0	10.0	10.0	8.8	8.5	9.4	0.88	0.85	0.94	2	2	2
CZ	15.0	15.0	15.0	9.0	9.5	9.8	0.60	0.63	0.65	7	7	7
EE	20.0	20.0	20.0	16.2	16.3	16.2	0.81	0.81	0.81	4	3	3
LV	23.0	23.0	23.0	16.8	17.4	18.0	0.73	0.76	0.78	6	6	4
LT	15.0	15.0	15.0	11.8	11.8	11.3	0.79	0.79	0.75	5	5	5
HU	16.0	15.0	15.0	15.6	14.7	14.9	0.97	0.98	0.99	1	1	1
PL	25.0	25.0	25.0	15.1	15.2	NA	0.60	0.61	NA	8	8	NA
RO	16.0	16.0	16.0	13.7	12.8	11.9	0.86	0.80	0.74	3	4	6
SI	27.0	27.0	27.0	12.2	12.4	12.2	0.45	0.46	0.45	10	10	9
SK	22.0	22.0	22.0	12.0	12.4	12.3	0.55	0.56	0.56	9	9	8

Source: EC, Eurostat, Fiscal Council's calculations

* For countries with progressive taxation system (Poland, Slovenia), the figure reported is the average tax rate (Poland - with two tax rates system) or the second rate (in Slovenia - with four tax rates system).

** Computed as the ratio between "revenues from direct tax paid by the households" and personal income tax base defined as "gross wages from the national accounts" (ESA code D11) from which social insurance contributions paid by employees were deducted. For the Czech Republic, the personal income tax base is "compensation of employees", which includes social security contributions paid by employers, given the use of the "super grossing" in computing the personal income tax due.

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

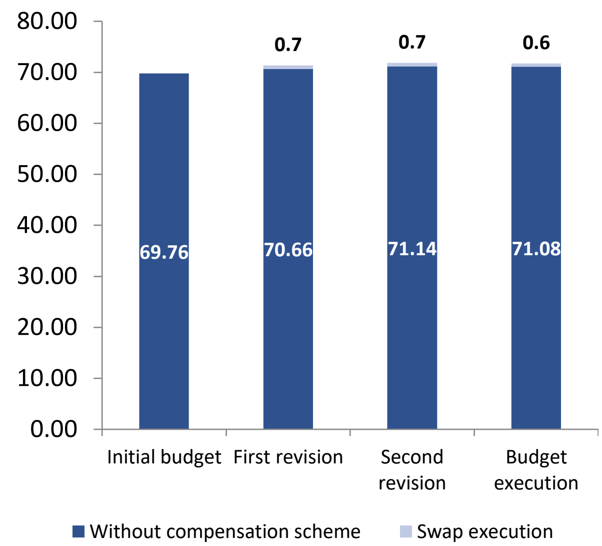
III.3.3. Social contributions

The revenues from social security contributions according to cash standards, without the compensation scheme impact, amounted to 71.1 billion lei at the end of 2017, by about 1.32 billion lei (representing 1.9%) bigger than the initial estimates, given that the dynamics of the average gross wage in the economy (+15.9%) was higher than the initial projections (+11.2%), but the average number of employees increased by only 3.5% compared to the initial estimation of 4.3%. In the sense of generating higher revenues than those considered in the initial draft budget acted also the enforcement titles paid during the year 2017, including those for the Law 85/2016 which establishes the payment of salary differences for the teaching staff for the period October

2008 - May 13 2011. The enforcement titles have generated additional payments of 560 million lei in 2017, increasing the social security contributions income by almost 180 million lei.

Analyzing the projection of revenues from social security contributions during 2017 it can be observed that the evolution above expectations of the relevant macroeconomic base was incorporated during the two budget revisions, both introducing upward revisions amounting to almost 1.4 billion lei, the actual achievements confirming these last projections. Otherwise, the Fiscal Council noted in the Opinions on the budget revisions from 2017 that the estimated levels of the social security contributions revenues were feasible in the context of an over-achievement reported to the initial program (101.7% according to the execution from the end of the first semester), corroborated with the upward revision of the salaries in the public sector.

Figure 12: Social security contributions, 2017 (billion lei)



Source: MPF

Compared to 2016, the receipts from social security contributions, without the impact of the compensation schemes, increased by 16.58%. In addition to the macroeconomic evolutions favorable for this budgetary aggregate (the significant increase in wages, both in the private sector and in the public sector, as well as the increase of the average number of employees in the economy), this aggregate has been positively influenced by the elimination from the calculation base of the capping at 5 average gross salaries for the calculation of individual social security contribution and for the calculation of social security contributions due by employers or persons assimilated to them for wages income or assimilated to wages (with a budgetary impact estimated by Ministry of Finance at 1,100 million lei, but adjusted by the Fiscal Council at only +372.8 million lei) and negatively influenced by the elimination of the social health insurance contributions payment by the pensioners (with a budgetary impact estimated by Ministry of Finance at 900 million lei).

At the same time, the receipts from social security contributions were influenced by the increase by 1,259.88 million lei (+21.42%) compared to year 2016 of the amounts transferred towards Pillar II[49]. Given that the level of the contribution rate remained constant, the higher transfers

[49] Contribution rate to Pillar II of mandatory private pensions was maintained in 2017 at the level of 5.1% which has been established in the previous year. Although, according to the law, as early as 2016, the

could be attributed to the wages increases, combined with an increase in the number of participants (+3.6% compared to previous year). Last but not least, the enforcement titles paid on the basis of the court decisions increased from 907.7 million lei in year 2016 to 1,181.9 million lei in 2017, which led to an advance of the revenues from the social insurance contributions by almost 90 million lei.

In order to reflect more accurately the dynamics of the receipts from social security contributions during 2014-2017, in the table below are presented the adjusted series of this budgetary aggregate[50], as well as the gross series obtained by eliminating the adjustments related to the swap compensation schemes and the transfers towards Pillar II:

Table 9: Social security contributions (million lei)					
		Budget execution 2014	Budget execution 2015	Budget execution 2016	Budget execution 2017
Adjusted series	**1**	**57,585.40**	**57,603.96**	**61,270.18**	**71,710.52**
Swap	2	357.07	264.92	299.44	632.59
Second Pension Pillar	3	4,053.88	5,149.71	5,882.75	7,142.63
Gross series*	**4=1-2+3**	**61,282.20**	**62,488.75**	**66,853.50**	**78,220.57**
* of which executory titles		1,405.43	1,313.27	290.74	378.57

Source: Fiscal Council's calculations

Thus, if the unadjusted series is considered, in 2017 revenues from social security contributions, amounted over 78 billion lei, topping the revenues collected in 2016 with about 17% (11.4 billion lei), the dynamic surpassing also the one observed in the budgetary execution, given that the latter includes also the transfers to Pillar II which appear as negative revenues. If we analyze the evolution of this budgetary aggregate eliminating the impact of the executory titles, the receipts from social contributions increased in 2017 with 16.95% (11.3 billion lei) compared to the previous year.

Before analyzing the evolution of social security contributions according to ESA 2010, it should be mentioned that since 2017, the statistical treatment of the special pensions was modified, these being simultaneously incorporated into social security contributions on the income side and

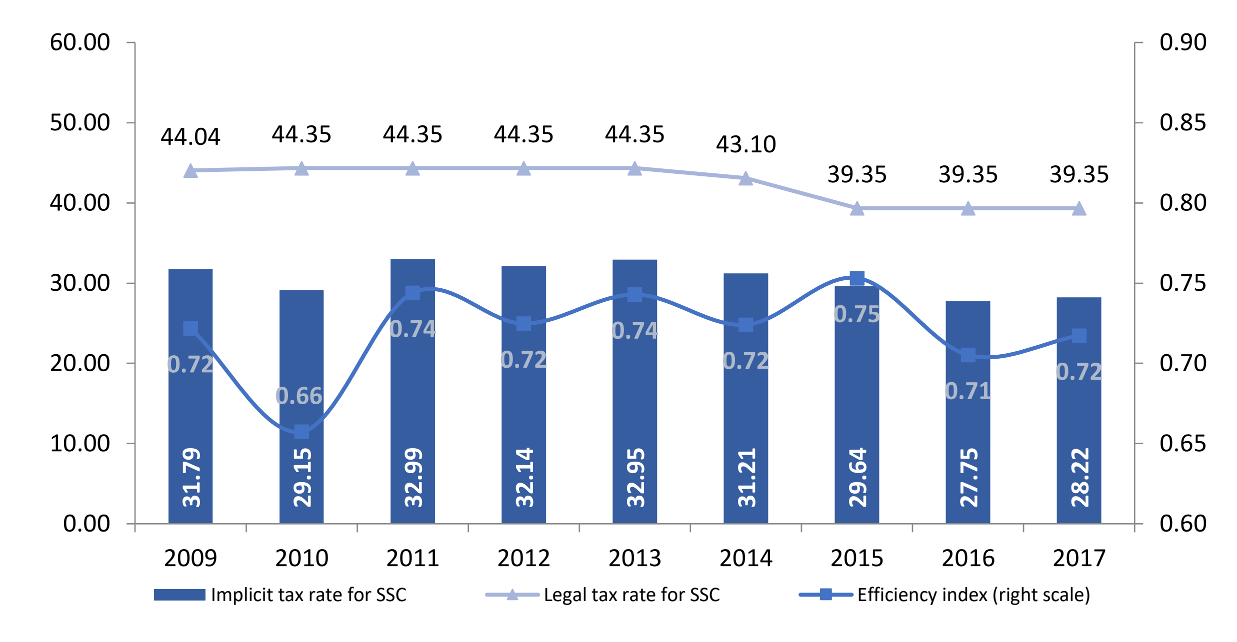
target contribution level of 6% of the gross salary should have been reached, postponing its implementation also for 2017 is symptomatic in terms of long-term goal shedding due to short-term budgetary pressures. The situation is all the more worrying, given that this decision has taken place in a favorable economic climate.

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

personnel on the expenditure side. Because the statistical treatment artificially alters the levels of these two budgetary aggregates, also affecting the comparability with the previous years, the amounts related to special pensions were eliminated. Thus, the social security contributions were calculated as total contributions paid by employers and employees. The same formula was applied to the other NMS CEE states included in analysis for comparability reasons when realizing the ranking of efficiency index of social security contributions revenues.

The dynamics of the receipts from social contributions according to ESA 2010 (+18.16%) was higher by about 2 pp than that recorded by the relevant macroeconomic base, represented by the gross wages in the national accounts, while the social security contribution rates have been maintained at the 2016 levels. Thus, the taxation implicit rate registered a slight increase, from 27.8% in 2016 to 28.2% in 2017, which led to an improvement in the taxation efficiency index from 0.71 to 0.72 after the year 2016 marked a pronounced worsening of the indicator.

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



Source: Fiscal Council's calculations

Compared to the other NMS CEE[51] states, Romania was ranked on the eighth position regarding the efficiency of the social security contributions collection, in each of the past three years. However, given that Poland was not taken into account for 2017, since data is not yet available, and previously this country was placed on the second place, Romania will most likely be placed

[51] There is no available data for gross wages in national accounts in 2017 for Poland.

on the second lowest position. From the perspective of the level of social contributions aggregate legal rate, Romania is on the sixth position, after Czech Republic, Slovakia, Poland, Hungary and Lithuania. However, it is noteworthy that although Estonia and Slovenia impose a lower level of social security contributions compared with the Romanian state, these countries obtained a higher implicit tax rate during the past three years. This result can also be explained by the different tax regime for social security contributions for certain categories of income (income from self-employment, copyright, rent, investment income, etc.).

Table 10: Taxation efficiency – social security contributions

Country	Legal tax rate for SSC* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2015	2016	2017	2015	2016	2017	2015	2016	2017	2015	2016	2017
BG	31.0	31.0	32.0	22.3	21.8	23.4	0.72	0.70	0.73	9	9	7
CZ	45.3	45.0	48.0	47.8	47.9	47.8	1.06	1.07	1.00	1	1	2
EE	35.4	35.4	35.4	31.4	31.4	31.7	0.89	0.89	0.90	5	5	4
LV	34.1	34.1	34.1	22.3	21.5	21.7	0.66	0.63	0.64	10	10	9
LT	40.0	40.0	40.0	35.3	35.5	35.8	0.88	0.89	0.89	6	6	5
HU	47.0	47.0	40.5	39.2	39.3	35.2	0.83	0.84	0.87	7	7	6
PL	39.4	39.4	41.5	40.5	40.4	NA	1.03	1.03	NA	2	2	NA
RO	39.4	39.4	39.4	29.6	27.8	28.2	0.75	0.71	0.72	8	8	8
SI	38.2	38.2	38.2	34.6	34.2	34.4	0.91	0.89	0.90	4	4	3
SK	48.6	48.6	45.6	46.9	46.6	47.3	0.97	0.96	1.04	3	3	1

Source: EC, Eurostat, MPF, Fiscal Council's calculation

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

** Computed as the ratio between "social contributions of the employers" (ESA code D611REC) plus “social contributions of the population" (ESA code D613REC) and ”gross wages” (ESA code D11). For Romania, the budgetary revenues include additional temporary receipts due to implementation of compensation schemes for clearing arrears (264.9 million lei in 2015, 299.4 million lei in 2016, and 636.6 million lei in 2017).

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

III.4. Budgetary expenditures

The budgetary expenditures, without the compensations scheme impact (in amount of 1.21 billion lei), have recorded an advance of 13.8% compared to the previous year (+33.4 billion lei), reaching a level of 274.9 billion lei at the end of the last year. In the context of a significant positive growth in the nominal GDP (+12.06%), the share of these in GDP increased by 0.35 pp, respectively from 31.67% of GDP to 32.02% of GDP. The main budgetary expenditure that registered a higher dynamic than the average were projects funded by external grants[52] (+89.7%), other transfers (+31.4%), personnel expenses (+22%), while lower dynamics than the average were registered by: transfers for public entities (-78.5%), expenditure funded from reimbursable funds (-31.1%), subsidies (-6.1%) and goods and services (-0.7%). The increase of 0.35 pp of the share of total expenditure in GDP could be explained by the substantial increase of the projects funded by external grants (+0.93%)[53], as well as the personnel expenses (+0.63%) driven by the sustained wage increases in the public sector. These increases more than compensated the lower values for goods and services (-0.63% of GDP), capital (-0.23 pp of GDP) and subsidies (-0.14% of GDP).

Compared to the initial budget for 2017, the budgetary expenditures were lower by about 2.4 billion lei, respectively by -0.27 pp of GDP, mainly due to the underachievement compared to the program of the projects funded by external post-accession grants and of goods and services (by -0.64 pp of GDP each other), interest (-0.11 pp of GDP), positive contributions coming from social assistance (+0.48 pp of GDP) and personnel expenses (+0.67 pp of GDP). Essentially, beyond the

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[52] Throughout this chapter, the amounts for the projects funded from EU grants are cumulated for the financial years 2007-2013 and 2014-2020. Strictly for the financial year 2014-2020, the increase is almost 2 times as compared to previous year, but in the context of a very slow start of EU funds absorption for this financial year in 2016, but also of the inclusion in 2017 of some amounts for agriculture 4 times higher than last year. Thus, from the total of about 22 billion lei of this category of budget revenues, only 9.6 billion lei represent structural funds, the difference being made up of European funds allocated to agricultural payments (about 12 billion lei) and of the amounts intended for the pre-financing of the projects from non-governmental sector in the event of temporary unavailability of European funds, based on Art. 10 of GEO no. 40/2015 (0.4 billion lei).

[53] Comparability with the previous years has to be done with caution, as the upward trend of the amounts received from the EU masks only the substantial increase of the amounts received for agriculture which only pass through the general consolidated budget (for details, see Box 1, Chapter III.4.3 Public investment expenditures). Exclusively for the structural funds, the increase is +0.73 pp of GDP for the year 2014-2020.

amounts for projects financed from EU funds where the values below the program from the expenditures part were generated by similar evolutions on the revenues side of the budget, the fiscal space generated by the savings on goods and services and interest was partly used to accommodate personnel spending higher than planned, mainly as a result of the wage increases subsequent to those decided in the initial budget, as well as the initial under-budgeting of the social assistance expenditures. Essentially, public investment expenditures were significantly decreased, partly as a result of the decrease in European funds revenue compared to the estimated level, but also partly to accommodate wage increases and the under-execution at the level of the budget revenues.

Figure 14: Quarterly revenues of the GCB in 2017 (million lei)

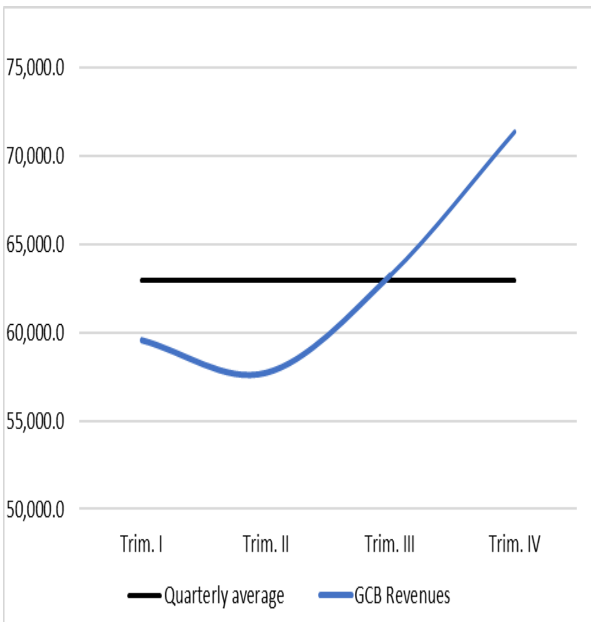
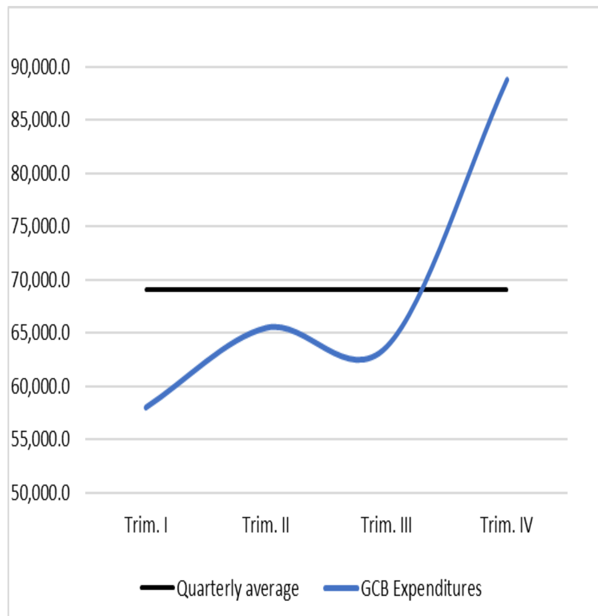


Figure 15: Quarterly expenditure of the GCB in 2017 (million lei)



Source: MPF

Note: The amounts are without the compensation schemes.

In 2017, the volatility of the quarterly execution of the GCB[54] expenditures is mostly attributable to their concentration in the last quarter, with the share of expenditures in total in the fourth quarter increasing relative to 2016 (respectively 32.2% compared to 30% in the previous year), indicating the reverse of the positive evolution of the previous year when there was a decline compared to the previous years regarding the share of the expenditures in the last quarter of the year in total budget expenditures. Thus, the total expenditures in the fourth quarter of 2017,

[54] Including the swap scheme.

amounted to about 88.8 billion lei (compared to 72.3 billion lei in fourth quarter of 2016, respectively an increase by 22.5%.), being higher with 39.4% than the level from the previous quarter of 2017 (compared to an increase by 26.7% of the fourth quarter expenditures compared to the third quarter of 2016).

Analyzing the evolution of the expenditures structure from the fourth quarter of 2017 compared to the previous quarter it can be noted the acceleration of capital spending (+228.9%, respectively a contribution of 32.9% of the total increase of fourth quarter/third quarter), as well as those attributable to the projects funded by external grants (+351.2%, respectively a contribution of 32.0% of total increase), causing a similar evolution of the public investment expenditures (for which the share of the fourth quarter in total year was 54.7%, respectively an advance against the previous quarter of about 140%). The other categories of budgetary expenditures had a total contribution in amount of 35.1% to the increase of total expenditure from the fourth quarter compared to previous quarter, respectively: the goods and services expenses had a contribution of 11.5% (+28.5% against the previous quarter), the personnel expenses had a contribution of 7.5% (+10.9% compared to third quarter), the social assistance expenditures had a contribution of 5.2% (+5.5% compared to third quarter), other transfers had a contribution of 4.8% (respectively an increase of 49.7% compared to previous quarter), and the subsidies had a contribution of 3.1% (+83.4%).

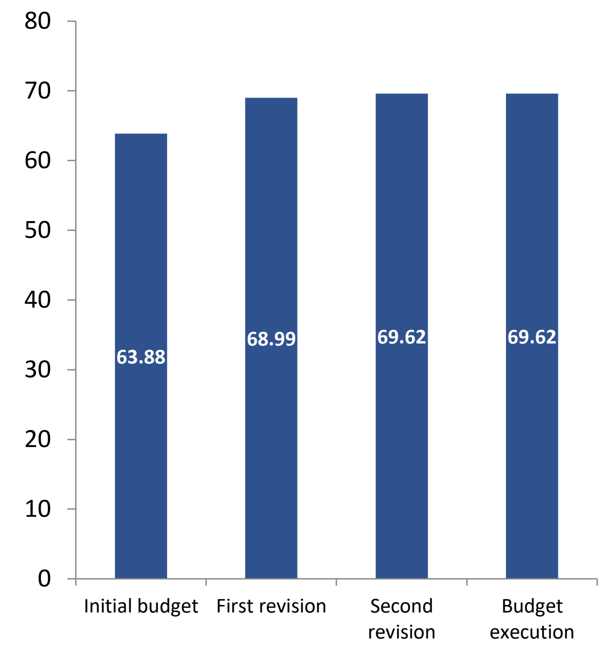
The expenditure concentration in the last quarter of the year highlights serious weaknesses in the budgetary programming process, especially for public investment expenditure (funded from capital expenditure and European funds), although the principle of prudence might justify the postponement of some expenditure until the projection regarding the budgetary revenue has a lower degree of uncertainty. Otherwise, compared to the year 2016, in 2017 the volatility of inter-quarterly budgetary revenues was much higher, most of this being achieved in the last quarter of the year (with a share in total year of 28.4% compared to 25.9% in 2016, respectively an increase compared to previous quarter by about 13%, compared to only 1% in 2016). The Fiscal Council reiterates its previous years' recommendation for a lower volatility of inter-quarterly budgetary expenditures.

III.4.1. Personnel and social assistance expenditures

The execution for the personnel expenditures increased by 5.74 billion lei compared to the amount considered in the draft budget for 2017. Initially, estimated at a level of 63.88 billion lei, the final execution for the personnel expenses accounted 69.62 billion lei, respectively 8.11% of GDP, above the ceiling considered for this category of expenditure (63.88 billion lei, respectively 7.7% of GDP), by 5.74 billion lei, respectively 0.31 pp of GDP.

The evolution projected during 2017 for personnel expenses was in flagrant contradiction with the Law on ceilings no. 5/2017, being forecasted overruns of the threshold both at first budget revision (by 5.11 billion lei or 0.4 pp of GDP[55]) and at the second budget revision (with a further 0.59 billion lei additional to the first revision, the overrun reaching a total of 0.5 pp of GDP, given that the estimation for GDP increased by 27.3 billion lei as compared to the time when the law on ceilings was drafted). The increasing trend in the allocations for personnel spending starting with the first budget amendment is explained by the insufficiency of the initial allocations, reflected in the budget execution in the first months of the year, on which the Fiscal Council warned in its Opinion regarding the budget draft.

Figure 16: Personnel expenditure in 2016 (billion lei)



Source: MPF

The magnitude of the review is unprecedented in the past 10 years, which may suggest an inability to control the personnel expenditure increases, exactly what the FRL should prevent. To this contributed also the impact of some wage increases decided after the approval of the draft budget, both situations generating pressures on this budgetary aggregate. The additional increase operated at the second budget revision, of lower amplitude however, appeared as a result of the under-budgeting of the allocation for the payments related to court decisions, amounts that were known in advance and should have been included in the draft budget.

Compared to 2016 personnel expenses increased by 12.58 billion lei, respectively by 22.06%. Unlike the year 2016 when the upward of the personnel expenses was occulted by the lower amounts paid for court decisions compared to 2015, in 2017, the impact of the payments of this amounts was not so strong. However, we note that the amounts paid in 2017 were higher than those paid in 2016 and also higher than those planned for 2017 (1,181.9 million lei amounts paid on the account of the executory titles in 2017 compared to a plan of 383 million lei and payments of 907.7 million lei in 2016), after in 2015, the amounts paid on the account of the executory titles were supplemented from 2.6 billion lei to 4.1 billion lei.

[55] On that occasion, the Fiscal Council warned about the unprecedented amplitude of exceeding the ceiling of personnel expenses for 2017.

Table 11: Enforceable titles issued / paid on the account of the court decisions regarding the payment of salary differences for some categories of employees, million lei										
		2011	2012	2013	2014	2015	2016	2017	2018 plan	Total
Enforceable titles issued, inclusive Law no. 85/2016	Central adm. (State budget)	3,240.0		8.5	3.8	82.3	1,599.4	67.4		5,001.4
	Local adm.	3,060.0		867.6	1,614.4	1,064.1	2,094.3	20.3		8,720.6
	Social security budget	116.0		28.6	5.5	12.2	7.6	1.2		171.0
	Total	**6,416.0**		**904.7**	**1,623.6**	**1,158.5**	**3,701.2**	**88.9**		**13,892.9**
Enforceable titles paid, inclusive Law no. 85/2016	Central adm. (State budget)		162.0	311.0	1,531.7	1,234.6	363.1	476.2	212.5	4,291.1
	Local adm.		153.0	306.0	2,447.2	2,806.1	544.6	705.0	300.0	7,261.9
	Social security budget		6.0	24.2	72.6	59.3	0.0	0.6	0.0	162.7
	Total		**321.0**	**641.2**	**4,051.5**	**4,100.0**	**907.7**	**1,181.9**	**512.5**	**11,715.7**

Source: MPF

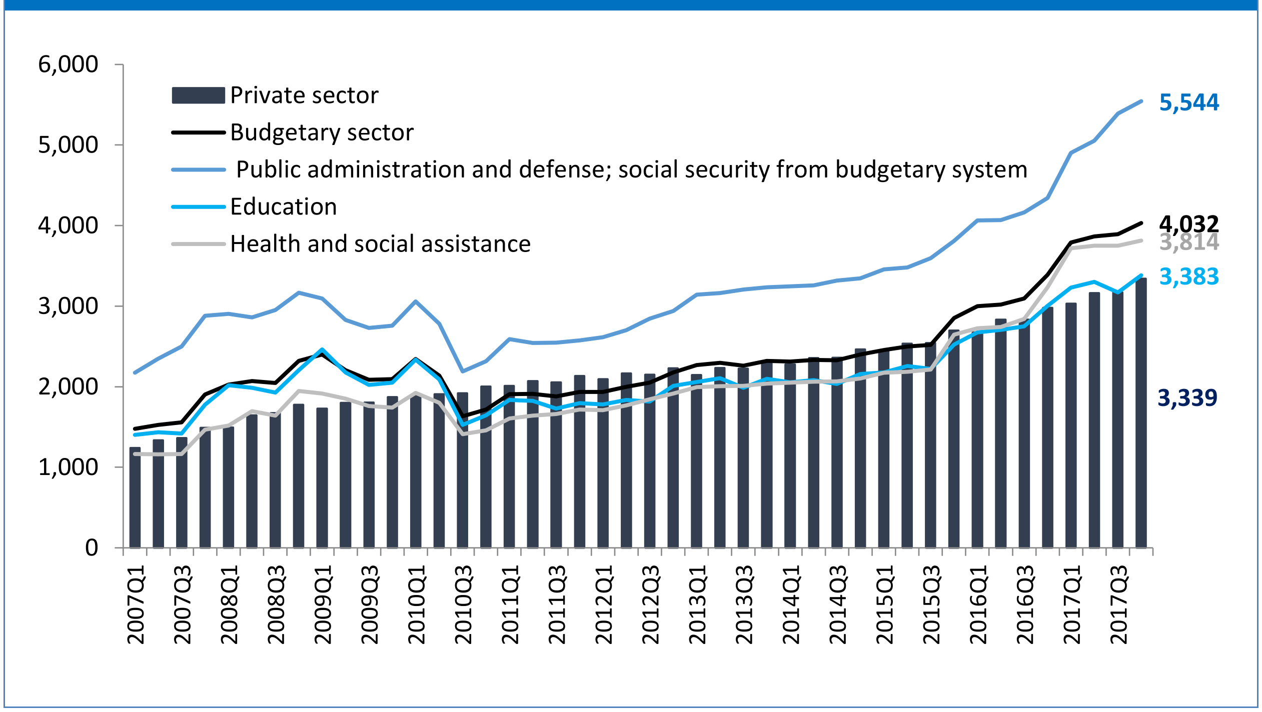
Beyond the increases decided over the year, the draft budget already included a number of increases in the state personnel spending. Some increases were led by the wage raises granted in the second part of 2016, respectively, the application, starting with August 2016, of the provisions of the Emergency Ordinance no. 20/2016 for the modification and completion of Government Emergency Ordinance no. 57/2015 regarding the remuneration of staff paid out of public funds in 2016. In addition, for the personnel from the local administration was foreseen an increase of 20% starting 1st February 2017, being estimated an additional expense of 1,478 million lei, and for the personnel employed in public institutions related to performances and concerts was foreseen an increase of the gross wage and bonuses of 50% also starting 1st February 2017, respectively an expenditure increase of 84 million lei. It has also been envisaged an increase of 15% of the gross salary and bonuses of the staff hired in the healthcare system, social assistance system and education system and an increase of 25% of the basic salary for the staff of the Health Insurance House, an increase in salaries for the personnel of the Public Health Directorates and Health County Houses at 85% of the salaries related to the National Health Insurance House and the salaries of the Romanian Agency for Salvation of Human Life on Sea similar to the salary rights of the General Inspectorate for Emergency Situations starting 1st January 2017 (GEO no. 20/2016). The cumulative impact of all these measures was estimated to lead to an increase in personnel expenditure by 4,850.2 million lei.

During the year, further salary increases were decided for 2017 as follows: a 30% increase in staff salaries in national libraries and national museums starting June 2017, a 15% increase in military staff base salary starting June 2017, a 10% increase in salaries within the Police from 1st of October 2017.

In addition to these amendments, we also note the entry into force, starting 1st July 2017, of the Unified Wage Law no. 153/2017 on the basis which salary increases were granted or allowed for some categories of budgetary personnel.

A negative influence on this budgetary aggregate had also the increase in the minimum wage from 1,250 lei/month to 1,450 lei/month starting with 1st February 2017, this measure having a budgetary impact of 469.9 million lei for 2017, according to the substantiation note to GD no. 1/2017 establishing the minimum gross salary guaranteed for payment starting January 6th 2017.

Figure 17: Average gross earnings in the private and public sector in the period 2007-2017 (lei/month)



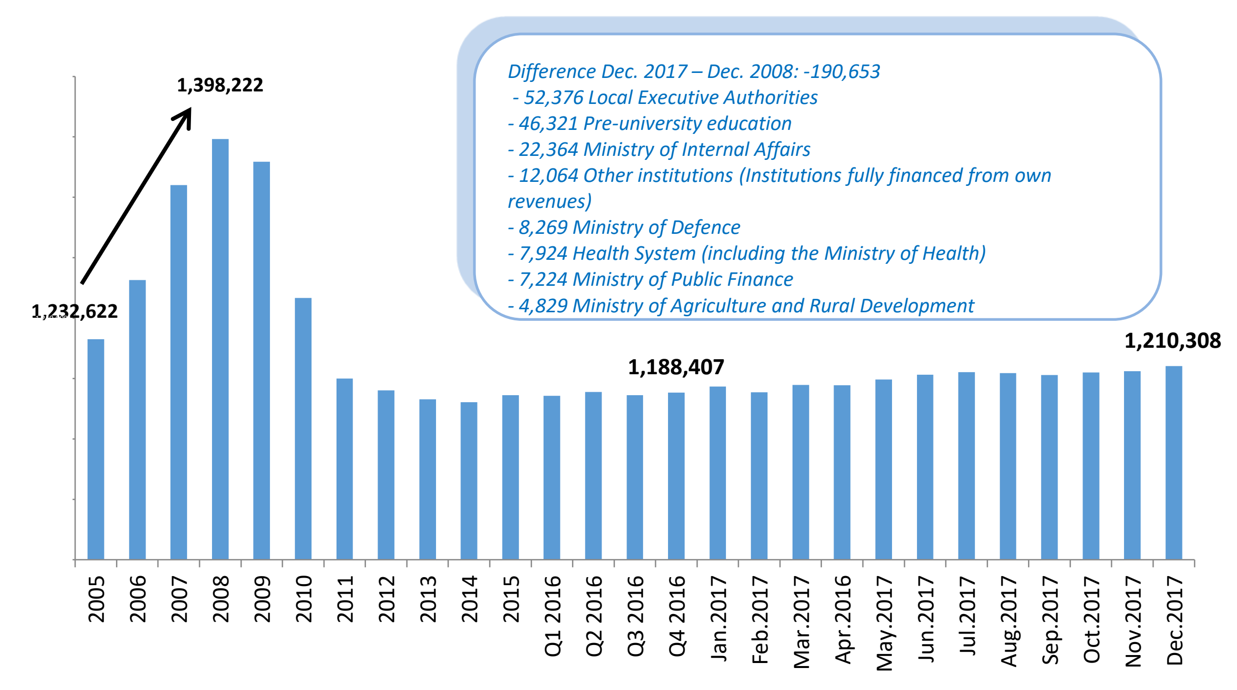
Source: NIS, Fiscal Council calculation

As a result of these increases, the annual average salary in the public system reached 3,895 lei in 2017, by 24.59% more than in 2016, surpassing the wage in the private sector which was 3,176 lei, by 12.23% higher compared to the previous year. Considering quarterly averages, the salary in the public sector for the fourth quarter of 2017 registered a level of 4,032 lei, by 18.95% more than in the similar period of 2016, and in the private sector of 3,339 lei, representing a growth of only 12.01%. In the public sector, the highest growth occurred in the public administration and defense sector (an increase of 27.67% compared to the average wage in the fourth quarter of 2016, reaching in the fourth quarter of 2017 a value of 5,544 lei), contributing strongly to raising the average wage from the public sector. In the healthcare sector it can be noted an increase of 17.86% compared to the average wage in the fourth quarter of 2016, reaching in the fourth quarter of 2017 a value of 3,813 lei. In education, the average wage reached 3,382 lei in the fourth quarter of 2017, recording an increase of 12.63% compared to the fourth quarter of 2016, being the smallest increase in the public sector, close to the one recorded in the private sector. In both education and healthcare sectors there were growth slowdowns of 6.4, respectively 4.3 pp, while for the public administration and defense sector the growth accelerated by 13.7 pp, increasing the already existing gap in the public sector.

Subsequently of the increase by 165,600 persons registered in 2005-2008, the total number of employees in the government sector decreased by 187,914 between December 2008 and December 2017 to a level of 1.21 million (see *Figure 18*). It should be noted, however, that in 2017 there was a continuation of the slight reversal of the decrease of the number of staff, present in the previous years, the number of occupied positions increasing by 21,163 (+1.78%) as compared to 2016 (compared with 3,149 and + 0,26% in 2016 respectively), especially at the level of the local executive authorities (+14,713 positions filled), the healthcare system, including the Ministry of Health (+6,578 positions vacated), but decreases were registered in the Ministry of Internal Affairs (-2,207 positions vacated), the Ministry of National Defense (-3.056 positions vacated) and in the Ministry of the Environment (-696 positions vacated).

Practically, most of the personnel reductions took place in the period 2009-2011, when the number of employees in the public sector declined by about 180,000, this being due mainly to the introduction of the rule of "one new employee to 7 departures from the system" (applied until 2012, inclusively), whereas in the period 2012-2014 the reduction was approximately of 9,540 persons. The adjustment recorded in the period 2009-2017 took place mainly at the level of local executive authorities (-52,376 positions vacated), pre-university education (-46,321 positions vacated), Ministry of Internal Affairs (-22,364 positions vacated), other institutions entirely financed from their own revenues (- 12,042 positions vacated), Ministry of Public Finance (-12,064 positions vacated), Ministry of National Defense (-8,269 positions vacated) and healthcare system, including Ministry of Health (-7,924 positions vacated). On the other hand, during the same period, increases were recorded at the Ministry of Justice (+3,194 positions filled), Ministry of Regional Development and Public Administration and European Funds (+1,536 positions filled), Ministry of Labor and Social Justice (+1,098 positions filled), Public Ministry (+1,047 positions filled), Ministry of Economy (+947 positions filled)[56].

Figure 18: The evolution of the public sector employment in the period 2005-2017

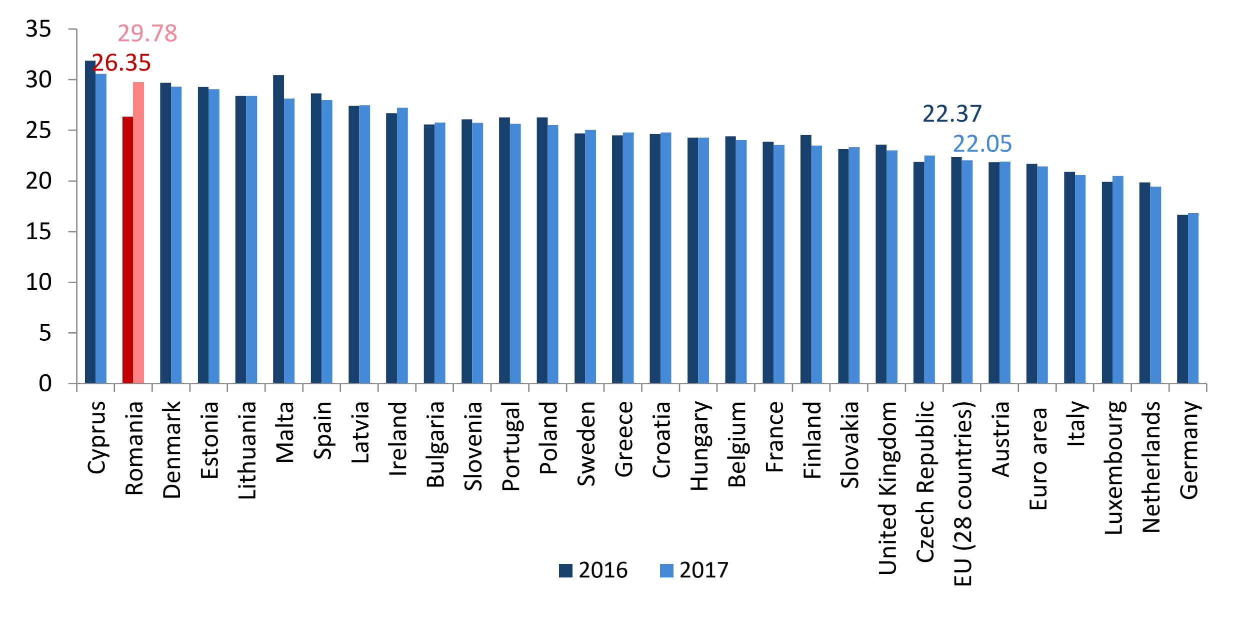


Source: MPF

The adjustment made in the period 2009-2012 is mainly the result of applying the rule of "one new employee to 7 departures from the system" given that most of the exits from the system were achieved through voluntary dismissal or retirement. The abandonment of this rule starting from 2013 was intended to reduce the adverse selection and allowed some changes in the structure of the personnel. Thus, the reductions in the period 2009-2012 was achieved only to a small extent based on qualitative criteria, such as reducing personnel where it was identified a surplus of employees whereas hiring personnel in the sectors with personnel deficit on the basis of cost standards rigorously defined and thus establishing an optimum level of operation. The Fiscal Council considers this approach to be appropriate and recommends that the new appointments to be made in the identified sectors with personnel deficit, even by transfer of posts from the sectors with personnel surplus to the sectors with personnel deficit, also having in view the strict framing in the wage bill previously approved.

[56] In the case of some ministries the position fluctuations also occurred as a result of the restructuring due to Government changes.

Figure 19: Wage bill as a share of total budget revenues in EU28 countries



Source: Eurostat

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

Compared to other European Union's countries, Romania's position in terms of the wage expenses in the public sector as a percentage of the total collected revenues has sharply deteriorated in 2017, following a good development starting 2011 due to the fiscal consolidation measures undertaken since mid-2010. If until 2010, the wage bill as a share of total budgetary revenues according to ESA 2010 data placed Romania in the first half of the ranking (on the 8th position in 2008 and on the 10th position in 2009), 2011 revealed a better ranking for our country, respectively 20th position out of 28 countries, following the 18th position in 2013, on the background of the recovery of wages and wage increases for some categories of state employees. In 2015, Romania was also on a good position namely the 20th position out of 28 countries, due to a slight increase of the revenues to the budget and to preserving the share of the wage bill in GDP. But then, in 2016 the situation has deteriorated and Romania ascended abruptly on 9th position, and in 2017 reached the 2th position as a result of both the increase in the share of wages and salaries in GDP (by 0.7 pp compared to the previous year[57]), and a lower share of

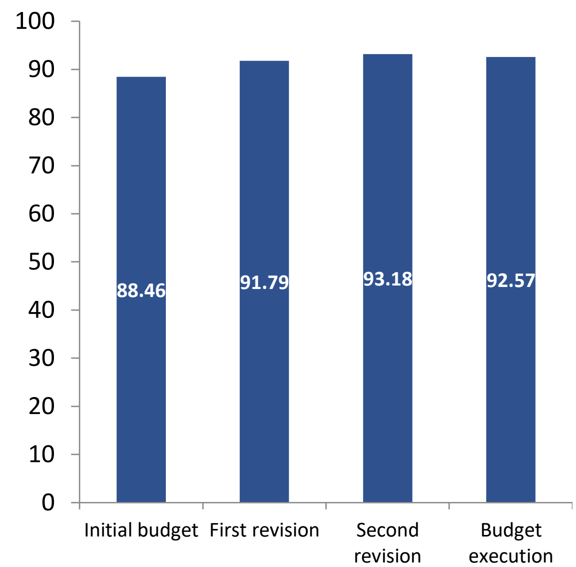
[57] Representing the largest growth in the EU28, followed by Luxembourg with an increase of 0.4 pp. Bulgaria and Czech Republic with an increase of 0.3 pp compared to the previous year.

revenues collected in GDP (by 1.3 pp compared to 2016[58]) being considered adjusted values according to the note presented above.

The Fiscal Council notes the manifestation of an accelerated growth trend in personnel expenses, Romania's position compared with other EU countries deteriorating strongly over the past two years. The repeated wage increases in the public sector and the entry into force as of 1st of July 2017 of Law no. 153/2017 regarding the salaries of the staff paid from public funds have consistently contributed to the worsening of situation related to this category of expenditure.

Social assistance spending in 2017 was above the value projected in the draft budget, being revised upwards on the occasion of the two budget revisions. Estimated in the initial budget at 88.46 billion lei, it recorded a final value, net of the impact of the compensation schemes, of 92.57 billion lei, by 4.65% (the equivalent of about 4.11 billion lei) more than in the initial program. Social assistance spending was much higher than planned, mainly as a result of registering a higher budgetary impact in the execution than initially estimated for the fiscal policy measures decided in 2016, but also due to introduction of additional measures with the occasion of the two budget revisions for 2017.

Figure 20: Social assistance expenditure in 2017 (billion lei)



Source: MPF

Thus, on the occasion of the first budget revision, the Fiscal Council recalled that at the time of the approval of the initial budget, this aggregate was under-budgeted; this could have been observed from an extrapolation of the trend of the quarterly execution from the previous year. Thus, among the previously approved measures that led to the increase of social assistance expenditures in 2017 are included: the increase in the number of beneficiaries of social aid by excluding the state child allowance from the family income when determining social assistance benefits; increasing the allowance granted to adults with serious visual handicap, by increasing

[58] Romania ranks the second place in the EU28 in terms of decreasing the share of budget revenues in GDP. The largest decrease (by 1.4 pp) compared to the previous year was registered in Greece, and Finland was the third, with a decrease of 1 pp.

with 25% the net salary of the debutant social assistant with medium education within the social assistance units in the budgetary sector, others than those with beds, and by the increase of the number of persons included under various types of disabilities; the increase and the modification of the method of setting the monthly child raising allowance and the insertion incentive; introduction of service pensions for clerks, aeronautical personnel, parliamentary civil servants, auditors of the Court of Accounts. The increase of the social assistance expenses on the occasion of the second budget revision was motivated by the payment of the rights of people with disabilities, the state child allowances, the child raising allowance and the health insurance contributions related to the allowances; the increased of the balancing transfers to the state social security budget (from the budget of Ministry of Labor and Social Justice) with a budgetary impact of 630.9 million lei, ensuring the payment of the state military pensions due to the retired military personnel and police officers who have ceased work in 2017, as well as the payments of the differences resulting from the recalculation of the pension rights (through the budget of the Ministry of Internal Affairs) with a budgetary impact of 363.5 million lei and the financing of the child protection system (through the local budgets) with a budgetary impact of 61.0 million lei. Other measures which affected the increase in this type of expenditures were the increase in the level of minimum pensions for retirees and the granting free of charge to enrolled students of rail transport.

Compared to 2016, the social assistance expenditure increased in 2017 also due to the pension point indexation by 5.25% as of 1st January 2017 (according to the provisions of Government Emergency Ordinance no. 99/2016 with subsequent amendments and supplements) and by 9% starting 1st July 2017 (according to the provisions of Government Emergency Ordinance no. 2/2017 with subsequent amendments and supplements), compared to an increase by 5% in previous year. The share of the social assistance expenditure in Romania is significant (10.78% of GDP) and the problem of the structural deficit of the public pension system is not yet solved. Thus, pension expenses are unsustainable in relation to the contributions collected, even if some measures were undertaken in order to improve this shortcoming in the medium and long run[59] .

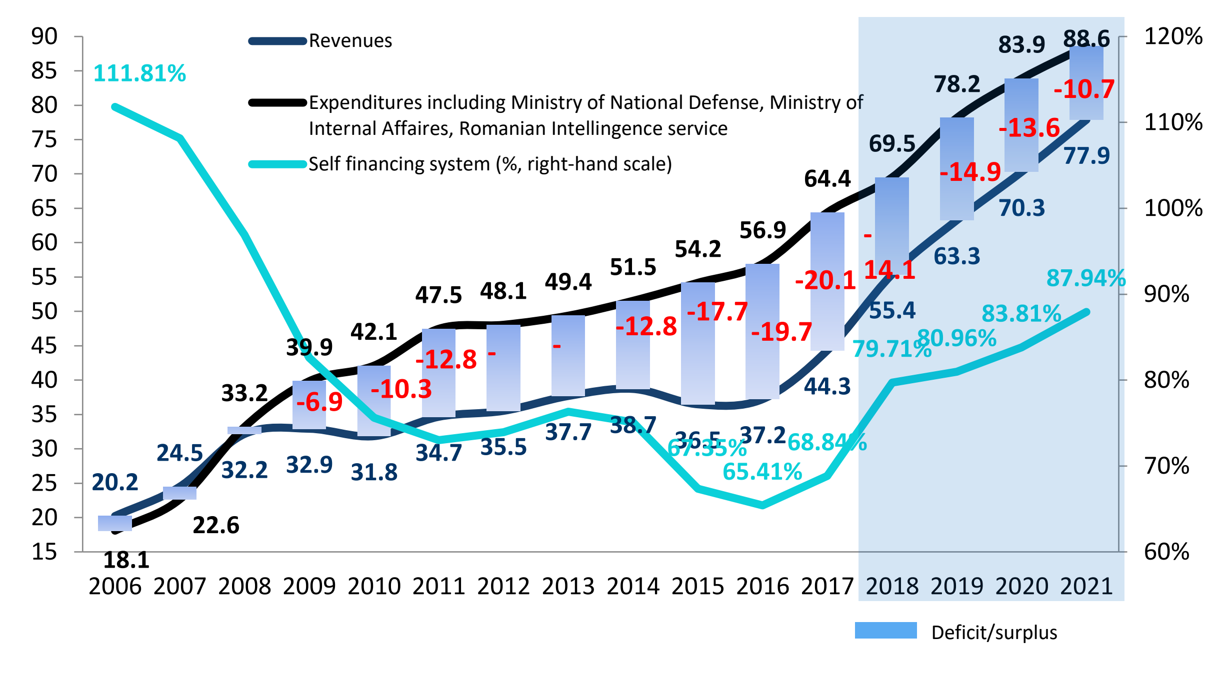
Since 2009, the deficit of the social security budget, considering also the special pensions has widened significantly up to a value of 20.1 billion lei in 2017, and the estimated trend for the following years (2018-2021) shows a reduction, reaching in 2018 a level of 14.1 billion lei, in 2019 of 14.9 billion lei, in 2020 of 13.6 billion lei and in 2021 the level of 10.7 billion lei.

From the perspective of the deficit as a percentage of GDP, the execution indicates a decrease from 2.28% in 2011 to 1.92% in 2014, followed by a new increase up to 2.48% in 2015 and to

[59] The Law No. 263/2010 regarding the unitary system of public pensions modified the indexation system, increased the standard retirement age and introduced more stringent criteria for early retirement.

2.58% in 2016 and a slight decrease in 2017, when it reached a level of 2.34% of GDP. The estimates for the following years indicate a decrease for the period 2018-2021 (1.55%, 1.52%, 1.29% and 0.95%).

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



Source: MPF, cash standard data

Note: In addition to the spending of the state social insurance budget for the period 2016-2010 were included spending with military pensions. According to Law no. 223/2015 from 1 January 2016, the funds necessary to pay military pensions and other social insurance rights due to military pensioners are provided from the state budget, through the budgets of the institutions: Ministry of National Defense, Ministry of Internal Affairs, and Romanian Intelligence Service.

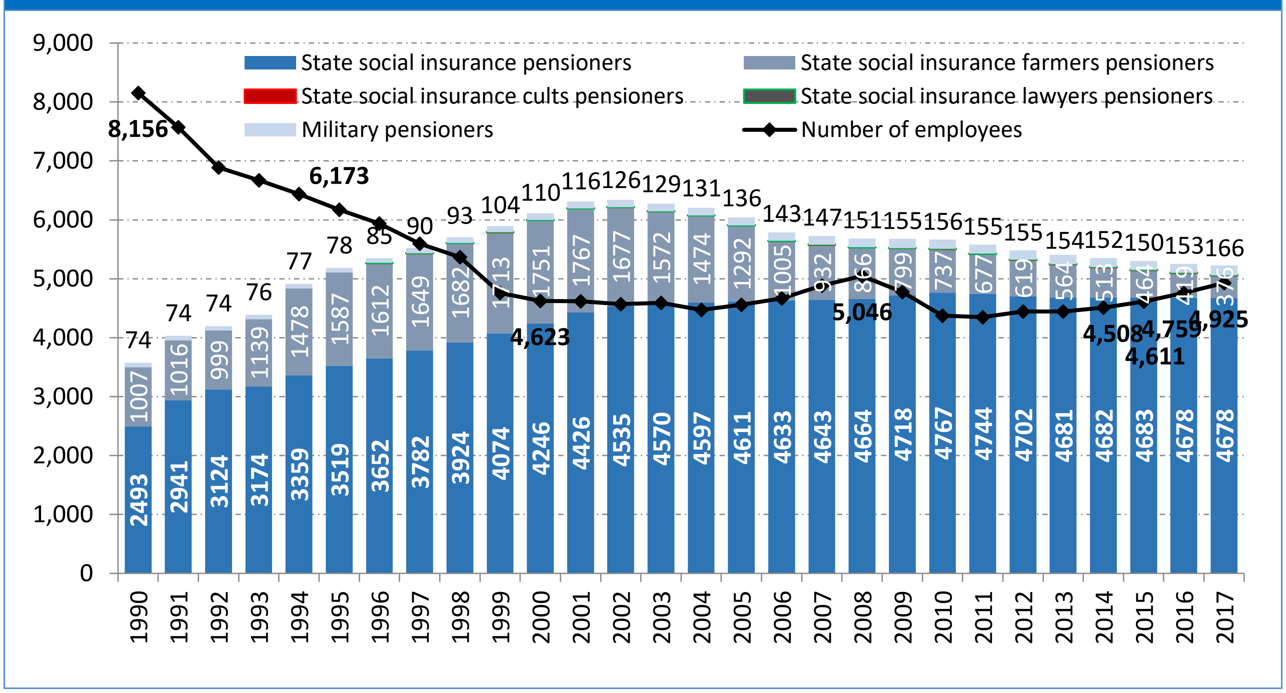
The deficit of the state social insurance budget has occurred on the account of excessive social security budget expenditure in the period 2007-2009 (+75.8%) and in the context of a favorable dynamics of the social contribution revenue during the period preceding the financial crisis, as a result of the economic boom and also anticipating to maintain this trend in the future. Unfortunately, a significant share of the social contributions revenue augmentation has proven to be of cyclical nature, the further developments invalidating the optimistic forecasts that led to the significant increase of the pension point. The self-financing of the system has fallen sharply from 2006 (from 118.81%) to 2011 (73.02%), reaching the historical minimum in 2016 (65.41%)

and it maintained at a close value in 2017 (68.84%). A slight recovery is expected in the future (up to 87.94% in 2021), but far from the funding needs.

Thus, the decision to increase certain permanent expenditures such as those related to pensions should take into account the trend of contributions, as well as the forecasts regarding the employees-pensioner's ratio, especially in the context of population aging; for instance, from 1st of January 2017 the elderly population of 65 years and over outnumbered the young people of 0-14 years (3,495 thousand compared to 3,057 thousand) according to the NIS. It also became obvious the need to find an indexation rule in order to ensure long-term sustainability of the social insurance budget instead of using the discretionary approach of the past.

The ratio between the number of contributors and the number of beneficiaries fell sharply in the last 27 years, from 2.28 employees per pensioner in 1990 to only 0.94 employees per pensioner in 2017, the number of the state social insurance pensioners having an increasing trend, while the number of employees had a decreasing trend, especially until 1999-2000. However, in recent years, the ratio has improved from 0.77 employees per pensioner in 2010 to 0.84 employees per pensioner at the end of 2014, being placed in 2016 at 0.91, slightly above the level registered in 2008 (0.89).

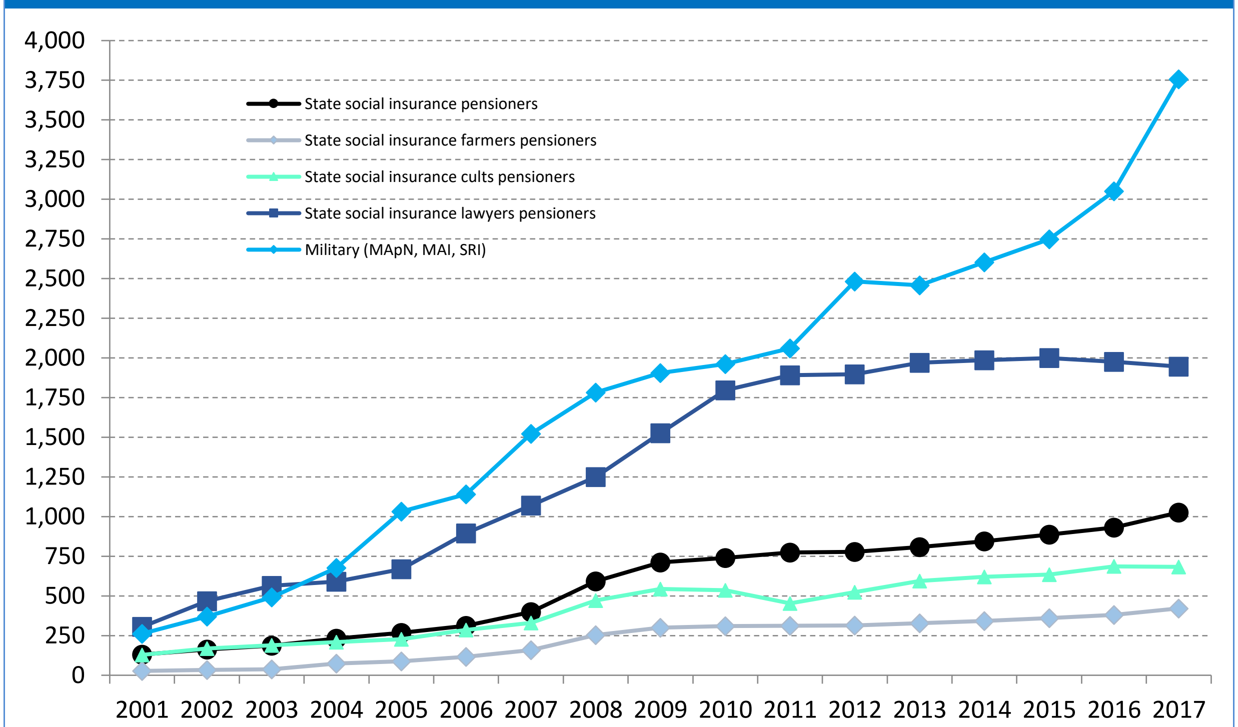
Figure 22: The evolution of the number of pensioners versus the number of employees (thousand persons)



Source: NIS, less the number of employees for 2017 for which the source is NCSP, Winter Forecast 2018

A measure aiming to improve the medium and long term financial situation of the social insurance budget was represented by the new pension law (Law no. 263/2010 of the unified public pension system, updated) through which it has been pursued a number of objectives designed to correct the imbalances recorded in the pension system. Nevertheless, returning to the special pension system eliminated in 2010, the occurrence of multiple exemptions and the new special pensions jeopardize the sustainability of the reforms initiated earlier and could generate new pressures on the social security budget deficit. The recently adopted laws introduce new rules, ensuring better conditions for early retirement and generous computing formulas based on the salary earned before retirement. It should be noted, however, that the unitary pension system currently applied provides better conditions for some categories of workers, in order to compensate for particularly risky working conditions and shorter occupations. Starting with 2015, special pensions were reintroduced and it can be noted a reduction of the link between pension contributions and future accrued pension rights which has the potential to generate a negative impact on long-term sustainability of the pension system, especially since other professional groups will be also encouraged to push for the restoration/establishment of privileges. Moreover, the renunciation of the pension indexation formula since 2017 affects substantially the sustainability of the pension system, the discretionary approach and the abandonment of the rules having the potential to contribute to the widening of the state social insurance budget deficit and maintaining the self-financing of the state social security budget far below the level required.

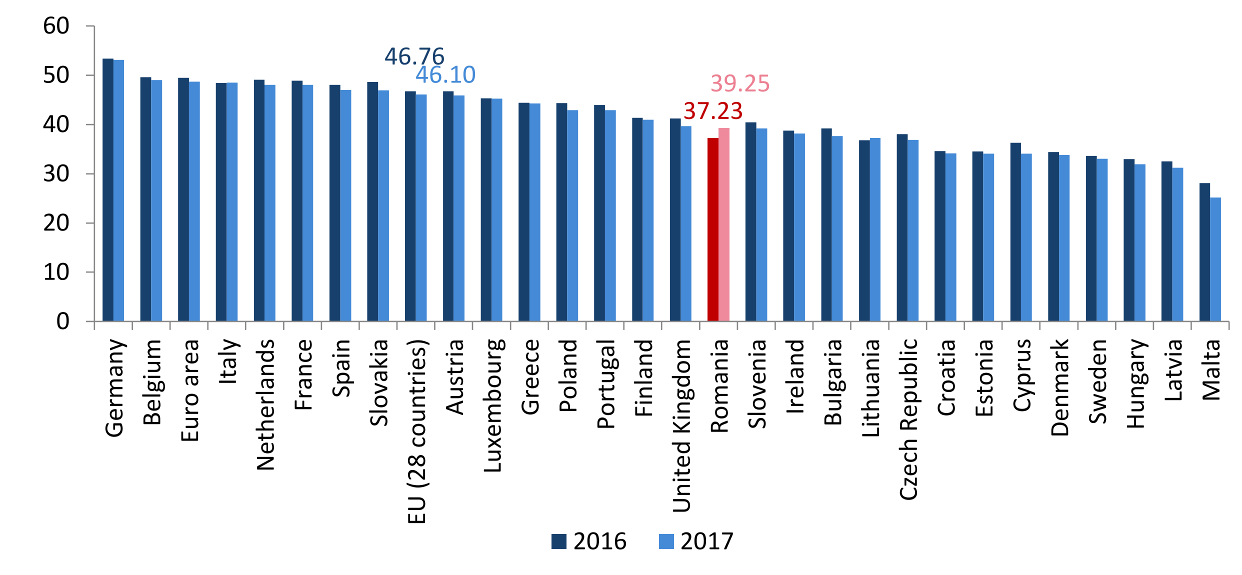
Figure 23: The evolution of the average pension (lei) in the period 2001-2016



Source: NIS

According to NIS data, in 2017, the average monthly pension was 1,070 lei, higher by 12.7% over the previous year, as a result of the pension point indexation by 5.25%, respectively by 45.8 lei and by 9%, respectively 82.5 lei. Pensions paid out of the social security budget were at an average level of 1,026 lei, and those corresponding to pensioners that were farmers were on average 422 lei. At the same time, the pensions granted to the military personnel have reached an average monthly level equal to 3.756 lei, 23.12% more than in 2016. It is worth noting that the average monthly pension corresponding to beneficiaries from defense system, public order and national security increased by approximately 91.57% during 2010-2017, as a result of the recalculation according to Law no. 119/2010 and Government Emergency Ordinance no. 1/2011 and the subsequent increases, even in the circumstances that the initial forecasts indicated a decline in the value of these pensions after applying the contribution principle. Article 121 of Law no. 223/2015 on state military pensions stipulates that the differences between the amounts of pensions due for December 2010 and those established under Law no. 119/2010 and GEO no. 1/2011, approved by Law no. 165/2011, as subsequently amended and supplemented, shall be returned to the beneficiaries, at their request, in a staggered manner, for a maximum period of 2 years from the date of entry into force of the Law, and until June 30 the beneficiaries can express their option with regard to the period of time envisaged for the recalculation of the pension. The Government Decision no. 146/2016 approved the Norms for the application of the provisions of this Article, specifying that in November 2016 the payments will be made for the differences for which applications were submitted until September 30, 2016, including, differences corresponding to the years 2011 and 2012, and the differences for the others requests and periods will be paid in November and December 2017.

Figure 24: Social security expenditure as a share of total budgetary revenues in EU28



Source: Eurostat

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

In the year 2017, Romania has ascended two places[60] compared to 2016 regarding the share of social security expenditures in total revenues, placing in the second half of the EU member states ranking. However, even this category of expenditure has a lower share in total budgetary revenues compared to the EU average, the share of social assistance expenditures in GDP increased by 2.03 pp in 2017 compared to the previous year, and the social assistance expenditure registered a significantly lower level compared to the financing sources (especially in the case of the SSC). The decrease in the share of budgetary revenues in GDP to 29.6%, a level similar to 2009, compared with 35% in 2015, contributes significantly to the deterioration of Romania's position in the ranking.

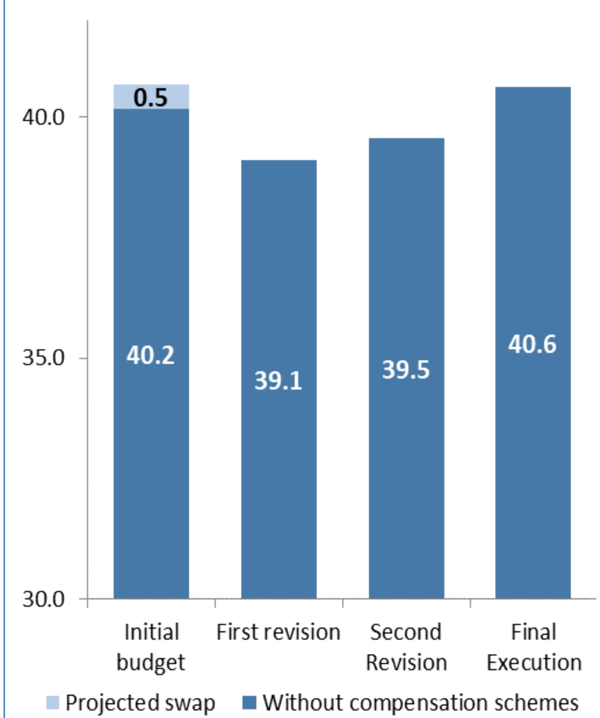
The Fiscal Council notes the manifestation of a sustained trend of reversing the pension reforms designed to ensure long-term financial sustainability and pleads strongly in the favor of maintaining the progress made in recent years, both in terms of the principles introduced (exclusive use of the principle of contribution in determining the pension value) and in terms of a strict compliance with the pension's indexation mechanism as introduced by the new pension law.

[60] Placed on 17th position out of 28 countries, after being placed on 25th position in 2015.

III.4.2. Goods and services expenditures

The execution of goods and services expenditures, without the impact of the swap compensation schemes registered a higher level, albeit relatively close to the one envisaged in the draft budget (+0.47 billion lei), but well above the ones projected during the two budget amendments made in 2017. Initially estimated at 40.15 billion lei, the final execution of this aggregate registered an increase of 1.1 billion lei compared to the level estimated at the second budget revision (approved in mid-November), but also in the conditions of advancement[61] of the closure of 2017 budget year (set for December 27). Compared to the previous year, in 2017 the goods and services expenditures, net of the impact of swap compensation schemes, decreased by 0.7%, respectively by 287 million lei.

Figure 25: Goods and services expenditures in 2017 (billion lei)



Source: MPF

The swap scheme was projected at the level of 522.7 million lei, but this was not reflected in the two budget revisions or in the final execution. Expressed as a share of GDP, the goods and services expenses reached a level of 4.7%, a minimum of the period 2009-2017, decreasing by 0.6 pp compared to the one registered in 2016 and by 0.9 pp compared to average of the period 2009-2016. The Fiscal Council appreciates positively this evolution which marks a substantial improvement against the amounts spent during 2009-2016, freeing also fiscal space. In 2017, this was used to significantly increase the allocations of personnel and social assistance expenditures. Also, it is relevant to make an analysis of the measure in which this reduction on goods and services expenditures did not affect the quality of the services offered by the state, especially

[61] Order no. 3315/22.12.2017, which advances with two days the submission of all payment documents to the Treasury changing the provisions of Order no. 3244/21.12.2017 regarding the approval of the Methodological Norms regarding the end of the budgetary year of 2017.

those provided thorough the Unique National Health Fund. However, the Fiscal Council cannot conclude in this regard.

Compared to the execution of the year 2016 (40.9 billion lei), this category of expenditures (without the swap scheme) was projected through the initial budget to a lower level by about 760 million lei. Although their execution for the first 8 months indicated an increase of 3.6% compared to the same period from the previous year, at the first revision operated in September 2017, the goods and services expenditures registered a surprising downward revision (by -1.1 billion lei), the most important reduction (over 1 billion lei) being operated to the budget of Unique National Health Fund. On the occasion of the second budgetary revision, the goods and services expenses were upward revised (but by only 0.4 billion lei, being, however, below the level envisaged in the initial budget). By the Substantiation Note attached to GEO no. 83/2017 regarding the second revision of the state budget for 2017, was reported, among the reasons which indicated the necessity to allocate additional amounts, the evolution of this budgetary aggregate which in the first 9 months of 2017 compared to the previous year registered an increase by 3.6%, determined especially, by the higher expenses of the Unique National Health Fund which increased by 5.2% over the same time period of the previous year. However, as in the previous years, the motivation for the modifications made on the occasion of the budgetary revision projects was not clearly explained in the substantiation notes accompanying the budget revision proposals in order to ensure the transparency of the decisions taken by the Government.

In the Opinion on the first budget revision for 2017, the Fiscal Council noted that the downward revision of the goods and services annual expenditures appeared as surprising given that this involved a nominal growth rate for this category of expenditures of -4.5% compared with the execution of 2016, while according to the first 8 months execution there was an increase of 3.6% against the same period of the previous year. Also, on the occasion of the second budget revision, the Fiscal Council noted that, although the proposed level for this category of expenditure is higher by about 500 million lei compared to the level from the first revision, the new level is lower by 3.4% than the level registered in the execution of 2016, while the preliminary execution at the end of October reveals higher expenditures by 4.2% compared to the period January-October 2016. The final execution confirmed the objections of the Fiscal Council regarding the necessity of some additional allocations for this budgetary aggregate compared to the amounts advanced at that time.

The Fiscal Council notes a chronic lack of transparency regarding the projection of this expenditure aggregate, the assumptions underlying this area of expenditure or the motivation for the major revisions made during the year not being explained in the documents accompanying the successive iterations of the budget. These explanations are even more necessary as there are some substantial changes with the potential to influence the achievement of the deficit target or the compliance with the fiscal rules. The Fiscal Council calls for a budgetary programming taking into consideration all expenditures envisaged in this budget chapter within the draft budget along with a proper enunciation of the funds' destination, as well as comprehensive explanations during budget revisions regarding the sources of potential increases in this category of expenses. Increased transparency could be a good starting point in streamlining the goods and services expenditure, this being necessary to be accompanied by a comprehensive reform of the public procurement system in general.

III.4.3. Public investment expenditures

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

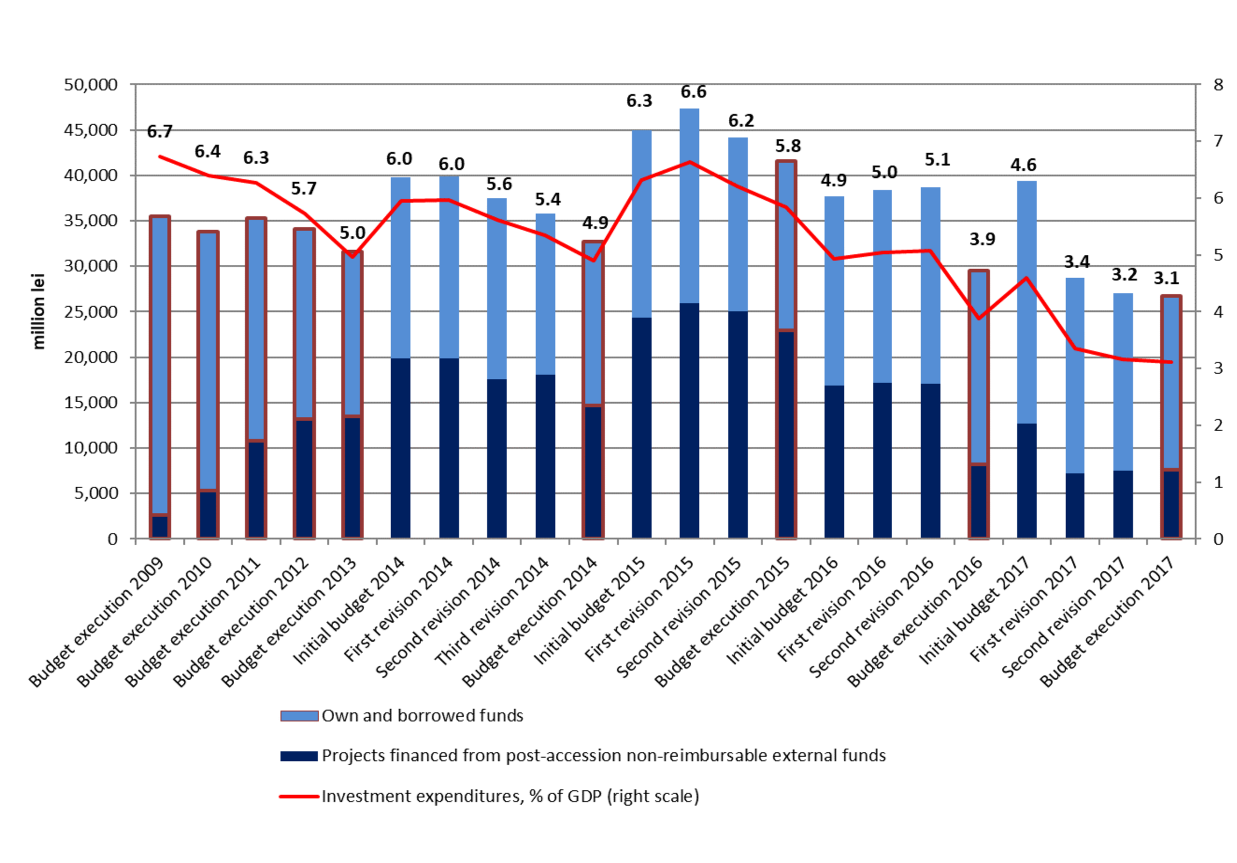
Compared to the previous year, in 2017, the state investment spending, considering all budget items of this category, including swap compensation schemes, decreased by 2.8 billion lei from 29.5 billion lei to 26.7 billion lei (in cash standards), respectively by 9.5% in nominal terms, and by 14.0% in real terms[62], the share of public investment spending in GDP reducing by 0.76 pp (from 3.87% of GDP to 3.11% of GDP). Compared to the previous 5 years' development, the execution of investment spending as percentage of GDP recorded in 2017 the lowest level, being by 1.95 pp below the average of the years 2012-2016 (5.06% of GDP), the year under review being the second consecutive year of declining public investments and a minimum of the period 2009-2017. The main causes of this development were the extremely slow pace of attracting EU funds for the financial year 2014-2020 (similar to the situation of the previous year), the high political uncertainty, as well as the constraints of keeping the budget deficit below 3% of GDP.

The analysis of this budgetary aggregate from the perspective of the comparison between the actual execution compared to the planned investment expenditures from the initial budget or established through revised budgets during 2014-2017 persistently reveals significant deviations, in the sense that the executions are invariably below the estimates of the initial and the revised budgets. Thus, the negative gap expressed as a percentage of GDP relative to the initial budget of the amounts actually spent reached in 2017 a level of 1.48% of GDP, being significantly higher than in the previous year (1.07% of GDP), contrary to the initial expectations of an increase in investment expenditure over the year based mainly on a notable improvement in the level of

[62] Using the GDP deflator as price index.

absorption of European funds compared to 2016. This would have been theoretically possible if we considered the difficulties inherent to the debut of the 2014-2020 financial exercise.

Figure 26: Investment expenditures in 2017 (million lei)



Source: MPF

The 2017 budget was elaborated by returning to an upward path of the aggregate investment expenditures, after the pronounced decline from 2016 (3.9% of GDP after reaching the level of 5.8% of GDP in 2015, a historical maximum during the period 2012-2017), on the basis of a possible revival of the absorption of European Funds and respecting Romania's commitment to NATO[63]. In the initial budget construction, the investment expenditures were envisaged to register a significant increase compared to the execution of the year 2016 (+9.9 billion lei), with increases located at the level of capital expenditures (+6.2 billion lei, of which more than 5.5 billion lei were allocated to the Ministry of National Defense) and at the level of the expenditures

[63] The allocation of 2% of GDP for the endowment of the army in order to strengthen Romania's strategic partner's profile at NATO, EU and USA level according to Governance Program 2017-2020, as well for streamlining the endowment of the army according to measure from the Memorandum approved by decision of Supreme Council of National Defence no. 174/24.11.2016

related to the projects financed by external EU funds (+4.5 billion lei), simultaneously with the reduction of the investment transfers (-0.8 billion lei). Thus, excepting the increase in the allocation for the army (based on the Romania's commitment within NATO to allocate a budget for defense representing 2% of GDP), by the budget construction for 2017, similar to the years 2013-2016, it was envisaged a larger weight of the external source financing (an increase in the EU funds absorption coming from the new financial year 2014-2020) in total investment expenditures, respectively, reducing the share of internal sources (capital expenditure), a correct and welcomed approach in the opinion of the Fiscal Council, thus freeing financing resources that could be used for fiscal consolidation.

Nonetheless, the plan to increase investment by substituting capital expenditures with non-reimbursable EU funds did not function also in 2017, revealing a major deviation from the initial estimation and with a much higher magnitude compared to that registered in the previous year, investment spending being by 12.7 billion lei lower than the amount estimated in the draft budget (respectively, with 1.48% of GDP), compared with the gap of only 8.1 billion lei (respectively by 1.07% of GDP) in 2016. This evolution was due both to the non-materialization of the expenditure forecast for projects financed by external non-reimbursable EU funds related to the new financial year 2014- 2020, where the difference between the execution value and the initial budgetary plan was -5.04 billion lei, respectively -0.59% of GDP, but mainly to the under-achievement of allocations from domestic sources, capital expenditures being by 6 billion lei below the level initially budgeted (respectively by 0.81% of GDP). If we analyze the evolution of the ratio: capital expenditure/projects funded by external non-reimbursable funds for the financing the investment expenditures it is noted the continuation of the upward trend of this ratio from 232% in 2016 to 238% in 2017 (reversing the downward trend of this ratio from the period 2010-2015, with a minimum of 74% reached in 2015[64]), proving the inability of the Romanian authorities to attract the amounts allocated by the EU for financing the public investment programs.

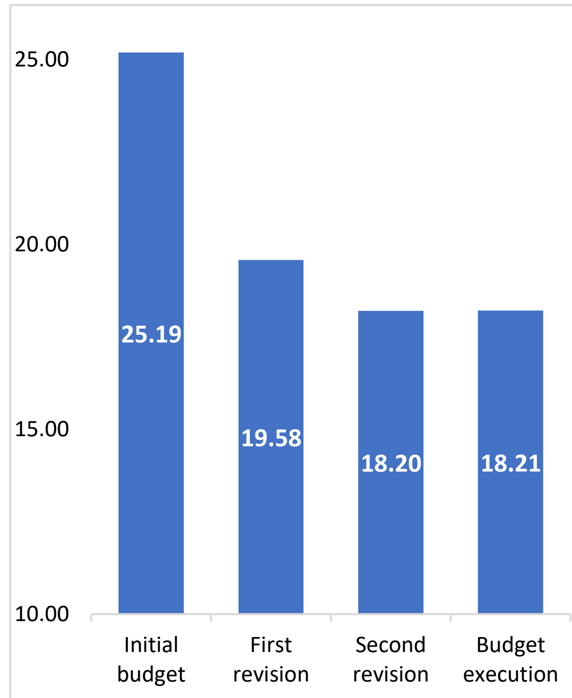
Also in 2017, the quarterly evolution of the investment spending shows a concentration in the last quarter (54.7% of the total year), which puts into question the effectiveness of the budgetary programming both in terms of the management of investment projects and of defining their importance and utility. Practically, in the last quarter investment spending was about 3.6 times more than the average of the three previous quarters which highlights serious deficiencies in budgetary programming for this aggregate characterized by an extremely high volatility of the quarterly distribution of the programmed spending compared to the actual ones. From the perspective of the evolution of the share of the quarterly investment expenditures in total execution, this fluctuated between about 6.3% in the first quarter and 22.8% in the third quarter

[64] Given that this year was a maximum for EU funds absorption, being the deadline for attracting European funds for the 2007-2013 financial period.

(with 16.2% in the second quarter), reaching 54.7% in the last quarter of 2017, being roughly in line with the quarterly evolution of flows related to projects funded by non-reimbursable funds.

In 2017, the capital expenditures for investment spending[65], were projected in the initial budget at a higher level (by 6.2 billion lei, of which about 90% for Ministry of National Defense) compared with the actual spending from the previous year, but the final execution registered a level by about 7 billion lei less than the initially programmed level (-27.7%), respectively, by 0.81 billion lei less than in 2016 (-4.2%).

Figure 27: Capital expenditures in 2017 (billion lei)



Source: MPF

The projects financed by post-accession external funds (NREF) for public investment spending, were projected by the initial budget of 2017 in a large expansion compared to the previous year (+4.5 billion lei, respectively, an increase of 54.8%), given the possible revival of the European funds absorption from the new financial year 2014-2020, after the slow start registered in the previous year, but they had a development much below expectations being substantially inferior to the level established by the initial budget (by -5.05 billion lei, respectively -39.7%), contributing significantly to the under-achievement of the initial programmed level for the investment expenditures.

This under-achievement did not lead to an increase in the deficit, the failure to implement investment projects involving savings regarding the co-financing and non-eligible expenditures, but the failure in absorbing European funds induces negative effects on the economic growth both from the perspective of the direct effects (the reduction of the public investments) and of the indirect effects[66], as well as from the perspective of the a lack of ability to absorb the European funds allocated to our country, by preserving a lower degree of absorption, reflected in the expenditures on projects funded by NREF just below the level registered in the previous year

[65] Representing the main component of the capital expenditure (that also include capital transfers and stocks).

[66] The contribution of investment to potential growth is crucial, ensuring a non-inflationary economic growth.

(compared to 2016, the expenditures related to the projects funded by NREF 2014-2020 were lower by 0.55 billion lei in 2017).

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

Starting with 2016, the budgetary aggregate projects financed by post-accession external funds (NREF) - out of which, mostly is used for investment - includes also funds for agriculture, which in the previous years were not included in NREF because these funds were considered not to transit the state budget being destined for the private sector. Since 2017, in addition to funds for agriculture, according to GEO no. 40/2015 were also included transitional amounts representing funds for the pre-financing of the projects from the non-governmental sector in the event of the temporary unavailability of European funds (TUF). Thus, in 2017 out of the total of 22 billion lei for the payments related the projects financed by NREF post-accession 2014-2020, about 12 billion were allocated to agricultural payments (respectively EAGF and EMFF related to the financial year 2014-2020), 0.4 billion for TUF and from the rest of 9.6 billion representing structural and cohesion funds of which the final beneficiary is the state, almost 79% were allocated for investment expenditures (percentage similar to the previous year). It is noteworthy that, in 2015, a year of maximum for the absorption of NREF 2007-2013, the projects financed by NREF post accession amounted to 24.6 billion lei (of which 0.5 billion lei for NREF 2014- 2020), of which 23 billion lei were allocated for investment expenditures (94% of the total NREF post accession). We mention that according to ESA 2010 methodology are relevant exclusively the structural funds of which final beneficiary is the state, the amounts for agriculture and pre-financing for non-governmental sector not being included in the public administration sector. Moreover, the transiting of the GCB of the amounts representing funds for agriculture and pre-financing for the projects from the non-governmental sector in the case of temporary unavailability of European funds makes practically impossible, at the aggregate level, the comparability of data from the budgetary execution of 2017 to that from the previous year (for the amounts NREF granted in basis of GEO no. 40/2015), as well the comparability to the European funds flows from the financial year 2007-2013.

Missing the target for the projects funded through external post-accession grants is correlated with the EU funds absorption rate, mainly those related to the new financial year 2014-2020, for which the underachievement of the revenues in 2017 compared to the initial budget was at aggregate level (including amounts for agriculture and TUF) of 5.07 billion lei, respectively an underachievement of 5.01 billion lei (0.6 % of GDP) of the structural funds of which final beneficiary is the state.

The expenditure regarding the projects funded by reimbursable programs that have a very small share in the total investment spending were below both the level in the previous year (by about 171 million lei, respectively by -38.9%), and of the initial budget projection, respectively by 206.4 million lei (representing only 83% of the program).

Figure 28: Projects funded by external post-accession grants in 2017 (billion lei)

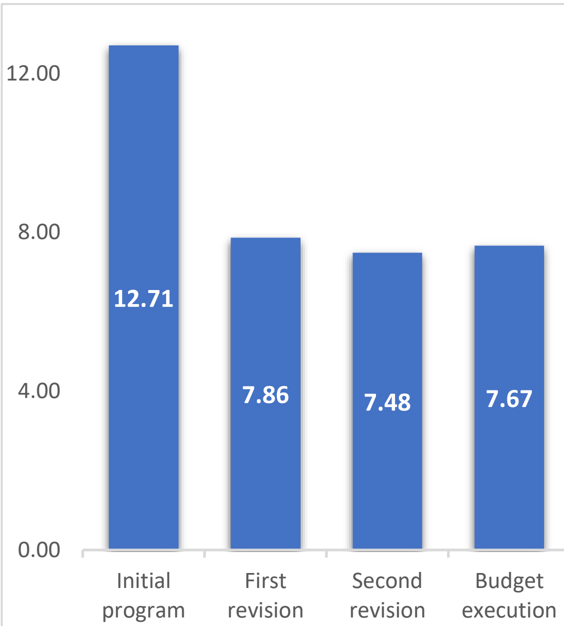
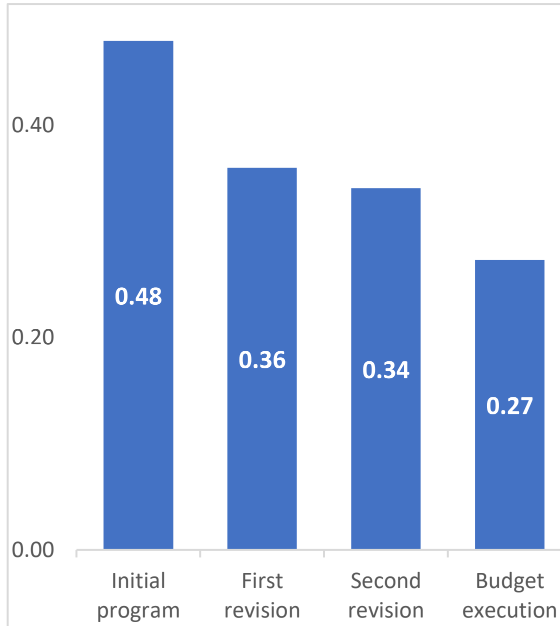


Figure 29: Expenditure funded from reimbursable funds in 2017 (billion lei)



Source: MPF

An analysis of the investment expenditures efficiency also reveals from this perspective an unsatisfactory result for our country, especially reported to the evolution of the other EU member states. In the Country Report for 2017 elaborated by the EC[67], it is reiterated that the high level of the public investment expenditures is accompanied by an insufficient infrastructure, given that, Romania has had, over the last decade, one of the highest rate of public investment from the EU, but, despite the recent achievements of the National Program of Local Development, the discrepancy between inputs (investments) and outputs (infrastructure) is extremely high, which suggest a poor efficiency of the public capital expenditures. Also the quality of infrastructure is one of the lowest, especially in the critical sectors, such as road, rail and energy infrastructure due to the very modest performances registered by the state-owned enterprises and the lack of progress in the sense of restructuring those who record losses. It should be noted that, even since 2016, the rate of new investments by the state owned companies[68] marked a drastically decrease

[67] https://ec.europa.eu/info/publications/2018-european-semester-country-reports_en.

[68] http://www.fiscalcouncil.ro/SOE%202016%20engl%2014martie2018.pdf.

to the level of 0.45%, after stabilizing around 4.5% during the period 2014-2015. This is confirmed by the recent empirical evidence which suggest that the inefficiency of public expenses could lead to an overestimation of effective social capital. The poor results of state owned enterprises, which are the main providers of infrastructure in this areas, are considered to be very worrying[69], and the poor condition of infrastructure is responsible for the low efficiency[70] with which Romania can deliver its goods and connect the producers with the consumers, compared to its main trading partners. This is supported by the statistical data published by Eurostat, if we consider the Romania's ranking on the second place among the EU member states, after Estonia, in terms of the share of public investment in GDP (the average over the last 10 years), respectively on the first place regarding the average of the share of public investment in total budget revenues over the same time period, while the quality of infrastructure places our country on the last position within the same group of countries. *Figure 30* shows for all EU Member States the correlation between the average of the last 10 years of the share of investment in GDP and the index of infrastructure efficiency[71]. Countries are grouped according to the median of the share of investment expenditure in GDP over the period 2008-2017 and the infrastructure efficiency index in 2017, in countries with this ratio above the median (characterized by a high efficiency of investment expenditures relative to the quality of the resulting infrastructure and represented in blue), respectively, in countries with a ratio equal to or less than the median, characterized by a lower efficiency of investment expenditures relative to infrastructure quality (represented in red). It is worth mentioning Romania's placement in this latter group of countries in a position that suggests that, from this perspective, the investment expenditures related to the quality of the infrastructure have the lowest efficiency in the EU. Thus, according to the Global Competitiveness Report 2017-2018 Romania is ranked on the 103th[72] position (out of 137 countries) in terms of the overall quality of infrastructure, respectively on the 120th[73] position (out of 137 countries) regarding the quality of roads. Compared with the assessment in the previous year, Romania has continued in 2017 to record a setback on indicators that compose the infrastructure pillar, highlighting chronic problems on the failure to spend adequately the fund for public investment. For comparability with the situation of the other NMS10 countries, Estonia, which in 2017 was the only country positioned ahead of Romania in terms of the share of public investment in GDP

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

[70] Measured by Logistics Performance Index (LPI), which, according to LPI Report developed by WB, is well below that of Germany, Italy and France (for the year 2016, the Report is made once every 2 years). Thus, compared to the previous report, Romania dropped 20 positions in the PLI ranking from 2014, ranking on 60th position in 2016, while Germany ranked 1st place, France 16th place and Italy 21tth position.

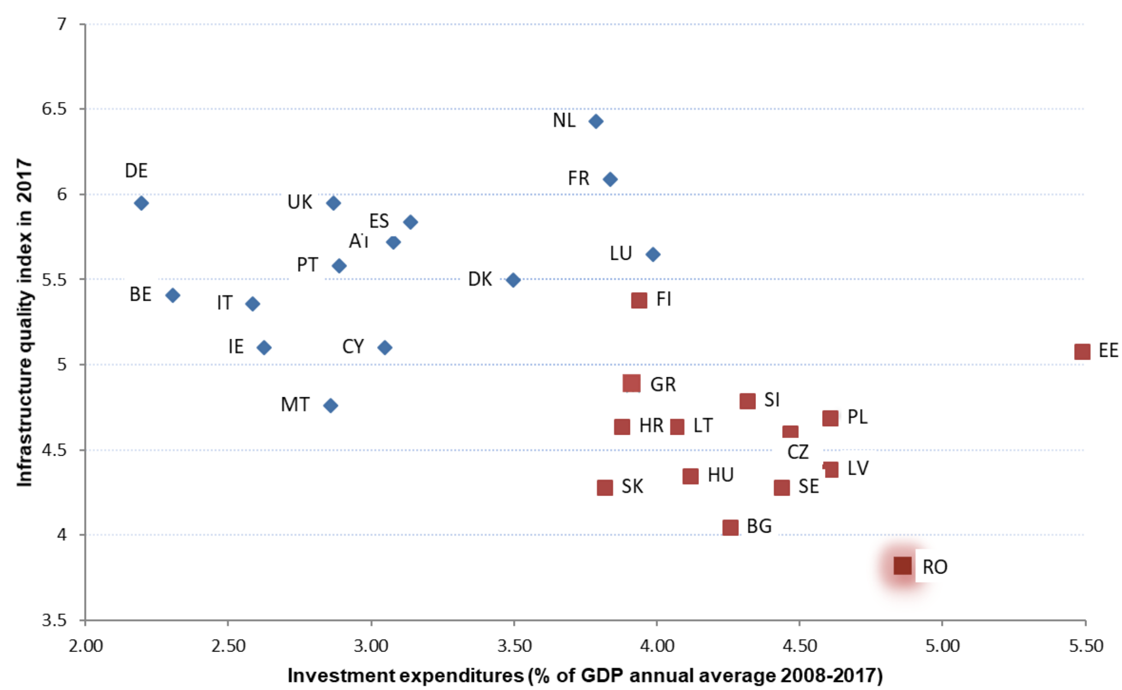
[71] It is taken from the 2017-2018 edition of the Global Competitiveness Report.

[72] A lower position compared with the assessment in Global Competitiveness Report 2016-2017 (place 99/138).

[73] A slight improvement compared with the place 128/138, according to the previous year's Report.

over the past 10 years, was ranked in the Global Competitiveness Report 2017-2018 on the 20th position in terms of overall quality of infrastructure (rising compared with 2016-2017 Report, placed on 22th position) and on 38th position for road quality (also ranked higher than last year, 45 position). According to the same report, Bulgaria occupies 78th place for the overall quality of infrastructure, 93th place for road quality (both upwards compared to the 2016-2017 Report[74]), Hungary placed on 48th position, respectively on 62th, Poland on 61th, respectively on 65th and the Czech Republic placed on 43th position for the overall quality of infrastructure, respectively, on 74th for the quality of roads.

Figure 30: Public investment expenditures and infrastructure quality



Source: Eurostat, World Competitiveness Report 2017-2018

In the case of Romania, there are high efficiency reserves regarding the use of public funds allocated to investments and the Government had initiated during 2013 - March 2014 a reform of the public investment management[75]. In this respect, it was signed a technical assistance

[74] In the previous year's edition ranked 79 for the overall infrastructure quality, respectively, 94 for road quality.

[75] In accordance with the requirements of the new legal framework, prior to approving the budget, the MPF is obliged to present to the Government the list of prioritized significant public investment projects to be financed through the state budget, which are selected according to opportunity, economic and social

contract with the World Bank for the project “Improvement of Public Investment Management”, aiming at improving the process of preparation, selection and strategic prioritization of the public investments projects, that ended in December 2015, and in 2016 the recommendations for improving the selection process of the investment projects and strengthening the role of the Public Investment Unit were implemented (GEO no. 88/2013[76] and GD no. 225/2014). Starting with 2017 are in force the provisions of the Decision no. 907/2016 regarding the elaboration phases and the framework content of the technical and economic documentation related to the objectives/projects financed by public funds in order to eliminate the deficiencies noted in the investment process, to optimize the financing and achievement of the investment objectives and to increase the efficiency of the use of public funds.

For the year 2017 we consider that some improvements were made, large infrastructure projects of over 100 million lei being evaluated and included on a priority list, monitored by a MPF profile unit, those being assigned prioritization scores that line ministries should reflect in their proposed budgets. However, with all the recent advances, the ability to develop and prioritize high quality projects proves to be quite limited.

Moreover, as highlighted in the Country Report of the EC for 2017, it is considered that the failure of systematically using the assessment tools for determining the legislative impact, poor strategic planning investments, delays in the recent reforms and reversal of the reform[77] regarding corporate governance in state-owned companies constitute an impediment to the investment growth. Also, among the reasons for not realizing investment projects are included: maintaining the administrative and regulatory burden, the inefficiencies in public administration and public acquisitions, the lack of predictability for legislation and the lack of timely and efficient consultation of stakeholders. Otherwise, EC noted that in terms of transparency is registered a regress in 2017, noting delays in publishing financial data of state-owned companies, and the new draft law on the establishment of the Sovereign Fund of Development and Investment also excludes this fund from the application field of the Law 111/2016 regarding the Corporate Governance of the public enterprises. And as regard the Master Plan of General Transport of Romania adopted in 2016, which represented an important step towards improving strategic investment in road infrastructures, the performances are slow up to date.

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justification, financial affordability, period remaining until the completion, Romania's commitments to international financial institutions.

[76] Modified in 2015 to align the process of prioritizing significant projects with the budget timetable.

[77] Law no.111/2016 on Corporate Governance was *de facto* canceled in December 2017 by a Parliament amendment which provides for derogation for almost 100 companies, including the largest state-owned enterprises.

The developments from 2012-2017, illustrate that it was maintained the under-execution pattern of investment spending compared with the initial annual planning, which reflects not only an easy way to achieve fiscal consolidation, but also an administrative inability to perform the planned investment projects funded through non-reimbursable EU funds.

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

III.4.4. The contingency reserve fund and the intervention fund at Government's disposal

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

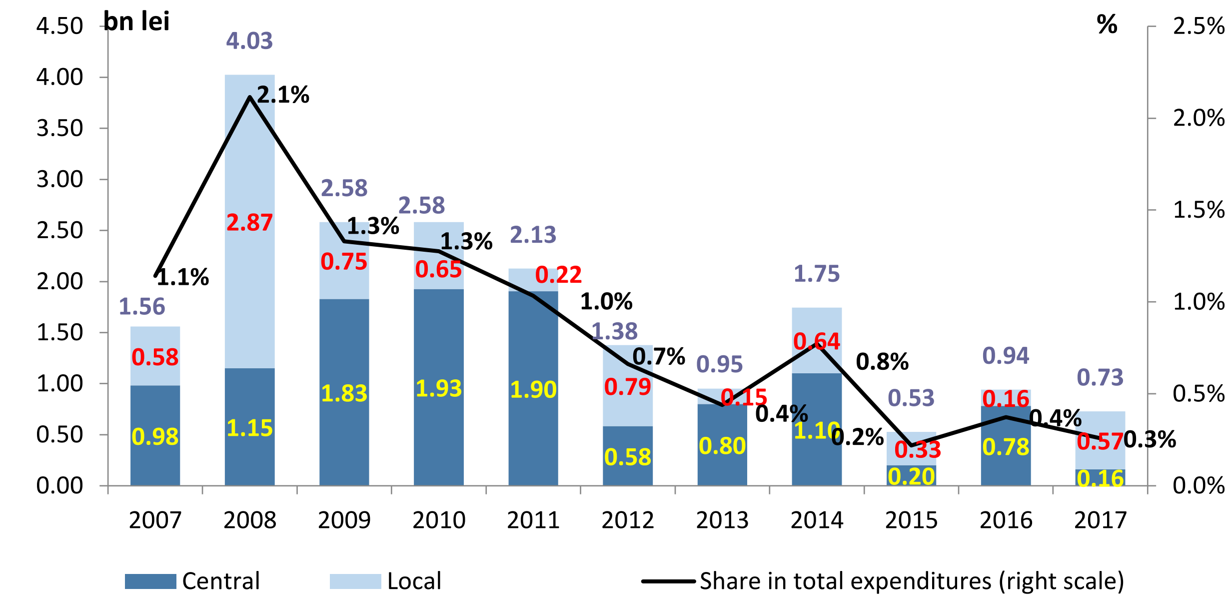
Also, we draw again attention to the emergency ordinances issued by the Government which established the use of money from the contingency reserve fund beyond the framework enforced by the Public Finances Law no. 500/2002, respectively for spending that cannot be classified as urgent or unforeseen expenditures. Thus, during 2017 were issued derogations from art. 30 paragraph (2) of Law no. 500/2002 repeatedly supplementing the expenditures of main authorising officers from the reserve fund. Thus, the Law no. 6/2017 of the state budget for 2017 allowed allocations from the budgetary reserve fund at Government's disposal towards the Ministry of Regional Development, Public Administration and European Funds for the financing of the National Local Development Program. Also, GEO no. 63/2017 regarding the revision of the state budget for 2017 established that, by derogation from the provisions of art. 30 para. (2) of the Law no. 500/2002, can be allocated amounts from the reserve fund to the Ministry of Regional Development, Public Administration and European Funds for programs / projects financed through non-reimbursable funds related to the 2014-2020 financial framework. Furthermore, GEO no. 83/2017 regarding the second revision of the state budget for 2017 allowed allocations from the reserve fund to the main authorising officers for providing social assistance rights, travel facilities benefiting different social categories, ensuring the national contribution and ineligible expenditure for projects funded by non-reimbursable funds, provision of subsidies to support agricultural producers, public service compensation for public passenger rail transport, subsidies for passenger transport by underground railway, as well as for public transport of passengers and goods of strict necessity by river freight between the localities in the Danube Delta and Tulcea and for ensuring the amounts related to interest payments, fees and other costs related to government public debt. These expenses cannot be considered unexpected and should have been considered when drafting the budget.

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

The Court of Accounts, in its Public Report for the year 2016 published in February 2018, identified the following issues regarding the allocations from the reserve fund: the under-evaluation of the necessary budgetary credits in the initial moment of drafting the budgets of the main authorising officers which subsequently led to the need of using resources from the contingency reserve fund available to the Government; regarding the formation and use of the contingency reserve fund at the disposal of the Government in 2016, it was found that 77.87% of the amounts for the whole year were allocated in December. As a result of its findings, the Court of Accounts recommends to the Ministry of Public Finance to pursue the reduction or elimination of the derogations from the rules on the allocation of resources from the Reserve Fund at the disposal of the Government, stipulated in art. 30 par. (2) of the Public Finance Law no. 500/2002, with the subsequent modifications and completions, aiming at "providing funds only for expenditures that justify urgency or unforeseen character occurring during the budget year, for which immediate financing is required and for which the funds existing in the budgets of the main authorising officers are insufficient in relation to their destination, for reasons beyond their will".

This report studies the use of the contingency reserve fund at the Government's disposal during 2017, based on the Government decisions published in Romania's Official Journal by which are allocated amounts to main authorising officers and to specific destinations.

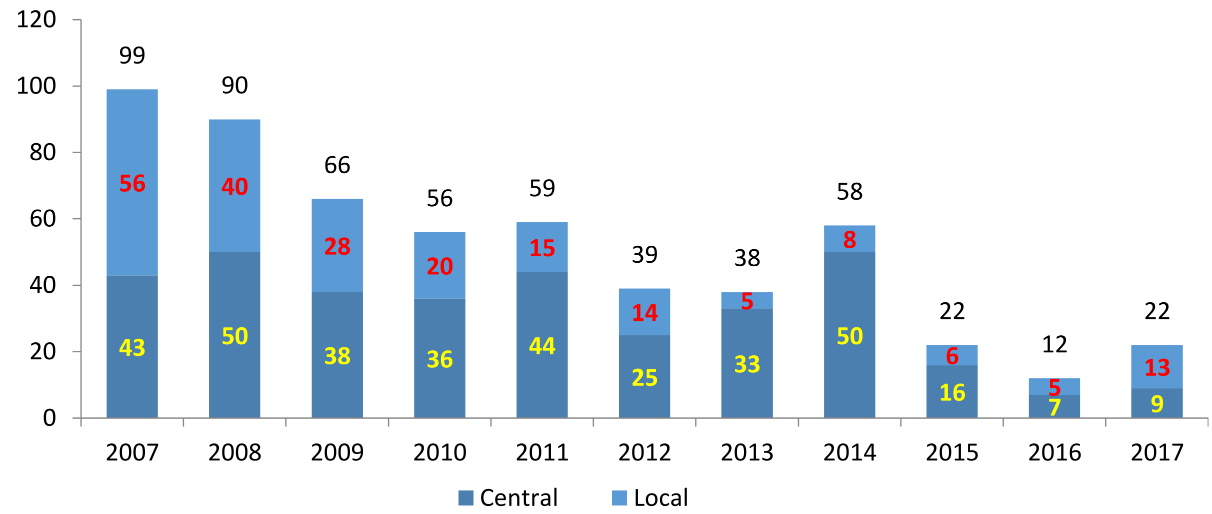
Figure 31: Total contingency reserve fund allocations (billion lei)



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

In 2017, there were allocated from the contingency reserve fund approximately 729.5 million lei (0.3% of the total spending), of which about 160.9 million lei to the central administration and 568.6 million lei to the local authorities. Compared to the previous year, the contingency reserve fund allocations were reduced by 212.8 million lei, i.e. 22.6%, on account of the decrease in transfers to the central administration of about 620.8 million lei, while the amounts received by the local authorities increased by 408.1 million lei. Thus, 2017 recorded the second lowest level of use of the reserve fund in the analyzed period, standing at around half of the 2014 allocations and representing less than one fifth of the peak reached in 2008.

Figure 32: Number of Government decisions regarding contingency reserve fund allocations



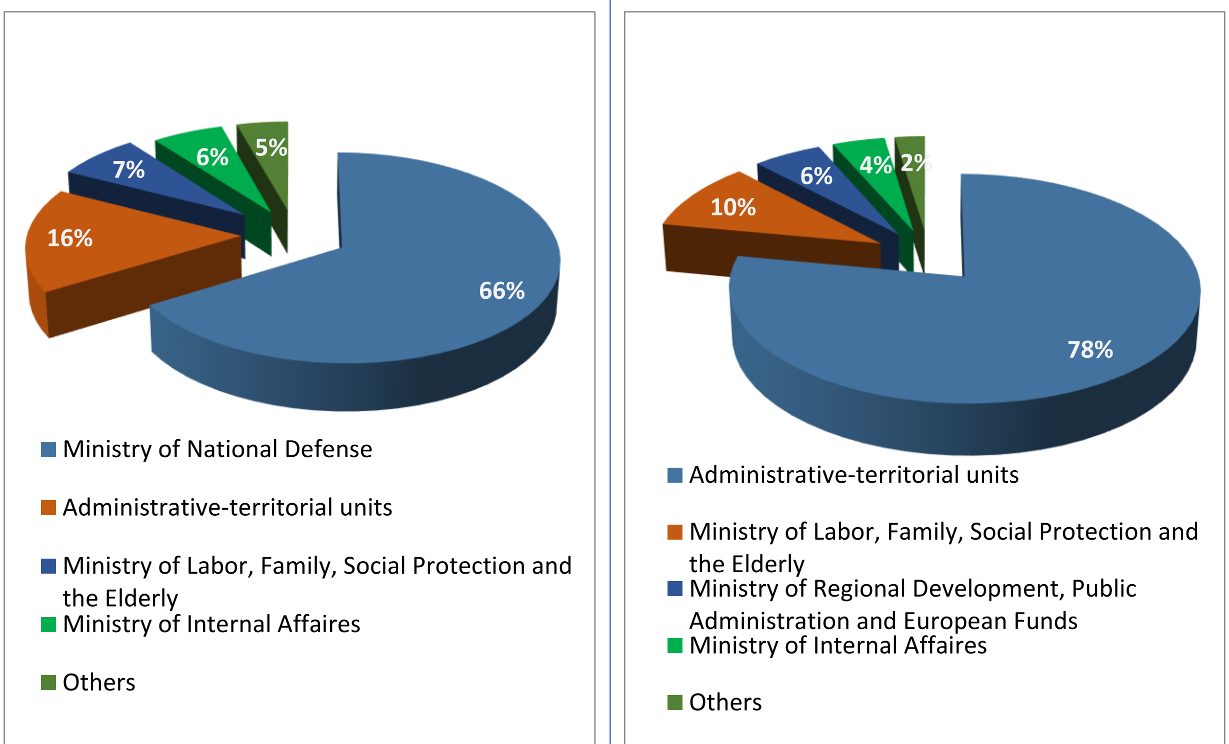
Source: Fiscal Council's calculations based on Government decisions regarding the contingency reserve fund allocations

In 2017, in terms of the number of Government decisions adopted for the purpose of allocating amounts from the reserve fund, there can be noticed an increase from 12 Government decisions in 2016 to 22 in 2017, this level being, however, much lower than the one recorded during 2007-2011. Also, the tendency of the preceding years to decide most spending from the contingency reserve fund in the last month of the year was maintained, 10 out of the 22 Government decisions being approved in December 2017, amounting 364.8 million lei, representing 50% of the allocations for the whole year. This practice makes it extremely difficult to track the amounts spent from the reserve fund and constitutes an additional argument for the discretionary nature of the formation and utilization of this fund.

From the perspective of the destinations for the allocations from the contingency reserve fund at the Government disposal, in 2017, they were mainly directed to the local authorities (78% of the total). The central authority received 22% of the total allocations from the contingency reserve fund, the main beneficiaries being the Ministry of Labor, Family and Social Protection that received 10% of the total, the Ministry of Regional Development, Public Administration and European Funds that received 5.5% of the total and the Ministry of Internal Affairs that received 4.2% of the total amounts allocated from the contingency reserve fund. Comparing the shares of the amounts allocated from the contingency reserve fund in the last two years (as shown in *Figure 33*) it can be observed that the main beneficiary in 2017 is represented by the local authorities that received 568.6 million lei, while in 2016 the allocations were directed mainly towards the central authority (781.7 million lei, i.e. 83% of total), the local authorities benefiting of allocations from the contingency reserve fund amounting 160.6 million lei (17% of total).

Figure 33: The beneficiaries of allocations from the contingency reserve fund (% of total allocations)

2016 **2017**



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

Based on the analyses elaborated in previous years, regarding the manner of using the amounts from the contingency reserve fund, the Fiscal Council revealed the lack of transparency in terms of their utilization, the nonexistence of explicit identification criteria of the expenditure that can be made from the contingency reserve fund, the absence of a Parliamentary or of other institution's control of the money utilization and formulated strong recommendations regarding amending the legislation that regulates the contingency reserve fund use. The Fiscal Council notes, however, in 2017, the lack of progress regarding the manner of using the amounts from the reserve fund.

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

According to the article 30, paragraph (4) of the Public Finance Law no. 500/2002, the intervention reserve fund at Government's disposal is allocated, based on government decisions, to main authorising officers of the state budget and local budgets, to finance urgent expenditures designed to eliminate the effects of natural disasters and to support the individuals affected. If the possible destinations of the allocations from the contingency reserve fund can be interpreted differently, in the case of the intervention fund, the allocations' destinations are clearly indicated in the law, the existence of such a fund being fully justified. During a year, this fund may be increased by allocations from the contingency reserve fund, depending on the needs regarding the amounts that are necessary for the removal of the effects of natural disasters. In 2017, the amounts allocated from the intervention reserve fund at Government's disposal amounted 68.7 million lei, their destinations being in accordance with the Public Finance Law no. 500/2002.

III.5. The public debt

The interest expenses in 2017, expressed in cash terms were very close to the value registered in 2016 (a slight increase of 1.11%, respectively +111 million lei), but their share in GDP decreased by 0.13 pp, from 1.31% to 1.18%, in the circumstances of a 12.6% nominal GDP advance. This development arises in the context of the 5.55% increase in the stock of debt, but the stagnation of interest expense can be explained by refinancing at lower costs of the amounts of debt that reached maturity. The final value of this expenditure chapter was close to the projection in the initial budget (with a difference of only -60 million lei, representing about -0.6%), suggesting a realistic assessment of this budgetary aggregate at the moment of drafting the budget.

Even if the public debt increased by 5.55% (+15.82 billion lei), according to ESA 2010 methodology, its share in GDP registered a significant decrease, from to 37.4% to 35.0% at the end of 2017 compared to previous year, as a result of sustained economic growth. On the other hand, according to national standards, the public debt increased by more than 29 billion lei (8.6%) while its share in GDP diminished from 44.5% of GDP at the end of 2016, to 42.9% in 2017.

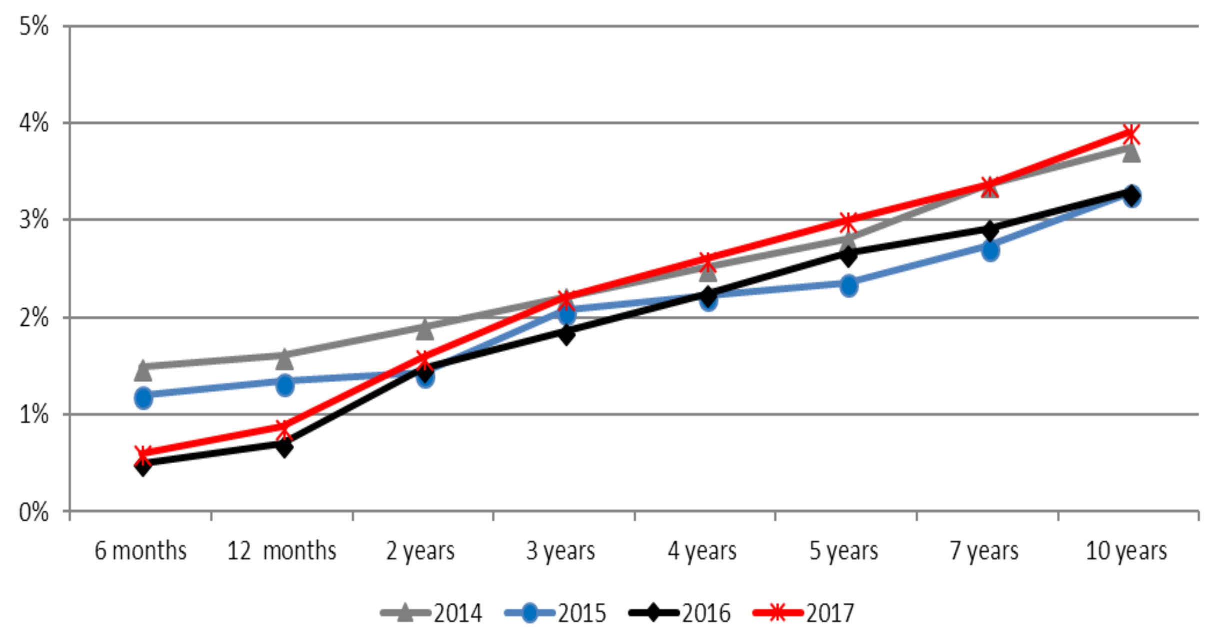
The average interest rate paid on public debt continued its downward trend in 2017, dropping to 4.0% from 4.3% in 2016. This development was anticipated in the 2016 Annual report elaborated by the Fiscal Council, by affirming that this decline should continue in the coming years given the much lower current expenses for debt refinancing and the relatively low average maturity of the public debt. The cost of attracting new resources in national currency registered a positive development in 2014-2016, due to the inclusion, starting with July 2014, of the bonds issued by the Romanian state in the calculation of the GBI-EM Global Diversified index series by JP Morgan, the extension of the average maturity of public debt, a loose monetary policy of the central bank, the obtainment of a BBB- rating from Standard & Poor's in May 2014[78], but also due to a liquidity surplus in the financial markets. On the other hand, the year 2017 marked a reversal of this trend by recording increases in the cost of attracting new resources in national currency for all maturities considered, the increase compared to 2016 ranging from +0.1 pp for maturities of 6 months to +0.62 pp for a maturity of 10 years (see *Figure 34*).

Regarding the cost of attracting new resources in foreign currency from the external markets[79], the Government was able to borrow cheaper in 2017 compared to 2016 in euros, the yields obtained for a maturity of 10 years being 2.41%, respectively 2.11% (compared to the level of 2.55% in 2016), and 3.55% for a maturity of 20 years compared to 3.9% in 2016.

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

[79] During 2017, Romania attracted from external markets 2.75 billion euro through two Eurobond issuances in April and October 2017, respectively of 2 billion euro for a period of 10 years and 0.75 billion euro with a residual maturity of 18 years.

Figure 34: The evolution of financing costs in national currency in the period 2014-2017



Source: NBR

The currency structure of the public debt shows an increase in the share of national currency loans from 52.7% in 2016 to 54.4% in 2017, while euro-denominated loans remained at a similar level to the previous year (38.3% compared to 38.2% in 2016). Thus, euro-denominated loans increased due to the two Eurobonds issuances in 2017, but their growth rate was similar to that of the government debt. On the other hand, in the absence of borrowing on the US market, the share of dollar-denominated debt decreased from 8.3% in 2016 to 6.7% in 2017.

Regarding the structure of the public debt[80], in 2017 has continued the process of increasing the share of the central administration debt (from 95.3% to 95.9%), while local debt decreased from 4.7% to 4.1%. Government bonds have the largest share in total debt, cumulating 37.2% of the total (compared to 36.1% in 2016), followed by euro-bonds with 27.1% (compared to 25.9% in 2016), state loans which represent 18.4% (compared to 21.4% in 2016) and treasury bills that provided 2.4% of total public debt financing (compared to 3.7% in 2016).

In what concerns the maturity structure of government securities newly issued in 2017, the trend of attracting longer-terms resources initiated in the last years continued. Therefore, the treasury bills with maturities lower than 1-year totaled approximately 27.1% of new loans in 2017, decreasing compared to the share of 29.8% recorded last year. Thus, the share of funding over longer periods has advanced compared to the period 2009-2012 (the share of treasury bills with

[80] According to the national methodology.

maturities lower than 1 year totaled 65% of new loans in 2009). The bonds with maturities of 1 to 5 years have a share of 47% in total issued securities in 2017 (compared to 41% in 2016), while those with a maturity of 5 to 10 years have a share of 23.7% in 2017 (compared to 23.5% in 2016), and those over 10 years have a share of 4.5% (from 5.7% in 2016). The preference in the last years of the state for borrowing on a longer-term was favored both by lower yields, excess liquidity in the financial markets as well as an improved risk perception regarding Romania. However, it should be noted that, despite the trend of attracting resources for longer periods, the residual average maturity of government securities issued on the domestic market decreased from 4.02 years in 2016 to 3.72 years in 2017.

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

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

Where d_t is public debt stock at time t, y_t represents nominal GDP at time t, pb_t – is primary deficit at time t, sfa_t - stock-flow adjustments at time t, and

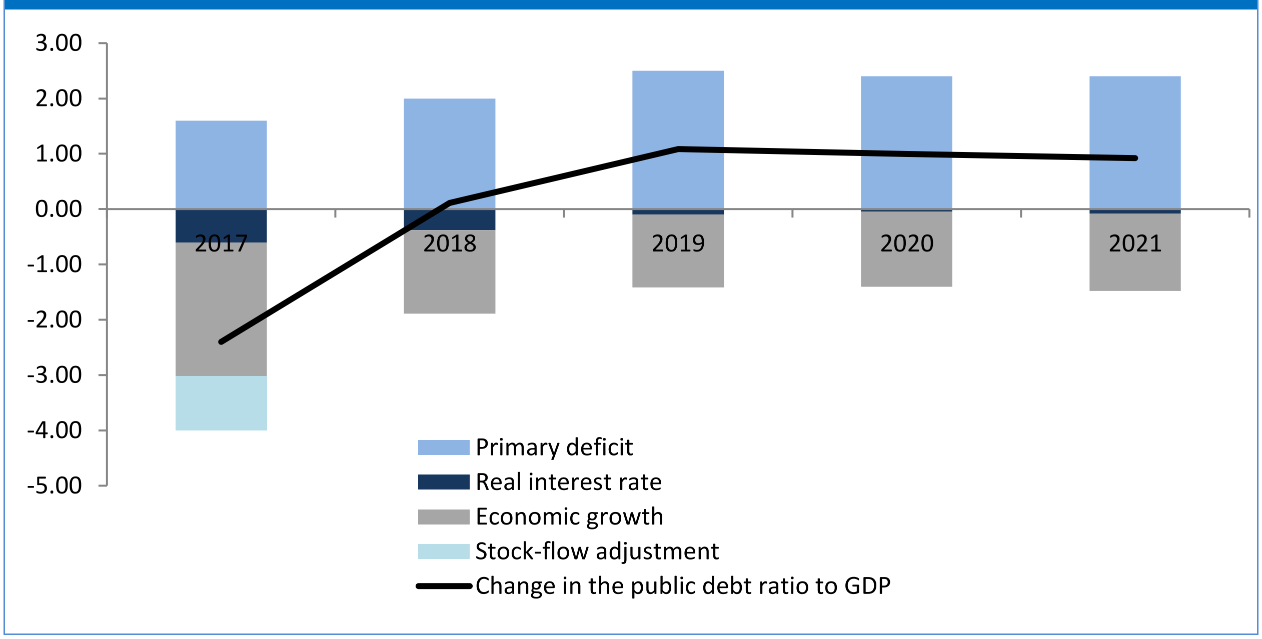
$$1+\lambda_t = \frac{1+i_t}{(1+\pi_t) * (1+\gamma_t)}$$

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

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

The year 2017 marked a significant decrease in the share of public debt as a percentage of GDP, respectively, by -2.4 pp. Using the dynamic equation presented above, a number of favorable contributions can be identified (in the sense of reducing the government debt ratio in GDP) from: the real economic growth (-2.41 pp), real interest rate (-0.61 pp) and stock-flow adjustments (-0.98 pp). On the other hand, the primary deficit registered in 2017 contributed to the increase of the share of public debt in GDP by +1.6 percentage points. As for the stock-flow adjustments, it acted in the sense of diminishing the public debt ratio to GDP due to the super-dividend paid in 2017 by the state-owned companies from the accumulated reserves (which is assimilated to a disinvestment according to ESA methodology) coupled with the reduction in liquidity reserves available in the State Treasury and the fees paid by Enel to the Romanian state according to the Paris Arbitration Court's decision. On the other hand, an unfavorable influence was exerted by the depreciation of the leu against euro (2.6% increase in the rate of exchange at the end of 2017 compared to the same period of the previous year), this factor being also found in the stock-flow adjustments. It should be noted that the remarkable high economic advance registered in 2017 (6.9%) have overlapped with a negative real interest rate (-1.7%), which led to a negative value for the coefficient λ_t and implicitly to a significantly favorable impact to the dynamics of the government debt expressed as a percentage of GDP. Concluding, in 2017, the negative impact of the higher budget deficit on the public debt path was overshadowed by a very high economic growth rate coupled with a negative real interest rate (due to high inflation rate), as well as by the influence of the stock -flow adjustments.

Figure 35: Contributions to changes in public debt as share of GDP in the period 2017-2021



Source: EC, MPF, Fiscal Council's calculations

For the estimation of the determinant factors' contributions to the changes in the public debt ratio to GDP in the period 2018-2021, the official EC forecasts for real GDP growth, the budget deficit as a share in GDP and the GDP deflator were used[81]. As the EC does not make projections of the interest spending for the government debt, the estimates for this indicator have been taken

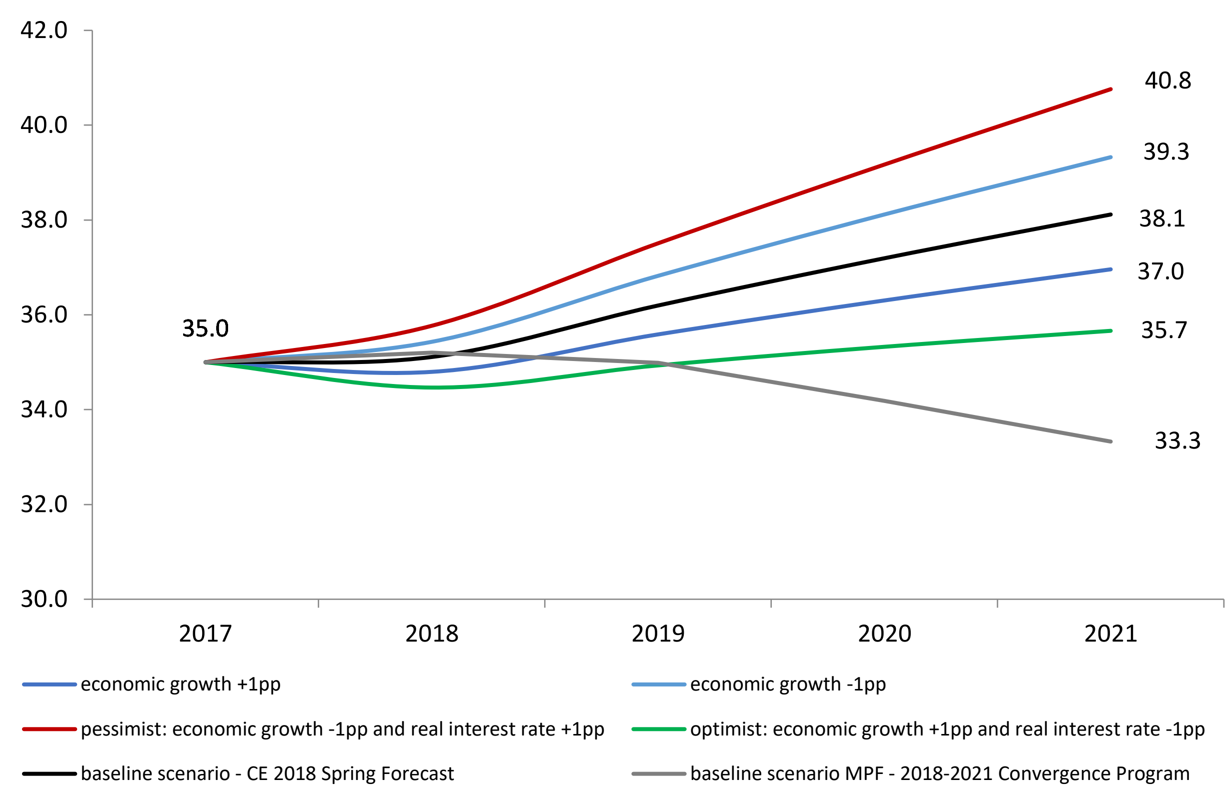
[81] Spring forecast of May 2018. As the forecast horizon of EC is for only 2 years, for the years 2020 and 2021, the projected values for 2019 were maintained.

from the Convergence Program 2018-2021, while the stock-flow adjustments were assumed to be zero. Thus, on the basis of the EC forecasts, a gradual advance of the public debt ratio is projected during the period 2018-2021, from 35% of GDP in 2017 to 38.1% of GDP in 2021. It should be noted that this evolution is based on the economic growth rates projected by the EC which are significantly lower than those predicted by the Government (an average spread over 1.5 percentage points), while budget deficits assessed by the EC are at a higher level than those laid down in the Convergence Program (an average difference of almost 1 pp). Thus, the estimates for 2018 in the Convergence Program provide an economic advance of 6.1% and a budget deficit of 3% of GDP, while the EC forecast is anticipating an economic growth of just 4.5%, accompanied by a budget deficit of 3.4% of GDP that would exceed the 3% benchmark set in the corrective arm of the SGP. Although the Convergence Program foresees a significant fiscal consolidation (totaling 1.5 pp of GDP) since 2019, it is not accompanied by concrete measures to support it. In the absence of such measures, the budget deficits for the period 2020-2021 not covered by the EC forecast were assumed at the level of the year 2019. On the other hand, the EC forecast foresees much higher levels of GDP deflator compared to the government estimates, leading to a negative real interest rates that partially mitigate the public debt advance. In conclusion, the projections for the evolution of the government debt ratio in GDP for the 2018-2021 horizon, based on the 2018 EC Spring Forecast, show a gradual increase of this indicator, especially starting 2019 (see *Figure 35*). In terms of the contribution of the determinant factors, the upward trajectory is driven by high budget deficits, while sustained economic growth and negative real interest rates exert a favorable impact.

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

For the construction of the scenarios we used the MPF projections from the Convergence Program 2018-2021 and the 2018 EC Spring Forecast. Thus, there are two baseline scenarios: one based on EC forecast, as described in the previous paragraphs, in which the EC's projections for the budget deficit, economic growth and GDP deflator were used (for the years 2020-2021, not covered by the EC forecast, the same values were assumed as in 2019), and the other, the MPF scenario based exclusively on the forecasts made under the Convergence Program 2018-2021. Thus, if the EC scenario foresees a gradual increase of the government debt to GDP ratio to 38.1%, the MPF scenario estimates a gradual decrease of the indicator starting with 2019 to 33.3% of GDP. The almost 5 pp difference between the two underlying scenarios has as main sources the higher budget deficits projected by the EC compared to those anticipated by MPF, as well as the lower economic growth predicted by the EC compared to MPF. On the other hand, as mentioned above, the EC forecast provides higher levels of GDP deflator compared to MPF estimates, which is likely to further mitigate the gap between the two projections. These differences clearly show both the sensitivity of the public debt path to the assumptions used and the increasing risks to the evolution of the public indebtedness.

Figure 36: Scenarios for the evolution of public debt (% of GDP)



Source: EC, MPF, Fiscal Council's calculations

Starting from the baseline scenario built with EC data - also taking into account the Fiscal Council's budget deficits estimates for the following period, which are closer to the EC's ones - several scenarios were built (see *Figure 36*):

- two optimistic scenarios, characterized by an economic growth higher than the EC projected one by 1 pp (and thus closer to government forecasts), adding to the second scenario a lower real interest rate by 1 pp. It is interesting to note that although the share of public debt is projected to decline in 2018, both scenarios anticipate an increasing trajectory of the indicator since 2019, at the end of the forecast horizon reaching 37% of GDP for the first scenario, respectively of 35.7% of GDP for the second scenario

- two pessimistic scenarios. For the first one the real GDP growth rate is lower by 1 pp, and for the other scenario was added a real interest rate higher by 1 pp. Both scenarios show an increasing trend starting 2018, at the end of the forecast horizon, the public debt reaching 39.3% for the first scenario, respectively, 40.8% of GDP for the second one.

It should be noted that compared to the baseline EC scenario and the four alternative scenarios elaborated, only the MPF forecast provides a downward trajectory of public debt. Moreover, even in the most optimistic scenario, the projected public debt for 2021 is by 2.4 percentage points higher than the MPF estimates. On the other hand, additional risks to the scenarios under consideration arise from potential negative exchange rate shocks, given the relatively high share of public debt denominated in foreign currencies. However, a favorable result of the sensitivity analysis is that the 45% threshold of the public debt in GDP, defined by the FRL, is not exceeded even in the most pessimistic scenario.

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

Furthermore, an additional constraint is related to the relatively high size of public debt as compared to the domestic financial sector and its most likely limited absorption capacity of an additional public debt stock at the current financial intermediation level. Thus, at the end of 2017, the share of Romania's public debt in total banking assets was about 65%, this level being high compared to the other EU member states. Also, the exposures to the government sector compared to total assets for local banks, the main holder of public debt on the domestic market, is among the highest in the EU (19%). The corollary of such situation is most likely to be an increased dependence on non-resident investors, which is associated with a rising vulnerability to interest shocks and changes in risk appetite in the global financial markets as well as a possible sovereign rating change. The current global financial markets, characterized by the abundance of liquidity, currently overshadow these vulnerabilities, but a deterioration in liquidity conditions may arise quickly, especially given the expected increase in interest of the US central bank (FED) and the current complicated global context.

The Fiscal Council considers that the next period, which coincides with the upward phase of the economic cycle, should be used to reduce indebtedness, as the current trajectory of the government debt ratio in GDP may lead to the accumulation of excessive vulnerabilities that

would become fully visible in a future downward phase of the economic cycle. High GDP growth largely conceals the rise in public debt as a percentage of GDP, with vulnerabilities having the potential to be quickly unveiled in the context of adverse cyclical developments. In addition, the continuing growth of public debt above 40% of GDP may become problematic at the current level of development of the economy and its limited absorption capacity by the local financial markets.

IV. The absorption of EU funds

In the 2014-2020 financial framework, as highlighted by the data provided by the Ministry of European Funds (MEF)[82], for Romania has been allocated structural and investment European funds (SIEF) of about 31 billion euro. The allocation for the Cohesion Policy, funded under the SIEF, is about 22.6 billion euro, being directed to seven operational programs: Regional OP, Infrastructure OP; Competitiveness OP; Human Capital OP; Administrative Capacity OP; SMEs Initiative OP and Technical Assistance OP. To this is added 19.3 billion euro for the Common Agricultural Policy[83], 168.4 million euro for the Operational Program for Fisheries and Maritime Affairs (OPFMA) and 441 million euro for the Operational Program for Assistance to Disadvantaged People (PADP). Including Cross-border Co-operation funding as well as those under the Connecting Europe Facility (CEF), Romania has more than 43 billion euro available under the Multi-Annual Financial Framework 2014-2020. Coordinated by the EU Cohesion Policy, the Structural and Cohesion Funds[84] are financial instruments designed to eliminate economic and social disparities between regions, supporting Member States' convergence, increased competitiveness and employment. Taking these issues into account, **this report analyzes the absorption of European funds in Romania, considering only Structural and Cohesion Funds[85]**.

Considering the obligation of Member States to contribute to achieving Europe 2020 strategy objectives, each country draws up a National Reform Programme (NRP) which transposes the EU's overall objectives into national targets and which is transmitted together with the Stability and Convergence Programme, both programs being integrated into the national budgetary plans for the next three years. Each Member State is faced with different economic circumstances and implements the overall objectives of EU in national targets by national reform programs, a document containing policies and measures in support of smart, sustainable and inclusive growth, high levels of employment and achieving the targets set by the Europe 2020 strategy.

In the 2017 NRP submitted by Romania to the European Commission in April 2017 were defined the reforms and development priorities, taking into account the priorities set out in the Annual Growth Survey 2017, the Country Report's recommendations for Romania in 2016 and the

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[82] According to the absorption stage for SIEF funded programs on 02 February 2018.

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

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

[85] The analyzes carried out by the MFE and EC on the absorption rate include the funding allocated through the NRDP and OPFMA.

measures taken in the context of the Europe 2020 strategy. Among the main directions of action set in the NRP in 2017, there may be mentioned: the modernization of labor market institutions and the integration into the labor market of people looking for a job or for those who are inactive; stimulating private investment in research, development and innovation by providing tax incentives and project funding; financing investments targeting the use of renewable energy sources; supporting investments in installations and equipment that lead to energy savings and thermal rehabilitation of residential buildings; reducing the school dropout rate; increasing the quality of higher education and correlating it with the labor market; increasing the quality of life of the rural population, increasing the quality of social services and reforming the national health system. It is important to note that the many priorities and development directions of NRP 2017 are fully or partially funded by European funds, so that the absorption of these funds is a relevant indicator of the capacity to meet the proposed objectives.

Compared to the 2007-2013 financial framework, for the 2014-2020 financial framework, there has been a change in the direction of EU policy towards achieving the Europe 2020 objectives, as set out in EC Commission position papers and Country Specific Recommendations. The total budget for the Cohesion Policy 2014-2020 is valued at about 355 billion euro and more than half of this budget (about 53%) is allocated to the group of new EU member states from Central and Eastern Europe: Bulgaria, the Czech Republic, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Hungary. As stated in the beginning of this chapter, Romania benefits from an allocation of about 22.59 billion euro from the structural and cohesion funds, higher if compared to the budget of 18.78 billion euro allocated for the 2007-2013 financial framework. At the level of operational programs, the following distribution of European funds is evidenced (see *Table 12*):

- Infrastructure OP, with a financing of 9.22 billion euro, resulted from the merger of the Sectoral Operational Program Transport and the Sectoral Operational Program Environment for the period 2007 - 2013, with a cumulated budget of 8.7 billion lei;
- Human Capital OP continues Human Resources OP from the previous period, including a new Youth Employment Initiative, and has a funding of 4.37 billion euro, higher by 1.17 billion euro compared to the period 2007 - 2013;
- The operational programs that registered high rates of absorption in the 2007-2013 financial exercise received funding by more than 65% higher (OP Regional Development OP - 6.76 billion euro compared to only 3.97 billion euro and Administrative Capacity Development OP - 0.55 billion euro compared to 0.21 billion euro);
- Technical Assistance OP has received 0.25 billion euro, also increasing compared to the period 2007-2013 when 0.17 billion euro were allocated;
- The only operational program that suffered a reduction in the allocated funds is Competitiveness OP, its budget decreasing from 2.54 billion euro to 1.33 billion euro;

- SMEs Initiative OP is a newly introduced operational program, with an allocation of only 0.1 billion euro.

Table 12: Comparison between the allocations for 2007-2013 and 2014-2020 (billion euro)

Total allocations 2014-2020		Total allocations 2007-2013	
	European funds		European funds
Regional Development	6.76	**Regional Development**	3.97
Large Infrastructure	9.22	**Environment**	4.41
		Transport	4.29
Competitiveness	1.33	**Competitiveness**	2.54
Human Capital	4.37	**Human Resources**	3.20
Administrative Capacity Development	0.55	**Administrative Capacity Development**	0.21
Technical Assistance	0.25	**Technical Assistance**	0.17
SMEs Initiative	0.1		
Total	**22.59**	**Total**	**18.78**

Source: EC, MEF

Analyzing the data provided by the EC at the end of April 2018 (see *Table 13*), it can be noticed that Romania continues to have a low absorption capacity of European funds, with an overall absorption rate of 9.34% (including the arranged pre-financing[86]) of the total funds allocated during the 2014-2020 programming period. At the level of the operational programs, the highest absorption rates were recorded by the programs with the lowest initial allocations: SMEs Initiative OP (83.78%), with a financing of only 100 million euro, followed by the Technical Assistance OP (22.61%), with a financing of 252.77 million euro. On the third place is ranked the Infrastructure OP with an absorption rate of 13.15%, followed by the Development of Administrative Capacity OP (10.8%) and Competitiveness OP (10.47%). The lowest absorption rates for the structural and cohesion funds are recorded by Human Capital OP (6.26%) and Regional Development OP (4.19%).

[86] According to GEO no. 64/2009, pre-financing is the amount transferred from structural instruments to beneficiaries through direct payment or indirect payment at the initial stage to support the start of the projects and/or during their implementation under the terms of the contract/decision/order for financing concluded between a beneficiary and the Managing Authority/the responsible intermediary body, in order to ensure the proper execution of the projects financed under the operational programs.

Up to this moment, the EC has been requested to provide approximately 1.24 billion euro for the following operational programs: Large Infrastructure OP (953.7 million euro), SMEs Initiative OP (93 billion euro), Competitiveness OP (86 billion euro) Technical Assistance OP (49.5 million euro), Regional OP (27 million euro), Administrative Capacity OP (25.5 billion euro) and Human Capital OP (3.9 billion euro). Following the submission of applications for payments, the EC made reimbursements of around 1.14 billion euro, the breakdown by operational programs being available in the table below.

Table 13: Structural funds absorption by operational programs for the period) 2014-2020 (million euro)						
	Total allocations 2014-2020 (cumulative)	Payment April 2018			Absorption rate April 2018	Absorption excl. pre-financing April 2018
		Total, out of which	**Pre-financing**	**EU Refunds**		
Regional Development	6,760.00	283.52	251.60	31.92	4.19%	0.47%
Large Infrastructure	9,218.52	1,212.30	354.01	858.29	13.15%	9.31%
Competitiveness	1,329.79	139.24	49.94	89.30	10.47%	6.72%
Human Capital	4,371.96	273.80	270.30	3.50	6.26%	0.08%
Administrative Capacity Development	553.19	59.73	34.45	25.28	10.80%	4.57%
Technical Assistance	252.77	57.14	8.51	48.63	22.61%	19.24%
SMEs Initiative	100.00	83.78	0.00	83.78	83.78%	83.78%
Total	**22,586.23**	**2,109.51**	**968.80**	**1,140.70**	**9.34%**	**5.05%**

Source: MEF, Fiscal Council's calculations

Table 14 presents an analysis of the situation in Romania compared to the other NMS CEE countries, based on the available data at the end of April 2018. The vast majority of these states (including Romania) received structural and cohesion funds allocations for the period 2014-2020 higher than in the previous financial year, with the exceptions being the Czech Republic (21.53 billion euro compared to 26.53 billion euro), Slovenia (3.07 billion euro compared to 4.1 billion euro) and Latvia (4.42 billion euro against 4.53 billion euro). On the other hand, if reporting the allocations received per inhabitant[87], shows that Romania is positioned on the penultimate place with about 1,132 euro/inhabitant, just ahead of Bulgaria (1,024 euro/inhabitant). On the opposite side, seven of the eleven analyzed countries registered allocations of over 2,000 euro per inhabitant, the highest values being recorded by Estonia (2,659 euro/inhabitant), Slovakia (2,532 euro/inhabitant), Lithuania (2,279 euro/inhabitant) and Latvia (2,208 euro/inhabitant). Compared with the period 2007-2013, the Baltic States retained some of the highest per capita allocations, Poland and Slovakia have risen significantly, while the Czech Republic and Slovenia have undergone significant decrease of this indicator.

From the perspective of absorption rates for structural and cohesion funds[88] registered at the end of April 2018, Romania is also ranked in the penultimate place, with only 9.34%. The last position is the newest member of the EU, Croatia, with an absorption rate of 8.52%. All the other countries included in the analysis had absorption rates higher than 12.5%, the largest values being recorded for Lithuania (20.11%), Estonia (19.85%), Poland (17.77%) and Hungary (17.73%). Thus, there are important differences between Romania and Croatia compared to the rest of the ranking, and measures are needed to recover the existing gap.

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

[88] The absorption rates for the funding provided under CF, ERDF and ESF, including the „Youth Employment Initiative" were considered.

Table 14: Absorption of structural funds for the period 2007-2013 – comparison with other EU member states					
	Total allocations 2014-2020 billion euro	Payments April 2018 billion euro	Absorption rate April 2018 %	Total allocations/ inhabitant 2014-2020 euro	Total payments/ inhabitant 2014-2020 euro
Bulgaria	7.42	1.16	15.64	1,024.44	**160.27**
Croatia	8.45	0.72	8.52	1,989.40	**169.54**
Estonia	3.50	0.69	19.85	2,659.33	**527.93**
Latvia	4.42	0.73	16.43	2,207.50	**362.76**
Lithuania	6.71	1.35	20.11	2,279.42	**458.33**
Poland	76.88	13.66	17.77	2,022.28	**359.38**
Czech Republic	21.53	3.01	14.00	2,047.89	**286.80**
Romania	**22.59**	**2.11**	**9.34**	**1,132.29**	**105.75**
Slovakia	13.71	1.96	14.30	2,531.75	**361.94**
Slovenia	3.07	0.40	12.97	1,488.50	**193.11**
Hungary	21.54	3.82	17.73	2,181.16	**386.69**

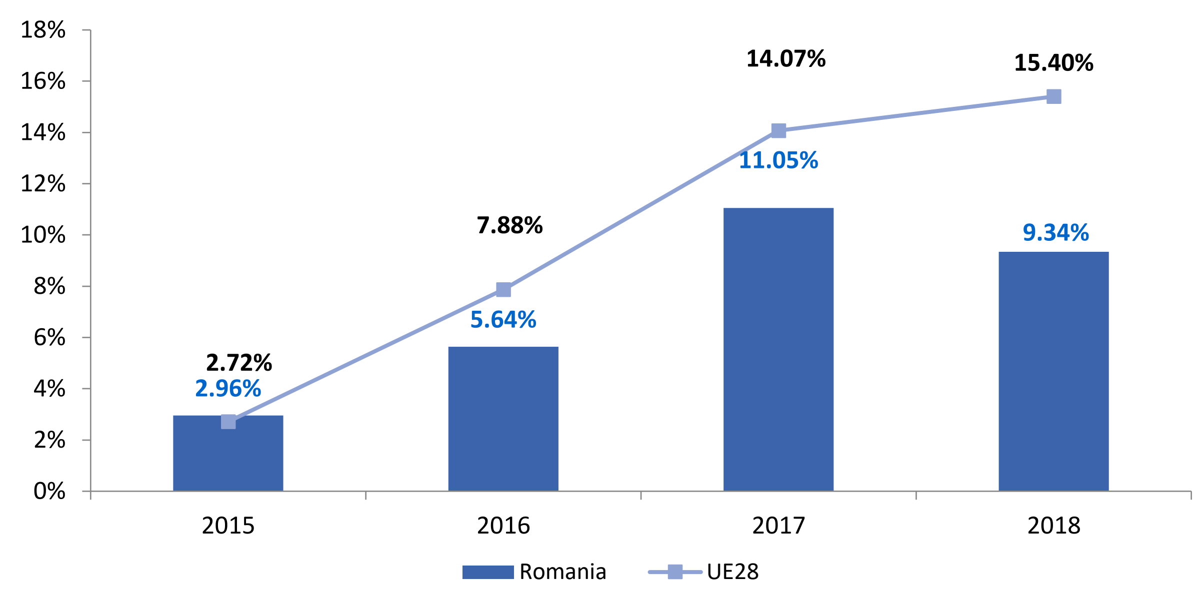
Source: EC, Eurostat, Fiscal Council's calculation

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

Analyzing the dynamics of the structural and cohesion fund absorption rates (see *Figure 37*), it can be noticed that the 2014-2020 financial exercise had a difficult start not only in Romania but also across the EU member states. The legal framework for this period was finalized late by the EC, European Parliament and Member States, mainly affecting those countries who lack experience and administrative capacity to recover the delays. As in the case of the 2007-2013 financial exercise, in the early years were registered very low absorption rates, Romania being in the vicinity of the average recorded at European level. But since 2017 a new problem emerges from the gap with the EU average, its level being even more pronounced according to the latest available data (April 2018). Although this trend is still at an early stage (the data series being too short to allow extrapolation of future absorption rates) it raises questions about the possibility of recurring difficulties in the absorption of European funds similar to those in the previous financial year. However, a surprising aspect is the decrease in the absorption rate of structural and cohesion funds in the first four months of 2018 compared to the situation recorded at the end of 2017. A more detailed analysis shows that this trend is the result of the decrease in the annual pre-financing by over 435 million euro. The reduction of the annual pre-financing affected most operational programs (Infrastructure OP by -232.3 million euro, Regional Development OP by -162.5 million euro, Competitiveness OP by -32.8 million euro, Technical Assistance OP by -5.6

million euro and SMEs Initiative by -2.6 million euro), which caused the decline in the absorption rate from 11.05% to 9.34%.

Figure 37: Evolution of EU funds absorption rate: Romania versus EU 28 average, 2015 – April 2018 (financial exercise 2014-2020)



Source: EC, Fiscal Council's calculations

The Country Report for Romania, published by the EC in March 2018, identified several factors contributing to the preservation of a low rate of absorption of European funds as well as for the application of financial corrections. Thus, there were highlighted significant inefficiencies in the management of public investment, as well as the lack of strategic planning in the medium and long term, which hinder the development of the infrastructure. At the same time, increasing the transparency and efficiency of the public procurement system is essential for the development of public investment. Another important aspect is that, in the absence of adequate strategic planning, Romania has no new projects in preparation to boost the absorption of the European funds. Last but not least, it was found that the project selection and prioritization mechanisms are fragmented, their standardization being recommended.

The absorption of EU funds remains an objective of national interest and a solution for stimulating the economy, especially in the context of the constraints imposed by the new Fiscal Compact. At the same time, structural funds and investment spending generate positive effects in society: improving quality and increasing access to healthcare, improve basic transport, infrastructure for water and waste, ensuring better integration of services for labor employment, social services and the education etc. The importance of attracting European funds is also highlighted by the EC forecasts on Romania's economic growth. Thus, in 2018 it is expected that the real GDP growth will be supported by a revival of investment by around 7.4% amid the progress in the implementation of projects financed from European funds. In this context, the difficulties related to the European funds absorption can have serious consequences, jeopardizing the economic growth projections.

Given the slow start of the implementation of the 2014-2020 programming period, doubled by a gradual deepening of the gap between the EU average (as measured by the latest available data), further efforts are needed to increase the absorption rate of the European funds. For this purpose, it is imperative that the issues identified in the previous financial period to be settled and to take into account that an early preparation of projects and increasing the administrative capacity for the European funds planning and management constitute key factors for speeding up the absorption rate. Despite progress in the public procurement reform, the slow implementation of the structural measures, difficult administrative procedures, lack of a stable hierarchy of priorities and strategic planning are important obstacles in the process of accessing European funds.

V. The sustainability of public finances

V.1. Arrears of the general consolidated budget

The evolution of the general consolidated budget's stock of arrears[89] to the private sector in 2017 indicates that it currently does not represent a major problem, as in the recent years a process of improving financial discipline, both at central and local level took place. At the end of 2017, the arrears registered a level of 308.5 million lei, increasing, however, by 106.6 million lei compared to the previous year.

As regards the outstanding payments with a delay of less than 90 days, that do not belong to the category of arrears according to the Public Finance Law no. 500/2002, they have reached a level of 601.7 million lei at the end of 2017, significantly higher compared to the previous year level (477.4 million lei), and relatively close to the level recorded in 2015 (606.8 million lei). Compared to 2016, the increase recorded in 2017 was mainly positioned at the level of the local budgets' outstanding payments (+122.1 million lei, respectively an upsurge of 19.8%) and at the level of the state budget (+25.6 million lei, respectively a rise of 42.8%), both increases being recorded mainly in the last quarter of 2017.

GCB's total outstanding payments to the firms in the private sector have reached a level of 810.3 million lei at the end of 2017, being higher by 142.9 million lei compared to the same period of the previous year, when they recorded a level of 667.4 million lei, this increase being mainly due to the growth of the arrears with a delay of less than 90 days (+121.4 million lei). It may be noted, however, their increase at the end of the year (a plus of 100-150 million lei in the stock of outstanding payments compared to the second and third quarters, the same pattern as in the case of the local budgets' outstanding payments), this development being, possibly, the effect of the application of the Order no. 3315/22.12.2017 amending the Methodological Norms regarding the closure of the fiscal year 2017, approved by the Order of the Minister of the Public Finance no. 3244/19.12.2017, by which the deadline for submitting the documents to the Treasury, was surpassed by 2 days namely from 29.12.2017 on 27.12. 2017, representing the deadline for the submission of the payment orders to the Treasury by the authorizing officers.

We also notice an increase compared to the previous year of 86 million lei for arrears over 360 days to other categories of persons, located at the Social Insurance Budget (excluding hospitals),

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

which appeared at the end of 2017, possibly due to the application of the provisions set by the Order no. 3315/2017.

Table 15: Quarterly evolution of GCB arrears in 2017 (million lei)					
	Q IV 2016	Q I 2017	Q II 2017	Q III 2017	Q IV 2017
State budget	**59.8**	**81.0**	**82.5**	**93.5**	**85.4**
Under 90 days	36.2	56.6	55.4	59.5	51.2
Over 90 days	10.7	11.3	13.2	8.6	9.4
Over 120 days	5.6	7.0	6.1	11.1	11.6
Over 360 days	7.4	6.1	7.8	14.3	13.2
Local authorities	**615.7**	**652.5**	**566.9**	**627.3**	**737.8**
Under 90 days	437.5	451.4	385.5	438.2	549.5
Over 90 days	76.3	79.5	72.7	67.0	81.1
Over 120 days	71.0	83.3	72.0	84.2	61.9
Over 360 days	30.8	38.3	36.7	37.9	45.3
Social security budget	**3.7**	**3.3**	**3.4**	**7.2**	**87.0**
Under 90 days	3.7	3.3	3.4	7.2	1.0
Between 90 and 360 days	0.0	0.0	0.0	0.0	86.0
Total	**679.2**	**736.8**	**652.9**	**728.0**	**910.1**
Under 90 days	477.4	511.3	444.3	504.9	601.7
Over 90 days	87.0	90.8	85.9	75.6	90.5
Over 120 days	76.6	90.3	78.1	95.3	73.5
Over 360 days	38.2	44.4	44.6	52.2	144.5
Total arrears (90-360 days)	**201.8**	**225.5**	**208.5**	**223.1**	**308.5**

Source: MPF

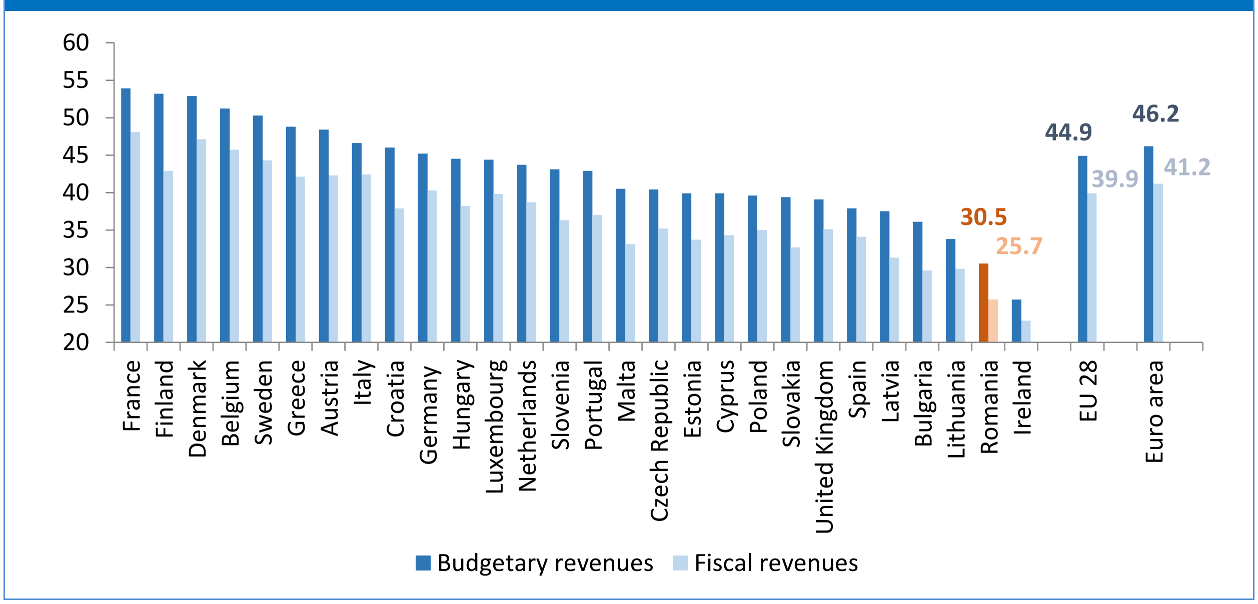
The considerable reduction of the GCB's outstanding payments in the last 5 years (from 3.8 billion lei in 2012) is explained mainly by the implementation of the EU Directive no. 7/2011 on combating late payment in commercial transactions (Law no. 72/2013) and other legislative measures taken in the recent years which aimed to reduce the stock of arrears (GEO no. 29/2011 to regulate the facility of payment rescheduling. GEO no. 3/2013 which restrict the local authorities' possibility of contracting new loans strictly to reduce their arrears. GEO no. 12/2013 which introduced a mechanism for the settlement of reciprocal payment obligations).

V.2. Tax collection in Romania – international comparisons

Romania recorded in 2017 a share of government revenues (tax and non-tax revenue) to GDP of 30.5% of GDP, by 14.4 pp lower than the EU average (44.9% of GDP), among the lowest among EU Member States, being succeeded only by Ireland. The level of tax revenues to GDP (taxes and social contributions) in Romania reached 25.7% of GDP in 2017, being placed on the penultimate position, with a difference of 14.2 pp compared to the EU average, which is 39.9% of GDP. Analyzing the data according to the ESA 2010 methodology, compared to 2016, the gap between Romania and the EU average deepened significantly, both in the case of the total budget revenues by other 1.3 pp of GDP (from a gap of 13.1 pp of GDP in 2016), and in the case of the tax revenues by another 1.1 pp of GDP (from a gap of 13.1 pp of GDP in 2016).

The share of tax revenues to GDP is significantly lower than in similar economies like Hungary (38.2%), Slovenia (36.3%), Czech Republic (35.2%) and Poland (35.0%). Compared to Bulgaria, the budget revenue gap is further widened by 2 pp compared to the previous year (from a gap of 3.6 pp in 2016 to 5.6 pp in 2017), and for the fiscal revenue by another 1.7 pp of GDP. In 2017 compared to 2015, the effect of the major changes introduced by the new Fiscal Code which included a large-scale fiscal easing lead to a reduction in the share of the budget revenues in GDP by 4.5 pp (meanwhile, their share in GDP for EU 28 increased by 0.2 pp), respectively, to the decline of the share of the fiscal revenues in GDP by 2.2 pp (while they increased by 0.5 pp for the whole EU).

Figure 38: Budgetary revenues and fiscal revenues in 2017 (% of GDP, ESA 2010)



Source: Eurostat. Tax revenues include social contributions.

The structure of fiscal revenues in Romania changed compared to 2016 due to the reduction by a further 1 pp of the VAT standard rate (from 20% to 19%) and the temporary reduction in fuel excise duty which together have diminished the share of indirect tax revenues compared to the previous year[90]; however, they are still well above the EU28 average, accounting for 40.1% compared to 33.6% in the EU, while the share of receipts from social contributions in total tax revenues was 36.2 % (by 2.9 pp below the EU28 average) and the share of direct tax in total tax revenues was only 23.7% (by 9.3 pp below the EU28 average). The indirect taxes represent the main component of total tax revenues in Romania, in fact, a specificity of the developing countries, their weight being significantly above the EU average (by 6.5 pp), although in 2017 were applied reductions in indirect taxes compared to previous year, in the context of decreasing the standard VAT rate by 1 pp and the temporary cancellation of the special excise on fuels (affecting the revenue from the first three quarters, then the excise duty being restored at the end of 2017, in two stages, on September 15 and October 1). The fiscal relaxation measures of the past two years, which led to the reduction of the standard VAT rate from 24% in 2015 to 19% in 2017, together with extending the application scope of the reduced VAT rates[91], contributed to the significant reduction of the gap between Romania and the EU average compared to 2010-2015. Moreover, the fiscal consolidation initiated in 2010 aimed at increasing the indirect taxes contributed to increasing their share in total tax revenues (from 43.7% in 2010 to 47.5% in 2012 and 47.3% in 2015), while at EU level this indicator ranged from 33.6% to 34.0% over the same period. It can be assessed, however, that indirect taxation is favorable to long-term economic growth, direct taxation having a more discouraging effect on engaging the production factors. Over the last two years, for Romania was noticed the reversing of the upward trend in the share of indirect taxes at a rapid pace (by reducing the VAT rate by 5 percentage points in the period 2016-2017), but they are still predominant as the share of total revenues. At European level, there is a tendency to balance direct taxes, indirect taxes and social contributions, and a lot of member states with the highest shares of budgetary revenues in GDP benefit also from high shares of direct taxes in total revenues.

In 2013 was launched a wide-ranging reform process of the Romanian tax administration, on May 8, 2013 being signed the Loan Agreement between Romania and the International Bank for Reconstruction and Development (IBRD), the loan value, of 70 million euro[92], following to be

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[90] The indirect revenue share in total tax revenues decreased by 2.4 pp; in 2016 the share of indirect revenue in tax revenues was 42.5% compared to the EU28 average of 33.8%.

[91] The reduction in the weighted average VAT rate was around 7.4 pp in 2017 compared to 2013, when the measure of reducing the legal VAT rate on bread and bakery products from 24% to 9% was initiated (in September).

[92] Law no. 212/2013 on the ratification of the Loan Agreement between Romania and the International Bank for Reconstruction and Development. At the amount of the loan, another 7 million euro are added,

used for the Revenue Administration Modernization Project (RAMP), aiming at developing the management function, improved technology and IT upgrading, as well as better services for taxpayers. Initially, the program was implemented for a period of 5 years[93] (since the fourth quarter of 2013), but given the delays in carrying out the program, at the request of the National Agency for Fiscal Administration (NAFA), the Romanian authorities requested in 2016 an extension for the contract, by GO no. 1017 / 29.12.2016, which was extended by a further 2 years (the execution of the project until 30 September 2020 and the deadline for withdrawing payments until March 31, 2021). According to this program, the central pillar of the tax administration reform is to redesign and increase the capacity of the IT system in order to manage a centralized huge database, including data and information on all taxpayers in Romania. The main tangible targets expected for the end of 2018 refer to: increasing voluntary tax compliance at declaration and payment for VAT to 83.5%, for the personal income tax, to 86.0% and for social contributions, to 82.5%. For the collection costs the target is set at 0.9% (from 1.1% in December 2012) and for the satisfaction of taxpayers regarding the integrity and quality of the services offered the increase should be +15%.

In 2017, compared with the previous years, the main indicators for the fiscal administration slightly improved, the degree of the voluntary compliance at declaration (in value) for NAFA being 85.4%, and the degree of voluntary compliance at payment reached 95.6%. The VAT degree of compliance at payment at the end of 2017 reached a level of 81.6%, for personal income tax, 83.8% and for social contributions, 80.0%, which put into the question reaching the targets proposed for December 31, 2018, including the cost of collection, which at the end of 2017 was 1.1%, basically the same as in the previous year (and as the starting value at 31.12.2012).

In the first phase of the program (2014-2015) the activities were focused on strengthening the central and local tax administrations in parallel with actions to streamline the activities, in 2016 were signed consulting agreements and was launched the procurement procedure for operationalize the computer system of the new integrated revenue management system (COTS-RMS)[94], the procedure being finalized in October 2017. Also in 2017 was established the National

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representing the NAFA contribution. RAMP was structured on four components: institutional development; increasing efficiency and operational effectiveness; modernizing services for taxpayers; coordination and project management.

[93] Bulgaria has applied a similar program of restructuring of the administration in the period 2002-2008, aimed at simplifying the tax administration structure and increasing the collection of taxes and fees, with great results in increasing collection efficiency, reducing administrative costs and reducing the grey economy (http://documents.worldbank.org/curated/en/704711468232153915/ - Bulgaria-Revenue-Administration-Reform-Project).

[94] This system will automate and optimize tax administration processes and allow the provision of modern electronic services tailored to the needs of taxpayers.

Center for Financial Information[95] in order to unify and make more efficient the IT system at MPF' level, including NAFA. Also, taxpayers' access to Virtual Private Space (VPS) has been significantly extended by implementing OMPF no. 660/2017[96], on the basis of which natural and legal persons or other entities in the capacity of users of VPS may transmit to the MPF or to the fiscal administration body, requests, documents or other. Through OMPF no. 1376/2016 were extended types of tax debts can be paid by credit cards in the online system through National Electronic Payment System (platform *ghiseul.ro*) and GD no. 949/2017 stipulated the obligation of the public institutions that collect taxes, fees, fines and other payment obligations, of the economic operators who are providers of public utility services, as well as of the legal entities that carry out retail activities and who annually realize a turnover of more than 10,000 euro, accepting receipts through bank cards and the possibility of accepting electronic payment tools with remote access. Also, in the Quick Benefits program (Quick Wins[97]), which includes 66 initiatives to improve the activity of the various functional areas of NAFA in the short term, in 2017 were completed 19 such projects. However, the progress is minor compared to the targets set, the World Bank assessments regarding the state of the NAFA's restructuring plan at the end of 2017[98], showing that practically not only that no progress been made compared to 2016, but the pace of implementation slowed even further. Thus, the rating for the progress on the achievement of objectives as well as for the overall progress is "unsatisfactory" (lower if compared to the February 2017 "moderately unsatisfactory" rating for these two indicators), and for the overall risk the rating is "high" (same as in 2016). Moreover, out of the total funds made available by the IBRD in August 2013, only 22% of them were drawn until February 6, 2018.

From the perspective of tax revenue collection, it can be appreciated that in recent years, the administrative tax collection has undergone an extensive transformation process following which it has become easier and more effective, the number of financial administration being considerably reduced at the central level, but it also should be diminished at the local structures level, because Romania still ranks above the average of the new EU countries regarding the number of financial administration related to the number of inhabitants[99].

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[95] The Substantiation Note showed the need for this Center in order to avoid major security incidents and system collapsing, after a series of such incidents occurred in 2017.

[96] Order approving the procedure for communication by electronic means of remote transmission between MFP and natural and legal persons.

[97] Implemented in the last quarter of 2016, the program was designed to facilitate voluntary compliance by taxpayers, aiming to increase the efficiency of internal tax administration processes.

[98] http://documents.worldbank.org/curated/en/625011517968957416/pdf/Disclosable-Version-of-the-ISR-Revenue-Administration-Modernization-Project-P130202-Sequence-No-10.pdf.

[99] According to the sixth edition of the report Tax Administration 2017 elaborated by the OECD, in 2015 Romania was placed second after Poland (similarly for the number of employees in the tax collection

Simplifying the tax system and reducing bureaucracy is a complex process that occurred gradually, and progress was highlighted by the report conducted by PricewaterhouseCoopers (PwC) and the World Bank (WB), Paying Taxes *2018*[100] (that considers 2016 as the reference year), according to which, in terms of ease of payment of taxes, Romania ranks on 42th place, a better position compared to the previous year (50th place, the two years being comparable from the point of view of the new methodology). For comparability with previous years (according to Paying taxes for 2012-2014), only for 2015[101], PwC and WB have calculated the positions according to the two methodologies. Thus, in the ranking shown in *Table 16* are listed for 2015 two positions corresponding to the two methodologies (the former one, which did not take into account the new sub-index of ex-post compliance is put in parenthesis) which makes that only 2015 and 2016 are comparable in terms of the position calculated by aggregating the sub-indices. For the rest of sub-indices, the results are comparable for all the analyzed years. Thus, from the perspective of the ease with which the taxes are paid, a considerable leap is observed in 2016 compared to 2012, given that only 14 payments (compared to 39 in 2012) are required for the fulfillment of fiscal duties, but also the improvement of other indicators (such as the number of hours per year to meet tax obligations), largely due to measures taken by tax authorities to facilitate electronic payments and online filing, as well as the expansion of online payment services (payment by bank card to the POSs installed at the territorial units of the State Treasury or via the platform *ghişeul.ro*).

Compared to the data released last year, the Paying Taxes 2018 report notes for Romania that in 2016 as compared to 2015, the number of hours required to pay taxes has increased to 163 hours (from 161 hours), the number of annual payments that a company should carry out for paying taxes remained constant, respectively, 14 payments and the share of taxes in total profit remained at the same level of 38.4% (despite VAT rate decreased by 4 pp). Thus, a medium-sized company in Romania has carried out during one year a number of 14 tax payments (higher than the European average of 12 annual payments, but well below the global average of 24 annual payments) and consumes for the calculation, the completion and the submission of tax returns 163 hours of work (higher than the European average of 161 hours, respectively, much lower than

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administration), while for the indicator “fiscal revenue/GDP per 1,000 employees”, Romania was placed on the penultimate position among NMS10 countries.

[100] The 2018 Report is based on the data last updated on July 1, 2017 and covers the fiscal year 2016 (data on tax revenues for companies are available after the financial statements consolidation).

[101] The methodology used in the last year's report - Paying taxes 2017 - took into account for the first time the sub-index of ex-post compliance (which includes two specific processes related to VAT reimbursement and company audits in case of corrections of errors in the tax return on profit tax). The Reports from the previous years do not include this sub-index. For methodological details, see the 2016 Annual Report, Box 2 (at http://www.fiscalcouncil.ro/RA2016%20engl%2018iulie2017.pdf, page 119).

the global average of 240 hours). From the perspective of the overall tax rate (the share of taxes and social contributions in the profit of a medium-sized company), Romania registered 38.4% in 2016, below the European average of 39.6%, respectively lower than the level of 40.5% recorded at the global level.

From the perspective of the ease with which a company can initiate VAT reimbursement processes and the necessary audits to correct possible errors in the profit tax returns, Romania is among the countries whose procedures are considered to be performing more difficult, but, compared to other European countries, it is better positioned than Italy, Bulgaria, Hungary and Slovenia. Thus, the ex-post compliance index was 76.82%, below the European average of 81.59%, but above the global average of 59.51% (where 100% represents the most efficient processes and 0% totally inefficient processes). For comparison with NMS10, Estonia recorded a level of this sub-index of 99.38%, Latvia of 98.11%, Poland of 77.36%, Bulgaria of 69.3%, Hungary of 63.94% and Slovenia only 59.94%. Overall, in 2016, Romania has made a progress on improving the efficiency of paying taxes, being positioned in the first half of the ranking for the countries in Central and Eastern Europe, ahead of Slovakia (48th position in the ranking at global level), Poland (51), Czech Republic (53), Slovenia (58), Bulgaria (90), Hungary (93), but after Latvia (13), Estonia (14) and Lithuania (18).

In *Table 16*, for comparability with the ranking for the years 2012-2014 on the ease for paying taxes computed according to the previous methodology (according to the Paying Taxes reports 2014, 2015 and 2016), the positions for the year 2015 determined without taking into account the new sub-index, are placed between brackets. It can be noticed a slight improvement in Romania's position within NMS10 in 2016 as compared to 2015 (mounting by two places).

Table 16: The efficiency of tax system										
	Estonia	Latvia	Slovenia	Lithuania	Bulgaria	Slovakia	Poland	Czech R.	Hungary	Romania
Year	**Ease of paying taxes (rank)**									
2012	32	49	54	56	81	102	113	122	124	134
2013	28	40	42	20	89	100	87	119	88	52
2014	30	27	35	49	88	73	58	122	95	55
2015	21(32)	15(26)	39(67)	27 (50)	83(99)	56(72)	47(62)	53(80)	77(89)	50 (43)
2016	**14**	**13**	**58**	**18**	**90**	**48**	**51**	**53**	**93**	**42**
	Number of payments per year to pay tax liabilities *									
2012	7	7	11	11	13	20	18	8	12	**39**
2013	7	7	11	11	13	20	18	8	11	**14**
2014	8	7	10	11	14	10	7	8	11	**14**
2015	8	7	10	11	14	8	7	8	11	**14**
2016	8	7	10	11	14	8	7	8	11	14
	Number of hours per year to pay tax liabilities **									
2012	81	264	286	175	454	207	286	413	277	**200**
2013	81	193	260	175	454	207	286	413	277	**159**
2014	81	193	245	171	423	188	271	405	277	**159**
2015	84	161	245	171	453	192	271	234	277	**161**
2016	**50**	**169**	**245**	**109**	**453**	**192**	**260**	**248**	**277**	**163**
	Total tax rate ***									
2012	49.4	35.9	32.5	43.1	27.7	47.2	41.6	48.1	49.7	**42.9**
2013	49.3	35.0	32.0	42.6	27.0	48.6	38.7	48.5	48.0	**43.2**
2014	49.4	35.9	31.0	42.6	27.0	51.2	40.3	50.4	48.4	**42.0**
2015	48.7	35.9	31.0	42.7	27.0	51.6	40.4	50.0	46.5	**38.4**
2016	48.7	35.9	31.0	42.7	27.1	51.6	40.5	50.0	46.5	**38.4**

Source: PwC and WB

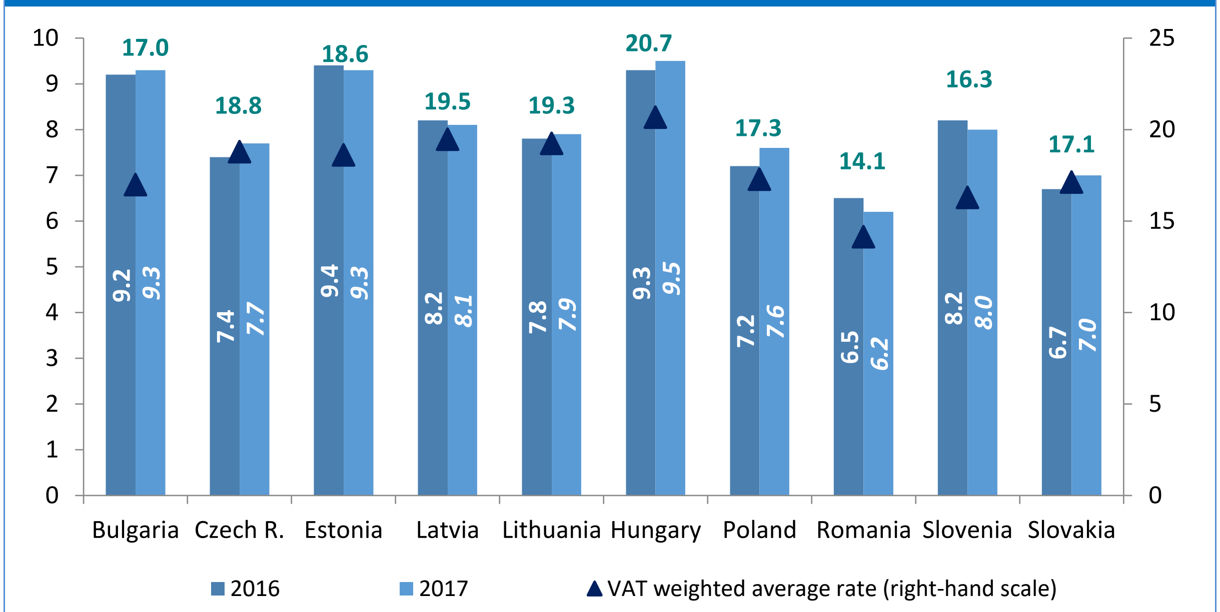
* Indicator reflecting the total number of fees and paid contributions, the method of payment, the frequency of payments, the frequency of tax returns and the number of agencies involved in the tax collection process for companies in the second year of activity. Where payment is made electronically, regardless of the frequency of payments, only one payment is recorded.

** Indicator that reflects the time needed for the preparation, completion and payment of the main tax obligations: profit tax, social contributions and labor taxes, other taxes.

*** Indicator reflecting the share in the commercial profit of the amounts related to compulsory taxes and social contributions paid by a company starting with the second year of activity.

Compared to similar economies, Romania enjoys an average tax collection rate from VAT receipts (see *Figure 39*), under the conditions of registering the lowest VAT weighted average rate. For example, in the year 2017 in terms of the VAT weighted average rate (based on HICP weights and characterized by the limitations described in subchapter III.3.1) and of VAT receipts, Romania was ranked on the last position of the new EU Member States. With a weighted average rate of 14.1%, Romania collected 6.2%[102] of GDP from VAT, being the last in the ranking but relatively close to Slovakia which, despite a higher average weighted rate (17.1%), collected 7% of GDP. It is worth mentioning Bulgaria, having a structure of the economy similar to that of Romania and a 17.0% VAT-weighted rate collected 9.3% of GDP for VAT receipts in 2017, similar to Estonia (which has a higher VAT-weighted rate of 18.6%) and close to Hungary (which collected 9.5% of GDP but having a VAT-weighted rate of 20.8%) and well above the level of countries with close weighted average rates (such as Slovakia with 17.1% or Poland with 17.3%).

Figure 39: VAT revenues in 2017 (% of GDP)



Source: EC, Eurostat

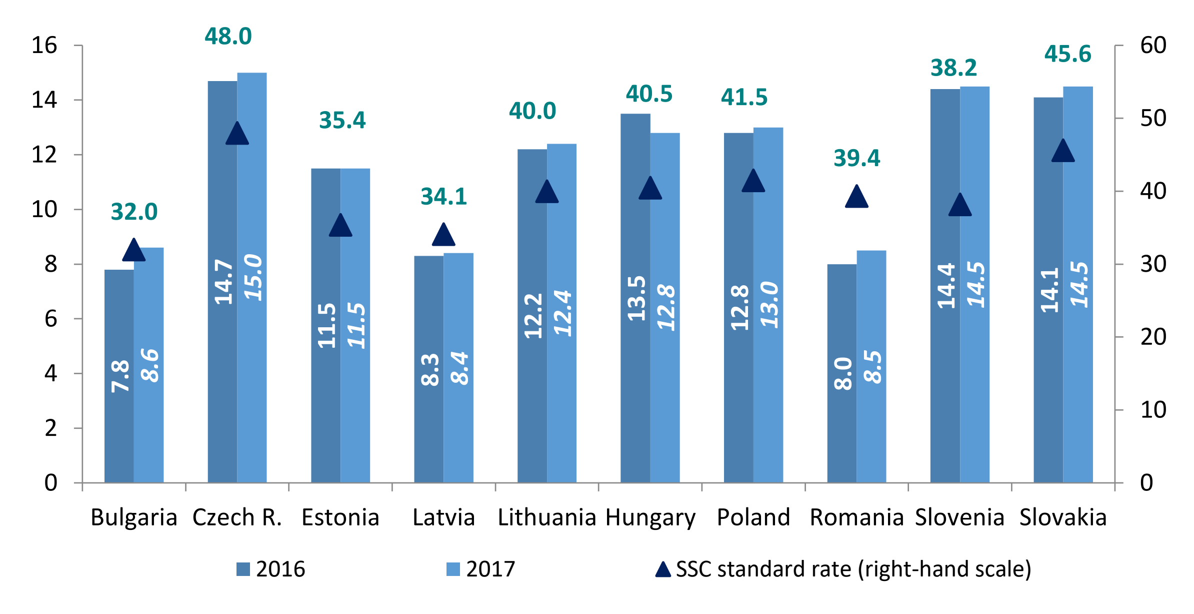
Comparing with the other selected countries regarding the share in GDP of the revenues from social security contributions paid by employees and employers relative to the statutory rate of social contributions, for Romania it is highlighted the low level of the collection (see *Figure 40*). Thus, the revenues from the contributions collected by Romania in 2017 even if slightly increased compared to the previous year (+0.5 pp of GDP), recording a value of 8.5% of GDP, corresponding to the statutory rate of 39.4% for the social contributions, remained one of the lowest values in

[102] The level of this indicator decreased by 0.3 pp compared to 2016, when 6.5% of GDP was collected from VAT.

the NMS10, surpassing only Latvia (8.4% of GDP) but with a statutory rate of social contributions of only 34.1%. Slovenia (14.5% of GDP), Estonia (11.5% of GDP) and Bulgaria (8.6% of GDP), recorded higher revenues for this budget category than Romania but in the context of significantly lower social contribution rates. Compared to Hungary, which collected from social contributions 12.8% of GDP, the statutory social contribution rate in Romania is by 1.1 pp lower, while compared to Lithuania (with 12.4% of GDP social contributions revenue), the statutory rate in Romania is lower by only 0.6 pp.

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

Figure 40: Social contributions revenues in 2017 (% of GDP)



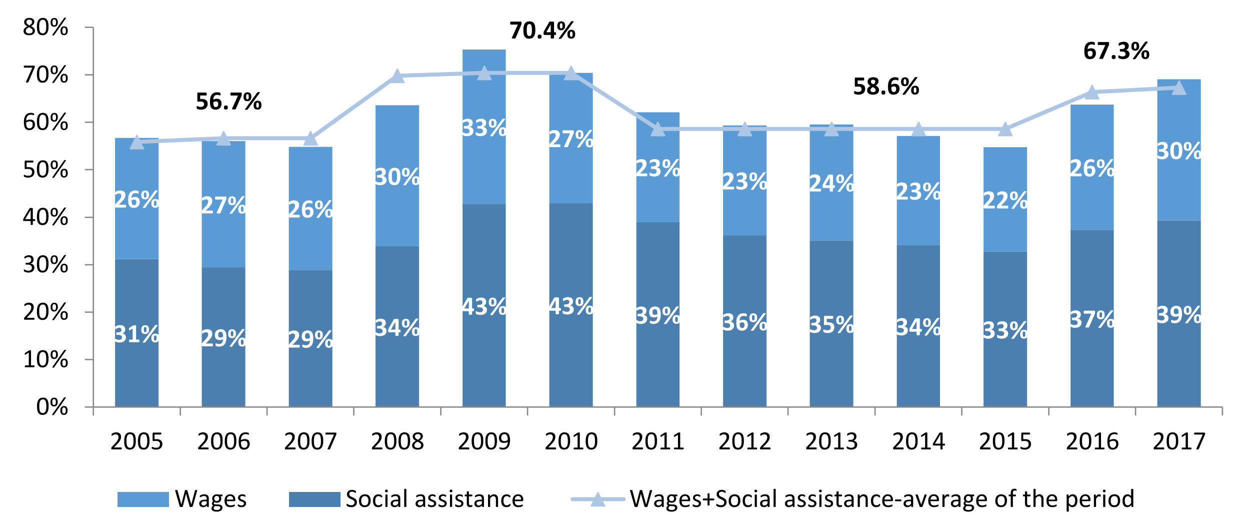
Source: EC, Eurostat

Concluding, it can be noticed an improvement in terms of efficiency and simplifying the administrative apparatus of tax collection, from both the perspective of decreasing the number of financial administrations (even if it can be noticed an increase in the number of employees in these structures), but also in terms of ease of paying taxes. The reform initiated in Romania in this field seems, however, to have led to positive results but under the initial expectations. The assessment made by the World Bank in February 2018 characterized as "unsatisfactory" both the progress of the project and the overall implementation, which represents a decline compared to the rating for the previous year (as "moderately unsatisfactory", and which, in turn, was in regression if compared to the 2015 "moderately satisfactory" assessment), while the risk of failure to complete its objectives was considered to be major, as in the previous assessment. Thus, even if it is considered that the first steps towards the goal of the RAMP project have been made, the successful completion of the NAFA reorganization being considered critical to the modernization of the project, the initial commitments were respected at a much slower compared to 2016 according to WB assessment. Thus, in the conditions of blocking the modernization process of NAFA after the first stage of the acquisition of the budgetary revenue management system (finalized in October 2017), WB specialists warned in February 2018 that because the implementation of the project phases was inadequate in the last 6 months, without any progress being made in achieving the project objectives, there is a potential risk of taking a decision to cancel the project. Therefore, given the current unfavorable situation with regard to the extremely low share of the budget revenues in GDP and the potential effect of the reform initiated with the WB support to bring significant positive effects over the medium and long term, we consider that further efforts are required for completing this project, at least with the same success as in Bulgaria, which has achieved notable results regarding the increase in the efficiency of tax collection.

V.3. Public expenditure – structure and sustainability

In Romania, the structure of budgetary expenditures is characterized by the dominance of personnel and social assistance expenditure (pensions, social aids, and so on). Although their relative importance has declined significantly in the 2011-2015 period as a result of the fiscal consolidation, 2015 representing the minimum of the analyzed period, starting with the year 2016 recorded the reversal of this evolution (*Figure 41*), the personnel and social assistance expenditure strongly increased by 9 pp, and in the year 2017 they increased by another 5.4 pp compared to the previous year, reaching 69.1% (from 63.7% in 2016), this level being close to the average 70.4% registered in the period 2008-2010. This development can be attributable to the nominal increase of these expenditure categories compared to the previous year, respectively by 21.7 % for the expenses related to the compensation of the employees (due to the wage increases in the public sector) and 13.3% for the social assistance expenditures, that surpassed the increase of only 7.7 for the budget revenues compared to the previous year. It is worth noting that the share of personnel expenditure in the total budget revenues in 2017 (29.8%) almost equaled the average of the period 2008-2010 (29.9%), while the share of social assistance expenditure (39.3%), although still with 0.6 pp below the average for the period 2008-2010 (39.9%), is increasingly diverging from the average of 2011-2015 (35.4%), the expansionary fiscal policy of the last two years cancelling the effect of adjustments in personnel and social assistance spending made in the period 2011-2015. Compared to the previous year, the share of social assistance expenditure in the total budgetary revenue increased by 1.9 pp, a more pronounced increase being noted for the evolution of personnel expenditure, as their share in the total revenues increased by 3.4 pp.

Figure 41: Social assistance and personnel expenditure as share of total budget revenues (%)



Source: Eurostat

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

The precarious state of the public pension system is an important vulnerability of the public finances position and the share of this expenditure category in total revenues is still too high and, applying the new pension law should have supported the aim of reducing the share of this expenditure category in total budgetary revenues in the medium-term. This objective, however, is currently jeopardized by the manifestation of some reversing pressures on the pension system reform, which were implemented in the period 2015-2016, being extensively commented on in the section on personnel and social assistance expenditure. Also, in terms of medium and long-term sustainability, it is important that any increases of wages in the public sector in the following years to be done only in line with the evolution of economic activity and, especially, with productivity gains, given that during 2016-2017 there was a trend of massively increasing the personnel expenses of the state by significantly higher rates than that of the nominal GDP and public revenue growth rate over this period of time.

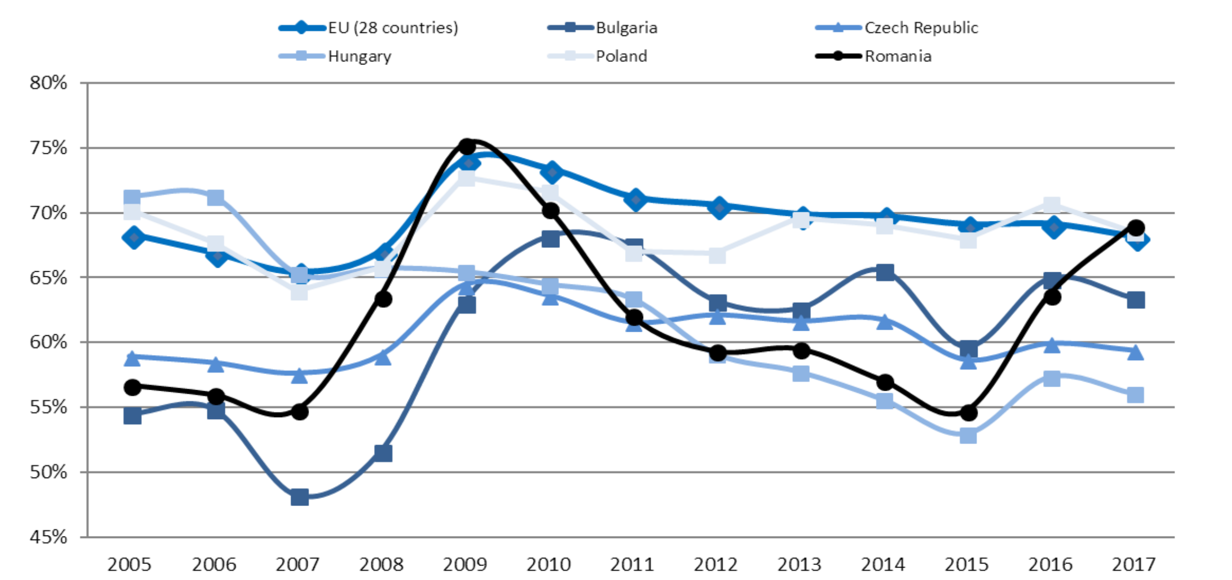
After a relatively stable evolution in terms of the expenditure share in the budgetary revenues, before 2007, the personnel and pension expenditure strongly increased during 2008-2009[103], with a maximum of 75.3% in 2009, when Romania recorded the largest share of personnel and

[103] Respectively, on average, their share in total budget revenues was 69%.

social assistance expenditures in total budget revenues at the level of CEE countries, and also a level much higher than the EU28 average. Following the implementation of the fiscal consolidation program, the share decreased significantly, falling below the level recorded in the CEE countries, with the exception of Hungary, in the period 2013-2015. However, starting with 2016 Romania reversed this trend, and due to the aggressive increases in the public-sector wages and pension benefits, in 2017 was recorded, similar to 2009, the highest level of the personnel and social assistance spending related to the budget revenues in the region (69.1%), above the EU28 average (68.2%).

The evolution of this indicator for the CEE countries and the EU28 average in the period 2005-2017 is presented in *Figure 42*.

Figure 42: Social assistance and personnel expenditure (including pensions) share in total budgetary revenues in EU 28 and CEE during 2005-2017



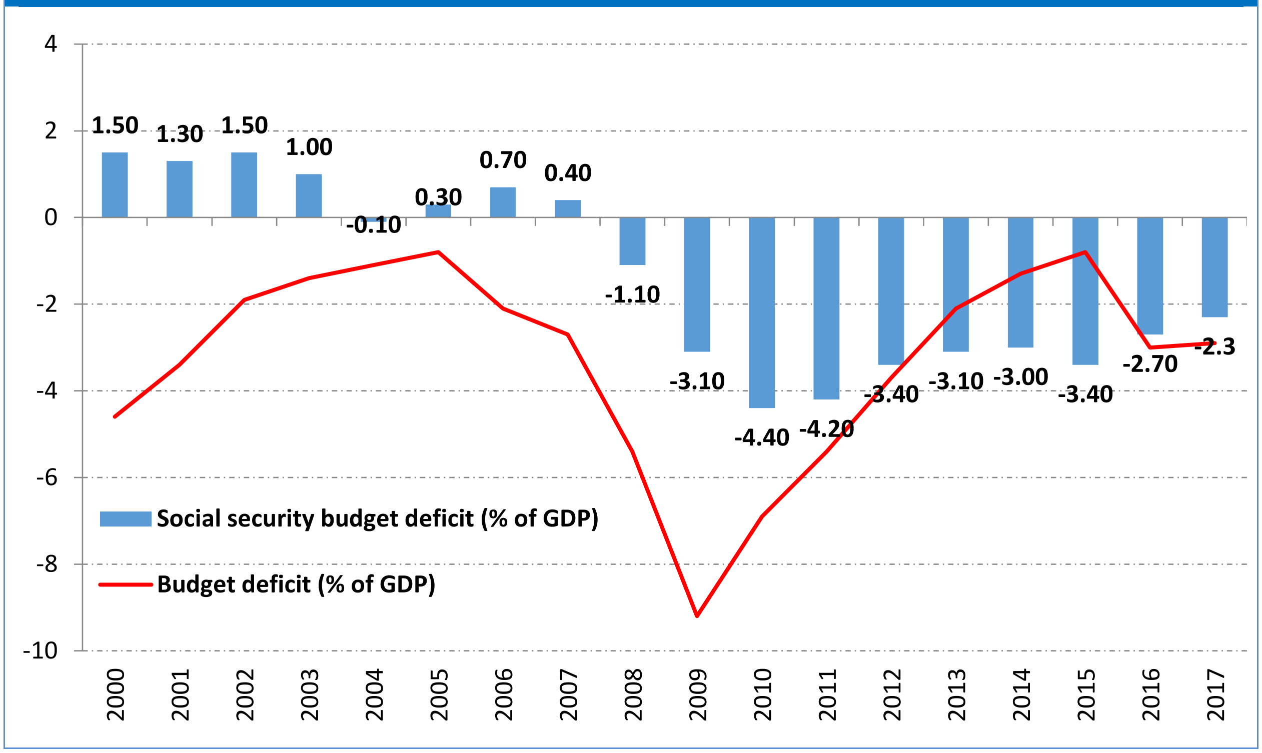
Source: Eurostat

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

Regarding the development of the social security budget (pensions, unemployment and health) it is noticed that, if in the period 2000–2007 were characterized by a relatively equilibrated or even positive balance, after 2008 their deficits have represented an important component of the GCB deficit, respectively between 64% and 79% in the period 2010-2016. Essentially, in the period 2013-2017, Romania would have had a significant budgetary surplus if the social security budget had been in equilibrium. In particular, the deficit recorded in the public pension system (1.7% of

GDP in 2017, and 75% of the social security budget deficit), practically the most important part of this budget, significantly affects the public finance position, representing a major risk to the sustainability of fiscal policy in the medium and long-term.

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



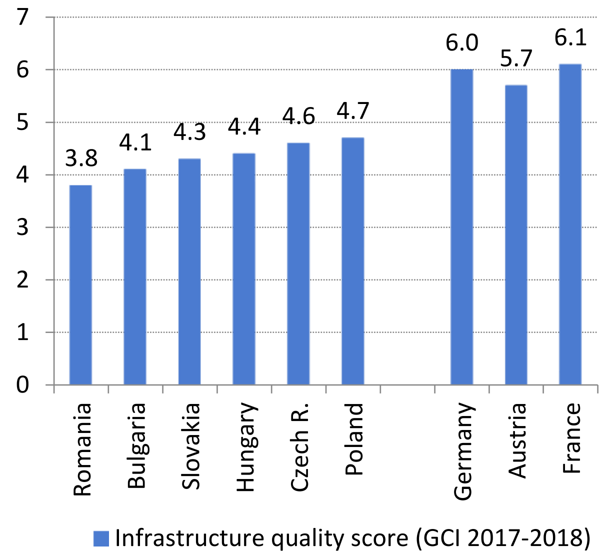
Source: Eurostat

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

The efficiency reserves on the side of budgetary expenditure are still very high. For instance, Romania had the second largest allocation for investment expenditure as a share of GDP from all European countries during 2008–2017; however, the results were modest, as Romania is still characterized by the weakest infrastructure in the EU (*Figure 44*).

According to the Global Competitiveness Report 2017-2018, with a score of 3.8, Romania ranks 83th out of 137 countries regarding the Infrastructure Pillar, on the 103th for the infrastructure overall quality, road quality being its weakest component, respectively ranking on 120th position.

Figure 44: Infrastructure quality

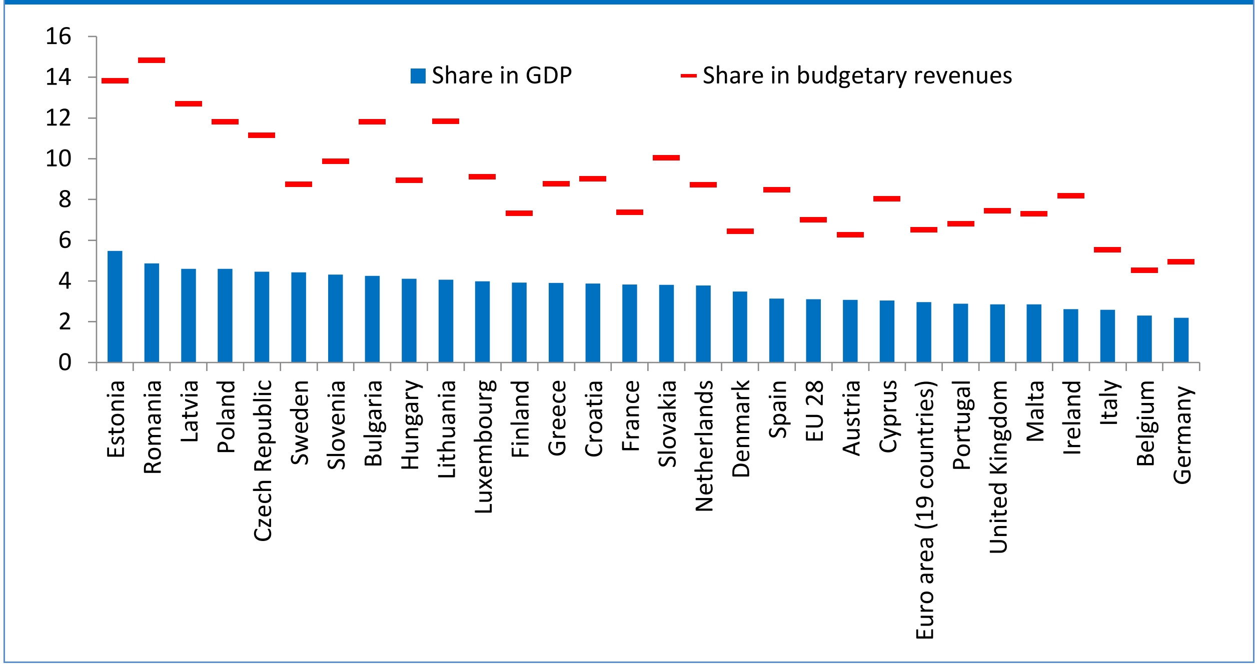


Source: World Economic Forum, The Global Competitiveness Report 2017-2018

The score regarding infrastructure is only a part of the global competitiveness index (GCI) for which Romania recorded a score of 4.28, being ranking 68th out of 137 countries, where Switzerland has the highest position (with a score of 5.86), however a worse position than the previous year (62th out of 137 countries, with a score of 4.30).

However, the investment expenditures have been significantly reduced in the last period, in 2017, representing the minimum of investment spending in the analyzed period, Romania ranking 16th in the EU in terms of allocations to this destination as a percentage of GDP (lower by 10 positions compared to the previous year's ranking) and second to last position in the CEE countries, before Bulgaria. It should be noted that, after 2015, that represented the first year after 2008 in which spending on public investments as a percentage of GDP increased compared to the previous year, given that 2015 was the last year for the absorption of EU funds for the financial framework 2007-2013, starting with 2016 it was noted the return to the evolution observed during the period 2009-2014, namely the decline of this category of expenditures, in 2017 the investment spending decreasing relative to the previous year by 0.8 pp of GDP (respectively, by -2.3 pp of GDP compared to 2015). Compared to 2016, the share of investment spending in the budget revenues decreased by 2.2 pp of GDP and by 5.4 pp of GDP compared to 2015, remaining far below the pre-crisis level. Under these circumstances, increasing the efficiency of public spending is more necessary given that it is unlikely that high levels of the past allocations for this destination can be sustained in the near future.

Figure 45: The share of investment expenditure in GDP and in total budgetary revenues (average 2008-2017)



Source: Eurostat

In the Convergence Program 2018-2021, MPF examines also the risks posed by an aging population and an upward cost of health services. It notes that in Romania there is a pronounced reverse age structure which will alter the ratio of working to retired population. Aging, migration and low birth rate are factors with negative implications on the labor market. The long-term forecast for the age-related expenditure shows that Pillar 1 will represent 7.7% of GDP in 2040 from a level of 7.3% in 2017, and 8.7 % at the end of forecasting period (2070), while Pillar 2 will have an increasingly share in the total pension expenditure, reaching 0.5% in 2040, respectively 1.1% at the end of the forecasting period, in 2070. The long-term projection of age-related expenditures shows an increase of 2.2 pp of GDP for the period 2016- 2070, above the EU average of 1.8 pp, and for the costs related to pension benefits, an increase by 0.7 pp of GDP, compared with only 0.2 pp for the EU average.

The Fiscal Council considers that even in 2011-2015 there has been some progress in both the structure and sustainability of public spending, thus correcting the previously accumulated imbalances, also partly increasing their transparency[104], although in the 2016-2017 period this trend was reversed, as showed by the hike of 13 pp of the "mandatory" expenditure (respectively those with salaries and pensions) in total budgetary revenue in 2017 compared with 2015, and a

[104] Given the ongoing reform of the public investment management, analyzed in detail in the section dedicated to the public investment.

high probability of manifesting future pressures in the sense of increasing their share. However, the reserves on the efficiency of the use of public money are still high, being absolutely necessary to continue the reform in this regard. An important step in this direction may be represented by finalizing the new law on public procurement, which can contribute to increasing transparency and reducing inefficiency of the public spending.

VI. 2018 – Macroeconomic and fiscal perspectives

VI.1. Macroeconomic framework

In the year 2017 was recorded an economic growth of 3.8% at a global level, the largest advance since 2011, supported by the recovery of investments and international trade. Assuming favorable financial conditions, the IMF estimates that the global economic growth rate will reach 3.9% over the next two years, with positive developments predicted for both advanced, emerging and developing economies[105]. At the European level, 2017 marked the highest economic growth in the last 10 years, being the first year of the post-crisis period in which all EU Member States' economies were growing. Given that the 2017 economic growth rate has exceeded most of the projections, on the background of a high level of confidence, synchronization with global expansion, low cost of funding and improved labor market conditions, the economic growth forecasts for 2018 has been revised upward for most EU Member States. Thus, according to the 2018 Spring forecast, the EC estimates for the current year a real GDP growth of 2.6% for EU[106] and 2.3% for the euro area, and for the year 2019 an economic advance of 2.3% at EU level and 2% at euro area level[107]. Thus, the EC anticipates that there is sufficient support for the European economy to grow above its potential over the next period, given the solid macroeconomic fundamentals, a declining unemployment rate and only a gradual increase in inflation. However, as it can be seen from the evolution of the projected values for the next two years, a gradual slowdown in economic growth is projected, in the context of a similar trend in international trade and a decline in monetary incentives.

Regarding the balance of risks associated with the economic growth forecasts, the EC estimated in the Winter forecast that it was largely balanced. However, in the Spring forecast there is a significant imbalance towards a negative balance of risks, although the levels forecasted for the economic growth have not undergone major changes. Among the main risk factors identified by the EC can be mentioned: the high dependence of the EU economy on global demand, which emphasizes vulnerability to external developments; the risk of a sharp destabilization of the financial markets, with potential effects on investors' risk aversion and international capital flows, among the most vulnerable states being those with high indebtedness; the risk of overheating of the global economy amid pro-cyclical fiscal stimulus for the US; reducing confidence in the multilateral international trading system, and subsequent commercial tensions and the adoption

[105] World Economic Outlook – April 2018.

[106] Not considering the UK.

[107] The forecasted levels of economic growth at EU level (excluding the UK) were revised upward against the Winter forecast of 2.5% for 2018 and 2.1% for 2019.

of protectionist measures with potential negative influences on trade and economic activity, predominantly in open economies; not at least, the risk that the Brexit negotiations will have a significantly different outcome than the current trade relations between the EU27 and the UK.

In the forecasts related to EU Member States, the EC expects positive growth rates, the highest projections of real GDP growth being found for Malta (5.8%), Ireland (5.7%), Slovenia (4,7%), Romania (4.5%), Poland (4.3%), Slovakia and Hungary (4%). In contrast, the lowest growth rate in the EU is estimated for Italy (1.5%), followed by Belgium and Denmark (1.8%), Greece (1.9%) and France (2%). In this respect, it should be noted that for all other EU states economic growth rates are projected to exceed 2%. Compared with the world's most important milestones, the projected EU economic growth (2.6%) is below the US (2.9%), China (6.6%) and the global economy (3.9%) but is superior to the forecast for Japan (1.3%).

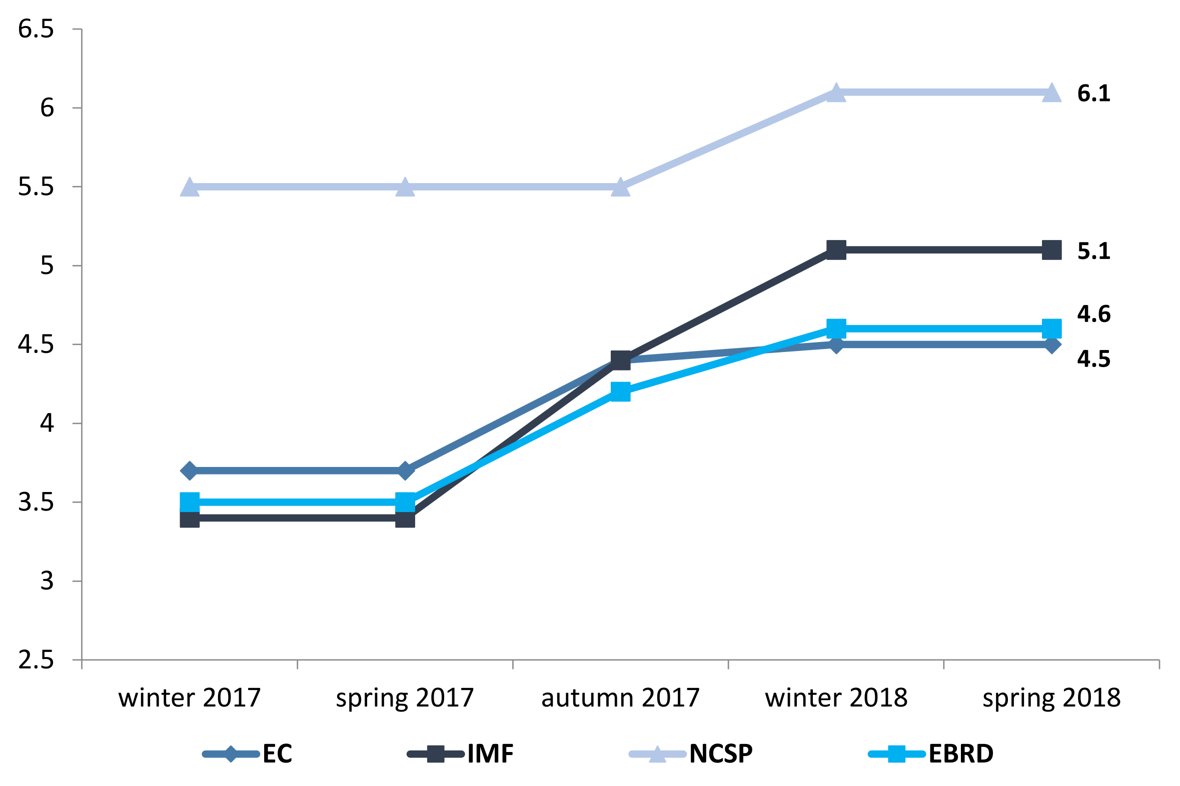
From the perspective of the real GDP gap compared to pre-crisis levels, the positive effects of sustained economic growth in 2017 are obvious. Thus, compared to the previous year (when about one third of EU countries were still below the real GDP level in 2008) in 2017 the number of these states decreased to 6 (accounting for about 22% of all EU states without the UK). Among them, Greece continues to show the biggest gap to the pre-crisis period (real GDP of about 75% compared to 2008), Croatia and Italy are close to 96%, while Cyprus, Portugal and Finland between 98% and 99%. At the opposite end, the top positions in the list of countries registering significantly higher real GDP levels compared to 2008 remained unchanged from the previous year: Ireland (+56.7%), Malta (+46.9%), Poland (+33.2%), Luxembourg (+21.9%) and Slovakia (+20.1%). Although in the post-crisis period there was an uneven development of the economic activity at the level of the EU Member States, it is noteworthy that 2017 is the first year of this period in which all EU economies have been growing. This is encouraging from the point of view of convergence within the Union but, on the basis of the developments in the last decade, the EC draws attention to the fact that most of the countries that have managed to exceed the level of pre-crisis economic activity are those with the highest GDP per capita, which raises questions about the real convergence in the coming period.

From the inflation perspective, 2017 saw a sharp increase at the EU level (1.7% after the 2016 inflation of only 0.3%), mainly driven by rising energy prices. Forecasts for the future development of the indicator provide a gradual growth on the back of wage increases and the continued rise in energy prices, but the results are amended by the low inflation rate for the service sector, which has the highest weight in the HICP (Harmonized Index of Consumer Prices). Under these circumstances, for the year 2018, the EC anticipates the inflation rate at the level of the previous year (1.7% for the EU and 1.5% for the euro area), and for the year 2019 an increase of 0.1 percentage points is foreseen for both the EU as a whole and the euro area. It should be noted that values of HICP aggregates mask important differences between EU Member States, due to the diverse monetary policies and differences in the exchange rate, as for the 2018 forecasts the biggest difference being recorded between Greece (0.5%) and Romania (4.2%). On the other hand, at the level of the euro area, the EC predicts a high homogeneity of inflation rates, estimating that in 2019 their standard deviation will reach the lowest value over the past 10 years. Regarding Romania, 2017 marked for inflation rate the year of reentering in positive territory[108], the first four months of 2018 witnessed a further advance, with the annual rate of HICP inflation of 3.4% in January rising up to 4.3% in April. In this context, the EC Spring Forecast for Romania projects an annual average HICP inflation rate of 4.2% in 2018, representing the highest estimated value for the EU Member States.

From the perspective of Romania's economic growth, the EC anticipates a significant slowdown from 6.9% in 2017 to 4.5% in 2018, but this level remains above the European average (2.6%) and the global average (3.9%), being the fourth highest growth rate in the EU after Malta, Ireland and Slovenia. Anticipated deceleration of growth is largely due to the slowdown in private consumption (from 10.1% to 4.9%), the net exports having a negative effect, amid more pronounced growth in imports (8, 2%) against exports (7.5%). On the other hand, it is estimated that investments will upsurge during 2018 (from 4.7% to 7.4%), in the context of the progress made in the implementation of projects funded by European funds. The unfavorable development of net exports is likely to contribute to worsening the current account deficit, which is projected to increase from 3.5% in 2017 to 3.6% in 2018. In 2019, the downward trend of the economic growth advance will continue, being projected at 3.9%, but still remains one of the highest values compared to other EU countries.

[108] The average annual inflation rate, calculated according to the HICP methodology, has been positive since May 2017, reaching 1.1% at the end of the year.

Figure 46: The evolution of the Romania's economic growth forecasts for 2018, %



Source: EC, IMF, NCSP, EBRD

Analyzing the dynamics of the economic growth forecasts for Romania in 2018, it is noted that they were revised upwards by all three international financial institutions (IFIs) considered, the most extensive correction being operated by the IMF (+1.7 pp), while the EBRD and the EC have made lower corrections, of around +1 pp. These revisions have taken place against the backdrop of high economic growth in 2017, which has surpassed even the most optimistic projections, and given the context of a favorable economic climate, both at European at global level. It should be noted that, like in the previous year, the growth rates projected NCSP are significantly more optimistic compared with the estimates of the three IFIs, on the average by 1.5 percentage points. On the other hand, the upward revision of the NCSP's own forecast had a smaller size, of only +0.6 pp.

According to the Inflation Report published by the NBR in May 2018, the annual CPI[109] inflation rate will continue its upward trajectory on the background of the dissipation of the statistical effects associated with the indirect tax regime and the elimination of non-tax rates in early 2017,

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

as well as under the impact of rising administrated prices for fuels. However, as a result of the gradual increase in the monetary policy rate, coupled with favorable base effects[110], the NBR anticipates a reduction in inflation starting with last quarter of 2018. Thus, according to the baseline scenario of the macroeconomic projection, an annual CPI inflation rate of 3,6% at the end of 2018 and 3% at the end of 2019 is projected, the expected value for the end of the current year being above the upper limit of the variation (1.5% - 3.5%) associated with the 2.5% target. Economic agents' expectations, coupled with high levels of aggregate demand surplus, will continue to increase prices, but these effects are expected to be mitigated as the accommodative monetary policy turns into a neutral one. On the other hand, external inflationary pressures are estimated at a low level, taking into account that the projected inflation for Romania's main trading partners is below 2%. It should be noted that the successive reductions in the VAT rate partially counteracted the inflationary pressures from 2016-2017 (the exhaustion of these effects playing a significant role in the upsurge of the inflation rate at the end of 2017 and the beginning of 2018), while the wage increases in the current year have the potential to stimulate the excess demand in the economy. Thus, the NBR considers that the risks associated with the forecast are inclined towards positive deviations, the main sources of risk being the following: the tensions between labor demand and supply being likely to fuel the aggregate demand surplus, while a possible increase in the gap between wage and the level of labor productivity may generate additional inflationary pressures; the sustained expansion of consumption on account of imports, to the detriment of domestic production, having the potential to aggravate the external imbalances.

The "signal" estimates for the GDP growth in the first quarter of 2018 showed a significant slowdown in economic growth, as the data recorded shows a stagnation compared to the previous quarter and an increase of 4.2% over the same period last year. The most likely deceleration in wage growth, coupled with the acceleration of inflation, has slowed down the increase in real disposable income and, implicitly, in the private consumption. Against this background, even if the first quarter has the smallest share, it is likely a negative revision of the economic growth forecast for 2018 by the international financial institutions, whose projections for the current year is currently in the range of 4.5 -5.1%.

According to the Fiscal Council, the balance of risks to real GDP growth in 2018 is tilted to the downside, compared to the NCSP estimates for real GDP growth of 6.1% in April 2018 and also of 5.2% on which the 2018 budget was built. Possible additional risks can be generated by the deceleration of private investment as a result of a gradual strengthening of monetary policy, a further reduction in public investment to meet fiscal targets, or an increase in uncertainty about

[110] Represented by the removal from the computation base of the shocks related to the increase in excise duty on fuels in September and October 2017, as well as of the increases in oil, electricity and gas price in the fourth quarter of 2017 and in the first quarter of 2018.

government policies. In addition, a possible recording of a budget deficit beyond the 3%[111] reference value stipulated by the corrective arm of the SGP could lead to a reassessment by the foreign investors of the risk associated with the domestic economy, which would further increase the cost of government borrowing and would put pressure on the exchange rate.

VI.2. The fiscal framework

The draft budget for 2018 foreseen a general consolidated budget deficit target of 2.96% according to cash methodology, respectively of 2.92% of GDP according to ESA 2010 standard. According to its opinion on the state budget law, the Fiscal Council noticed that the draft budget for 2018 and its associated medium term framework, as in the case of last year's budget, are characterized by a deliberate and large deviation from the SGP’s preventive arm imposed by the national legislation through FRL, the convergence towards the medium-term objective (structural deficit of 1% of GDP) being expected to start in 2019, but with a structural effort lower[112] than the minimum target of 0.5 pp of GDP. Moreover, the Fiscal Council has repeatedly drawn the attention to the fact that a major fiscal loosening initiated in the context of an output gap close to zero in 2016 and then positive in the period 2017-2020 is counterproductive because it accentuates the pro-cyclicality of the fiscal policy, with a permanent negative impact on the budget deficit.

With regard to the fiscal position expressed in structural terms, following the accelerated fiscal consolidation in 2010-2015 (the structural budget balance decreasing to -0.2% of GDP in 2015), among an advance in the positive GDP’s deviation while maintaining the budget deficit close to the 3% target, in 2017 the structural deficit deteriorated significantly to 3.3%[113] of GDP (deepening from 2.1% of GDP in 2016). Although Romania is subject to the **Procedure of Significant Deviation from the MTO** initiated in June 2017, **for the year 2018, according to the Convergence Program 2018-2021 is estimated that the structural deficit is widening by 0.4% of**

[111] The EC estimates for Romania a budget deficit of 3.4% of GDP in 2018 and 3.8% of GDP in 2019 (Spring Forecast 2018).

[112] In the Report on the macroeconomic situation for 2017 and its projection for the years 2018-2020, the adjustment pace was projected to be only 0.31 pp of GDP for 2019 and 0.43 pp of GDP for 2020, while according to the EC Recommendation of June 2017, the adjustment should have started in 2017 by a pace of 0.5 pp of GDP. On May 22, 2017, the EC warned Romania of entering into the Significant Deviation Procedure from the OTM, the first evaluation mission under this procedure took place on September 26-27, 2017, and in December 2017, following the mission’s assessment, EC requested a 0.8% of GDP reduction in the budget deficit for 2018, a recommendation that would have been expected to be included in the draft budget for this year.

[113] According to the EC Spring Forecast 2018.

GDP compared to the previous year. It is worth noticing that this document, although recently elaborated, does not clearly indicate the convergence path towards the MTO, suggesting an adjustment step of 0.4 pp per year between 2019 and 2021, but without precisely specifying the measures that will lead to this result, contrary to the FRL's rules and to the EC recommendations, implying that the automatic correction mechanism is not working. **Moreover, the EC projections published on the occasion of the Spring Forecast released in May 2018 indicate levels of the budget deficit for 2018 significantly higher than the government estimates, respectively a level of 3.4% of GDP for the headline deficit (according to ESA 2010 methodology), and 3.8% of GDP in structural terms, this projections being consistent with the Fiscal Council's assessments. Thus, Romania is among the few countries that reversed the fiscal consolidation trend, being the only EU country with estimated budget deficits for 2018 and 2019 above the 3% of GDP deficit target.**

In its opinion on the draft budget, the Fiscal Council identified a high probability of a negative income gap, with the sources, on one hand the optimistic estimate of the GDP growth rate, considering the macroeconomic scenario on which the budget was based rather inappropriate from the viewpoint of a prudent fiscal approach and, on the other hand, of including ex-ante in the VAT revenue projection the impact of measures taken by NAFA to improve the VAT collection and the introduction of the disbursed VAT payment, estimated at 4.9 billion lei. Moreover, the Fiscal Council also identified at that time an under-assessment of the social assistance expenditures in the budget of at least 3 billion lei, considering their execution in the last quarter of the previous year. Thus, the Fiscal Council has assessed as significant the likelihood of the need for corrective actions during the year 2018 to avoid exceeding the 3% of GDP deficit ceiling set by the SGP corrective arm.

Both revenues and expenditures were at the end of March 2018 under the quarterly program of the initial GCB. Thus, total general government budget revenues are less than the planned amount with about 3.13 billion lei (a minus equivalent to 0.34% of GDP), having a degree of achievement compared to the program of 95.5% while the expenditures are lower by 7.63 billion lei (-0.83% of GDP), being at 90.3% of the program, so that the so that in the budgetary balance the impact is favorable in order to achieve a budget deficit about 4.5 billion lei under its quarterly target (a deficit of 4.46 billion lei compared to the quarterly target of 8.96 billion lei), respectively, an achievement degree of 49.8%.

Regarding the budgetary revenues, the execution below the quarterly targets was principally due to a massive underperformance of the *amounts received from the EU*[114] (-3.4 billion lei under the

[114] In the case of the amounts related to the non-reimbursable external funds related to the 2014-2020 financial framework, in the period January-March 2018, the majority of the amounts received were earmarked for the financing of agricultural projects, namely 4,079.5 out of the total of 4,450.7 million lei.

program, respectively 57.3%, mainly due to the non-achievement of the program for the financial framework 2014-2020, which recorded a negative gap compared to the target of 3.39 billion lei, respectively, 56.8% of the program), but also to the execution under the program in the case of *fiscal revenues*, with an achievement degree of 95.1%, respectively by 1.82 billion lei below the program. For this latter revenue aggregate, compared to the first quarter of this year's program, quarter-on-quarter revenue surpluses were recorded only at the level of the receipts from the *personal income tax* (+882 million lei, or 115.5%[115]) and *other taxes on income, profit and capital gains* (+86 million lei, respectively, 116.2% of the program), while significant under executions of the quarterly targets were recorded at the level of *VAT* receipts (-1,252 million lei, respectively 91.4% of the program), *excise duties* (-829 million lei, respectively 87.6% of the program), *other taxes and duties on goods and services* (-219 million lei, respectively 79.2% % of the program) and *corporate income tax* (-186 million lei, with an achievement degree of 95.2%).

The *non-tax revenues* receipts were above the program (107.9%, respectively, an increase of 349 million lei) on the background of a higher than expected performance of the *property income* received by the state budget. Also, well above the initial expectations were the revenues from *SSC* (+1,158 million lei, respectively 105.6% of the program). In the case of *VAT* receipts, their under-collection compared to the quarterly program may also have been generated by the increase in VAT reimbursements, which accounted for 4.1 billion lei compared to 2.9 billion lei in the first quarter of the previous year.

On the expenditure side, the execution for most expenditure categories was lower than the program for the end of the first quarter, except for those related to *goods and services*, which exceeded the program by 659 million lei (108.1%). The largest share of the total expenditures deviation of 7.3 billion lei compared to the programmed level was registered for the *projects financed by non-reimbursable funds* (-3.4 billion lei, corresponding to the 2014-2020 financial framework, respectively 58% of the program), followed by *other transfers*[116] (-2.4 billion lei, 57% of the program). Other significant shortages compared to the levels programmed for the first quarter were recorded in *interest expenses* (-0.59 billion lei, 82.2% of the program), *subsidies* (-0.57 billion lei, 81.1% of the program), *personnel expenses* (-348 million lei) and *capital spending*, which represent 94.5% of the quarterly program (-240 million lei).

Essentially, the budget execution for the first quarter of 2017 shows a significant underachievement for the *revenue from the EU funds for the 2014-2020 financial framework*, but also a relevant one for the *fiscal revenues*, while on the expenditure side, the underachievement

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[115] Since February, the impact of the reduction of the tax rate on personal income tax by 6 percentage points has been manifested.

[116] These include contributions to the European Union and other international bodies and transfers to state-owned economic agents.

is much higher compared to the initial planning, especially for the *projects funded by external post-accession funds* and for *other transfers*.

Taking into account the budgetary execution in the first quarter of this year, the Fiscal Council considers as relevant the risks of underachievement of the programmed VAT revenue as well as of the significant overruns for the amounts estimated in the draft budget for social assistance, personnel and goods and services spending. **In the context of maintaining the current fiscal-budgetary policy parameters, the 2018 risk balance appears to be significantly tilted towards exceeding the 3% budget deficit target, requiring corrective measures in revenues or expenditures, to avoid entry into the EDP**. In the direction of registering a deficit close or below the deficit target, it could act, similarly to the previous year, an underachievement of the investment spending as a result of a low absorption of EU funds for 2014-2020 financial framework. Under these circumstances, the Fiscal Council recommends to the Government to accelerate structural reform measures with an impact on the rate of revenue collection and on the efficiency of public money spending, in particular, to speed up the implementation of the program aiming to modernize the system of budget revenue management. The Fiscal Council also reiterates its recommendation on the rapid operationalization of the public investment prioritization process and a real reform of the public administration expected to set the various state levels on the basis of performance management, which could generate significant gains in efficiency at the level of the budgetary expenditure.

The Fiscal Council has repeatedly drawn attention to the risk associated with the repetitive conduct of targeting a budget deficit very close to 3% of GDP as being likely to lead to a weakening of the position of public finances and to a complication in their management in the event of some adverse shocks, thus keeping fiscal policy in the trap of pro-cyclical behavior. This slippage, whose subsequent correction through fiscal consolidation in the downward phase of the economic cycle is likely to generate economic and social costs that will cancel the positive short-term effects of fiscal relaxation, as the economic theory shows, international empirical studies, and also Romania's experience in the last 10 years. Moreover, the deepening of the budget deficit took place together with the deterioration of the quality of public spending, in the sense of increasing the share of personnel spending and social assistance expenditure, to the detriment of those generating long-term economic growth, like investment, education or health expenditures, which have reached alarmingly low levels relative to GDP compared to the previous years.

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Appendix – Glossary of terms

Adjustment program - a detailed economic program, usually supported by use of IMF resources, that is based on an analysis of the economic problems of the member country and specifies the policies implemented or that will be implemented by the country in the monetary, fiscal, external, and structural areas, as necessary to achieve economic stabilization and set the basis for self-sustained economic growth.

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

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

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

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

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

Automatic stabilizers - features of the tax and transfer systems that tend to offset fluctuations in economic activity without direct intervention by policymakers. Examples are unemployment compensation and progressive taxation rates.

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

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

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

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

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

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

Capital account - account which reflects the evolution of capital transfers and acquisitions/ sale of non-financial assets.

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

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

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

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

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

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

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

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

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

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

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

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

Direct Public Debt - total public debt, except guaranteed public debt.

Disinflation - process of reducing inflation.

Economic classification - expenditure structuring based on their economic nature and effect.

Economic growth - annual growth rate of the real GDP

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

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

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

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

European semester - additional tool for preventive surveillance of economic and fiscal policies of the Member States; the European Semester is a six-months period every year during which the Governments of the member states have the opportunity to collaborate and discover the experiences and opinion of their EU homologues in order to detect any inconsistencies and emerging imbalances of economic and fiscal policies that could violate the rules of the Stability and Growth Pact.

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

Eurosystem - the central banking system of the euro area. It comprises the ECB and the national central banks of those EU Member States whose currency is the euro.

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

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

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

Expansionary fiscal policy - is a fiscal policy behavior that has an accelerating effect in aggregate demand growth and possible amplification of inflationary pressures.

Expansionary monetary policy - the monetary policy behavior has effect in stimulating aggregate demand and a possible amplification of inflationary pressures.

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

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

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

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

Fiscal consolidation - the policy aimed to reduce budgetary deficits and the accumulation of public debt.

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

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

Fiscal revenues - budget revenues collected through taxation. Fiscal revenues include: personal income taxes, corporate income taxes, capital gain taxes, property taxes and fees, good and services taxes and fees, taxes on foreign trade and international transactions, other taxes and fiscal fees, social contributions.

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

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

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

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

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

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

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

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

Implicit tax rate - the ratio between revenue collected for a particular type of tax and its associated tax basis.

Inflation - reflects the widespread and persistent increase in prices and it is typically measured by the consumer price index. Inflation erodes the purchasing power of money: the same amount is used to buy fewer goods.

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

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

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

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

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

Nominal variables – variables expressed in current prices.

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

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

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

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

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

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

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

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

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

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

Real convergence - in the process of adhesion to a single currency area, it is necessary to achieve also a real convergence, respectively a high degree of similarity and cohesion of economic structures of the candidate countries; although the Maastricht treaty does not mention real convergence criteria, these can be summarized by a series of economic indicators like GDP per capita, the degree of openness, the share of the commerce with member states, economic structure.

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

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

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

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

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

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

S1 - indicator of the sustainability gap that shows increasing taxes or reducing expenditure (as a percentage of GDP) required subject to a debt level of 60% of GDP at the end of the period.

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

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

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

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

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

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

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

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

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

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

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

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

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

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