Romania

Fiscal Council

Annual Report

2019

Note:

The Annual Report for 2019 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 10, 2020.

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List of abbreviations

BRF	Budget Reserve Fund
CEE	Central and Eastern Europe
CF	Cohesion Fund
CPI	Consumer price index
EAFRD	European Agricultural Fund for Rural Development
EAGF	European Agricultural Guarantee Fund
EC	European Commission
EBRD	European Bank for Reconstruction and Development
EDP	Excessive Deficit Procedure
EGDI	E-Government Development Index
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
ESIF	European Structural and Investment Funds
EU	European Union
FC	Fiscal Council
FRL	Fiscal Responsibility Law No 69/2010
FS	Fiscal Strategy
FSA	Financial Supervisory Authority
GCB	General consolidated budget
GDP	Gross Domestic Product
GEO	Government Emergency Ordinance
IBRD	International Bank for Reconstruction and Development
HICP	Harmonized Index of Consumer Prices
IMF	International Monetary Fund
MEF	Ministry of European Funds
MPF	Ministry of Public Finance
MTO	Medium-term objective
NAFA	National Agency for Fiscal Administration
NBR	National Bank of Romania
NCSP	National Commission for Strategy and Prognosis
NIS	National Institute of Statistics
NMS	New EU Member States
NMS CEE	New Member States from Central and Eastern Europe
NPISH	Non-profit institutions serving households
NPLD	National Program for Local Development
NRDP	National Rural Development Program

NREF	Non-reimbursable external funds
NRP	National Reform Program
OECD	Organization for Economic Co-operation and Development
OP	Operational Program
OPFMA	Operational Program for Fisheries and Maritime Affairs
OPADP	Operational Program for Assistance to Disadvantaged People
pp	Percentage points
RAMP	Revenue Administration Modernization Project
SGP	Stability and Growth Pact
SME	Small and Medium Enterprises
SSC	Social Security Contribution
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact)
TUEF	Temporary Unavailability of European funds
VAT	Value added tax
VTTL	VAT Total Tax Liability
WB	World Bank

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I. Summary

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

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

The economic activity in Romania continued its upward evolution in 2019, the growth rate stabilizing close to 4%. Economic growth was more balanced, based on investments and consumption, while net exports had a significant negative impact. The economic advance was accompanied by an upward but less volatile evolution of inflation and by a slight increase in the current account deficit which reached 4.6% of GDP at the end of the year. The Romanian economy is characterized by a high level of the twin deficits which raises important challenges for the fiscal policy.

The labor market continued its evolution from previous years, with the unemployment rate falling to 3.9%, while wages continued to record significant increases both in the public and private sectors.

In 2019, Romania's economy continued to evolve on an upward trend, the gross domestic product (GDP) advancing by 4.1% compared to the 4.4% increase recorded in 2018. Unlike previous years, when consumption was the main driver of economic growth, in 2019 both the final consumption expenditure and the gross fixed capital formation contributed decisively to GDP growth (+3.8 pp each), a positive impact being also exerted by government consumption (+1.1 pp). The change in inventories (-2.9 pp, after being the factor with the second highest positive contribution after consumption in the previous year) and net exports (-1.7 pp, due to a more pronounced dynamics of imports in comparison to exports) had an unfavorable influence on economic growth. From the supply perspective, GDP growth was supported by almost all sectors of the national economy, with the most important contributions belonging to constructions and trade.

2019 was characterized by a less volatile evolution of inflation, the gap between the maximum and minimum values being considerably reduced compared to the previous year. At the end of December 2019, the inflation rate was 4% (up from 3.3% at the end of 2018), while the increase in prices throughout the economy, as measured by the GDP deflator, stood at 6 9%. The current account deficit increased slightly from 4.4% in 2018 to 4.6% in 2019, about half being financed by foreign direct investments. It should be noted that the average deficit recorded in the last 3 years is 3.9% of GDP, being in the immediate vicinity of the 4% attention threshold set by the European Scoreboard. The deepening of the current account deficit was mainly determined by the sizeable budget deficits from recent years, the Romanian economy being characterized by a high level of the twin deficits, a unique case in the region, which raises important challenges for the fiscal policy in terms of unfavorable international developments, accentuated by the magnitude of the COVID-19 pandemic shock.

The non-governmental credit remained on a moderately upward trajectory, registering an advance of 2.4% in real terms compared to the previous year, due to the increase in the volume of loans granted in lei. The labor market continued its evolution from previous years, the average number of employees increasing to 5.2 million people (+1.7% compared to 2018), so that the ILO unemployment rate fell to 3.9%. The average gross earnings across the economy was 4,923 lei, up by 13% compared to 2018, its dynamics being supported by increases in both public and private sector earnings.

The conduct of fiscal policy in 2019 resulted in a major slippage from the initial deficit targets, both in cash and ESA 2010 terms, while also amplifying the deviation from the MTO. Thus, after Romania has constantly been under the significant deviation procedure from the MTO between 2017 and 2019, the excessive deficit procedure was also launched in March 2020.

The 2019 general consolidated budget (GCB) was based on a macroeconomic scenario that estimated a real GDP growth of 5.5%, with a budget deficit target of 2.76% of GDP, respectively a deficit of 2.78% of GDP according to the ESA 2010 methodology. The structural deficit estimated at that time for 2019 was 2.97% of GDP, thus, deviating substantially from the medium-term objective (MTO) of 1% of GDP. Against the background of macroeconomic developments below the initial estimates and the massive non-realization of budget revenues, coupled with an increase in budget expenditures, the final budget execution recorded a large slippage from the initial deficit targets, both according to cash (4.56% of GDP) and ESA 2010 standards (4.29% of GDP), leading to the launch of the excessive deficit procedure (EDP) on March 4, 2020, by the European Commission (EC). The structural deficit also deteriorated significantly to 4.3% of GDP compared to 2.92% of GDP in 2018, 3.05% of GDP in 2017, 1.9% of GDP in 2016 and 0.4% of GDP in 2015[1]. It is also worth mentioning the very high value of the primary structural deficit, which reached 5.2% in 2019 (the highest level in the EU), and has been growing steadily during the last 4 years, from only 0.4% in 2015.

Fiscal policy has been strongly pro-cyclical between 2006 and 2015, and during the 2016-2019 period it became expansionist again,

Romania has pursued a strong pro-cyclical fiscal policy between 2006 and 2015, stimulating the economy during expansion periods (2006-2008) and slowing down during the periods when it operated below potential (2010-2015), thus contributing to the amplification

[1] According to data obtained from AMECO (May 2020).

significantly exceeding the limits imposed by the MTO and exhausting the necessary fiscal space to counter a recession.

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 was partially reversed in an abrupt manner starting with 2016 as a result of the new Fiscal Code, which brought a broad fiscal relaxation while simultaneously legislating significant increases in expenses, especially with salaries and pensions, in contradiction with the fiscal principles and rules established by the FRL, as well as with the European fiscal governance treaties to which Romania has acceded. During the 2016-2019 period, the conduct of fiscal policy became strongly expansionist again, the positive fiscal impulse amounting to 3.9 pp of GDP, significantly exceeding the limits imposed by the MTO given that, in 2017, Romania had been placed in the preventive arm of the Stability and Growth Pact.

Investment expenditures, expressed as a percentage of GDP, recorded a slight increase, compared to 2018, reaching 4.11% of GDP (from 3.59% of GDP), but their level remains well below the average of the 2009-2018 period (by 1 pp of GDP).

Relative to the last 5 years, the 2019 execution of investment expenditures as a percentage of GDP continued to exhibit a slightly upward trend after the minimum recorded in 2017, registering a share in GDP close to the level of the 2014-2018 period (4.24% of GDP), but below the average of the 2009-2018 period (by 1 pp). In comparison to the previous year, investment expenditures increased by 9.4 billion lei (+0.52 pp of GDP) while, relative to the initial budget, investment expenditures were 6.3 billion lei lower (respectively, by 0.6% of GDP), the deviation being higher than the one recorded in the previous year by 0.1 pp of GDP. This development is largely attributable to the non-materialization of the expenditure forecast for projects financed from non-reimbursable external funds related to the 2014-2020 financial framework, partially offset by the increase in capital expenditures.

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

In what concerns the management of public investments, it can be appreciated that very limited progress has been made during 2019, being necessary to increase the transparency of the process of prioritizing public investments and to streamline the allocation and spending of public money in this field. Frequent changes in fiscal policy, non-systematic application of regulatory impact assessment tools, poor strategic investment planning, the cancellation of corporate governance reform in state-owned companies, budgetary pressures arising from the new pension law amid the very limited fiscal space and the expansionary fiscal-budgetary policy represent serious impediments for the significant increase of investments in the medium and long run.

The collection efficiency index increased significantly for direct taxes paid by the population, stagnated in the case of VAT and social security contributions, and recorded a slight decrease for direct taxes paid by enterprises. On the other hand, the significant advance of excise duties related to tobacco products may suggest a collection improvement in this area.

The collection efficiency index for direct taxes paid by the population recorded a significant increase (from 0.71 in 2018, to 0.79 in 2019), but the increase was not caused by receipts from income tax, given their evolution, being triggered by other taxes included in this category. On the other hand, the collection efficiency for direct taxes paid by enterprises decreased slightly (from 0.27 to 0.26), a detailed analysis of this category indicating a slower evolution of the corporate income tax paid by non-financial agents, partially offset by a faster dynamic of the corporate income tax paid by commercial banks.

The already low level of the collection efficiency index remained unchanged in the case of VAT (no significant revenue increases were identified that would result from improved collection efficiency, although the Ministry of Public Finance initially anticipated a favorable impact of 6 billion lei) and of social security contributions. Regarding excise duties, the actual execution exceeded the initial program by over 0.3 billion lei, and the significant advance of excise duties related to tobacco products may suggest a collection improvement in this area.

Romania has a very low level of budget revenues relative to GDP, of only 31.7% (ESA 2010), while tax revenues stand at 26.7% of GDP, ranking on the penultimate place in the EU in 2019, similar to the 2016-2018 period, as an effect of the major changes brought by the new Fiscal Code. Compared to Bulgaria, the share of budget revenues in GDP is lower by 6.7 pp and that of tax revenues by 3.5 pp of GDP.

In 2019, the budget revenues of Romania recorded a level of 31.7% of GDP, according to the ESA 2010 methodology, being 13.4 pp below the European average and among the lowest in the European Union (EU). Tax revenues (taxes and social security contributions) stood at 26.7% of GDP, being 13.2 pp below EU average and ranking Romania on the penultimate place. Compared to the previous year, the budget revenues gap towards the EU average has widened by 0.2 pp of GDP. The share of tax revenues in GDP is significantly lower than in other Eastern European countries such as Hungary (36.8%), Slovenia (36.5%), Poland (36.2%) and the Czech Republic (34.6%). Compared to Bulgaria, the share of budget revenues in GDP is lower by 6.7 pp and that of tax revenues by 3.5 pp of GDP. The relatively abrupt reduction of budget revenues during the last 4 years is the result of major changes brought by the new Fiscal Code, by the ample fiscal relaxation materialized in the decrease of the share of budget revenues in GDP between 2015 and 2019 by 3.8 pp of GDP, and that of tax revenues by 1.3 pp of GDP, while across the EU they increased by 0.4 and 0.7 pp of GDP, respectively.

The room for increasing performance in the field of tax collection remains significant, and the cancellation of the revenue administration modernization project initiated in 2013 in collaboration with the World Bank, coupled with delays in taking measures to digitalize the tax administration are likely to reverse the administrative reform process initiated in 2011-2013.

The process of reforming the Romanian tax administration was launched in 2013 in collaboration with the World Bank (WB). The Fiscal Council noted in its reports a series of improvements in the efficiency and simplification of the administrative tax collection process. In 2018, at the initiative of the Romanian authorities, the Revenue Administration Modernization Project (RAMP) was stopped, although it would have ended in 2021. The abandonment of the RAMP program led to the impossibility of creating an information system that would allow The National Agency for Fiscal Administration (NAFA) to centralize financial data from all over the country. In 2019, with reconfirmation in 2020, the intention to resume the NAFA digitalization program was announced.

In 2019, there was a deterioration in the use of the reserve fund, the total amount of expenses incurred this year representing the maximum of the analyzed period (2007-2019).

The deterioration of the use of the reserve fund appears both from the perspective of the total expenses incurred and from the perspective of the number of Government decisions adopted in order to allocate amounts from this fund. Thus, in 2019, approximately 5.2 billion lei (1.4% of total expenditures) were allocated from the budget reserve fund, of which approximately 4.3 billion lei to the central administration and 0.9 billion lei to the local one. Compared to the previous year, the allocations from the reserve fund increased by about 2.5 billion lei (they practically doubled), as a result of increasing the transfers to the central administration by 2.8 billion lei, while the amounts redirected to local authorities were lower by about 0.3 billion lei.

In this context, it is necessary to amend the legislation governing the use of the reserve fund.

The Fiscal Council considers it necessary to amend the legislation governing the use of the reserve fund, reiterating the recommendation to explicitly specify the expenditures that can be incurred from the reserve fund, coupled with a greater transparency, including by regularly reporting to Parliament on the use of the fund.

Personnel expenditures increased significantly in 2019, their share in total budget revenues being higher than the levels recorded during the pre-crisis period (2007-2008).

Compared to 2018, personnel expenditures increased by approximately 16.2 billion lei (+18.8%) in cash terms and, compared to 2016, this aggregate increased substantially by about 45.8 billion lei (+79.5%). Following the salary increases from 2019, the average gross salary reached 6,472 lei/month in the public sector, being 36.6% higher than in the private sector. Compared to the other EU countries, Romania has for the second consecutive year the highest share of personnel expenditures in total budget revenues (33.8%), being even higher than the levels recorded during the pre-crisis period (2007-2008) .

The self-financing capacity of the pension system has apparently improved in the last two years following the transfer of contributions from employers to employees which led to an increase in labor taxation through social security contributions. But this development has no counterpart in a greater solidity of the public budget. At the same time, the share of social assistance expenditures in total budget revenues remains high.

Starting with 2018, the change in the taxation of earnings by transferring contributions from employers to employees has led to an increased taxation of labor through social security contributions, but taxation at the aggregate level was not affected because the income tax has been reduced. Due to these measures, the self-financing capacity of the pension system has apparently improved in recent years. Thus, the deficit of the social security budget decreased to 0.92% of GDP in 2019 from 1.21% of GDP in 2018. But this decrease has not led to a greater solidity of the consolidated budget and there is a need for substantial macroeconomic adjustments. In fact, the estimates for the 2020-2022 period show the deterioration of the social security budget.

The new pension law, although motivated by the need to correct inequities, creates great difficulties for the public budget. The return to budgetary sustainability calls for a reconsideration of the implementation timetable for the new pension law.

Law no. 127/2019 on the public pension system, although motivated by the need to correct inequities, greatly complicates the medium-term budget construction as the provisions on increasing the pension point (from 1.265 lei currently to 1.775 lei from September 1, 2020 and, respectively, to 1.875 lei starting with September 1, 2021), the modification of the calculation formula and the new established rights imply additional expenses of a very large magnitude. Thus, social assistance expenditures reached 10.8% of GDP in 2019 and, according to the projections of the Fiscal Council, they are expected to increase to 12.2% of GDP in 2020, 14.4% of GDP in 2021 and up to 15.5% of GDP in 2022, even without taking into account the impact of the COVID-19 pandemic on the GDP dynamics.

In 2019, public debt increased to 35.2% of GDP due to the high primary deficit, its unfavorable impact being partially offset by the effects of economic growth, real interest rate and the stock-flow adjustment. Given the latest EC forecasts, according to the Fiscal Council's calculations, public debt is projected to grow rapidly over the next 2 years up to 54.3% of GDP. This steep advance of

Public debt, according to ESA 2010 methodology and measured as a share of GDP, increased from 34.7% in 2018 to 35.2% in 2019. This development was caused by the high level of the primary deficit (+3.1% of GDP, representing the highest primary deficit in the EU in 2019), while real economic growth (with an impact of -1.4 pp), real interest rate (with an impact of -1.1 pp) and the stock-flow adjustment (with an impact of -0.2 pp) acted in the sense of decreasing the share of public debt in GDP. Given the latest EC forecasts on the economic impact of the COVID-19 pandemic, according to the Fiscal Council's calculations, an accelerated increase in public debt is forecasted over the next 2 years up to 45.9% of GDP in 2020 and 54.3% of GDP in 2021, exceeding the 45%

public debt poses a number of challenges in meeting the financing needs.

and 50% thresholds set by the FRL. Taking into account more unfavorable scenarios for the real GDP growth rate and the evolution of the interest rate, the debt level could reach 56.7% of GDP, a value close to the 60% reference level under the excessive deficit procedure. At the same time, the steep advance of public debt is expected to lead to a rapid increase in financing needs, raising a number of important challenges regarding the limited debt absorption capacity of the domestic market, uncertainties about the availability of financing in foreign markets and future developments. of financing costs. In this context, an important resource for financing the economy, starting in 2021, can be the economic recovery plan proposed by the EC, through which Romania could receive around 33 billion euros.

The magnitude of the shock caused by the COVID-19 pandemic led to a radical adjustment of Romania's economic growth forecasts, the IMF and the EC anticipating a contraction of real GDP between 5% and 6%. The first budget revision for 2020 is built on a decline in real GDP of only 1.9%. In this context, the Fiscal Council considers that it is necessary to take into account two additional macroeconomic scenarios for the current year: a contraction of real GDP placed in the 4%-6% range, respectively a more severe contraction of GDP, of 8%-9%.

Even since 2019, there has been a reduction in the growth rate of the Romanian economy, mainly due to the slowdown in external demand and the contraction of industrial production. Thus, forecasts elaborated at the end of the previous year predicted a moderate economic advance in 2020, but the magnitude of the shock caused by the COVID-19 pandemic, unprecedented in contemporary history, caused a major and very rapid turnaround in economic activity. Consequently, forecasts concerning economic growth underwent radical adjustments, pointing towards a severe contraction of the European economy (-7.1% according to the IMF, -7.4% according to the EC) and of the Romanian economy (-5% according to the IMF, -6% according to EC). The macroeconomic scenario elaborated by the Government on the occasion of the first budget revision for 2020 is much more optimistic, being built on the assumption of a 1.9% decline in real GDP. In this context, starting from the NIS analyzes on the economic impact of the pandemic, from the historical reference of the economic crisis that started in 2008 and from other available data, the Fiscal Council considers that it is prudent and necessary to take into account two additional macroeconomic scenarios for the current year: one based on a contraction of real GDP placed in the 4%-6% range, and a scenario that predicts a more severe contraction of GDP, of 8%-9%.

The initial budget construction for 2020 and the associated medium-term budgetary framework maintained the expansionary stance of fiscal policy, even in the

The initial budget construction for 2020 and the associated medium-term budgetary framework maintained the expansionary stance of fiscal policy, although the budget was built in the context of an imminent risk of entering the excessive deficit procedure. While the budget deficit for 2019 was significantly above the 3% of

context of an imminent risk of entering the excessive deficit procedure. The actual deficit reduction expected at that time for 2020 was based only on temporary elements.

GDP threshold, the expected reduction for 2020 was only achievable at the level of temporary elements. Based on the data available at that time, the level of the budget deficit estimated by the FC for 2020 was 4.6-4.8% of GDP (above the MPF target by 1-1.2 pp of GDP), amid a negative gap of revenues, a macroeconomic framework considered optimistic, the failure to take into account measures with an unfavorable impact on budget revenues that were in the final stages of the legislative process and the undersizing of expenditures with goods and services and social assistance.

In March 2020, EC notified Romania on the launch of the excessive deficit procedure.

EC notified Romania on the triggering of the excessive deficit procedure in March 2020, establishing an adjustment schedule, in the sense of gradually reducing the actual and structural deficit, aiming to end the excessive deficit situation by 2022 at the latest. Although European fiscal rules were suspended in March to allow for measures required to combat the economic effects of the pandemic, on April 6 EC reconfirmed the launch of the excessive deficit procedure on the grounds that violations of the European fiscal rules preceded the pandemic.

The first budget revision from April 2020, adopted in the context of the extraordinary circumstances caused by the COVID-19 pandemic, revised substantially upwards the budget deficit estimate for the current year, but FC considers that the risks related to it are significantly inclined on the negative side. Maintaining the current timetable for the implementation of the pension law implies significant increases in the risks related to the sustainability of public debt in the short, medium and long run.

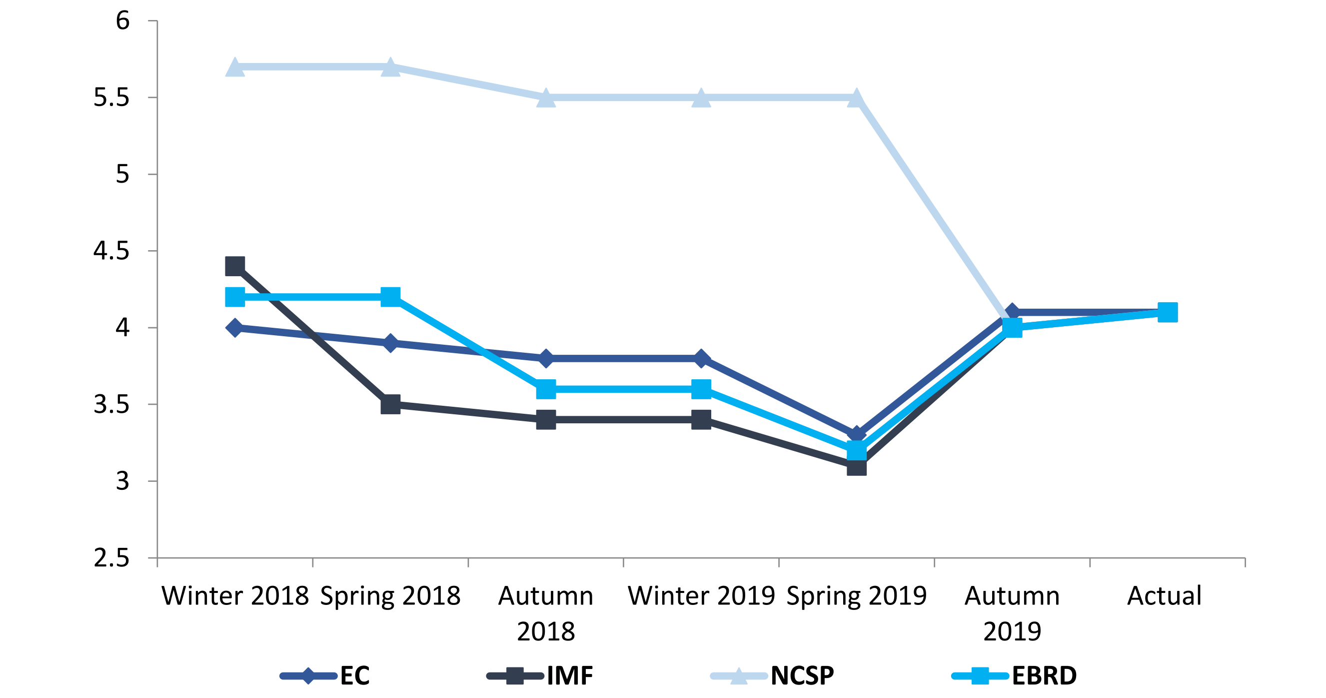
In April 2020, the Government exceptionally adopted the first revision of the GCB, in the context of declaring the manifestation of extraordinary circumstances represented by the COVID-19 pandemic. FC maintains its assessment on the fiscal-budgetary framework for 2020, expressed in its Opinion on the draft budget revision published on April 24, considering that, in addition to the macroeconomic scenario assumed by the Government which leads to a deficit of 6.7%, it is prudent to consider two additional scenarios based on a more severe contraction of real GDP. The two scenarios would lead to budget deficits for 2020 of 8.1%-8.9% and 9.9%-10.4% of GDP, respectively, well above the current Government estimate. The balance of risks related to these estimates inclines, in the FC's opinion, on the negative side, respectively the recording of a higher budget deficit.

FC reiterates that maintaining the current timetable for the implementation of the pension law, in the absence of credible and substantial compensatory measures, would make it almost impossible to reduce the budget deficit in 2021 from the current level which is already dangerously high. The return to fiscal-budgetary sustainability is essential for overcoming this very difficult period and calls for a reconsideration of the pension law enforcement timetable, as well as for the timely, public communication of fiscal-budgetary policy plans.

II. Macroeconomic Framework in 2019

The economic activity in Romania continued to evolve on an upward trend in 2019, the growth rate stabilizing around 4% (4.1% advance in real terms, compared to 4.4% in the previous year). Thus, after a period of successive increases starting with 2011, the level of real GDP in 2019 was 28.3% higher than that recorded in 2008 when the maximum value from the pre-crisis period was recorded. The trajectory of the Romanian economy was in line with EU trends where 2019 marked a moderate but stable advance in the context of positive developments in the US-China trade relationship, but the balance remains fragile amid existing geopolitical and social tensions[2]. Compared to other EU countries, Romania ranked fifth in the top of economic growth behind Ireland (5.5%), Hungary (4.9%), Malta (4.4%) and Estonia (4.3%).

Figure 1: The evolution of economic growth forecasts for 2019



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

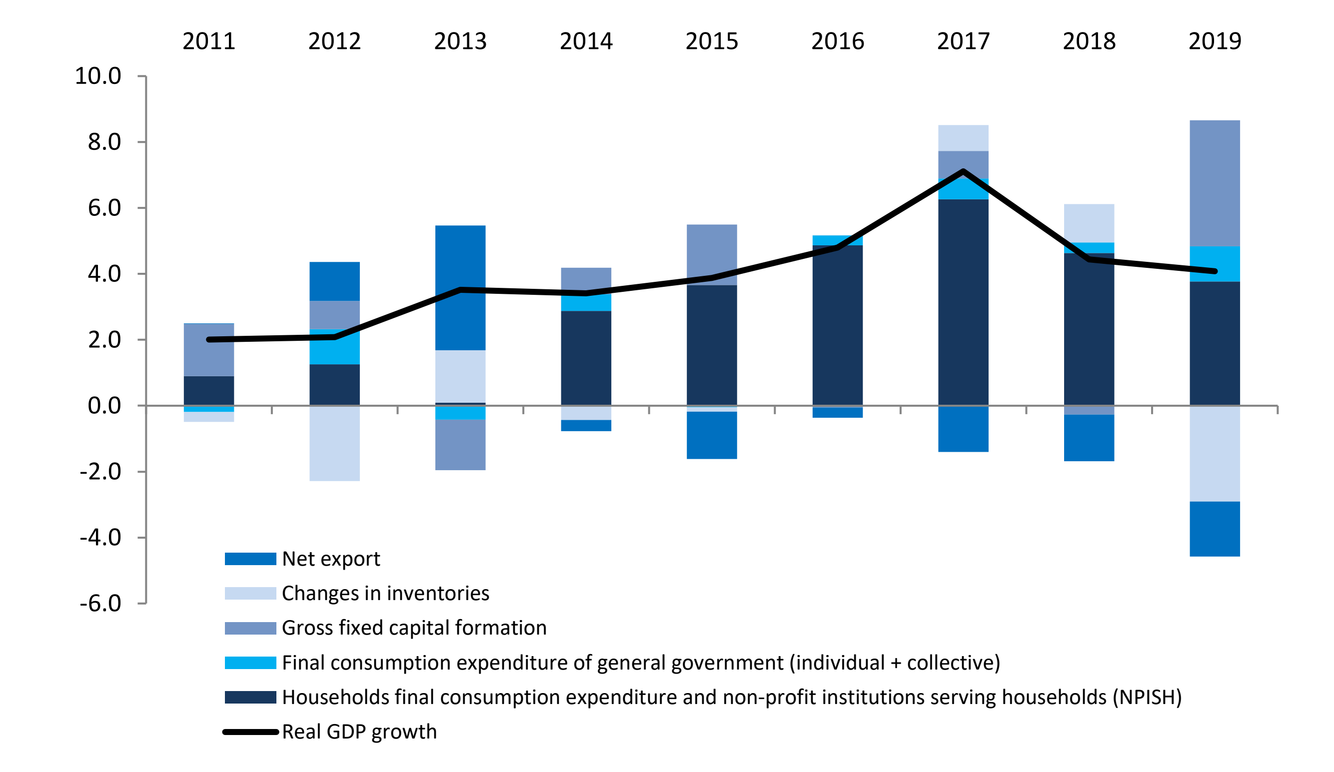
Analyzing *Figure 1*, it is observed that the initial forecasts of the EC, IMF and EBRD exhibited a significant decrease in the pace of economic growth in Romania during 2019. Subsequently, the forecasts were revised upwards as the results of the first quarters of 2019 showed higher-than-expected developments. Finally, the effective GDP growth rate was close to the EC, IMF and EBRD projections from the beginning of 2018. On the other hand, the NCSP forecasts displayed a significant positive gap compared to those of the EC, IMF and EBRD, being on average more optimistic by about 1.4 pp. Compared to the initial

[2] According to the EC 2020 Winter Forecast.

NCSP forecast of 5.5%, which was taken into account when drafting the budget for 2019, the actual economic growth was lower by 1.4 pp, thus, creating the premises to encounter difficulties in achieving the planned parameters of the budget execution. However, the significant underestimation of the GDP deflator (which had a value of 6.9% compared to the projection of 2.1%) allowed the nominal variables of the macroeconomic framework (relevant from the perspective of fiscal revenues, excluding excise duties) to accommodate, at least in part, the overestimation of the real GDP growth rate.

In terms of aggregate demand (see *Figure 2*), the main contribution to the 4.1% economic growth, recorded in 2019, was provided by household consumption and gross fixed capital formation, the two components having a positive impact of 3.8 pp each on economic growth. While household consumption expenditure was the main driver of growth in most of the previous years (but on a downward trend after contributions of 6.3 pp in 2017 and 4.6 pp in 2018), it is worth mentioning the significant recovery of gross fixed capital formation after having made a negative contribution (-0.3pp) to economic growth in 2018 (partially, due to a favorable base effect). However, it should be noted that historical developments of this aggregate display a lot of inconsistency, the sign of its contribution to economic growth alternating four times in the last 5 years, although investments were expected to improve by making progress in the implementation of projects financed through European funds. A positive impact was also exerted by government consumption which had a contribution of 1.1 pp to GDP growth (in the context of a 6.4% increase over the previous year, in real terms), this being one of the largest positive contributions of this factor to economic growth in recent years, a similar value being registered in 2012.

Figure 2: Contributions to real GDP growth



Source: Eurostat, Fiscal Council's calculations

In what concerns the negative contributions to economic growth, the change in inventories is noted for the second consecutive year with an impact of -2.9 pp, after being the factor with the second largest positive contribution in 2018 (1.2 pp). Also, similar to past evolutions recorded since 2014, net exports continue to have a negative impact on economic growth (-1.7 pp) due to the stronger dynamics of imports (real growth of 8%) in comparison to exports (real growth of only 4.6%). At the same time, it should be mentioned that the growth rates of both components are on a downward trend after 2016 when imports increased by 16.5% and exports by 16%.

In terms of aggregate supply, GDP growth was supported by almost all sectors of the national economy[3], with the most important contributions being made by constructions (+1pp) with a share of 6.4% in GDP formation and by wholesale and retail; repair of motor vehicles and motorcycles; transport and storage; hotels and restaurants (+0.9 pp) with a share of 18.2% in GDP formation. In this sense, it should be noted the recovery of the construction sector, also as a result of the facilities granted in 2019, this sector having a negative impact on economic growth in the previous year. Positive contributions, but of a smaller magnitude, were also recorded by the following sectors: professional, scientific and technical activities; activities of administrative services and support services (+0.4 pp) with a share of 7.8% in GDP formation, real estate transactions (+0.4 pp) with a share of 7.2% in GDP formation, information and communications (+0.4 pp) with a share of 5.5% in GDP formation, public administration and defense; social insurance in the public system; education; health and social assistance (+0.3 pp) with a share of 13.6% in GDP formation, entertainment, cultural and recreational activities; repairs of household goods and other services (+0.3 pp) with a share of 3.4% in GDP formation. The only sectors with a negative contribution on economic growth were industry (-0.3 pp), which also has the largest share in GDP formation (21.8%), and agriculture, forestry and fishing (-0.1 pp), with a share of 4.1% in GDP formation. Thus, it is worth noting the decline in industrial activity after being the main driver of economic growth in previous years. Overall, the gross value added by the entire economy contributed with 3.3 pp to economic growth, the remaining difference of 0.8 pp corresponding to net taxes on products. Compared to 2018, there is a significant change in the contribution structure of the national economy to GDP growth, industry and construction switching their roles, from the sector with the greatest positive impact to the main sector with a negative influence.

Unlike 2018, which was characterized by high inflation with steep developments during the year, the indicator ranging between 5.4% (May 2018) and 3.3% (December 2018), 2019 recorded slightly lower inflation rates and the gap between the maximum and minimum values has narrowed considerably[4]. Both the inflation rate recorded at the end of 2019 (4%) and the average annual inflation of 3.8% significantly exceeded the 2.8% level taken into account for both indicators when elaborating the 2019-2021 Fiscal Strategy. In what concerns the CPI inflation adjusted to eliminate the effects of tax changes, it rose during the first quarter of 2019 to 3.6%, then declined over the next two quarters to the value of 3.1% and resumed its upward trend in the fourth quarter, recording a level of 3.7% at the end of the

[3] According to the National Institute of Statistics (NIS) press release from April 7, 2020.

[4] According to the Inflation Reports from May 2019, August 2019, November 2019 and February 2020, published by the National Bank of Romania (NBR).

year. The price increase across the entire economy, as measured by the GDP deflator, stood at 6.9% in 2019. The difference between the value of the deflator and the average annual inflation of 3.8% is mainly caused by price increases affecting government consumption (8.2%) and gross capital formation (6.1%).

2019 began with an increase in the inflation rate, reversing the downward evolution that was recorded in the last part of the previous year, so that at the end of March there was an advance of 0.8 pp compared to December 2018, while at the same time exceeding by 0.5 pp the upper limit of the variation range. Several factors with an unfavorable impact contributed to this development, such as: the increase in vegetable prices, the increase in the international price of oil, the depreciation of the national currency and the increase in the excise duty on cigarettes. At the same time, the first quarter of 2019 recorded an overall increase in the inflation expectations of economic agents. After reaching a maximum of 4.1% in April, the inflation rate decreased slightly, registering a level of 3.8% at the end of June, which represents a decrease of 0.2 pp compared to the previous quarter. This development was caused by the influence of exogenous factors represented by the correction of the oil price (amid concerns about a slowdown in the global economy) and by the implementation of the timetable for increasing excise duties on tobacco products which was done earlier than scheduled. The third quarter started with a return of inflation to 4.1%, followed by a gradual decrease to 3.5%, thus reaching the upper limit of the variation range associated with the 2.5% target. The decrease in inflation was due to the reduction in the price of vegetables (as a result of the favorable harvest obtained at European level), while an opposite influence was exerted by the price of tobacco products, as well as by the persistence of inflationary pressures from fundamental factors (core inflation recording a slight increase during the third quarter). October saw a temporary re-entry of inflation within the variation range (3.4%), but subsequently there were gradual increases towards 4% at the end of December which represents an advance of almost 0.6 pp compared to the previous quarter, respectively an exceeding by 0.5 pp of the upper limit of the variation range. This evolution was mainly caused by the manifestation of a base effect in the case of fuel, by the supply shocks registered at the level of some agri-food products and by the moderate depreciation of the national currency. At the same time, unlike the CPI inflation rate, core inflation had an upward trajectory throughout the year (from 2.5% to 3.7% at the end of 2019), reflecting both the impact of circumstantial factors (depreciation of the national currency, tariffs increases in the telecommunications sector as a result of legislative changes introduced at the end of 2018, supply shocks in the pork meat segment due to the global manifestation of the swine fever) and fundamental ones (persistent inflationary pressures due to company labor costs and excess demand).

Given the evolution of inflation during 2019, NBR kept the monetary policy interest rate unchanged at 2.5% throughout the year. Similarly, the minimum reserve requirements were maintained at 8%, for both domestic and foreign currency liabilities.

With regard to the external position, the current account deficit maintained its upward trend in 2019, reaching 4.6% of GDP from 4.4% in 2018, amid an increase of 1.2 billion euros (+13.6%) compared to the previous year, while nominal GDP advanced by 9.1%. The deepening of the current account deficit was mainly determined by the sizeable budget deficits from recent years, the Romanian economy being characterized by a high level of the twin deficits, a unique case in the region, which raises important challenges for the fiscal-budgetary policy. At the same time, the trajectory of the current account deficit raises questions about the dangers posed by external and competitiveness imbalances, the European scoreboard setting an attention threshold when the average of the last 3 years' deficits exceeds 4% of GDP. In the case of Romania, this average reached 3.9% of GDP, being located in the immediate vicinity of the threshold.

The increase in the current account deficit was largely caused by the deepening of the deficit of the balance of goods and services from 6.4 billion euros in 2018 to 8.6 billion euros in 2019 (the situation being generated by the balance of goods which deteriorated by almost 2.6 billion euros, while the balance of services registered a surplus higher by 0.4 billion euros compared to the previous year). Positive contributions to the evolution of the current account deficit also came from the primary income balance[5], the deficit of which decreased by 0.7 billion euros, respectively from the secondary income balance[6], its surplus increasing by 0.2 billion euros. In nominal terms, exports of goods and services continued to grow in 2019, registering an advance of 5.9% compared to the previous year (+5 billion euros), but this evolution is significantly lower than the 9.3% advance recorded in 2018. On the other hand, the growth rate of imports remained higher relative to exports (+8.2%, representing +7.5 billion euros), but again there was a significant slowdown in comparison to the 11.5% increase recorded in 2018.

Analyzing the changes in the current account balance in terms of difference between the savings and investment rates, it can be noted that the savings rate maintained its level from the previous year while the investment rate increased by 0.2 pp of GDP, thus, explaining the growth of the current account deficit by 0.2 pp of GDP (from 4.4% to 4.6%). Comparing these results with those from 2007, when the highest current account deficit of the analyzed period was recorded (13.6% of GDP), the adjustment to the current level was mainly achieved through the reduction of the investment rate by 8.4 pp, while the savings rate advanced by only 0.6 pp.

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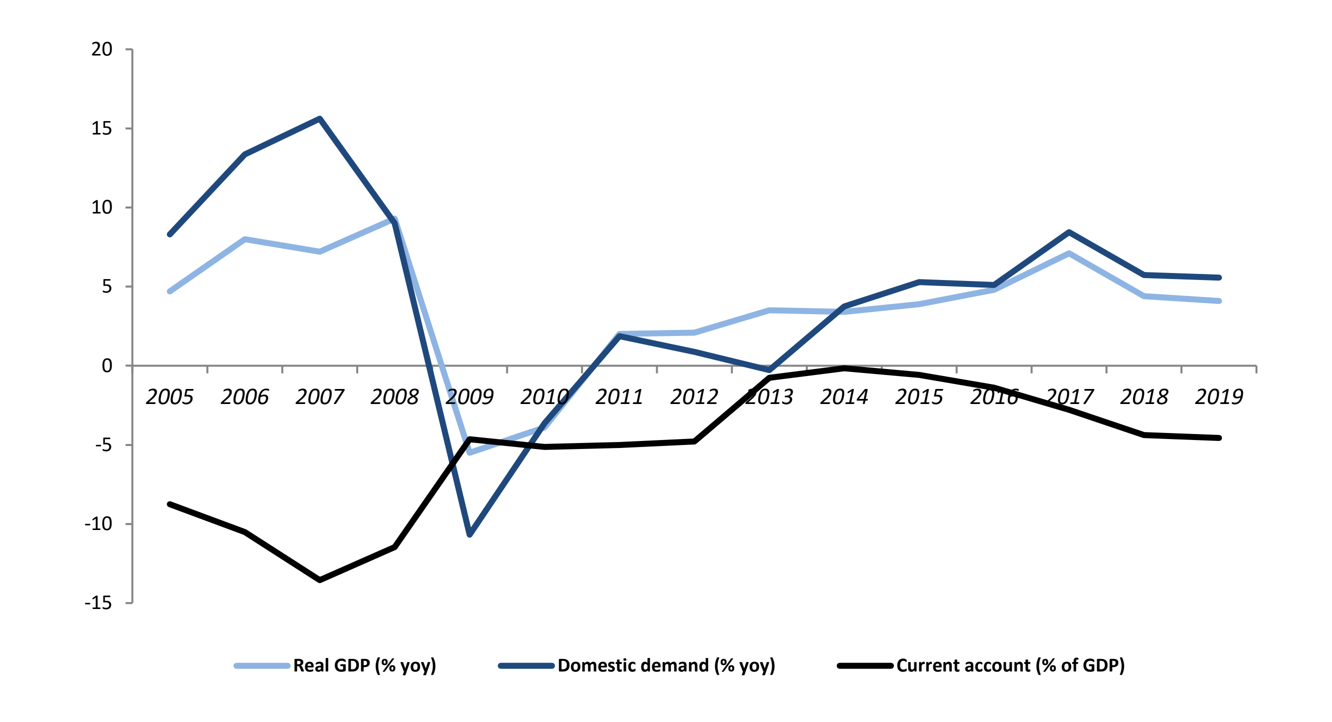
[5] Primary income denotes the income received for the contribution to the production process, for the provision of financial assets and for renting natural resources, as reflected by the flows between residents and non-residents. Primary income includes the compensation of employees, investment income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

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

Figure 3: The evolution of real GDP, domestic demand and current account balance between 2005-2019



Source: NBR, Eurostat, Fiscal Council's calculations

Direct investments of non-residents in Romania amounted to 5,334 million euros in 2019, this value representing an increase of just 1.3% in comparison with 2018. Thus, it can be observed that direct investments of non-residents remained on a moderately ascendant trajectory, the levels recorded during the last 3 years being significantly above the 2010-2015 average. However, they are still much lower compared to the pre-crisis period, with the average annual value of foreign direct investments in 2007-2008 being around 8,373 million euros. Net foreign direct investments[7] registered a decrease of 3.9% compared to the previous year, reaching the level of 5,368 million euros. Due to this deterioration, to which is added the significant deepening of the current account deficit, net foreign direct investments funded only about 53% of it.

In 2019, the external debt of Romania increased by 6% compared to the previous year, reaching 105.9 billion euros at the end of December, but supported by the stronger GDP dynamics, the external debt to GDP ratio decreased marginally to 48%. Consequently, following the gradual reduction of the external debt to GDP ratio during recent years, a significant improvement can be observed in comparison to the 2010-2012 period, when the indicator stood at around 75%. On the other hand, the growth rate of external debt accelerated in 2019 relative to the previous years. Moreover, the indicator is expected to increase significantly in the future in order to reflect the deterioration of the current account balance.

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

At the end of 2019, 69.6% of total external debt was represented by long-term debt, this category registering a substantial increase of 5.4 billion euros (7.9%) compared to the previous year. Short-term external debt increased by 0.7 billion euros (2.1%), reaching 32.2 billion euros, and its share in total external debt decreased by 1.2 pp from 31.6% in 2018 to 30.4% in 2019[8]. Thus, 2019 marked a reversal in the tendency of restructuring the maturity of external debt which started in 2014 and was characterized by a reduction in the share of long-term debt (which stood at around 80% between 2013-2014), coupled with increases in the share of short-term debt. On the other hand, 2019 is the second year over the last decade in which the share of long-term external debt stood below 70%. In this respect, it should be noted that prioritizing short-term debt may contribute to a higher vulnerability of Romania's external position if financing difficulties should arise.

The evolution of long-term external debt in 2019 was mainly the result of bond issues on the international markets in April and July 2019, through which the Romanian government obtained a total financing of almost 5 billion euros with maturities ranging between 7 and 30 years[9], and of the increase in private external debt (+1.4 billion euros). These developments were partially offset by the reduction of financial loans (-1.5 billion euros) and of non-residents' deposits (-0.7 billion euros).

The dynamics of non-governmental loans continued on an upward path and recorded a 2.44% advance in real terms in December 2019 compared to the same period of the previous year, exhibiting a slowdown in the growth rate of this monetary indicator. Thus, domestic currency denominated loans increased by 5.04% in real terms, while foreign currency denominated loans continued to lose ground, decreasing by 1.10% in euro equivalent. Among the factors which contributed to the dynamics of lending activity are the growth of disposable income (due to wage increases in the public and private sectors) and the favorable evolution of the labor market (manifested through the reduction of the unemployment rate, coupled with an increase of average earnings and of the minimum guaranteed wage). On the other hand, in 2019 the credit standards for households were significantly tightened amid the entry into force from January 1 of the prudential measures adopted by the NBR aimed at limiting leverage. At the same time, the adverse evolution of interest rates in the context of rising inflationary pressures led, starting with May 2019, to the replacement of the benchmark interest rate for domestic currency denominated loans, represented by ROBOR with IRCC (benchmark index for loans granted to consumers). The level of the new index, calculated as a weighted average of interest rates on interbank money market transactions, was lower than the one registered by ROBOR, having impact on the cost of loans granted at variable interest rate. The demand for loans from households had a discontinuous evolution, marked by a substantial decline in the first quarter, a significant increase in the second quarter, followed by a constant level in the third quarter, while the last quarter registered an important increase in demand for mortgage loans and a similar decrease in demand for consumer loans. With regard to non-financial firms, the credit standards were tightened in the second half of the year, while

[8] According to data available on the NBR website.

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

the demand for loans followed an upward trend, the highest increase being recorded in the second quarter of 2019[10].

The ratio of non-performing loans continued its downward trend from previous years, reaching 4% in December 2019, compared to 5% in December 2018. 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 below the 100% threshold (72.8% in December 2019, in comparison to 76.2% in December 2018).

The moderate expansion of lending activity in 2019 was due both to the dynamics of household loans (+3.4% in real terms) and of the loans granted to non-financial corporations (+2.2% in real terms). In the case of households loans, the advance was caused exclusively by those granted in domestic currency (+9.3% in real terms), while loans in foreign currency declined by 10.3% in euro equivalent. In the case of non-financial corporate loans, the positive variation was driven by all loan categories, both in domestic (+0.2% in real terms) and in foreign currency (+6.82% in euro equivalent).

The labor market continued its evolution from previous years with the average number of employees rising to 5,154 thousand persons[11], representing a 1.7% advance compared to the previous year, supported by an increase in the number of employees in both the private (+1.7%) and the public sector[12] (+1.6%). Thus, the ILO unemployment rate maintained its downward trend from previous years and reached 3.9% which represents the minimum level recorded since 2004[13].

In 2019, the gross average monthly wage across the entire economy amounted to 4,923 lei[14], representing an increase of 13% as compared to 2018. Thus, the net average wage was 3,036 lei, up by 14.9% over the previous year, and the real wage increased by only 10.7% due to the average annual inflation of 3.8%. The positive dynamics of the average wage was supported by the evolution of both public sector (+15.1% for the gross average earnings, amid additional wage increase measures) and private sector earnings (+12.3% for the gross average earnings, amid the persistence of a tight labor market and the migration of the domestic workforce). Last but not least, another factor that influenced the dynamics of the gross average wage across the economy was the increase of the minimum guaranteed wage from 1,900 lei in December 2018 to 2,080 lei as of January 2019.

Given the obligation of the Fiscal Council to include in its annual report an *ex post* evaluation of the macroeconomic and budgetary forecasts comprised by the Fiscal Strategy that is the subject of the

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

[11] According to the preliminary NCSP forecast from April 2020.

[12] The public sector includes public administration, education, health and social assistance, excluding armed forces and assimilated personnel. The private sector is approximated by removing the public sector from the values recorded for the entire economy.

[13] According to unemployment data available on the NIS website.

[14] According to the preliminary NCSP forecast from April 2020.

report (according to art. 61 of the FRL), *Table 1* presents the main macroeconomic forecasts of the 2019-2021 Fiscal Strategy relative to the actual values achieved in 2019, according to the latest available data.

Table 1: Main macroeconomic indicators in 2019 (Fiscal Strategy forecast versus actual)

	Fiscal Strategy 2019-2021	Actual 2019
	- % change, year on year -	
GDP		
GDP (billion lei)	1,022.47	1,059.80
Real GDP	5.5	4.1
GDP deflator	2.1	6.9
GDP Components		
Final consumption	5.9	6.0
Private consumption expenditure	6.4	5.9
Government consumption expenditure	4.0	6.4
Gross fixed capital formation	6.9	18.2
Exports (volume)	6.9	4.6
Imports (volume)	7.8	8.0
Inflation		
December 2019	2.8	4.0
Annual average	2.8	3.8
Labor market		
ILO unemployment rate (end of period)	4.1	3.9
Average number of employees	3.4	1.7
Gross average wage	14.7	13.0

Source: NCSP, Eurostat, MPF

III. Fiscal policy in 2019

III.1. Main features of the fiscal-budgetary policy in 2019

The manner of elaborating and implementing fiscal-budgetary policies in Romania in the last years has been characterized by a series of common features, as revealed by the analysis made in this report:

- Romania has pursued a clear pro-cyclical fiscal policy between 2006-2019, stimulating the economy during the expansion period (2006-2008 and 2016-2019) and slowing it 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;
- Such an approach has exhausted the required fiscal space to stimulate the economy during the recession periods and moreover can severely constrain the fiscal-budgetary policy in difficult economic periods such as the one caused by the COVID-19 pandemic. Consequently, the automatic, beneficial and stabilizing action of the automatic stabilizers was severely amputated by the pro-cyclical discretionary policy;
- Regarding the relevance of the fiscal rules and the commitment toward fiscal discipline, it can be appreciated that, since the elaboration of the FRL in 2010 and until now, the fiscal rules have exerted a weak constraint on fiscal policy makers;
- The rule related to the structural deficit (medium-term objective of -1% of GDP) has been violated since 2016, without explicitly providing for the adjustment path to the MTO. Practically, the only anchor of the fiscal-budgetary policy was represented by the 3% of GDP threshold for the headline deficit;
- The Fiscal Council has repeatedly warned that the idea of placing the budget deficit below 3% of GDP would be sufficient is incorrect; this level does not represent a “target”, but a ceiling whose reach is allowed only in adverse cyclical conditions, of deep recession, which was not the case of Romania in the period 2016-2019;
- Two important vulnerabilities of the budgetary constructions in recent years have been represented by: a) the very low level of fiscal revenues compared to other EU countries and b) the increasing deterioration of the structure of budget expenditures, the share of wages and pensions spending currently exceeding 75% of fiscal revenues. Both elements are likely to significantly reduce the space for maneuver for fiscal policy makers. In the period 2016-2019, these vulnerabilities were amplified by the significant reduction in taxation implied by the new Fiscal Code, applicable starting 2016, the fiscal loosening being further continued, being accompanied by accelerated increases in public sector wages;
- It is not the stock of public debt the largest problem for public finances, but the large and rising deficits, the very high pressures on the public budget, which would require major corrections in the coming years.

III.2. 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 31st of each year, the Ministry of Public Finance (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 (FS) for the period 2019-2021 was elaborated and approved in March 2019[15], at the same time with the draft budget proposal, which implies that both documents set out an identical fiscal framework for 2019.

Under these circumstances, the requirement for the Fiscal Council to assess in its Annual Report the objectives, targets and indicators established through the Fiscal Strategy and the annual budget is reduced to an *ex-post* analysis of the projections set out in the draft budget, the *ex-ante* assessment of the compliance with the rules regarding the limits defined for the budgetary indicators stipulated by the Law of ceilings being in this situation irrelevant. The Fiscal Council draws attention to the perpetuation of this situation over the past 6 years, with the Government issuing the Fiscal Strategy or an updated version of it together with the draft budget for the respective year, which is not likely to create an efficient budgetary planning based on *ex-ante* compliance with fiscal rules and undermining the role of guidance that a medium-term fiscal and budgetary strategy must have for the budget.

Moreover, for 2019, three draft budgets (and, respectively, three FSs) were elaborated during January-March. In this context, the Fiscal Council issued two Opinions[16], corresponding to the initial budget (January, 31) and the one approved by the Parliament (March, 9). Furthermore, for the first time since

[15] The final version of the FS, two other versions being published on January 31st, 2019, respectively, on February 8th, for each corresponding a draft budget.

[16] The first one on February 5 (according to the first budget proposal for 2019), the second one (according to the new parameters of the 2019 budget law approved in Parliament) on March 11, 2019.

the establishment of the Fiscal Council, the budget deficit target was increased after the submission of the draft budget in the Parliament, in violation of the provisions of art. 15 of the Public Finance Law.

The GCB for 2019 (the updated version from March, 9, 2019) was based on a macroeconomic forecast scenario that estimated an economic growth at 5.5% in real terms, while the headline deficit target was projected to 2.76% of GDP according to cash standards (from 2.82% of GDP in 2018), respectively to 2.78% of GDP according to ESA 2010 methodology, smaller if compared with the estimate for 2018 at that time (2.88%[17] of GDP). In the presence of an increasing positive output gap, maintaining the budget deficit close to the 3% ceiling involved the deterioration of the structural deficit and a significant deviation from the MTO set at 1% of GDP, respectively, a structural deficit projected for 2019 at 2.97% of GDP, relative slightly lower compared to the estimated level for 2018, 3.03% of GDP[18]. The Fiscal Council considered in its Opinion that the budget targets proposed by the draft budget for 2019, as well as by the Fiscal Strategy 2019-2021, reflected the absence of any structural adjustment in the period 2019-2020, the deviation from the medium-term objective continuing to be placed at a high level, of about 2 pp of GDP. Furthermore, Romania was already placed in the Procedure of Significant Deviation from the MTO since 2017, and the European Commission (EC) recommended in late December 2018 an annual adjustment of 1% of GDP in 2019 and 0.75% of GDP in 2020, but the initial budget for 2019 proved that Romania deviated substantially from existing EU fiscal rules implemented in FRL, and that the automatic mechanism to correct these deviations set in the national and European legislation was not functional.

The final budget execution showed a significant exceeding of the budget deficit target, according to the cash methodology, the budget deficit recorded 4.56% of GDP, respectively 48.3 billion lei (compared to an initial projection of 28.25 billion lei), in the context of a nominal GDP by 37.3 billion lei higher than that used for the initial budget forecast. According to ESA methodology, the budget deficit deepened to 45.5 billion lei, respective, 4.29% din PIB, significantly above the level projected in the initial budget and exceeding by 1.3 pp of GDP the limit provided by the corrective arm of the Stability and Growth Pact, of 3% of GDP, which determined the launch by the EC of the Excessive Deficit Procedure against Romania on March 4, 2020.

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[19] that explain the gap of 2.8 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 (a gap of +1.6 billion lei);

[17] At the time of drafting the budget (March 2019). According to data updated in May 2020, the ESA 2010 deficit for 2018 is 2.93% of GDP.

[18] At the time of drafting the budget (March 2019). According to data updated in May 2020, the structural deficit for 2018 is 2.92% of GDP.

[19] Data processed from government debt and deficit notification tables, https://insse.ro/cms/ro/content/nivelul-datoriei-%C8%99i-deficitului-guvernamental.

- payments in advance for the purchase of military equipment that will be recognized only at delivery according to the European methodology (gap of -2.98 billion lei);
- differences between the decisions on the payment of the amounts of the pollution tax refund (1.46 billion lei) and the actually paid amounts (3.04 billion lei), resulting a gap of -1.58 billion lei;
- payment of amounts in the account of Law no. 85/2016 already recorded in the execution of ESA 2010 in 2016 (a gap of +0.5 billion lei);
- differences in the treatment of interest expense, those according to ESA 2010 being higher compared with the cash methodology (thus, the ESA deficit being higher by 1.07 billion lei compared to cash deficit);
- differences between social contributions and VAT receipts according to ESA and cash methodologies of -1.56 billion lei for January 2019;
- the compensation decisions set by the National Authority for Restitution of Properties amounted to 1.32 billion lei while 1.25 billion lei were actually paid (a gap of +0.07 billion lei;
- the contribution of the state-owned companies in the public administration sector was -1.25 billion lei (compared to +0.3 billion lei registered in the previous year, in 2019 state-owned companies made a positive contribution to reducing the gap).

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 ask to the state-owned companies to distribute additional dividends[20] from the reserves accumulated in previous years has no influence on the ESA 2010 budget deficit which is relevant for the evaluation of fiscal rules at the European level.

In terms of fiscal policy rules for 2019, the nominal ceilings for the GCB balance, the primary balance, total expenses (excluding revenues from post-accession EU funds, pre-accession funds and financial assistance from other donors) and personnel expenditure were established by the GEO no. 14/12.03.2019[21] (see *Table 2* below). The budget execution reveals the *ex-post* non-compliance of the nominal ceilings and as a share in GDP for most indicators (except for personnel expenses), even if the value of nominal GDP was higher than initially estimated (+37.3 billion lei). Practically, at the elaboration, respectively, execution of the budget for 2019, most of the fiscal rules enshrined by the European and the national legislation (FRL) were circumvented.

Thus, when drafting the budget for 2019, similar to previous years, almost all the fiscal rules were violated[22], as follows:

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

[21] By the Decision of the Constitutional Court of Romania no. 128/2019, the draft law for the approval of the ceilings submitted at the end of February was declared unconstitutional, the approval of the ceilings (March 14, 2019) being subsequent to the approval of the FS 2019-2021 (March 9, 2019), a new situation also.

[22] These derogations from the FRL were recognized as such in the text of GEO no. 14/2019.

- the presentation of an adjustment plan through which the annual structural deficit converges towards the MTO, agreed with the institutions of the European Union (art. 7 letter (c)), correcting measures for MTO deviation (art. 14 para 1) and the adjustment path towards the MTO (art. 26 para 3);
- annual increase of the public spending (art. 12 letter d);
- the deadline for elaboration of the fiscal-budgetary strategy (art. 26 para 1), certifying the conformity of the fiscal-budgetary strategy and the fiscal-budgetary framework associated with the FRL (art. 29 para 4);
- the obligation for the Government to submit to Parliament an annual budget that conforms with the principles of fiscal responsibility, fiscal rules and any other provisions of the FRL (art. 30 para. 4) and which provides that, in the absence of the above compliance, the requirement to mention the deviations, as well as the measures and deadlines until the Government will ensure compliance with them (art. 30 paragraph 5).

In relation to the budget execution, almost all the fiscal rules have been violated *ex-post* (except for personnel expenses, in nominal terms and as share in GDP), as follows:

- the GCB balance expressed in nominal terms and as share in GDP (art. 12 letter a) and, respectively, letter b)), the GCB primary balance (art. 12 letter b);
- the compliance with the nominal ceilings stipulated by the GEO no. 14/2019 for the total GCB expenditure (net of financial assistance from the EU and other donors) (art. 12 letter c);
- prohibiting the increase of the total GCB spending (net of financial assistance from the EU and other donors) in the context of budgetary adjustments only when it is made for the public debt service or for the payment of Romania's contribution to the EU budget (art. 24).

Table 2 presents the limits specified in the initial fiscal-budgetary framework, as established by GEO no. 14/2019 (in blue) and the budget execution (in black). The italic figures are the percentages of GDP of the initial budget indicators recalculated with updated data on nominal value of GDP (1,059.8 billion lei versus 1,022.5 billion lei in the initial budget). When taking into account the same provisional data for GDP value (third row in the table), it can be noticed that for all indicators, except personnel spending the limits expressed as a share of GDP were exceeded. In fact, the increase in total expenditures was due to the massive under-estimation of social assistance, goods and services, as well as capital spending in the initial budget.

Table 2: Nominal ceilings for GCB balance, total* and personnel expenditure						
	GEO no.14/2019			Execution 2019		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
million lei	-28,248.7	337,207.3	102,420.1	-48,300.2	344,404.1	102,341.2
% of GDP budget draft	**-2.76%**	**33.0%**	**10.0%**			
% of GDP provisional data for 2019	*-2.67%*	*31.8%*	*9.7%*	**-4.56%**	**34.9%**	**9.7%**

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

Source: MPF, Eurostat

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

The first budget revision, approved in August 2019 (GEO no. 12/14.08.2019) rectified upward both GCB revenues and expenditures by 2.23 billion lei, respectively, by 2.44[23] billion lei compared to the initial budget, leading to an increase of 0.2 billion lei in the projected headline deficit. The budget revision draft was accompanied by the GEO no. 6/2019 regarding the establishment of certain facilities that grant, primarily, an amnesty of some budgetary obligations - principal and accessories - conditioned by the full payment of the fiscal obligations for the current year, with an impact estimated by the Ministry of Public Finance at 1.89 billion lei, which was considered by the Fiscal Council's opinion as inappropriate to be *ex ante* included in the budgetary revenues projection.

In relation to the limits stipulated by GEO no. 14/2019[24], the Fiscal Council noted the partial violation of the fiscal rules established by the FRL, as follows:

- non-compliance with the nominal ceilings of GEO no. 14/2019 for the budget deficit and the primary budget deficit (art. 12 letter b) – overrun of 0.2 billion lei, while maintaining the share in GDP was possible only as a result of the upward revision of the nominal GDP level[25];
- non-compliance to the art. 12 letter c) – the forecasted level for the GCB total expenditures, excluding financial assistance from EU and other donors exceeded the ceiling from the GEO no. 14/2019 by 3.1 billion lei, out of which only 2.2 billion lei represents the supplementation of the amounts destined for the payment of Romania's contribution to the EU budget (justifying partially this increase, according to art. 24);

[23] At the time of drafting the first Fiscal Council's Opinion (August 6, 2019), the data received from MPF showed an increase for the GCB revenues by 2.4 billion lei and for the GCB expenditures by 2.6 billion lei compared to the initial budget.

[24] GEO no. 12/2019 stipulated the derogations from the rules, redefining the ceilings of GEO no. 14/2019.

[25] Given the evolution of GDP in the first 6 months of 2019, it was increased by 8.5 billion lei (to 1031 billion lei).

- non-compliance with the provision of the art. 26 para. (5) and art. 14, by not applying the EC recommendation to initiate a structural adjustment of 1% of GDP during 2019.

Budgetary revenues, including the swap scheme (amounting to 850 million lei, with a symmetrical effect on revenue and expenditure), were revised upward by about 2.23 billion lei, as a result of the increase in estimates of non-tax revenues, corporate income tax and European funds, the latter being due to the *ex-post* settlement of projects previously funded by internal resources, partially compensated by the reduction of estimates regarding the revenues from social contributions and by the increase of the reimbursed amounts related to the car pollution tax (recorded as negative revenues).

Considering the GCB revenues aggregates net of swaps, the following revisions were performed:

- *Fiscal revenues* - were increased at the level of: *corporate income tax:* +1.1 billion lei (out of which 0.8 billion lei represented the positive impact of the fiscal amnesty and NAFA envisaged measures, FC considering in its Opinion an over-estimation by the same amount), *other taxes on personal income, corporate profit and capital gains* (+0.7 billion lei), *other taxes and duties on goods and services* (+0.6 billion lei), *excise duties* (+0.5 billion lei). The estimate for *the use of goods, authorization of the use of goods and conducting activities* was decreased by -1.9 billion lei[26]. The receipts from *VAT* have been maintained unchanged. In its Opinion, the FC showed that the degree of accomplishment of the half-year program of 91.5%, corresponding to a minus of 2.8 billion lei, would have required their reduction. At the same time, the MPF's premise regarding offsetting the decrease in the VAT revenues by the cumulative effect of the fiscal amnesty, the NAFA commitment to increase the collection efficiency in the second part of the year, in conjunction with the estimation of a more favorable evolution of the relevant macroeconomic base was considered by the FC to be unlikely to realize and leading to an overestimation by 3 - 4 billion lei;

- *Non-tax revenues* – were increased by 2 billion lei, due to the better than expected receipts in the first semester of the year (+1.1 billion lei) extrapolated for the whole year. The FC warned that, beyond the negative impact on the potential for investment of the state-owned companies generated by the withdrawal of the profits accumulated in previous years in the form of super-dividends by the major shareholder, such an evolution cannot be permanent, most likely causing the decrease of the budgetary revenues in the next period;

- *Social contributions* (-2.2 billion lei, in line with the execution of the first semester). In its Opinion, the FC mentioned that the failure in achieving the programmed revenues for the first 6 months (by 2.3 billion lei) wasn’t extrapolated for the whole year, the MPF planning on obtaining additional revenues of about 1.1 billion lei from the fiscal amnesty, which the FC considered to be unlikely to be achieved. Thus, the FC identified an additional revenue gap compared to the MPF estimates of about 2 billion lei;

[26] Respectively, reimbursements of the car pollution tax of 2.8 billion lei in the execution of the first semester, compared with an initial estimate of 1 billion lei.

- *Other amounts received from the EU for operational programs funded under the convergence objective* (+1.9 billion lei), corresponding to the authorities' intention to settle *ex-post* projects financed with non-EU funding on EU funds. The Fiscal Council, in its Opinion, expressed reservations about the achievement of the planned amounts, given the significant risks regarding both the uncertain eligibility of these projects from the perspective of granting the European funding and the short time remaining until the end of the year for clarifying this case with the EC representatives;

- The estimates for the *inflows of European funds* were reduced by 0.6 billion lei. The FC considered in its Opinion that, in the context of attaining a degree of achievement of only 22% in the first semester for the annual target, and of 18% for the *structural and cohesion funds,* it would be very unlikely to achieve the new targets.

The budgetary expenses, excluding the swap scheme, were augmented by 2.4 billion lei, mainly due to significant increases for:

- *Capital expenditures:* +3.75 billion lei, out of which, 1.5 billion lei for supplementing the amounts related to the National Program for Local Development (NPLD);

- *Social assistance expenditures* (+1 billion lei), as a result of the initial under-budgeting, validating the FC's warning from its previously Opinions (February 5 and March 11, 2019). Given the up to date execution, as well as the projected increase of the pension point starting from September 1, 2019, the Fiscal Council identified in its Opinion a need of additional allocation of approximately 2.5 billion lei in the context of maintaining the decision to pay a few days in advance before the end of the year the pensions distributed through the Romanian Post;

- *Investment expenditures* (from internal and external sources) by 1.93 billion lei;

- *Budgetary reserve fund* (+0.5 billion lei[27]).

Downward revisions were operated for:

- *Projects funded by post-accession non-reimbursable external funds 2014-2020* (-1.3 billion lei), given the massive under-execution of the inflows from European funds in the first semester;

- *Goods and services* (-0.4 billion lei) – in its Opinion, FC showed that the decrease appears unjustified, in the context of exceeding the half-year program by about 0.44 billion lei, and of a growth rate from the first 6 months of 13.4%, higher that initially projected for the whole year (8.8%), considering that the annual target could be exceeded by 1-2 billion lei;

- *Subsidies* (-0.4 billion lei).

[27] By derogation from the provisions of art. 30 paragraph (2) of Law no. 500/2002 on public finances.

In its Opinion on the first budgetary revision, the FC warned that there are significant risks to exceed not only the assumed deficit target, but also the reference level of 3% of GDP for the headline deficit, by over 0.5-0.7% of GDP, in the absence of compensatory measures.

The second budgetary revision[28], approved at the end of November (GEO no. 71 / 29.11.2019), provided for a major downward revision of the GCB revenues, by 18.3 billion lei, while the level of the total expenses was reduced by only 620 million lei, the headline deficit being by 17.6 billion lei higher compared to the in the first budgetary revision's level, respectively, 46.1 billion lei (+17.9 billion lei above the ceiling established by GEO no. 14/2019). Thus, in its Opinion, the FC highlighted that the second revision recognized the significant revenues gaps and additional expenditures previously identified by the FC, and revealed by the budget execution.

In this context, the deviations from the fiscal rules were in line with the revisions made, thus enforcing the non-compliance with the quasi-majority of the fiscal rules except for those concerning personnel expenses. Compared to the first budgetary revision, the ceilings were exceeded by: 5.4 billion lei for *total expenses, excluding financial assistance from the EU and other donors* (8.6 billion lei gap from the limit set by GEO no. 14/2019) and with 18.1 billion lei for the *primary balance of the GCB* (by 18.3 billion lei compared to the ceiling defined by GEO no. 14/2019). Thus, by the second budgetary revision for the year 2019, the provisions of art. 12, letter a) - c), art. 17 para. (2)[29], art. 24, art. 26 para. (4) and (5) of the FRL were violated. The GEO no. 71/29.11.2019 stipulated the derogations from the aforementioned fiscal rules, redefining the ceilings of GEO no. 14/2019.

Compared to the first budgetary revision, ***the GCB revenues*** net of swap scheme[30], were revised downward by 18.3 billion lei, with significant decreases at the level of:

- *Fiscal revenues* (-10.5 billion lei). Out of this category, were revised downwards: *VAT* (-3.45 billion lei, confirming the FC's assessment from the Opinion regarding the first budgetary revision); *tax on profits, wages, income and capital gains* (-1.24 billion lei, of which *tax on profits*: - 0.4 billion lei31, FC considering another possible overestimation by 0.2-0.3 billion lei), *tax on the use of goods, authorization of the use of goods and conducting activities* (-1.66 billion lei32); *excise duties* (-0.4 billion lei, FC evaluating a possible execution over expectations by about 0.4 billion lei);
- *The amounts received from the EU in the account of the payments made and pre-financing related to the financial framework 2014-2020* (-6 billion lei), *other amounts received from the EU for operational programs funded under the convergence objective* (-1.8 billion lei, the FC's warning from the previous Opinion regarding the imminent possibility of non-materialization of these

[28] The FC Opinion published on 28.11.2019 was based on the set of indicators transmitted by the MPF on 26.11.2019, which differ substantially from those subsequently approved in Parliament.

[29] Personnel expenses were increased by 335 million lei compared to the first budgetary revision.

[30] In amount of 850 million lei, similar to the first budgetary revision.

[31] Justified by MPF by not realizing the expected impact of the fiscal amnesty.

[32] The determining factor was the non-approval in 2019 of the tender timetable regarding the sale of 5G type licenses (estimated in the initial budget at 2.4 billion lei).

amounts being validated - the request of the Government to settle *post factum* from EU funds the amounts spent from the state budget in the period 2014-2019 through NPLD was rejected by the EC);

- *Social contributions* (-2.9 billion lei, validating the assessments from the previous Opinions of the FC, and the impact of the slower dynamics of labor market indicators);

- *Non-tax revenues* (-0.9 billion lei), due under expectations revenues (validating the warning from the FC's Opinion at the first budgetary revision) and failure to achieve additional revenues from the use of confiscated goods.

In its Opinion regarding the second revision, FC reiterated the importance of the consistent application of prudence in the fiscal policy, by including only *ex-post* the additional revenues from improving the collection, or from other initiatives like fiscal amnesty in the budget construction.

Eliminating the influence of swap schemes, ***the budgetary expenditures*** were revised upwards by 620 million lei. The estimates were increased for: *social assistance* (+4 billion lei, in line with the FC estimates), *goods and services* (+1.05 billion lei, validating the FC warning against the risk of exceeding this level by 1-2 billion lei.), *capital expenditures* (+0.9[33] billion lei), *other transfers*[34] (+0.4 billion lei); *personnel expenses* (+0.34 billion lei). These increases were partially offset by decreases in the level of: *projects funded by post-accession non-reimbursable external funds 2014-2020* (-6.74 billion lei); *expenditures funded from reimbursable* (-0.2 billion lei); *interest* spending (-0.44 billion lei) and *subsidies* (-0.15 billion lei).

Investment expenditures were reduced by 5.2 billion lei, confirming the reservations expressed by the Fiscal Council in its Opinions on the initial budget and the first budgetary revision; moreover, the massive decrease of expenditure on projects funded from EU funds was only to a small extent offset by the increase of capital expenditures from internal sources.

In its Opinion on the second budgetary revision, the FC appreciated that the main factors which led to the massive budgetary slippage are of permanent nature, being difficult to correct and requiring credible consolidation measures in the short and medium term.

Concerning **the relevance of the fiscal rules** and the commitment to respect the fiscal discipline, it can be appreciated that, since the elaboration of the FRL in 2010 and until now, the national fiscal rules have exerted a weak constraint on the fiscal and budgetary policy makers, which determined:

- ✓ non-compliance with the annual ceilings set for the BGC deficit, the primary deficit, the total and personnel expenses, these being frequently violated *ex-post*;

- ✓ frequent violation of the ban on increasing total and personnel expenditures during budget

[33] To supplement the amounts related to the National Program for Local Development (NPLD) by 1.8 billion lei.

[34] To finance projects from the Program for stimulating the setting up of small and medium enterprises Start-Up Nation Romania and ISPA projects in the field of transport.

revisions;

- ✓ the fiscal-budgetary strategy was not elaborated in time (July 31);
- ✓ as a rule, tax reduction measures were not accompanied by coherent compensation measures;
- ✓ the rule on the structural deficit (medium-term objective of -1% of GDP) has been violated since 2016, without explicitly providing for the adjustment path to the MTO in the fiscal budgetary strategies for the period 2017-2019;
- ✓ the only anchor of the fiscal-budgetary policy in the period 2016-2019 was represented by the threshold of 3% of GDP for the actual budget deficit, CF warning each time that this level is not a "target", but a ceiling whose reach is allowed only in certain adverse cyclical or recessionary conditions, which, in the case of Romania, did not manifest themselves in this time interval.

The inoperability of fiscal rules is highlighted by the ease with which the government has assumed each time the derogations from the fiscal rules stipulated by the FRL when preparing the initial budget and the two revisions for 2019.

The Fiscal Council notes the prolonged *de facto* inoperability of the fiscal-budgetary framework based on rules stipulated in both the FRL and the European Treaties to which Romania acceded. Moreover, the non-compliant conduct of the Romanian fiscal policy the failure to comply with the European treaties in the field were sanctioned at the level of the European Commission, **by opening the excessive deficit procedure - a component of the corrective arm of the Stability and Growth Pact (SGP) in March 2020 after, starting with 2017, it was placed in the significant deviation procedure from the MTO - a component of the preventive arm of the SGP, the Romanian authorities ignoring all the EC recommendations from 2017-2019 regarding the decrease of the structural deficit.**

The Fiscal Council warned in its Reports from 2016-2018 on the risk of targeting a budget deficit close to the ceiling of 3% of GDP, which could create the premises of the need to adopt structural adjustment measures, in the context of entry into the downward phase of the economic cycle, which, most likely will start in 2020. Moreover, the FC warned that maintaining or enrolling on an even moderate growth path of the public debt/GDP ratio in the context of a period of economic growth masks the accumulation of vulnerabilities that would materialize in an (inevitable) future downward phase of the business cycle. It should be noted that, in the documents accompanying the EC Recommendation on the opening of the excessive deficit procedure for Romania in March 4, 2020[35], the output gap for 2019 was estimated at 0.1% of potential GDP (compared to 0.7% in the previous year) provided that, in the context of a increasing current account deficit, wage increases and inflation rate, the reversal of the economic cycle is likely to occur faster than would indicate the value of the output gap. In the case of Romania, there is also an additional constraint, related to the relatively high size of public debt compared to that of the domestic financial sector, implying a limited capacity to absorb an additional stock of public debt. In fact,

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

in the *Debt Sustainability Monitor* published by the EC in January 2020[36] (before the pandemic), the data for Romania indicate high risks regarding the medium-term fiscal sustainability, estimating that the public debt will increase rapidly until 2025, exceeding the reference value of 60% of GDP foreseen in the treaty, reaching in 2030 more than 90% of GDP, under the assumption of maintaining the current policies (the timetable for applying the pension law) and as a result of the increasing costs related to the aging population. In this sense, it is worth mentioning the very high value of the structural primary deficit, which has been constantly growing in the last 4 years, reaching 5.2% in 2019 (the highest level recorded in the EU), from 3.1% in 2018, 1.8% in 2016-2017, compared to 0.4% in 2015.

In fact, in the Country Report elaborated by the EC in November 2018[37] under the Significant Deviation Procedure from MTO, another warning was issued regarding the non-compliance with the adjustment pace recommended in the previously reports, recommending an annual adjustment of the structural balance of 1% of GDP starting with 2019, according to the requirements of the preventive arm of the Stability and Growth Pact.

In the following, the evolution of the main budgetary aggregates during 2019 in cash standards is presented (*Table 3*) along with a summary analysis of the budget execution.

The results of the **budget execution** (including the swap scheme) for 2019 indicate a budget deficit in cash terms by 20.05 billion lei higher that estimated in the initial program (+1.89 pp of GDP), the revenues being by 21.4 billion lei below the initial expectations, and the expenditures by only 1.36 billion lei.

Budgetary revenues without the impact of the swap compensation schemes were by 21.4 billion lei lower than the initial budget estimates, mainly due to the under execution[38] at the level of: *fiscal revenues* (-5.48 billion lei, as a result of lower than expected receipts from: *the use of goods, authorization of the use of goods and conducting activities* (-3.51 billion lei), *VAT* (-3.47 billion lei), *personal income tax* (-0.6 billion lei)); *social contributions* (-6.24 billion lei), against the background of the under-estimation of this aggregate from the initial budget and the negative impact of the wage dynamics below the initial assessment; *amounts received from the EU in the account of the payments made and pre-financing related to the financial framework 2014-2020* (-8.67 billion lei); *non-tax revenues* (-1.2 billion lei). Revenues higher than the initial budget estimates, but of small amplitude, were registered at: *corporate income tax* (+0.53 billion lei), *excise duties* (+0.36 billion lei) and *other taxes on personal income, corporate profit and capital gains* (+0.33 billion lei).

[36] https://ec.europa.eu/info/publications/debt-sustainability-monitor-2019_en.

[37] https://ec.europa.eu/info/files/recommendation-council-recommendation-view-correcting-significant-observed-deviation-adjustment-path-toward-medium-term-budgetary-objective-romania-1_en.

[38] In line with the reservations expressed by the Fiscal Council in the Opinion regarding the initial budget.

Table 3: The evolution of the key budgetary aggregates during 2019 (cash standards, billion lei)				
	Initial budget	First revision	Second revision	Budget execution
Total revenues	**341.8**	**344.1**	**325.8**	**320.4**
Fiscal revenues	161.6	162.8	156.1	156.1
Social Contributions	117.2	115.1	112.1	111.0
Post-accession EU funds, pre-accession funds and financial assistance from other donors	33.7	35.0	27.2	25.3
Total expenditure, of which:	**370.1**	**372.5**	**371.9**	**368.7**
Current expenditure, out of which:	345.0	343.6	342.1	342.3
Projects from EU funds	38.4	37.3	30.6	28.0
Capital expenditure	25.1	28.9	29.8	30.1
Budget balance	**-28.2**	**-28.5**	**-46.1**	**-48.3**

Source: MPF

Note: Amounts without the compensation schemes impact

The execution for the ***budgetary expenditures*** was lower by 1.4 billion lei compared to the initial budget. The main categories which registered decreases were: *projects funded by post-accession non-reimbursable external funds 2014-2020* (-10.5 billion lei) and *payments made in the previous years and recovered in the current year* (-3.7 billion lei), partially compensated by increases above the initial programmed level at: *social assistance expenses* (+5.15 billion lei, due to the initial budgeting inadequate to cover the pension point increase from September 1, 2019, validating the FC's warnings in its Opinions); *capital expenditures* (+4.95 billion lei that partial offset the massive under execution of the *expenses related to the projects funded from non-reimbursable external funds* for investment spending; *goods and services* (+4.2 billion lei, as a result of initial sub-budgeting); *other expenditures* (+1.5 billion lei).

Table 4 presents the evolution of budgetary revenues and expenditures according to national standards (cash), expressed as percentages of GDP. The benchmarks for 2019 are the year before and the year 2009, which marked the peak of the recession following the 2008 financial crisis.

From the perspective of the national methodology, compared to the previous year, in 2019 there was a deterioration of budget deficit of 1.69 pp of GDP, the budgetary revenues decreased by 0.75 pp of GDP, while the budgetary expenditures increased by 0.93 pp of GDP.

The GCB revenues that had the most unfavorable evolution were: *the amounts received from the EU in the account of the payments made* (-0.46 pp of GDP), against a low degree of absorption rate; *non-tax revenues* (-0.29 pp from GDP) and *fiscal revenues* (-0.23 pp from GDP, of which, personal income tax was lower by 0.2 pp of GDP compared to 2018, and VAT by 0.07 pp). These unfavorable developments were partially offset at the aggregate level of budget revenues, by higher receipts from *social insurance contributions* (+0.17 pp of GDP) and from *corporate income tax* (+0.04 pp of GDP).

On the expenditures side, compared to the previous year, the following budgetary aggregates significantly increased: *personnel expenses* (+0.61 pp of GDP), backed on the wage growth calendar according to the Law no. 153/2017 regarding the wages of the personnel paid from public fund; *capital expenditures* (+0.33 pp of GDP), accommodating the decline in external financing for investment spending; *expenditures on goods and services* (+0.29 pp of GDP); *social assistance spending* (+0.18 pp of GDP). Lower budgetary expenses compared to the previous year were registered for *interest* (-0.21 pp of GDP), and *subsidies* (-0.03 pp of GDP).

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

	2009	2015	2017	2018	Initial budget 2019	Budget execution 2019	Changes initial budget 2019/2018	Changes 2019/2018	Changes 2019/2009
Total revenue	**29.6**	**32.8**	**29.4**	**31.0**	**32.3**	**30.2**	**1.3**	**-0.8**	**0.6**
Fiscal revenue	16.4	19.4	16.3	15.0	15.2	14.7	0.3	-0.2	-1.7
Personal income tax	3.5	3.7	3.5	2.4	2.2	2.2	-0.1	-0.2	-1.3
Corporate income tax	2.0	1.9	1.7	1.6	1.6	1.7	0.0	0.0	-0.3
Property tax	0.6	0.8	0.6	0.6	0.6	0.6	0.0	0.0	-0.1
VAT	6.5	8.0	6.2	6.2	6.3	6.2	0.0	-0.1	-0.3
Excise duties	2.9	3.7	3.1	3.0	2.9	3.0	-0.1	0.0	0.0
Social contributions	9.0	8.1	8.4	10.3	11.1	10.5	0.8	0.2	1.5
Non-tax revenue	3.1	2.7	2.5	2.8	2.7	2.6	-0.2	-0.3	-0.6
Donations	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.6
Amounts received from the EU for payments made	0.4	2.4	2.0	2.85	3.18	2.39	0.3	-0.5	2.0
Total expenditure	**36.6**	**34.2**	**32.2**	**33.9**	**34.9**	**34.8**	**1.1**	**0.9**	**-1.8**
Personnel expenditure	8.8	7.3	8.1	9.0	9.6	9.7	0.6	0.6	0.8
Goods and services	5.3	5.7	4.7	4.7	4.6	5.0	-0.1	0.3	-0.4
Interests	1.1	1.3	1.2	1.4	1.3	1.1	-0.1	-0.2	0.0
Subsidies	1.4	0.9	0.7	0.7	0.7	0.7	0.0	0.0	-0.7
Projects funded by post-accession non-reimbursable external funds	0.5	3.4	2.2	2.6	3.6	2.6	1.0	0.0	2.1
Social assistance	12.0	10.7	10.8	10.6	10.3	10.8	-0.3	0.2	-1.2
Capital expenditure	4.1	2.6	2.3	2.5	2.4	2.8	-0.1	0.3	-1.3
Budget balance	**-6.95**	**-1.45**	**-2.83**	**-2.87**	**-2.67**	**-4.56**	**0.2**	**-1.7**	**2.4**

Source: MPF

Note: Amounts without the compensation schemes impact

Table 5 presents the development of budgetary revenues and expenditures in ESA 2010 standards, expressed as a percentage of GDP. The analysis for 2019 is made by comparing with the previous year and, respectively, with 2009, characterized by a budget deficit at a historical maximum.

The fiscal consolidation initiated in 2010, was characterized by a fast pace, aiming to correct the major imbalances in the public finances position, Romania managing to reduce the budget deficit (according to ESA 2010 standards) in a relatively short period of time, from 9.1% of GDP in 2009 to 0.6% of GDP in 2015. However, the years 2016-2019 marked a reversal of this trend, with a significant increase in the budget deficit as compared to 2015, determined by a massive decline in budget revenues (by 3.8 pp in 2019 compared to 2015), thus, partially canceling in an abrupt manner the results achieved in the fiscal consolidation process.

Table 5: The evolution of budgetary revenue and expenditure according to ESA 2010 (% of GDP)

	2009	2015	2016	2017	2018	2019	Changes 2019/2018	Changes 2019/2009
Total revenue	**30.3**	**35.5**	**31.9**	**30.8**	**31.9**	**31.7**	**-0.2**	**1.4**
Fiscal revenue, out of which:	16.2	19.9	17.8	16.4	15.3	15.4	0.1	-0.8
Indirect taxes, out of which:	10.2	13.3	11.3	10.3	10.4	10.6	0.1	0.3
VAT	6.3	8.1	6.4	6.2	6.3	6.2	-0.1	-0.1
Excise and custom duties	3.9	5.2	4.9	4.1	4.1	4.4	0.2	0.4
Direct taxes, out of which:	5.9	6.6	6.4	6.1	4.9	4.8	-0.1	-1.1
Personal income tax	3.3	3.7	3.6	3.6	2.1	:	:	:
Corporate income tax	2.3	2.3	2.2	2.0	2.4	:	:	:
Social contributions	9.7	8.1	8.8	9.4	11.4	11.3	-0.1	1.6
Other current revenue	1.4	2.1	1.6	1.6	2.0	1.8	-0.2	0.4
Total expenditure	**39.4**	**36.1**	**34.5**	**33.5**	**34.8**	**36.0**	**1.2**	**-3.4**
Intermediate consumption	6.0	5.9	5.6	5.2	5.1	5.4	0.3	-0.6
Compensation of employees	10.3	7.8	9.0	9.8	10.9	11.2	0.3	0.9
Interest payments	1.4	1.6	1.5	1.3	1.1	1.2	0.1	-0.2
Social assistance	12.7	11.5	11.5	11.6	11.6	11.8	0.2	-0.9
Subsidies	1.1	0.4	0.3	0.4	0.4	0.4	0.0	-0.7
Other current expenditure	1.7	2.4	1.4	1.7	1.7	1.4	-0.3	-0.3
Gross fixed capital formation	5.8	5.2	3.6	2.6	2.7	3.4	0.7	-2.4
Budget balance	**-9.1**	**-0.6**	**-2.6**	**-2.6**	**-2.9**	**-4.3**	**-1.4**	**4.8**

Source: Eurostat

In 2019, the budget revenues were by 0.2 pp of GDP lower than in the previous year and by 1.4 pp of GDP higher compared to the 2009 level. Fiscal revenues increased slightly, by 0.1 pp of GDP owing to indirect taxes (+0.1 pp of GDP). Compared to 2009, fiscal revenues are lower by 0.8 pp of GDP, mainly due to direct taxes, which decreased by -1.1 pp of GDP, as a result of the cut in the personal income tax rate from 16% to 10% starting with 2018.

The significant adjustment compared to 2009 was accomplished exclusively at the level of budget expenditures, which were in 2019 by 3.4 pp of GDP below the level of 2009, due to reductions in the following components: gross fixed capital formation (-2.4 pp of GDP), social assistance (-0.9 pp of GDP), subsidies (-0.7 pp of GDP), intermediate consumption (-0.6 pp of GDP), and interest spending (-0.2 pp of GDP). In contrast, the remuneration of employees increased by +0.9 pp of GDP. Compared to the previous year, budget expenditures increased by 1.2 pp of GDP, the main categories that contributed to this increase were the remuneration of employees and intermediate consumption (+0.3 pp of GDP each) and social assistance (+0.2 of GDP).

In essence, the fiscal adjustment in 2009-2015 was mainly made on the level of investment, personnel and social assistance expenditure, although the decrease in these latter categories has largely been reversed over the past four years, notably the remuneration of employees, that in 2019 was by 3.4 pp higher than in 2015, on the background of both an alert wage dynamics and the change in the fiscal treatment of social contributions starting with 2018.

III.3. 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[39]. The provisions of TSCG and of the Directive no. 85/2011 were incorporated into domestic law by amending the FRL in December 2013, so, beginning with 2015, the medium-term budgetary planning has been constrained by the new rule for the budget deficit. However, while in 2015 the structural deficit stood below the 1% of GDP target, since 2016 there has been a deliberate and sizeable deviation from this rule, so that starting with 2017, Romania was the object of the Significant Deviation Procedure from the MTO (SDP), being at that time also the first EU country placed in the SDP.

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[40] (because the cyclical component of the budget balance will be positive).

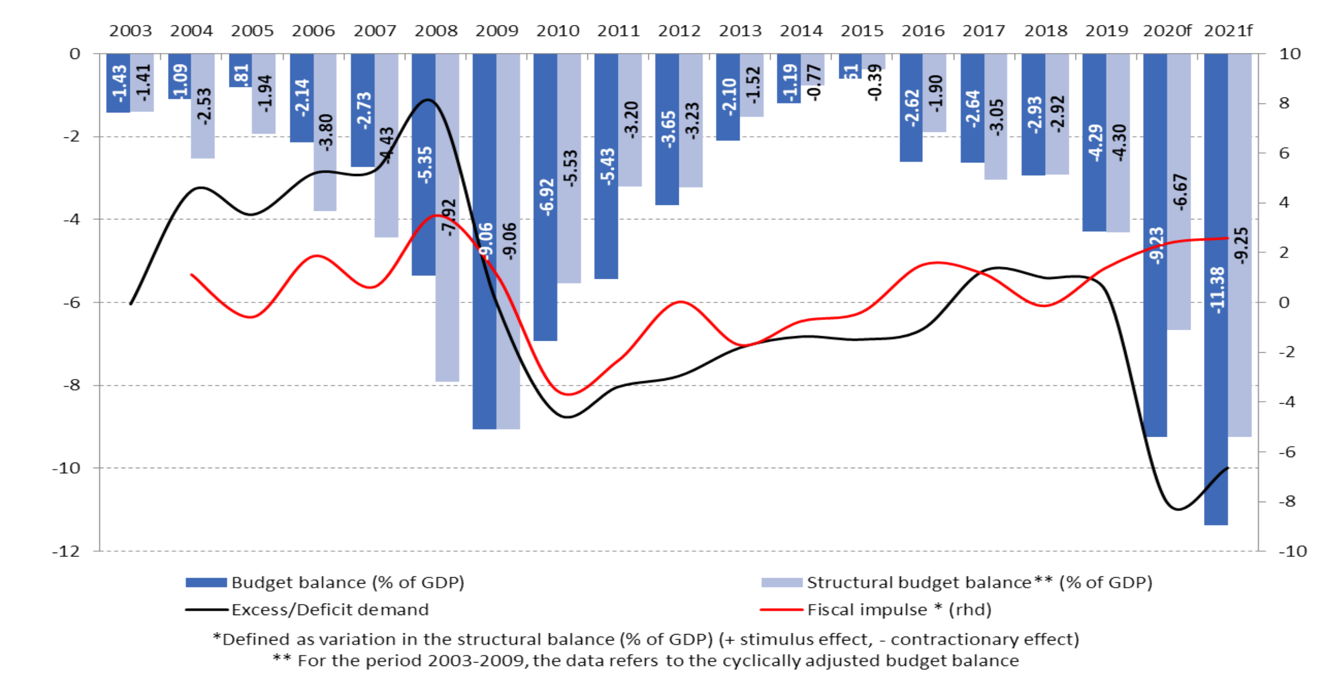
Despite the fact that it conveys the fiscal stance of an economy much clearer, the structural budget balance presents a number of disadvantages, the most important one being related to the uncertainties associated with its estimation, which is sensitive to the degree of relativity of reported real GDP data (provisional, semi-final, final), especially in recent years. 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

[39] 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.

[40] For example, complying with the MTO in 2019 would have implied an actual budget deficit of at most 1% of GDP.

data and the estimation methodology. Compared to the previous Annual Report of the Fiscal Council, the output gap was revised significantly by the EC from 0.76% in 2017, 0.94% in 2018 and 0.62% in 2019 (AMECO data base, may 2019) to 1.28% in 2017, 0.99% in 2018 and 0.47% in 2019, according to the EC latest update, in the May 2020.

Figure 4: Structural deficit, fiscal impulse and excess demand



Source: AMECO, Fiscal Council`s calculations

The draft budget for 2019 (the updated version from 9 March) targeted an overall deficit of 2.78% of GDP, according to the ESA 2010 methodology, corresponding to a structural deficit of 2.97% of GDP that was equivalent to a slight improvement of about 0.06 pp of GDP compared to the 2018 structural deficit which was estimated at 3.03% of GDP at that time. Moreover, in its Opinions on the draft budget for 2020 and the Fiscal-Budget Strategy 2019-2021, the Fiscal Council considered that the proposed budgetary targets reflect the lack of any structural adjustment in the period 2019-2020, the deviation from the medium-term objective continuing to be placed at a high level (of about 2 pp of GDP). The budget execution for 2019 indicated an actual deficit of 4.29% of GDP, compared to 2.93% of GDP in 2018, while the structural deficit deteriorated further, reaching 4.29% of GDP compared to 2.93% of GDP in 2018, according to the latest EC estimates[41]. Thus, the deterioration of the structural deficit was 1.39 pp of GDP contrasting with the estimated improvement anticipated by MPF, and this was mainly

[41] For the years 2020-2021, in the absence of corrective measures, the EC estimated in the last document that does not include the effect of the COVID-19 pandemic (November 2019) further deterioration of the structural position, from 3.5% in 2019 to 4.4% of GDP in 2020 and 5.9% of GDP in 2021. In May 2020, the EC estimates that the headline deficit will deepen to 6.67% of GDP in 2020 (from 4.3% in 2019) and to 9.25% of GDP in 2021.

due to the significant deviation from the target of the headline deficit proposed in the initial budget (by 1.36 pp of GDP).

The results of the budget execution for 2019 determined that, on March 4, 2020, the EC notifies Romania on the **opening of the Excessive Deficit Procedure (EDP)**, requiring the correction of the effective budget deficit (ESA2010), according to an adjustment schedule with the following objectives: 3.6 % of GDP in 2020, 3.4% of GDP in 2021 and 2.8% of GDP in 2022, corresponding to nominal growth rate of net primary public expenditure of 8.2% in 2020, 5.5% in 2021 and 5.5% in 2022, respectively an annual structural adjustment of 0.5% of GDP in 2020, 0.8% of GDP in 2021 and 0.8% of GDP in 2022, to put an end to the excessive deficit situation in 2022 at the latest. The EC also suggested supporting fiscal consolidation through structural reforms, in line with the recommendations addressed to Romania in the context of the European Semester and in particular those related to the Macroeconomic Imbalance Procedure. The deadline for Romania to take effective measures, in accordance with article 3 (4a) of Regulation (EC) no. 1467/97, to report in detail the consolidation strategy envisaged to achieve the targets was set for 15 September 2020.

It should be noted that, in the context of the announcement of the COVID-19 pandemic, in March the fiscal rules at European level were suspended to allow automatic stabilizers to operate and for taking measures to combat the economic effects of the pandemic, the EC sent a letter to the MPF on April 6, 2020 confirming the launch of the EDP by virtue of the fact that the breaches of European fiscal rules - transposed by the FRL at national level -precede the pandemic and, therefore, are not caused by it. Thus, the reporting deadline of 15 September 2020 is maintained, stating that the assessment of effective actions in response to the EC Recommendation will take into account the economic and fiscal impact of the COVID-19 pandemic and the implications of activating the escape clause of the Stability and Growth Pact (SGP).

Romania has pursued a strong pro-cyclical fiscal policy between 2006 and 2015, stimulating intensively but unnecessarily and counterproductively the economy during the expansion period (2006-2008) and slowing down when it operated below potential (2010-2015), thus, contributing to the amplification of the economic cycle fluctuations and to the deepening of the imbalances accumulated in the economy (see *Figure 4*). Basically, the pro-cyclicality of the fiscal policy during the pre-crisis economic boom has exhausted the required fiscal space to stimulate the economy during the recession that followed and the need to reduce the budget deficit during the crisis (primarily due to funding constraints) led, inevitably, to maintaining the pro-cyclicality of the fiscal policy. Consequently, the automatic, beneficial and stabilizing action of the cyclical deficit (the automatic stabilizers) was canceled by the pro-cyclical discretionary policy. Over the period 2009-2015, the structural budget deficit declined sharply, from 9.1% of GDP in 2009 to 0.4%, and at a fast pace, the average rate of adjustment being around 1.45 pp per year. At the same time, it should also be considered that as the starting level was high it required the rapid adoption of decisive measures in order to ensure the sustainability of fiscal policy, and this adjustment was made predominantly in 2010 and 2011 when the structural budget deficit decreased by an average of 2.9 pp per year, the fiscal consolidation being mainly carried out on the expenditure side through reforms concerning the wages in the public sector, the public pension system and budget programming. On the revenue side, the most important measure was to increase the standard VAT rate from 19% to 24%, starting in July 2010.

The fiscal consolidation conducted between 2010-2015 has been partially reversed and in a steep manner since 2016 as a result of the new Fiscal Code, which implies a broad loosening of the fiscal policy, while simultaneously regulating significant increases in spending, especially for wages and pension benefits. This development is in **flagrant contradiction with the FRL's fiscal principles and rules, as well as with the European fiscal governance treaties signed by Romania.** Thus, during 2016-2019 the fiscal policy stance became expansionary with a strong positive fiscal impulse, amounting to 3.9 pp of GDP, that exceeded significantly the limit imposed by the MTO, Romania being in the preventive arm[42] of the Stability and Growth Pact (SGP). Moreover, although the EC recommended at the end of November 2018 an annual adjustment of 1% of GDP in 2019 and 0.75% of GDP in 2020, through the parameters of the initial budget for 2019, Romania has substantially deviated from the existing EU fiscal rules transposed by the FRL, proving that the automatic correction mechanism, stated by the EU and national laws, is not currently *de facto* functional.

Continuing the expansionary fiscal stance that started in 2016 and carried on throughout 2017-2019, 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 2019 stood at a significantly higher level than in 2008, respectively 35.2% of GDP compared to 12.4% of GDP (using ESA 2010 methodology[43]), as well as the EC estimates regarding the placement on an accelerated trend of the evolution of the public debt in the next period[44] and also of a "high" risk related to the medium-term public debt of Romania (worsening from "medium" risk in 2018), highlight major risks to the public debt sustainability.

It should be noted that practicing in the period 2016-2019 a pronounced expansionary policy, circumventing the rules established by TSCG and FRL, while abandoning the structural deficit target, determined the EC to **maintain the decision to place Romania's in the EDP even in the context of the COVID-19 pandemic manifestation due to that the violation of European tax rules being prior to the pandemic, is not due to it.**

[42] In 2017, Romania became the first EU country subject to the Significant Deviation Procedure from MTO (SDP), and this being renewed in 2018-2019. The EC recommendations regarding needed structural adjustments have not been deliberately followed all these years.

[43] According to the national methodology, the share of GDP in public debt was 42.6%.

[44] "The Monitor of the Public Debt Sustainability for 2019" (published by the EC in February 2020), shows that in the absence of corrective measures, Romania's public debt would reach 62.3% of GDP in 2025, and 91, 2% of GDP in 2030; these assessments concern the situation prior to the outbreak of the pandemic, being consistent with the impact of the application of the Pension Law starting September 2020.

III.4. Budgetary revenues

GCB revenues, eliminating the impact of the swap compensation schemes for the outstanding obligations towards the budget (amounting to 714 million lei), increased in 2019 by 8.85% (corresponding to a nominal change of 26 billion lei) compared to the previous year. Thus, budgetary revenues registered 320.4 billion lei, representing 30.4% of GDP, which denotes a slight decrease compared to the level of 30.9% of GDP registered in 2018. This evolution was determined mainly by the decrease in the *amounts received from the EU*[45] (-0.4 pp), *non-tax revenues* (-0.3 pp) and *tax revenues* (-0.1 pp), and was partially offset by the increase in *social security contributions* (+0.3 pp).

At the level of *tax revenues*, there were no significant changes compared to the previous year, the largest developments being recorded in the case of *wages and income tax* (-0.2 pp, amid the fiscal facilities granted in the construction sector), respectively in the case of *other taxes and duties on goods and services* (+0.1 pp), while variations in the other aggregates from this category were below 0.1 pp of GDP. Although the fiscal facilities granted in the construction sector also affected *social security contributions*, they had a slight increase accounting for 0.3 pp of GDP amid favorable developments in labor market indicators. Regarding *non-tax revenues* (-0.3 pp), the decrease of their share in GDP reflects the fact that the super-dividends granted in 2019 in the form of extraordinary payments from the reserves of state-owned companies had a lower level than those granted in the previous year. Last but not least, the evolution of the *amounts received from the EU* must be interpreted with caution because, in addition to the impact of the *ex-post* settlement in 2018 of non-EU funded projects, these amounts include funds for agriculture[46] and pre-financing to the non-governmental sector, all of which do not represent actual public administration revenues. Thus, the amounts related to the 2014-2020 financial framework increased by about 3.9 billion lei compared to 2018, and the advance in the absorption of structural funds whose final beneficiary is the state was of 5.2 billion lei.

Compared to the initial budgetary projection, the budget revenues for 2019 were significantly lower by 21.4 billion lei, representing a gap of over 2 pp in GDP. This highly unfavorable development was due to significant shortfalls in almost all categories of budget revenues: *tax revenues* (-0.5 pp), *social security contributions* (-0.6 pp), *non-tax revenues* (-0.1 pp) and *amounts received from the EU* (-0.8 pp).

In the case of *tax revenues*, the underperformance is mainly due to *VAT* (-0.3 pp of GDP, as a result of the failure to achieve the expected increase in revenues on the basis of improved collection efficiency), to the *tax on the use of goods, authorization of the use of goods and conducting activities* (-0.3 pp of GDP, amid the delay of the auction for the rental of 5G frequency bands by mobile operators) and to the

[45] An important influence at the level of this category of revenues was exercised *by other amounts received from the EU* (-0.38 pp) which registered a value of 3.9 billion lei in the 2018 execution as a result of the intention of the authorities to settle *ex-post* on EU funds projects carried out with non-EU financing, while the value of this budgetary aggregate was only 0.3 billion lei in 2019. It should be noted that this effect is mainly manifested in the cash execution because, according to the ESA 2010 methodology, these revenues are allocated to the year in which the project for which EU funding is requested was carried out.

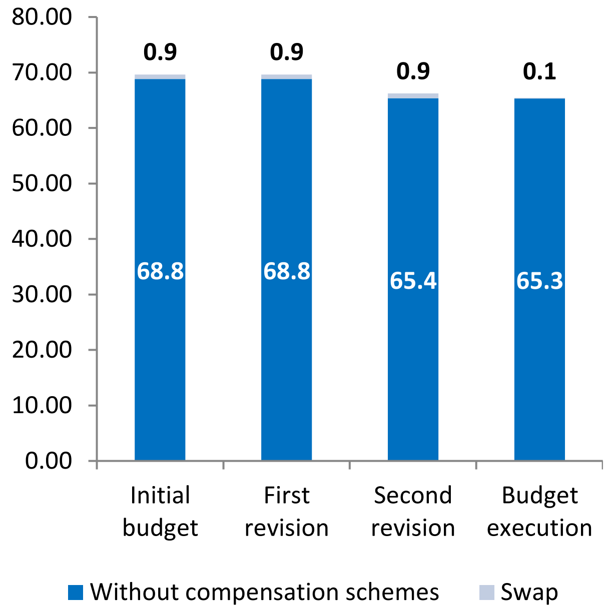
[46] Amounts granted through the European Agricultural Guarantee Fund (EAGF), the European Agricultural Fund for Rural Development (EAFRD) and the European Fund for Fisheries and Maritime Affairs (FEPAM).

wages and income tax (-0.05 pp), which were only partially offset by exceeding the initial program in the case of *other taxes and duties on goods and services* (+0.07 pp) and the *corporate income tax* (+0.05 pp). The substantial negative gap recorded by *social security contributions* (-0.6 pp) is partly due to the non-realization of revenues estimated to be obtained as a result of the tax amnesty, as well as to the additional negative impact generated by the slowdown in labor market indicators. Regarding the significant underperformance of the *amounts received from the EU* for the 2014-2020 financial framework (-8.7 billion lei compared to the initial projection), this is mainly due to the downward revision of structural funds (-5.9 billion lei), but also to the decrease of the amounts allocated for the agricultural sector which transit the consolidated budget (-1 billion lei).

III.4.1. VAT and excise duties

VAT revenues in cash standards, eliminating the impact of the swap compensation schemes, registered a level of 65.3 billion lei in 2019, being 3.5 billion lei below the projection of the initial draft budget. The adjacent graph shows the evolution of VAT revenues and compensation schemes projected by the draft budget and amended by the budget revisions, compared to the actual values from the budget execution. While the first revision maintained the projection of VAT revenues at the initial level, the second one revised it downwards by almost 3.5 billion lei, this value being in close vicinity to the actual execution. Thus, the level of VAT revenues, net of the impact of the compensation schemes, was in line with the FC's assessments, which pointed out in its opinion on the first budget revision that VAT revenues were overestimated by about 3-4 billion lei.

Figure 5: VAT revenues in 2019 (billion lei)



Source: MPF

In what concerns the compensation scheme, it was initially estimated at 0.85 billion lei and was maintained at this level by both budget revisions, but the actual execution recorded a much lower level, respectively below 0.1 billion lei.

It should be mentioned that the non-fulfillment of the projected level of VAT revenues occurs in the context in which the MPF estimated that these revenues would increase by about 6 billion lei, based on taking into account ex-ante the effect of measures aimed at improving collection efficiency. Given that the impact of such measures is difficult or even impossible to estimate ex-ante, the FC evaluated in its opinion on the draft budget for 2019 that VAT revenues were overestimated by about 5 billion lei. Thus, a preliminary assessment could indicate that, although the budgeted target was missed by 3.5 billion lei, the measures aimed at improving collection would have materialized in a revenue increase of 2.5 billion lei compared to the expected level of 6 billion lei. In this respect, the following clarifications are required:

- The projection from the initial budget did not fully incorporate the estimated 6 billion lei to be obtained from collection improvement. Thus, taking into account the execution of VAT revenues at the end of 2018 and the forecasted advance of 7.9% for the relevant macroeconomic base (final consumption of households, excluding self-consumption and NPISH[47]), only about 4.5-5 billion lei were included in the initial budget as the impact of collection improvement measures;
- The effective increase of the relevant macroeconomic base was 11.6%, exceeding the forecast of 7.9% on which the budget construction was based, which stimulates an advance of VAT revenues by over 2 billion lei compared to the projected level.

Therefore, cumulating the effects of the above-mentioned factors, it is found that they explain almost entirely the evolution of VAT revenues, which leads to the conclusion that measures aimed at improving VAT collection, assessed by the MPF at 6 billion lei, did not produce a significant impact on the actual level of revenues.

Compared to the previous year, VAT revenues, eliminating the impact of swap compensation schemes, advanced by almost 10% (+5.9 billion lei), mainly due to the increase in the final consumption of households. Collection performance can also be investigated in this case by making an *ex-post* projection of VAT revenues and comparing it with the actual execution. Thus, starting from the data of the 2018 budget execution and applying the 11.6% increase of the expenditures with the final consumption of households (excluding self-consumption and NPISH), it is obtained an *ex-post* projection of the 2019 VAT revenues of about 66.3 billion lei, while the actual execution recorded a level of 65.3 billion lei. The results indicate an unfavorable difference of almost 1 billion lei, without identifying any significant revenue increase that would result from improved collection efficiency, despite the considerable impact estimated by the MPF when drafting the initial program.

Given that the *ex-ante* inclusion of the impact of collection improvement measures into the projection of VAT revenues has been a recurring practice in the last two years, it must be reiterated that this approach lacks prudence, initial budgetary targets being missed in both years which called for significant adjustments with potential destabilizing effects from an economic and social point of view. Thus, the FC launched a series of warnings regarding the oversizing of VAT revenues in its opinions on the draft budget for 2019 and on the first budget revision, these warnings being subsequently validated by the actual budget execution, the negative impact being mitigated by the evolution above expectations of the relevant macroeconomic base, as well as by the discretionary adjustment of VAT refunds.

In the following analysis, the effectiveness of VAT revenue collection will be assessed in relation to the ratio between the implicit tax rate[48] and the weighted average tax rate. Regarding the latter, it should be noted that, starting with the 2015 Annual Report, the weighted average VAT rate[49] was determined,

[47] Non-profit institutions serving households.

[48] Defined as the ratio between the actual income collected for a given tax category and the corresponding macroeconomic tax base.

[49] 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

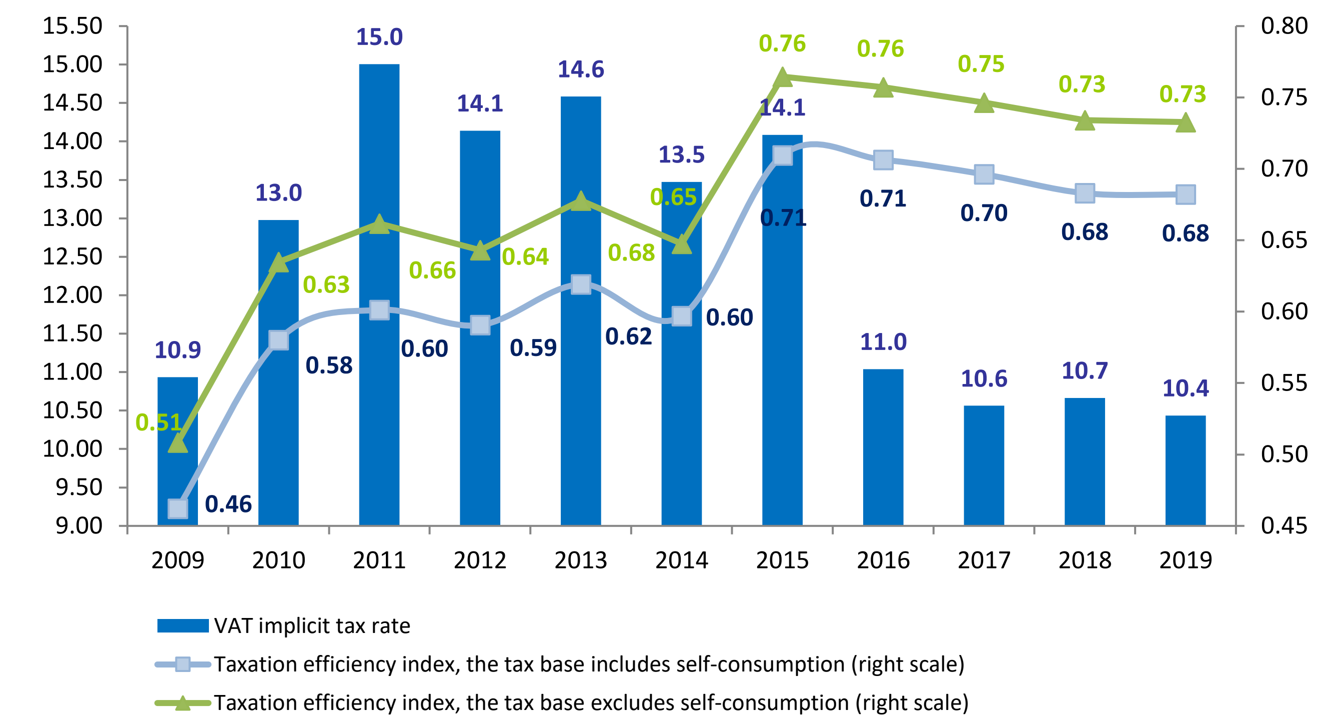
representing a change of methodology relative to the 2010-2014 Annual Reports, so, the results presented here are not comparable to those from the above-mentioned editions. The weights used to determine the weighted average VAT rate are those of the harmonized index of consumer prices (HICP), which is the only available source when making international comparisons, although they represent only an approximation of the weighted average VAT rate for the entire economy. Thus, given that the goods and services subject to a 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 collection efficiency being overstated to a certain extent.

Figure 6 shows the evolution of the VAT implicit tax rate and of the taxation efficiency index for Romania, using as tax base both the final consumption of households and NPISH (right-hand scale, in blue) and the final consumption of households and NPISH excluding self-consumption (right-hand scale, in green). The decision to evaluate the effectiveness of VAT revenue collection by excluding self-consumption and the farmers' market from the tax base is justified by the fact that these components have an important size in the case of Romania, the results for the taxation efficiency index being higher by 7% to 10% compared to the situation in which they were computed based on the total final consumption of households and NPISH.

Analyzing the evolution of the VAT taxation efficiency index it can be noticed that, after a period of relative stability between 2010 and 2014, 2015 marked a substantial improvement in the effectiveness of revenue collection, reaching the peak of the post-crisis period. Subsequently, the efficiency index suffered minor decreases, but remained close to the value recorded in 2015, 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 led to a decrease in the weighted average VAT rate from 18.4% in 2015 to 14.5% in 2018, while 2019 marked a slight decrease to the level of 14.2% amid changes in HICP weights. Thus, it should be noted that the reduction of VAT rates during 2016-2017 (materialized by significant decreases of both legal and weighted average rates) has not led to an improvement in collection efficiency and, implicitly, in voluntary compliance. At the same time, it can be noticed that the efficiency of VAT collection in Romania in 2019 remained at a level similar to the previous year, this result being consistent with the analysis based on the comparison between the *ex-post* projection of this aggregate and actual revenues, which led to the conclusion that there were no significant increases in revenues that could indicate an improvement in collection.

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.

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



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

In comparison to the efficiency of VAT collection at the level of 2019, corresponding to the group of new EU Member States (NMS), the index of 0.68[50], recorded by Romania, is significantly lower than those registered by Estonia, Hungary, Slovenia (each having a taxation efficiency index of 0.98), Bulgaria (0.93), the Czech Republic (0.87) and Poland (0.82). Thus, in 2019 Romania collected VAT revenues representing 6.2% of GDP (according to the ESA 2010 methodology), compared to 9.7% of GDP in Hungary, 9.3% of GDP in Bulgaria, 8.9% of GDP in Estonia, 8.1% of GDP in Slovenia, 8% of GDP in Poland and 7.7% of GDP in the Czech Republic. At the same time, the weighted average VAT rates in these countries were 20.4% in Hungary, 18.7% in the Czech Republic, 18.6% in Estonia, 17.1% in Poland, 16.7% in Bulgaria and 15.9% in Slovenia, while Romania recorded a weighted average rate of only 14.2%. In this sense, it should be noted that starting with 2016, Romania has the lowest weighted average VAT rate compared to other NMS countries, following the 5 pp reduction of the standard rate from 24% to 19%. In the taxation efficiency ranking, our country stands on the last place, down one position compared to 2018 due to the advance of Lithuania, while Slovenia remained on the first place during the last 2 years.

The country ranking based on the taxation efficiency index should be interpreted by also taking into account the structural differences between the analyzed economies, given that the higher percentage of rural population in Romania is reflected in a bigger size of self-consumption and farmers' market (which are non-taxable), having an impact on the value of this index, as shown in *Figure 7*. Thus, the

[50] 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.

conclusion of a study developed by Aizenmann and Jinjarak (2005)[51], which 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 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		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
BG	17.0	16.9	16.7	14.8	15.2	15.6	0.87	0.90	0.93	4	4	4
CZ	18.8	18.8	18.7	16.2	16.2	16.3	0.86	0.86	0.87	5	5	5
EE	18.6	18.6	18.6	18.0	18.0	18.2	0.97	0.97	0.98	1	3	3
LV	19.5	19.3	19.2	13.5	14.3	14.5	0.69	0.74	0.75	9	7	8
LT	19.3	19.2	19.1	12.6	12.6	13.1	0.65	0.66	0.69	10	10	9
HU	20.7	19.9	20.4	18.9	19.9	20.0	0.91	1.00	0.98	3	2	2
PL	17.3	17.1	17.1	13.3	14.0	14.0	0.77	0.82	0.82	6	6	6
RO	14.1	14.5	14.2	9.9	9.9	9.7	0.70	0.68	0.68	8	9	10
SI	16.3	15.9	15.9	15.4	15.9	15.7	0.95	1.00	0.98	2	1	1
SK	17.1	17.3	17.1	12.5	12.6	12.9	0.73	0.73	0.76	7	8	7

Source: EC, Eurostat, Fiscal Council's calculations

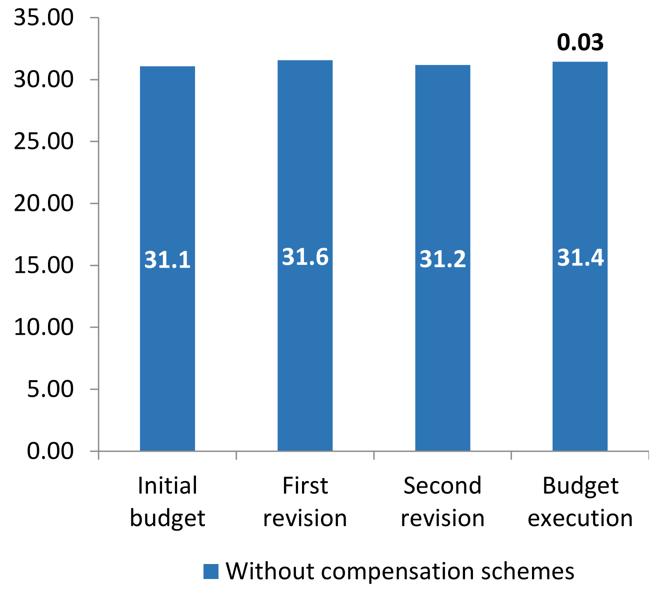
* Calculated as a ratio between "VAT revenues" (ESA code D211REC) and "Households and NPISH Final Consumption Expenditure" (ESA code P31_S14_S15). In the case of Romania, VAT revenues include additional receipts due to implementing the compensation scheme for clearing arrears (+236 million lei in 2017, +205.5 mil. lei in 2018 and +96.4 mil. lei in 2019).

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

[51] 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.

Revenues collected from **excise duties**, eliminating the impact of swap compensation schemes, amounted to 31.4 billion lei (representing almost 3% of GDP) in 2019, this level being higher than the projection of the initial draft budget by almost 0.4 billion lei. Thus, the initial program estimated revenues of 31.1 billion lei from excise duties, taking into account a 6.4% forecasted increase for the relevant macroeconomic base (final consumption of the population in real terms), additional revenues of about 0.6 billion lei as a result of the rise in the level of excise duties on tobacco products, as well as an expected positive effect of 1 billion lei due to potential improvements in the collection of excise duties.

Figure 7: Excise duty revenues in 2019 (billion lei)



Source: MPF

The first budget revision increased the level estimated initially by about 0.5 billion lei as a result of the project to introduce soft drinks with a high sugar content in the sphere of excisable products, as well as to increase the total excise duty for cigarettes 4 months ahead of the initial schedule (January 1, 2020).

The second budget revision cut the forecasted level of excise revenues by 0.4 billion lei as a result of cancelling the two aforementioned measures and due to the non-achievement of additional revenues from the reduction of tax evasion. However, the FC appreciated in its opinion regarding the second revision that there are premises for achieving revenues higher than the updated level, a fact confirmed by the actual 2019 execution which recorded excise revenues amounting to 31.4 billion. lei (by about 0.2 billion lei above the level estimated at the second revision).

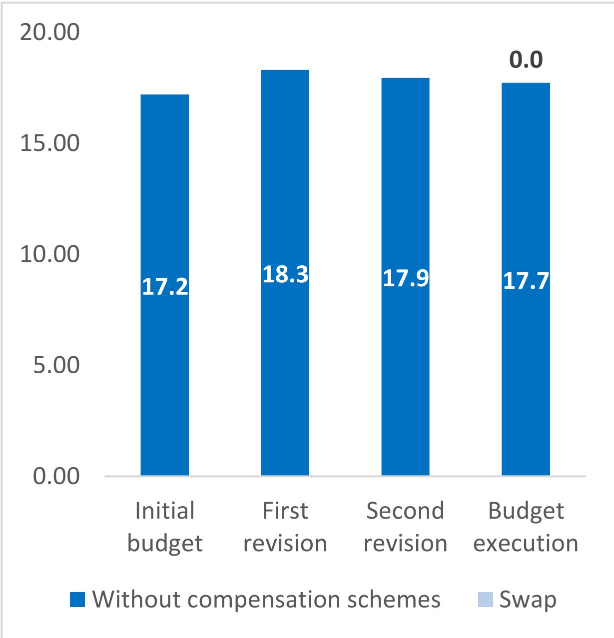
Compared to the previous year, the level of revenues collected from excise duties increased by 2.9 billion lei (+10.3%), in the context of a 6.4% advance of the final consumption of the population in real terms and amid the increase of excise duties on tobacco products from April 1, 2019. Given that only the aggregate level of excise duties is presented in the budget construction, which does not allow studying the impact of changing a single category, it is of interest to perform an analysis of the structure of excise revenues. Thus, about 55% of revenues came from excise duties on energy products, down from over 60% in 2018, but the decrease is mainly due to the significant advance of excise duties on tobacco products. They represent the second important component of excise revenues, with a share of over 41% in total revenues (compared to about 36% in the previous year), followed at a considerable distance by excise duties on alcohol, distillates and alcoholic beverages, which have retained a share of about 4% in total revenues, while the rest of the categories continued to stand below 1%.

Analyzing the evolution of each category compared to 2018, it is found that the revenues from excise duties on energy products increased by almost 6.5% (+1.1 billion lei), similar to the relevant macroeconomic base. However, the most important advance was recorded in the case of excise duties on tobacco products which, after stagnating in 2018, registered an increase of 31.5% (+3.1 billion lei) compared to the previous year, this being significantly higher than the 0.6 billion lei increase anticipated by the MPF due to the increase in the level of excise duties starting with April 1, 2019. The third category, represented by excise duties on alcohol, distillates and alcoholic beverages, has also registered a sizeable advance of 12.1% (over 0.1 billion lei) but, due to its low share in total revenues, the impact on the entire aggregate is not significant. Consequently, it can be concluded that the performance of excise revenues improved during 2019, as confirmed by the fact that the actual execution exceeded the initial program by over 0.3 billion lei, and as the significant advance of excise revenues on tobacco products may suggest a collection improvement in this area.

III.4.2. Direct taxes

The revenues from **corporate income tax**, according to cash standards and excluding the compensation schemes, amounted to 17.7 billion lei, by 2.1 billion more than in the 2018 execution (+13.4%), and by 0.5 billion lei higher than the initial budget estimates. The initial program forecasted revenues of 17.2 billion lei from corporate income tax in the context of anticipating an unfavorable effect of almost 0.2 billion lei as a result of the increase in gambling taxation, respectively of the growth in own revenues of ANRE and ANCOM, and of a positive effect estimated at 0.5 billion. lei on based on a potential improvement in collection rate. The value initially projected for this budget aggregate was supplemented by 1.1 billion lei at the first budget revision based on a higher growth rate for the execution at 6 months than forecasted in the draft budget.

Figure 8: Corporate income tax revenues in 2019 (billion lei)

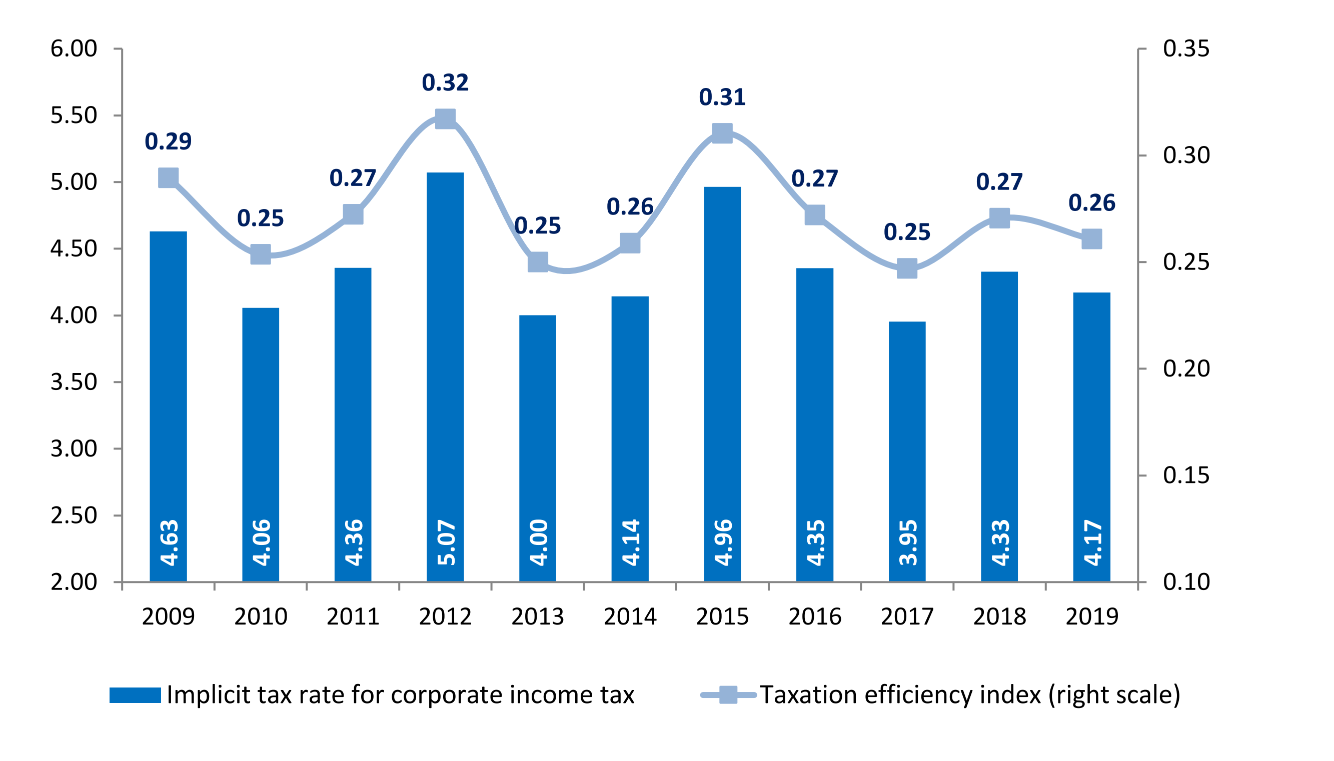


Source: MPF

However, in its opinion issued at that time, the FC considered that the adjusted level was too optimistic and would result in an overestimation of the tax revenues. This warning materialized in the subsequent evolution of this budgetary aggregate, the second revision diminishing the estimated level by about 0.4 billion lei, while the final execution recorded a failure to achieve the updated level by another 0.2 billion. lei.

The positive evolution of corporate income tax revenues compared to the previous year (+13.4%) exceeded the dynamics of the relevant macroeconomic base (nominal GDP, which advanced by only 11.3%), which could indicate at first sight a materialization of the expected positive impact due to the increase in the collection rate. However, an analysis of the revenue structure related to this budget aggregate indicates a situation similar to 2018. Thus, the above expectations evolution of the corporate tax revenues was supported mainly by corporate tax paid by commercial banks, which increased by more than 70% compared to the previous year (representing an advance of almost 0.9 billion lei), generating additional revenues of about 0.7 billion lei compared to the estimates based on the evolution of nominal GDP. On the other hand, the corporate income tax paid by non-financial economic operators (which is the main component of corporate tax revenue by over 88% of total revenues) advanced slower than nominal GDP, by only 8.4% (+1.2 billion lei). This growth rate implied a reduction of about 0.4 billion lei compared to the estimates based on nominal GDP dynamics (partly justified by MPF's expectations regarding the negative effects of the increase in gambling taxation, respectively of the increase in ANRE and ANCOM own revenues), thus no additional revenues being identified from improving the collection rate.

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



Source: EC, Eurostat, Fiscal Council's calculations

In order to further analyze this evolution, the collection efficiency index was calculated according to the ESA 2010 methodology. However, it should be noted that the results presented in this report are not comparable to the previous editions before the 2018 report, for reasons related to data availability[52]. As it can be seen in *Figure 9*, the collection efficiency index for corporate income tax recorded the highest value of the post-crisis period in 2012 (amid the recommencement of economic growth in 2011),

[52]The aggregate of "current taxes on income, wealth, etc. paid by corporations to government and rest of the world" was used for determining the implicit tax rate, while previous editions before the 2018 report employed the aggregate of "direct taxes paid by enterprises".

followed by a significant decrease during the next two years. In 2015 there was an improvement in collection efficiency, the index coming close to the level recorded in 2012, but the increase was temporary because, following the reduction in corporate income tax revenues the index decreased sharply in the next two years, 2017 marking its lowest value throughout the analyzed period. In this context, 2018 exhibited a slight recovery with the collection efficiency index rising from 0.25 in 2017 to 0.27. In 2019, a slight reduction of the index to 0.26 was recorded. The decrease was determined by the faster growth rate of the relevant macroeconomic base (gross operating surplus) compared to the taxes paid by enterprises, respectively 11.7% compared to 7.7%. Given that the profit tax revenues, in cash standards, increased by 13.4% compared to 2018, the deterioration of collection efficiency is most likely due to the negative evolution of other categories of revenues included in this aggregate.

Table 7: Taxation efficiency – corporate income tax

Country	Legal corporate income tax rate (%)			Implicit tax rate* (%)			Taxation efficiency index**			Rank		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
BG	10.0	10.0	10.0	4.9	5.0	5.1	0.49	0.50	0.51	2	1	1
CZ	19.0	19.0	19.0	7.1	7.4	7.0	0.38	0.39	0.37	3	2	2
EE	20.0	20.0	20.0	3.9	5.1	4.8	0.19	0.25	0.24	10	8	9
LV	15.0	20.0	20.0	3.7	2.3	2.2	0.25	0.11	0.11	6	10	10
LT	15.0	15.0	15.0	3.2	3.4	3.6	0.22	0.23	0.24	9	9	8
HU	9.0	9.0	9.0	5.0	3.3	2.9	0.55	0.36	0.32	1	3	3
PL	19.0	19.0	19.0	4.6	5.2	4.7	0.24	0.27	0.25	8	6	7
RO	16.0	16.0	16.0	4.0	4.3	4.2	0.25	0.27	0.26	7	7	6
SI	19.0	19.0	19.0	4.8	5.2	5.8	0.25	0.28	0.30	5	5	5
SK	21.0	21.0	21.0	7.2	6.9	6.7	0.34	0.33	0.32	4	4	4

Source: EC, Eurostat, Fiscal Council's calculations

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

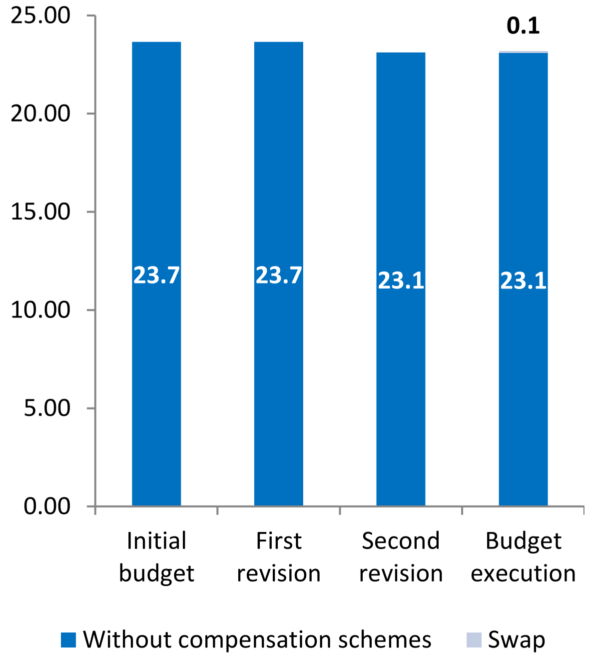
** Computed as the ratio between the implicit and legal tax rate.

*** Compared to the previous report, local taxes were not taken into account when determining the legal corporate income tax rate.

Compared to the other NMS countries, Romania ranks sixth in 2019, close to Poland (0.25), Lithuania (0.24) and Estonia (0.24) that rank on the next positions. On the other hand, Bulgaria (0.51) and Czech Republic (0.37) continue to occupy the first two places, at a considerable distance from the other states included in the analysis. In 2019, is noticed a slight general trend of worsening the efficiency of revenue collection from corporate income taxes, as six out of ten countries recorded reductions in the efficiency index, while Latvia remained at the same previous year's position. A substantial decrease in the efficiency index was registered for Hungary, due to the reduction of the corporate income tax rate from 19% to 9% (beginning with 2017). This measure caused a spectacular increase in the index during 2017 because the revenues included payments referring to the previous rate of 19% (as a result of a tax facility granted to companies that allowed the companies to postpone the payment of corporate income tax), and as anticipated in the previous editions of the report, the rise in the collection efficiency index was temporary, and was followed by a sizeable reduction over the last two years.

Revenues from **personal income tax**, according to cash standards, amounted to 23.1 billion lei, by 0.6 billion lei lower than the budgeted level at the beginning of the year. The initial program anticipated revenues of 23.7 billion lei, based on an estimated increase in the average number of employees by 3.4%, respectively an advance of 14.7% for the average gross wage, while anticipating a reduction in revenues by about 0.8 billion lei as a result of facilities provided for the construction sector. The level initially forecasted for personal income tax revenues was maintained at the first budget revision, while the second adjustment reduced it by almost 0.6 billion lei due to the unfavorable evolution of labor market indicators compared to the initial estimates (in 2019, according to the preliminary version of the Spring forecast of NCSP, the average number of employees increased by 1.7%, and the average gross salary by 13%, both levels being lower than the assumptions taken into account when drafting the budget).

Figure 10: Personal income tax revenues in 2019 (billion lei)

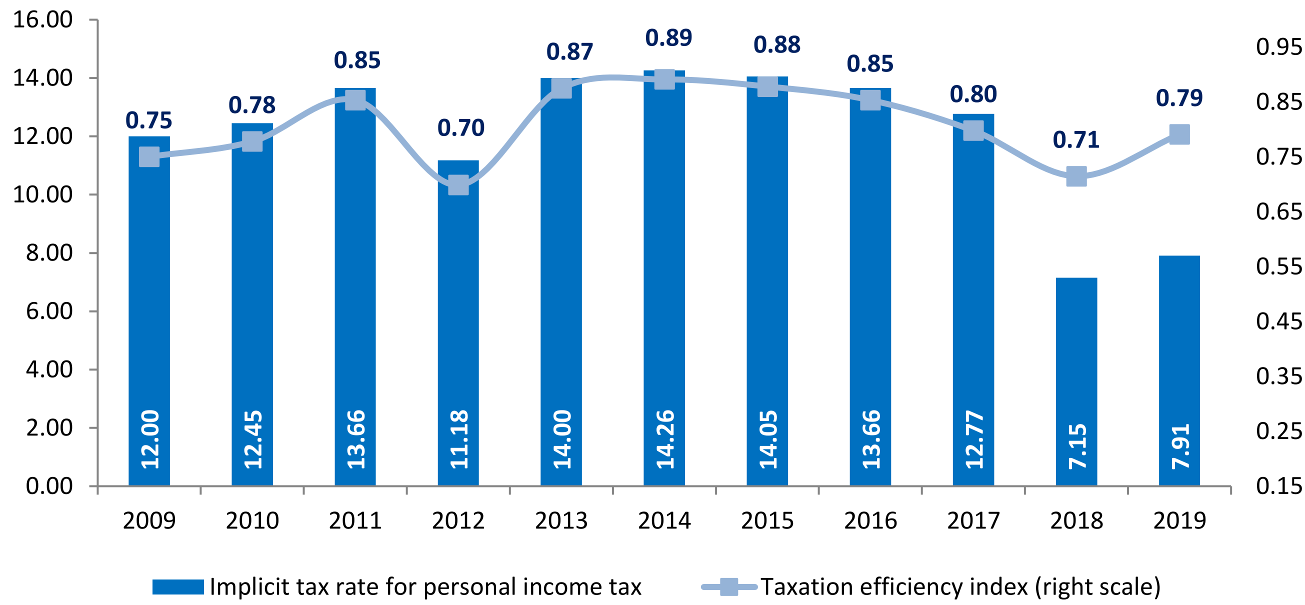


Source: MPF

The final execution confirmed the updated estimates on the occasion of the second revision, accounting 23.1 billion lei, net of the impact of swap compensation schemes. This value of revenues represents an advance of only 2.3% (+0.5 billion lei) compared to 2018, the dynamics of this category of budget revenues being significantly lower than the relevant macroeconomic bases even taking into account the negative impact of the facilities granted in constructions, estimated by the MPF at 0.8 billion lei. Thus, starting from the budget execution of 2018 (with revenues, net of the impact of compensation schemes, of 22.6 billion lei) and extrapolating with the average number of employees (+1.7%), respectively of the average gross wage (+13%) dynamics, appears as justified a level of revenues of about 25.1 billion lei (taking into account the unfavorable impact of the facilities granted in constructions, as mentioned above). Consequently, there is a deficit of revenues of about 2 billion lei, which raises questions about the efficiency in collecting this category of revenues.

In order to investigate this aggregate's development in more detail, the structure of its main components was analyzed. Thus, the payroll tax (which represents 78.4% of the revenues from personal income tax) had a particularly slow dynamics, recording an increase of only 1.3% (+0.2 billion lei) compared to the previous year. By contrast, the faster growth rate of the entire category (2.3%) was achieved as a result of the favorable contributions made by the other components of the personal income tax: dividend receipts (share of 7.7% in total revenues) increased by 31.3% (+0.4 billion lei) compared to the previous year, revenues based on the unique declaration (share of 6.7% in total revenues) increased by 500% (+1.3 billion lei) compared to the previous year, and the pension tax (share of 4.4% in total revenues) advanced by 17.7% (+0.2 billion lei) compared to the previous year, against the increase of the pension point by 15% from September 1, 2019. In conclusion, the analysis of the main components of personal income tax shows that the slow dynamics of this budget revenues' category, well below the evolution of the relevant macroeconomic bases, is due almost exclusively to payroll taxes which is likely to suggest a reduction in the efficiency of collection during 2019.

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



Source: EC, Eurostat, Fiscal Council's calculations

Similar to the analysis of collection efficiency for corporate income tax, for reasons related to data availability, the results presented in this report are not comparable to the 2018 previous editions[53]. According to the ESA 2010 methodology, revenues from income tax paid by households and NPISH increased by about 5.7 billion lei (+23% compared to the previous year), although personal income tax receipts in cash standards improved by only 0.5 billion lei (+2.3%). These developments suggest an additional positive impact, most likely due to other categories of revenue composing this aggregate. Consequently, the collection efficiency index registered a significant increase in 2019 up to 0.79, after in 2018 the minimum threshold of the period 2013-2018 was reached (0.71). The interpretation of the

[53] For determining the implicit tax rate was used the aggregate "current taxes on income, wealth, etc. paid by households and NPISH to government and rest of the world", while in the previous editions of the report the aggregate "direct taxes paid by households" was used.

previous year's evolution must take into account the entry into force of measures that had a negative impact on personal income tax revenues. Thus, the transfer of contributions from employer to employee led to a decrease in the personal income tax calculation base, and the total effect exceeded the reduction of the legal rate from 16% to 10%, being equivalent to a reduction of the income tax rate to 9.33% which allows comparison with previous years. Therefore, considering an equivalent legal rate of 9.33%, the tax efficiency index would have recorded an improved value of 0.75 but, even in these conditions, a clear deterioration of the collection could be observed in the case of taxes paid by households and NPISH in 2018.

Table 8: Taxation efficiency – personal income tax

Country	Legal personal income tax rate* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
BG	10.0	10.0	10.0	9.4	9.5	9.7	0.94	0.95	0.97	2	2	1
CZ	15.0	15.0	15.0	11.0	11.4	11.6	0.73	0.76	0.77	7	5	5
EE	20.0	20.0	20.0	16.4	15.4	14.9	0.82	0.77	0.75	3	4	6
LV	23.0	23.0	23.0	18.0	16.3	15.0	0.78	0.71	0.65	5	7	7
LT	15.0	15.0	20.0	11.4	11.8	16.1	0.76	0.79	0.80	6	3	3
HU	15.0	15.0	15.0	15.9	16.0	14.2	1.06	1.07	0.94	1	1	2
PL	25.0	25.0	25.0	15.8	16.1	15.8	0.63	0.65	0.63	8	8	8
RO	16.0	10.0	10.0	12.8	7.1	7.9	0.80	0.71	0.79	4	6	4
SI	33.2	33.2	33.2	13.7	14.1	14.0	0.41	0.42	0.42	10	10	10
SK	22.0	22.0	22.0	12.0	12.4	12.8	0.54	0.56	0.58	9	9	9

Source: EC, Eurostat, Fiscal Council's calculations

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

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

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

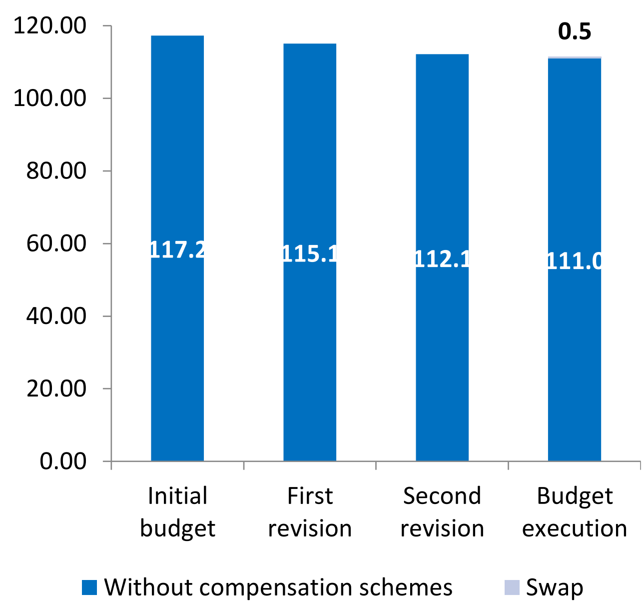
The increase in the collection efficiency index is also seen when comparing with other NMS. Thus, Romania ascended two positions compared to the 2018 ranking (from sixth to fourth place), behind Bulgaria (0.97), Hungary (0.94) and Lithuania (0.80). Bulgaria and Hungary remained in the top two for the last three years, recording significantly higher efficiency index values than the other analyzed countries. A constant evolution is also observed at the bottom of the ranking, Slovenia (0.42) and Slovakia (0.58) occupying the last places in each of the last three years. Overall, an increased heterogeneity of the efficiency index is observed, the difference between the first and the last ranked accounting for more than 50 pp.

III.4.3. Social security contributions

SSC revenues in cash standards, eliminating the impact of compensation schemes, amounted to about 111 billion lei at the end of 2019, which is lower by approximately 6.2 billion lei (-5.3%) relative to the estimates from the draft budget, given that the average number of employees increased by only 1.7%, compared to the initial projection of 3.4%, and the average gross salary increased by only 13%, compared to the initial projection of 14.7%. The underperformance of SSC revenues occurred in the context of a fiscal amnesty granted by the MPF (along with the first budget revision), which estimated that it will generate additional revenues of 1.1 billion lei. In view of the above, the FC pointed out in its opinion on the draft budget for 2019 that the assumptions regarding the dynamics of labor market indicators were overly optimistic and unlikely to materialize at the expected levels. Furthermore, in its opinion on the first budget revision the FC appreciated that a potential positive impact of the amnesty cannot be taken into account ex-ante in the budget revenue projection. On the other hand, the enforcement titles paid during 2019 must also be taken into account, including Law no. 85/2016 which establishes the payment of salary differences to the teaching staff for the period October 2008 - May 13, 2011. Although the planned value of the enforcement titles for 2019 was about 1.5 billion lei, the actual payments reached almost 2 billion lei, which led to an increase in SSC revenues compared to the planned level by around 167 million lei.

Analyzing the projection of SSC revenues during 2019, it can be noticed that the first budget revision recognized the existence of a revenue deficit of about 2.1 billion lei due to the non-realization of the 6-month revenue plan, and the FC estimated at that time an additional revenue gap of about 2 billion lei as a result of the fact that the revenue deficit had not been extrapolated for the entire year, while the effects of the tax amnesty were taken into consideration ex-ante. The FC's warning was validated by the second budget revision which diminished the estimated level of SSC revenues by another 3 billion lei (recognizing the slower dynamics of labor market indicators compared to the initial estimates), while the actual execution was 1.1 billion lei lower than the projection from the second revision.

Figure 12: Social security contributions revenues in 2019 (billion lei)



Source: MPF

Compared to 2018, SSC revenues, eliminating the impact of compensation schemes, increased by 13.4 billion lei (+13.7%) mainly due to the positive evolution of the average number of employees, respectively of the average gross salary. For a more detailed analysis of the performance of SSC revenues, an *ex-post* projection of this budget aggregate will be carried out and its starting point is represented by the 2018 budget execution which recorded a net level, eliminating the impact of compensation schemes, of 97.6 billion lei. Extrapolating the starting point with the actual dynamics of the relevant macroeconomic bases (+1.7% for the average number of employees, respectively +13% for the average gross salary), but also taking into account the negative impact of facilities granted in the construction sector (evaluated by the MPF at almost 1.4 billion lei), a revenue level of about 110.8 billion lei appears to be feasible, which is very close to that recorded in the 2019 budget execution. Therefore, the collection efficiency for this aggregate seems unchanged, the negative difference compared to the 2019 initial budget being the results of overestimating SSC revenues, mainly due to the formulation of overly optimistic assumptions about the dynamics of labor market indicators.

In order to reflect more accurately the dynamics of SSC revenues between 2016 and 2019, in the table below are presented the adjusted series of this budgetary aggregate[54], as well as the gross series obtained by eliminating the adjustments related to the swap compensation schemes and to the transfers towards Pension Pillar II:

Table 9: Social security contributions (million lei)

		Budget execution 2016	Budget execution 2017	Budget execution 2018	Budget execution 2019
Adjusted series	**1**	**61,270.2**	**71,705.7**	**98,101.1**	**111,473.4**
Swap	2	299.4	632.6	490.9	464.3
Pension Pillar II	3	5,882.8	7,142.6	7,717.8	8,487.3
Gross series*	**4=1-2+3**	**66,853.5**	**78,215.8**	**105,327.9**	**119,496.5**
*out of which enforcement titles		290.7	378.6	55.0	668.0

Source: FSA, MPF, Fiscal Council's calculations

Thus, if the gross series is considered, SSC revenues amounted to over 119 billion lei in 2019, exceeding the receipts from the previous year by 13.5% (+14.2 billion lei), this dynamic being slightly slower than the one observed in the budget execution (+13.6%) because the gross series includes the transfers to Pension Pillar II which advanced by only 10%. If the impact of enforcement titles is eliminated, SSC revenues increased in 2019 by just 12.9% (+13.6 billion lei) compared to the previous year, taking into account the significant increase of payments related to enforcement titles.

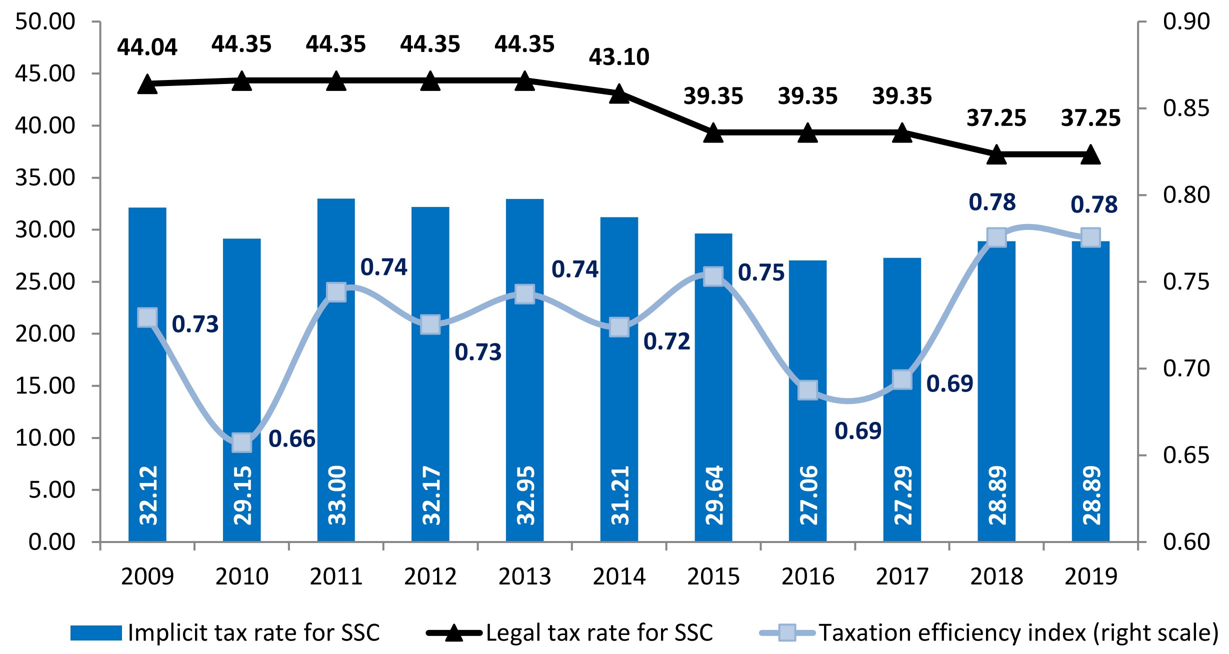
Before analyzing the evolution of SSC revenues according to ESA 2010 methodology, it should be mentioned that since 2017, the statistical treatment of special pensions was modified, these being simultaneously incorporated into social security contributions on the revenue side and into personnel

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

expenditures. Because this statistical treatment artificially alters the levels of the two budgetary aggregates, also affecting the comparability with previous years, the amounts related to special pensions were eliminated. Thus, SSC revenues were computed as total contributions paid by employers and employees. The same formula was applied to the other NMS countries in order to assess the collection efficiency of SSC on the basis of comparable data series.

SSC revenues in 2019, according to the ESA 2010 methodology, had a relatively similar dynamics to those in cash standards, registering an advance of 11.2% compared to the previous year. This development appears as a result of the aforementioned factors regarding the increase of the average number of employees, respectively of the average gross salary, and the negative impact of the facilities granted in the construction sector. Given that the gross aggregate salaries also increased by 11.2%, the SSC implicit tax rate remained unchanged compared to 2018 (28.9%) and the collection efficiency index maintained a level of 0.78. This confirms the conclusion obtained based on the analysis of the cash execution which pointed out that the efficiency of SSC collection remained relatively unchanged during 2019.

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



Source: EC, Eurostat, Fiscal Council's calculations

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

Table 10: Taxation efficiency – social security contributions												
Country	Legal SSC rate* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2017	2018	2019	2017	2018	2019	2017	2018	2019	2017	2018	2019
BG	32.0	33.0	33.0	22.7	23.1	24.0	0.71	0.70	0.73	8	9	9
CZ	48.0	48.0	48.0	47.9	48.0	48.1	1.00	1.00	1.00	2	1	2
EE	35.4	35.4	35.4	31.4	31.6	31.8	0.89	0.89	0.90	6	6	6
LV	34.1	35.1	35.1	21.8	23.1	23.3	0.64	0.66	0.66	10	10	10
LT	40.0	39.5	21.0	35.5	36.2	21.7	0.89	0.92	1.04	5	5	1
HU	40.5	38.0	38.0	35.8	33.9	32.2	0.88	0.89	0.85	7	7	7
PL	41.5	41.5	41.5	40.2	40.0	39.8	0.97	0.96	0.96	3	2	3
RO	39.4	37.3	37.3	27.3	28.9	28.9	0.69	0.78	0.78	9	8	8
SI	38.2	38.2	38.2	36.3	36.1	36.1	0.95	0.95	0.94	4	4	5
SK	45.6	48.6	48.6	47.3	46.6	45.9	1.04	0.96	0.95	1	3	4

Source: EC, Eurostat, Fiscal Council's calculation

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

** Computed as the ratio between "employers' actual social contributions" (ESA code D611REC) and "households' actual social contributions" (ESA code D613REC) relative to "gross wages and salaries" (ESA code D11). In the case of Romania, revenues include additional temporary receipts due to implementing the compensation scheme for clearing arrears (632.6 million lei in 2017, 490.9 million lei in 2018 and 464.3 million lei in 2019).

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

Compared to the other NMS countries, Romania continued to rank 8th in terms of the SSC collection efficiency in 2019 and climbed to 6th place in terms of the aggregate legal SSC rate (after Slovakia, Czechia, Poland, Slovenia and Hungary), as a result of the Lithuanian legal rate decreasing from 39.5% to 21%. Out of the countries that have a lower legal rate than Romania, it is noteworthy that Estonia has achieved higher implicit tax rates over the past three years. This result could also be explained by different SSC tax regimes for certain categories of income (income from self-employment, copyright, rent, investment income, etc.).

III.5. Budgetary expenditures

The budgetary expenditures, net of compensation swap schemes (in the amount of 0.7 billion lei) registered an advance of 14.8% compared to the previous year (+47.5 billion lei), reaching the level of 368.7 billion lei at the end of 2019. Even in the context of a significant growth of nominal GDP (+11.3%), the share of budgetary expenditures in GDP increased by almost 1.1 pp, respectively from 33.7% to 34.8% of GDP. The main aggregates which registered a higher dynamic than the average were: *capital expenditures* (+28.8%), *personnel expenses* (+18.8%), *goods and servi*ces (+18.3%), *other transfers* (+16.8%), while lower dynamics than the average were registered by *projects funded by non-reimbursable external funds* (-27.5%)[55], *transfers for public entities* (-26.6%), *subsidies* (+6.6%) and *other expenditures* (+8.36%). The increase as share in GDP of the total expenditures was due to the substantial growth in *personnel spending* (+0.61 pp) driven by the sustained wage increases in the public sector, *capital expenditures* (+0.4 pp), *goods and services* (+0.3 pp) and *social assistance* (+0.18 pp). The most significant reduction as share in GDP compared to the previous year was recorded for the *interest expenses* (-0.21 pp).

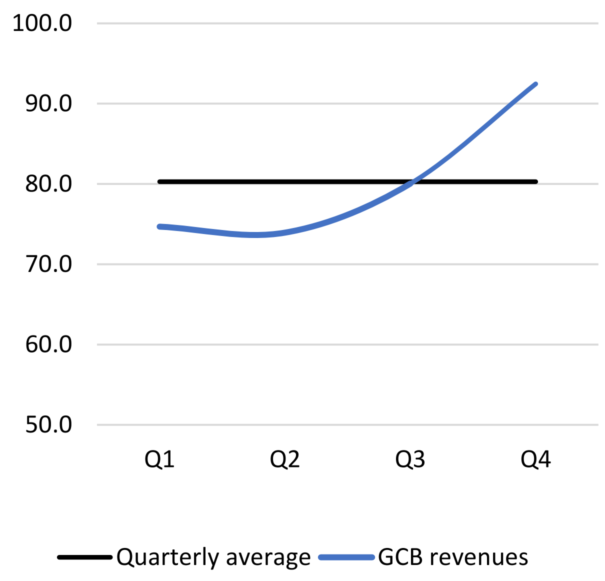
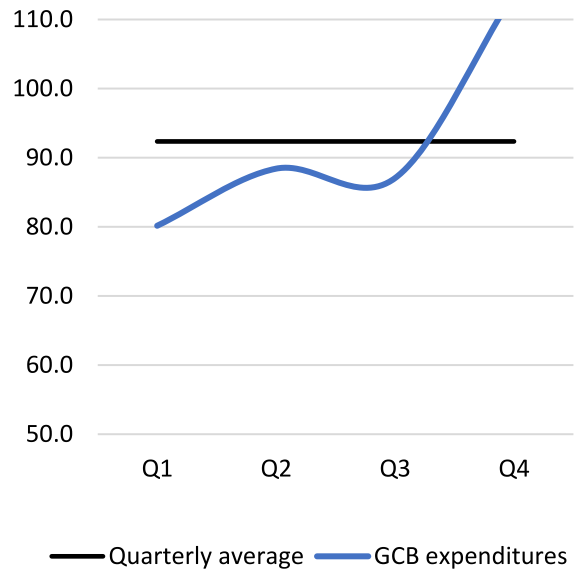
Compared to the amounts established in the initial 2019 budget, the execution for budgetary expenditures was lower by about 1.4 billion lei (-0.4%), respectively by 0.13 pp of GDP, mainly, as a result of the non-achievement of *projects funded by post-accession non-reimbursable external funds* (-0.99 pp) and *interest spending* (-0.12 pp), while positive contributions came from *social assistance* (+0.49 pp), *capital expenditures* (+0.47 pp, against the background of supplementing the amounts related to the National Program for Local Development - NPLD) and *goods and services* (+0.4 pp).

The pressures on social assistance and goods and services expenditures were much higher than initially anticipated as a result of initial sub-budgeting. Essentially, public investment expenditures were significantly reduced, partly as a result of lower than initially expected European funds revenues, and also to partially accommodate the increases in the above-mentioned categories of expenditure.

In 2019, the analysis of the quarterly execution of GCB's expenditures[56] shows a concentration in the last quarter, in the quarter share in total year slightly decreasing compared to 2018 (30.8% respectively, compared to 31.2% in previous year). Thus, the total expenses amounted to 113.8 billion lei in the fourth quarter of 2019 (compared to 100.7 billion lei in the fourth quarter of 2018, respectively an increase of 12.96%), and higher by 30.7% compared to the previous quarter (against an increase by 34.8% in the fourth quarter compared to the third quarter of 2018).

[55] Throughout this chapter, the amounts related to projects from EU funds are cumulated for the financial years 2007-2013 and 2014-2020. Strictly for the 2014-2020 financial year, there was an increase of 18.7% compared to the previous year. Thus, out of the total of 34.3 billion lei of this category, only 17.8 billion lei represent structural funds, the difference being constituted by European funds allocated to payments for agriculture (about 13.4 billion lei) and by amounts intended for pre-financing of non-governmental sector in the event of temporary unavailability of European funds, based on art. 10 of GEO no. 40/2015 (3.1 billion lei).

[56] Including the swap compensation scheme.

Figure 14: Quarterly revenues of the GCB in 2019 (billion lei)	Figure 15: Quarterly expenditures of the GCB in 2019 (billion lei)
	

Source: MPF

Analyzing the intensification of expenditures in the fourth quarter of 2019 compared to the previous quarter, about 63.5% of the total increase is attributable to the acceleration of capital expenditures (+124%, contribution of 31.8%), to projects funded by post-accession non-reimbursable external funds (+253.3%, contribution of 40%), respectively to the payments made in previous years and recovered in the current year (+485.8%, contribution of -8.2%), and approximately 36.5% is determined by increases in expenditure on goods and services (+32.7%, contribution of 16.3%), personnel expenditures (+5.1%, contribution of 4.8%), social assistance (+4.9%, contribution of 5.2%), other expenses (+56.2%, contribution of 3.7%) and interest spending (+49.4%, contribution of 3%).

The high proportion of expenditure made in the last quarter of the year highlights serious weaknesses in the budgetary programming process, especially for public investment spending (funded from capital expenditure and European funds), although the principle of prudence might justify the postponement of some expenditure until the budgetary revenue projection has a lower uncertainty degree. Otherwise, in 2019, the quarterly development of budgetary revenues, indicates that were largely achieved in the last quarter of the year, but in a much smaller share than in the previous year (28.8% in total year compared to 30.6% in 2018, respectively an increase against the previous quarter of 15.5%, in contrast to 23.7% in 2018).

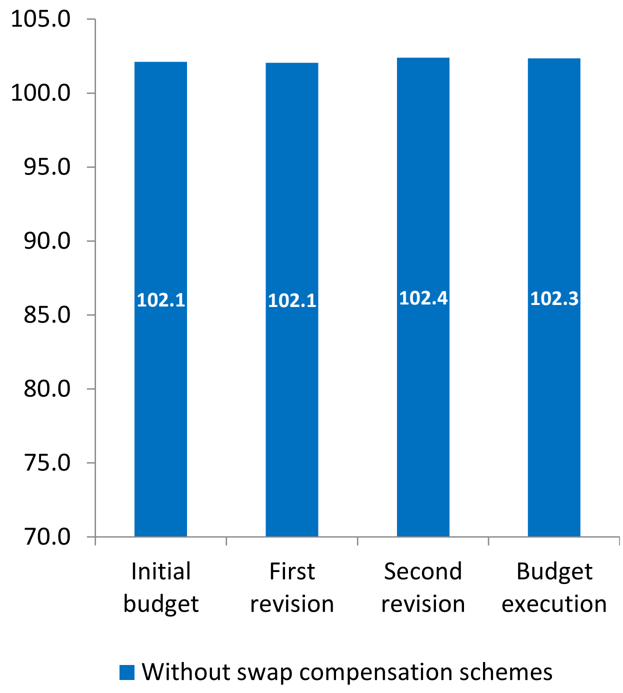
As in the previous years, the Fiscal Council reiterates the recommendation for a lower volatility of inter-quarterly budgetary expenditures.

III.5.1. Personnel and social assistance expenditures

The **personnel** expenditures increased by 0.2 billion lei compared to the amount projected in the 2019 draft budget. Initially projected to 102.1 billion lei, the execution amounted to 102.3 billion lei, respectively 9.7% of GDP, higher by 0.02 pp of GDP than the initial budget level.

The personnel expenditures during the year 2019 observed the ceilings defined by GEO no. 14/2019. Thus, on the occasion of the first budget revision, the projected level was decreased by about 66.7 million lei (-0.1%), while the nominal GDP was revised upwards by 8,500 million lei (+0.8%) compared to the estimates used in the initial budget. The second budget revision increased the personnel expenses by 335.5 million lei (+0.3%) compared to the previous budget iteration and by 267.8 million lei (+0.3%) compared to the initial budget. At the same time, the level of nominal GDP was increased by 18,300 million lei (+1.8%) compared to the moment of setting the ceilings.

Figure 16: Personnel expenditures in 2019 (billion lei)



Source: MPF

On the occasion of the first budget revision, Fiscal Council warned that extrapolating monthly expenditure flows for the first six months to the whole year would require a need for additional allocations. At the same time, the development of personnel expenses in the first months of 2019 was influenced to a certain extent by non-recurring elements (such as granting holiday vouchers, compensations according to Law no. 85/2016), and the budget revision had in view restricting employment in the public system, according to the rule of 1 new employee at 3 exits from the system, thus justifying the new projected level of this expenditure aggregate.

Compared to 2018, personnel expenses increased significantly, by 16.2 billion lei, respectively by 18.8%. Unlike 2018 when the increase in personnel spending was offset by lower amounts paid on account of court decisions on the payment of salary differences for some categories of public servants compared to 2017, in 2019, the impact of paying these amounts was significant. Thus, we note that for 2019, the enforceable titles paid (1,951.6 million lei) were higher, both compared to those planned (1,462.5 million lei) and considerably higher than in the previous year (160.6 mil. lei).

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	2019	2020 plan	Total
Enforceable titles issued, inclusive Law no.85/2016	Central administration. (State budget)	3,240.0		8.5	3.8	82.3	1,599.4	67.4	996.9	1,461.6		7,459.9
	Local administration	3,060.0		867.6	1,614.4	1,064.1	2,094.3	20.3	0	0.0		8,720.7
	Social security budget	116.0		28.6	5.5	12.2	7.6	1.2	0.0	0.9		172.0
	Total	**6,416.0**	**0.00**	**904.7**	**1,623.7**	**1,158.6**	**3,701.3**	**88.9**	**996.9**	**1,462.5**		**16,352.6**
Enforceable titles paid, inclusive Law no.85/2016	Central administration. (State budget)		162	311	1,531.7	1,234.6	363.1	476.2	80.8	999.7	1,096	5,159.1
	Local administration		153	306	2,447.2	2,806.1	544.6	705	79.2	947.7		7,988.8
	Social security budget		6	24.2	72.6	59.3	0	0.6	0.6	4.2		167.5
	Total		**321**	**641.2**	**4,051.5**	**4,100**	**907.7**	**1,181.8**	**160.6**	**1,951.6**	**1,096**	**13,315.4**

Source: MPF

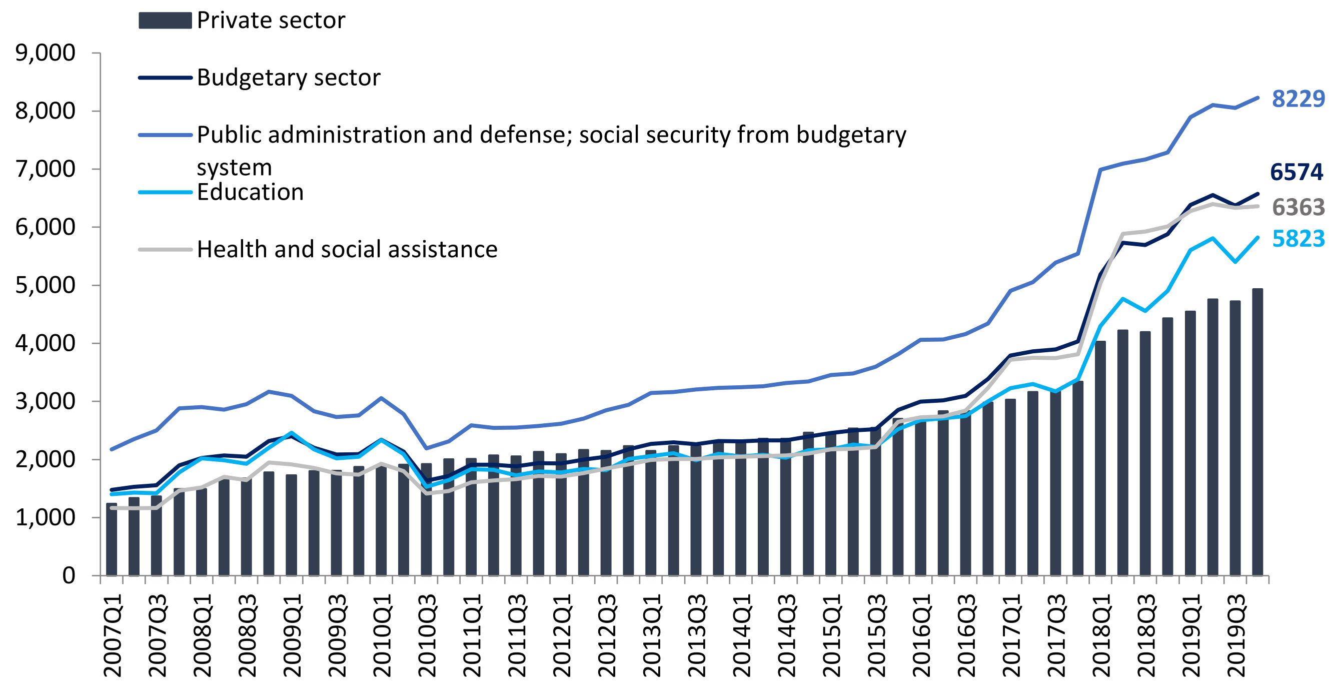
The draft budget for 2019 included a series of increases in state personnel expenditures determined by the entry into force, starting with July 1, 2017, of the Law no. 153/2017 on the remuneration of personnel paid from public funds, on the basis of which salary increases were granted or allowed for some categories of budgetary employees. Thus, starting with January 1, 2019, the gross amount of base wages, function payments, monthly payments and employment allowances was increased by 25% of the difference between their level set by law for 2022 and the December 2018 level. The impact of this increase was estimated by the Ministry of Public Finance at approximately 8.9 billion lei. Also, according to the provisions of the same law, starting with December 1, 2018, food allowance was granted to personnel paid from public funds[57] representing the 12th part of two minimum gross wages guaranteed. The budgetary impact for 2019 this measure was assessed at about 3.2 billion lei.

A negative impact on this budgetary aggregate also had the increase of the guaranteed minimum gross wage in payment from 1,900 lei/month to 2,080 lei/month starting with January 1, 2019, according to the Government Decision no. 937/2018 for establishing the guaranteed minimum gross wage, from December 10, 2018. Moreover, by the same normative act for high educated personnel, with at least one year of seniority, the guaranteed minimum gross wage was set at 2,350 lei/month. The cumulative impact of these two measures was about 0.33 billion lei according to the substantiation note accompanying the emergency ordinance. It is also to be mentioned that GEO no. 114/2018 established a minimum gross wage even higher for employees in construction sector, at 3,000 lei/month. According

[57] Except for the staff of the Ministry of National Defense, the Ministry of Internal Affairs, the Ministry of Justice - National Administration of Penitentiaries, the Romanian Intelligence Service, the Foreign Intelligence Service, the Protection and Guard Service and the Special Telecommunications Service, as well as local police personnel who, according to law, benefit from food rights under the Government Ordinance no. 26/1994.

to the substantiation note, this measure was adopted in order to stimulate employment in the construction sector, which was declared a priority sector[58], as in recent years faced difficulties in hiring skilled labor force and confronted with unfair competition.

Figure 17: Average net earnings in the private and public sector in 2007-2019 (lei/month)



Source: NIS, Fiscal Council's computation

As a result of these increases, the average gross wage in the public sector reached 6,472 lei/month in 2019, by 15.1% higher than in 2018, and exceeding by 36.6% the private sector average of 4,739 lei/month (by 12.3% higher than in the previous year). Considering quarterly averages, the monthly average gross wage in the public sector for the fourth quarter of 2019 registered 6,574 lei, higher by 11.8% than in the same period of 2018, while for the private sector was 4,933 lei, by 11.3% more than in the fourth quarter of 2018. The highest increase was recorded in the public education sector, the average net salary reaching 5,823 lei in the fourth quarter of 2019, by 18.8% higher than the same period of the previous year. This dynamic has strongly contributed to rising the average wage in the public sector.

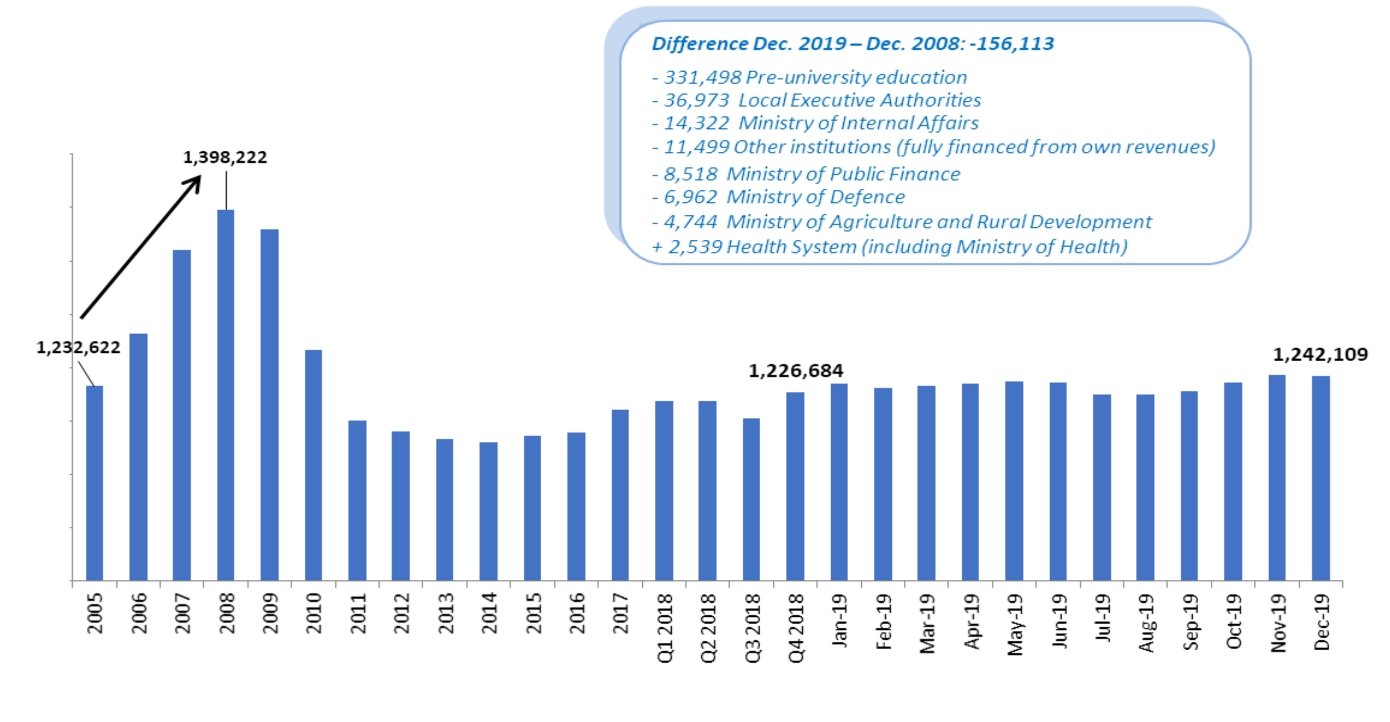
The gross wages for the personnel in health and social assistance have increased the least. Their level in the last quarter of 2019 was 6,363 lei/month, with a growth rate of only 5.8% compared to the last quarter of 2018. The average gross monthly wage of public administration and defense employees

[58] Following the agreement between the Government of Romania and the Federation of Employers of Construction Companies on measures for a sustainable economic growth in Romania, based on investments in the next 10 years, concluded on November 29, 2018.

mounted to 8,229 lei in the last 3 months of 2019, higher by 13.1% compared to the same period of the previous year.

After an increase by 165,600 people registered during 2005-2008, the total number of employees in the governmental sector decreased by 156,133 people during December 2008 – December 2019, up to the level of 1.24 million (*Figure 18*). 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, mainly due 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 made in the period 2009-2019 mainly took place at the level of local executive authorities (-36,973 positions filled), Ministry of Internal Affairs (-14,322 positions filled), other institutions fully financed from own revenues (-11,499 positions filled), Ministry of Public Finance (-8,518 positions filled), Ministry of Public Defense (-6,962 positions filled), Ministry of Agriculture and Rural Development (-4,744 positions filled). On the other hand, in the same period were registered increases to the level of Ministry of Justice (+3,199 positions filled), Ministry of European Funds (+1,326 positions filled), Ministry of Labor and Social Justice (+1.149 positions filled) Public Ministry (+987 positions filled).

Figure 18: The evolution of the public sector employment in the period 2005-2019

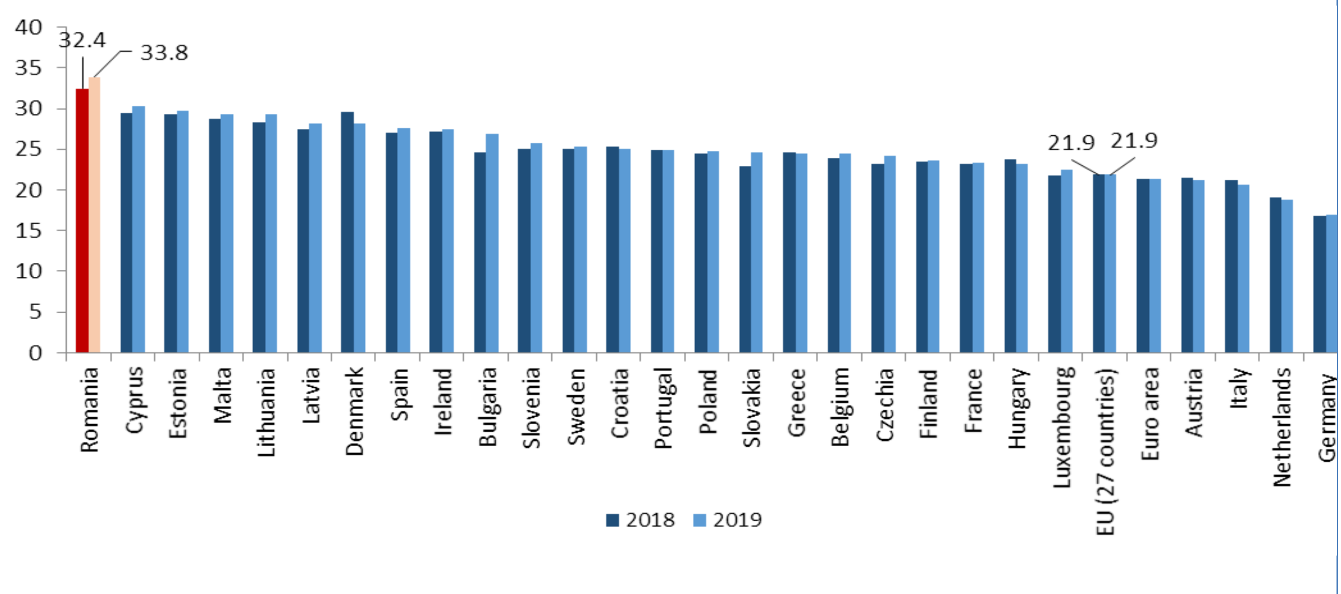


Source: MPF

It should be mentioned that in 2019, the growth rate of the number of employees was lower than in the previous year, respectively 0.9% (+11,095 people) compared to 1.71% (+20,706 people). Employment growth was recorded mainly for local executive authorities (+7,323 positions), health system, including the Ministry of Health (+6,409 positions) and for the Ministry of Internal Affairs (+3,284 positions). On the other hand, personnel reductions were registered at the Ministry of Education and Research (-6,821 positions occupied) and the Ministry of Public Finance (-699 positions occupied).

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.

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.

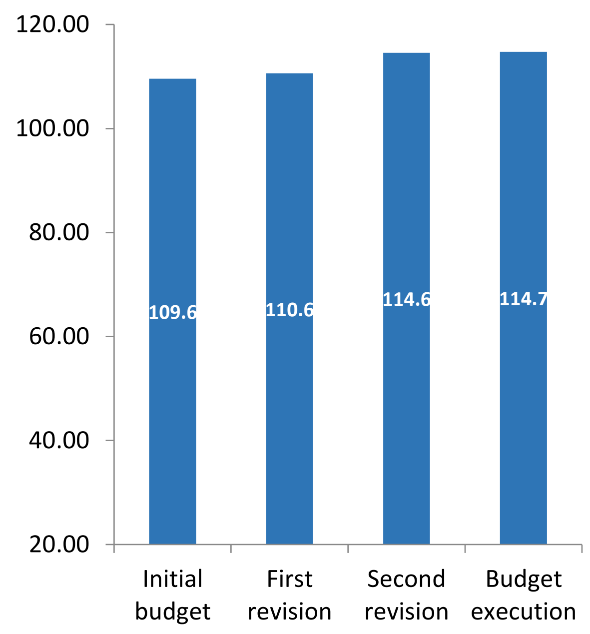
Regarding the share of personnel spending in the public sector in total revenues, in 2019 Romania was on the first position in the 27 EU countries, as in the previous year. If until 2009, the wage bill as a share of total budgetary revenues according to ESA 2010 data placed Romania in the first half of the ranking (on the 8th position in 2008 and on the 10th position in 2009), in 2011 was placed on 19th position out of 27 countries, on the background of the fiscal measures initiated in 2010. In 2013 Romania ranked on the 17th position due to wage increases for some categories of public employees, and in 2015, on the 20th position out of 27 countries, owing 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 ascents rapidly to 10th place, reaching second place in 2017 and first place in 2018. This evolution is the result of the dynamics of the personnel spending share in GDP which increased by 0.4 pp in 2019 compared to 2018, given that budget revenues relative to GDP decreased by 0.1 pp. When asserting the dynamics of wages in GDP in the public sector, it should be made in relation to the evolution of public finances, internal and external imbalances of the economy

The Fiscal Council notes the manifestation of an accelerated growth trend in personnel expenses over the past three years, that should be considered together with the evolution of public finances and internal and external imbalances in the national economy. The repeated wage increases in the public sector and the entry into force starting 1st of July 2017 of the Law no. 153/2017 regarding the wages for the personnel paid from public funds have consistently contributed to this situation.

Social assistance spending in 2019 was above the value projected in the draft budget, being revised upwards on the occasion of the two budget revisions. According to the draft budget released in January 2019 for public debate, the estimates for social assistance expenditures amounted to 109.8 billion lei, but in the version sent to Parliament for approval were reduced by 2.2 billion lei. Following the parliamentary debates, the consolidated budget for 2019 recorded an additional 2.03 billion lei generated by the adoption of the amendment on doubling the child allowance. Consequently, the initial budget for social assistance amounted to 109.6 billion lei. The final execution, net of compensation schemes, recorded 114.7 billion lei, by 4.7% (equivalent with 5.2 billion lei) more than in the initial program, validating the Fiscal Council's assessments regarding the underestimation of this budgetary aggregate in the initial budget.

Figure 20: Social assistance spending in 2019 (billion lei)



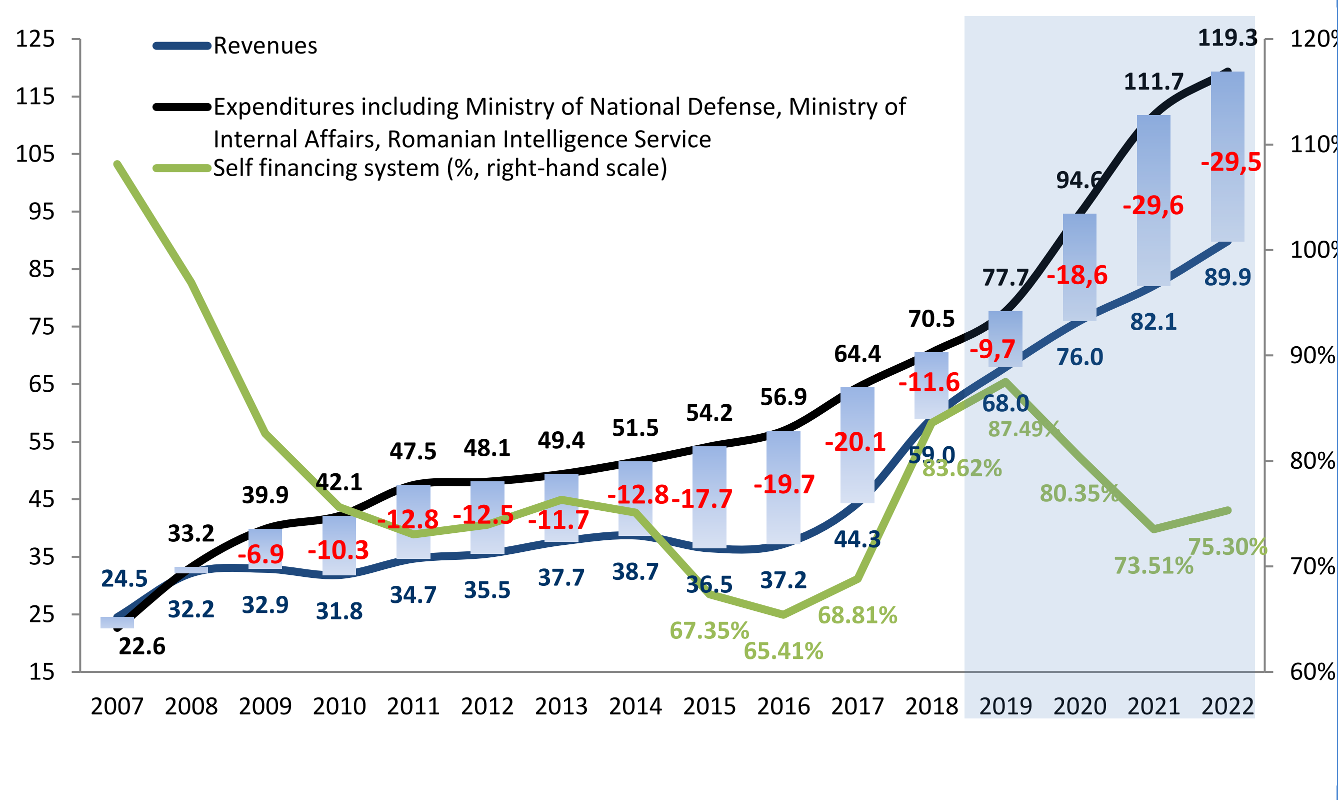
Source: MPF

Compared with 2018, the social assistance expenditures were higher by almost 13,4 billion lei, respectively, +13.2%. Fiscal policy measures with the highest impact on social assistance expenditures evolution were: the increase by 15% of the pension point from September 1, 2019, up to 1,265 lei, with a budgetary impact of about 3.2 billion. lei, raising the social allowance for pensioners from 640 to 704 lei starting with September 1, 2019 with an estimated impact of 1.5 billion lei, increasing the allowance for the companion of disability persons classified in the first degree of disability from 880 lei to 1,012 lei, as well as doubling child allowances starting with March 1, 2019, the budgetary impact of this measure being assessed at 2.9 billion lei.

On the occasion of the first budget revision, social assistance expenditures were revised upwards by about 1 billion lei, and at the second revision additional increased by about 4 billion lei. These decisions validated the Fiscal Council warning in its opinion on the draft budget regarding the under-estimation of this aggregate, given the execution for January, as well as the pension point increase from September, 1, 2019.

Starting with 2009 the deficit of the social security budget, considering also the special pensions has widened significantly up to a value of 20.1 billion lei in 2017. In 2018, the deficit was significantly reduced to 11.6 billion lei, mainly as a result of the fiscal measures regarding the reinstatement of the tax structure of income from salaries, pensions self-employment and copyright by transferring contributions from employer to employee Thus, although the total contribution rates decreased from 39.25% to 37.25%, the transfer of contributions from employer to employee determined a significantly increase of gross wage, leading practically to an increase in the level of taxation through social security contributions with almost 13.9%. In addition to raising labor taxation through social contribution taxes, the reduction in the deficit is also explained by the reduction in the contribution to Pension Pillar II (from 5.1% in 2017 to 3.75% in 2018. In 2019, the deficit of the social insurance budget continued to decrease, reaching 9.7 billion lei, as a result of the increase in the number of employees in the economy.

Figure 21: The development 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 estimates for the following years, according to data presented in the 2020-2022 Fiscal Strategy show that the social insurance budget deficit will re-enter in an upward trend, registering a significant increase up to 18.6 billion lei in 2020, 29.6 billion lei in 2021, reaching 29.5 billion lei in 2022. In its Opinion on the draft budget for 2020, the Fiscal Council drew attention to the fact that the impact of the new pension law is only partially taken into account in the medium-term budget projection, as social assistance expenditure appearing to be underestimated by around 1.3 pp of GDP (approximately 15.6 billion lei) in 2021, respectively by 2.4 pp of GDP (approximately 30.8 billion lei) in 2022[59]. Assuming that the expenditure would fully reflect the schedule of the announced pension point increase, the social security budget (SSB) deficit would be much higher than estimated in the current situation.

When expressing the deficit as a percentage of GDP, the results indicate a decrease from 2.29% in 2011 to 1.92% in 2014, followed by a further increase in 2015 to 2.48%, and a significant decrease in 2018, when it reached 1.21% of GDP. The downward trend of the deficit as a share in GDP continued in 2019, its level reaching 0.92% of GDP. Projections for the following years indicate an increase in the period 2020-2022[60] (1.65%, 2.43% and 2.26%). As previously stated, the share of the SSB deficit in GDP would be at a higher level if the aggregate expenditure on social assistance fully covers the future increases in the pension point. It is worth judging the evolution of the SSB deficit with emphasis on the twin deficits in the last years, and a more fragile state of the public budget.

The deficit of the state social insurance budget has occurred on the account of excessive social security budget expenditure in the period 2007-2009 (+75.8%) and in the context of a favorable dynamics of the social contribution revenue during the period preceding the financial crisis, as a result of the economic boom and also anticipating to maintain this trend in the future. Unfortunately, a significant share of the social contribution revenues augmentation has proven to be of cyclical nature, the further developments invalidating the optimistic forecasts that led to the significant increase of the pension point. The system's self-financing has fallen sharply from 2006 (from 118.81%) to 2011 (73.02%), reaching the historical minimum in 2016 (65.41%) and stood at a close value in 2017 (68.84%). In 2018, the self-financing capacity registered an increase up to 83.6%, and continued in 2019 when reached 87.5%. Estimates show the entry on a downward trend starting with 2020, at a level of 80.4%, having in view the action of the correlation aforementioned in the end of the previous paragraph.

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

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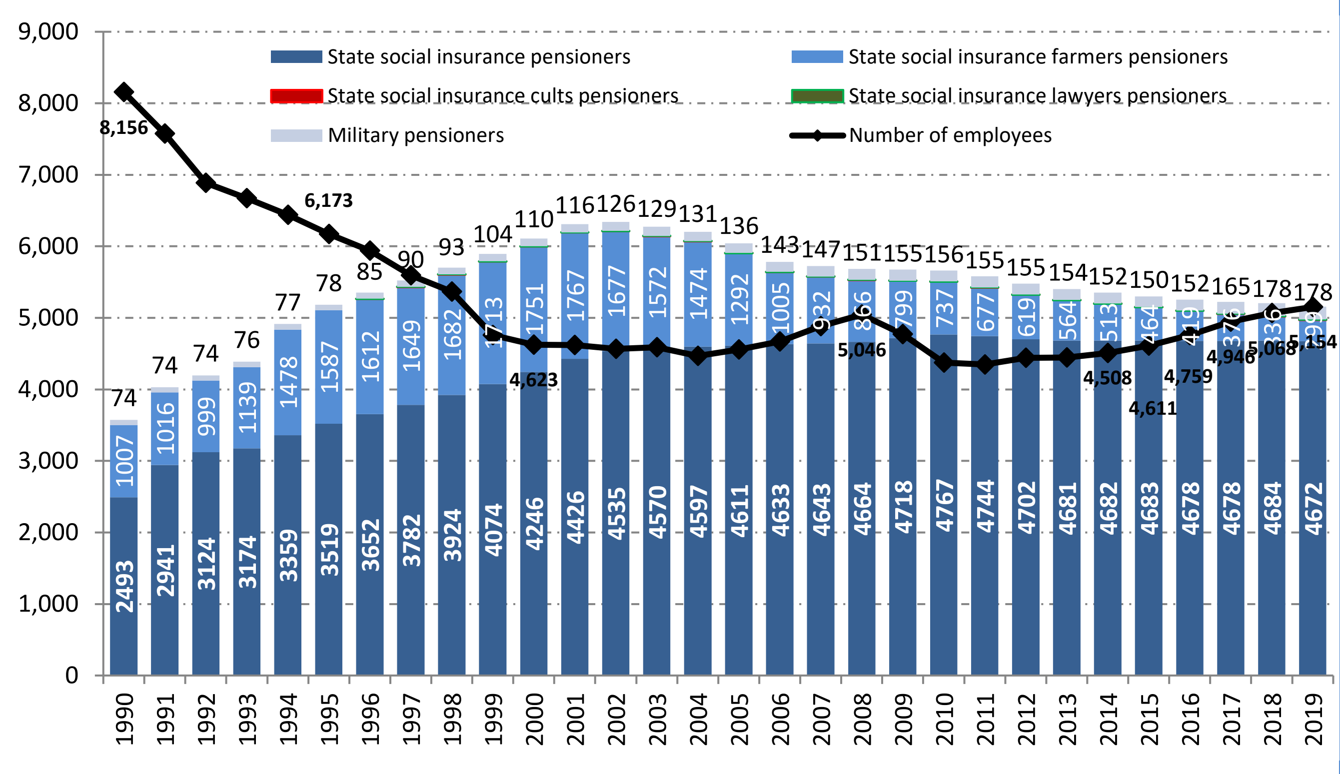
[59] These figures refer to the situation before the outbreak of the Covid-19 pandemic.

[60] According to the assumptions presented by the MPF in the Fiscal Strategy for the period 2020-2022.

The ratio between the number of contributors and the number of beneficiaries fell sharply in the last 28 years, from 2.28 employees per pensioner in 1990 to only 0.94 employees per pensioner in 2017, the number of the state social security pensioners being on an increasing trend, while the number of employees showed 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, in 2016 reaching 0.91, slightly above the 2008 level (0.89). The projections of European Commission[61] show that the ratio between population aged over 65 years old and population between 15-64 years old will increase from 28.1% in 2019 to about 53% in 2050.

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



Source: NIS

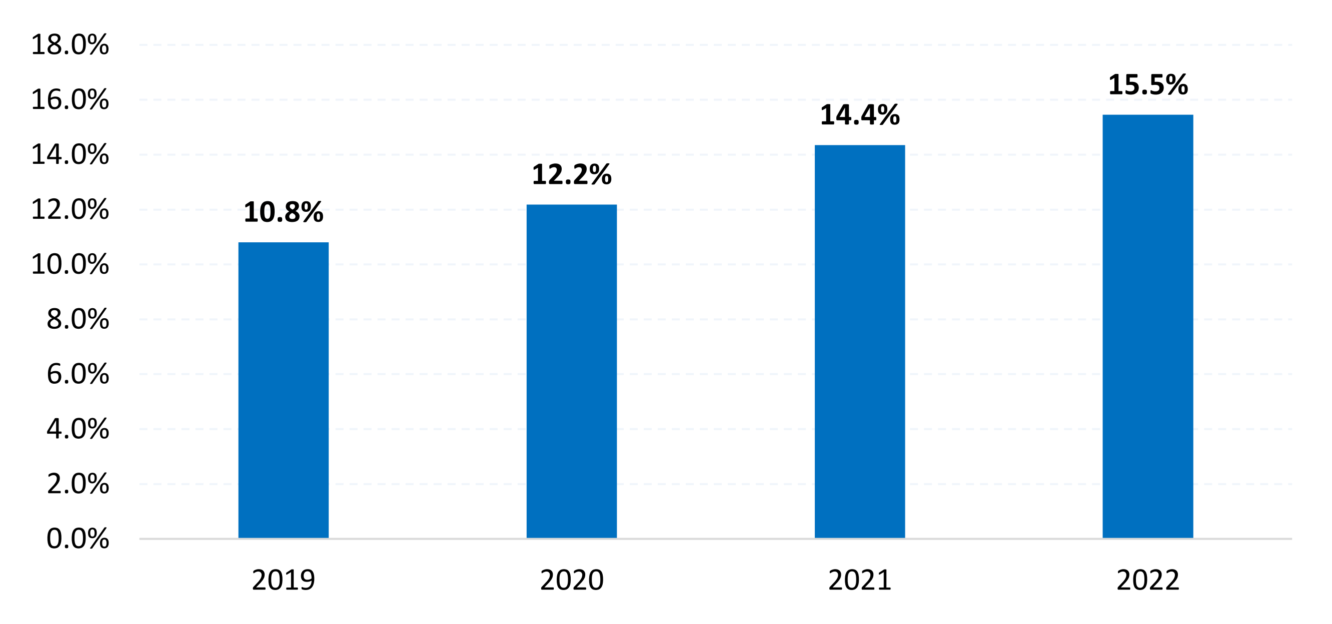
Note: The source for the number of employees for 2019 is NCSP, April 2020 Forecast

The Government's intention to adopt a new policy for the public pensions system emerged in adopting the new pension law (Law no. 127/2019, published in Romania's Official Journal on July 9, 2019). This normative act aims at solving a series of inequities of the existing system. This law introduces a new formula for calculating the pension that is much more equitable than the one currently used because it generates equal pensions at equal contributions, solves the difficulty of proving by insured persons of earnings for which contributions have been paid and encourages further education. On the other hand, the new pension law is not financially sustainable since it provides for the doubling pension benefits in

[61] According to Ageing Europe Report-looking at the lives of older people in the EU (https://ec.europa.eu/eurostat/web/products-statistical-books/-/KS-02-19-681).

only three years, establishes new pension rights, facilitates the early retirement process, causing an increase in the number of beneficiaries in the system, and the minimum pension will reach levels close to average pension in time. In addition, the application of the new formula involves a recalculation of all pensions and will generate significant costs for the budget. Thus, social assistance expenditures reached in 2019 about 10.8% of GDP and according to the calculations of the Fiscal Council are expected to increase to 12.2% of GDP, 14.4% of GDP in 2021 and up to 15.5% of GDP in 2022 (see Figure 23).

Figure 23: Social assistance spending (% of GDP, in cash standards)



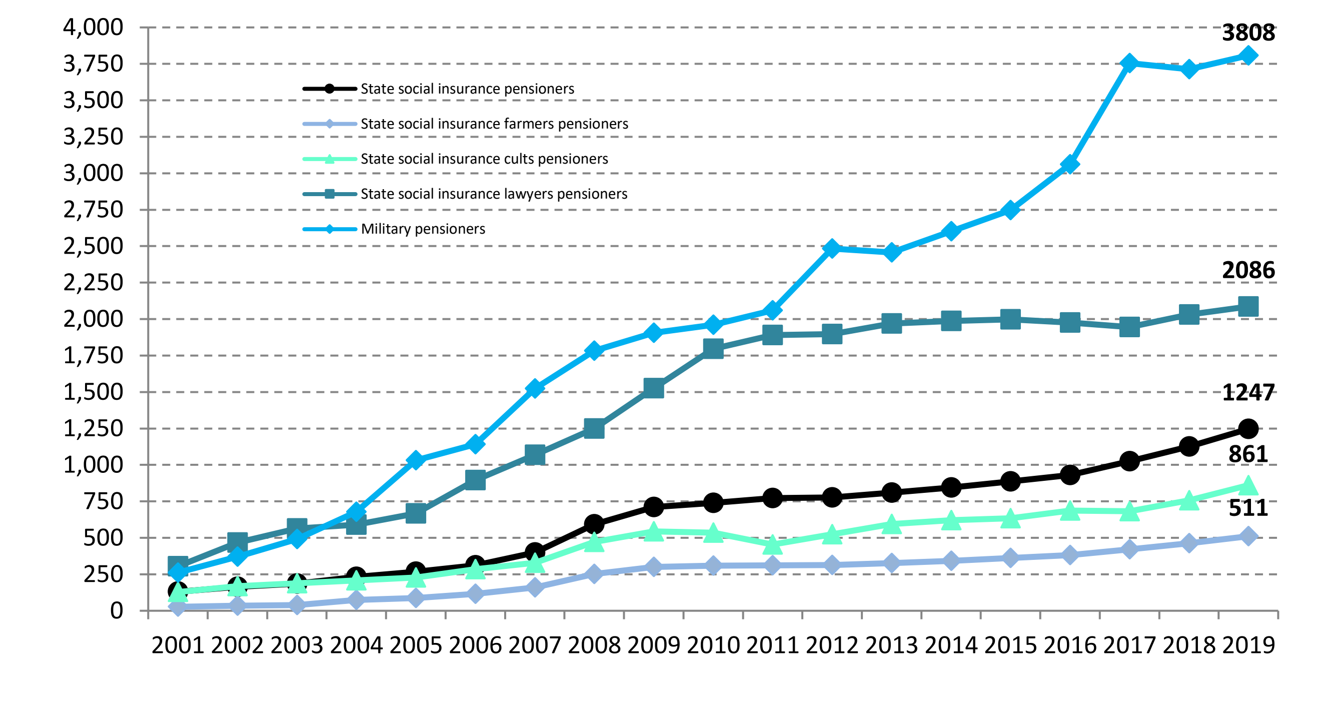
Source: MPF, NCSP

Therefore, the impact of the Law no. 127/2019 on the public pension system, is likely to further complicate the medium-term budget construction, with recurring implications on long-term and very long-term. Even if most of its provisions enter into force on September 1, 2021, until that moment, significant phased increases of the pension point are set, from 1,265 lei at present to 1,875 lei starting with September 1, 2021. However, maintaining the special pensions contribute to generate a negative impact on long-term sustainability of the pension system, particularly since other professional groups will be also encouraged to push for the restoration/establishment of pension rights that largely are not corelated with the contributory stages to the public pension system, but significantly higher compared to the large mass of the contributors. Moreover, the renunciation of the pension indexation formula since 2017 noticeably affects the sustainability of the pension system, the discretionary approach having the potential to contribute to the widening of the state social insurance budget deficit (this rule will entry again into force starting with 2022).

According to NIS data, in 2019, the average monthly pension was 1,293 lei, higher by 10.3% compared to the previous year, as a result of the pension point indexation by 15%, respectively by 165 lei starting with September, 1. The pensions paid from the social security budget were at an average level of 1,247 lei, and those corresponding to retired farmers were on average 511 lei. At the same time, the pensions granted to the military reached an average monthly level of 3,807.9 lei, increasing by 94.5 lei (2.5%)

compared to the 2018 level. It is worth noting that the average monthly pension for beneficiaries from defense system, public order and national security increased by approximately 94.2% during 2010-2019, as a result of the recalculation according to Law no. 119/2010 and GEO no. 1/2011 and to the subsequent increases, even if the initial forecasts indicated a decline in the value of these pensions after applying the contribution principle.

Figure 24: The evolution of the average pension (lei) in the period 2001-2019

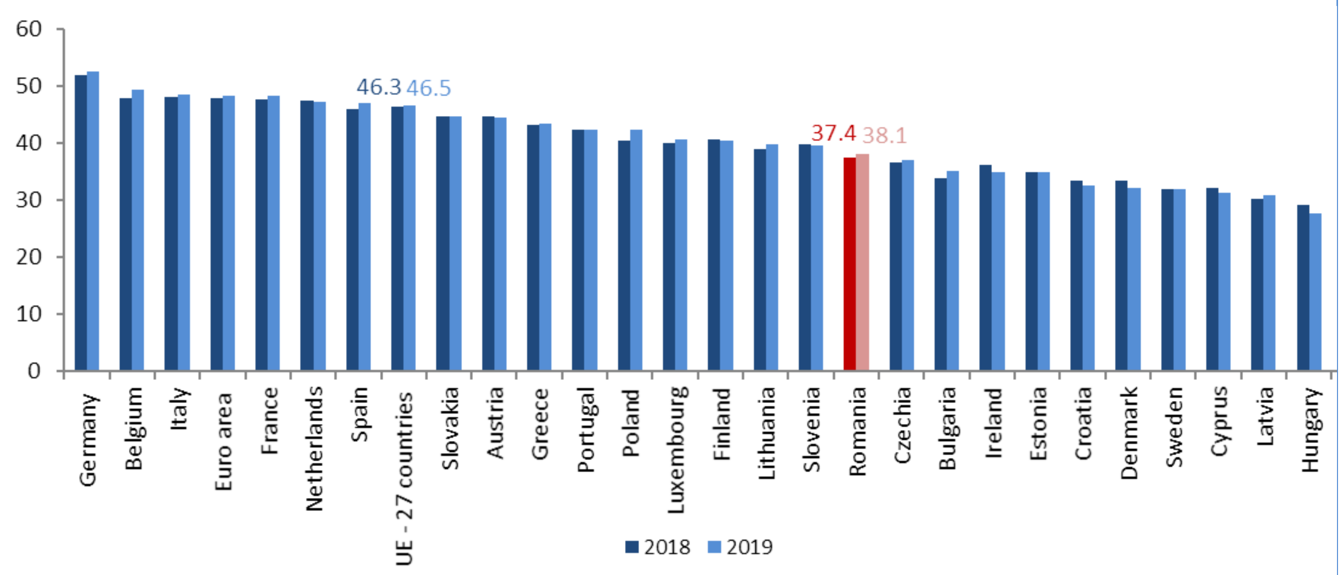


Source: NIS

In 2019, considering the share of social assistance expenditures in total revenues, Romania remained on the same position[62] as in 2018, being placed in the second half of the EU27 ranking. The share of social assistance expenditures in total budget revenues increased by 0.8 pp in 2019 compared to the previous year. This evolution was due to the faster growth rate of this category of expenditure (+0.2 pp of GDP) compared to the growth rate of budget revenues which decreased by 0.1 pp of GDP. Even if this expenditure aggregate has a lower share in total budget revenues compared to the EU average, increasing the share of budget revenues in GDP to 31.2% in 2018 has contributed to improving Romania's position in the ranking compared to previous years.

[62] Placed on 18/27, following 26th position in 2014.

Figure 25: Social security expenditure as share of total revenues in EU27



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).

The Fiscal Council notes major risks to the financial sustainability of the pension system 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 pension law. The Fiscal Council also highlights that maintaining the current timetable and framework for the application of the pension law makes it almost impossible to reduce the budget deficit in 2021 compared to this year's level, that is already worryingly high. Returning to a sustainable trajectory of the public finance position, especially having in view the economic consequences of the COVID-19 pandemic, calls for a reconsideration of the timetable for the application of the new pension law.

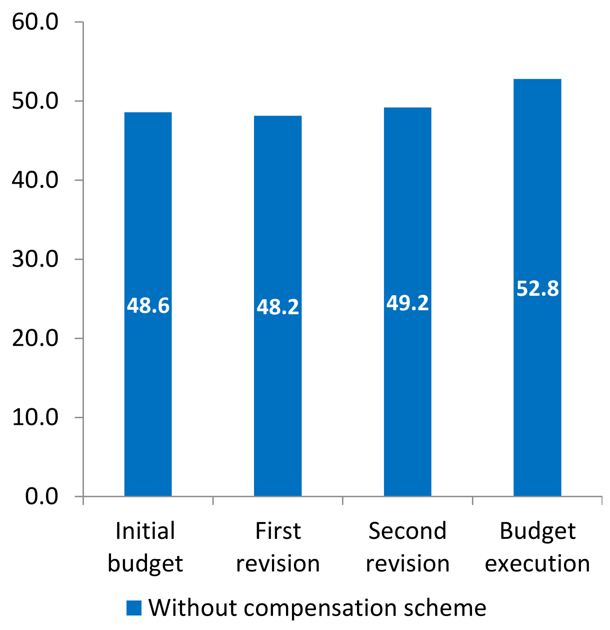
III.5.2. Goods and services expenditures

The execution of **goods and services** expenditures was considerably higher than the forecast in the draft budget (+4.2 billion lei), as well as compared to the two budget revisions' estimates for 2019. Initially estimated at 48.6 billion lei, the final execution of this aggregate reached 52.8 billion lei, by 4.6 billion lei above the amount projected in the first budget revision and by 3.6 billion lei above the amount proposed in the second budget revision.

Expressed as share of GDP, goods and services expenditures increased by 0.3 pp compared to 2018, reaching 5% of GDP, while compared to the 2009-2018 average was below by 0.5 pp.

Compared to 2018 execution (44.6 billion lei), this expenditures' category (net of the swap compensation scheme) was projected in the initial budget version of February 2019 by 1.9 billion lei higher.

Figure 26: Goods and services expenditures in 2019 (billion lei)



Source: MPF

Following the parameters of the 2019 budget law approved in Parliament in March, the expenditures on goods and services were increased by about 2 billion lei (and by 4 billion lei higher than the previous year's execution). The aggregate of goods and services expenses increased by 18.31%, respectively by 8.2 billion lei, compared to 2018. The exceeding of these expenditures compared to the initial budget estimate was determined, in particular, by the need to ensure the payment of medicines, as well as the outstanding invoices from the local public administration[63].

During 2019, the budgetary allocation was reduced on the occasion of the first budget revision and increased through the second budget revision. At the first budget revision, operated in August 2019, goods and services expenditures were revised downward by 0.4 billion lei, respectively 0.9% compared to the budget proposal. This decrease appeared to be surprising, given that, over the year, the execution of the goods and services expenditures during the first 6 months indicates an increase of 13.4% compared to the same period of the previous year, and significantly higher than that of growth rate (8.8%) initially projected for the whole year. Thus, decreases were registered in the budget of institutions financed wholly or partly from own funds (-314.5 million lei), the budget of Unique National Health Fund – UNHF (-66.7 million lei) and the budget of the National Company for Roads Infrastructure Administration (-48.2 million lei), given that the evolution of the goods and services expenses at the level

[63] According to the Report on general government budget for December 2019.

of this company indicates for 6 months an increase of 53% over the same period of 2018, by 22 pp higher than estimated growth rate for the whole year.

On the occasion of the second budget revision, expenditures on goods and services were revised upwards. Even in these conditions, the Fiscal Council considered as high the risks of exceeding the updated coordinates of this category of expenses. Thus, although increasing by about 1 billion lei compared to the level of the first revision (by 0.6 billion lei above the level in the initial budget), the new level was only by 10.3% higher than the 2018 budget execution, in the context of higher expenses for the end of October' execution by 16.6% compared to the same period of the previous year.

As in the previous years, the motivation for the modifications made on the occasion of the budgetary revision drafts was not clearly explained in the substantiation notes accompanying the budget revision proposals in order to ensure the transparency of the decisions taken by the Government. The explanatory note attached to GEO for the second state budget revision for 2019 indicated as argument for the need to allocate additional amounts, only the achievement degree of this budgetary aggregate of 102.9%, the exceed being determined by the high level registered by the territorial administrative units, respectively, 111.1%. The same document specifies the increase of the expenditures with goods and services at the level of the Unique National Health Fund by 400 million lei for medicines, with and without personal contribution.

The cumulative increases in the allocations for this expenditure aggregate, in the context of budget revisions, as well as the final execution confirmed the Fiscal Council warnings regarding the necessity of some additional allocations for this budgetary aggregate compared to the amounts set at that time.

In the previous years, the aggregate of goods and services expenditures proved to be difficult to control. Thus, during 2011-2013 and 2017-2019, the level of expenditure on goods and services (without the impact of compensation schemes) registered in budget executions was higher than the one initially budgeted, or even the upward revisions operated in the budget amendments, while the period 2014-2016 was characterized by a different situation, with a final execution lower compared to the last budget iteration.

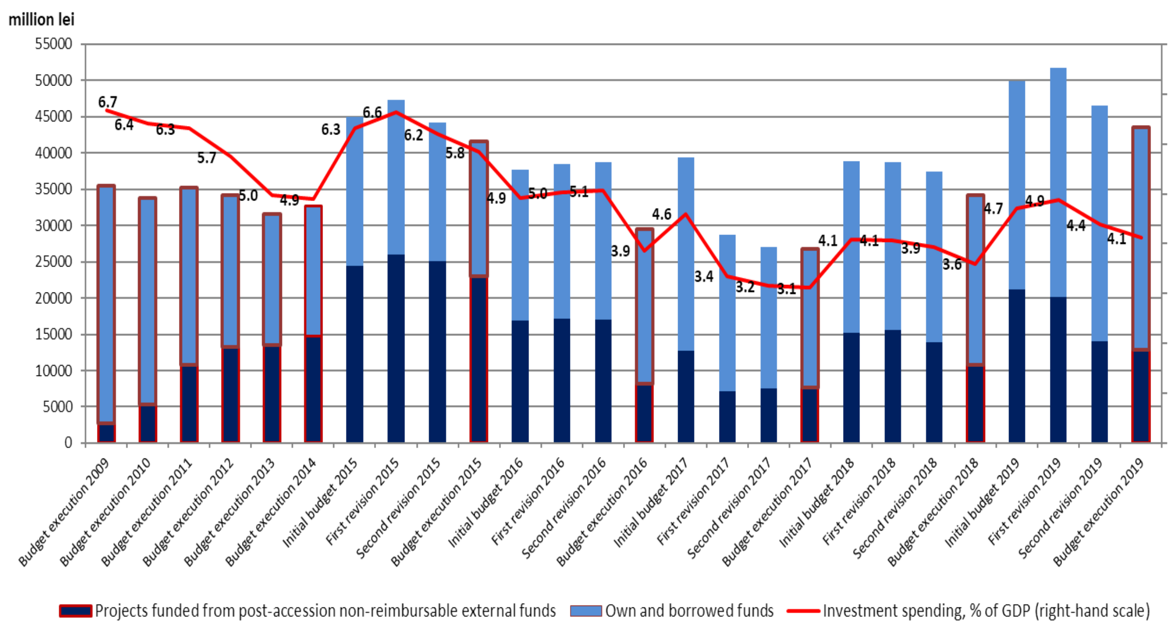
The Fiscal Council notes a chronic lack of transparency regarding the projection of this expenditure aggregate, the assumptions underlying this category of expenditure or the motivation for the major revisions made during the year not being explained in the documents accompanying the successive iterations 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 clarification 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 essential to go together with a comprehensive reform of the overall public procurement system.

III.5.3. 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 2019, the state investment spending, considering all budget items of this category, including swap compensation schemes, increased by 9.4 billion lei from 34.2 billion lei to 43.6 billion lei (in cash standards), respectively by 27.4% in nominal terms, and by 19.2% in real terms[64], the share of public investment spending in GDP increasing by 0.52 pp (from 3.59% of GDP in 2017 to 4.11% of GDP). Compared to the previous 3 years' development, in 2019 the execution of investment spending as percentage of GDP significantly improved, by over 0.6 pp compared with the 2016-2018 average, being close to the last 5 year's average (4.24% of GDP in 2014-2018 period of time), but by 1 pp below the 2009-2018 average (5.17% of GDP).

Figure 27: The evolution of public investment expenditure in the period 2009-2019 (million lei, % of GDP)



Source: MPF

The analysis of this budgetary aggregate from the perspective of the comparison between the actual execution and planned investment expenditures from the initial budget or established through revised budgets during 2015-2019 persistently reveals significant deviations in the sense that the executions are invariably below the estimates of the initial and the revised budgets (*Figure 27*). Thus the negative gap expressed as percentage of GDP relative to the initial budget of the amounts actually spent for investment reached in 2019 a level of 0.34%, below the previous year's gap (0.55% of GDP), this result

[64] Using the GDP deflator as price index.

being based mainly on the increase of internal funding resources to compensate for the massive non-realization in attracting European funds as estimated in the initial budget. Thus, the execution related to the initial program for internal financing funds represented 96.8% in 2018, while in 2019 the achievement degree of the program advanced to over 134%, offsetting the significant reduction in the achievement degree of the initial program for European funds to finance investment expenditure to 60.3% (from 71.2% in 2018).

The 2019 budget was elaborated by returning the aggregate investment expenditures to an upward path after the modest result from 2018 (3.6% of GDP), on the basis of a possible revival of the absorption of European funds and respecting Romania's commitment to NATO[65]. In the initial budget construction, the investment expenditures were planned to increase by more than 11 billion lei compared to the 2018 program[66]. The increases were located mainly at the level of the *expenditures related to the projects financed by external EU funds* (+6 billion lei), and *capital expenditures* (+4.1 billion lei, out of which 1.9 billion lei were additionally allocated to the Ministry of National Defense). Thus, excepting the increase in the in the allocation for the army (based on the Romania's commitment to NATO to allocate a budget for defense representing 2% of GDP), by the budget construction for 2019, similar to the years 2013-2018, it was foreseen a larger weight of the external source financing (an increase in the EU funds absorption coming from the new financial year 2014-2020) in total investment expenditures, respectively, reducing the share of internal sources (capital expenditure), a correct and welcomed approach in the opinion of Fiscal Council, thus freeing 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 2019, revealing a major deviation from the estimation from the initial budget of the investment expenses (-6.3 billion lei, -0.6% of GDP respectively), a level superior compared to the difference between the execution and the initial budget for 2018 (of -4.6 billion lei, -0.5% of GDP respectively). This deviation from the initial plan was due to the non-materialization of the expenditure forecast both for *projects financed by external non-reimbursable funds related to the new financial year 2014-2020,* where the difference between the execution value and the initial budgetary plan was -8.4 billion lei, respectively -0.8% of GDP, and *other transfers related to investments* (-2.5 billion lei, respectively -0.25% of GDP). These failures were partial offset by the *capital expenditures* increase (+5 billion lei, respectively +0.5% of GDP compared with the initial budget). If we analyze the evolution of the ratio *capital expenditure/projects funded by external non-reimbursable funds* for the financing of investment expenditure, in 2019 the ratio maintained its increasing trend over the last 4 years, with a level twice higher than the 2012-2015 average[67], and superior to the previous

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

[66] Respectively, significantly above the 2018 execution (+15,7 billion lei).

[67] 115% on average with a minimum of 74% in 2015, given that this year was a maximum for EU funds absorption, being the deadline for attracting European funds for the 2007-2013 financial period.

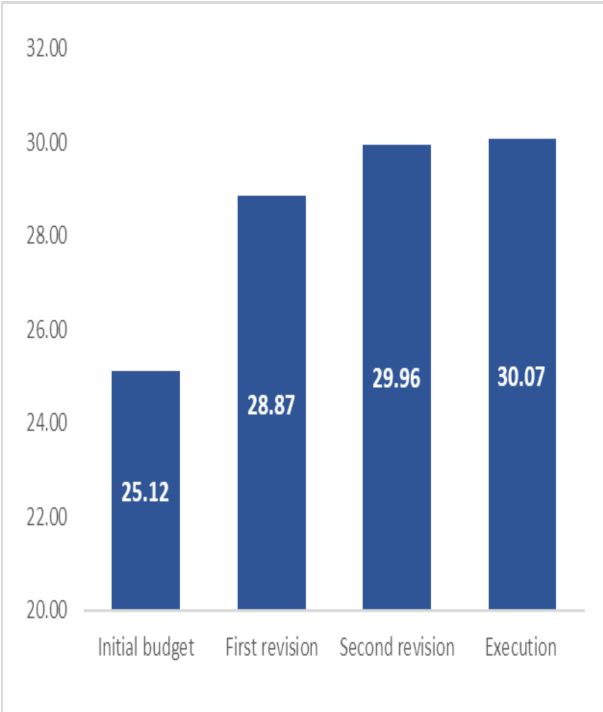
year (235% compared to 209%), proving the inability of the Romanian authorities to attract the amounts allocated by the EU for financing public investment programs.

Also, in 2019, the quarterly evolution of the investment spending shows a concentration in the last quarter (almost half of the total for the year), which puts into question the effectiveness of the budgetary programming both in terms of the management of investment projects and of establishing the criteria for financing investments according to their importance and usefulness. Practically, in the last quarter investment spending was 2.7 times more than the average of the three previous quarters, which highlights serious deficiencies in budgetary programming for this aggregate that systematically presents an extremely high volatility of the quarterly distribution of the programmed spending compared to the actual ones. From the perspective of the evolution of the share of the quarter in total yearly execution, this fluctuated between 11.1% in the first quarter, 17.1% in the second quarter and 24.3% in the third quarter, reaching 47.3% in the last quarter of 2019, being roughly in line with the quarterly evolution of flows related to projects funded by non-reimbursable external funds.

In 2019, the *capital expenditures* for investment[68], were projected in the initial budget by 4.1 billion lei higher compared with the initial program from the previous year, respectively by 2.5 billion lei over the 2018 actual spending.

The final execution registered a level by about 5 billion lei higher than the programmed level in the 2019 initial budget (+19.7%), respectively by 7.4 billion lei over the 2018 execution (+32.6%). The supplementation of the investment expenses from domestic funds was necessary to counterbalance the major failure in achieving the planned amounts attracted from the European Union funds.

Figure 28: Capital expenditures in 2019 (billion lei)



Source: MPF

The *projects financed by post-accession external funds* for public investment spending, were projected by the 2019 initial budget in a large expansion compared to the previous year's initial budget (by 6 billion lei), and by +10.4 billion lei more than 2018 execution (basically, doubling them), given the hypothesis of a possible revival of the European non-reimbursable funds from the new financial year 2014-2020.

[68] The main component of GCB capital expenditures (which also include capital transfers and stocks).

The 2019 execution was, again, much below the initial expectations (-8.4 billion lei, and -0.8% of GDP), respectively by 40% lower than the initial estimates.

This underachievement did not lead to an increase in the deficit, the failure to implement investment projects involving savings regarding the co-financing and non-eligible expenditures, but the failure in absorbing European funds at the level planned for this year would induce negative effects on the economic growth both from the perspective of the direct effects and those propagated[69], as well as from the perspective of lack of ability to absorb European funds allocated to our country, by preserving a lower degree of absorption.

Box 1: Changing the scope of budget revenues and expenditures for projects funded by non-reimbursable funds during 2016-2019

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 (TUEF). Thus, in 2019 out of total of 34.3 billion lei for the payments related to the projects financed by NREF 2014-2020, 13.4 billion lei were allocated to agriculture (respectively EAGF and EMFF related to the financial year 2014-2020), and 3.1 billion lei for TUEF. Out of the rest of 17.8 billion lei representing structural and cohesion funds of which final beneficiary is the state, 12.8 billion lei (72% of the latter) was allocated for investment expenditure. It is noteworthy that, in 2015, a year of maximum absorption of NREF 2007-2013, the projects financed by post accession NREF amounted to 24.6 billion lei (out 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). 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 2018 to the European funds flows from the 2007-2013 financial framework.

Missing the target for the projects funded through external post accession grants is correlated with the EU funds absorption rate from the financial year 2014-2020 for which the underachievement of the revenues in 2019 compared to the initial budget was at aggregate level (including amounts for

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

agriculture and TUEF) of 8.7 billion lei, -0.83% of GDP respectively, due to the evolution under expectations of the structural funds and funds for agriculture.

The expenditures regarding the projects funded by reimbursable programs, that have a very small share in total investment spending were over the previous year level (by 44 million lei, respectively, +11%), and far below the initial budget projection (by 275 million lei, -39% respectively).

Figure 29: Projects funded by external post-accession grants in 2019 (billion lei)

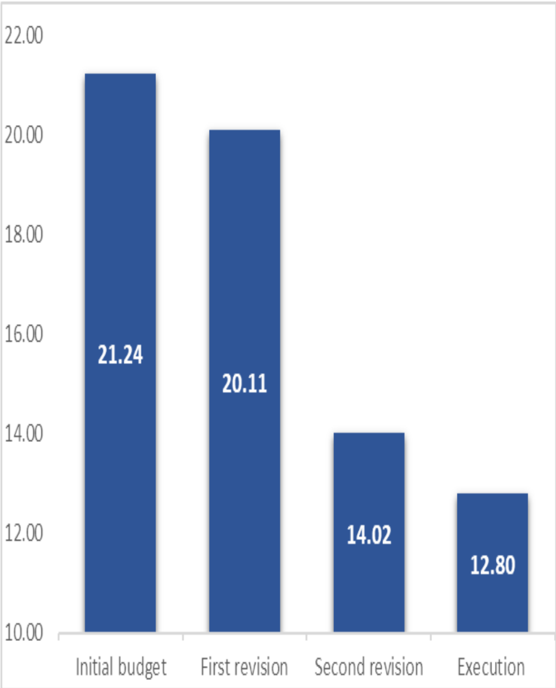
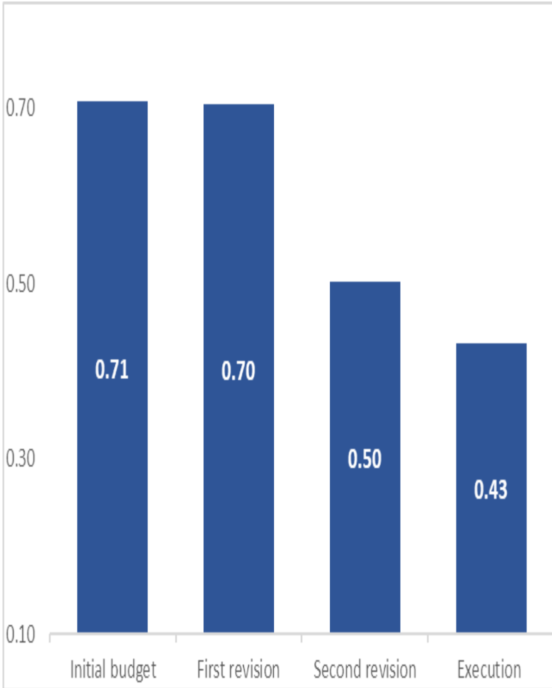


Figure 30: Expenditures funded from reimbursable funds in 2019 (billion lei)



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 2019 elaborated by the EC[70] it is reiterated that the high level of the public investment expenditures is accompanied by an insufficient infrastructure, with negative impact on the connection to the main transport corridors[71], on labor mobility, but also on private external investors decisions to invest, thus accentuating regional disparities. Given that, Romania has had, over the last decade, one of the highest rates of public investment from the EU, the infrastructure is insufficient both in terms of quality and quantity, which suggest a poor efficiency of the public capital expenditures. Moreover, the EC notes that insufficient investments in transport, energy and environmental infrastructure are affecting the potential of the economy to approach the EU levels. Thus, the Report lists as the main factors that contributed to this state: the low degree of absorption of European funds;

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

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

reduced administrative capacity and persistence of inefficiency in preparing, prioritizing and implementing investment projects.

The quality of infrastructure is one of the lowest, especially in the critical sectors, such as road, rail and energy infrastructure due to the very modest performances registered by the majority of state-owned enterprises and the lack of progress in the sense of restructuring those who record losses. It should be noted, that in 2018 the rate of new investments for the state-owned companies[72] significantly reduced compared with 2017 (to 1.3% from 3%), a level considerably lower than the average recorded during the pre-crisis period (about 12%). Moreover, the empirical evidence in the literature suggests a correlation between the inefficiency of public expenditure and the overestimation of the effective social capital, and the poor results of the state-owned enterprises, which are the main infrastructure providers in these fields, are considered to be particularly worrying[73]. Further, the poor condition of infrastructure is directly responsible for the low efficiency[74] with which Romania can deliver its good and connect the producers with consumers, compared to its main trading partners.

This is supported by the statistical data published by Eurostat, if we consider the Romania's ranking in terms of the share of public investment in GDP (the average over the last 10 years) on the sixth place among the EU member states (after Estonia, Latvia, Hungary, Poland and Swedish), respectively on the second place (after Estonia) 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 31 shows for all EU Member States the correlation between the average of the last 10 years of the share of investment in GDP and the index of the road infrastructure efficiency[75]. Countries are grouped according to the median of the share of investment expenditure in GDP over the period 2010-2019 and the road infrastructure efficiency index in 2019, 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 road infrastructure quality (represented in red). It is worth mentioning Romania's placement in this latter group of countries on the last position suggests that, from this perspective, the investment expenditures related to the quality of the road infrastructure have the lowest efficiency in the EU.

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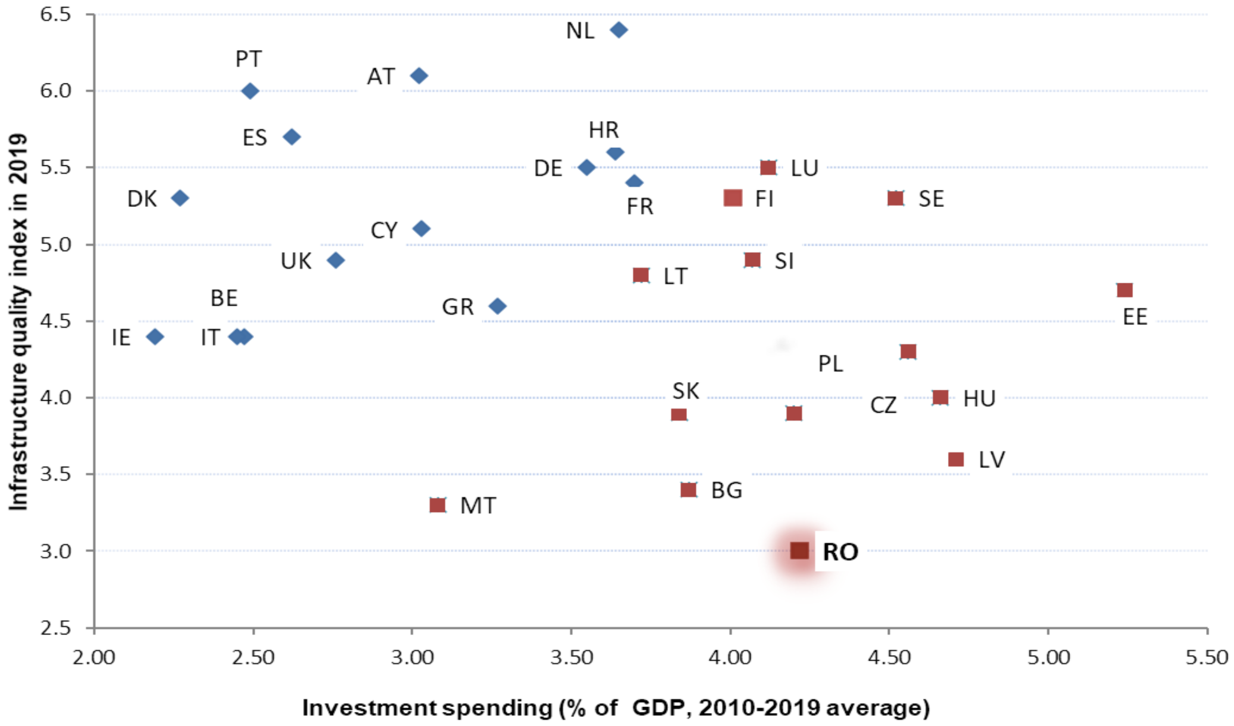
[72] http://consiliulfiscal.ro/SOE%202018_final.pdf.

[73] https://ec.europa.eu/economy_finance/publications/country_focus/2015/pdf/cf_vol12_issue1_en.pdf.

[74] Measured by Logistic Performance Index (LPI), which, according to 2018 LPI Report developed by WB is well below that of Germany, Italy and France. Thus, compared with the previous report (from 2016), since 2018 Romania has raised 7 positions in LPI ranking for infrastructure, placing on 51st position, but at a great distance from Germany occupying the 1st place, France-13th place and Italy -at position 19 in the ranking.

[75] This sub-indicator is composed of the infrastructure scores for: 1. roads (connectivity and quality); 2. the railway; 3. the airway and 4. the seaways. According to the 2019 edition of the Global Competitiveness Report, https://www.weforum.org/reports/global-competitiveness-report-2019.

Figure 31: Public investment expenditures and infrastructure quality index



Source: EUROSTAT, World Competitiveness Report 2019

According to the 2019 *Global Competitiveness Report*, Romania is ranked on 55th position (out of 141 countries) in terms of transport infrastructure quality, respectively on 119th position[76] regarding the quality of roads. Compared with the assessment in the previous year, Romania has gained one position for the global competitiveness indicator, respectively, the 51st place, (being also positioned after Bulgaria). Compared with EU member states we maintain on the last position in terms of overall quality infrastructure (especially that of road transport, highlighting chronic problems on the failure to spend in an adequate manner the funds for public investments. Moreover, over the last two years, the share of public investments in GDP and in budgetary revenues significantly decreased compared with the average over the last 10 years: thus, compared to an average in the last 10 years of 4.22% of GDP, in 2018 and 2019 were allocated only 2.7% of GDP, respectively 3.4% of GDP (versus 5.2% of GDP in 2015) and relative to the share of public investments in the total revenues, as 10 years average, of 12.8% , in 2018 this represented only 8.5%, and 10.7% in 2019 (versus 14.6% in 2015), which is likely to further contribute to deepening the gap between the quality of infrastructure in Romania and in most EU countries in the coming years.

For comparability with the situation of other new member states, Estonia is placed in the Global Competitiveness Report for 2019 on 38th position in terms of roads quality, respectively on 58th position in terms of transport infrastructure quality, Poland is placed on 57th position, 25h respectively, Hungary is placed on 71st position, 30th respectively, Czech Republic is placed on the 68th position, 22nd

[76] A regress compared to the assessment in the 2018 Global Competitiveness Report (113th place/140).

respectively, Slovakia is placed on the 72^{nd} position, 42^{nd} respectively and Slovenia is placed on the 33^{rd} position for roads quality, 47^{th} respectively for transport infrastructure quality. Bulgaria is placed on the 102^{nd} position for roads quality (11 places far from Romania), respectively 68^{th} position for quality of transport infrastructure, although the investments allocation as share of GDP as average of the last 10 years are well below Romania (3.9% of GDP, respectively 10.7% of budget revenues).

In the case of Romania, there are high efficiency reserves regarding the use of public funds allocated to investments and the Government had initiated during 2013-March 2014 a reform of the public investment management[77]. In this respect, it was signed a technical assistance contract with the World Bank for the project "Improvement of Public Investment Management", aiming at improving the process of preparation, selection and strategic prioritization of the public investments projects, that ended in December 2015, and in 2016 the recommendations for improving the selection process of the investment projects and strengthening the role of the Public Investment Unit were implemented (GEO no. 88/2013[78] and GD no. 225/2014). Starting with 2017 are in force the provisions of the *Decision no. 907/2016 regarding the elaboration phases and the framework content of the technical and economic documentation related to the objectives/projects financed by public funds* in order to eliminate the deficiencies noted in the investment process, to optimize the financing and achievement of the investment objectives and to increase the efficiency of the use of public funds. The *Decision no. 363/2018 for modification and completion of the methodological Norms regarding the prioritization o*f *public investment projects*, approved by Government Decision no. 225/2014, new clarifications have been added to the procedure for prioritizing new investments.

Concerning transparency, we mention that only in 2016 and 2018, on the website of MPF is recorded a list of large infrastructure projects of over 100 million lei, monitored by a MPF profile unit. However, as for 2019 this list is no longer public, suggests that the reform of public investment management has reached a deadlock, the ability to develop and prioritize major investment projects proving to be quite limited.

And as regard the *Master Plan of General Transpo*rt of Romania adopted in 2016, which represented an important step towards improving strategic investment in road and rail infrastructures, is recording a very slow pace of the progress so far.

Moreover, as highlighted in the Country Report for 2019 (published in February 2020) it is considered that frequent changes in fiscal policy, lacking an institutional legal frame to assess the legislative impact, poor strategic planning investments, a very slow pace in public sector reforms and even weakening the

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

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

reform regarding corporate governance in state-owned companies[79] constitute real impediments to the investment growth. Among the reasons for not realizing investment projects are included: the lack of efficiency in public administration, mainly regarding public acquisitions, a high degree of legislative unpredictability, lacking of *ex-ante* impact for the legislative measures and promoting through emergency ordinances, measures of great impact on the private environment without the consultation of the stakeholders. Furthermore, the EC notes that public investment could be affected by persistent uncertainty, both due to the unpredictability of the policy-making process and the budgetary pressures on public investment arising from the new pension law. The EC report emphasizes the need to direct investment towards key policy areas and to strengthen the prioritization of public investment projects and their preparation.

The investment expenditure's evolution from 2012-2019, shows maintaining the under-execution pattern of investment spending compared with the initial annual planning, which reflects an administrative inability to perform the planned investment projects funded through non-reimbursable EU funds, and also an easy way to achieve fiscal consolidation.

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. A good prioritization of investments, their orientation towards increasing investments in research, development and innovation, in the physical and digital infrastructure can contribute to reducing regional disparities and to improving the productivity and long-term growth of the Romanian economy.

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

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

[79] The Law no. 111/2016 on corporate governance was *de facto* cancelled in December 2017 by an amendment of the Parliament providing for derogations for almost 100 companies, including the largest state-owned enterprises.

Also, we draw 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, the GEO no. 12/14.08.2019 regarding the state budget revision for 2019 allowed allocations from the budgetary reserve fund at Government's disposal to the Environment Fund and Environment Fund Administration[80], the Ministry of Regional Development and Public Administration[81], and so on.

Beside these GEOs, a large number of Government decisions issued during the year have established the use of the budgetary reserve fund at Government's disposal by derogation from the Law no. 500/2002, article 30 para (2) for:

- financing the National Program of Local Development, first and second stage;
- refunding the amounts representing the special tax for cars and vehicles, the pollution tax for vehicles, the tax for polluting emissions;
- different investment expenditures;
- payments accounting for the current and capital expenditures for certain administrative – territorial units;
- ensuring the continuity of the public service of thermal energy supply;
- financing the spending for supporting the child's protection system and the public centers for adult people with disabilities;
- elections of Romanian members in the European Parliament, etc.

These above-mentioned expenditures cannot be considered as unforeseen and should have been taken into account when substantiating the state 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 on 2018 published in February 2019, identified the following issues regarding the allocations from the budgetary reserve fund:

- the amount used from the reserve fund was the largest in the last 10 years;

[80] For the refund of the amounts representing the special tax for cars and vehicles, the pollution tax for vehicles, the tax for polluting emissions from vehicles and the environmental stamp for vehicles, approved by the Law no. 258/2018.

[81] For the financing of the National Program of Local Development, stages I and II.

- the initial provisions of the Budget Reserve Fund (BRF) were increased by 9.22 times during the budgetary year, both on the basis of budget revisions and of the abandonments of some budgetary credits approved by the annual budgetary laws by the main authorizing officers, as well as from the unused amounts allocated through Government Decisions;
- the under-estimation of the necessary budgetary credits in the initial moment of drafting the budgets of the main authorizing officers which subsequently led to the need of using resources from the contingency reserve fund at Government's disposal;
- regarding the formation and use of the contingency reserve fund it was found the continuation of the practice of allocating the budgetary reserve fund to the Government's disposal by derogations from the provisions of art. 30 of the Law no. 500/2002 (these accounted for 77.3% of the total amount allocated in 2018), as well as the violation of art. 54, para (10) of the Law no. 500/2002 by constituting the BRF from the amounts deriving from the renunciations of the main budgetary authorizing officers;
- the important share of allocations by derogation from the Public Finances Law indicates the ignorance of the principle of functioning of the BRF, that of being a real reserve resource, used exclusively in difficult times, only in the last instance and only under the conditions when all other ways of financing were exhausted.

At the local and central level, the allocations from BRF mainly concerned predictable expenses (the provision of the public heating service, some local or international events whose occurrences were certain) and expenses generated by the underestimations of the budgetary credits needed at the moment of drafting main authorizing officers' budget.

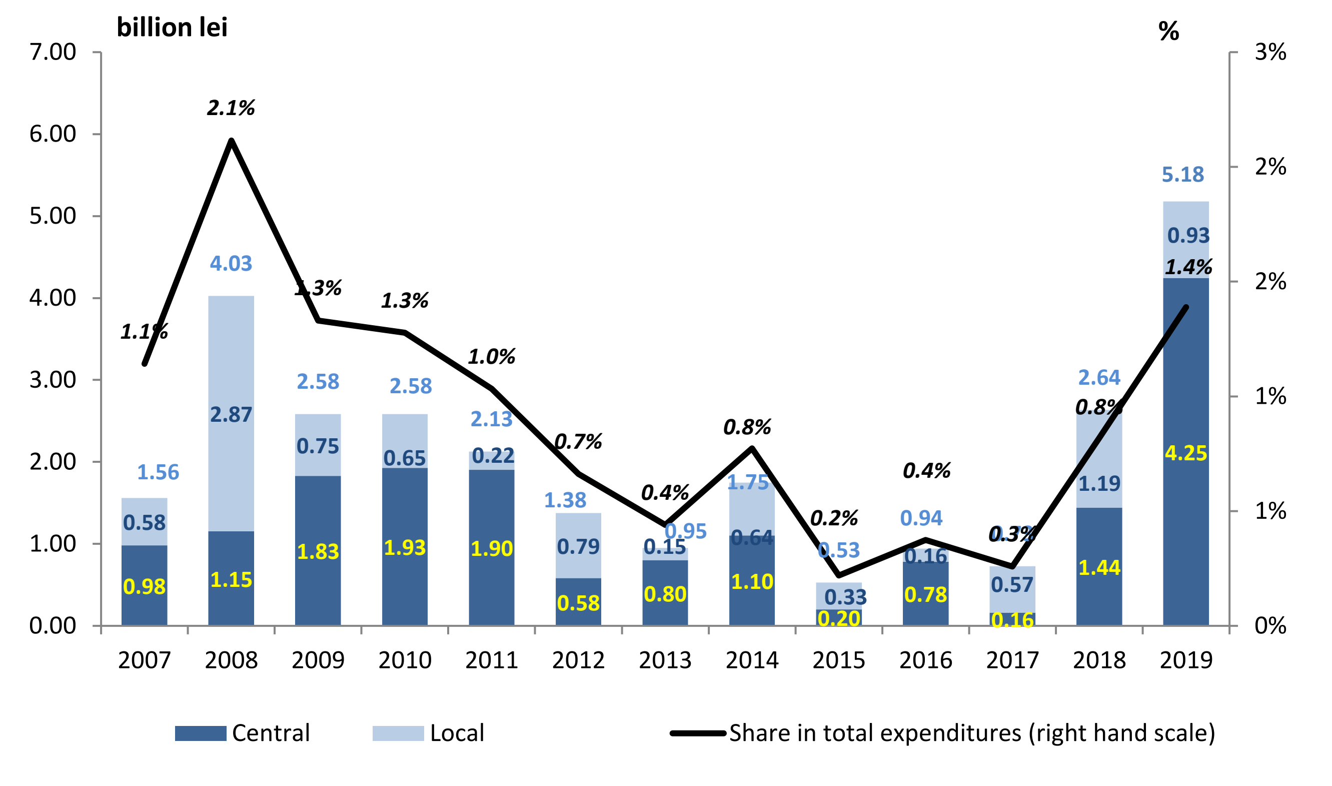
This report studies **the use of the contingency reserve fund** at Government's disposal during 2019, based on the Government decisions published in Romania's Official Gazette by which are allocated amounts to main authorizing officers and to specific destinations.

In 2019 the allocations from the contingency reserve fund amounted to 5,176.8 million lei (1.4% of total expenditures, 0.5% of GDP respectively), out of which about 4,245.3 million lei to the central administration and 931.4 million lei to the local authorities. Compared to the previous year, the distributions from the budgetary reserve fund increased by 2,540.6 million lei (basically, doubled compared to those registered in 2018, which were by 9 times larger than in 2017). By structure, the transfers toward the central administration increased by 2,801 million lei (+96.4%), while the amounts towards local authorities decreased by 260.4 million lei (-21.8%).

In 2019 was recorded the peak level of use of the reserve fund in the analyzed period, the allocated amounts being higher than in the period 2007-2018, by 28% over the maximum level reached in 2008, and approximately by 3 times larger than the average of the 2007-2018 period (see *Figure 32*).

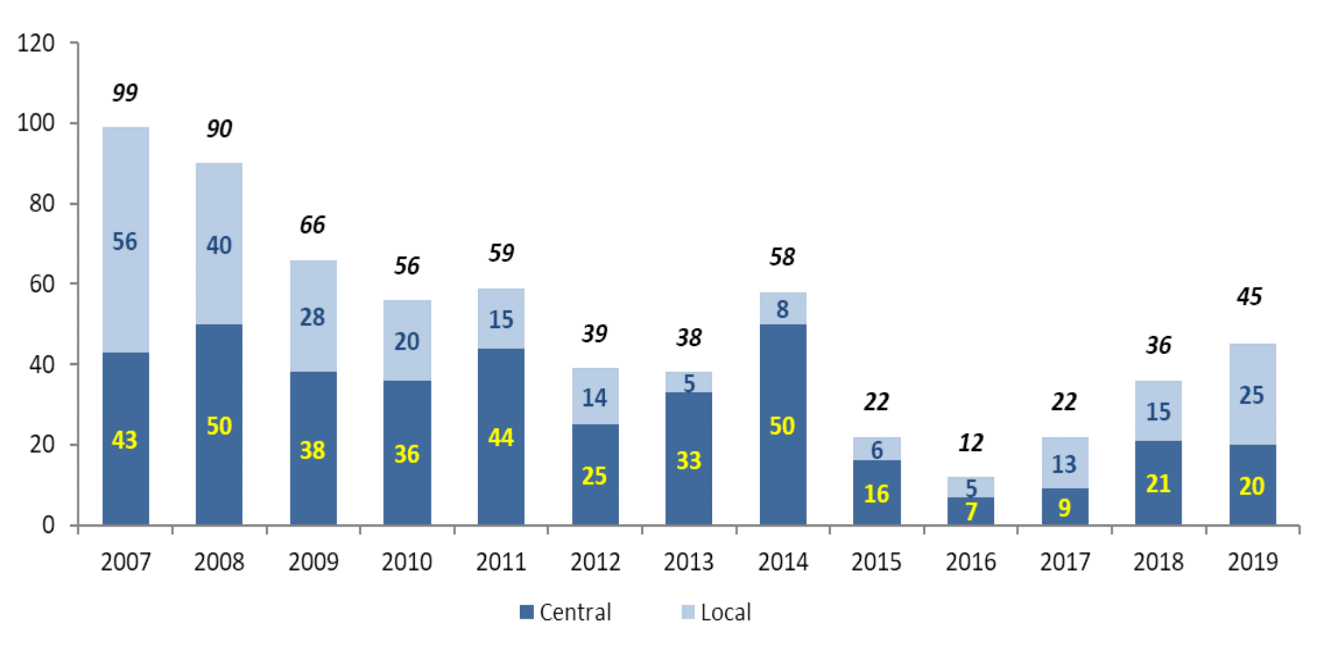
In 2019, from the perspective of the number of Government Decisions adopted for the purpose of allocating amounts form the reserve fund, there can be noticed a significant increase from 36 in 2018 to 45 in 2019, this level being lower than that registered over the period 2007-2009 and close to the one during 2010-2015 (see *Figure 33*).

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



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

Figure 33: Number of Government decisions regarding contingency reserve fund allocations

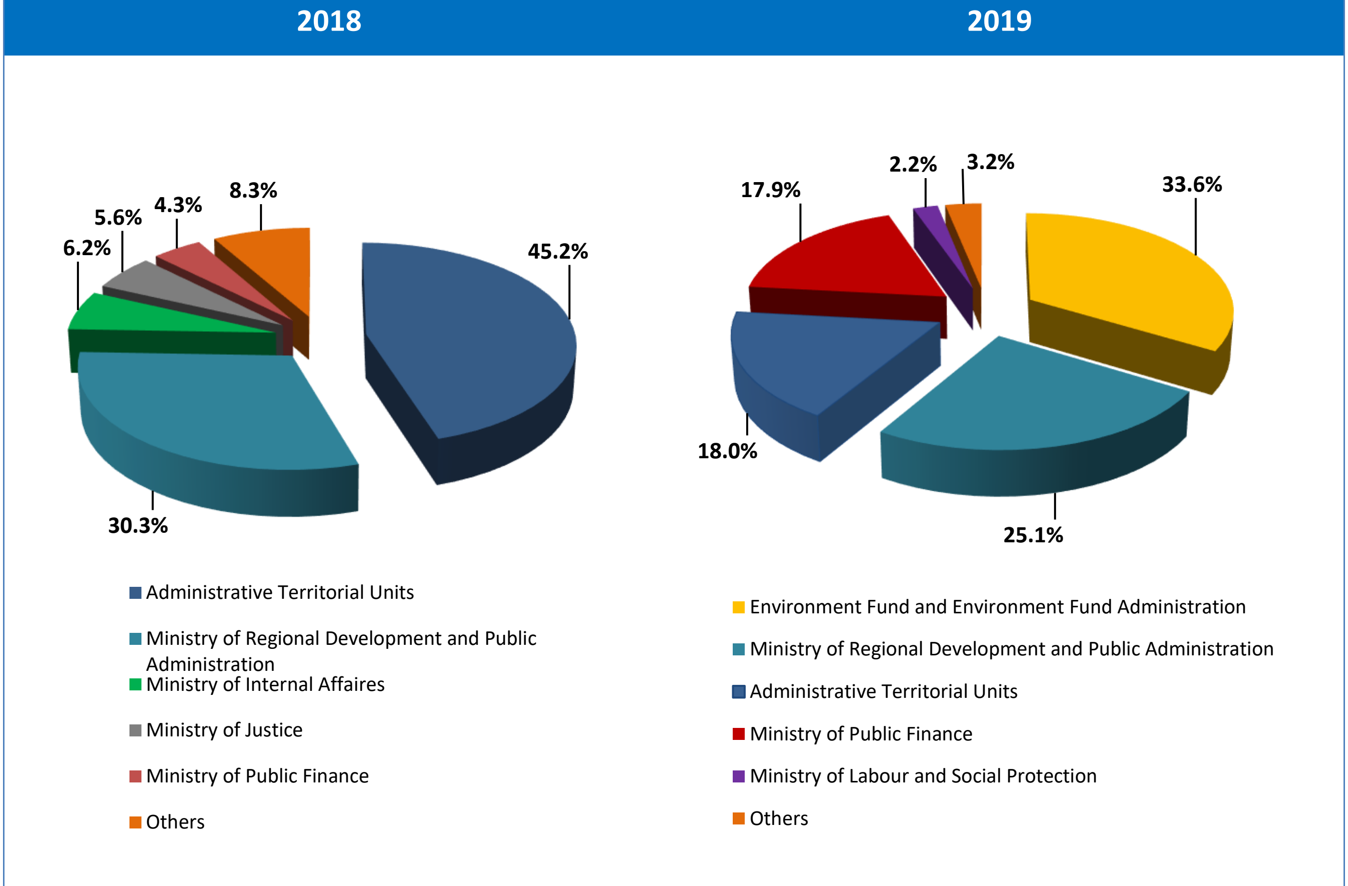


Source: Fiscal Council's calculations based on Government decisions regarding the contingency reserve fund allocations

Also, it is notable that the tendency of the preceding years to decide most spending from the contingency reserve fund in the last months of the year was maintained, 10 out of 45 Government decisions being approved in December 2019, amounting to 1,641.1 million lei, representing 31.7% 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.

Comparing the allocated amounts from the reserve fund in the last 2 years (see *Figure 34*), it is notable that the main beneficiary in 2019 is represented by the central authority which received 4,245.3 million lei (3 times more than in 2018), respectively a share of 82% of the total, while the local authority benefited of 931.4 million lei (-22% compared to the previous year), respectively 12% of the total allocations. In 2018, the reserve funds were directed in percentage of 54.8% to the central authority (1,444.3 million lei), and the administrative territorial units received 1191.8 million lei, respectively 45.2% of the amounts allocated from the reserve fund.

Figure 34: The beneficiaries of allocation from the contingency reserve fund (% of total allocations)



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

In terms of destinations, in 2019, the allocations from the reserve fund at Government's disposal were directed mainly towards the central authority. The main beneficiaries were: The Environment Fund and

Environment Fund Administration with 33.6%[82] of the total allocations from the budgetary reserve fund at local and central level, the Ministry of Regional Development, the Public Administration that received 25.1%[83] of the total and the Ministry of Public Finance that received 17.9%[84] of the total allocations from reserve fund.

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 for 2019 the accentuation of the deteriorating trend started in 2018 from the perspective of the magnitude of the allocations and the use of 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 authorizing officers are required. The Fiscal Council also recommends limiting the amounts that can be assigned and used from this fund as a share of total budgetary expenses, a level of 1% being apparently adequate for urgent expenses, given the previous developments.

According to the article 30, paragraph (4) of the Public Finance Law no. 500/2002, **the intervention reserve fund** at Government's disposal is allocated, based on government decisions, to main authorizing officers of the state budget and local budgets, to finance urgent expenditures designed to eliminate the effects of natural disasters and to support the individuals affected. If the possible destinations of the allocations from the contingency reserve fund can be interpreted differently, in the case of the intervention fund, the allocations' destinations are clearly indicated in the law, the existence of such a fund being fully justified. During a year, this fund may be increased by allocations from the contingency reserve fund, depending on the needs regarding the amounts that are necessary for the removal of the effects of natural disasters. In 2019, the amounts allocated from the intervention reserve fund at

[82] Accordingly, in the amount of 1,737 million lei, representing 41% of the amounts allocated to the central authority in 2019.

[83] Accordingly, in the amount of 1,300 million lei, representing over 31% of the amounts allocated to the central authority in 2019.

[84] Accordingly, in the amount of 926.2 million lei, representing judicial and extrajudicial expenses derived from court actions regarding the representation of state interests and civil damages in the Arbitration File no. ARB/05/20 (Romania case vs. Micula brothers).

Government's disposal amounted 375.2 million lei (less by 27% than the previous year), their destinations being in accordance with the Public Finance Law no. 500/2002.

III.6. The public debt

Interest expenses in cash standards registered a decrease of almost 0.8 billion lei in 2019 compared to the previous year (representing a reduction of about 6.1%) and, amid a 11.3% increase of nominal GDP, their share in GDP decreased from 1.4% to 1.2%. This evolution occurs in the context of an accelerated growth of public debt in recent years (+5.5% in 2017, +9.7% in 2018 and +13% in 2019). At the same time, it should be mentioned that the actual execution of interest expenses was almost 1.3 billion lei below the projection from the initial budget (-9.4%, the partial update of the forecasted level being made on the occasion of the second budget revision), which suggests an overestimation of this aggregate when drafting the budget.

Public debt, measured according to the ESA 2010 methodology, advanced by about 43 billion lei (+13%) in 2018 compared to the previous year, and its share in GDP increased from 34.7% to 35.2% due to the fact that the growth rate of nominal GDP (+11.3%) was lower than the one of public debt. On the other hand, from the perspective of the national methodology, public debt increased by about 48 billion lei (+12%), and its share in GDP increased from 42.1% in 2018 to almost 42.4% in 2019.

The average interest paid on public debt has ceased the decreasing trend from the last decade, rising from 3.6% in 2018 to almost 4% in 2020. The evolution may seem surprising given that 2019 marked a reduction in interest expenses (measured in cash standards), compared to the previous year. However, it should be mentioned that, according to the ESA 2010 methodology, interest expenses had an opposite evolution, registering a significant advance (+2.2 billion lei, representing +20.1%) compared to 2018. The substantial gap between the results of the two approaches can be explained by differences in the treatment of issuance premiums, related to the renewal of previous government bond issues, which are fully included in the amount of interest expenses according to cash standards, while the ESA 2010 methodology allocates them gradually over the entire life of the loan.

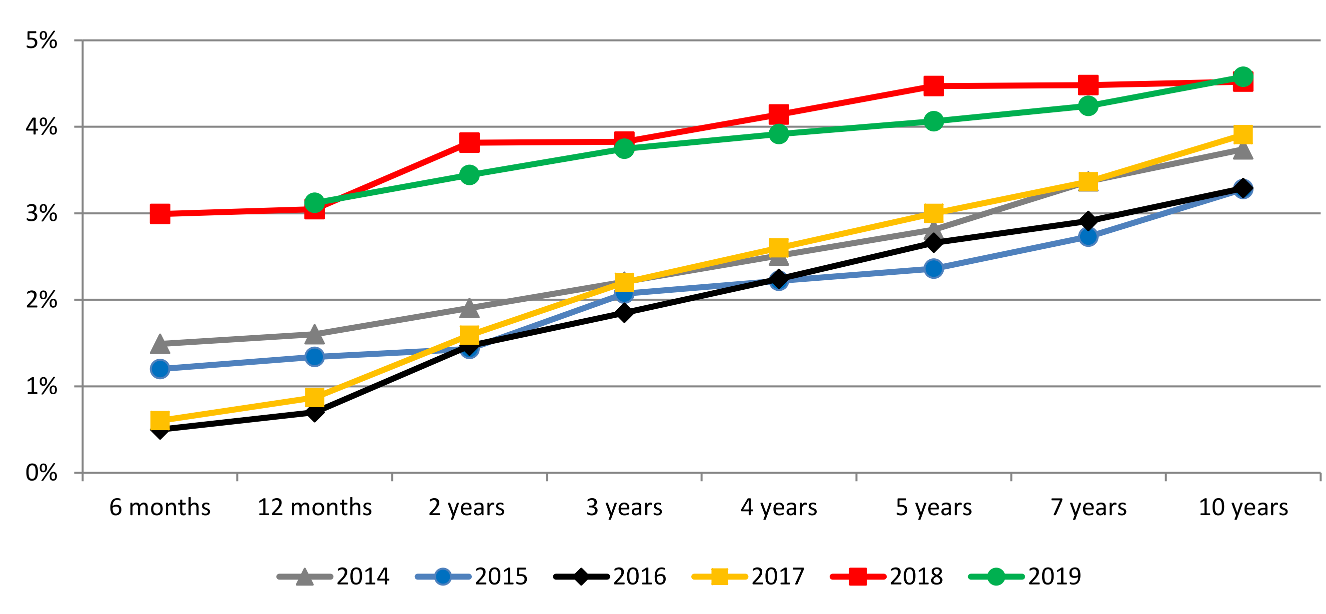
The cost of attracting new resources in national currency registered a positive development between 2014-2016, due to the inclusion, beginning with July 2014, of the bonds issued by the Romanian government in the calculation of the GBI-EM Global Diversified index series by JP Morgan, the extension of the average maturity of public debt, the relaxed monetary policy conducted by the central bank, the achievement of a BBB- rating from Standard & Poor's in May 2014[85], but also due to a liquidity surplus in the financial markets. However, starting with 2017, there was a reversal of this trend manifested by an increase in the cost of attracting new loans in national currency, the upward trajectory accentuating considerably during 2018 amid the sharp rise in inflation. In this context, 2019 marked a slight reduction

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

(between 0.1 and 0.4 pp) in the cost of attracting new resources in national currency for most of the considered maturities (see *Figure 35*), except for maturities of 1 year, respectively 10 years, which recorded increases of about 0.1 pp.

A declining evolution was also observed for the cost of attracting new resources in foreign currency from external markets in 2019[86], the yields of eurobonds having values of about 2.1% for maturities of 7 and 12 years (compared to 2.6% in the previous year), of 3.6% for the maturity of 15 years, respectively between 3.4% and 4.7% for the maturity of 30 years (compared to 5.2% in the previous year).

Figure 35: The yield curve for government securities issued in domestic currency between 2014-2019



Source: NBR

Regarding the structure of public debt[87], the gradual expansion of central government debt continued in 2019 (96.3% of the total debt, compared to 96% in the previous year). Government bonds maintained their position as the main instrument of government public debt with a share of 42.3% (compared to 41.1% in 2018), followed by eurobonds with 30.4% (compared to 28.9% in 2018), the other categories of instruments registering decreasing shares, as follows: government loans (12% compared to 14.9% in 2018), loans from the general account of the State Treasury (13.7% compared to 14% in 2018) and treasury certificates (0.4% compared to 1% in 2018). The structure by currencies reveals a slight increase in the share of loans in national currency from 55.8% in 2018 to 56.7% in 2019 (amid borrowing 48.1 billion lei through issues in national currency made on the domestic market), corroborated with the reduction of the share of loans contracted in dollars from 7.3% in 2018 to 6.7% in 2019, respectively of

[86] During 2019, Romania obtained financing on the external market through several eurobond issues, made in March and July, with a total value of 5 billion euros and maturities of 7, 12, 15 and 30 years.

[87] According to the national methodology, the data being available on the MPF website.

those contracted in euro from 36.4% in 2018 to 36.1% in 2019 (although new resources were borrowed in euro through issues totaling 1.6 billion on the domestic market and 5 billion on the external market).

In what concerns the maturity structure of government securities in national currency issued on the domestic market in 2019, the trend of attracting longer-term resources, initiated in recent years, has continued and even intensified. Thus, treasury certificates with maturities of up to 1 year represented only 3.1% of the value of new loans contracted in 2019, a sharp decrease compared to the share of 10.7% recorded in 2018. Bonds with maturity between 1 and 5 years represented 55.7% of the value of new loans contracted in 2019 (slightly exceeding the share of 54.6% recorded in 2018), those with maturity between 5 and 10 years had a share of 33.6% in 2019 (compared to the level of 25% recorded in 2018), and those with maturity over 10 years had a share of 7.7% in 2019 (representing a slight decrease compared to 9.7% in 2018). As a result of the trend of attracting resources in the longer term, the average residual maturity of government securities in national currency newly issued on the domestic market continued its upward trend from previous years, increasing from 4.6 years in 2018 to 5.6 years in 2019. It may be noted that the orientation of government public debt towards longer maturities allows a reduction in vulnerability to short-term interest rate developments, as well as to any difficulties encountered in the process of refinancing the outstanding debt.

In order to forecast the evolution of 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 denotes the stock of public debt at time t, y_t denotes the nominal GDP at time t, pb_t denotes the primary deficit at time t, sfa_t denotes the stock-flow adjustment at time t, and

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

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.

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

The year 2019 recorded a moderate increase (+0.5 pp) in the share of public debt as a percentage of GDP. Using the dynamics equation presented above, it is possible to identify the factors that contributed to this evolution. Thus, real economic growth (-1.4 pp as impact), real interest rate (-1.1 pp as impact) and the stock-flow adjustment (-0.2 pp as impact) acted in the sense of decreasing the share of public debt in GDP, while the 2019 primary deficit (+3.1% of GDP, the highest in the EU) was the only factor that contributed to its increase. However, the impact of the primary deficit was substantial, outweighing the cumulative effect of the other three factors that had a beneficial influence on government debt. Regarding the stock-flow adjustment, although its size is small, it is the result of several factors with significant impact that acted in opposite directions. Thus, the continuation of granting superdividends from the reserves accumulated by state-owned companies (which is assimilated to divestments according to the ESA methodology), the late payment of the court decisions regarding salary differences in education, respectively the registration of lower interest expenses according to the cash standards compared to those determined according to the ESA methodology, acted in the sense of decreasing the share of public debt in GDP. On the other hand, the purchase of military equipment with payments in advance (which will be recognized according to the ESA methodology when the delivery is made), the payment of higher amounts for the refund of the pollution tax compared to the payment decisions originally issued, the contribution of state-owned companies that are consolidated in the public administration sector, but also the collection in the following month of the VAT and SSC obligations related to the current month contributed to the increase of the share of public debt in GDP.

Similar to the previous year, the economic growth recorded in 2019 (4.1%) overlapped with a negative real interest rate (-3.2%, amid high inflation), which led to a negative value of the λ_t coefficient and, implicitly, to a favorable impact on the dynamics of public debt expressed as a percentage of GDP. Thus, the unfavorable impact of the high budget deficit (4.3% of GDP, representing a large increase compared to 2.9% in 2018) was partially compensated by the real economic growth rate, corroborated with the registration of a negative real interest rate.

Analyzing the level of public debt at the end of 2019, it should be noted that, although its share in GDP is relatively low (both relative to the 60% of GDP reference value applied at EU level and to the alert thresholds set by the FRL – which institutes the application of preventive measures when exceeding 45% of GDP), the level of debt is very sensitive to the future evolution of the differential between the real growth rate and the cost of financing, represented by the real interest rate. Although this differential has been favorable over the last 8 years, which has allowed the maintenance of a relatively stable level of the share of public debt in GDP, even against the background of budget deficits, the impact of severe economic shocks may lead to an accelerated growth of public debt as a result of the reversal of the differential between economic growth and the real interest rate. Even in the absence of major shocks, Romania's fragile position is underlined by the EC Debt Sustainability Monitor[88] (2019 edition), which places medium and long-term sovereign debt risk at a "high" level, highlighting an unfavorable evolution compared to the 2018 edition of the report which evaluated the risk at a "medium" level. Thus, considering unchanged policies and the implementation timetable of the pension law that was adopted in 2019, the EC estimated that Romania's public debt will exceed the reference value of 60% of GDP by 2025, reaching 91.2% in 2030.

[88] https://ec.europa.eu/info/sites/info/files/economy-finance/ip120_en.pdf.

The risks related to the evolution of public debt appear all the more obvious taking into account that the beginning of 2020 marked the manifestation of a serious economic crisis, generated by the partial closure of economies as a result of measures implemented internationally to combat the pandemic caused by the SARS-CoV-2 virus. Thus, the EC Spring 2020 forecast operated a major adjustment to the projections of the Autumn 2019 forecast (which estimated that real GDP at EU level will increase by 1.4% in 2020), anticipating that the current year will mark a major recession in all Member States, the dynamics of real GDP at European level being estimated at -7.4%. The EC forecasts for the main factors that impact the dynamics of Romania's public debt foreshadow a rapid and sizeable deterioration of the degree of indebtedness, *Table 12* comparing Autumn 2019 and Spring 2020 forecasts for the real GDP growth rate, budget deficit and GDP deflator:

Table 12: EC forecasts on the key indicators that impact the dynamics of the national public debt - Spring 2020 versus Autumn 2019

Forecast	Real GDP growth rate (%)		Budget deficit (% of GDP)		GDP deflator (%)	
	2020	2021	2020	2021	2020	2021
Autumn 2019	3.6	3.3	-4.4	-6.1	4.5	4.4
Spring 2020	-6.0	4.2	-9.2	-11.4	2.3	2.5

Source: EC

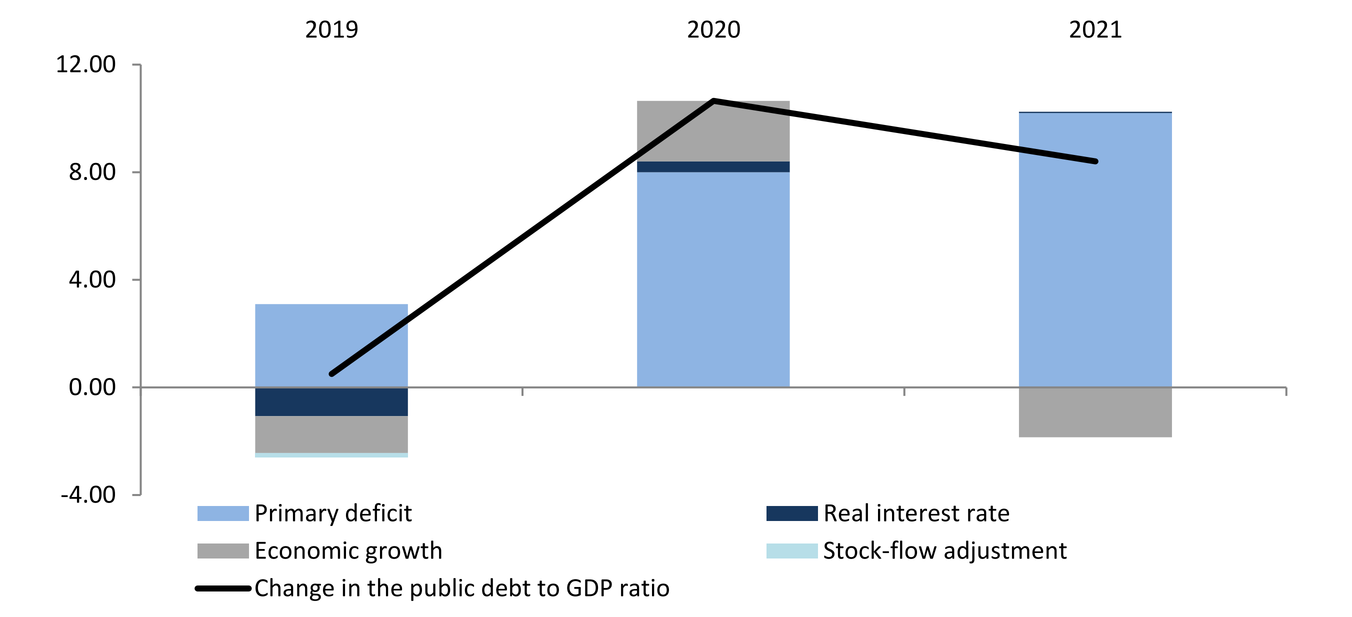
Even in the absence of up-to-date estimates of interest expenses, the severe worsening of the macroeconomic framework in 2020 is likely to cause a sharp reversal of the differential between economic growth and the cost of financing, the adverse effect of the recession being potentiated by the reduction of the GDP deflator which will lead to an increase in the real cost of financing. To this effect is added the unfavorable impact of the rapid increase in the budget deficit, accentuated by the cost of measures aimed at mitigating the economic and social effects of the pandemic. However, the deepening of the deficit is projected to continue in 2021, despite the perspective of economic recovery, due to the implementation of the current timetable for pension increases, as well as a result of the increase in child allowances (postponed until January 1, 2021).

Based on the updated EC projections for the 2020-2021 period and on the MPF estimates for the evolution of interest expenses (outlined in the 2020-2022 Fiscal Strategy[89]), the share of public debt in GDP was forecasted over the next 2 years, considering that the stock-flow adjustment will be equal to 0. The results indicate a major impact of the deterioration of the macroeconomic framework on Romania's public debt which is projected to increase from 35.2% of GDP in 2019 to 45.9% in 2020, the pronounced upward trajectory continuing in 2021 (due to the high budget deficit) to a projected level

[89] Because the 2020 Convergence Program has not been published at the time when this report was elaborated. Interest expenses are expected to rise compared to the projections of the 2020-2022 Fiscal Strategy (which were made before the onset of the COVID-19 economic crisis), given that the crisis is likely to restrict the access of emerging economies to funding from external markets.

of 54.3% of GDP. Thus, under the impact of the economic crisis caused by the COVID-19 pandemic, corroborated with the budgetary impact of the current enforcement calendar of the pension law, Romania's public debt is projected to increase rapidly over the next 2 years (a similar evolution being recorded during the previous crisis of 2008-2009), so that by the end of 2021 it rises significantly towards the 60% of GDP ceiling set at European level.

Figure 36: Contributions to changes in the public debt to GDP ratio for the 2019-2021 period



Source: EC, MPF, Fiscal Council's calculations

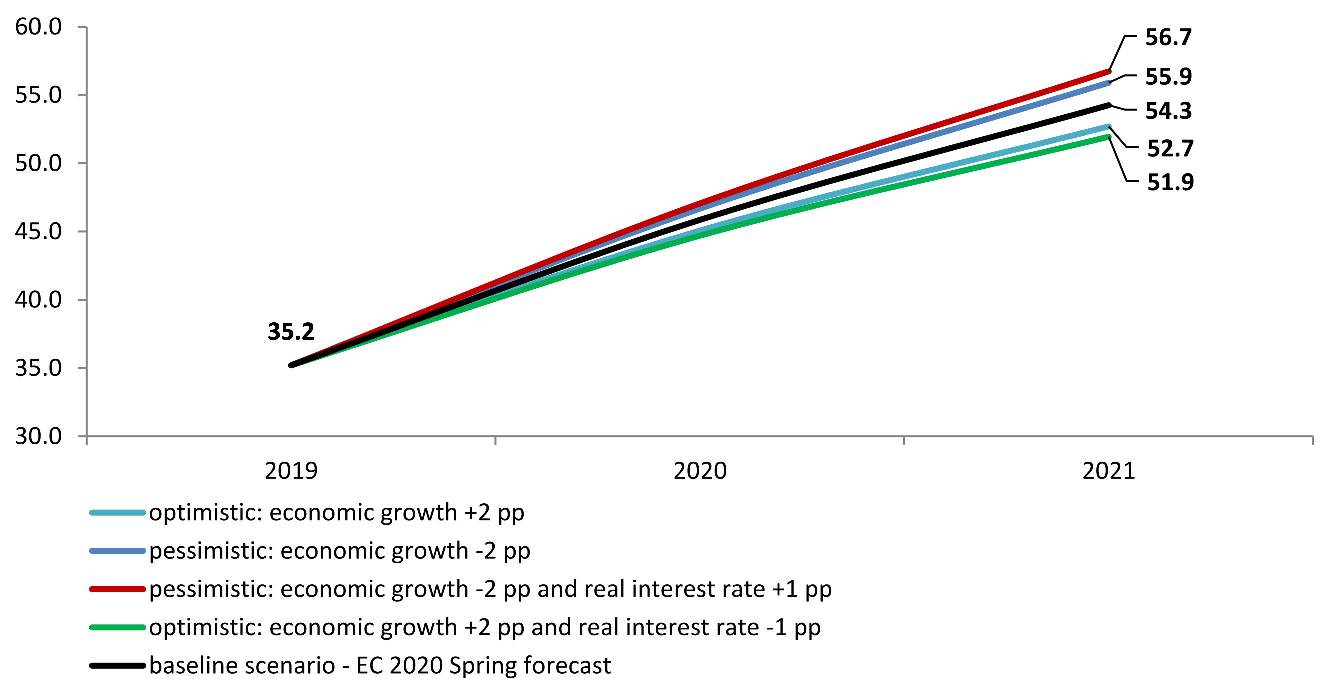
The pronounced upward trajectory of public debt (see *Figure 36*) is driven by the unfavorable differential between the real GDP growth rate and the real interest rate on public debt (in 2020), corroborated with the impact of the budget deficit (and, implicitly, of the primary deficit) which is sizeable and rising during the 2-year forecast. However, it should be taken into account that the projection of public debt depends heavily on the forecasts used for the real interest rate and the real GDP growth rate. A higher-than-projected real interest rate entails higher debt financing costs and may lead to an increased public debt as share of GDP. Also, a lower GDP growth rate may lead to an increase in the share of public debt compared to initial estimates. Given the important uncertainties regarding the actual realization of the forecasts (amplified by the magnitude of the pandemic shock, unprecedented in recent history) and taking into account that the projection of interest expenses is based on the MPF estimates from the 2020-2022 Fiscal Strategy, it is appropriate to conduct a sensitivity analysis to assess the impact of changes in the considered variables on the evolution of public debt.

Starting from the EC baseline scenario, outlined in the Spring 2020 forecast, and considering the MPF estimates for interest expenses from the 2020-2022 Fiscal Strategy, several alternative scenarios for the evolution of public debt were defined (see *Figure 37*):

- Two optimistic scenarios, the first one being characterized by a real GDP growth rate that is 2 pp higher than the baseline forecast, and the second one adding a 1 pp decrease in real interest rates. It is interesting to note that, despite the optimistic assumptions underlying them, the two scenarios continue to anticipate a significant increase in public debt (due to the high deficits projected for the 2020-2021 period), reaching at the end of the forecast horizon a level of 52.7% of GDP in the case of the first scenario, respectively of 51.9% of GDP in the case of the second scenario;

- Two pessimistic scenarios, the first one being characterized by a real GDP growth rate 2 pp lower than the baseline forecast, and the second one adding a 1 pp increase in real interest rates. As a result of the more pronounced upward trajectory of public debt, both pessimistic scenarios anticipate exceeding the 55% of GDP threshold at the end of the forecast horizon, reaching a level of 55.9% of GDP in the case of the first scenario, respectively of 56.7% of GDP in the case of the second scenario.

Figure 37: Scenarios for the evolution of public debt (% of GDP)



Source: EC, MPF, Fiscal Council's calculations

The results of the sensitivity analysis show that, regardless of the considered scenario, Romania's public debt is projected to increase sharply until 2021, exceeding 50% of GDP even in the case of the most optimistic assumptions, while pessimistic scenarios anticipate exceeding 55% of GDP. The reporting of these values is relevant in the context in which the FRL was amended at the end of 2013, one of the changes being the introduction of thresholds for public debt that trigger actions by the Government. Thus, if public debt exceeds 45% of GDP, the MPF draws up a report to justify the debt increase and presents proposals for maintaining this indicator at a sustainable level. If public debt exceeds 50% of GDP, the Government has to freeze public sector wages and possibly take additional debt reduction measures. If the indicator rises above 55%, social assistance expenditures from the public system are also automatically frozen. All these new provisions aim to prevent the public debt from exceeding the 60% of GDP threshold stipulated in the Maastricht Treaty. In this context, it should be noted that most of the considered scenarios anticipate exceeding the 45% threshold by the end of 2020, followed by exceeding the 50% threshold (even 55% in the case of pessimistic scenarios) by the end of 2021, this evolution occurring due to the forecast of a growing budget deficit which offsets the effects of the economic recovery expected to materialize in 2021. At the same time, further risks relative to the analyzed scenarios stem from potential negative exchange rate shocks, given the relatively high share of public debt denominated in foreign currencies.

An additional constraint is related to the already large size of the public debt compared to that of the domestic financial sector and the most likely limited capacity to absorb an additional stock of public debt at the current level of financial intermediation. Thus, at the end of 2019, the share of Romania's public debt in total banking assets was around 75% (compared to almost 68% in 2018), and the exposure to the government sector related to local bank assets (these being the main holder of public debt in the domestic market) remained close to 20%, the levels of these indicators being among the highest in the EU. Maintaining this situation can most likely lead to a higher dependence on non-resident investors, which is associated with an increasing vulnerability to interest and exchange rate shocks, changes in risk appetite on the global financial markets, and a possible change of sovereign rating.

The manifestation of the above-mentioned risks is all the more plausible in the context of the crisis caused by the COVID-19 pandemic, and the current projections foreshadow a sizeable increase in public debt over the 2020-2021 period, amid high levels of budget deficit, as well as due to the unfavorable differential between real GDP dynamics and financing costs. Moreover, the steep advance of public debt is expected to lead to a rapid increase in financing needs, raising a number of important challenges regarding the limited debt absorption capacity of the domestic market, uncertainties about the availability of financing in external markets and the future evolution of the cost of financing. In this context, the possibility of obtaining funds to finance budget deficits and outstanding public debt will be an important constraint of fiscal policy during this period, as the issue of financing has the potential to suffer additional complications if the investors' risk aversion increases, as well as in the event of a deterioration of Romania's sovereign rating. At the same time, given the high level of the financing needs, a prudent conduct recommends analyzing all available possibilities for obtaining access to financial resources, both public and private. In this context, an important resource for financing the economy, starting in 2021, could be represented by the economic recovery plan proposed by the EC through which Romania could benefit from about 33 billion euros. However, the poor position occupied in the ranking of the absorption of European funds highlights the reduced institutional capacity of our country which can be an impediment in accessing the funds allocated through the economic recovery plan.

IV. The absorption of EU funds

In the 2014-2020 financial framework, according to the data provided by the Ministry of European Funds (MEF) [90], Romania has been allocated European structural and investment funds (ESIF) of about 30.9 billion euro. A key objective funded through ESIF is the EU cohesion policy which aims to eliminate economic and social disparities between regions, to support the convergence of Member States and to increase competitiveness and employment. The Structural and Cohesion Funds [91] are financial instruments designed to achieve the objectives of the EU cohesion policy and, through them, Romania was allocated about 22.6 billion euro directed towards six operational programs (OP): Regional OP, Infrastructure OP, Competitiveness OP, Human Capital OP, Administrative Capacity OP and Technical Assistance OP. It should be noted that seven operational programs had been initially defined (the above mentioned and the SME Initiative OP), but in October 2018 the SME initiative was integrated into the Regional OP, while its allocation was increased by 150 million euro[92]. In addition to the funds related to the EU cohesion policy, 19.5 billion euro were allocated for the Common Agricultural Policy[93], 168.4 million euro for the Operational Program for Fisheries and Maritime Affairs (OPFMA) and 441 million euro for the Operational Program for Assistance to Disadvantaged People (OPADP), additional funds being granted for Cross-border Cooperation and through the Connecting Europe Facility (CEF) instrument. Given the diversity of programs, instruments and funding sources, **this chapter analyzes the absorption of European funds in Romania, considering exclusively the Structural and Cohesion Funds**.

Compared to the 2007-2013 financial framework, the 2014-2020 programming period introduced a new legislative framework and a homogenous set of rules in order to establish a clear link with the Europe 2020 strategy for stimulating smart, sustainable and inclusive growth in the EU, for an improved coordination, ensuring consistency and simplifying access to ESIF[94]. The total budget for the 2014-2020 cohesion policy is set at approximately 355 billion euro out of which almost 190 billion euro (about 53%) is allocated to the group of new EU Member States from Central and Eastern Europe: Bulgaria, Czechia, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Hungary[95]. As stated in the beginning of this chapter, Romania benefits from an allocation of about 22.6 billion euro from the structural and cohesion funds, higher in comparison to the 2007-2013 budget which amounted to 18.8 billion euro, and *Table 13* presents a comparison between the allotment of funds for each operational program during the two programming periods. It may be noted that, except for the Competitiveness OP,

[90] According to the absorption report for ESIF funded programs from January 31, 2020.

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

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

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

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

[95] A detailed presentation of the funds allocated to each country, together with their respective absorption rates, can be found in *Table 15*.

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

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

Total allocations 2014-2020		Total allocations 2007-2013	
Regional	6.9	**Regional**	4.0
Infrastructure	9.2	**Environment**	4.4
		Transport	4.3
Competitiveness	1.3	**Competitiveness**	2.5
Human Capital	4.4	**Human Resources**	3.2
Administrative Capacity	0.6	**Administrative Capacity**	0.2
Technical Assistance	0.3	**Technical Assistance**	0.2
Total	**22.6**	**Total**	**18.8**

Source: EC, MEF

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

In the NRP that was elaborated in April 2019, reforms and development priorities were set taking into account the issues highlighted by the 2019 Annual Growth Survey, the 2019 Country Report for Romania and the 2018 Country Specific Recommendations. Analyzing the progress made towards achieving the national targets related to the Europe 2020 strategy, the document appreciates that the target of reducing the population at risk of poverty and social exclusion has been exceeded and that good results have been achieved in the field of employment, reducing greenhouse gas emissions, the promotion of energy from renewable sources and tertiary education. On the other hand, the results obtained in terms of investments in research and development and early school leaving are significantly lower than the established targets.

The 2019 NRP has established a series of policies to respond to economic challenges in the fiscal-budgetary sphere (with an emphasis on measures to improve the management of public investments, streamline budget expenditures and improve the collection of taxes), in the sphere of public administration (with a focus on further decentralization, strategic planning and prioritization of government policies, strengthening transparency and participatory governance, improving human resource management, professionalizing administrative staff, increasing the capacity to absorb

European funds, further reforming the public procurement system, preventing, combating and reducing corruption at all administrative levels) and in the sphere of the business environment (with a focus on measures to create an investment-friendly environment, develop transport infrastructure, stimulate sectors with growth potential and improve the performance of public enterprises).

In order to achieve the national objectives related to the Europe 2020 strategy, the 2019 NRP outlined the main reform directions, such as: modernization of labor market institutions, equal access to lifelong learning, increasing the quality of employment in rural areas (the objective of employment); ensuring a high quality scientific basis, stimulating private investments in research, strengthening the European dimension of research policies and programs (the objective of research, development and innovation); reducing greenhouse gas emissions, mitigating the effects of climate change, improving waste management, protecting nature and conserving biodiversity (the objective of environment and climate change); promoting renewable energy sources, encouraging the production of energy from renewable resources (the objective of renewable energy sources); increasing energy efficiency, modernizing centralized heating systems (the objective of energy efficiency); modernization of the school curriculum, increasing the quality of pre-university education, strengthening vocational and technical education, strengthening the social package in education, improving the educational infrastructure (the objective of early school leaving); development and integration of the information system in education and research, development of institutional capacity, increase of the quality of higher education and correlation with the labor market, promotion of entrepreneurial education (the objective of tertiary education); increasing the quality of life for the rural population and the marginalized population in the urban area, reducing poverty among the most disadvantaged people, reforming the health system (the objective of social inclusion and combating poverty). It should be noted that many priorities and development directions under the 2019 NRP are funded in whole or in part from European funds, so that the degree of absorption of these funds stands out as a relevant indicator of the ability to meet the proposed objectives.

Analyzing the data available in February 2020 (see *Table 14*), there is an improvement in the absorption of European funds compared to the results recorded by the Fiscal Council in March 2019[96]. Thus, relative to March 2019, the absorption rate (including pre-financing[97]) increased from 20.5% to 29.9% of the total funds allocated for the 2014-2020 programming period. At the level of operational programs, it is found that the Technical Assistance OP (60% compared to 39.7% in March 2019) and the Regional OP (29.5% compared to 17.8%) recorded the largest increases in absorption rates, the advance registered by the other operational programs being below 10 pp: Administrative Capacity OP (27.9% compared to 18%), Human Capital OP (29.2% compared to 19.7%), Competitiveness OP (29.9% compared to 21.7%), respectively Infrastructure OP (29.9% compared to 22.4%). Thus, unlike previous years, there is a trend

[96] See the 2018 Annual Report of the Fiscal Council.

[97] 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.

of uniformity among the absorption rates of the six operational programs, with the exception of Technical Assistance OP which recorded a much higher level of the indicator.

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

	Total allocations 2014-2020 (cumulative)	Payments February 2020			Absorption rate February 2020	Absorption rate excluding pre-financing February 2020
		Total, out of which:	Pre-financing	EU refunds		
Regional	6,860.0	2,025.7	614.4	1,411.3	29.5%	20.6%
Infrastructure	9,218.5	2,756.3	602.7	2,153.6	29.9%	23.4%
Competitiveness	1,329.8	397.4	85.8	311.6	29.9%	23.4%
Human Capital	4,372.0	1,278.4	281.9	996.5	29.2%	22.8%
Administrative Capacity	553.2	154.5	35.8	118.8	27.9%	21.5%
Technical Assistance	252.8	151.7	15.8	135.9	60.0%	53.8%
Total	**22,586.2**	**6,764.0**	**1,636.3**	**5,127.7**	**29.9%**	**22.7%**

Source: EC, Fiscal Council's calculations

According to the situation reported by MEF, until January 31, 2020, 5.6 billion euros were requested to the EC for the following operational programs: Infrastructure OP (2,326.9 million euro), Regional OP (1,568.1 million euro), Human Capital OP (1,105.2 million euro), Competitiveness OP (337.5 million euro), Technical Assistance OP (143.8 million euro) and Administrative Capacity OP (128.5 million euro). Following the submission of payment applications, the EC had made reimbursements of around 5.1 billion euro by February 2020 and their breakdown by operational program is also presented in *Table 14*. Thus, it can be seen that the actual absorption rates (calculated by eliminating pre-financing) are on average about 7 pp lower compared to the ones that include pre-financing.

Table 15 presents an analysis of the situation in Romania compared to the other new EU Member States from Central and Eastern Europe based on data available in February 2020. The majority of these countries (including Romania) received a larger amount of structural and cohesion funds for the 2014-2020 programming period compared to the previous financial framework, with the exception of Czechia (21.5 billion euro compared to 26.5 billion euro), Latvia (4.4 billion euro compared to 4.5 billion euro), Slovenia (3.1 billion euro compared to 4.1 billion euro) and Hungary (21.5 billion euro compared to 24.9

billion euro). On the other hand, when comparing the allocations per inhabitant[98], Romania stands on the penultimate place with approximately 1,132 euro/inhabitant, ahead only of Bulgaria (1,024 euro/inhabitant). On the opposite side, seven of the eleven analyzed countries have allocations of over 2,000 euro/inhabitant, the highest values being recorded by Estonia (2,659 euro/inhabitant) and Slovakia (2,505 euro/inhabitant).

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

	Total allocations 2014-2020 billion euro	Payments February 2020 billion euro	Absorption rate February 2020 %	Total allocations 2014-2020 /inhabitant euro	Total payments/ inhabitant February 2020 euro
Bulgaria	7.4	2.8	38.2	1,024.2	391.4
Czechia	21.5	8.2	38.2	2,047.9	781.8
Croatia	8.5	2.3	27.1	1,990.3	539.0
Estonia	3.5	1.6	46.3	2,659.3	1,231.5
Latvia	4.4	1.7	38.0	2,207.5	837.9
Lithuania	6.7	2.5	37.3	2,279.4	850.7
Poland	76.9	33.4	43.5	2,022.2	878.7
Romania	**22.6**	**6.8**	**29.9**	**1,132.3**	**339.1**
Slovakia	13.6	4.3	31.9	2,504.8	799.3
Slovenia	3.1	1.1	36.7	1,488.5	546.9
Hungary	21.5	9.2	42.7	2,181.2	931.0

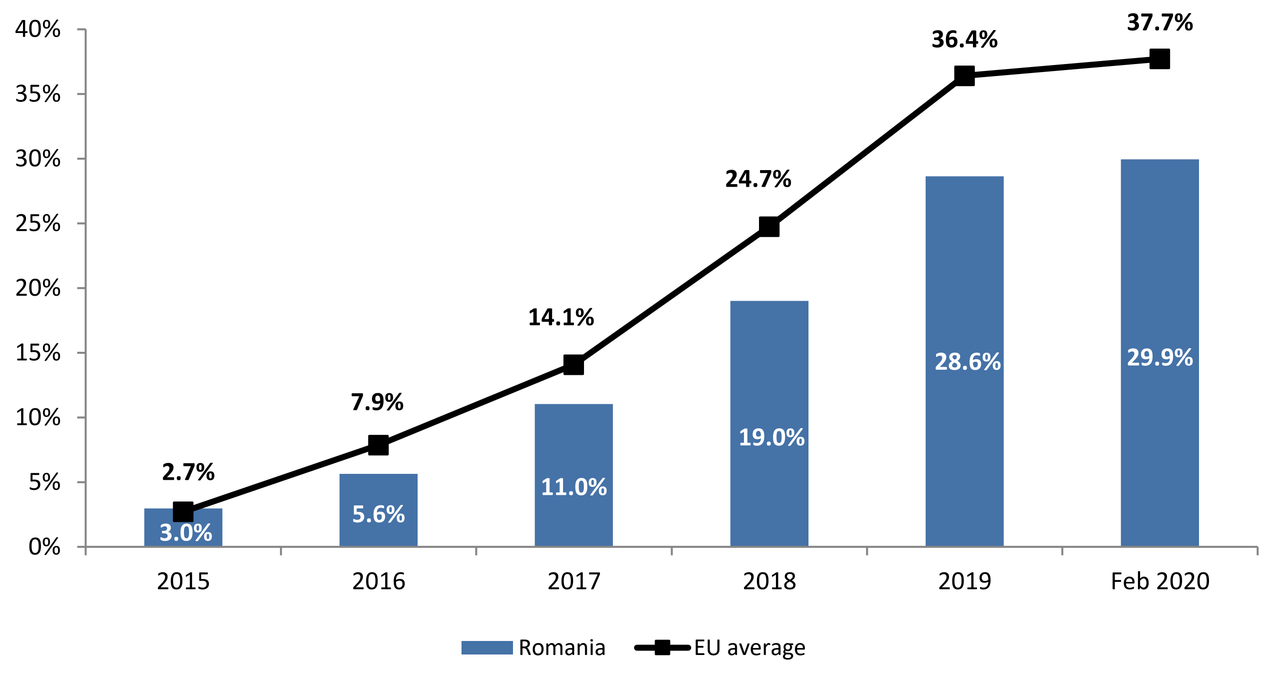
Source: EC, Eurostat, Fiscal Council's calculation

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

From the perspective of the absorption rates of structural and cohesion funds recorded in February 2020, Romania and Croatia continue to occupy the last positions in the ranking, our country remaining on the penultimate place (with an absorption rate of 29.9%) while preserving a slight lead over Croatia (with an absorption rate of 27.1%). With the exception of Slovakia (31.9%), all the other states included in the analysis reached absorption rates of over 36%, with the highest values being recorded for Estonia (46.3%), Poland (43.5%) and Hungary (42.7%). Thus, although Romania registered an advance of over 9 pp compared to March 2019, the growth rate was lower in comparison to the majority of the new Member States from Central and Eastern Europe, and the gap towards them remained the same or even widened compared to developments from previous years. In this sense, it should be noted that the average absorption rate of the analyzed countries (excluding Romania and Croatia, which rank on the last positions) is 40.9%, highlighting an unfavorable gap of 11 pp in the case of our country.

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

Figure 38: Evolution of EU funds absorption rate: Romania versus EU average, 2015-February 2020 (2014-2020 financial framework)



Source: EC, Fiscal Council's calculations

The unfavorable gap relative to the other EU Member States can also be observed by analyzing the evolution of the absorption rates of the structural and cohesion funds in Romania compared to the EU average (see *Figure 38*). The 2014-2020 programming program started with difficulty both in Romania and at EU level, due to the late completion of the related legislative framework. Consequently, the first years of the period recorded low absorption rates, with Romania being close to the European average. However, since 2016 there has been an unfavorable gap towards the EU average, which has continued to increase every year, so that in February 2020 it had reached almost 8 pp. Given that the funds allocated for the 2014-2020 programming period can be spent by the end of 2023, the unfavorable evolution of the absorption rate, both relative to the EU average and to the new Member States in the region, raises serious questions about the possibility of repeating the difficulties in absorbing European funds, manifested during the previous financial framework.

In the Country Report published at the beginning of 2020, the EC considers that Romania is one of the main beneficiaries of the cohesion policy, many programs being dedicated to funding the structural transformations of the Romanian economy and mobilizing private investments, but points out that the absorption of allocated funds is well below the European average (a fact confirmed by the analysis carried out in this chapter). The low absorption rate can also be explained in terms of limited progress or lack of any progress in implementing the 2019 Country Specific Recommendations regarding:

- Improving the set of core competences acquired through education, especially the digital ones, the EC noting the lack of comprehensive reforms in this area despite being supported through the ESF;

- Focusing investment policy on key areas such as transport, infrastructure and innovation. Thus, despite the availability of European funds, the EC notes the delays in implementation due to lack of administrative capacity and inefficiency of public procurement procedures;
- Improving the preparation of financing applications, prioritizing large-scale projects and accelerating their implementation, the EC noting that the 2020-2022 Fiscal Strategy provides for low levels of capital expenditures, respectively for those financed by European funds;
- Improving the efficiency of public procurement and implementing the national strategy in this area. The EC mentions the change in the *ex-ante* control system and the persistence of unpredictability in legislative changes as risk factors with a significant impact on the absorption of European funds.

The absorption of European funds is an objective of national importance and a solution for stimulating the economy, generating a series of positive effects for society such as: reducing disparities between regions, poverty and social exclusion, improving the quality and relevance of education, developing a sustainable transport network and investments in infrastructure, improving water and waste management systems, promoting the competitiveness of companies, as well as their research and innovation capacities, etc. Moreover, in the context of the large-scale budget slippage recorded in 2019, when the GCB deficit has substantially exceeded the 3% of GDP threshold, the importance of absorbing European funds becomes even more pronounced in order to reduce the strain on the public budget. Given that the available data indicates an unfavorable evolution of absorption rates, with the gap towards the EU average and the Member States in the region widening from one year to the next, increasing the absorption rate of European funds appears to be a pressing need. In this regard, given the limited progress made in implementing the EC recommendations, efforts to improve the absorption of European funds should focus on: strategic investment planning in key areas, increasing the administrative capacity to manage projects, prioritizing large-scale projects and accelerating their implementation, improving the efficiency of the public procurement system and ensuring the predictability of the legislative framework.

V. The sustainability of public finances

V.1. Arrears of the general consolidated budget

The arrears of GCB[99] to the private sector are no longer a major problem as a result of improving financial discipline during recent years both at central and local levels. At the end of 2019, the volume of arrears registered 136.4 million lei, decreasing by 56.2 million lei compared to the same period of the previous year, respectively a reduction by 29%.

In what concerns the outstanding payments with a delay of less than 90 days, that do not belong to the category of arrears according to the Public Finance Law no. 500/2002, they have reached a level of 808.6 million lei at the end of 2019, representing an inferior level compared to the preceding year (842 million lei) by 33.3 million lei, respectively, lower by 4%. Compared to 2018, the decrease in arrears was mainly located at the level of the social security budget (-235 million lei, respectively a level of 15.2 million lei relative to 250 million lei in December 2018). Significant increases in outstanding payments with a delay of less than 90 days were registered at the level of local budgets, by 190.9 million lei (+38%) compared to the end of 2018, and in the case of the state budget, increased by 15 million lei (+12%).

The total outstanding payments of the GCB to private sector companies reached a level of 926.6 million lei at the end of 2019, lower by 91.5 million lei compared to the same period of the previous year (1017.7 million lei). This reduction was mostly caused by the decrease of total arrears by 57.4 million lei (-30%), mainly in the local budgets' arrears (-44.2 million lei). Also the outstanding payments with a delay of less than 90 days to private sector decreased by 36.7 million lei (-4.4%), and in their structure mainly for hospitals (-235 million lei), which offset the increase in local budgets (+188.1 million lei).

The following table shows the quarterly evolution of the stock of outstanding payments of GCB (arrears and overdue payments with a delay of less than 90 days) in total and in structure: state budget, local budgets and social security budget (SSB), compared to the end of the previous year. Overall, there is a good development, with a significant reduction in the stock of outstanding payments at SSB level and a relatively close to the previous year's level in the case of the state budget. In contrast, at the level of local budgets, even if the stock of arrears decreased compared to the previous year (-60.5 million lei, respectively by 35%), however, in terms of outstanding payments with a delay of less than 90 days, there is a deterioration compared to the end of 2018 (+191 million lei, respectively +38%), resulting in the increase of the stock of outstanding payments of GCB by 130.4 million lei (+19.4%).

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

Table 16: Quarterly evolution of GCB overdue payments (0-360 days) in 2019 (million lei)					
	Q4 2018	**Q1 2019**	**Q2 2019**	**Q3 2019**	**Q4 2019**
State budget	**111.1**	**93.2**	**123.0**	**138.9**	**126.1**
Under 90 days	89.8	70.7	98.9	114.6	100.6
Over 90 days	2.2	2.8	3.3	5.3	6.2
Over 120 days	6.1	5.5	7.6	6.8	7.2
Over 360 days	12.9	14.2	13.1	12.2	12.2
Local budgets	**673.3**	**734.6**	**794.6**	**812.2**	**803.7**
Under 90 days	502.0	578.8	638.1	662.2	692.8
Over 90 days	70.9	58.8	62.3	54.3	38.7
Over 120 days	70.0	64.1	62.4	54.3	34.4
Over 360 days	30.4	32.9	31.7	41.4	37.8
Social security budget	**250.2**	**17.5**	**19.2**	**10.6**	**15.2**
Under 90 days	250.2	17.5	19.2	10.6	15.2
Between 90 and 360 days	0.0	0.0	0.0	0.0	0.0
Total overdue payments	**1,034.6**	**845.3**	**936.7**	**961.7**	**945.0**
Under 90 days	**842.0**	**667.1**	**756.2**	**787.4**	**808.6**
Over 90 days	73.1	61.5	65.7	59.6	44.9
Over 120 days	76.2	69.6	70.0	61.2	41.5
Over 360 days	43.4	47.1	44.8	53.5	50.0
Total arrears (90-360 days)	**192.6**	**178.2**	**180.5**	**174.3**	**136.4**

Source: MPF

The sizeable reduction of GCB's outstanding payments during the last 7 years (from 3.8 billion lei in 2012 to 0.14 billion lei in 2019) is explained mainly by the implementation of the EU Directive no. 7/2011 on combating late payments in commercial transactions (Law no. 72/2013) and of other legislative measures taken in recent years which aimed to reduce the stock of arrears (GEO no. 29/2011 for regulating the facility of payment rescheduling, GEO no. 3/2013 which restricts the local authorities' possibility of contracting new loans in order to reduce their arrears, GEO no. 12/2013 which introduced a mechanism for the settlement of reciprocal payment obligations).

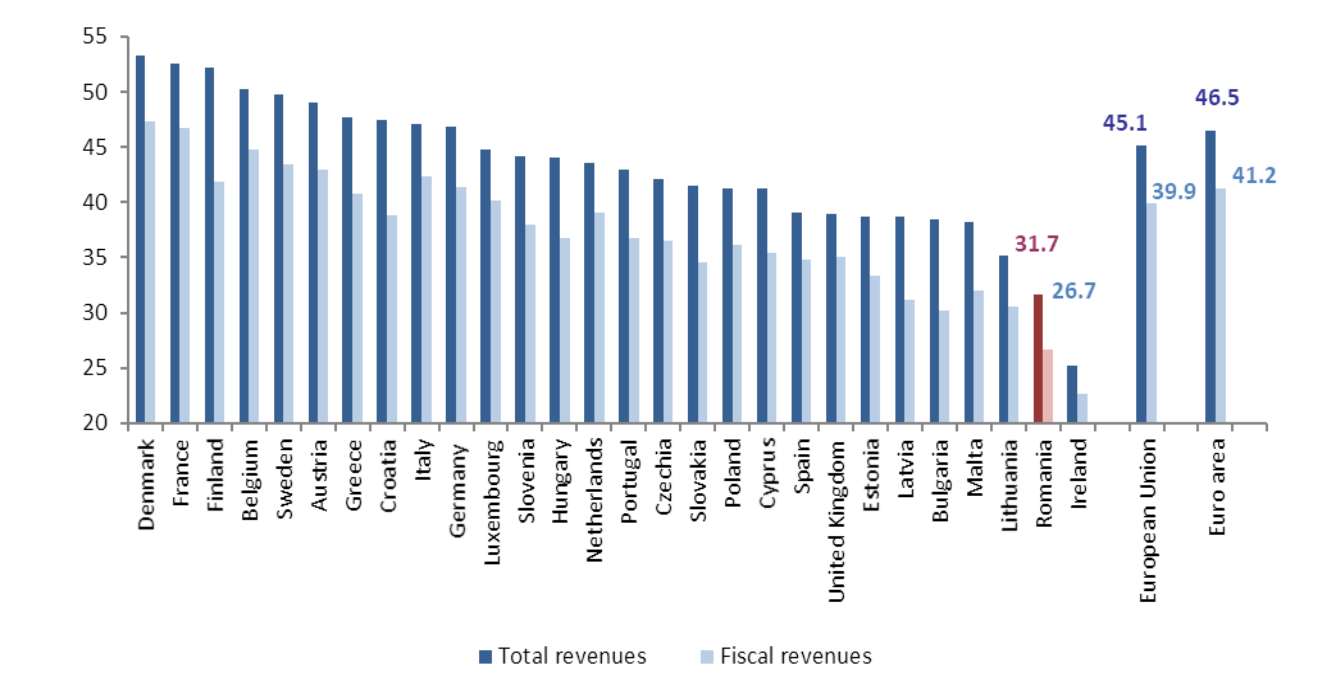
V.2. Tax collection in Romania – international comparisons

The ratio of budgetary revenues to GDP in Romania (tax and non-tax revenues) reached 31.7% in 2019, according to ESA 2010 methodology, a level that is by 13.4 pp lower than the EU average (45.1% of GDP), among the lowest across EU Member States. The ratio of tax revenues to GDP (taxes and social contributions reached 26.7% in 2018, ranking Romania again on the penultimate place, with a gap of 13.2 pp towards the EU average (39.9% of GDP). Analyzing these results in comparison to the previous year, the gap towards the EU average deepened by 0.2 pp in the case of budgetary revenues (from 13.2 pp in 2018) and stood at 13.2 pp in the case of tax revenues.

The share of tax revenues in GDP in 2019 for Romania is significantly lower than in countries with similar economies such as Hungary (36.8%), Slovenia (36.5%), Poland (36.2%) and the Czech Republic (34.6%). Compared with Bulgaria, the share of budgetary revenues in GDP is lower by 6.7 pp, respectively by 3.5 pp in the case of tax revenues.

In 2019, compared to 2015, the effect of the major changes brought by the new Tax Code, which caused an ample fiscal relaxation, led to a 3.8 pp reduction in the ratio of budgetary revenues to GDP (while the indicator increased by 0.4 pp across EU28), respectively to a 1.3 pp decrease in the ratio of tax revenues to GDP (while the indicator advanced by 0.7 pp across EU28).

Figure 39: Budgetary and tax revenues in 2019 (% of GDP, ESA 2010)



Source: Eurostat, tax revenues include SSC

In 2019 the tax revenues' structure in Romania changed slightly compared to 2018[100]. Thus, the share of indirect revenues in total tax revenues increased by 0.7 pp, to 39.7%, net higher than the European average (33.6%). The share of revenue from social contributions (SSC) in total tax revenues reached 42.3%, with 9 pp above the EU28 average (33.3%), Romania ranking fourth in the EU28, after Slovenia,

[100] 2019 is the second consecutive year for which the share of indirect taxes in total tax revenues is lower than for social contributions, the latter increasing significantly due to changes in the social contribution regime through their transfer from employers to employees, as well as additional receipts from legal entities paid on the account of disabled persons, starting with 2018.

Czech Republic and Slovakia. Regarding direct taxes, their share in tax revenues decreased from 18.4% in 2018[101] to 18% (by 15.1 pp below the EU28 average).

Indirect taxes continue to be an important component of tax revenues in Romania, a characteristic which is typical to developing countries, their share in total tax revenues remaining significantly above the EU average (+6.1 pp). The fiscal relaxation measures of the past five years, which led to the reduction of the standard VAT rate from 24% in 2015 to 19% in 2017, coupled with the extension of the reduced VAT rates[102], contributed to the significant reduction of the positive gap between Romania and the EU average, compared to the 2010-2015 period. The fiscal consolidation initiated in 2010, which aimed at raising indirect taxes, led to increasing their share in total tax revenues (from 43.9% in 2010 to 47.3% in 2015), while at EU level this indicator ranged from 33.6% to 33.9% during the same period. In the 2016-2019 period, Romania witnessed a rapid tendency of reversing the share of indirect taxes in total tax revenues (from 42.6% in 2016, to 39.7% in 2019), but they still occupy an important place among budgetary revenues.

The structure of budgetary revenues in Romania is mainly oriented towards indirect taxes and SSC revenues (together they amount to 82% of tax revenues), while, at European level, there is a tendency to balance the share of direct taxes, indirect taxes and SSC revenues, many EU countries that recorded high weights of budgetary revenues in GDP also benefit from relatively high weights of direct taxes in total revenues.

In 2013 an ample reform process of the Romanian tax administration was launched, on May 8, 2013 being signed the Loan Agreement between Romania and the International Bank for Reconstruction and Development (IBRD) which amounted to 70 million euro that were intended to be used for the Revenue Administration Modernization Project (RAMP). Bulgaria has implemented a similar program for restructuring the tax administration between 2002 and 2008 and achieved very good results in increasing collection efficiency, reducing administrative costs and combating the gray economy[103]. RAMP was structured into four components: institutional development; increasing efficiency and operational effectiveness; modernizing services for taxpayers; coordination and project management. The tax administration reform aimed at redesigning and increasing the capacity of the IT system in order to manage a centralized database that includes data on all taxpayers in Romania. The main targets that had to be achieved by the end of the implementation period were: increasing collection efficiency for taxes and social contributions and improving tax compliance, as well as by reducing the fiscal burden of taxpayers.

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[101] This revenue category is strongly affected by the reduction of the personal income tax from 16% to 10% in 2018.

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

[103] http://documents.worldbank.org/curated/en/704711468232153915/Bulgaria-Revenue-Administration-Reform-Project.

The implementation period of the project was initially estimated at 5 years (starting with the fourth quarter of 2013), but given the delays in carrying out the program 2016 was prolonged by 2 years[104]. Between November 2013 and 2017, the WB conducted periodic analyzes of the implementation and results of this program; starting with 2015 the progress towards achieving the objectives deteriorated, as well as the general risk rating from "high" in 2014 to "substantial" in the 2015-2017 period. The NAFA modernization process stopped immediately after the first stage of the acquisition of the budgetary revenue management system, which was completed after huge delays in October 2017. On November 19, 2018 the MPF submitted, on behalf of NAFA, the request for the cancellation of the RAMP project and the WB was notified that the termination date of the RAMP program[105] was set by the Romanian government on March 31, 2019, the implementation of RAMP being cancelled. Out of the total funds made available by the WB in 2013-2019 were drawn 25.86%[106] (18.1 million euros out of the 70 million euros allocated).

The positive effects registered in NAFA's activity during the implementation of the RAMP project are minor in comparison to the initial objective of the reform, which aimed to implement a computer system that would have allowed NAFA to centralize financial data from the entire country[107] and only limited to the improvement of NAFA procedures; the improvement of NAFA's capacity to analyze and forecast revenues; the participation of over 500 employees in training courses; the development of the voluntary compliance strategy and also the consolidation of management integrity, internal controls, audit techniques and the improvement of anti-fraud measures.

In 2019 NAFA announced the implementation of the program "Strengthening the capacity of the National Agency for Fiscal Administration to support modernization initiatives"[108] with a duration of 2 years. The general objective of the project is to strengthen the capacity of NAFA, by introducing business-oriented electronic public services, mainly targeting the implementation of SAF-T. This is an international standard for the electronic exchange of data between companies and tax authorities on information relevant to tax audits. The expected advantages are: reducing the cost of compliance for companies and improving voluntary compliance, as well as more efficient use of NAFA resources. The total value of the project is 84.7 million lei (18 million euros), of which a large part is financed from non-reimbursable EU funds from the European Social Fund, respectively 71.1 million lei (15 million euros).

It can be appreciated that, due to the implementation of the reform process that aimed at simplifying and making the administrative apparatus for collecting taxes more efficient, the number of fiscal administrations at central level has been considerably reduced, although more efforts are required at

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[104] At the NAFA's request Romanian authorities asked for an extension for the contract, respectively the execution of the project until September 30, 2020 and the deadline for withdrawing payments until March 31, 2021.

[105] By GD no. 109 / 10.02.2020 it was agreed by both parties to cancel the financing of the RAMP project.

[106] https://static.anaf.ro/static/10/Anaf/Relatii_R/Raport_audit_27052019.pdf.

[107] This objective was practically canceled by GEO no. 77/30.10.2017 which established the National Center for Financial Information, within the MPF.

[108] https://static.anaf.ro/static/10/Anaf/Relatii_R/descriere_SIPOCA_604.pdf.

the local level. According to the OECD *Tax administration 2019*[109], Romania was placed in 2017 on the second-place regarding the number of financial administrations (and similar for the number of employees in tax collection apparatus/1000 of inhabitants). Compared to the indicator tax revenue /GDP per one thousand employees, Romania was on the penultimate place among NMS-CEE, and expressed in percentage of wage costs/operating budget on the first place in NMS -CEE (and the second of the EU28 states, after France).

The broad and complex process of simplifying the tax system and reducing bureaucracy has taken place gradually, the recognition of this progress being highlighted by the annual Paying taxes reports issued by PricewaterhouseCoopers (PwC) and the WB's Doing Business reports. Thus, the latest available report, Paying Taxes 2020 (for the reference year 2018[110]), ranks Romania, from the perspective of ease of paying taxes, on the 32th place among the 189 analyzed countries, a better position compared to the previous year (49/190 countries). Compared to the previous year, in 2018 the annual number of hours required to pay taxes remained the same (163 hours), as did the number of annual payments that a company must make in order to pay tax duties (14 payments). The share of taxes in total profits dropped from 40% in 2017 to 20% due to transferring social contributions from employer to employee[111]. Thus, a medium-sized company in Romania made 3.1 more payments per year compared to the European average (10.9 annual payments), well below the global average (23.1 annual payments), and consumed for calculating, filling and filing tax returns 3 hours above the European average (160 hours), well below the global average (233.9 hours). From the perspective of the total tax rate (20%), in 2018 Romania placed well below the European average (39.0%), and the global average (40.5%)- see *Table 17* referring to the efficiency of the tax system.

From the perspective of the new sub-index of *ex-post* compliance introduced since 2015, respectively of the ease with which a company can start the processes related to VAT refund and to the audit that is required in the case of correcting errors found in the tax returns concerning corporate income tax, Romania is among the countries whose procedures are considered to be carried out with great difficulty being better positioned only relative to Bulgaria. Thus, the *ex-post* compliance index registered a level of 76.8% (as in the previous year), below the European average of 83.1%, but above the global average – 60.9% (where 100% represent processes with maximum efficiency and 0% totally inefficient processes). For comparison with NMS-CEE countries: Estonia recorded a level of 99.4% for this sub-index, Latvia - 98.1%, Lithuania - 97.5%, Slovakia - 87.2%, Slovenia - 80%, Poland - 77.4%, Bulgaria - 71.2% and Hungary – 87.5%.

[109] http://www.oecd.org/ctp/administration/tax-administration-23077727.htm.

[110]The report is based on the latest data updated on July 1, 2019 and refers to the fiscal year 2018 (data on corporate taxation are available after financial statements consolidation). Also includes the reforms implemented since May 2018 to May 2019.

[111] From 22.75% in 2017 to 2.25% in 2018 for employer (concurrent with the increase from 16.5% to 35% for employee).

Table 17: The efficiency of the tax system										
	Estonia	*Latvia*	*Slovenia*	*Lithuania*	*Bulgaria*	*Slovakia*	*Poland*	*Czech R.*	*Hungary*	*Romania*
Year	**The ease of paying taxes (aggregate ranking)**									
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**
2017	14	13	41	18	92	48	69	45	86	**49**
2018	12	16	45	18	97	55	77	53	56	**32**
	Number of payments per year required in order to pay tax duties*									
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**
2017	8	7	10	10	14	8	7	8	11	**14**
2018	8	7	10	10	14	8	7	8	11	**14**
	Number of hours per year required in order to pay tax duties**									
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**
2017	50	169	233	99	453	192	334	230	277	**163**
2018	50	168,5	233	95	441	192	334	230	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**
2017	48.7	32.6	31.0	42.6	27.7	49.7	40.7	46.1	40.3	**40.0**
2018	47.8	38.1	31.0	42.6	28.3	49.7	40.8	41.6	37.9	**20.0**

Source: PwC and WB

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

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

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

It should be noted that, from the perspective of the Digital Economy and Society Index (DESI, see *Box 2*) for 2019, according to the EC study[112], Romania ranks 27th out of the 28 EU member states. In terms of digital public services, Romania has the lowest performance among Member States, despite the high share of e-government users (ranked 7th in the EU). This poor performance in the efficiency of e-government provisioning public services is also revealed by the ranking concerning the e-Government Development Index (EGDI[113]) developed by the United Nations (UN) Romania being placed the last in the EU, and respectively, on the 67th place out of 193 countries analyzed in 2018[114], although recorded an increase in the number of online services compared to the previous edition. Among the reasons for this poor development are: the deficient legislative framework in the field of digitization, the non-standardized technological infrastructure in public institutions, as well as the lack of concern regarding the development of the necessary digital competences in the administrative apparatus. The study conducted by the UN shows that a good performance of e-government is a key element for implementing a sustainable development.

Box 2: Digital Economy and Society Index (DESI)

The index monitors overall digital performance in the EU, tracking Member States' progress towards a digital economy and society, and is the analytical tool for the evolution of digital competitiveness in the European Semester. DESI includes a detailed analysis of national digital policies, providing an overview of progress in the digitization of the economy, while identifying sectors that need investment and priority measures. The areas covered are: connectivity, skills, use of internet services, implementation of digital technology by enterprises, digital public services, investment in research - development - innovation dedicated to information and communication technology and the use of funds available for research and innovation under the program Horizon 2020 by the Member States. The statistics from the last 5 years have shown that the performance of countries that set ambitious targets in line with the EU Digital Single Market Strategy and made targeted investments has improved significantly in a relatively short period of time.

Compared to similar economies, Romania enjoys an average tax collection rate from VAT receipts (see *Figure 40*), despite registering the lowest VAT weighted average rate. In terms of VAT receipts as share of GDP and VAT weighted average rate (based on HICP weights and characterized by the limitations described in subchapter III.3.1), Romania was ranked in 2019 on the last position of the new EU Member States. With a weighted average rate of 14.2%, Romania collected 6.2%[115] of GDP from VAT, being the last in the ranking, with a gap of -1 pp compared with Slovakia which collected 7.2% of GDP from VAT,

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[112] https://ec.europa.eu/digital-single-market/en/countries-performance-digitisation.

[113] EGDI measures 3 major aspects of e-government: providing online services, telecommunications connectivity and digital abilities.

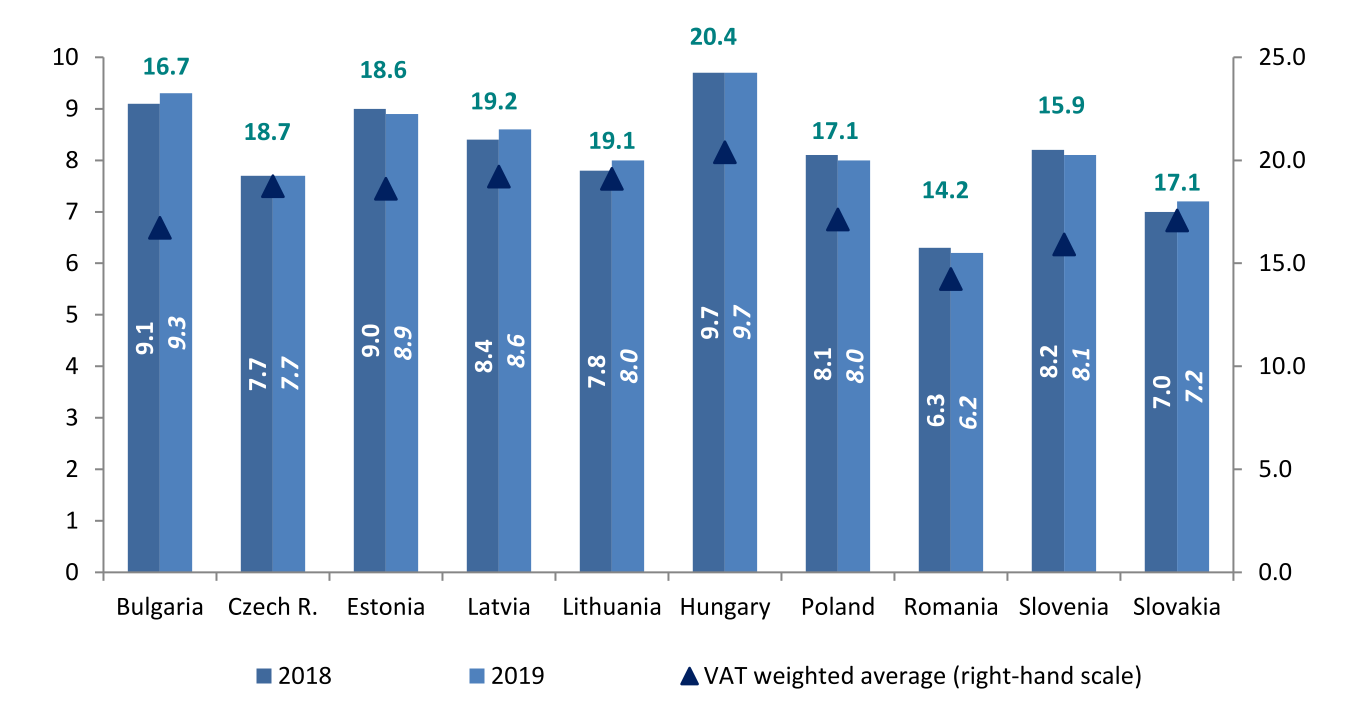
[114] The study is conducted with a frequency of 2 years, the last release was in September 2018.

[115] This indicator decreased by 0.1 pp compared to 2018, when 6.3% of GDP was collected from VAT.

despite a higher average weighted rate (17.1%). It is worth mentioning the exceptional performance of Bulgaria, having a structure of the economy similar to that of Romania and a 16.7% VAT-weighted rate collected the second highest share of VAT receipts to GDP (9.3% of GDP in 2019), behind Hungary with 9,7% of GDP (while having a VAT-weighted rate of 20.4%) and well above the level of countries with higher weighted average rates, such as Latvia (19.2%), Poland (18.7%), Estonia (18.6%) or Slovakia (17.1%).

According to a recent EC study on VAT collection[116], in 2017, Romania ranked last by the level of VAT collection among all EU Member States, recording a VAT collection deficit[117] (VAT Gap) estimated at 29.3 billion lei, respectively at 35.5% in the theoretically estimated revenues to be collected (VTTL), the highest value in the EU and CEE.

Figure 40: VAT revenues in 2019 compared with the previous year (% of GDP)

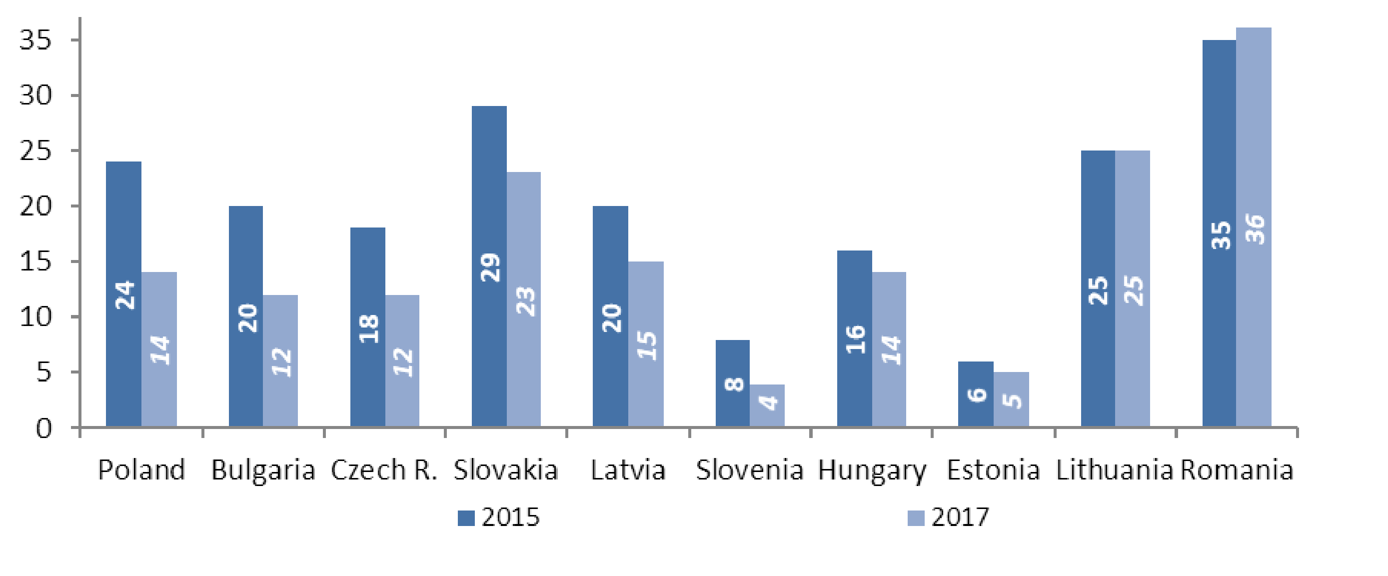


Source: EC, Eurostat

[116] *Study and Reports on the VAT Gap in the EU-28 Member States: 2019 Final Report* https://ec.europa.eu/taxation_customs/sites/taxation/files/vat-gap-full-report-2019_en.pdf.

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

Figure 41: VAT gap in 2017 compared with 2015 (% of VTTL)



Source: EC-Taxud, 2019

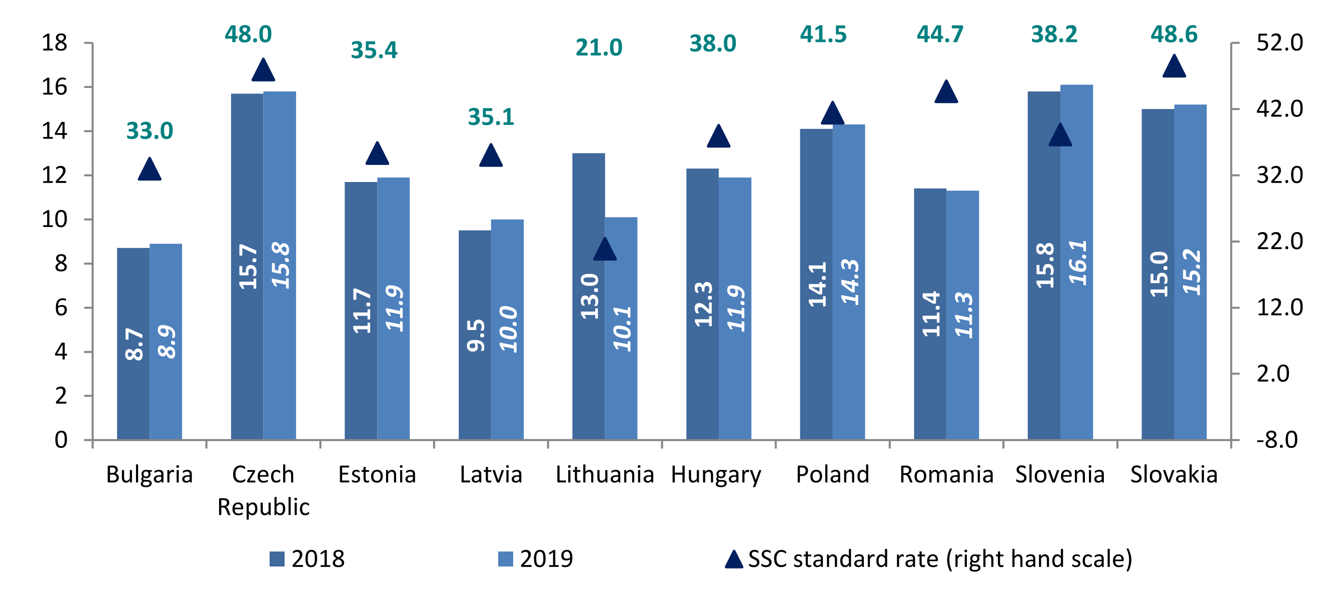
Comparatively, Estonia recorded a VAT gap relative to the theoretically estimated revenues to be collected of 5%, the Czech Republic and Bulgaria 12%, Hungary and Poland 14%, Slovakia 23%. Note the evolution of Bulgaria and Poland in 2015-2017 (see *Figure 41*), when both countries implemented consistent fiscal administration reform programs during this period. Thus, compared to 2015, in 2017, Bulgaria reduced this indicator by 8.2 pp, and Poland by 10 pp (and by 6 pp in 2017 compared to 2016), while for Romania this indicator even increased from 35% to 36%, remaining at the highest level in the EU.

Regarding the share in GDP of **social security contributions** paid by employees and employers relative to the statutory rate, Romania is evidenced by having the lowest level of collection rate for this category of revenues (see *Figure 42*). Thus, the revenues collected in 2019 decreased slightly compared to the previous year (-0.1 pp of GDP), registering a level of 11.3% of GDP, but corresponding to the statutory rate of 44.7%[118] (corresponding to the legal rate of 37.25% adjusted with the tax base, to make it comparable with other countries) - ranking the third among the analyzed member states - represents one of the lowest values in this sample, superior only to Lithuania (receipts of 10.1% of GDP, in the context of a statutory rate of only 21%) and Latvia (with 9% of GDP, with a statutory rate of 35.1%) and Bulgaria (8.9% of GDP, but with a statutory rate of only 32.4%). Slovenia (SSC revenues of 14.6% of GDP), Estonia and Hungary (each, 11.9% of GDP), surpassed Romania, even the legal rates of social contributions are significantly lower. Compared to Poland, which collected 14.3% of GDP from social contributions, the statutory rate in Romania is by 3.2 pp higher, while compared to the Czech Republic which is the leader of this ranking with SSC revenues of 15.8% of GDP, the equivalent legal rate in

[118] Starting with 2018 this level was calculated as equivalent to the increase in gross wages due to the shift of social contributions from the employer to the employee.

Romania is by 3.3 pp lower. A more detailed analysis of the indicators on tax efficiency is presented in sub-chapters III.4.1. VAT and excise duties, respectively, III.4.3. Social security contributions.

Figure 42: Social security contributions revenues in 2019 (% of GDP)



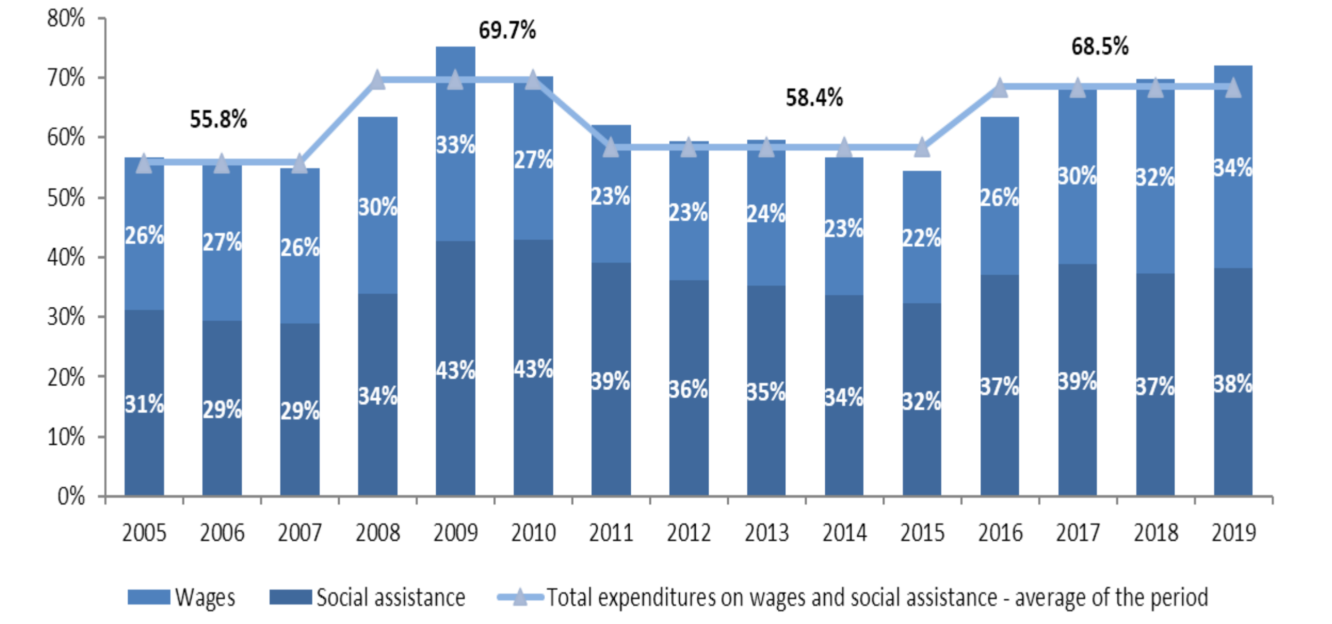
Source: EC, Eurostat

Concluding, after a relative improvement in terms of efficiency and simplifying the administrative apparatus of tax collection, from both the perspective of decreasing the number of financial administrations (even if it can be noticed an increase in the number of employees in these structures), but also in terms of ease of paying taxes, in 2019 the reform initiated in Romania in this field seems to be stagnating, and having in view the cancelling the RAMP project, and also the reform measures implied , can be even considered as a regress. Romania's position in 2018 among the first half in the global ranking of *Paying Taxes 2020* can be seen as a positive result, but maintaining a leading position implies further efforts to continue investments in fiscal infrastructure and digital technology, since the digitalization of the financial reporting has the potential to make more efficient the internal processes of the tax authorities, including the control and monitoring mechanisms.

V.3. Public expenditure – structure and sustainability

In Romania, the budgetary expenditures' structure is characterized by the dominance of personnel and social assistance expenditure (pensions, social aids, etc.). Although their relative importance has declined significantly in 2011-2015 period as a result of the fiscal consolidation, 2015 representing the minimum of the analyzed period, starting with the year 2016 recorded the reversal of this evolution (*Figure 43*), the personnel and social assistance expenditure strongly augmented by 9 pp compared to the previous year. In 2019, the increasing trend continued, but with a smaller pace, reaching 72.1% (from 69.7% in 2018) and higher than the average of 69.7% for the period 2008-2010.

Figure 43: The evolution of social assistance and personnel expenditures as share of total budget revenues (%)



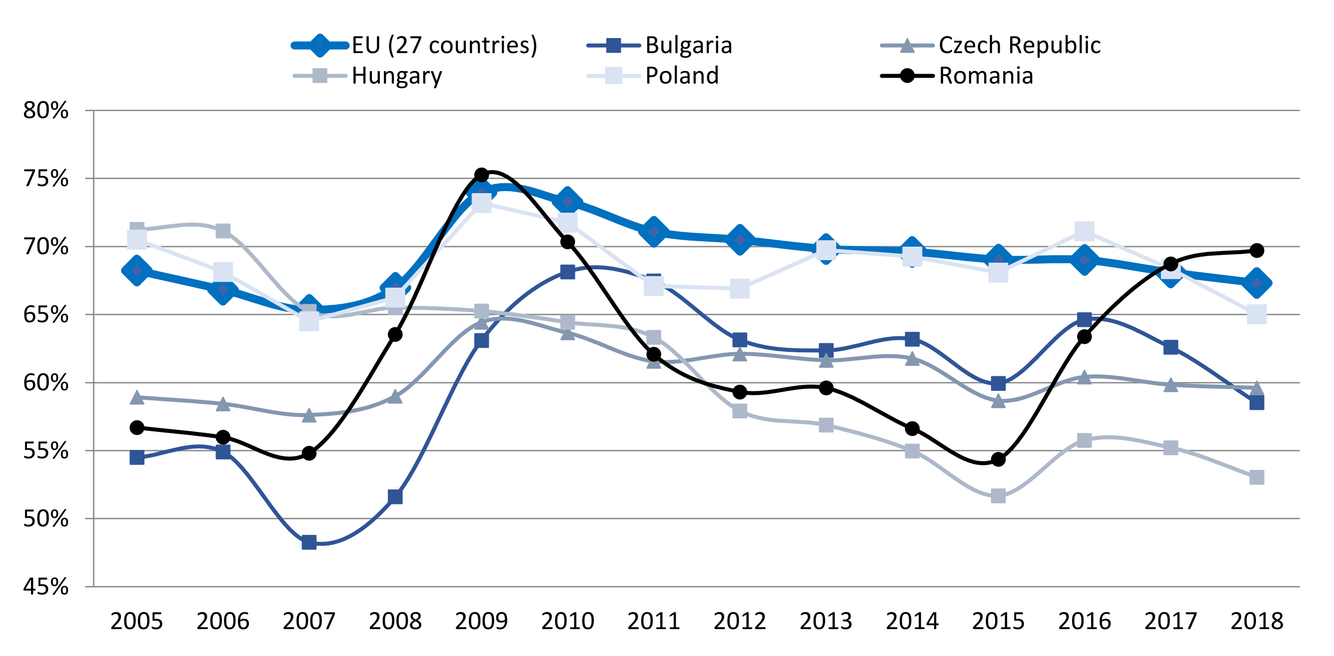
Source: Eurostat

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.

This development can be attributable to the nominal increase of these expenditure categories compared to the previous year, respectively by 14.6% for the expenses related to the compensation of the employees (due to the wage increases in the public sector) and 13.8% for the social assistance expenditures, that surpassed the increase of 10.6% 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 2019 (33.8%) is superior to the average of the period 2008-2010 (29.9%), while the share of social assistance expenditure (38.2%), although at distance compared to the average for the period 2008-2010 (39.8%), is still higher compared to the average of 2011-2015 (35.3%), the expansionary fiscal policy of the last three years cancelling the effect of adjustments in personnel and social assistance spending made in the period 2011-2015. Compared to the previous year, the share of social assistance expenditure in the total budgetary revenue increased by 0.9 pp, while personnel expenditure’s share in the total revenues increased by 1.4 pp.

Starting with 2018, the change in the tax regime by transferring contributions from employer to employee determined a significant increase in gross wage, which was equivalent to increasing the contribution to the social security system. These measures, combined with the reduction in the share transferred to Pillar II, have contributed to a substantial improvement in the system's self-financing capacity over the last two years. On the other hand, the share in total revenue for this category of expenditure still remains very high compared to other EU Member States and the application of the new pension law contributes further to its growth. 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 2016-2019 there was a trend of massively increasing the personnel expenses by significantly higher rates than nominal GDP and public revenue growth rates over this interval.

Figure 44: Social assistance and personnel expenditures (including pensions) share in total budget revenues in EU28 and CEE in the period 2005-2019



Source: Eurostat

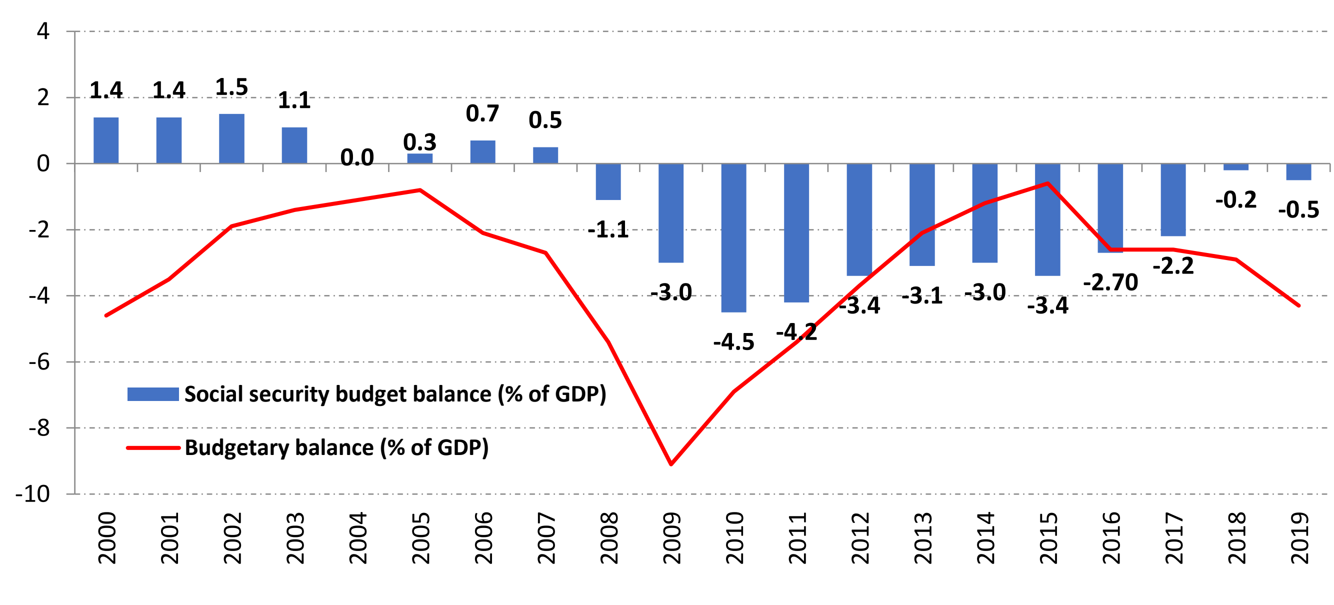
Note: Taking into account the change in the treatment of special pensions by Eurostat, for Romania the personnel spending and the budget revenues have been adjusted accordingly to avoid double counting.

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[119], with a maximum of 75.3% in 2009, when Romania recorded the largest share of personnel and social assistance expenditures in total budget revenues at the level of CEE countries, and also a level superior to the EU27 average. Following the implementation of the fiscal consolidation program, the share decreased significantly, falling below the level recorded in the CEE countries, with the exception of Hungary, in the period 2013-2015. However, starting with 2016 Romania reversed this trend, and due to the aggressive increases in the public-sector wages and pension benefits, in 2018 was recorded, similar to 2009, the highest level of the personnel and social assistance spending related to the budget revenues in the region (70.1%). In 2019, the share of this spending category in revenues reached 72.1%, being by 5.1 pp above the next ranked country, Poland and by 21.2 pp above the first ranked country, Hungary. Compared with the EU28 average (67.7%) is by 2.7 pp above. The evolution of this indicator for the CEE countries and the EU28 average in the period 2005-2019 is presented in *Figure 44*.

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

Regarding the development of the social security budget (pensions, unemployment and health) it is noticed that, if in the period 2000–2007 was characterized by a relatively equilibrated or even positive balance, after 2008 registered deficits that represented an important component of the general consolidated budget deficit, respectively between 65% and 85% in the period 2010-2017. In 2019, the deficit of social insurance systems reached 12% of the total deficit, after in 2018 was reduced considerably, as a result of the fiscal measures repositioning the assessment of the tax base, materialized in the increase of taxation through social contributions (reaching 7% of the total budget deficit). Basically, in the period 2013-2016, 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 2019), 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 45* is relevant for the relationship that can be established between the dynamics of wage growth and social assistance expenditures in recent years, and the dynamics of the SSB balance besides the evolution of the consolidated public deficit.

Figure 45: Social security budget deficit (pensions, unemployment and health) and total budget deficit – ESA 2010 (% of GDP)



Source: Eurostat

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

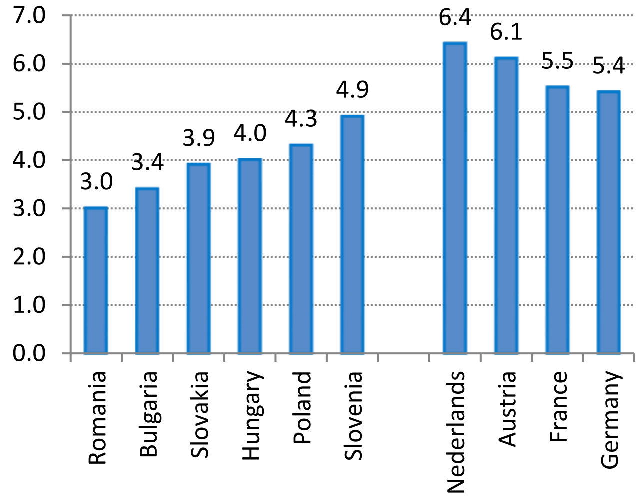
According to the Global Competitiveness Report 2019 edition, Romania ranks on one of the last positions compared with EU member states in terms of transport infrastructure quality, with a score equal to 71,7% [120]. However, the score on the Infrastructure pillar represents only a part of the global

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

competitiveness index (ICG 4.0), for which Romania registers a score of 64%, rising a position to 51st place out of 141 countries, compared to 140 in 2018. The top is led by Singapore (with a score of 84.8%), followed by the United States (with 83.7%) and Hong Kong (with 83.1%).

The efficiency reserves on the budget expenditure side are still very high. For example, Romania ranked 5th in terms of allocation for investment expenditures in 2009-2019 as a percentage of GDP among all EU countries and in second place as their share of budget revenues in the last 11 years. Despite all these budgetary efforts, the results were very modest, with Romania having the weakest transport infrastructure in the EU in 2019 (*Figure 46*), after occupying the third position in 2018, being followed only by Bulgaria and Malta[121]. Related to the previous year, investment expenditures increased in 2019 by about 0.7 pp, reaching 3.4% of GDP. Thus, is the second year of the analyzed period when this budget aggregate increase as share in GDP against the previous year but this value is still significantly lower than in 2009, by 41% lower, respectively by 2.4 pp of GDP.

Figure 46: Quality of transport infrastructure



Source: World Economic Forum, The Global Competitiveness Report 2019

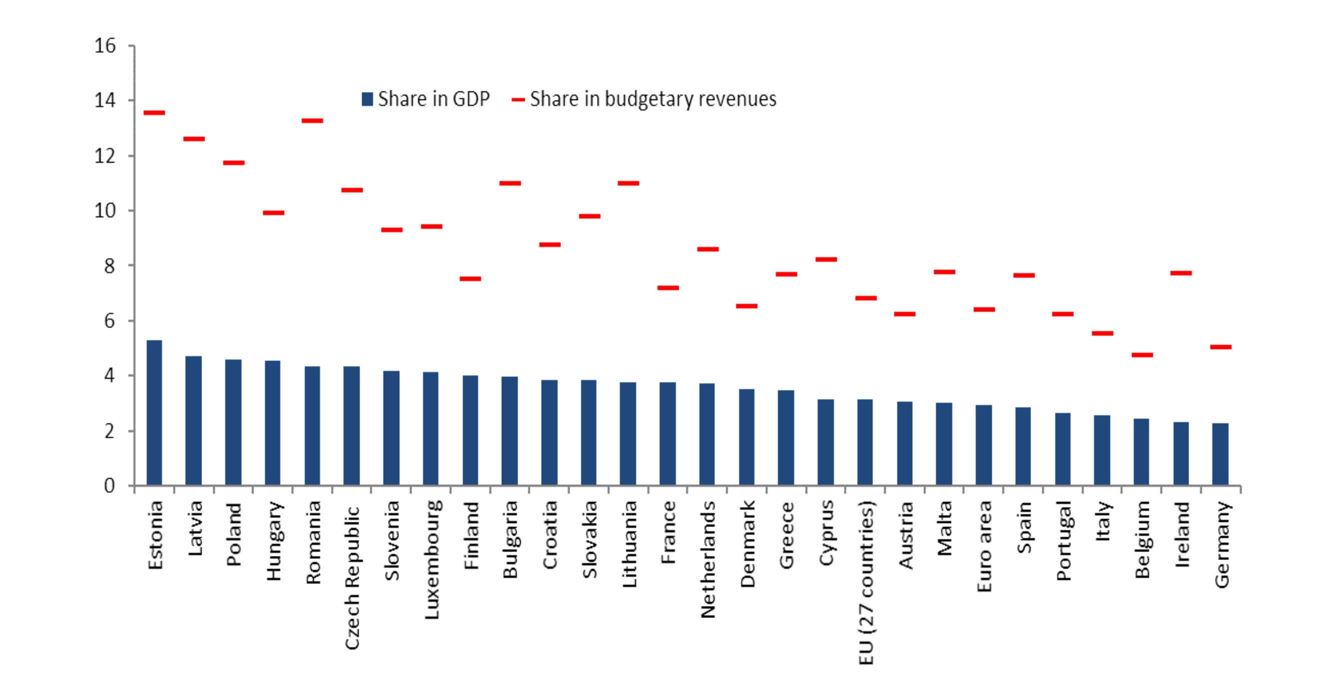
Compared to 2015[122], public investment expenditures as share of GDP are 34.6% lower, respectively by 1.8 pp. From the perspective of investment spending as share of GDP, Romania was placed in 2019 on the 14th place in the EU27 (rising 7 positions compared to 2018) and on the penultimate place among the CEE countries, before Bulgaria.

Related to budget revenues, public investments spending increased by 2.3 pp compared to the previous year, but reduced by 3.9 pp compared to 2015, staying well below the pre-crisis level. Under these circumstances, increasing the efficiency of public spending is more than necessary, given that it is unlikely that high levels of the past allocations for this destination can be sustained in the near future.

[121] World Economic Forum, The Global Competitiveness Report 2019.

[122] 2015 was the first year after 2008 that public investment expenditures increased as share of GDP compared to the previous year, given that this year was the deadline for attracting European funds for the financial year 2007-2013.

Figure 47: The share of investment expenditures in GDP and in total budgetary revenues (average 2009-2019)



Source: Eurostat

VI. 2020 – Macroeconomic and Fiscal Perspectives

VI.1. Macroeconomic framework

In 2019, Romania was in the process of decreasing the growth rate of the economy, under the action of slowing external demand and contraction of industrial production, both originating from unfavorable external developments, such as the US-China trade war, and the placing of the world economy in the final phase of the economic cycle after an unusually long expansion phase. The forecasts of moderate economic growth for Romania have changed radically following the outbreak of the COVID-19 pandemic in early 2020.

The magnitude of the pandemic shock at the global economy level, provoked by the SARS-CoV-2 virus, is unparalleled in contemporary history causing a major and very rapid turn in the economic activity. The unprecedented impact, since the Great Economic Crisis of 1929-1933 and without terms of comparison in recent history regarding its dimensions and intensity, derives from its multiple economic transmission channels: both on the demand and supply side, with an aspect related to confidence (of consumers and companies), as well as a possible transmission and amplification of these shocks on the financing channel, all against the background of a global health crisis. Altogether, the current crisis is leading to amplified uncertainties in assessing current and future economic policies and developments, which by themselves can be a channel for the transmission and amplification of shocks. The current crisis also has a peculiarity from the perspective of economic policies - being determined by a health crisis, as an exogenous factor, their active response may be, in some cases, undesirable for a period of time even in the most affected sectors. After overcoming the acute phase of the health crisis, active economic policies can help a faster return to economic coordinates close to the previous ones, but the remanence of adverse effects and structural changes that may affect future dynamics are to be considered, as well as the possibility that, in many facets, *post*-pandemic economies may differ, sometimes radically, from pre-pandemic ones.

The latest IMF forecast[123] for the world economy estimates that gross domestic product will decline by 3.0% in real terms, thus revising by 6.3 pp the previous forecast (January 2020), much above the economic contraction caused by the recession of 2008-2009, when global GDP fell by 0.07% in 2009. The distribution of this contraction shows a higher impact for the advanced economies, of -6.1% (a downward revision of -7.7 pp from the last forecast), mainly in the European countries, the economic impact being almost double compared to the crisis from 2008-2009 (a contraction of 3.3% GDP in 2009). For emerging economies is predicted a smaller contraction, of only 1.0% (a revision of -5.4 pp compared to the previous forecast), and for some emerging Asian countries is foreseen a sluggish continuation of economic growth. This evolution is in contrast to the effect of the global financial crisis of 2008-2009 when emerging economies continued to grow, but at a much slower pace (2.8% in 2009 compared to

[123] World Economic Outlook – April 2020, https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020.

5.7% in 2008). For this year is expected that the US economy will contract by 5.9% (a revision of -7.9 pp), and the Euro area by 7.5% (a revision of -8.8 pp). The European Union economy would contract by 7.1% (a revision of -8.7 pp) more than in 2009, when recorded a real GDP contraction of 4.2%. For 2021, the IMF forecast anticipates a rapid recovery of economies, by 5.8% at global level, 4.7% in the euro area and 4.8% for the EU economy, simultaneously with a pick-up for European emerging and developing countries, at 4.2%.

The EC Spring Forecast[124] estimates for 2020 a real GDP contraction of 7.4% for EU27[125] (from +1.5% in 2019) and 7.7% for the euro area (from +1.2% in the previous year), and for 2021 a rapid recovery is forecasted to materialize in a real GDP growth of 6.1% for the EU27 and 6.3% for the euro area. Compared to the 2020 Winter Forecast, for this year the economic growth projection was revised downwards by -8.8 pp for the EU27 and by -8.9 pp for the euro area. The economic scenario and the underlying assumptions are relatively similar to those of the IMF, namely: (i) a gradual lifting of restrictions, (ii) the pandemic remaining under control, (iii) a significant effect of fiscal and monetary measures adopted by euro area and EU27. A different pandemic cycle compared to expectations, the persistence of uncertainties (regarding jobs, income, sales, economic outlook in general), lower efficiency than expected of the economic policies - for some states due to limited fiscal space available - and other factors (reassessment of participation in global value-added chains, the presence of permanent effects on business sector and labor market, etc.) could lead to more pessimistic scenarios in terms of the future trajectory of European economies. In general, the risks are considered to be overwhelmingly tilted towards more unfavorable economic evolution than in the baseline scenario.

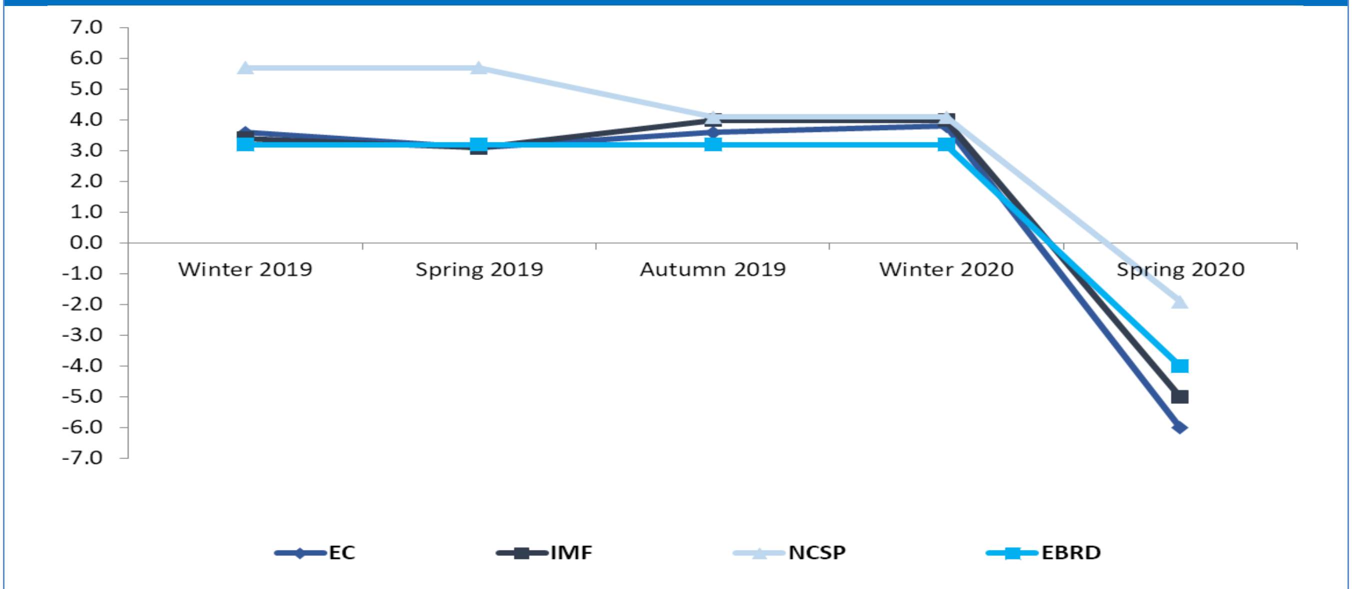
Concerning the economic growth forecasts inside EU27, the EC predicts for 2020 large contractions for Greece (-9.7%), Italy (-9.5%), Spain (-9.4%), France (-8.2%), Ireland and Lithuania (both by -7.9%). The lowest decreases are expected for Poland (-4.3%), Luxembourg (-5.4%), Austria (-5.5%), Malta (-5.8%) and Denmark (-5.9%). For United Kingdom a GDP drop of 8.3% is expected, close to the most vulnerable countries to the actual crisis. The decline in economic activity - starting the first or second quarter of this year - is expected to mark a turning point in the second quarter of next year at the latest. According to the European Commission's projection the world GDP is projected to decline to 3.5% in 2020 in real terms, and to pick-up to 5.2% in 2021. The rapid economic recovery is anticipated to bring the real GDP to higher levels in 2021 compared to 2019 or before the global financial crisis of 2008-2009, but this recovery will be heterogeneous, given the structural characteristics of each economy, the magnitude of the negative shock, and the fiscal-monetary measures adopted that may lead to different trajectories. However, the projection shows that the GDP per capita dispersion degree in European countries could be reduced, even in the context of uneven developments, and would constitute a new phase of restarting the process of economic convergence for European countries, assuming economic normalization in the coming years.

[124] European Economic Forecast, Spring 2020, https://ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-forecasts/spring-2020-economic-forecast-deep-and-uneven-recession-uncertain-recovery_en.
[125] Excluding the United Kingdom.

Relating to the inflation development for EU 27, expressed by the Harmonized Index of Consumer Prices (HICP), for 2020 are estimated low values (0.6% in the EU27 and 0.2% in euro area) in line with the usual macroeconomic relations, and for some countries, even deflationary phenomena are foreseen. It is notable that emerging countries within the euro area, and specially outside the euro area, higher HICP compared with other member states are expected – due to both different monetary and exchange rate policies (for non-euro area countries) and inflationary effects owing to economic convergence process (such as the Balassa-Samuelson effect, administered price alignments, changes in the structure of the consumer basket, etc.). From the perspective of HICP inflation, the major difference in 2020 for EU27 countries is between the anticipated inflation in Hungary (3%), Poland and Romania (2.5%) and the one projected for Greece (-0.6%), Ireland and Italy (-0.3%).

From the perspective of the economic growth rate, the EC anticipates for Romania a contraction of 6% in 2020 - close to that projected by the IMF of 5% - followed by a return to +4.2% next year (+3.9% in the IMF projection). The determinants of the rapid and broad contraction trajectory in 2020 and the moderate return in 2021 are mainly private consumption and gross fixed capital formation (which contract in 2020 by 6.2% and 15%, and then increase by 4.9% and 5% in the following year). Net exports are expected to have a stabilizing effect on economic dynamics, with a positive contribution in 2020 and a gradual return to the previous situation (negative contribution) in 2021. Both the drop in the real economic advance in 2020 and its recovery in 2021 are estimated to be smaller in magnitude compared to most EU countries and the euro area (on average by -7.4 and -7.7% in 2020, and +6.1 and +6.3% in 2021) depending on the particularities of the structure of the economy, the degree of integration in European and global value-added and production chains, the measures taken by the authorities - in the context of twin deficits (current account and budget deficit), as well as the restrictions for the economic policies due to these two imbalances, the spread of the pandemic and the sanitary measures taken by the authorities, as well as other specific elements.

Figure 48: Economic growth forecasts for 2020 in Romania



Source: EC, IMF, NCSP, EBRD

For 2020, the initial forecasts of the EC, IMF and EBRD expected a moderate economic growth in Romania. Subsequently, as more favorable statistical data appeared, the forecasts were revised slightly upwards. In this regard, a process of aligning growth projections to a level of around 4% takes place during 2020, followed, after the outbreak of the pandemic by a new episode of divergence, most of the updated projections of the international financial institutions and the European Commission, anticipating a more severe economic contraction for this year.

According to the Inflation Report, published by the NBR in May 2020, the annual CPI[126] inflation rate will reach 2.8% by the end of 2020 and then decrease in 2021 to the central point of the target range of 2.5%. The projection of a significant deceleration of inflation takes into account the overall economic dynamics, the effect of fundamental factors - the opening of a negative GDP deviation, the slower advance of wages relative to labor productivity - acting to reduce it, partially offset by rising exogenous prices. The CORE2 inflation - which more accurately reflects the impact of the key factors - is projected to drop sharply, to 3.1% and 2.2% respectively in 2020 and 2021.

The latest statistical data published by the National Institute of Statistics (NIS), respectively, those for the first quarter of 2020, indicate a slowdown in the economy, at 2.4% year-on-year, from 4.1% in the previous year, corresponding to a quarter-on-quarter advance of 0.3%, with the remark that the estimates for the first quarter only partially reflect the negative impact of the pandemic, as the emergency state started in mid-March. By branches of activity, the commercial sector, IT, construction and professional activities contribute mainly to the formation of GDP and industry is the branch whose contraction reduces the economic advance. Regarding the GDP utilization in Q1 2020, the main components are consumption (mainly, households) and gross fixed capital formation, while net exports of goods and services act in the opposite direction; also, the significant value of the inventory change contribution to GDP is noteworthy.

In the opinion issued on the occasion of the first budget revision for this year, the Fiscal Council considered that the risks to the real GDP development are tilted downwards, the NCSP projection estimating a 1.9% contraction of real GDP, which substantiated the budget rectification (and was maintained in the Convergence Program of 25 May this year), being considered optimistic in relation to the evolutions of the internal and external environment marked by a high degree of uncertainty. The FC argued the need to take into account two other scenarios that consider more severe contractions of the real GDP, respectively 4-6% and 8%-9%.

When setting up the analysis regarding the macroeconomic scenario assumed by the Government, the FC starts from the first study of the National Institute of Statistics (NIS) which *is representative at the level of economic sectors and at the total economy* (with a response rate of 71.3%). Accordingly, this study analyzes the sectors: manufacturing, construction, retail and services. Their share in GDP (for 2019) is about 65% (considering the manufacturing industry is about 80% of the industrial sector in

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

Romania[127]). The NIS study reveals a contraction in turnover in March and April, by 32% and 40%, year on year. Assuming that cost structures are difficult to change (in the sense of reducing costs), due to the rigidity for both prices for intermediate consumption and contracts settled on the labor market, it was considered that this change is fully transmitted to the gross value added of companies in these sectors.

Considering the historical trend and the NCSP projection for these sectors for 2020, was calculated the contribution of the activity decline in each of the above sectors on the annual GDP dynamics, starting from the data for March and April (April dynamics will be extrapolated for the first half of the month - assuming, implicitly, the hypothesis that after the relaxation of social distancing measures, the economic activity returns to the normal before the pandemic). These calculations lead to an average decline (in terms of annual economic advance) of about 2.6-2.7 pp for each month considered[128]. Thus, for the interval assumed/ with available information up to now, the total impact is -7 pp; starting from a 4.1% increase of GDP for 2020 (projected before this revision – the NCSP winter forecast 2020) corrected with the direct anticipated impact of the pandemic according to the NIS survey, will result an annual GDP dynamics estimate of about -3% for 2020. Considering the assessments from the previous FC opinion regarding the economy dynamics for 2020 - considered as overestimated by about 0.5 pp in the initial draft budget – implies a corrected estimate of -3.5%, also taking into account the NIS data. This level is considered by the FC as a minimum threshold for the real GDP contraction in this year, based on the assessment based on the official data of the National Institute of Statistics.

There are many arguments whose assertion, individually or together, can lead to a larger contraction in GDP relative to the minimum threshold determined above:

(i) for the second half of May this year, the return of the economy to the pace before this unprecedented situation is very unlikely;
(ii) a very rapid recovery of the economy in the third and fourth quarters is also highly unlikely, and could affect the economy over a longer period of time[129];
(iii) other sectors of the economy (representing 35% of GDP) will also suffer from the pandemic;
(iv) the impact (assessed by the NIS) of the contraction in international trade (responses positioned around a decline of "up to 25%" and "25-50%") could amplify the expected effects and could make the restart of economic activity more difficult, particularly as Romania is integrated and dependent on the international value-added chains, the pick-up of the economy decoupled from that of the main trading partners[130] being practically impossible;
(v) the NIS study, which is the basis of the FC estimates, is carried out between March, 17-19, the subsequent developments not being likely to bring improvements, on the contrary;
(vi) agriculture, which usually has a significant contribution to GDP in the first, second and fourth

[127] EUROSTAT NACE A*64 data, with a breakdown of GDP by formation into 64 (sub-) sectors.
[128] Being about 2.5 pp in March and 2.9 pp in April 2020.
[129] For example, a sluggish/slower start will reduce the annual GDP dynamics by 0.5-1 pp, subject to the hypothesis that in the second half of May, after the alleged relaxation of the exceptional state, the developments recorded in April will continue.
[130] At the same time, the estimated economic contraction for Romania's main trading partners is much wider.

quarters, could have a weaker dynamic[131];

(vii) the fall in turnover could be translated into gross value added due to the increase in intermediate consumption costs caused by the current extraordinary situation;

(viii) the assessment of the effects of contraction in the economic sectors is made in isolation, the functional interrelationships (which are usually analyzed, for example, using the input-output matrices) not being taken into account;

(ix) the implications of the financing channel are not considered, and could be a major source of downside risks to the GDP dynamics - as capital outflows from emerging economies reached around 100 billion dollars[132] in Q1 2020 - almost double than the peak of the previous crisis of 2008-2009 - and, moreover, most of the capital outflows took place in other emerging economies than China. Moreover, global economic circumstances could lead to new waves of capital withdrawals from emerging economies, which would complicate, to the point of making it impossible, the recourse to finance the current account deficits of the balance of payments by emerging countries.

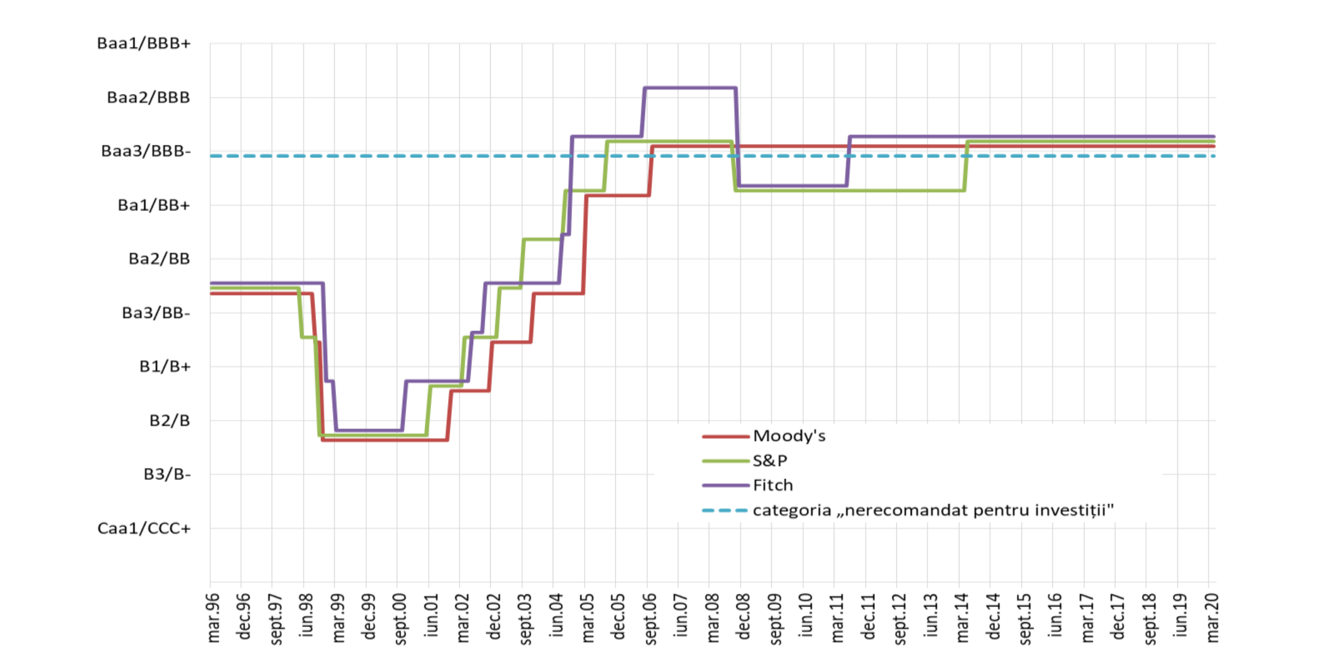
Another risk factor for Romania is represented by the rating placed in the immediate vicinity of the category “not recommended for investments” (see *Figure 49*) – and the impact of adverse developments can be significant on financing the domestic economy. In this regard, according to the statement issued on June 5, 2020, Standard & Poor's maintained Romania's rating at BBB- and the negative outlook on the economy, estimating that the negative effects caused by the COVID-19 pandemic will lead to a substantial increase in public debt.

Another element for substantiation of an alternative macroeconomic scenario is to compare the current situation with that of the major economic crisis that began in 2008, noting that the magnitude of the current shock could be even higher compared to that one. Therefore, the real GDP dynamic in 2009 and 2010 (-5.6% and respectively, -3.9%) is, also, a reference base for the development of this year. Moreover, the previous crisis - rooted in the financial sector – hence being more homogeneous relative to the source and the transmission mechanism, seems to have been easier to combat using economic policies. The current crisis, with its many facets, requires both more extensive economic measures in terms of instruments and in the size of the needed funding resources.

[131] For at least 3 reasons - the basic effect of last year, a less good agricultural year given the current weather conditions, as well as the impact of the pandemic on supply chains and on sector financing.

[132] According to the “Capital Flows Report: Sudden Stop in Emerging Markets” of April 9, 2020, available on the website of IIF (International Institute of Finance) - https://www.iif.com/Publications/ID/3841/Capital-Flows-Report-Sudden-Stop-in-Emerging-Markets.

Figure 49: The evolution of sovereign rating in the period January 2008 - April 2020



Source: Fitch, Moody's, S&P, FC's calculations

Taking into consideration the above assessments, historical references, as well as the above described risk factors, some with a high probability of achievement, the FC considers necessary to consider a macroeconomic scenario with a contraction of the real GDP in the range of 4-6% for this year. Such a scenario is also supported by the projections of international institutions[133]. The projections of other research institutions take into account baseline scenarios close to the values of the GDP dynamics mentioned above, respectively, a contraction of 4-6%. At the same time, the data used for the internal economy - from NIS - can be corroborated with those that appear in research studies and questionnaires collected by various organizations.

Given the current exceptional uncertainties, the FC considers that, in addition to the scenario assumed by the Government in the first budget revision (-1.9% of real GDP) and the one proposed above (between -4 and -6% of real GDP in 2020), it is appropriate considering a scenario with an even more severe contraction in the real GDP for this year, of about 8-9%. In conclusion, the FC appreciates as more likely to place the economic dynamics of this year to a level close to -5%, as well as a higher plausibility - especially in the context of the materialization of some risks described above - of a scenario for an economic contraction between 8 and 9%.

[133] For example, the International Monetary Fund estimate a GDP contraction of 5% for Romania in 2020, in the last World Economic Outlook, the April edition.

VI.2. Fiscal framework

The year 2020 can be seen as both a turning point and a unique moment in recent global history, in the context of a double crisis, in economy and public health, characterized by huge uncertainties. The position of public finances in Romania is unfavorable, for the following reasons:

(i) The accumulation of high structural deficits during the economic boom led to a lack of fiscal-budgetary space which is needed in the recession phase of the economic cycle, especially if we face very strong adverse shocks - such as this pandemic. The previous large budget deficits, highlighted also by Romania's singular position within the corrective arm of the SGP, make the adoption of measures to overcome the current crisis situation particularly complicated due to the sensitivity of internal and external investors to a further increase of deficits. The lack of fiscal-budgetary space and the very complicated financing lead to a vicious circle that can postpone the moment of economic recovery;

(ii) The public debt appears small – relative to the European context – being 35.2% of GDP at the end of 2019 (ESA2010 methodology) and amid the extension of the average maturity of public debt and the improvement of its structure – in terms of a lower exposure to currency risk, an increase in the share of long-term debt and a decrease in the share of debt with variable interest rates. However, the current level of debt is very sensitive to the differential between the government debt yield (cost of financing), on the one hand, and the growth rate of nominal GDP, on the other. It can be mentioned in this respect almost doubling the public debt in one year – from 12.3% in 2008 to 21.8% of GDP in 2009. It should be mentioned, the EC's 2019 Debt Sustainability Monitor, that places the risk of Romania's public debt at a "high" level (except for the short-term) – worsening from a "medium" level in the report for 2018. However, the Report shows that in the absence of corrective measures, Romania's public debt would reach 62.3% of GDP in 2025, and about 91.2% of GDP in 2030; these figures refer to the situation before the outbreak of the pandemic and incorporate the increase in pensions according to the current timetable;

(iii) the current account deficit is another element of vulnerability, which is mainly generated by the reflection of the substantial public sector deficit. Thus, recent data show that Romania is singular also in this regard, both in the region and among larger EU countries, with a current account deficit of 5.3% of GDP in 2019 and having both past and projected significant deficit values (above the 4% of GDP threshold from the EU Macroeconomic Imbalance Procedure).

In order to characterize the fiscal-budgetary framework for 2020, in the following will be labelled three important moments from the FC perspective: the draft budget for 2020, the launching of the excessive deficit procedure against Romania at the beginning of March this year, and the first budgetary revision in mid-April in the context of declaring by the Government the commencement of state of emergency and manifestation of extraordinary circumstances in Romania.

1. The draft budget for 2020. In its opinion, the FC appreciated that by the way of drafting the 2020 budget and the associated medium-term budgetary framework was maintained the expansionary stance of the fiscal-budgetary policy. In addition, the budget for 2020 was made in the context of an imminent risk of entering the Excessive Deficit Procedure, as the headline deficit for 2019 was significantly above the 3% of GDP threshold, and its reduction aimed for 2020 was based only on temporary elements. The FC noted in its opinions the following relevant/problematic aspects regarding the initial budget for 2020:

- The GCB initial draft predicted a cash deficit of 3.59% of GDP, lower by 0.83 pp of GDP[134] compared to the projected 2019 deficit (4.43% of GDP), and expressed in ESA terms by only 0.23 pp;
- The level of structural adjustment of 0.32 pp of GDP proposed for 2020 was significantly lower than in the EU Council recommendation issued in the context of the Significant Deviation Procedure (in November 2019), respectively a structural adjustment of 1% of GDP in 2020. In 2019, at the time of drafting the 2020 budget, the data indicated a structural deficit of 3.5% of GDP, by 0.8 pp of GDP over the previous year (2.7% of GDP);
- The level of the budget deficit estimated by FC based on the available data at that time, was 4.6-4.8% of GDP, above the MPF target by 1-1.2 pp of GDP, backed by a negative revenue gap due to an oversized starting point (the 2019 revenues), a macroeconomic framework considered as optimistic, not taking into account by the MPF of certain initiatives that were in the final stage of the legislative process[135] that diminish the budget revenues and the underestimation of budget expenditures (goods and social services and assistance);
- Not enough measures have been identified to offset the budget slippage, which deepens in the medium term, leading to the accumulation of public debt and the vulnerability of the public finances, the fiscal space being practically exhausted;
- The balance of risks related to the budget balance for 2020 was tilted on the negative side, respectively recording a higher budget deficit.

2. In March this year, the EC notified Romania on the **launching of the EDP, the headline deficit in ESA terms for 2019 being estimated at 4.3% of GDP** (4.67% in cash terms), establishing an adjustment calendar with the following objectives regarding the headline deficit: 3.6 % of GDP in 2020, 3.4% of GDP in 2021 and 2.8% of GDP in 2022, corresponding to an annual structural adjustment of 0.5% of GDP in 2020, 0.8% of GDP in 2021, and 0.8% of GDP in 2022, to put an end to the situation of excessive deficit by 2022 at the latest. Furthermore, the EC recommended supporting fiscal consolidation through structural reforms, in line with the recommendations addressed to Romania in the context of the European Semester and Macroeconomic Imbalance Procedure. The deadline for Romania to take effective measures, in accordance with article 3 para. (4a) of Regulation (EC) no. 1467/97, and to report in detail on the planned consolidation strategy for achieving the targets was set for September 15, 2020.

[134] Based on exceptional elements - reimbursements of vehicle registration taxes made in 2019 and for 2020 the rental of 5G frequency bands for the next 10 years by mobile operators (both accounting for 4.9 billion lei).

[135] After the publication of Law no. 5/2020, were established: the reduction in excise duties on energy products and the elimination of over-taxation for part-time employees and the abrogation of the additional taxation on the energy and banking sector established by GEO no. 114/2018. Taken together, these measures implied lower budget revenues by about 0.5 pp of GDP.

Despite the fact that fiscal rules have been suspended at European level to allow both for the automatic stabilizers to operate and for taking measures to combat the economic effects of the pandemic, the European Commission sent a letter to the Ministry of Public Finance on April 6th, 2020, confirming the launch of the EDP by virtue of the fact that the breaches of European fiscal rules - transposed by the FRL at national level - precede the pandemic and, therefore, are not caused by it. However, the assessment of the effective actions taken in response to the EC Recommendation will account for the economic and fiscal impact of the COVID-19 pandemic, as well as for the implications of activating the Stability and Growth Pact (SGP) derogation clause.

3. In April this year, the Government exceptionally adopted a **draft GCB revision**, in the context of the declaration by the Executive of the **beginning of the manifestation of extraordinary circumstances represented by the COVID-19 pandemic**.

The FC maintains its assessment on the coordinates of the fiscal-budgetary framework for 2020 as stated in its Opinion on the draft budget revision published on April, 24, 2020 and reiterates several relevant issues identified at that moment:

- The first 2020 budget revision was elaborated, in the conditions of the announcement by the Government of extraordinary circumstances that allow, according to art. 8 of the FRL, the temporary deviation from the requirements of the fiscal rules established by the FRL. The FC validated the manifestation of extraordinary circumstances, stating that, after their termination, there is a legal obligation to adopt fiscal-budgetary policy measures leading to an improvement of the structural balance of the general consolidated budget at least equal to the requirements of the SGP;
- The magnitude of the pandemic shock, which led to the partial lockdown of the economies, is accompanied by very high uncertainties; the prevailing risk is that there will be a more severe deterioration of the economic activity in comparison to initial anticipations;
- The FC considered that the macroeconomic scenario assumed by the Government, built on a decline of the real GDP by 1.9%, is very optimistic. Thus, starting from the NIS studies on the economic impact of the pandemic, from the historical reference of the previous economic crisis that began in 2008, based on its own quantitative and qualitative assessments as well as other data and forecasts, the Fiscal Council appreciated that it is prudent and necessary to consider two more macroeconomic scenarios for the current year: one based on a contraction of real GDP that is between 4% and 6%, and a scenario that predicts a more severe contraction of the GDP, of approximately 8%-9%;
- The draft budget revision recorded a downward amendment of the total estimated revenues of GCB, respectively by 19.05 billion lei, while the total budget expenditures increased by 12.9 billion lei. Thus, the projected budget deficit increased by 31.95 billion lei and 3.1 pp of GDP, respectively, compared to the initial target;
- The negative revision of the revenue projection took place at the level of almost all categories of budget revenues from the domestic economy, being largely attributable to the deterioration of

the macroeconomic framework. A favorable impact on budget revenues was generated by the additional amounts received from the EU to counteract the negative effects associated with the COVID-19 pandemic. The upward revision in total expenditure was due to the amounts allocated to fight against the effects on public health and economic activity generated by the COVID-19 pandemic. Thus, the main increases were located at the level of social assistance expenditures and reserve funds;

- The FC appreciated that the likely budget deficit, admitting the macroeconomic framework assumed by the Government, is in the range of 7.3-7.45% of GDP, as a result of an overestimation of revenues by about 0.3% of GDP and an underestimation of expenditures by 0.3-0.45% of GDP;
- Two scenarios for the macroeconomic framework, considered plausible by the FC, one with an economic decline between 4 and 6% and another between 8 and 9%, led to budget deficits for 2020 of 8.1% - 8.9% and, respectively, of 9.9% - 10.4% of GDP. The balance of risks related to these estimates is inclined, in the FC's opinion, on the negative side, respectively the registration of a higher level of the budget deficit;
- High budget deficits put great pressure on the possibility of financing given that access to resources from external markets is becoming increasingly problematic - especially for emerging economies. According to the estimates of the Fiscal Council, Romania's financing needs would increase from 8.6% of GDP in 2019, to levels between 11% and 14.3% of GDP, depending on the scenarios considered for 2020, respectively between 119.5 billion lei (24.7 billion euros) and 144.3 billion lei (30 billion euros);
- Although fiscal rules have been temporarily suspended in the EU, covering such financing needs poses great challenges for Romania, resulting from the limited debt absorption capacity of the internal market, uncertainties about the availability of financing on foreign markets, the cost of financing, the low level and possible deterioration of the sovereign rating etc.;
- The FC considered that programs aimed at supporting the economy that involve a budgetary effort must be conditioned by the existence of financing sources and they must not jeopardize the return to the sustainability of public finances in the medium term;
- It is important to emphasize the advantage of prudence and moderation in fiscal policy, which could have provided a much higher fiscal/budgetary space in times of very severe crisis such as the current one. The margin of maneuver is much limited by the very low level of fiscal revenues, the second lowest in the EU, thus Romania not having a capacity to react similar to that of countries that mobilize a significant part of GDP to the public budget;
- The very large magnitude of Romania's financing needs requires the consideration of all possibilities for access to financial resources;
- The FC once again pointed out that maintaining the current timetable for the application of the new pension law would make it almost impossible to reduce the budget deficit in 2021 compared to the current year level, which is already dangerously high. The return to fiscal-budgetary sustainability requires a reconsideration of the pension law enforcement calendar;

- The early public communication, of the fiscal-budgetary policy plans for the return to a sustainable trajectory of the fiscal-budgetary policy in Romania in the medium-term is essential for going through this very difficult period.

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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, balance of payments and in structural areas to set the basis for economic stabilization and sustainable economic growth.

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

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

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

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

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

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

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

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

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

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

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

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

Cash methodology – involves recording revenues when they are actually received and recording 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.

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

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

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

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

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

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

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

Cyclical adjustment of budgetary revenues – elimination of the budgetary revenue's component dependent 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.

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

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

Eurosystem – the central banking system of the euro area. It comprises the European Central Bank and the national central banks of 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 goods and services.

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

Fiscal Compact – part of the Treaty on Stability, Coordination and Governance signed on March 2, 2012 by all EU member states, 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 – 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 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 the actually collected revenue for a specific type of tax and the corresponding macroeconomic tax base.

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

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

Nominal convergence criteria (Maastricht) – the four criteria set out in Article 140 (1) TFEU that must be fulfilled by each EU Member State before it can adopt the euro, namely: 1) the inflation rate must not exceed by more than 1.5 pp the average of the three best performing EU countries in this respect; 2) the long-term nominal interest rate must not exceed by more than 2 pp the average interest rate in the first three member states with the best performance in terms of price stability; 3) the public budget deficit must be less than 3% of GDP, 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. It also acknowledged as GDP deviation.

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

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

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

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

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

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

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

Swap – chain compensation scheme for outstanding obligations to 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.

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

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