Romania

Fiscal Council

Annual Report

2016

Note:

The Annual report for 2016 was approved by the Chairman of the Fiscal Council, according to article 56, paragraph (2), letter d) of Law no. 69/2010, after being adopted by the members of the Council through vote, on June 7, 2017.

The analysis of the financial performance of SOEs and that regarding the estimation of tax evasion in Romania will be completed later, as inputs become available. We estimate that for state-owned enterprises, the financial reports of Romanian companies for 2016 will be received by the Fiscal Council from the Ministry of Public Finance in the period June-July 2017, the raw data requiring further laborious processing to complete the Fiscal Council analyzes.

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List of abbreviations

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
ECB	European Central Bank
EBRD	European Bank for Reconstruction and Development
EMFF	European Maritime and Fisheries Fund
EMU	Economic and Monetary Union
ERDF	European Regional Development Fund
ESA 2010	European System of National and Regional Accounts 2010
ESA 95	European System of Accounts 1995
ESF	European Social Fund
EU	European Union
FC	Fiscal Council
FRL	Fiscal Responsibility Law No 69/2010
FS	Fiscal Strategy
GCB	General consolidated budget
GDP	Gross Domestic Product
GEO	Government Emergency Ordinance
GFCF	Gross fixed capital formation
IBRD	International Bank for Reconstruction and Development
HICP	Harmonized Index of Consumer Prices
IMF	International Monetary Fund
LIOP	Large Infrastructure Operational Programme
MEF	Ministry of European Funds
MPF	Ministry of Public Finance
MTO	Medium-term objective
NAFA	National Agency for Fiscal Administration
NBR	National Bank of Romania
NCEF	National Commission for Economic Forecasting
NCRIA	National Company for Road Infrastructure Administration
NHPP	National House of Public Pensions
NIS	National Institute of Statistics
NMS CEE	New Member States from Central and Eastern Europe

NMS 10	10 new EU member states (excluding Croatia)
NPISH	Non-profit institutions serving households
NRDP	National Rural Development Program
NREF	Non-reimbursable external funds
NRP	National Reform Programme
NSVFSA	National Sanitary Veterinary and Food Safety Authority
OECD	Organization for Economic Co-operation and Development
OPFMA	Operational Programme for Fisheries and Maritime Affairs
pp	Percentage points
RAMP	Revenue Administration Modernization Project
SGP	Stability and Growth Pact
SME	Small and Medium Enterprises
SSC	Social Security Contribution
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (The Fiscal Compact)
VAT	Value added tax
WB	World Bank

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I. Summary

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

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

The year 2016 registered for the Romanian economy the highest annual rate of growth within the post-crisis period, sustained solely by consumption, the structure of the economic growth being unbalanced. The current account deficit has deepened, but is almost entirely funded by foreign direct investment.

In 2016 the Romanian economy recorded the highest rate of economic growth in the post-crisis period, namely 4.8%, the real gross domestic product (GDP) in 2016 being by 9.0% higher than the one registered in 2008 (+4.6 percentage points - pp), supported by pro-cyclical fiscal policy and fast wage increases, while the gross fixed capital formation had contributed by -0.8 pp, the decrease being determined exclusively by the evolution of public investments, which contracted by about 24.3% in real terms. Against the fast growth of the domestic demand, the current account deficit deepened to 2.43% of GDP, from 1.22% of GDP at the end of 2015, but it is almost entirely financed by foreign direct investment. Under these circumstances, Romania's external debt rose in nominal terms by 2.32% in 2016 compared to 2015 up to EUR 92.53 billion, but its weight in GDP decreased from 56.5% to 54.6%. The economic growth has taken place in the context of a moderate credit growth of 1.8% in real terms compared to the previous year. The labor market had a favorable evolution, with the average number of employees rising to 4,701 thousand persons, respectively by 3.4% compared to 2015. The gross average earnings per economy was 2,887 lei, increasing by 12.8% compared to 2015, a dynamic well above that of labor productivity, driven mainly by the evolution of public sector earnings that advanced 21.1% in nominal terms.

The fiscal policy deliberately deviated from the medium-term objective in 2016, the cash deficit target set in the draft budget being reached, while the target according to ESA 2010 methodology was marginally missed. Moreover, the 3% of GDP threshold for the actual deficit was exceeded in 2016.

The general consolidated budget (GCB) for 2016 was based on a 2.8% of GDP budget deficit target in cash terms and a 2.95% of GDP in the European System of National and Regional Accounts 2010 terms (ESA 2010), up by more than 2 pp of GDP compared to the values recorded in 2015 as a result of the tax cuts provided for by the new Fiscal Code and the increases in budgetary expenditures, especially salaries and social assistance. Thus, there was a deliberate deviation from the medium-term budgetary objective (MTO), respectively a structural budget deficit of maximum 1% of GDP, the structural deficit for 2016 being estimated at 2.73% of GDP at that time. The final budget execution was in line with the deficit target, according to the cash methodology, the budget deficit standing at 2.4% of GDP, but above the target according to ESA 2010 methodology, the budget deficit amounting to 3.04% GDP, thus marginally exceeding even the benchmark set by the corrective arm of the Stability and Growth Pact. The structural deficit has deteriorated to 2.6% of GDP.

The national fiscal rules have exerted a weak constraint on fiscal policy authority since the FRL established them in 2010. In addition, starting with 2016, the structural deficit rule is also violated. The European Commission issued a warning to Romania on 22 May 2017.

For the third consecutive year, the Government has elaborated late the fiscal strategy, respectively simultaneously with the elaboration of the state budget draft, compared to the legal deadline of 31 July, which is not likely to create an efficient fiscal-budgetary planning based on ex-ante compliance with tax rules. Thus, the verification of fiscal rules regarding the ceilings in the draft budget becomes irrelevant. Moreover, on the occasion of budget revisions, the law on ceilings is constantly violated *ex-ante*, even if the final budget execution sometimes validates the initial ceilings, as was the case in 2016. The Fiscal Council once again notes the permanence of the inoperability of fiscal rules related to the budget deficit and reiterates its recommendations on compliance with these rules, ascertaining that in 2016 the European rules on the structural deficit level stipulated by the Stability and Growth Pact preventive arm as well as the Fiscal Compact were significantly violated. Moreover, the compliance with the corrective arm of the Stability and Growth Pact could be under discussion, as the budget deficit according to the European methodology ESA 2010 slightly exceeded the 3% of GDP threshold.

In this context, on 22 May 2017, in accordance with Article 121 (4) of the TFEU and Article 10 (2) of Regulation (EC) no. 1466/97, the European Commission (EC) issued a warning to Romania regarding the observation of a significant deviation from the MTO in 2016 and the lack of correction by at least 0.5% of GDP in 2017, following to be initiated the procedures laid down in EU law.

Romania remains in the trap of pro-cyclical fiscal policies, stimulating the economy at a time when it evolves very close to its potential level.

In 2006-2015, Romania pursued an intensively pro-cyclical fiscal policy, unnecessarily and counterproductively stimulating the economy during the expansion periods (2006-2008) and slowing down in periods when it was operating under potential (2010-2015), thus contributing to the amplification of the economic cycle fluctuations and to the deepening of the imbalances accumulated in the economy. Maintaining the expansionary character of fiscal policy initiated in 2016 and continued in 2017, in the context of a near zero output gap in 2016 and positive in 2017, only contributes to maintaining the pro-cyclicality of fiscal policy, and the vulnerability of public finances to shocks, the need for corrections in difficult economic times not being excluded.

The efficiency of tax collection declined in 2016 compared to 2015, the fiscal space for performance improvement in this area being still significant. Following the tax cuts provided by the new Fiscal Code, the share of tax revenue in GDP dropped sharply, being the second lowest rate in the EU. The reform of the tax administration initiated in 2013 must continue at a faster pace.

The efficiency of taxation index decreased noticeably in the case of social security contributions (SSC, from 0.76 to 0.71) and in the case of personal income tax (from 0.86 to 0.80) and increased marginally in case of the value added tax (VAT, from 0.71 to 0.72) and corporate tax income (from 0.22 to 0.23). In addition, excise tax revenues were significantly lower than those that would have prevailed given the sustained increase in consumption of the previous year. Thus, budget revenues were lower than those that should have been collected taking into account the evolution of the economy, even by adjusting with the impact of tax cuts applied following the implementation of the new Fiscal Code. Romania recorded in 2016 a tax revenue level of 25.9% of GDP, standing at the penultimate place in the European Union (EU), with a gap of 13.9 pp compared to the EU average of 39,8% of GDP. Moreover, the gap separating us from the EU average deepened significantly in 2016 compared to 2015, by 2.9 pp, respectively. Considering the structure, the prevalence of indirect taxation in Romania, to a greater extent than in the EU, is likely to support long-term economic growth, direct taxation having a more deterrent effect in mobilizing production factors.

In 2013, an extensive process of reforming the Romanian tax administration was launched in collaboration with the World Bank (WB), and the Fiscal Council notes an improvement in the efficiency and simplification of the tax collection administrative apparatus, both in terms of the decrease in the number of financial administrations (although there is an increase in the number of employees), but also in light of the ease of paying taxes. The reform initiated in Romania in this area seems to have led to positive results but below the initial expectations. Further, the reform has the potential to lead to significant long-term effects in the long run, but we appreciate that additional efforts are needed to ensure the success of this project.

The personnel expense increased very rapidly in 2016 and the pressures for other wage increases remain high

Compared to 2015, personnel expenses increased by 5.01 billion lei, or 9.64%, in cash terms, but in reality, this increase was much higher, being overshadowed by the lower amounts paid in 2016 compared to the previous year on account of court decisions, as well as the lifting of the mandatory SSC payment for the employer in the case of police, army and special service employees. Taking into account these factors, the personnel expenses growth was 18.88% compared to 2015. Compared to other EU countries, Romania's position on wage expenditures in the public sector as a percentage of total revenue worsened considerably in 2016, respectively, 20th in rank from 12th. In addition, for the year 2017, the draft budget envisaged a further increase of the state personnel expenses by about 12% and the draft of the unitary wage law, not yet adopted at the moment when this report was elaborated, envisages massive increases in public wages in the coming years.

The financial position of the public pensions system has also deteriorated in 2016, the social security budget

In 2016, the deficit of the social insurance budget reached 2.58% of GDP, up from 2.49% of GDP in 2015, which represents a significant part of the general government deficit. The return to the special pension system eliminated in 2010 and the emergence

deficit reaching 2.58% of GDP, the reforms previously initiated in this area being gradually reversed. The special pensions removed in 2011 were reintroduced and the automatic indexing mechanism introduced in 2011 is de facto abandoned since 2017.

of multiple exemptions and special pensions threaten the sustainability of reforms previously initiated and generate additional pressures on the social security budget deficit. Moreover, the expected abandonment of the pension indexation mechanism from 2017 substantially affects the sustainability of the pension system, the discretionary approach and the abandonment of the rules having the potential to contribute to the widening of the state social security budget deficit.

The Fiscal Council notes the emergence of a sustained trend of reversing pension system reforms designed to ensure its long-term financial sustainability, and strongly advocates maintaining the progress made in recent years, both from the perspective of the principles introduced (the exclusive use of the principle of contribution to the determination of the appropriate pension), as well as from the perspective of strict compliance with the indexation mechanism introduced by the new pension law.

Public investment expenditure declined steeply in 2016 compared to 2015, its share in GDP declining from 5.85% of GDP to 3.88% of GDP. The Fiscal Council advocates in favor of a firm implementation of the legal framework on public investment management and appreciates that some progress has been made in reforming public investment management.

Compared with the previous year, in 2016, public investment expenditure decreased as a percentage of GDP by 1.97 pp, from 5.85% of GDP to 3.88% of GDP, the level being by 1.64 pp below the average of 2011-2015. The main cause of this development is the extremely slow pace of attracting European non-reimbursable funds for the 2014-2020 financial period. Also in 2016, the quarterly evolution of investment expenditure indicates a concentration in the last quarter - 41.3% of the total year, which calls into question the efficiency of the budget programming process. It is true that the efficiency reserves in terms of how to spend the public funds allocated to the investments are high and the Government initiated a process of public investment management reform between 2013 and March 2014. At the level of 2016, it may be appreciated that improvements have been made regarding transparency in this area, the list of prioritizations of investment projects related to the state budget law for 2016 being made public. The Fiscal Council advocates a firm implementation of the legal framework for public investment management and appreciates that some progress has been made in reforming public investment management, the transparency of the prioritization process being still at the beginning, as well as the efficiency of the process of allocating and spending public money for priority public investment.

Public debt declined marginally as a percentage of GDP in 2016 despite the high budget deficit, mainly due to high economic growth, but also due to short-term factors, and in the future, will be on a growth path.

Public debt declined in 2016, its share in GDP reducing, according to the European methodology ESA 2010, to 37.6% from 38% of GDP at the end of the previous year, in the sense of diminishing acting the real economic growth (-1.74 pp), inflation (-0.78 pp) and stock-flow adjustment (-0.82 pp), while the primary deficit contributed to a 1.54 pp increase in the government debt to GDP ratio and the real interest rate to 0.62 pp. In the period 2017-2020, according to the baseline scenario, public debt is projected to increase gradually according to the baseline scenario from 37.6% in 2016 to 43.3% at the end of the interval, and in the context of unfavorable scenarios, the increase in public indebtedness may be even higher. The forecast is based on the EC's projections on economic growth and budget deficit, which are more unfavorable than those of the Government in the Convergence Program 2017-2020. If we use the latter, in the baseline scenario, public debt diminishes to 37% of GDP in the 2020 horizon.

As regards the absorption of European funds, it can be appreciated that in 2016, following the adoption of special measures, substantial progress has been made for the 2007-2013 programming period which has led to an absorption rate for this financial year of over 90%. However, the implementation of the projects associated with the 2014-2020 programming period, despite the progress made in designating the

Although Romania faced major problems in attracting European funds, progress has been visible over the past two years and the results of sustained efforts have been seen in increasing Romania's capacity to absorb European structural funds. Thus, at the end of March 2017, Romania absorbed 90.44% of the total funds allocated under the 2007-2013 programming period, a significant increase compared to January 2016, when the absorption rate was 69.91%. However, Romania remains the country with the lowest performance in the EU in terms of absorption of EU funds for the 2007-2013 financial period, with a rate of only 90.44% in 2016, the other new Member States (excluding Croatia) having absorption rates ranging between 94.03% and 95%.

Also, the implementation of projects associated with the 2014-2020 programming period, despite the progress made in designating the management and control authorities and in fulfilling the *ex-ante* conditionalities, was characterized by an

management and control authorities and in fulfilling the ex ante conditionalities, was characterized by an extremely slow start.

extremely slow start. It is true that the new 2014-2020 multiannual financial framework had a difficult start not only in Romania, but also in the other EU Member States. The legislative framework for this period was finalized late by the EC, the European Parliament and the EU Member States, affecting more countries with lack of experience and administrative capacity to recover delays. The Fiscal Council considers that the absorption rate needs to be stepped up, the European funds being an engine for sustaining the economy, especially in the context of the current budgetary constraints.

The draft budget for 2017 and its associated medium-term framework are characterized, as in the case of last year's budget, by a deliberate and large deviation from all fiscal rules imposed by both national legislation and the European treaties signed by Romania. The balance of risks regarding the deficit target is on the negative side. The risk of re-entering into an excessive deficit procedure appears to be significant in the hypothesis of maintaining current policies.

In its opinion on the Draft Budget of 3 February 2017, the Fiscal Council considered that the draft budget for 2017 and its associated medium-term framework are characterized, as in the case of last year's budget, by a deliberate and large deviation from all fiscal rules imposed by both national legislation and the European treaties signed by Romania. Furthermore, the intention of placing the budget deficit in the immediate vicinity the ceiling of 3% of GDP (according to ESA 2010 methodology) is by no means benign, being likely to lead to a weakening of the position of public finances and to complicate their management in the event of the occurrence of an adverse shock, keeping the fiscal policy in the trap of pro-cyclical behavior.

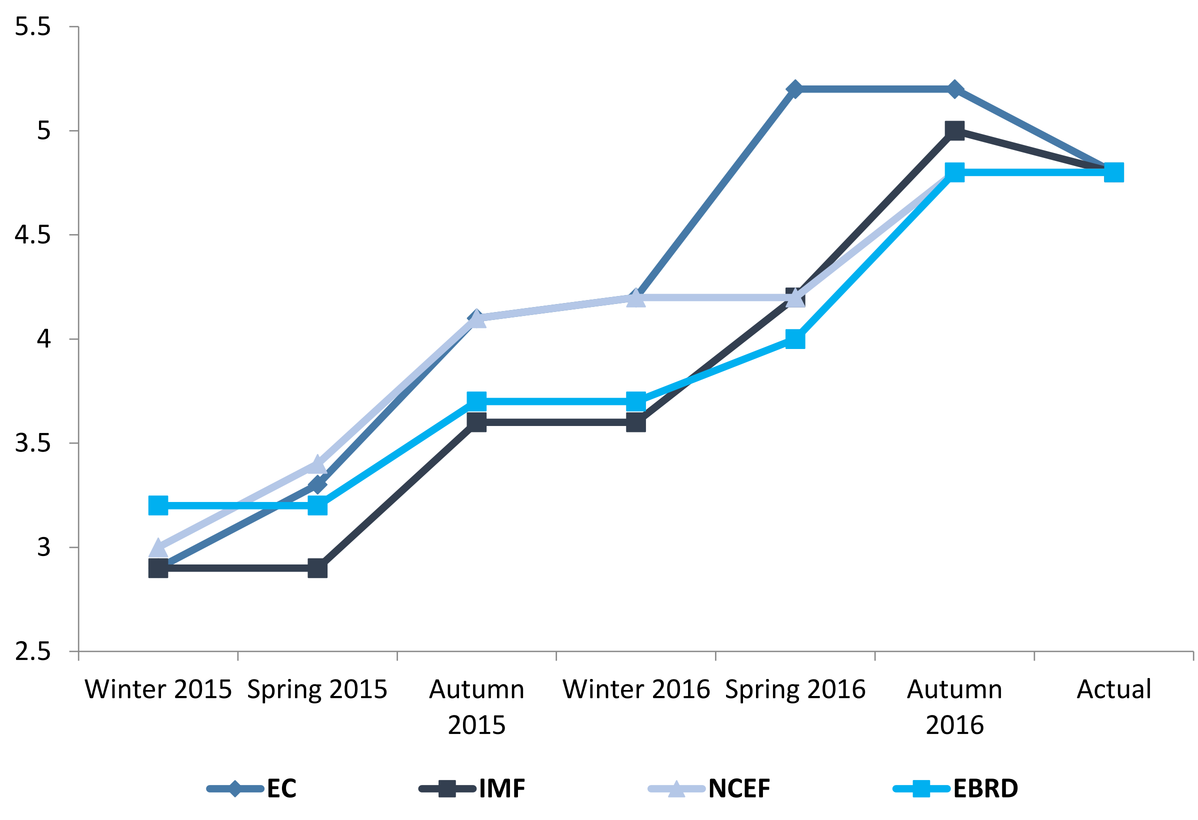
Moreover, the EC’s projections published in the May 2017 spring forecast indicate levels of the budget deficit for the year 2017 higher than those of the Government, namely 3.5% of GDP, both in terms of the actual deficit and the structural deficit. This projection is consistent with that of the Fiscal Council, the risk of re-entering into an excessive deficit procedure appearing to be significant.

In the context of maintaining the current fiscal-budgetary policy parameters, the 2017 risk balance appears to be significantly leaning in the sense of exceeding the 3% target for this year's budget deficit, requiring corrective measures on the revenue or expenditure side to avoid entering into an excessive deficit procedure. In order to achieve the target or even register a smaller deficit than projected could act, without being a desirable outcome, a failure to implement the scheduled public investment expenditure, as a result of a low absorption rate of EU funds for the 2014-2020 financial framework, given the current evolution of investments financed from this source.

II. Macroeconomic framework in 2016

In 2016 Romanian economy registered the highest annual economic growth in the post-crisis period, the GDP growth reaching 4.8% in real terms, a higher dynamic compared to the level of 3.9% reached in 2015. After 5 years of positive developments (a cumulative growth of about 16.3%), the real GDP in 2016 is higher compared to 2008 by 9.0%. Compared to the initial forecasts considered in preparing the draft budget for 2016, and also to the forecasts of the European Commission (EC) and the National Commission for Economic Forecasting (NCEF), the economic growth was higher by approximately 0.7 pp, the development above expectations being attributable to the strengthening of the upward slope for the private consumption (+7.3%).

Figure 1: The evolution of economic growth forecasts for 2016



Source: EC, International Monetary Fund (IMF), NCEF, European Bank for Reconstruction and Development (EBRD)

From a GDP utilization point of view, the main contribution to the economic growth registered in 2016 came from the household final consumption expenditure (+4.6 pp), its increase in real terms being 7.4%, owed to the disposable income growth due to the loosening fiscal measures regarding lowering indirect taxes (reduction of the standard VAT rate from 24% to 20% from January 1, 2016 and the introduction of the reduced VAT rate of 9% for food from June 1, 2015), to the real wage growth favored by the public sector wage increases simultaneously with an inflation rate which is in negative territory[1], as well as an increasing consumer confidence in the future economic perspectives. Also, positive but smaller influences were recorded by the component changes in inventories (1.1 pp) and government consumption (0.6 pp contribution and an increase in volume by 4.5%). Negative influences were recorded for the net exports (-0.7pp), under the conditions of a higher expansion of imports (+9.8% in real terms) compared to exports (+8.3%) and gross fixed capital formation by -0.8 pp. Regarding this last component, we notice a serious imbalance of the economic growth structure in 2016, the contribution of gross fixed capital formation (GFCF) to GDP growth being negative even if of small importance, while the contribution of consumption boosted the GDP growth, even though in the FS 2016 - 2018 was designed a favorable composition for investment growth in the economy (see *Table 1*). Although investment was favored by low interest rates and a stable investor confidence, private investment growth has been offset by the public investment evolution. The main cause is the under-execution of the public investment program, which decreased by 24.3% in real terms[2] in the context of major failures regarding the absorption of the EU funds compared to the initial prognosis, especially in the segment of financing investment projects. This significant reduction in the public investment was determined by the fact that in 2016 the volume of the funds for the financial year 2014-2020 represented only 46.2% of the original program. On the other hand, another factor influencing the decrease of public investment expenditure (expressed in accordance with the ESA 2010 standard) in 2016 compared to the previous year was the achievement of a large volume of investments in 2015, especially in the last month of the year, 2015 representing the deadline for attracting European funds for the 2007-2013 financial year. On the supply side, increases in the economic activity's volume were recorded in all sectors[3], the most significant being recorded in information and communication (+13.8%), followed by wholesale and retail trade, repair of motor vehicles and motorcycles, transport and storage, hotels and restaurants (+11.3%), professional, scientific and technical activities; administrative and support services (+7.9%), shows, culture and recreation activities; repair of household goods and other services (+6.3%), net tax per product (+4.1%), public administration and defense, education, health and social assistance (+3.0%), construction (+1.8%), industry (+1.8%), real estate transactions (+1.3%), financial intermediation and insurance sectors (+1.2%). The activity in the agriculture, forestry and fishery sector has stagnated compared to the previous year. It is noteworthy the increase in the contribution of the services' sector through its components:

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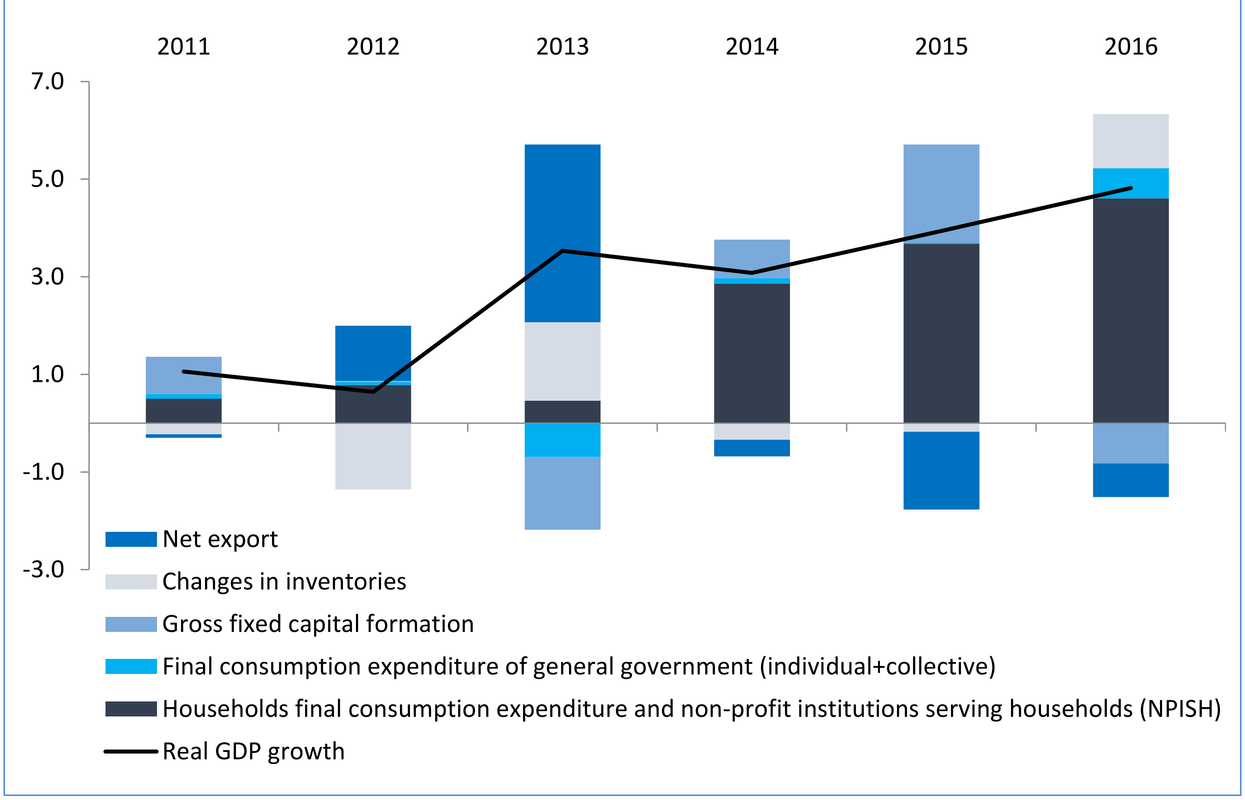
[1] Namely, an average of -1.55% compared to 2015.

[2] GDP deflator was used (values of public investment expenditure according to ESA 2010 methodology)

[3] According to NIS press release April 7, 2017
http://www.insse.ro/cms/sites/default/files/com_presa/com_pdf/pib_tr4r2016_2.pdf

wholesale and retail trade; repair of motor vehicles and motorcycles; transport and storage; hotels and restaurants with the highest contribution to GDP growth respectively of +1.9%, information and communication with a contribution to GDP growth of 0.7% followed by professional, scientific and technical services; activities of administrative services and support services and net taxes on product, each of them with a contribution to GDP growth of +0.5%; the industrial sector decreased its contribution to GDP growth to the level of +0.4%.

Figure 2: Contributions to economic growth



Source: Eurostat, Fiscal Council's calculations

The annual inflation rate registered at the end of 2016 was outside the target range (1.5% - 3.5%), associated to the target of 2.5%, reaching a level of -0.54%, significantly below the level projected in the Fiscal Strategy 2016-2018, respectively 1.8%. In the absence of the direct effect of reducing the standard VAT rate, the adjusted CPI inflation rate calculated by the NBR was placed at a level of 0.85%. The inflation rate varied over the year in the negative territory between -3.46% and -0.2%, the average price growth in 2016 being -1.55%, below the level projected in the Fiscal Strategy (0.5%), while the average CPI inflation rate excluding the transitory effects of VAT reduction, as estimated by NBR was located in the positive territory throughout 2016, between 1.7% and 0.6%, with an average of 0.99%. The price increases in the economy as a whole, measured by the GDP deflator registered a level of 2.2% in 2016.

In the first quarter of 2016 the negative annual inflation rate has grown to -2.98% in March, the development reflecting the overlapping of two important changes in indirect tax regime: extending reduced VAT rate of 9% on all food in June 2015 and reducing the standard VAT rate from 24% to 20% in January 2016. Even in the absence of the extensive transmission of reducing VAT rate, annual growth in consumer prices would have been on downward trend at the beginning of 2016, falling to 1.2% in March, due to the reduction of imported inflation, which contributed the evolution of external prices and exchange rate. The annual growth rate of consumer prices advanced substantially at the end of the second quarter (from -3.46% in May to -0.7% in June), due to the end of the first-round effect of the extension of reduced VAT rate of 9% in all foods products. The value remained, however, negative due to the maintenance of the effect induced by the reduction of the standard VAT rate. During the third quarter, the annual inflation rate attenuated its negative value to -0.57% in September, this trend being favored by the first diminishing signs of the disinflationary influences from the external environment. The annual rate of CPI inflation remained negative and relatively stable in the fourth quarter, its evolution being the result of incidental factors (atypically reduction of the price of tobacco products and broad lowering of the vehicles' insurance tariff), which have offset in a large extent the opposite impact of factors with persistent action (inflationary pressures associated with a widening excess demand and the dynamics of commodity prices on international markets).

The inflation rate for the end of 2016 was projected by the NBR into positive territory until August when it has been taken a significantly downward revision respectively by 1 pp compared to the previous report, due to the global context characterized by an inflation that remained persistently at low values. Other reasons that led to the massive revision of the projection were represented by the influences coming from internal measures of fiscal loosening, those relating to revenue policies or those related to the Law on debt discharge ('datio in solutum') and external factors especially the starting of legal proceedings for Brexit.

The Board of Directors of the National Bank decided to maintain the monetary policy interest rate at 1.75% throughout 2016, a decision justified by the divergence from the target trajectory of the expected annual inflation and the risks induced by the potential fiscal and wage policy stance in the context of an election year and the uncertainty about global economic growth and euro zone economic recovery. Since October, it was decided to reduce the minimum reserve requirement ratio for the foreign currency denominated liabilities of credit institutions at 10% from 12%, after another drop of 2 pp in early January, both decisions aimed at further harmonization of minimum reserve requirements to the standards and practices of the ECB. The minimum reserve requirement ratio for liabilities in lei was unchanged at 8% throughout 2016.

As regards the external position, 2016 witnessed the continuation of the evolution recorded in the previous year, the current account deficit increasing at 2.43% of GDP, from 1.22% of GDP registered at the end of the last year, or around 2.17 billion euro in nominal terms, GDP also increasing by approximately 6.0% considering values expressed in euro. The increase of the current account deficit from 1,944 million euro in 2015 to 4,118 million euro in 2016 is mainly attributable to the increase of the primary revenues'[4] deficit from 3,738 million euro in 2015 to 4,826 million euro in 2016 (respectively, 1,088 million euro). A significant negative contribution to the variation of the current account balance was generated by the worsening the goods and services balance from a deficit of 1,001 million euro in 2015 to a deficit of 1,741 million euro in 2016, exclusively based on the goods balance (-1,505 million euro), while a smaller negative contribution to the variation of the current account balance[5] had the secondary income balance[6] (-345 million euro). The exports of goods and services continued to grow in 2016 at a rate of approximately 6.7% (+4,422.5 million euro) in the context of improving the EU economic outlook, the main trading partner of Romania, the dynamic being closed to the one of imports that recorded an increase of about 7.5% (+5,030.1 million euro) in the context of amplifying domestic demand growth rate.

Analyzing the changes in the current account balance in terms of difference between the rate of saving and the rate of investment, it can be seen that the savings rate had a negative dynamic in 2016 compared to 2015, the latter decreasing by 1.15 pp of GDP, while the investment rate registered a growth of 0.06 pp of GDP which determined the widening of the current account deficit by 1.21 pp of GDP (from -1.22% in 2015 to -2.43% of GDP in 2016). Considering the period 2008-2016, the current account deficit adjustment of 9.36 pp of GDP was realized by reducing investments by 8.41 pp of GDP, while the savings advanced by only 0.95 pp of GDP in the analyzed period.

The foreign direct investment of non-residents in Romania increased significantly compared to the previous year, respectively by 18%, their value amounting to 4.081 million euro, a level significantly higher than the average of the past 6 years, but their value in absolute terms is much lower than that recorded during the period preceding the economic and financial crisis (during

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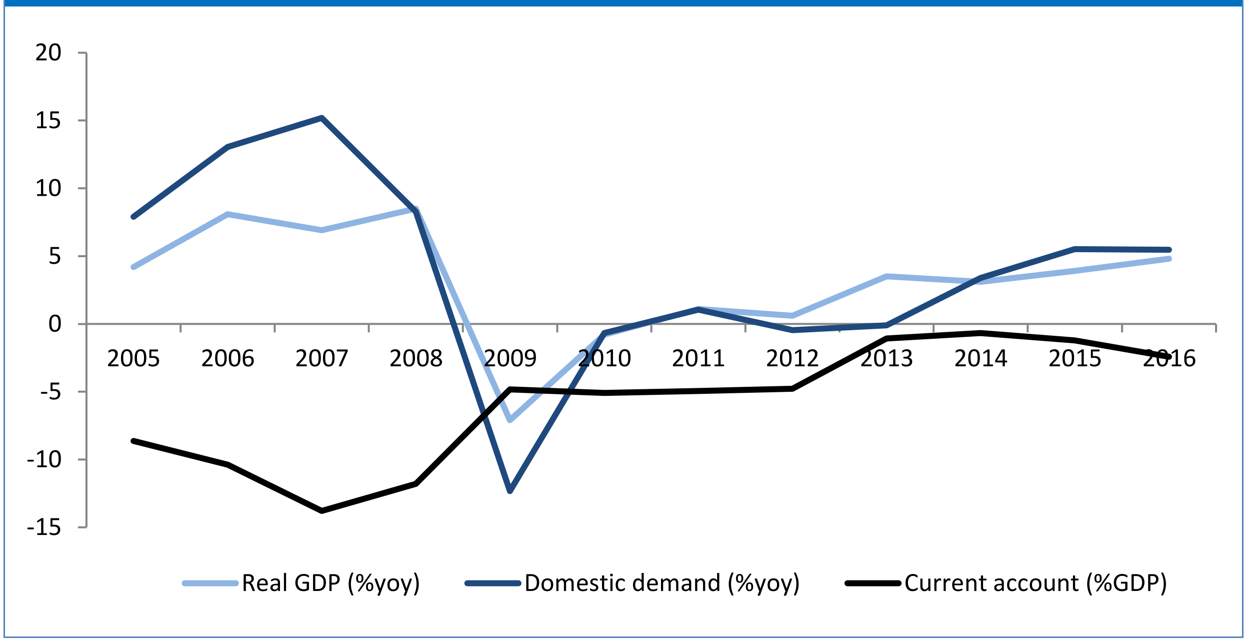
[4] The primary income account shows the amounts payable and receivable in return for providing temporary employment, financial resources or non-financial assets to another non-resident entities. Thus, primary income represents the return that rests with institutional units for their contribution to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

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

[6] Secondary income account shows the redistribution of income, i.e. the situation in which the resources for current purposes are provided by a state without counterpart. Examples are personal transfers and current international aid.

2007-2008 the average annual value of foreign direct investment was about 8.373 million euro). In terms of net foreign direct investment[7], they increased by 30.7% compared to the previous year, their value amounting to 3.863 million euro; thus, it can be seen that in 2016 foreign direct investments financed almost entirely the current account deficit, respectively in a proportion of 93.8%.

Figure 3: The evolution of the real GDP, domestic demand and current account, 2005-2016



Source: NBR, Eurostat, Fiscal Council's calculations

The external debt of Romania increased in nominal terms by 2.32 % in 2016, compared to 2015, to a level of 92.53 billion euros, its share in GDP decreasing from 56.5% to 54.6%. Although, compared to the maximum level registered by this indicator, at the end of 2012, when it reached a level of 100.86 billion euro (75.5% in GDP), the external debt decreased by 8.33 billion euro (-8.25%) at the end of 2016. Regarding the medium and long-term external debt, it represented 74.7% of total external debt at the end of 2016, respectively 69.12 billion euro, its share being lower than the one from December 31st, 2015 (78%). The short-term external debt recorded an increase of 17.8% to a level of 23.42 billion euro (25.3% of total external debt).

At the beginning of 2016 the debt to the IMF was fully repaid, given that at the end of 2015 the debt to be repaid to the IMF recorded a level of 0.12 billion euro. The downward trend of the external debt was as well due to the decrease of private external debt, especially in the context

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

of deleveraging in the banking sector. In 2016, the external public debt increased from 30.94 billion euro at the end of 2015 to 31.69 billion euro at the end of the year.

In 2016, the non-governmental loans dynamic was kept in positive territory, recording a growth of 1.79% in real terms in December 2016 compared to the same period of the last year and compared to an increase of +3.89% in December 2015. The moderation of private sector lending was driven by the decrease of the balance of foreign currency denominated loans, decreasing by 13.2% in euro equivalent, while domestic currency denominated loans had an upward trend, increasing by about 14.8% in real terms in December 2016 compared to the same period from 2015. The main factors which contributed to a positive trend of the lending activity were represented by deleveraging of households and increase of their confidence (in the context of an improvement of their expectation about personal financial situation and economic policy in general, but also of reducing concerns about rising unemployment), the reduced interest rates (especially the cost of the national currency denominated loans decreased to a level comparable to the cost of financing in euro) and easing lending requirements through a faster access to unsecured funding. Other exogenous factor that favored the upward trend of lending dynamics is represented by the acquisition of previously externalized credits by some banks. The level of non-performing loans continued its descending trajectory in the context of accelerating the balance sheets clean up, and also decreasing the deterioration rate of the portfolio quality. An improvement can be seen in the liquidity of the banking system, the loans/deposits ratio for non-governmental sector reducing below 100% to the level of 80.3% in December 2016, an adequate level from a macro prudential point of view.

The positive evolution of the lending activity in 2016 is attributable to the dynamics of households' loans (an advance in real terms of 5.28%), but the loans for companies have decreased (-1.65% in real terms). For households' lending the advance came exclusively from the acceleration of the lei component (+26.3% in real terms), as a consequence of lower interest rates, of the ongoing governmental program "First Home" exclusively in domestic currency but also as a consequence of more simple procedures for verifying the incomes of applicants, and due to the ongoing conversion operations in lei of the loans denominated in Swiss francs, while foreign currency loans, expressed in euro recorded a negative trend (-16%). For companies, the negative variation (-1.65% in real terms) was determined by the descending evolution of the flow of foreign currency loans (-11.5% in euro equivalent), in lei recorded a positive trend (+4.52% in real terms).

Regarding the developments in the labor market, in 2016 it was very favorable, the average number of employees continued to increase to a level of 4,701 thousand people[8], advancing by

[8] According to the data processed by the Fiscal Council on the basis of monthly data published by NIS.

3.4% compared to 2015, in the context of an increasing number of jobs created by the private sector (+3.9%) while the dynamic attributable to the public[9] sector was +1.5%. In 2016, the average gross wage[10] per total economy was 2,887 lei, growing by 12.8% from 2015, while net average wage was 2,088 lei, increasing by 13%, compared to 2015. Considering an average inflation of -1.55%, the real wage increased by approximately 14.3%. The positive trend of the average salary was mainly driven by the growth of wages in the public sector (+21.1% in nominal terms), generated by the repetitive wage increases, especially in the latter part of 2015 (from October 1, 2015, a 25% increase in wages in the health sector, respectively, from December 1, 2015, increase by 25% the wages for staff working in social assistance sector and National House of Public Pension, doubling salaries for staff working at National Sanitary Veterinary and Food Safety Authority, increasing of teaching staff salaries by 15% and 10% increase of budgetary personnel salaries who did not receive any other salary increases in 2015), as well as due to the implementation of salary increases according to GEO 20/2016 amending and supplementing Government Emergency Ordinance no. 57/2015 on remuneration of personnel paid from public funds in 2016 from August 1, 2016 (increasing salaries for health care workers and staff in education, including granted compensations) and the salaries of staff in public authorities similar to parliamentary services (Law no. 293/2015). During the same period, average wages in the private sector[11] advanced in nominal terms by 10.8%, the dynamics being higher than the productivity gains. Also, since May 2016 has increased the guaranteed minimum wage to 1,250 lei (from 1,050 lei in December 2015).

[9] Public sector is determined by the sum of sectors: public administration and defense, education, health and social assistance

[10] According to the data processed by the Fiscal Council on the basis of monthly data published by NIS

[11] The private sector is approximated by removing public administration and defense sectors, education and health and social assistance.

Table 1: Macroeconomic indicators in 2016 (FS forecast versus effective)		
	Revised Fiscal Strategy 2016-2018	**Effective 2016**
	- % yoy -	
GDP		
GDP (million lei)	746,600.0	761,473.6
Real GDP	4.1	4.8
GDP deflator	1.8	2.2
GDP components		
Final consumption	4.2	6.9
Private consumption expenditure	4.7	7.3
Government consumption expenditure	2.1	3.3
Gross fixed capital formation	6.2	-0.8
Exports (volume)	5.8	8.3
Imports (volume)	7.2	9.8
Inflation rate		
December 2016	1.8	-0.5
Annual average	0.5	-1.55
Labor market		
Unemployment rate at the end of period	4.8	4.8
Average number of employees	3.5	3.4[12]
Gross average wage	7.2	12.8[13]

Source: National Institute of Statistics (NIS), NCEF

[12] According to the calculated data by FC based on monthly data published by NIS: for achievements, the reported dynamic refers to figures published in the monthly bulletins of NIS including only economic agents with more than 4 employees.

[13] According to the calculated data by FC based on monthly data published by NIS that include only economic agents with more than 4 employees.

III. Fiscal policy in 2016

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

Under article 61, para. (2) of the FRL, the Fiscal Council's Annual Report must contain "a discussion and analysis of the implementation of the fiscal policy set forth in the Fiscal Strategy and the annual budget approved in the previous budget year" 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 progress against the fiscal policy 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 in improving the conduct of fiscal policy consistent with principles and rules of this law in the current budget year.

According to article 26, para. (1) of the FRL, until 31st of July each year, the Ministry of Finance is required to submit to the Government the Fiscal Strategy for the next 3 years accompanied by the draft law approving the ceilings specified in the fiscal framework. The Fiscal Strategy for the period 2016-2018 was drafted and approved in December 2015, at the same time with the draft budget proposal for 2016, which implies an identical fiscal framework for 2016 in both documents mentioned above. Under these circumstances, the obligation of the Fiscal Council to assess the Annual Report the compliance with the objectives, targets and indicators established through the Fiscal Strategy and the budget is reduced to an *ex post* analysis of the projections contained 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. We remind that this situation has been perpetuated over the past 3 years, with the Government issuing the Fiscal Strategy or an updated version of it at the same time as the draft budget for the envisaged year, which is not likely to create an efficient budgetary planning based on *ex-ante* compliance with fiscal rules.

The general consolidated budget for 2016 was based on a macroeconomic forecast scenario with an economic growth estimated at 4.1% in real terms, while the deficit target was projected to 2.8% of GDP according to cash standards, respectively a budget deficit determined according to ESA 2010 methodology of 2.95% of GDP. As a result of the fiscal loosening measures adopted, was projected a deliberate deviation from the medium-term budgetary objective in 2016 (but also between 2017-2019), respectively a structural budget deficit of maximum of 1% of GDP, the structural deficit for 2016 being estimated at 2.73% of GDP.

The final budget execution recorded the achievement of the deficit target, according to cash methodology, as the budget deficit was 2.4% of GDP, or 18.29 billion lei (compared with a projection of 20.9 billion lei). Instead, according to ESA 2010 methodology, was recorded a deficit of 3.04% of GDP, or 23.13 billion lei, exceeding the projected target of 2.95% of GDP and, marginally, even the reference value set by the Stability and Growth Pact's corrective arm. The significantly higher gap compared to the initial projections between the budget deficit according to the cash methodology and the one corresponding to ESA 2010 - about 0.65% of GDP compared to 0.15% of GDP - was mainly determined by: the impact of Law no. 85/2016 on the teaching staff who did not obtain court decisions for the payment of the salary differences for the period October 2008 - May 13, 2011 and benefits from these rights starting with 2016, which involved additional expenses of about 3.8 billion lei, fully registered in the execution according to ESA 2010, while the cash execution includes only the amount actually paid in 2016, respectively about 908 million lei (a gap between ESA 2010 and cash methodology of 2.9 billion lei or 0.38% of GDP); the difference between the compensation decisions established by the National Authority for Property Restitution amounting 2.13 billion lei and the amounts actually paid worth of 0.75 billion lei (a gap between ESA 2010 and cash methodology of 1.38 billion lei or 0.18% of GDP). It is noted that the increase in the gap between the budget deficit according to the European methodology and the one according to the national methodology was mainly due to temporary factors. The aggregate contribution of the state-owned companies in the public administration sector to the consolidated budget balance was positive in 2016, respectively of about 1.6 billion lei, increasing by about 0.4 billion lei compared to the previous year.

In terms of fiscal policy rules, the nominal ceilings for the general government balance in 2016, the primary balance, total expenses (excluding income from post-accession EU funds, pre-accession funds, and financial assistance from other donors) and personnel expenditure were established by Law no. 338/2015[14] (see *Table 2* below). The budget execution confirms the compliance with the ceilings for the budget balance and the primary balance, as well as for the total expenses (excluding income from post-accession EU funds, pre-accession funds, and

[14] The Law on the approval of the ceilings of certain indicators specified in the Fiscal Strategy, which entered into force in December 2015.

financial assistance from other donors) and personnel expenditure. However, these ceilings have only been met *ex post*, due to the under-execution of programmed expenditure, the tax fiscal being violated *ex ante,* in the budget planning process, on the occasion of the two budget revisions.

Table 2: Nominal ceilings for GCB balance, total and personnel expenditure						
	Law no. 338/2015			Budget execution 2016		
	GCB balance	Total expenditure*	of which: Personnel expenditure	GCB balance	Total expenditure*	of which: Personnel expenditure
million lei	**-20,905.50**	**238,875.50**	**57,334.90**	**-18,294.34**	**235,155.22**	**57,040.07**
% of GDP	*-2.8%*	*31.5%*	*7.7%*	*-2.4%*	*31.0%*	*7.5%*

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

Source: MPF

The first budget revision, approved at the beginning of August 2016, significantly increased both general consolidated budget revenues and expenditure compared to the original approved budget with 4.2 billion lei, keeping the budget balance at the initially projected nominal level of -20.9 billion lei. Compared to the limits of the ceilings stipulated by Law no. 338/2015, both the limit for the budget balance of GCB, which was kept at the initially level, and the primary balance are respected, while the personnel expenses and total expenses, excluding financial assistance from the EU and other donors have exceeded the ceilings of the Law mentioned above[15], being inconsistent with the fiscal rules established by article 12, letter a), b) and c) of the FRL, as well as article 17 para. (2), which prohibits the increase of personnel expenses during the budget amendments, article 24 which prohibits the increase of the total spending of the GCB during budget amendments other than for paying debt service and financial contribution of Romania to the EU budget and article 26 para. (5) which reaffirms the obligation of respecting the ceilings imposed by the law for the next budget year. It is also important to note that the approved version of the first budget revision differs from the one notified to the Fiscal Council, so the present figures do not correspond to those in the Opinion issued in early August 2016. Both the revenue and the expenditure in the approved budget rectification are with 450 million lei lower than those in the form received by the Fiscal Council, the difference on revenues being exclusively at the level of the VAT receipts category, and on the expenses on several subcategories.

At the level of revenues, the budget revision envisaged an increase by 4.2 billion lei. The income aggregates at the level of which, in the context of the execution at mid-year, were made

[15] Overruns of the ceilings by +1.5 billion lei for *personnel expenses* and by 2.7 billion lei for *total expenditure excluding financial assistance from the EU and other donors*.

important changes compared to the original budget were: *non-tax revenues* (+1,484 million lei), *corporate income tax* (+1,053 million lei), *personal income tax* (+897 million lei), *VAT* (+856 million lei), *other taxes on income, profit and capital gains* (+470 million lei) and *social contributions* (-982 million lei). The Fiscal Council warned about the upward revision of the non-tax revenues, underlining the risk that the actual amounts at the end of the year would be lower than the updated program, the final execution being lower by 2,692 million lei compared to the amount stipulated in the first revision and by 1,208 million lei lower than the one envisaged by the initial program. In the second half of 2016, the Government envisaged extraordinary revenues of about 847 million lei, corresponding to the reclassification of some sums from the budget financing of the previous years, and the Fiscal Council warned that it is difficult to reconcile the under-performance at the level of the half-year execution with the upward revision of the program for the year 2016, even taking into account these temporary revenues. The Fiscal Council was also extremely skeptical about the proposed level of post-accession funds for the 2014-2020 financial year, given that at the end of the first semester the corresponding revenues accounted for only 5.1% of the amount budgeted for the whole year. Given that the half-year execution revealed a weak absorption of European funds and especially in the context of the historical experience, which indicates that it is unlikely that the acceleration of European fund inflows in the second half of the year would be sufficient in order to bring incomes closer to the programmed levels, the proposed level appeared to be unfeasible, and this was confirmed by the budget execution for 2016.

At the level of the budgetary expenditures, the increase of 4.2 billion lei was determined by the increase in the expenditure related to *projects financed from external non-reimbursable funds* (+2.292 million lei), *personnel expenditure* (+1.500 million lei) and *social assistance expenditure* (+1.376 million lei). A massive downward revision of the projection was envisaged at the level of expenditure related to *projects financed from post-accession non-reimbursable funds 2014-2020* (-2.034 million lei). Only a third of the revision proposal for the social assistance aggregate was due to the legislative measures that emerged after the 2016 budget approval (Law no. 66/2016 on the increase and modification of the method of setting the monthly indemnity for child raising and the insertion incentive, with an impact of + 305 million lei and Law no. 342/2015 - approved on December 22, 2015 - regarding the exclusion of the state allowance from the family income when establishing the social assistance aid, with an impact of +140 million lei), being mainly the result of the tendencies revealed by the half-year budget execution, as the half-year expenditures indicated the achievement of more than half of the initial allocation for the whole year, being foreseen additional expenditures of about 900 million lei. The upward revision of the personnel expenditure has occurred as a combined effect of the compensatory amounts resulting from the Law no. 85/2016 (with an impact in cash terms of about 1 billion lei), the salary increases operated in August 2016 and the savings revealed by the budget execution at the end of the first semester, as payments accounted for 48.5% of the amount initially allocated for the whole year.

The second budget revision, approved in November 2016, compared to the levels approved in the first budget revision, stipulated an increase of the estimated GCB revenues and expenditures by approximately 0.5 billion lei, while maintaining the budget deficit target at the originally projected level (20.9 billion lei). The revision proposal violates: the provisions of art. 12, lit. (a), (b) and (c) which prohibits the exceeding of the nominal and GDP percentage ceilings of the general consolidated government balance, the primary balance, the personnel costs and the total consolidated general government expenditure excluding the financial assistance from the EU and other donors (except for the GCB balance as a nominal level and as a percentage of GDP); art. 17 par. (2) according to which personnel expenditure may not be increased during the year on budget revision occasion; art. 24 according to which total expenditure, excluding financial assistance from the EU and other donors, can be supplemented by budget rectifications only for the payment of the public debt service and for payment of Romania's contribution to the EU budget.

The GCB revenues were revised upward by 489.2 million lei (net of swap impact) compared to the level programmed by the first budget revision. The categories of budget revenues that were changed from the projected values during the first budget revision, considering net swap values, were: *personal income tax* (+567.3 million lei), *nontax revenues* (+182.5 million lei), *taxes on using goods, authorizing the use of goods or on carrying activities* (-121.9 million lei). The Fiscal Council reiterated in its opinion on the second budget revisions the concerns expressed during the first budget revision of the excessively high level of projected nontax revenues. The Fiscal Council also stressed out that maintaining the projection of the estimated amounts to be attracted from European funds for the year 2016, in the context of which the receipts at the end of September accounted for only 22% of the amount proposed for the whole year, was an extremely unlikely evolution. The budgetary execution at the end of the year also revealed the need for an amendment in the sense of a considerable decrease in this budgetary aggregate.

Eliminating the influence of the compensation schemes for the budgetary arrears, the modification in the budgetary expenditures of 442.2 million lei was located at the level of the following categories: *social assistance expenditure* (+1,132.9 million lei), *capital expenditure* (+593.9 million lei), *interest* (-680.9 million lei), *goods and services* (-454.0 million lei). The Fiscal Council was once again skeptical about the investment spending reaching the programmed level, given that the Government was considering spending more than double the amount spent in the first three quarters of 2016 in the last quarter of the year. The upward revision of spending on social assistance had as sources the increase of the allocations for this chapter in the state budget by 426.3 million lei, as well as the increase of the planned expenditures for social assistance in the local budgets by 674.6 million lei. The additional expenditure did not come as a result of new legislative measures, but due to of the insufficient budgeting of the military pensions and, at the level of local budgets, of the expenses related to the payment of allowances for disabled persons who give up their attendant.

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

- the lack of compliance with the annual ceilings set for the general government deficit, the primary deficit, the total expenditure and personnel expenditure, these being often violated *ex post*;
- the frequent violation of the ban on increasing the total expenditure and personnel expenditure during the budget amendments;
- the Fiscal Strategy has not been developed on time (July, 31);
- usually, the measures to reduce taxes are not accompanied by coherent compensation measures (such as increasing the tax base/growing other taxes or reducing expenditures);
- the structural deficit rule is violated in 2016 (medium term objective of -1% of GDP), but also will be in 2017-2019.

The draft Government Ordinances on the two budget revisions for 2016 stipulate the corresponding exemptions from the aforementioned fiscal rules and redefines the ceilings in Law no. 338/2015 in line with the levels of budgetary aggregates in the rectification proposal. The Fiscal Council once again notes the persistence of the inoperability of the fiscal rules that do not concern budget deficit and reiterates its recommendations on compliance with these rules, noting that in 2016 also the European rules on the structural deficit level stipulated by the preventive arm of the Stability and Growth Pact as well as the Fiscal Compact were significantly violated. Furthermore, compliance with the corrective arm of the Stability and Growth Pact could also be questioned, as the budget deficit according to the European methodology ESA 2010 slightly exceeded the 3% of GDP threshold. Under these circumstances, the Fiscal Council notes the *de facto* inoperability of the fiscal and budgetary framework based on rules stipulated in the Fiscal-Budgetary Law no. 69/2010 republished, as well as by the European Treaties Romania adhered to.

The evolution of the key budgetary aggregates during 2016 according to cash standards is presented in *Table 3*.

Table 3: The evolution of the main budgetary aggregates during 2016 (billion lei)				
	Initial budget	First revision	Second revision	Budget execution 2016
Total revenues	**230.1**	**234.3**	**234.8**	**223.0**
Fiscal revenue	135.1	138.4	138.7	136.0
Social contributions	61.7	60.8	60.8	61.0
EU Funds	13.1	13.5	13.5	6.9
Total expenditure, of which :	**251.0**	**255.2**	**255.6**	**241.3**
Current expenditure, of which	231.8	235.7	235.5	222.3
Projects from EU funds	17.0	17.3	17.2	10.4
Capital expenditure	19.2	19.5	20.1	19.0
Budget deficit	**-20.9**	**-20.9**	**-20.9**	**-18.3**

Source: MPF

Note: Amounts without the compensation schemes.

The results of the budget execution in the fiscal year 2016 indicate a budgetary deficit in cash standards with 2.6 billion lei lower than the forecast of the initial program (approximately 0.34% of GDP), so that despite the fact that revenues were below expectations (-7.1 billion lei), expenditures decreased by 9.5 billion lei compared to the initial estimates.

On the budgetary revenues side, net of the swap impact, the difference from the estimated amount to be received was -7.1 billion lei, mainly due to the very poor evolution of the absorption of European funds[16] (-6.0 billion lei compared to the estimated level from the initial budget), but also as a result of revenues below forecasts in *goods and services taxes* (-2.2 billion lei) and *non-fiscal revenues* (-1.2 billion lei). Revenues above expectations were recorded in *taxes on profit, wages, income and capital gains*, by 2.9 billion lei above the level estimated in the initial budget, a category of budgetary revenues that recorded a massive positive rectification at the first revision, justified by the over-performance compared to the initial program at the end of the first semester and against the upward revision of the projected GDP dynamic and gross average wage.

As regards the expenditure, their amount has decreased by 9.7 billion lei compared to the initial estimated value, the main categories among which were recorded decreases being: *projects funded by external post accession grants 2014-2020* (-6.1 billion lei), *goods and services* (-2.2 billion lei), *other transfers* (-1.4 billion lei) and *interest* (-1.1 billion lei). A good evolution was registered by *social assistance* (+2.5 billion lei), an expenditure category that has registered

[16] Including the amounts for the 2014-2020 financial framework.

positive adjustments on the occasion of both budget revisions, with additional expenses stemming largely from insufficient initial budgeting, and less due to a result of the new legislative measures.

Table 4: The development of budgetary expenditure and revenue according to ESA 2010, %GDP

	2009	2010	2011	2012	2013	2014	2015	2016	Changes 2016 to 2015	Changes 2016 to 2009
Total revenue	**31.5**	**32.7**	**33.7**	**33.6**	**33.3**	**33.5**	**35.0**	**31.7**	**-3.3**	**0.2**
Fiscal revenue	16.8	17.5	19.0	18.9	18.6	18.9	19.9	17.8	-2.1	1.0
Indirect taxes, out of which:	10.7	11.8	13.0	13.1	12.7	12.7	13.3	11.3	-2.0	0.6
VAT	6.5	7.5	8.6	8.2	8.1	7.6	8.1	6.5	-1.6	0.0
Excises	3.1	3.0	3.1	3.1	3.1	3.3	3.4	:	:	:
Direct taxes, out of which:	6.2	5.7	6.0	5.8	5.9	6.2	6.6	6.5	-0.1	0.3
PIT	3.6	3.4	3.4	3.6	3.5	3.6	3.7	3.7	0.0	0.1
CIT	2.4	1.8	1.8	1.7	1.7	1.8	2.0	2.0	0.0	-0.4
SSC	10.0	9.3	9.0	8.7	8.6	8.5	8.1	8.1	0.0	-1.9
Other current revenue	1.6	2.7	2.3	2.3	2.1	2.0	2.1	2.3	0.2	0.7
Total expenditure	**40.9**	**39.6**	**39.1**	**37.2**	**35.4**	**34.9**	**35.8**	**34.7**	**-1.1**	**-6.2**
Intermediate consumption	6.3	5.4	5.7	6.0	5.7	5.7	5.7	5.3	-0.4	-1.0
Compensation of employees	10.7	9.5	7.8	7.8	8.1	7.7	7.7	8.2	0.5	-2.5
Interest payments	1.5	1.5	1.6	1.8	1.8	1.6	1.6	1.5	-0.1	0.0
Social assistance	13.2	13.7	13.1	12.1	11.7	11.5	11.5	11.6	0.1	-1.6
Subsidies	1.1	1.0	0.9	0.7	0.5	0.5	0.5	0.4	-0.1	-0.7
Other current expenditure	1.8	1.9	2.1	2.5	1.9	2.3	2.5	2.5	0.0	0.7
Gross fixed capital formation	6.0	5.7	5.4	4.9	4.6	4.3	5.2	3.6	-1.6	-2.4
Budget deficit	**-9.5**	**-6.9**	**-5.4**	**-3.7**	**-2.1**	**-1.4**	**-0.8**	-3.0	**-2.2**	**6.5**

Source: Eurostat

The fiscal consolidation initiated in 2010 in order to correct the existing major imbalances regarding the public finances position, was characterized by an alert pace, Romania succeeding in a relatively short period a significant budget deficit reduction, expressed according to ESA 2010 standards, from 9.5% of GDP in 2009 to 0.8% of GDP in 2015. However, the year 2016 marked a significant 2.2 pp increase in the budget deficit compared to the previous year, amid a massive fall in revenue, thus partly reversing the results of the fiscal consolidation process.

The budgetary revenues are 3.3 pp of GDP lower than the previous year and only 0.2 pp of GDP above the level of 2009, amid the significant decrease compared to 2015 of the amounts received from the EU and the negative evolution of VAT receipts which reached the level of 2009 as a result of the fiscal loosening measures introduces in the new Fiscal Code. Compared to 2015, the share to GDP of the *personal income tax, corporate income tax* and *social security contributions receipts* remained approximately constant. A revenue category that recorded increases compared to both 2009 and 2015 is represented by *other current revenues*, with a 0.7 pp in GDP increase compared to 2009 and a 0.2 pp in GDP over the previous year.

The significant fiscal adjustment compared to 2009 was achieved almost exclusively at the level of budget expenditures, which are 6.2 pp of GDP below the level of 2009, by means of decreases registered at the level of the following components: *intermediate consumption* (-1.0 pp of GDP), *compensation of employees* (-2.5 pp of GDP), *social assistance* (-1.6 pp of GDP), *subsidies* (-0.7 pp of GDP) and *gross fixed capital formation* (-2.4 pp of GDP). Instead, *other current expenditure* category increased by 0.7 pp of GDP. Compared to the previous year, the expenditures declined by 1.1 pp of GDP, through decreases in the level of the next categories: *gross fixed capital formation* (-1.6 pp of GDP), *intermediate consumption* (-0.4 pp of GDP), *interest* (-0.1 pp of GDP), *subsidies* (-0.1 pp of GDP). The categories of budgetary expenditures that registered increases compared to 2015 were: *compensation of employees* (+0.5 pp of GDP) and *social assistance* (+0.1 of GDP). In essence, the fiscal adjustment in the period 2009-2016 was mainly made at the level of *investment*, personnel expenses and social assistance expenditures, the latter two being partially reversed in the year 2016.

Table 5: The development of budgetary revenue and expenditure according to cash methodology (% of GDP)												
	2009	2010	2011	2012	2013	2014	2015	Initial budget 2016	Execution 2016	Changes initial budget 2016 to 2015	Changes 2016 to 2015	Changes 2016 to 2009
Total revenue	**30.8**	**31.6**	**32.1**	**32.4**	**31.4**	**32.0**	**32.6**	**30.3**	**29.4**	**-2.3**	**-3.2**	**-1.4**
Fiscal revenue	17.1	17.4	18.5	19.1	18.7	18.6	19.4	17.8	17.9	-1.6	-1.5	0.8
PIT	3.6	3.4	3.4	3.5	3.6	3.5	3.7	3.5	3.6	-0.2	-0.1	0.0
CIT	2.1	1.9	1.8	1.8	1.7	1.8	1.9	1.9	2.0	0.0	0.1	-0.1
Property tax	0.7	0.7	0.7	0.7	0.7	0.9	0.8	0.8	0.8	0.0	0.0	0.1
VAT	6.7	7.4	8.5	8.5	8.1	7.6	8.0	6.8	6.8	-1.2	-1.2	0.1
Excises	3.1	3.3	3.4	3.4	3.3	3.6	3.6	3.6	3.6	0.0	0.0	0.5
SSC	9.4	8.6	9	8.7	8.5	8.6	8.0	8.1	8.0	0.1	0.0	-1.4
Non fiscal revenue	3.3	3.7	3.2	3.1	2.7	2.6	2.7	2.5	2.4	-0.2	-0.3	-0.9
Donations	0.6	0.8	0.1	0.1	0	0.0	0.0	0	0.0	0.0	0.0	-0.6
Amounts received from the EU for payments made	0.4	1	1.1	1.3	1.4	1.7	2.4	1.7	0.9	-0.7	-1.5	0.5
Total expenditure	**38**	**37.8**	**36.3**	**34.8**	**33.8**	**33.7**	**34.1**	**33.1**	**31.8**	**-1.0**	**-2.3**	**-6.2**
Personal expenditure	9.2	8	6.8	6.8	7.3	7.5	7.3	7.6	7.5	0.3	0.2	-1.7
Goods and services	5.5	5.6	5.6	5.8	6.1	5.8	5.7	5.7	5.4	0.0	-0.3	-0.1
Interest payments	1.2	1.4	1.6	1.8	1.7	1.5	1.3	1.5	1.3	0.2	0.0	0.1
Subsidies	1.4	1.3	1.1	1	0.8	0.9	0.9	0.9	0.9	0.0	0.0	-0.5
Projects financed from post-accession grants	0.5	1.4	1.9	2.2	2.2	2.2	3.4	2.2	1.3	-1.2	-2.1	0.8
Social protection	12.5	12.8	12	11.2	10.7	10.7	10.7	10.5	10.8	-0.2	0.1	-1.7
Capital expenditure	4.3	3.6	4.1	3.2	2.8	2.6	2.5	2.5	2.5	0.0	0.0	-1.8
Budget deficit	**-7.2**	**-6.2**	**-4.2**	**-2.5**	**-2.5**	**-1.7**	**-1.5**	**-2.8**	**-2.4**	**-1.3**	**-0.9**	**4.8**

Source: MPF

Note: Amounts without the compensation schemes.

From the cash methodology perspective, compared to the previous year, in 2016 was recorded a deterioration in the budget deficit of 0.9 pp of GDP, budgetary revenues decreasing by 3.2 pp of GDP, higher than the budgetary expenditure decrease (-2.3 pp of GDP). Compared to 2015, the main categories of budgetary revenues had an unfavorable evolution, standing out *VAT* receipts (-1.2 pp of GDP, as a result of the fiscal loosening measures involved in the new Fiscal Code), *amounts received from the EU* (-1.5 pp din PIB). On the expenditure side, compared to the previous year, have decreased *goods and services expenditure* (-0.3 pp of GDP) and *expenditures for projects funded by external non-reimbursable grants* (-2.1 pp of GDP), a small part being compensated by the raise in *personnel expenditure* (+0.2 pp of GDP) and *social assistance* (+0.1 pp of GDP)

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

III.2. The structural budget balance in Romania

The signing and ratification by Romania of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union in 2012 stipulates a fiscal framework based on rules, with a benchmark in the case of Romania of a structural deficit target of maximum 1% of GDP[17]. The TSCG's provisions and the one of Directive no. 85/2011 were incorporated into the national law by amending the Fiscal Responsibility Law no. 69/2010 in December 2013, so the medium-term budgetary planning is constrained by the new rule for the budget deficit enforced by the TSCG, starting with 2015.

Thus, the draft budget for 2016 targeted a budget deficit according ESA 2010 methodology of 2.95% of GDP, corresponding to a 2.73% of GDP structural deficit which was equivalent to a structural deterioration of the budget balance of about 2 pp of GDP compared to the projected level of 2015 at that time (December 2015) and respectively 0.7% of GDP. The budget execution for 2016[18] indicated a level of the headline deficit according to the European methodology of 3% of GDP, compared to 0.8% of GDP in 2015, while the structural balance has significantly deteriorated in 2016, reaching -2.6% of GDP according to the latest EC estimations. The structural

[17] The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union requires the contracting parties to ensure convergence towards country-specific MTO, imposing a structural deficit limit of 0.5% of GDP, respectively 1% for the member states with a public debt significant below 60% of GDP. In the case of Romania, the structural deficit has to be maximum 1% of GDP.

[18] Published in April 2017 by Eurostat.

budget balance was lower by 0.15 pp of GDP than originally anticipated, despite a headline deficit higher by about 0.1 pp of GDP than that of the GCB draft as a result non-recurrent factors (one-off factors) that negatively affected the actual budget balance without influencing the budget balance in structural terms[19]. At the same time, the level of structural deficit is well above the 1% of GDP exceptionally set for EU countries with a debt level well below 60% of GDP. Moreover, for the following years, a further deterioration in the fiscal position is anticipated.

The table below shows the level of MTO for EU countries, noting that Romania is placed in a group of only 8 countries with structural deficits placed at the 1% of GDP threshold due to a relatively low level of the public debt (Hungary has a higher deficit as a MTO due to the fact that TSCG provisions are not yet in force, the level being determined within the preventive part of the SGP). To the extent that public debt will rise - which is likely considering the current budget deficits - it is not excluded to witness a revision of the MTO level for Romania in the sense of a smaller structural deficit.

Table 6: MTO's levels for EU countries

Country	Belgium	Bulgaria	Czech R.	Denmark	Germania	Estonia
MTO	0%	-1%	-1%	-0.5%	-0.5%	0%
Country	Ireland	Latvia	Lithuania	Luxemburg	Hungary	Malta
MTO	-0.5%	-1%	-1%	-0.5%	-1.5%	0%
Country	Netherlands	Austria	Poland	**Romania**	Slovenia	Slovakia
MTO	-0.5%	-0.5%	-1%	**-1%**	0%	-0.5%
Country	Finland	Sweden	Italia	France	Croatia	Spain
MTO	-0.5%	-1%	0%	-0.4%	-1.75%	0%
Country	Cyprus	Portugal				
MTO	0%	0.25%				

Source: Convergence programs (countries from non-euro zone) or Stability programs (countries from euro zone)
Note: Revised in 2016.

In 2009-2015, the structural deficit was reduced from 8.8% of GDP to 0.56%, the average rate of adjustment of 1.64 pp per year until 2014 being extremely fast (see *Figure 4*); at the same time, we have to remember that the starting level was high, which required a rapid adoption of decisive measures to ensure the sustainability of the fiscal policy. It should be noted that this adjustment was made mostly in 2010 and 2011, when the structural deficit was reduced on average by 2.9 pp per year, the fiscal consolidation being achieved mainly on the expenditure side through

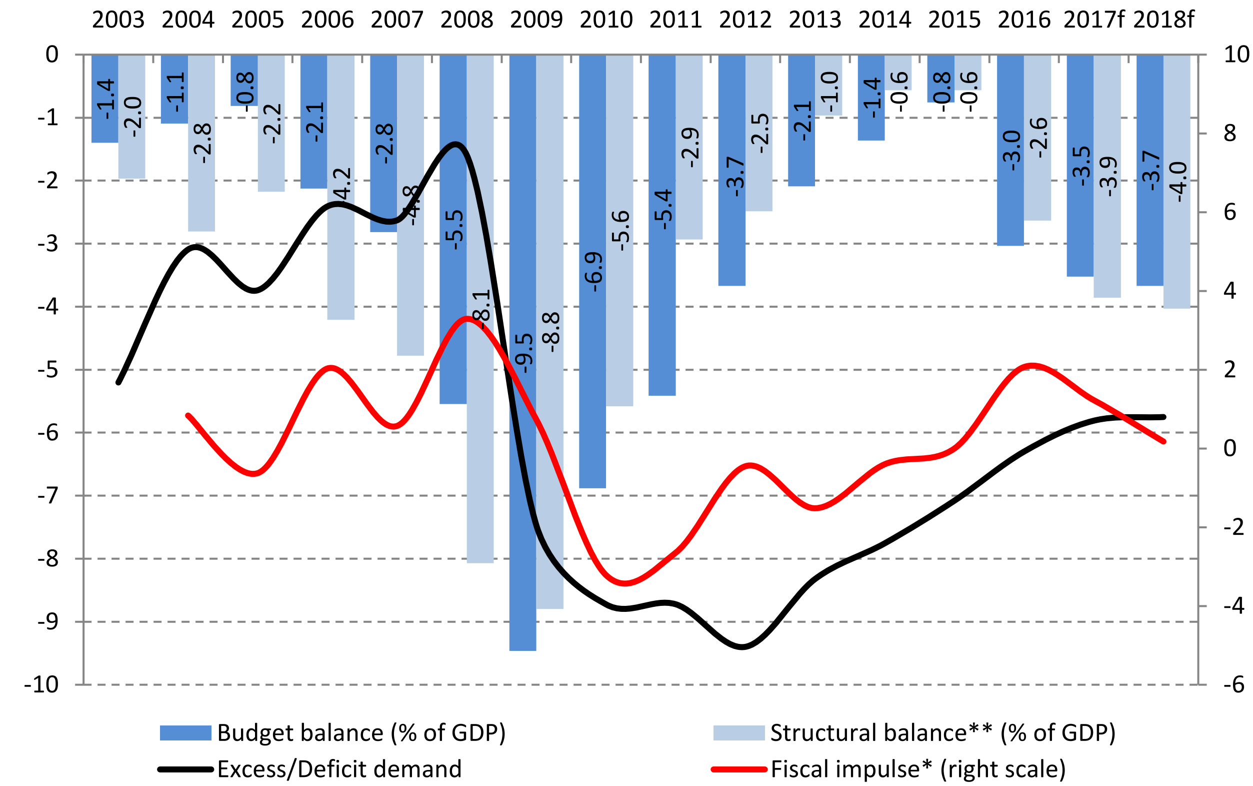
[19] The one-off factors were represented mainly by the Law no. 85/2016.

reforms in the public wages, in the pension system and in the budgetary programming. At the same time, on the revenue side, the most important measure was the increase in the standard VAT rate from 19% to 24% since July 2010.

Basically, once the achievement of MTO was met in 2014 and 2015, the fiscal consolidation process initiated in Romania in 2010 could be considered completed, other fiscal adjustments not being necessary. However, it should be taken into account the fact that defining the target in terms of structural deficit implies a target for the headline deficit appropriately adjusted according to the economic cycle, thus with the closure of the output gap in 2016 and its re-entry into positive territory projected for the period 2017-2018, compliance with the structural deficit target of 1% of GDP will be equivalent to the registration of headline deficit levels lower than this level (the cyclical component of the budget balance will be positive).

Romania practiced in the period 2006-2015 a significant pro-cyclical fiscal policy, stimulating strongly but useless and counterproductive the economy in times of economic expansion (2006-2008) and slowing the economy when it was operating below potential (2010-2015), contributing to the exacerbation of business cycle fluctuations and to deepening the accumulated imbalances in the economy (*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, the need to reduce the budget deficit during the crisis (primarily due to funding constraints) therefore implying, inevitably, maintaining the pro-cyclicality of the fiscal policy. Consequently, the automatic, beneficial and stabilizing action of the cyclically deficit (the automatic stabilizers) was canceled by the pro-cyclical discretionary policy.

Figure 4: Structural deficit, fiscal impulse and excess demand



*Defined as variation in the structural balance (% of GDP) (+ stimulus effect ,- contractionary effect)
** For the period 2003-2009, the data refer to the cyclically adjusted budget balance

Source: AMECO, Fiscal Council`s calculations

The fiscal consolidation conducted in 2010-2015 has been partially reversed and in a steep way since 2016 as a result of the entry into force of the new Fiscal Code, which implies broad loosening of the fiscal policy[20] while simultaneously regulating significant increases in spending, especially on wages. This development is in **flagrant contradiction with the FRL's fiscal principles[21] and rules, as well as fiscal governance treaties at the European level at which Romania adhered.**

[20] The main measures in terms of the budgetary impact refers to: extending the scope of the reduced VAT rate of 9% for all food, restaurant and catering services, reducing the standard VAT rate at 20% in 2016 and 19% in 2017, reducing the special constructions tax to 1% in 2016 and its elimination in 2017, decreasing at 5% the tax on dividends since 2016 and eliminating the fuel supraexcise since 2017.

[21] The principle of fiscal responsibility stated by article 4 of the FRL requires the government *"to manage fiscal policy prudently".*

Therefore, in 2016 the fiscal policy stance became loose, with the fiscal impulse being strongly positive, amounting to 2.07 pp of GDP, significantly exceeding the limits imposed by the MTO.

Between 2017 and 2018, the fiscal policy will maintain its expansionary character, with the fiscal impulse forecasted at about 1.2% of GDP in 2017 and about 0.2% of GDP in 2018, even if this implies exceeding with more than 2.8 pp in GDP the level of structural deficit allowed by the MTO. It should also be noted that the MPF projection included in the 2017-2020 Convergence Program differs significantly from that of the EC, with deficits projected around 3% of GDP over the period 2017-2018, and will follow an adjustment path of 1 pp between 2019-2020.

Thus, according to the EC forecast, since 2017 are estimated significant deviations from the medium term budgetary objective, namely, **structural balance levels of -3.9% of GDP in 2017 and -4.03% of GDP in 2018**[22], but also from the budget deficit threshold set by the corrective arm of the Stability and Growth Pact, with estimated budget deficits of 3.5% of GDP in 2017 and 3.7% in 2018. Moreover, there is a paradigm shift in conducting the fiscal policy in the medium term between the Fiscal Strategy 2015-2017 (related to the budgetary construction for 2015) which provided the following guidelines: "*macroeconomic prudence and fiscal responsibility*" by maintaining the MTO to -1% of GDP and the Fiscal Strategy 2017-2019 which is based on "a firm commitment to support the change that would stimulate economic growth" and which confirms the deviation from the MTO in 2016-2019 and the return to a path of convergence towards the MTO from 2018, respectively 2019, but without detailed and concrete measures to do so.

In this context, it is relevant to mention and emphasize that in the recent press releases of the rating agencies the fact that evaluations are subject to maintaining the progress regarding the structural position of public finances[23]. Thus, in April 2017, as specified by MPF and the rating agencies' press release, Moody's maintains the Baa3 rating for long-term debt and the P-3 for short-term debt, changing the outlook to stable (from positive), similar with the level granted by other rating agencies (Standard & Poor's, Fitch and JCRA).

The structural budget balance, despite the fact that it reflects more accurately the fiscal position of an economy, presents a number of disadvantages, the most important being related to the uncertainties associated with its estimation. Thus, the value of the structural balance is dependent on the output gap, in turn dependent on potential GDP, an unobservable variable that is often subject to more or less significant revisions depending on the revision of the statistical

[22] According to the 2017-2020 Convergence Program, the MPF forecasts a structural balance of -2.9% of GDP in 2017 and -3.0% of GDP in 2018 (as a result of different EC estimates of the level of the output gap in the period 2016-2018, as well as for the actual budget balance in the years 2017-2018).

[23] Moody's press release in late 2016 explicitly mentions the existence of risks associated with the fiscal policy stance.

data and the methodology used. Compared to the previous version of the Fiscal Council annual report, the output gap trajectory has been revised by the EC from an estimate of 0.0% for 2016 and 0.3% for 2017 in the spring 2016 forecast, to -0.1% for 2016 and 0.7% in 2017, in the spring 2017 forecast, and the structural deficit from an estimate of 2.8% for 2016 and 3.4% for the year 2017 in the EC spring 2016 forecast to 2.6% for 2016[24] and 3.9% in 2017 in the EC spring 2017 forecast.

Further, maintaining the expansionary character of fiscal policy initiated in 2016 and continued in 2017, in the context of an output gap very close to zero will only help to maintain the pro-cyclicality of the fiscal policy and exposing the public finances' position to shocks, not being excluded the need for corrections in difficult economic times due to the depletion of the fiscal space. Moreover, considering the placement of government debt level at the end of 2016, a significantly higher level than in 2007, respectively 37.6% compared to 13.2% of GDP, it is difficult to imagine the existence of a fiscal space to stimulate the economy in times of recession, existing risks even for the sustainability of the public debt. Furthermore, such a policy is in flagrant contradiction with the rules established by the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and the FRL, the compliance with the structural deficit target in the period 2016-2018 being abandoned. Additionally, the adjustment path towards the MTO is not appropriate, the automatic correction mechanism envisaged by the law not being currently functional *de facto*.

III.3. Budgetary revenues

The revenues of the general consolidated budget, without the impact of the compensation schemes (750.3 mil. lei) decreased in 2016 by 4.08% (respectively, a minus of 9.5 billion lei) compared with the previous year, reaching a level of 222.97 billion lei, representing only 29.28% of GDP, a minimum of the period 2006-2016. Compared to 2015, the share of budgetary revenues in GDP decreased significantly, respectively by 3.41 pp of GDP, the decrease being localized at the level of *amounts received from the EU in the account of payments made and prefinancing*[25] respectively, by -1.53 pp of GDP (noting that 2015 was a peak of attracting European funds, as it represented the deadline for attracting the funds related to the financial year 2007-2013 and in

[24] The structural deficit for 2016 was revised downwards by the EC as a result of one-off measures that accounted for -0.38% of GDP.

[25] Throughout this subchapter, the revenue from EU funds are cumulative for the financial years 2007-2013 and 2014-2020.

2016 the performance to attract funds for the new financial year 2014-2020 was well below expectations), as well as for the *tax revenue* (-1.52 pp) and *non-tax revenue* (-0.31 pp).

In the case of the *tax revenues*, the most significant decreases in the share of GDP were: *VAT receipts* (-1.26 pp due to the reduction of the standard VAT rate from 24% to 20%), *excises* (-0.12 pp of GDP), the revenues from *personal income tax* (-0.09 pp) and *other taxes on goods and services* (-0.08 pp). Slight increases in the share of GDP compared to the previous year were reported for the revenues from *corporate tax* (0.08 pp) and *other fees and taxes* (0.03 pp of GDP). It should be noticed that the decline in the main categories of revenue compared to the previous year is mainly due to the fiscal loosening measures introduced by the new Fiscal Code, namely: lowering the standard VAT rate by 4 pp, introducing reduced VAT rates (9% for the supply of drinking water and water for irrigation in agriculture, 5% for the supply of textbooks, books, newspapers and some magazines, and reduced rate from 9% to 5% for services consisting in allowing admission to castles, museums); reducing the *excise duty* on alcoholic beverages (by 30%) and the repeal of excise duties on luxury goods; the *dividend tax* reduction (from 16% to 5%); elimination of the special tax of 1% for agricultural buildings; eliminating the hotel tax; microenterprises taxation modification; removing the requirement for payment of social insurance contributions paid by employers for staff of the army, police and civil servants with special status, etc. Regarding the evolution of the revenues from *personal income tax* and *social security contributions* it is comprised the impact of reduction by almost 3 billion lei for the compensatory amounts resulting from the court decisions to grant salary rights compared with 2015.

Compared to the initial budget, the budget revenues were lower by 7.1 billion lei (-3.1%, respectively, by 0.93 pp of GDP smaller, mainly as a result of developments far below the expectations for the *amounts received from the EU in the account of payments made and prefinancing* for the new financial year (-0.90 pp of GDP), while the increasing by 0.12 pp of GDP in *tax revenues* due to the development above the expectations of the macroeconomic indicators compared to the initial projections, was canceled by lower than estimated *non-tax* revenue (-0.16 pp of GDP) and *social security contributions* (-0.10 pp of GDP).

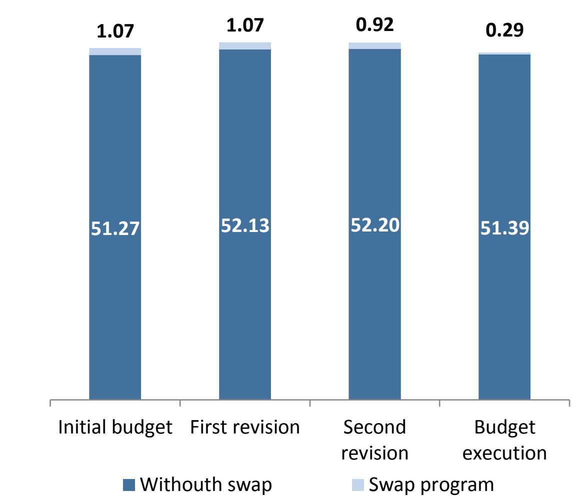
For the tax revenue, higher levels than initially estimated had registered the revenues from *corporate income tax* (+0.13 pp of GDP), explained in terms of a higher elasticity of this budgetary aggregate to GDP growth, the receipts from *personal income tax* (+0.19 pp of GDP) benefiting from the advance of the number of employees by 3.4% and the gross average salary of 12.8% compared with 2015, significantly higher than the initial forecasts values, and also of the tripling *dividend tax* that partially offset the cuts in the tax rate from 16% to 5%. A minus of the budgetary revenues was recorded in the receipts from *other taxes on goods and services* (-0.22 pp of GDP or -1.74 billion lei) due to much lower than forecasted revenues from the national health fund, respectively of the contribution due for the contracts cost-volume/cost-volume outcome, and *excises* (-0.06 pp of GDP), explained by the Ministry of Public Finance by changes in excise duties on energy products in December, in the context of tax optimization for the economic operators in the perspective of reducing the excise duties from January 1, 2017.

III.3.1. VAT and excises

The **VAT** receipts, without the impact of the compensation schemes, recorded in 2016 a level of 51.39 billion lei, respectively 6.75% of GDP, slightly above the amount envisaged in the draft budget, respectively 116 million lei.

This result arises from revenues in the 2016 draft budget considered overvalued[26] by the Fiscal Council, offset by a higher than expected dynamics of the relevant macroeconomic base (final consumption of households (excluding self-consumption component) and NPISH[27]) of 8.2% compared to 6.2%, the value taken into account in the draft budget for 2016, a significant revenue gain in January, and an improved in collection efficiency.

Figure 5: VAT revenues in 2016 (billion lei)



Source: MPF

Figure 5 includes the evolution of the revenues programmed in the draft budget and in the budgetary revisions, the actual receipts, as well as the compensation schemes. Thus, VAT receipts without the impact of the swap scheme recorded values close to those originally planned (+0.2%), but lower than those envisaged in the two budget revisions (-1.4% at the first budget revision, respectively -1.6% in the second). It should be noted that in January (for which the standard rate was 24%) the receipts were well above the initial expectations amounting to 6.97 billion lei (compared to 5.96 billion lei in January 2015), as a result of a large volume of investment in the

[26] In the opinion on the State Budget Law for 2016, the Fiscal Council warned about the overestimation of VAT revenues by 3.2 billion lei, out of which about 1 billion lei had as source a MPF assessment higher compared to the FC's one on the first-round effects on 11 months of the 20% reduced standard VAT rate. Subsequently, on the first budget revision, FC reassessed the concern from the initial budget draft, given the above-expected January earnings, private consumption dynamics higher than baseline estimates (reflected in the upward revisions of NCEF projected dynamics), and the higher level of VAT receipts for 2015 as compared to the estimates available at the time of drafting the budget.

[27] Non-profit institutions serving households.

last month of 2015, which was the deadline for attracting European funds for the 2007-2013 financial framework.

Also in the case of the compensation scheme, which would have added to the VAT revenues, in the initial program for 2016, the level was projected to 1,070 million lei, later being reduced by 147 million lei in the second budget revision to 923 million lei, but at the level of the final execution, the VAT receipts related to the swap scheme amounted to only 287 million lei (26.8% of the initial program).

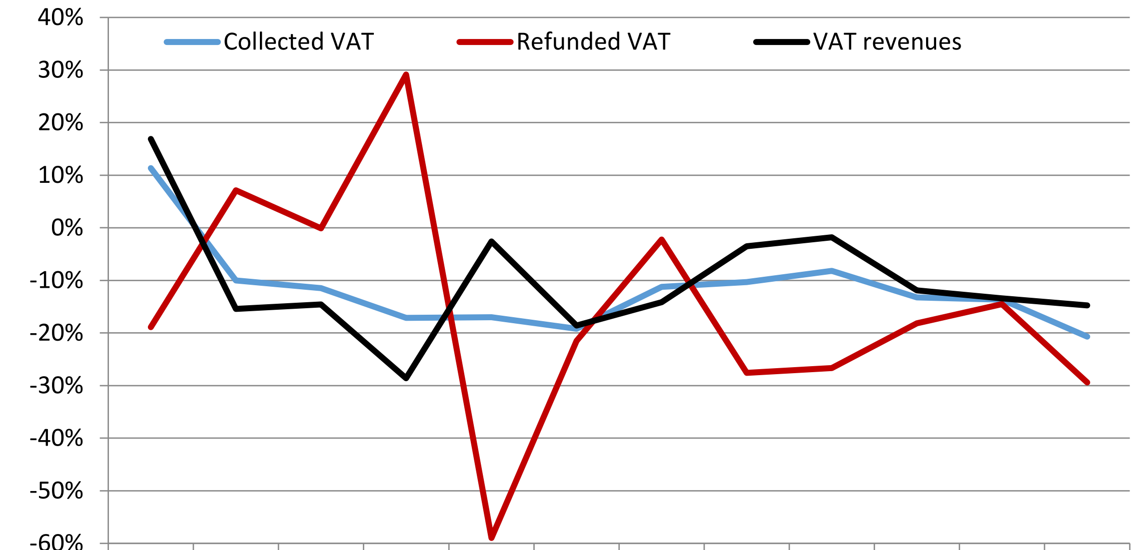
Compared to the previous year, the level of these revenues, net of the impact of swap schemes, decreased by 9.8% (or 5.6 billion lei) as a result of the implementation of the fiscal relaxation measures introduced by the new Fiscal Code for 2016, respectively the reduction of the VAT rate from 24% to 20% and the extension of the applicability of the reduced VAT rate of 9% for drinking water and water for irrigation in agriculture, respectively 5% (in the case of delivery of school textbooks , books, newspapers, some magazines, and services consisting of allowing access castles, museums), after the previous year, since June 1, the VAT rate for food, restaurants and catering services has been reduced from 24% to 9%.

It is of interest to carry out an analysis of how VAT receipts have performed compared to what would have been justified by the impact of the discretionary measures adopted and the evolution of the relevant macroeconomic base, to provide a first hint of the collection efficiency in 2016. Thus, applying the projection methodology of VAT receipts described by the Fiscal Council in the draft budget for 2016, the budgetary impact of the discretionary measures was revised upward to 8.58 billion lei as a result of a higher consumption, as well as because of the reduction of VAT rate to 9% for drinking water and water for irrigation in agriculture, and the theoretical VAT receipts that should have prevailed under these conditions were recalculated at a level of 50.06 billion lei. Under these circumstances, there is an additional revenue of about 1.33 billion lei, which could be attributed to an improvement in collection efficiency. However, if we consider also the extraordinary receipts for January 2016, which added an increase of 1 billion lei compared to the previous year (6.97 billion lei, or + 11.4% versus January 2015, amid the acceleration of EU funds absorption in the last month of 2015), the added revenue from improving collection efficiency in 2016 can be appreciated around 300 million lei.

From the perspective of the evolution of the monthly flow of actual receipts in 2016 compared to the previous year, besides the impact of the reduction of the standard VAT rate by 4 pp and the extension of the applicability of the reduced VAT rates, it is worth mentioning that in the first half of the year it is noticed the impact of extending the scope of the reduced VAT rate on food, restaurant and catering services implemented from June 2015. As can be seen in *Figure 6*, which details the evolution of net of swap VAT receipts for January-December 2016 compared to the same period of the previous year, in 2016 the actual receipts[28] decreased in nominal terms by 9.8% and 12.9%, respectively, excluding January. Between February and June 2016, the receipts decreased by 16.4%, being influenced by the VAT rate drop by 4 pp, but also by the extension of the 9% reduced rate for food from June 1, 2015, and in the second half by 10.1%. Similar to determining the annual theoretical VAT receipts that should have prevailed in terms of the actual consumption and discretionary measures adopted, the same exercise can be resumed in terms of monthly earnings. Thus, VAT receipts should have fallen by -12.1% (respectively excluding January, by -14.5%), which, compared to actual revenue growth, also suggests an improvement in the efficiency of collection during the 2016. In order to determine how collection efficiency evolved during the year (excluding January, for the above-mentioned reasons), the dynamics of the theoretical receipts will be analyzed separately compared to the actual ones from February-June 2016, respectively from the second semester compared to the same period of the previous year. Thus, the monthly average of the theoretical net of swap receipts in the period February-June 2016 was at the level of 3,730 million lei, decreasing by 19.5% compared to the same period of 2015, while the monthly average of the actual receipts amounted to 3,873 million lei (-16.4% compared to the average of the corresponding period in the previous year), which translates into a supplementary monthly flow of about 143 million lei attributable to the increase in collection efficiency (respectively, accumulated for the first 5 months of 2016, an increase of 713 million lei). On the contrary, in the second half of the year the monthly flow of actual receipts amounted to 4,177 million lei (-10.1% compared with the same period of the previous year), lower than the 4,245 million lei monthly flow of receipts that should have prevailed (8.6% lower than the average of the second semester of 2016), which suggests that in the second semester there was a decrease in the efficiency of tax collection, resulting in a minus of 409 million lei. Summing up, for the 11 months analyzed, an increase of 304 million lei in VAT revenues is explained by the improvement of collection efficiency in 2016, which took place in the first half of the year.

[28] VAT receivable represent the observable values in the monthly budget execution, which are equal to the VAT collected less the VAT refunded, being influenced also by the dynamics of the reimbursements that undergo meaningful monthly variations.

Figure 6: VAT increasing rate, compared to the same period of the previous year



	Jan.16	Feb.16	Mar.16	Apr.16	May.16	Jun.16	Jul.16	Aug.16	Sept.16	Oct.16	Nov.16	Dec.16
Collected VAT	11.35%	-10.02%	-11.48%	-17.10%	-16.97%	-19.18%	-11.22%	-10.29%	-8.19%	-13.20%	-13.66%	-20.69%
Refunded VAT	-18.91%	7.12%	-0.08%	29.15%	-58.97%	-21.49%	-2.22%	-27.60%	-26.67%	-18.13%	-14.51%	-29.38%
VAT revenues	16.90%	-15.39%	-14.56%	-28.60%	-2.57%	-18.60%	-14.14%	-3.50%	-1.79%	-11.87%	-13.43%	-14.73%

Source: MPF, Fiscal Council`s calculations

Also, if we analyze strictly the evolution of collected VAT revenues (equal to VAT receivable plus VAT reimbursements) in 2016 (*Figure 6*), it is noted that they had an average monthly rate of growth lower than that of the actual receipts by 1.8 pp, the latter being favorably influenced by the decrease of VAT reimbursements compared to the same period last year by 17.4% (about 3.15 billion lei).

Further, the assessing of the efficiency of tax collection will be done through the ratio between the implicit tax rate (defined as the ratio between the actually collected revenue for a specific type of tax and the corresponding macroeconomic tax base) and the weighted average VAT rate. Concerning the latter, in the case of VAT, it should be noted that starting with last year, in the Annual Report for 2015, the weighted average tax rate[29] was determined, which is a methodological change compared to the 2010-2014 Fiscal Council's reports, so that results obtained are not comparable to those presented in the previous editions.

[29] Previously the standard VAT rate was used, and in 2015 we introduced the weighted average VAT rate taking into account the effect of the reduced rates, being determined according to the share of the products in the consumer basket and the related VAT rate as well as the time moment of the legislative changes in the level of VAT.

The weights used are those of the harmonized index of consumer prices (HICP), which is the only available source, and is only a proxy for the weighted average VAT rate in the economy. For example, the weighted average rate of VAT for Romania determined based on the HICP in 2016 was 14.6% while the weighted average rate of the whole economy is higher, thus the Fiscal Council's calculations overestimate, to a certain extent, the efficiency of the collection.

Figure 7 shows the evolution of the implicit tax rate and the taxation efficiency index for VAT in Romania, using as a 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 (which in Romania has a significant weight, the data for the efficiency of the collection being thus superior[30] (the right-hand scale, in green color)). Using the methodology described above, it can be observed the recording of a slight increase in the taxation efficiency in 2016 compared to the previous year (+0.3% when excluding self-consumption, respectively + 1.2% if that is included in the base), 2015 marking a significant leap for this indicator compared with the post-crisis period (between 20% and 22% depending on the tax base used - compared to the average 2009-2014). It is worth mentioning that in 2016 there was a relatively large difference between the evolution of revenues from VAT aggregates expressed in the ESA2010 standard (used to determine the efficiency tax index), namely a 14.4% reduction compared to 2015 compared to cash (-9.8%), mainly explained by the large volume of investments made in the last month of 2015 (deadline for EU funds absorption related to 2007-2013 financial framework), the January revenues (corresponding to the December sales of the previous year) being accounted for in the previous year's execution in ESA terms, respectively, in the current year in terms of cash. Analyzing the evolution of the VAT collection efficiency tax index (*Figure 7*), it can be seen how, after a relative stability of the efficiency index in 2011-2013, there has been a significant deterioration in the VAT collection in 2014. After the decrease in the VAT rate for food products, restaurants and catering services from 24% to 9% as of 1 June 2015, respectively a weighted average VAT rate of 18.3% in 2015 (close to the one recorded in 2008-2009 of 18.2%), there was a substantial improvement in the VAT tax efficiency, and a major breakthrough in collection compared to the starting year of the economic and financial crisis. The higher rate of collection efficiency compared to previous years was also maintained in 2016, with a 4 pp decrease in the standard VAT rate and the extension of the applicability of the 9% and 5% reduced VAT rates[31]. Even under these circumstances, Romania collected only 11.2% of the tax on consumption in 2016, compared to the standard legal rate of 20% or a weighted average share of 14.6%.

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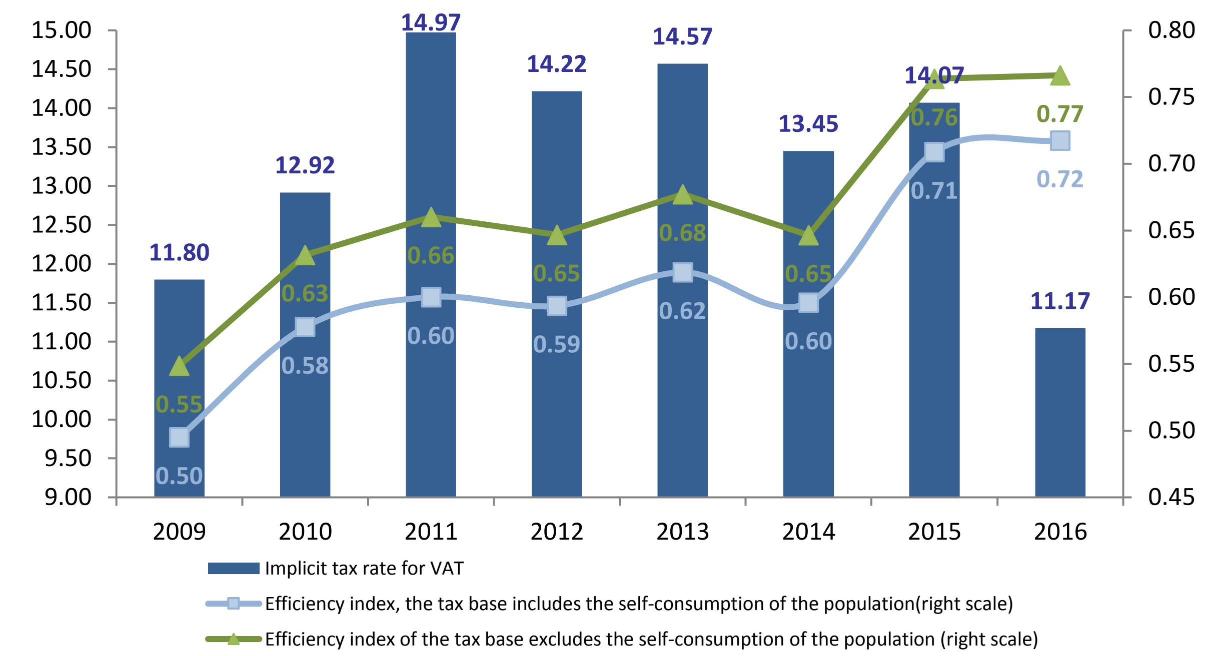
[30] Depending on the share of self-consumption in population consumption, the values of this indicator in the case of excluding the self-consumption component and farmhouse market are higher by 6 to 10%.

[31] 9% for drinking water and water for irrigation in agriculture, respectively 5% for the delivery of school textbooks, books, newspapers, some magazines and services for allowing access to castles and museums.

Figure 7: The evolution of the implicit tax rate and efficiency tax index for VAT in Romania



Source: Fiscal Council's calculation

Comparing the effectiveness of taxation for VAT in 2016 for the group of new EU member states from Central and Eastern Europe (CEE NSM) the value of 0.72[32] recorded by Romania is significantly lower than that one recorded by Slovenia (0.98), Estonia (0.95), Bulgaria (0.91), Hungary (0.86), and Czech Republic (0.83). Romania collected in 2016 VAT revenue worth 6.5% of GDP (execution ESA 2010), compared to 8.3% of GDP in Slovenia, Bulgaria 9.4%, Estonia and Hungary, given that the weighted average VAT rate in these countries was: 16.4% in Slovenia, 17.0% in Bulgaria, 18.6% in Estonia and 21.8% in Hungary; Romania registered a weighted average rate of 14.6%[33]. By 2016, lower efficiency of taxation as defined above was noticeable in Lithuania, Latvia, Poland and Slovakia. In this ranking, Romania retained its sixth position as in the previous year, while the weighted average share is currently at the lowest level compared to the ECE NSM countries.

[32] In Table 7, for comparison purposes, the same tax base is used for all countries, including the population self-consumption

[33] The difference between 20% standard rate and the weighted average rate comes largely from the extension of the reduced VAT rate to food, restaurant and catering services and water, which have a high share in the consumer basket, cumulatively 35.2%

Table 7: Taxation efficiency - VAT												
Country	Weighted average VAT rate (%)			Implicit tax rate* (%)			Taxation efficiency index**			Rank		
	2014	2015	2016	2014	2015	2016	2014	2015	2016	2014	2015	2016
BG	17.2	17.1	17.0	14.2	14.3	15.4	0.83	0.84	0.91	4	4	3
CZ	18.9	18.8	18.8	15.4	15.6	16.0	0.82	0.83	0.85	5	5	5
EE	18.8	18.8	18.6	16.9	17.7	17.7	0.90	0.94	0.95	2	2	2
LV	19.4	19.4	19.5	12.4	12.6	13.1	0.64	0.65	0.67	7	9	9
LT	19.4	19.3	19.2	12.1	12.2	12.0	0.62	0.64	0.63	9	10	10
HU	21.8	21.7	21.8	18.5	19.7	18.7	0.85	0.91	0.86	3	3	4
PL	16.8	17.1	17.1	11.9	12.0	12.1	0.71	0.70	0.71	6	7	8
RO	20.8	18.4	14.6	12.4	13.1	10.5	0.60	0.71	0.72	10	6	6
SI	16.4	16.5	16.4	15.7	16.0	16.1	0.95	0.97	0.98	1	1	1
SK	18.9	18.7	17.1	11.9	12.5	12.2	0.63	0.67	0.71	8	8	7

Source: EC, Eurostat, MPF, 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 Romania, the revenues for 2014, 2015 and 2016 include additional receipts due to implementation of compensation scheme for clearing arrears (+9473 million lei in 2014, +157 million lei in 2015, and +287 million lei in 2016).

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

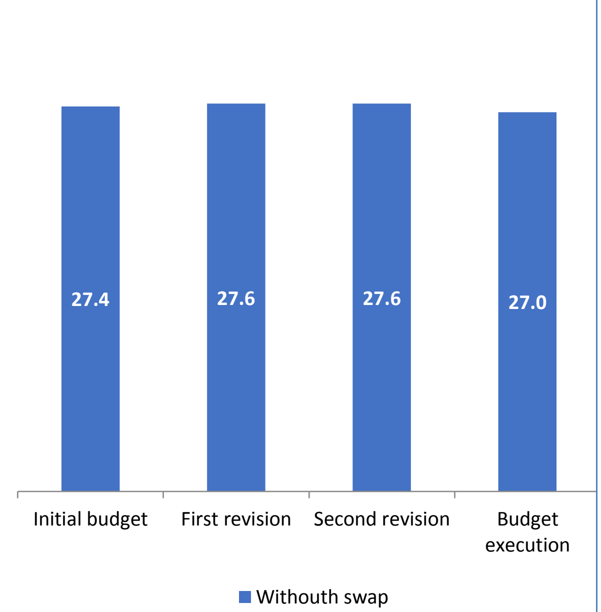
The differences in the tax efficiency index should be interpreted taking into account also the structural differences between the analyzed economies, given that the higher percentage of the rural population in Romania is reflected in a higher share of the self-consumption component and the farmhouse market (non-taxable), which has an impact on the value of this index, as shown in *Figure 7*. Thus, the conclusion of a study[34] that examined a panel of 44 countries during 1970-1999 (Aizenmann J. and Y. Jinjarak) was that the efficiency of VAT collection is inversely proportional to the share of agriculture in GDP, and directly proportional to the degree of urbanization and the degree of openness of the economy - the indicators related to Romania being unfavorable in the case of these three variables. It should also be noted that the current methodology for calculating the VAT collection efficiency indicator, although taking into account the impact of reduced VAT rates, does not include the impact of other GDP components that are

[34] 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.

subject to VAT (part of intermediate consumption and gross fixed capital formation in the case of VAT non-payers who do not have the right to deduct).

The revenue collected from the **excise** duties in 2016 amounted to 26.96 billion lei (3.54% of GDP), a level inferior to the one from the initial projections envisaged in the draft budget (by 425.4 million lei), the first supplementary budget revision altering the collected revenues to 27.6 billion lei, respectively by 180 million lei more than the initial budget draft, maintained also at the second budget rectification. The revaluation was due to the exceeding of the cash program in the first semester of 2016 by 256 million lei, due to the evolution over the initial expectations of private consumption, whose dynamics in real terms was changed in the upward direction (by 1.6 pp) in the Spring forecast of the NCEF as compared to the timing of the draft budget.

Figure 8: Excises, 2016 (billion lei)



Source: MPF

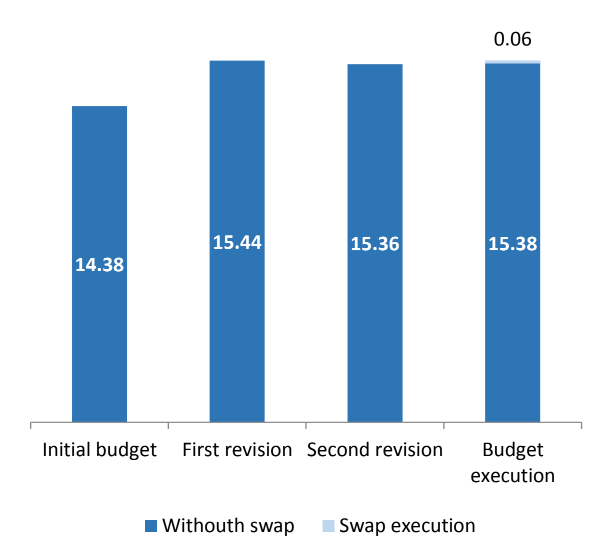
In 2016, the real growth of private consumption was of 7.3%, superior by 2.9 pp to the initial estimates, which, corroborated with the unfulfillment of the excise tax revenues compared to the initial program level (-1.6%) could indicate a loss of efficiency in collecting this revenue category. It is true that, according to MPF, there was a loss of excise revenues in the last month of 2016 (respectively a loss of income compared to the base scenario of about 427 million lei) explained by the fiscal optimization of the economic operators in the context of the reduction of excises on energy products as of 1 January 2017. However, for the year 2016, the loss of revenue compared to what should have been collected taking into account the growth above expectations growth in private consumption and the impact of legislative changes on certain categories of excise duty from January 1, 2016 is much higher (about 1.03 billion lei), which, even in the context of accepting the explanation regarding the evolution of this budgetary aggregate in the last month of last year, suggests a lower collection efficiency compared to 2015 (respectively a loss of excise revenues of about 600 million lei).

Compared to the previous year, the level of revenues collected from the excise duties was by 3.6% or 939 million lei higher, but this dynamic was significantly lower than the one recorded by the private consumption (+7.3%), or the increase in the retail sale of the fuel for vehicles in specialized stores by 11.3% (with a favorable effect on fuel excise receipts). The negative impact of the measures regarding the re-establishment[35] of the excise levels for alcohol and alcoholic beverages (negative impact estimated by the Government at 312.5 million lei) and the elimination from the excise scope of the category "other excisable products" (coffee and luxury products with an estimated impact of -72 million lei) was compensated by the increase of the excise level for tobacco products by 4.5% (positive impact estimated at about 456 million lei) and the introduction into the tax scope from the point of view of non-harmonized excise duties on electronic cigarettes and heated tobacco products.

III.3.2. Direct taxes

The revenues from the **corporate income tax** according to cash standards, in amount of 15.4 billion lei, without the compensation schemes (in the amount of 65 million lei), registered a significant increase of 11.5% in 2016 (+1.58 billion lei) compared to 2015, being higher than the estimates of the initial budget (by about 1 billion lei, respectively +6.9%), based on a better than expected evolution for the revenues collected from the non-financial economic agents (+13.87%) facilitated by the reduction of the number of insolvencies[36], but weighed down by the decrease in corporate tax collected from commercial banks (-41.48%). A discretionary measure that negatively affected corporate income tax revenues in 2016 was the introduction of differentiated tax system rates for microenterprises between 1% and 3% of

Figure 9: Corporate income tax, 2016 (billion lei)



Source: MPF

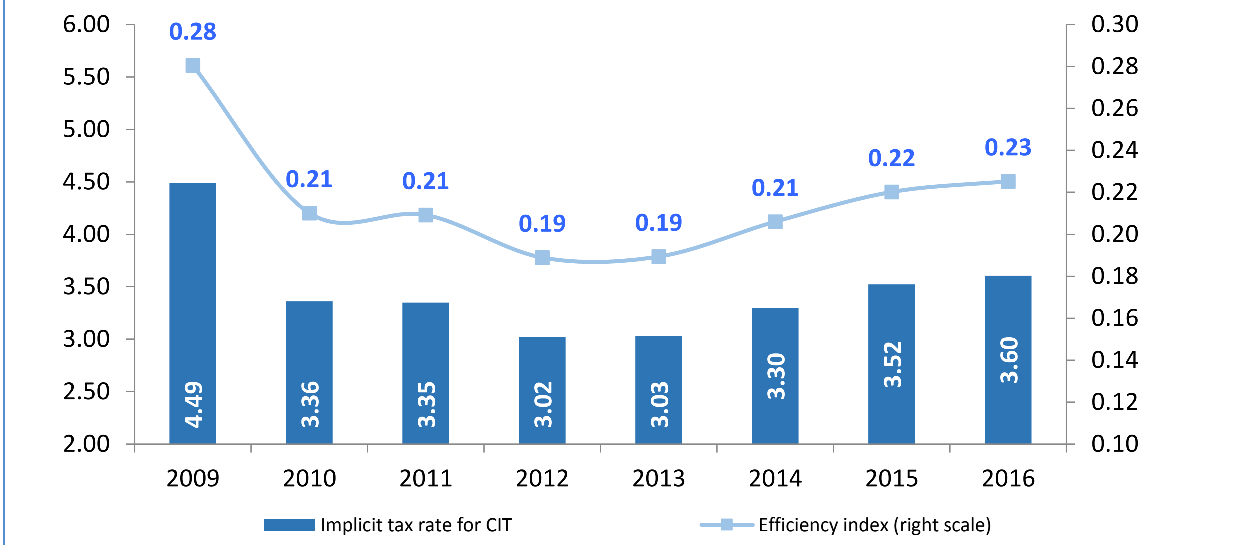
[35] Reduction of the excise tax for alcoholic beverages by 30%, from about 1000 euro / hl pure alcohol to about 700 euro / hl pure alcohol

[36] According to the National Trade Register Office (NTRO), the number of companies which became insolvent in 2016 was by 18.48% lower than in 2015 (8,371 companies in 2016 compared to 10,269 in 2015). At the same time, the number of companies registered in 2016 (105,982) decreased by 6.35% compared to 2015. The insolvency rate calculated as the ratio between the newly opened insolvency cases reported to the number of active companies decreased from 1.33% in 2015 to 1.03% in 2016.

total revenues, according to the number of employees, compared to the previous 3% rate. Moreover, the income ceiling up to which a firm is considered to be a microenterprise has been increased from the equivalent in lei of 65,000 euros to 100,000 euros, the impact of these two measures being estimated by MPF at about -300 million lei. Other two measures with a lower impact were the extension of the eligible assets for the application of the exemption scheme for the reinvested profit (-56 million lei) and the revision of the dividend tax regime received from Romanian legal entities by non-taxation of the dividends received by a Romanian legal person (-57 million lei). In total, the fiscal policy measures adopted in 2016 about the corporate income tax amounted to a negative impact of 413 million lei.

The level of the efficiency index of the corporate income tax, expressed according to ESA 2010 standards, showed a significant reduction in the period 2009-2012, a gap that has not been recovered so far; *Figure 10* suggests a direct link between the effectiveness of collection and the cyclical position of economy. After the resumption of economic growth in 2011, the efficiency index seems to be stabilized, followed by an upward trend, its level in 2016 being the highest since 2010. While in cash terms the dynamic of the corporate income tax receipts was +11.5% in 2016 compared to 2015, according to ESA 2010 standards, the increase was 9,4%, indicating an improvement in the efficiency index in 2016, as the corporate income tax revenues have advanced at a superior rate compared to the relevant macroeconomic base (the gross operating surplus, +6.9%), the elasticity of this aggregate to the macroeconomic base being high at a level of 1.4 (elasticity relative to GDP is 1.3). However, the elasticity observed is lower than the one estimated by the EC at the end of 2014 at a level of 1.81, but this can also be explained by the fiscal policy measures adopted in the meantime (non-taxation of reinvested profits, etc.). As a percent of GDP, corporate tax receipts are at a level of 2.01%, a slight increase of 0.04 pp in GDP relative to the previous year.

Figure 10: Implicit tax rate and efficiency tax index for corporate income tax in Romania



Source: Fiscal Council's calculations

Compared to other countries from Central and Eastern Europe (CEE) [37], in 2016, Romania was ranked in the ninth position, descending with two positions in the ranking[38], although the tax efficiency index is slightly higher in 2016 compared to 2015. It can be noted that Romania registered a slight increase in efficiency collection compared to the previous year, but the same trend can be noted for the other CEE countries, especially in Hungary where the efficiency index has increased significantly based on the massive increase of the tax revenues related to corporate tax.

Table 8: Taxation efficiency – corporate income tax

Country	Legal corporate income tax			Implicit tax rate *			Taxation efficiency index **			Rank		
	2014	2015	2016	2014	2015	2016	2014	2015	2016	2014	2015	2016
BG	10.0	10.0	10.0	4.3	4.6	4.6	0.43	0.46	0.46	1	1	1
CZ	19.0	19.0	19.0	6.5	6.8	6.9	0.34	0.36	0.36	2	2	2
EE	21.0	20.0	20.0	4.1	5.4	4.8	0.20	0.27	0.24	8	4	7

[37] Poland was not included in the ranking for the year 2016 due to unavailability of data on the gross operating surplus.

[38] The delimitation between Romania and Latvia was based on the third decimal of the efficiency index.

LV	15.0	15.0	15.0	3.3	3.6	4.0	0.22	0.24	0.27	5	5	5
LT	15.0	15.0	15.0	2.7	3.2	3.5	0.18	0.21	0.23	9	8	8
HU	19.0	19.0	19.0	3.9	4.3	5.8	0.20	0.22	0.30	7	9	4
PL	19.0	19.0	19.0	3.4	3.6	NA	0.18	0.19	NA	10	10	NA
RO	16.0	16.0	16.0	3.3	3.5	3.6	0.21	0.22	0.23	6	7	9
SI	17.0	17.0	17.0	3.8	3.9	4.4	0.22	0.23	0.26	4	6	6
SK	22.0	22.0	22.0	6.6	7.4	7.6	0.30	0.34	0.35	3	3	3

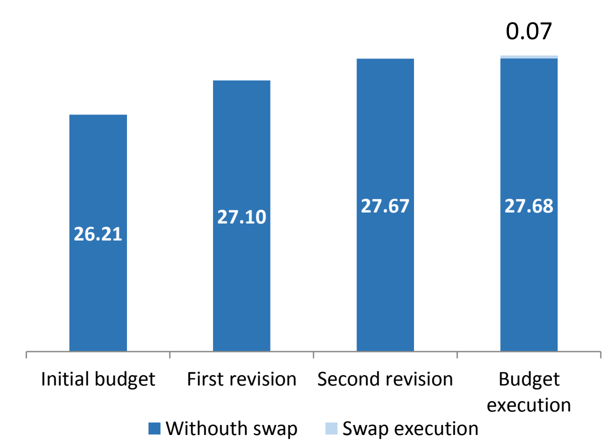
Source: EC, Eurostat, MPF, Fiscal Council's calculations

* Calculated as the ratio between "direct taxes paid by enterprises" (ESA code D51B_C2) and "gross operating surplus" (ESA code B2A3G).

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

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

Figure 11: Personal income tax, 2016 (billion lei)

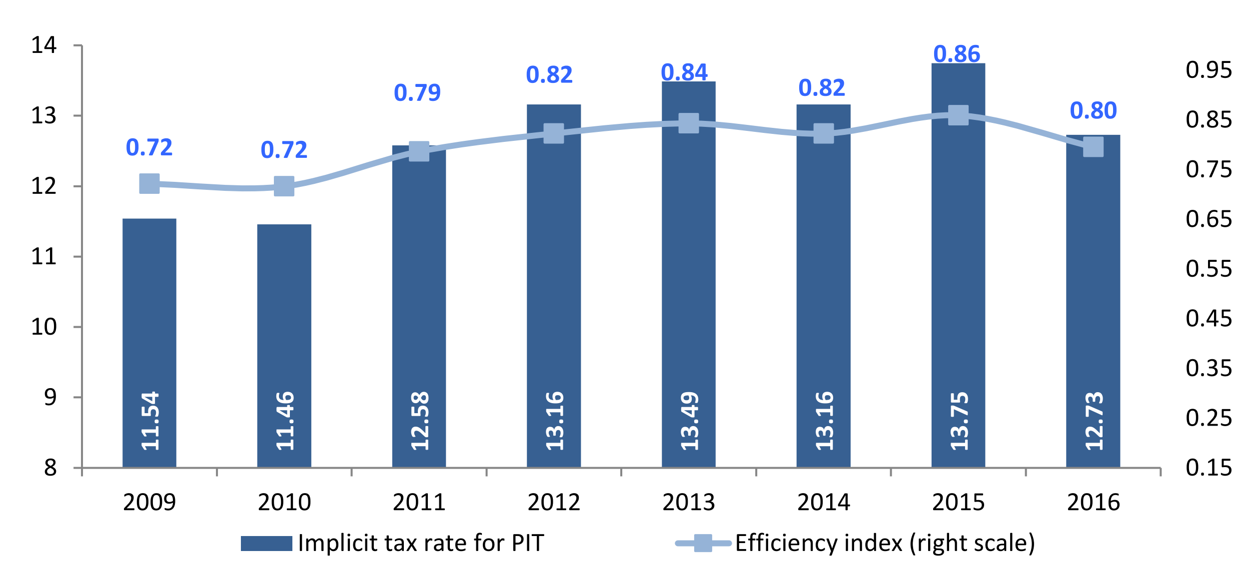


Source: MPF

The receipts from the **personal income tax** expressed in cash standards, in amount of 27.7 billion lei, performed above expectations, being over the initial budget estimates by about 1.5 billion lei (+5.64%), exceeding also the revenues collected in 2015 by about 1,1 billion lei (+4.26%). The dynamics of this budgetary aggregate reflects an increase of 12.8% of the average gross wage in the economy (much higher than the initial projection of +7.2%), but also the 3.4% increase of the average number of employees (compared to the close initial projection of +3.5%). The growth rate (+4.26%) was lower than in the previous year (revenues in 2015 exceeded by +12.5% the previous year's revenue), amid the negative impact of fiscal policy measures that affected this category of budget revenues. In 2016, the dividend tax rate was reduced to 5%, the initial impact estimated by MPF being -1,357.2 million lei at the level of tax on dividends paid to Romanian individuals. However, in 2016 there was a change in the behavior of economic agents, which distributed about 3 times more dividends than in 2015, which led to an impact of only -200 million lei. However, this behavior can only be a temporary one, and the loss of revenue initially calculated will be seen in the years to come. Another measure with a negative impact on the personal income tax revenues was the increase of the personal deductions granted to employees who earn gross revenues below the threshold of 3,000 lei. According to the ex-post calculations of the Fiscal Council, on the basis of wage distribution from December 2016, the negative impact of this measure was 488 million lei, 51.4 million less than the initial MPF estimation. Other measures targeted: the increasing of the flat-rate payment rates from 25% to 40% for income from the disposal of goods (including net rental income) with a negative impact of 111.8 million lei, the increase in the non-taxable monthly amount taken into account at Establishing the monthly taxable income from pensions at 1,050 lei with a negative impact of 137,8 million lei and the revision of the investment income chapter with the rewriting of the Fiscal Code, which led to an estimated budget impact of -230,3 million lei. In total, fiscal policy measures adopted in 2016 in relation to income tax and wages have had a negative impact of 1,167.9 million lei.

According to ESA standards, the revenues from personal income tax reached 28.3 billion lei, respectively +3.72% of GDP, thus registering a decrease of 0.02 pp in GDP compared to 2015. The dynamics of personal income tax revenues in 2016 compared to 2015 according to ESA 2010 methodology (+6.5%) is higher than in cash terms (+4.26%), but is well below the evolution of the macroeconomic base (gross wages in the national accounts, from which social insurance contributions paid by employees were deducted, which increased by 15%). Despite the fact that personal income tax revenues were negatively affected by the discretionary measures adopted in 2016, even after correcting for their impact, the rate of increase in personal income tax revenues was lower than that of the relevant macroeconomic base, which is equivalent to a reduction in the collection efficiency. Thus, the taxation efficiency index for personal income tax decreased from 0.86 in 2015 to 0.8 in 2016, or 0.83 if we consider the impact of the discretionary measures adopted by the new Fiscal Code. The level of the taxation efficiency index is similar to that observed for 2012-2014, the improvement trend observed since 2010 being stopped for now.

Figure 12: The evolution of the implicit tax rate and taxation efficiency index for personal income tax in Romania



Source: Fiscal Council's calculations

Compared to the other countries in the region, Romania drops two positions in the ranking[39] compared to the previous year, with a tax efficiency index of 0.8 and an implicit tax rate of 12.7% (calculated as a ratio between the direct taxes paid by the population and gross wages in the national accounts - including those from the unobserved economy, from which the SSC was to be paid by the employees). The countries that have outpaced Romania in 2016 as compared to 2015 are Estonia and Latvia (the breakdown between Romania and Latvia was made taking into account the third decimal of the efficiency index), which kept their efficiency index constant, while Romania's efficiency index dropped by 0.06 pp in 2016 compared to 2015.

[39] There is no data available regarding the gross wages in the national accounts for Poland in 2016.

Table 9: Taxation efficiency – personal income tax												
Country	Legal corporate income tax* (%)			Implicit tax rate** (%)			Taxation efficiency index ***			Rank		
	2014	2015	2016	2014	2015	2016	2014	2015	2016	2014	2015	2016
BG	10.0	10.0	10.0	9.2	8.7	9.0	0.92	0.87	0.90	2	2	2
CZ	15.0	15.0	15.0	9.3	9.1	9.4	0.62	0.60	0.62	7	7	7
EE	21.0	20.0	20.0	17.2	16.4	16.4	0.82	0.82	0.82	4	4	3
LV	24.0	23.0	23.0	16.6	16.0	16.6	0.69	0.70	0.72	6	6	6
LT	15.0	15.0	15.0	11.7	12.0	12.1	0.78	0.80	0.80	5	5	4
HU	16.0	16.0	15.0	15.3	15.7	14.7	0.96	0.98	0.98	1	1	1
PL	25.0	25.0	25.0	14.6	15.1	NA	0.58	0.61	NA	8	8	NA
RO	16.0	16.0	16.0	13.2	13.7	12.7	0.82	0.86	0.80	3	3	5
SI	27.0	27.0	27.0	12.0	12.2	12.4	0.45	0.45	0.46	10	10	9
SK	22.0	22.0	22.0	11.7	12.1	12.5	0.53	0.55	0.57	9	9	8

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

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

** Computed as the ratio between "revenues from direct tax paid by the population" (ESA code D51A_C1) and personal income tax base defined as gross wages from the national accounts (ESA code D11) from which social insurance contributions paid by employees were deducted. For the Czech Republic, the personal income tax base is "compensation of employees", which includes social security contributions paid by employers, given the use of the "super grossing" in computing the personal income tax due.

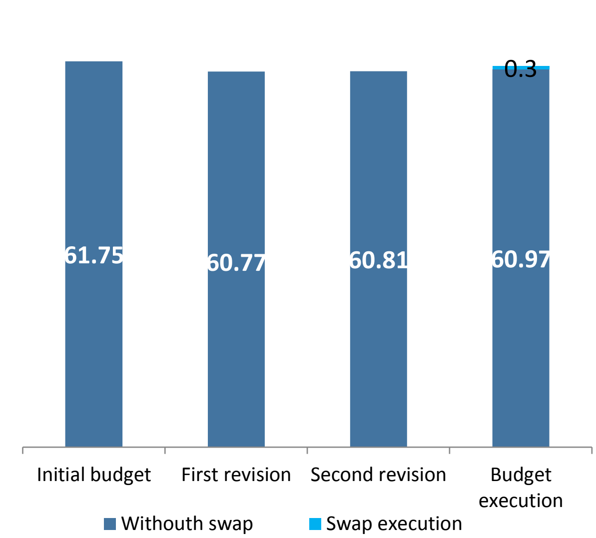
*** Computed as a ratio between implicit tax rate and legal tax rate.

III.3.3. Social contributions

The revenues from social security contributions, without the impact of compensation schemes, amounted to 61 billion lei at the end of 2016 in cash standards, by -1.25% or -773.8 million lei smaller than the initial estimates (61.75 billion lei), given that the dynamic of the average gross wage in the economy (+12.8%) was significantly higher than the initial projection (+7.2%), while the average number of employees increased by 3.4%, a pace close to that considered in the initial projection, respectively of +3.5%. A factor that contributed to higher revenues from those envisaged in the initial budget for 2016 was the adoption of the decision to pay compensatory amounts following the ratification of the Law no. 85/2016 which establishes the payment of salary differences for the period October 2008 - May 13, 2011 for the teaching staff who did not obtain court decisions in this respect, the latter having such rights from 2016 (about 907.7 million lei paid in the previous year), which generated additional income of about 290.7 million lei.

Analyzing the projection of revenues from social insurance contributions during 2016 it can be observed that the evolution above expectations of the relevant macroeconomic base was not incorporated during the two budget revisions, even being recorded a downward revision of this category of revenues by about 1 billion lei with the occasion of the first budget revision, while the second budget revision maintained the estimates of revenues at the level of the first one, the actual achievements confirming this last projection.

Figure 13: Social security contributions, 2016 (billion lei)



Source: MPF

On the occasion of the budget revisions made in 2016, the Fiscal Council noted that the latter incorporated the significant under the program execution for this budgetary aggregate, the execution at the end of the first semester accounting for a major under- achievement of the program, the revenues being with about 1.090 million lei smaller (corresponding to an achievement degree of 96.4%). The evolution appeared to be worrying as it was located at the level of pension contributions and decoupled from the dynamics of other income categories with the same tax base as health insurance contributions, unemployment contributions and personal income tax, in the context of a more favorable dynamics associated with wage earnings than the hypothesis used in substantiating the initial budget construction, these elements indicating the existence of a significant collection problem.

The Fiscal Council recommends investigating the causes that had a negative effect on revenues from pension contributions, which are much lower than would have been justified by the discretionary measures taken[40] and adopting the necessary corrective measures, especially as the deficit in the pension system has already reached an unsustainable level.

Compared to 2015, the receipts from social contributions, without the impact of the compensation schemes, increased by 6.3%, being lower than the dynamic of 15.0% recorded by

[40] Increasing the share of contributions for privately managed pension funds by 0.1 percentage points in 2016 and cancelling the requirement to pay social security contributions by employers for military personnel, police and civil servants with special status.

the relevant macroeconomic base (gross wages in national accounts). This dynamic is explained mainly by the increasing amounts transferred[41] towards the Pillar II (857.52 million lei), as well as the lower payments compared to the previous year (907.7 million lei compared to 4,100 million lei) on account of court decisions, which had a negative impact of about 1,022.5 million lei. Thus, Pillar II transfers increased by 16.7% in 2016 compared to the previous year, as the number of participants increased by 4.12% compared to 2015. Additionally, in the sense of lower receipts compared to the previous year acted the cancellation of the requirement to pay social security contributions by employers for military personnel, police and civil servants with special status in the context of returning to the existing pension system prior to 2010 (-936 million lei).

In order to reflect more accurately the dynamics of the receipts from social security contributions, in the table below are presented the revenues from social contributions, adjusted with the impact of several factors that have influenced the evolution of this budgetary aggregate in 2012-2016[42].

[41] The contribution rate to the private pension fund increased by 0.5 pp per year, starting on 1 January of each year so that in 2016 the share was 5.1%, compared with 5% in 2015, 4.5% in 2014, 4.0% in 2013, 3.5% in 2012 and 3.0% in 2011. Although in 2016 the target level of 6% of gross wage should have been reached, according to the law, the decision to reduce to just 0.1 percentage points the additional transfers of contributions to Pillar II (from 5% to 5.1%) is symptomatic from the perspective of sacrificing long-term goals to deliver a short-term fiscal space. Moreover, this decision also took place in a favorable economic environment that did not justify such a measure.

[42] In the years 2012-2013 the social contributions revenues from GCB were adversely affected by the repayment of amounts illegally collected from pensioners representing social health insurance contributions. The Constitutional Court decided in April 2012 that the health insurance contribution applies only to pension income exceeding 740 lei, deducting this amount from the tax base and the Government decided to refund these amounts, withheld illegally, in equal monthly installments during the period June 2012 - September 2013.

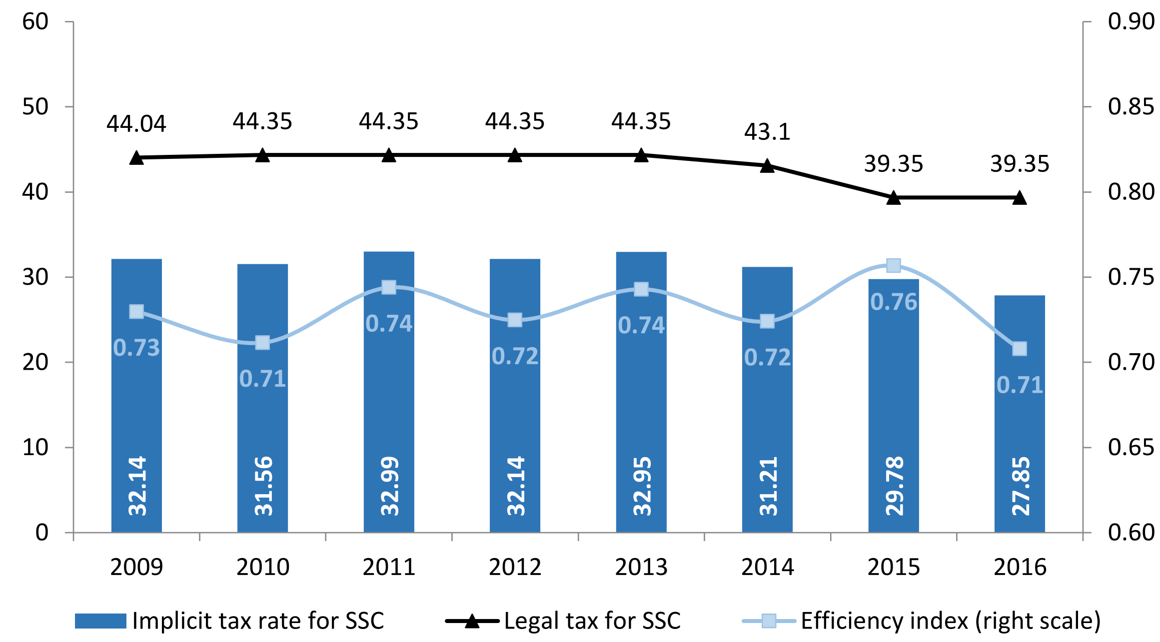
Table 10: Social security contributions (million lei)						
		Budget execution 2012	Budget execution 2013	Budget execution 2014	Budget execution 2015	Budget execution 2016
Adjusted series	**1**	**51,658.30**	**54,378.90**	**57,585.40**	**57,603.96**	**61,274.42**
Swap	2	407.60	31.10	357.07	264.92	299.44
Second Pension Pillar	3	2,595.90	3,229.90	4,053.88	5,149.71	6,007.23
Amounts illegally withheld / refunded to retirees	4	262.80	788.50	-	-	-
Gross series*	**5=1-2+3+4**	**54,109.40**	**58,366.20**	**61,282.20**	**62,488.75**	**66,982.21**
* of which executory titles		111.35	222.50	1,408.40	1,313.30	290.70

Source: Fiscal Council's calculations

Thus, if the unadjusted series is considered, it appears that in 2016 the revenues from social contributions, amounted 67 billion lei, surpassing the revenues collected in 2015 with about 7.2% (4.5 billion lei), the dynamic surpassing the one observed in the budgetary execution, given that the latter includes also the transfers to Pillar II which appear as negative revenue. If we analyze the evolution of this aggregate budgetary eliminating the influence of the amounts paid to Pillar II, it can be noticed that in 2016 the increase of SSC receipts compared to the previous year according to the cash methodology is about 9% (5.5 billion lei).

The dynamics of the revenues from social contributions according to ESA 2010 (+7.6%) was lower by about 7.4 pp than that recorded by the relevant macroeconomic base (+15.0%) - respectively the gross wages in the national accounts, while the social contribution rates have not been changed in 2016, these developments implying a worsening of the implicit tax rate to 27.85% from 29.78% in 2015. Thus, the tax efficiency index decreased to 0.71 in 2016 from 0.76 in the previous year, an evolution contradictory to 2015, when this indicator experienced a significant appreciation of 4 pp. The reduction of 5 pp is partly justified, namely by 2 pp, by the impact of the cancellation of the requirement to pay social security contributions by employers for military personnel, police and civil servants, which generated lower social security revenues by 936 million lei, as well as by the reduction by 1,022.5 million lei in the amounts received in the previous year following the application of Law no. 85/2016 which establishes the payment of salary differences for the period October 2008 - May 13, 2011 for the teaching staff who did not obtain court decisions in this respect, the latter having such rights from 2016, compared to those paid in 2015 on account of court decisions obtained by the same category of employees. However, beyond the influence of these factors, the taxation efficiency index in 2016 decreased by about 3 pp.

Figure 14: The development of the implicit tax rate and taxation efficiency index for social security contributions in Romania



Source: Fiscal Council's calculations

* Legal tax rate was calculated as a weighted average of rates applicable in 2014: 44.35% in the first 9 months of the year and 39.35% respectively from 1 October.

In comparison to other countries in the region[43], Romania was ranked on the eighth position regarding the efficiency of the social contributions collection, maintaining its position from 2015, but given that Poland was not taken into account for 2016, since data is not yet available, and previously this country was placed above Romania. Thus, Romania will most likely be placed on the second lowest position in the region in terms of the efficiency of collecting social security contributions, deteriorating its position from 2015 with a place. Moreover, the implicit tax rate was below the level registered in Estonia and Slovenia, that impose a lower level of social security contributions, but this can also be explained by the different tax regime for social security contributions for certain categories of income (income from self-employment, copyright, rent, investment income, etc.). Instead, the position of the statutory rate of social security

[43] There is no available data for gross wages in national accounts in 2016 for Poland.

contributions is fifth in the region, on a par with Poland (after Slovakia, Hungary, Lithuania and the Czech Republic).

Table 11: Taxation efficiency – social security contributions												
Country	Legal tax rate for SSC* (%)			Implicit tax rate** (%)			Taxation efficiency index***			Rank		
	2014	2015	2016	2014	2015	2016	2014	2015	2016	2014	2015	2016
BG	31.0	31.0	31.0	22.5	22.3	22.5	0.72	0.72	0.73	8	9	7
CZ	45.3	45.3	45.0	47.6	48.1	48.2	1.05	1.06	1.07	2	2	1
EE	36.0	35.4	35.4	33.6	32.4	32.4	0.93	0.92	0.92	4	5	5
LV	35.1	34.1	34.1	24.4	23.4	22.8	0.70	0.69	0.67	9	10	9
LT	40.1	40.0	39.8	36.2	36.4	37.1	0.90	0.91	0.93	6	6	3
HU	47.0	47.0	47.0	38.6	39.7	39.6	0.82	0.84	0.84	7	7	6
PL	39.6	39.4	39.4	42.4	44.1	NA	1.07	1.12	NA	1	1	NA
RO	43.1	39.4	39.4	31.2	29.8	27.9	0.72	0.76	0.71	8	8	8
SI	38.2	38.2	38.2	34.8	35.4	35.3	0.91	0.93	0.92	5	4	4
SK	48.6	48.6	48.6	47.2	47.9	47.8	0.97	0.99	0.98	3	3	2

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

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

** Computed as the ratio between "actual social contributions" (cod ESA D61REC) and "gross wages and salaries" (cod ESA D11). For Romania, the budget revenues include additional receipts due to implementation of compensation scheme for clearing arrears (357.1 million lei in 2014, 264.9 million lei in 2015, and 299.4 million lei in 2016).

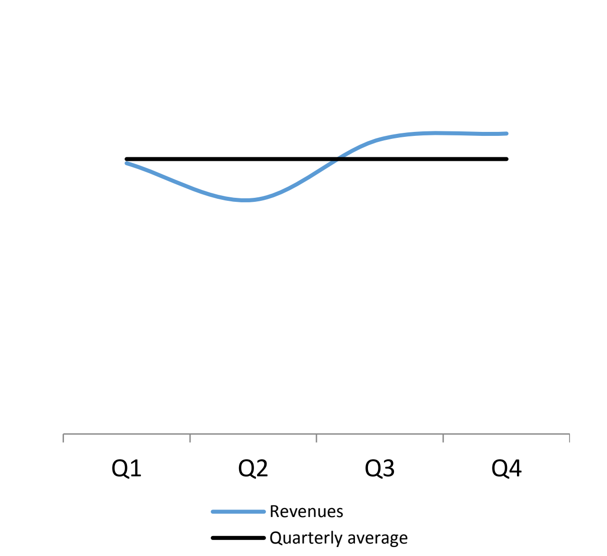
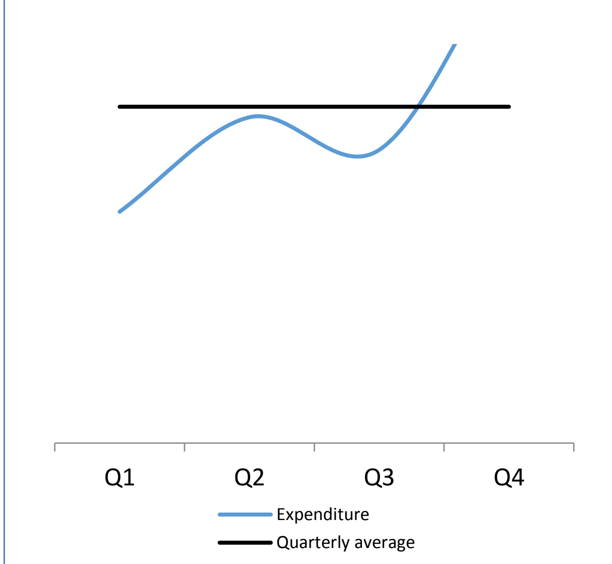
*** Computed as the ratio between implicit and legal tax rate.

III.4. Budgetary expenditures

The budgetary expenditures, without the compensation schemes (in amount of 750.3 million lei), have registered a negative rate of growth (-0.6% compared to the previous year), reaching a level of 241.3 billion lei at the end of last year, in the context of an important positive growth in the nominal GDP (+7.1%), thus, decreasing its share in GDP by 2.5 pp, respectively from 34.2% to 31.7%. The main budgetary expenditure categories that registered a higher dynamic than the average were *personnel expenses* (+9.6%), *social assistance* (+7.8%), *capital expenses* (+7.3%), *subsidies* (+5.3%) and *interest* (+4.6%), while lower dynamics than the average were registered by *projects funded by external grants*[44](-57.8%), *transfers for public entities* (-33.1%), *other transfers* (-2.8%) and e*xpenditure funded from reimbursable funds* (-2.5%). The significant decrease of 2.5 pp of the share of total expenditure in GDP is attributable in particular to the *projects funded by external grants* (-2.09 pp) in the context of a slow start in absorption of EU funds under the new financial year and the deadline reached for EU funds that could be absorbed in the previous financial year, and also the decrease of *goods and services* as a share in GDP (-0.36 pp), while *personnel expenses* recorded an increase (+0.17 pp) driven by the sustained wage increases in the public sector. Essentially, the investment expenditures were significantly reduced, partly as result of lower revenues from European funds and partly to accommodate the tax cuts decided through the new Fiscal Code.

Compared to the initial budget for 2016, the budgetary expenditures were lower by 9.7 million lei, respectively by -1.32 pp of GDP, mainly due values below program of *projects funded by external postaccession grants* (-0.88 pp of GDP), *goods and services* (-0.28 pp of GDP), *other transfers* (-0.18 pp of GDP), *interest* (-0.14 pp of GDP), positive contributions coming from *social assistance* (0.32 pp of GDP). Essentially, beyond the amounts for projects financed from EU funds where the values below the program from the expenditures part were generated by similar size values on the revenues side of the budget, the fiscal space generated by the savings on goods and services, and interest was partly used to accommodate social assistance spending higher than planned, mainly as a result of observing during the budget execution of a higher budgetary impact than initially estimated for the fiscal policy measures decided in 2015.

[44] Throughout this chapter, the amounts for the projects funded from EU grants are cumulated for the financial years 2007-2013 and 2014-2020.

Figure 15: Quarterly revenues of the GCB in 2016 (million lei)	Figure 16: Quarterly expenditure of the GCB in 2016 (million lei)
	

Source: MPF

Note: The amounts are without the compensation schemes.

Also in 2016, the quarterly evolution of the general consolidated budget expenditures still indicates a spending acceleration in the last quarter of the year, but at a lower rate compared to the previous year. Specifically, the total spending in Q4 2016 reached 72.3 billion lei (compared with 80.3 billion lei in Q4 2015), being higher by 26.6% than the level recorded in previous quarter (while in the previous year the advance was 42.5%), but with 10% lower compared to those of the Q4 2015.

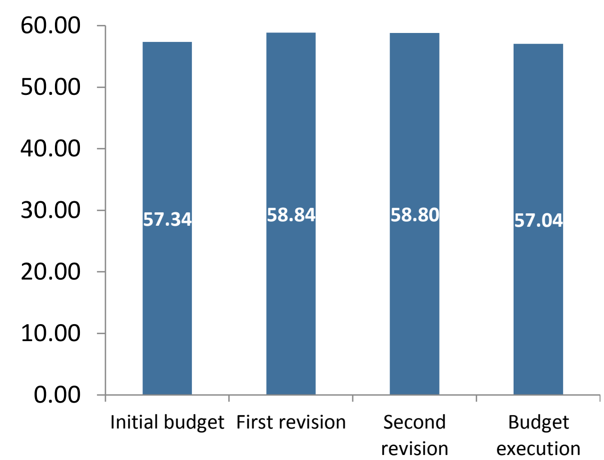
About 44% of the spending increase in Q4 2016 compared to the previous quarter was caused by the acceleration of capital spending (+103.4%, 31.2 pp contribution) and of the expenses regarding the projects financed through external non – reimbursable grants (+144%, 8.8 pp contribution), and for about 56% due to the increases in goods and services expenses (+53.5%, 32.5 pp contribution) personnel expenses (+13.5%, 12.1 pp contribution), other transfers (32.2%, 5.6 pp contribution), social assistance (+3.6%, 4.9 contribution) and subsidies (+36%, 3.9 contribution).

The expenditure concentration in the last quarter highlights serious weaknesses in the budgetary programming process although the principle of prudence might partial justify the postponement of some expenditure until the projection regarding the budgetary revenue has a lower degree of uncertainty. The Fiscal Council reiterates its previous years' recommendation for a lower volatility of inter-quarterly budgetary expenditures.

III.4.1. Personnel and social assistance expenditures

The execution for the **personnel expenses** decreased by 0.29 billion lei compared to the amount considered in the draft budget for 2016. Initially, estimated at a level of 57.34 billion lei, the execution for the personnel expenses accounted for 57.04 billion lei, respectively 7.49% of GDP, placed below the ceiling considered for this category of expenditure (57.33 billion lei, respectively 7.7% of GDP) by 0.29 billion lei, respectively 0.20 pp of GDP.

Figure 17: Personnel expenditure in 2016 (billion lei)



Source: MPF

However, the evolution projected during 2016 for personnel expenses was in contradiction with the Law on Ceilings no. 338/2015, being expected surpassing of the threshold both at first budget rectification (by 1368.1 million lei and 0.1 pp of GDP) and at the second budget rectification (by 1500.5 million lei and, respectively, 0.1 pp of GDP), while the estimate for GDP increased by 11,600 million lei as compared to the time when the law on ceilings was drafted). The increase trend in personnel spending until the second budget rectification is explained by the adoption of the decision to pay the compensatory amounts resulting from Law no. 85/2016 for the teaching personnel who did not obtain court decisions for the payment of the salary differences for the period October 2008 - May 13, 2011 and benefits from these salary rights starting with 2016 (approximately 900 million lei, the tranche corresponding to the previous year of the total of about 3.8 billion lei), the salary increases foreseen for 1st August 2016, respectively the growth of the salaries for the medical staff and the teaching personnel in education according to GEO no. 20/2016 with an estimated impact for the year 2016 of about 873 million lei, the increase of the salaries of the personnel from the public authorities paid similarly to the parliamentary services according to the law no. 293/2015 and the change in salaries for the clerical and places of worship's staff (in the budget of the General Secretariat of the Government, an increase of 92.7 million lei). Although, the amounts related to personnel expenses were increased less than would be justified by the above measures, in the context of a budget execution at the end of the first semester that recorded some savings, as the expenses representing only 48.5% of the initial allocation for all year. Moreover, in the final execution were registered significant savings compared to the planned amounts to be spent on the occasion of the second budget rectification, respectively of 1.76 billion lei, but the sources of this evolution were not explained by MPF.

Compared to 2015, the personnel expenses increased by 5.01 billion lei, respectively, by 9.64%. In fact, this increase was much higher, being occulted by the lower amount paid in 2016 compared to the previous year on the account of the court decisions that have generated savings in the wage bill envelope. Thus, in 2015, the amounts paid on the account of the executory titles were supplemented, with the purpose of granting salary rights to certain categories of employees in the budgetary sector from 2.6 billion lei to 4.1 billion lei, and the amount paid in the year 2016 for the teaching staff who did not obtain court decisions for the payment of salary differences for the period October 2008 - May 13, 2011 amounted to approximately 1.01 billion lei. The abolition of the mandatory SSC payment for the employer in the case of police, army and special service employees in the context of the return to the existing service pension system prior to 2010, implied savings of 0.94 billion lei.

Table 12: Enforceable titles issued / paid in the account of the court decisions regarding the payment of salary differences for some categories of budgets, millions lei

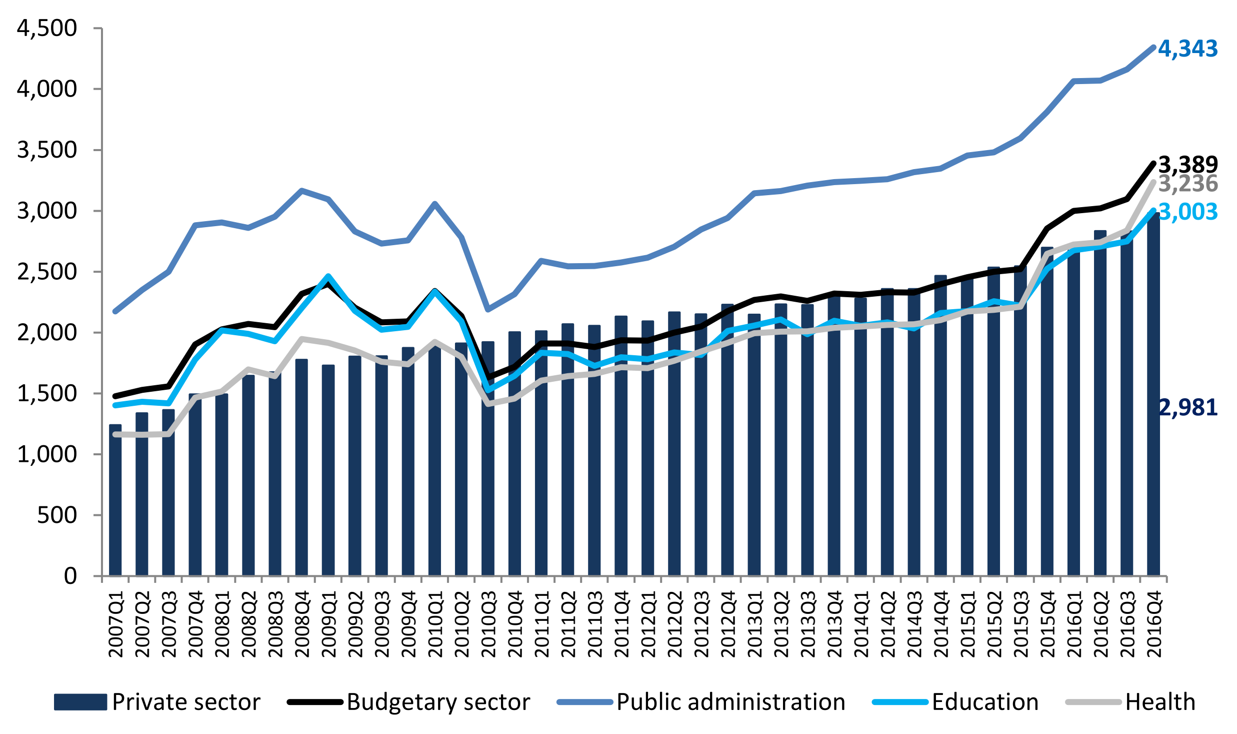
		2011	2012	2013	2014	2015	2016	2017 plan	Total
Enforceable titles issued, inclusive Law no. 85/2016	Central adm. (State budget)	3,240.0		8.5	3.8	82.3	1,661.6	0.0	4,996
	Local adm.	3,060.0		867.6	1,614.4	1,064.1	2,133.8	0.0	8,740
	Social security budget	116.0		28.6	5.5	12.2	4.0	0.0	166
	Total	**6,416.0**		**904.7**	**1,623.6**	**1,158.5**	**3,799.4**	**0.0**	**13,902**
Enforceable titles paid, inclusive Law no. 85/2016	Central adm. (State budget)		162.0	311.3	1,531.7	1,234.6	363.1	168.5	3,771
	Local adm.		153.0	306.0	2,447.2	2,806.1	544.6	214.5	6,471
	Social security budget		6.0	24.2	72.6	59.3	0.0	0.0	162
	Total		**321.0**	**641.4**	**4,051.5**	**4,100.0**	**907.7**	**383.0**	**10,405**

Source: MPF

Beyond the increases decided over the year, the draft budget already included a number of increases in the state personnel spending. Thus, in the health sector, it was foreseen an increase of the salaries of the staff hired in the sanitary units by 25% starting 1st October 2015, respectively an increase in spending for 2016 by 1.5 billion lei, and in the education, were specified increases by 15% starting 1st December 2015, representing an annualized increase of the budget expenditure by 1.7 billion lei. The increase of the salary for the personnel from the local administration's subordinated institutions starting 1st August, 2015 implied an additional expense of 0,87 billion lei, the updating of the norm of food and equipment for soldiers and policemen accounted for another 0,75 billion lei, and the increase from 1 December 2015 with 10% for the salaries of administration, research, culture, diplomacy, justice, army personnel accounted for 2.73 billion lei. The 25% increase in salaries in the social assistance and for the personnel of the National House of Public Pensions represented 0.56 billion lei, respectively, 0.41 billion lei, and setting the salaries for the personnel of the National Sanitary Veterinary and Food Safety Authority similar to the staff of the Ministry of European Funds (doubling the salaries) increased the personnel expenses by 0.25 billion lei.

A negative influence on this budget aggregate had also the increase in the minimum wage from 1,050 lei/month to 1,250 lei/month starting with 1st May, 2016, this measure having a budgetary impact of 204,31 million lei, the number of beneficiaries in the budgetary sector being of 39,322 employees according to the substantiation note to GD no. 1017/2015 establishing the minimum gross salary guaranteed for payment.

Figure 18: Average gross earnings in the private and public sector in the period 2007-2016 (lei/month)



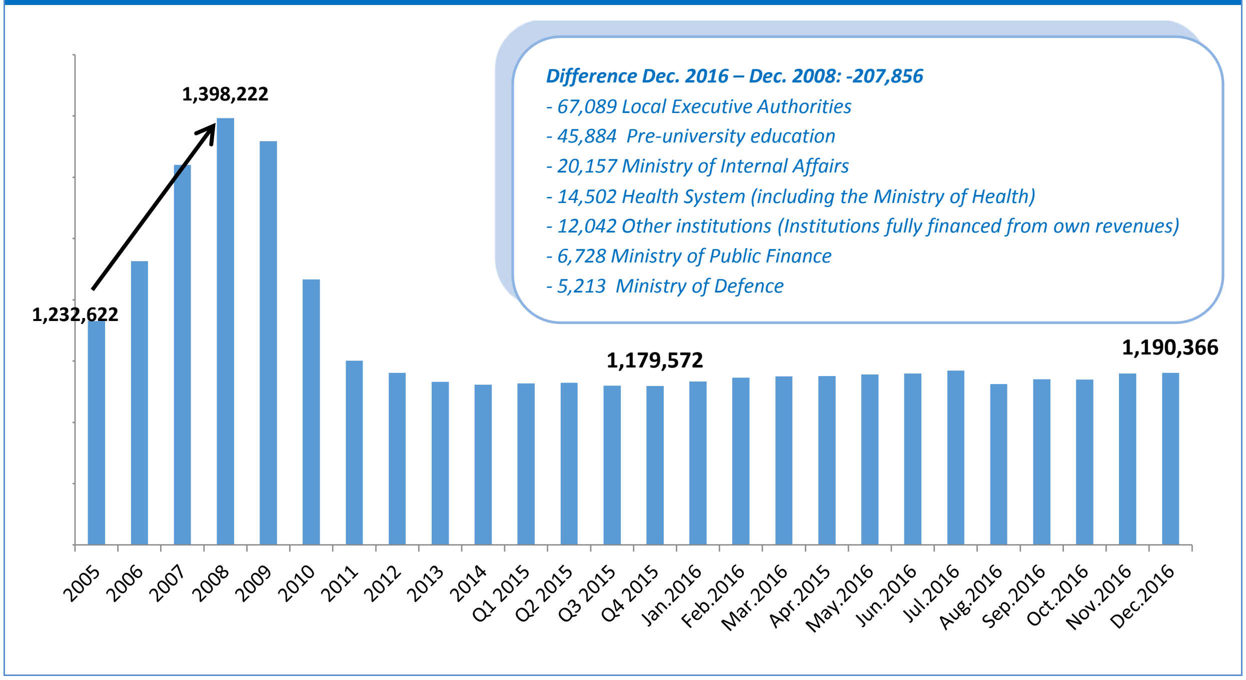
Source: NIS, Fiscal Council's calculations

As a result of these increases, the annual average salary in the public system reached 3,126 lei, by 21.06% more than in 2015, surpassing the wage in the private sector which was 2,830 lei, by 10.79% higher compared to the previous year. Considering quarterly averages, the salary in the public sector for the fourth quarter of 2016 registered a level of 3,389 lei, by 18.74% more than in the similar period of 2015, and in the private sector of 2.981 lei, representing a growth of only 10.55%. In the public sector, although the highest growth occurred in the health and public services sector (an increase of 22.21% compared to the average wage in the fourth quarter of 2015, reaching in the third quarter of 2016 a value of 3.236 lei), the average was increased by the value of the average salary in public administration and defense (4,343 lei in the fourth quarter of 2016, a 13.95% increase in the fourth quarter of 2016 compared to the same period in 2015). In education, the average wage reached 3.003 lei in the fourth quarter of 2016, recording an increase of 19.04% compared to the fourth quarter of 2015.

Subsequently of the increase by 165,600 persons registered in 2005-2008, the total number of employees in the government sector decreased by 207,856 between December 2008 and December 2016 to a level of 1.19 million (see *Figure 19*). It should be noted, however, that in 2016 there was a continuation of the slight reversal of the decrease of the number of staff, present in the previous years, the number of occupied positions increasing by 3.149 (+ 0.26%) As compared to 2015 (compared with 6,434 and + 0,5% in 2015 respectively), especially at the level of the local executive authorities (+10,274 occupied posts), the health system, including the Ministry of Health (+5,681 occupied posts), but decreases were registered in the Ministry of Internal Affairs (-6.393 positions filled), state higher education institutions (-4.632 positions filled) and school education (-825 positions filled).

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, owing mainly to the introduction of the rule of "one new employee to 7 departures from the system" (applied until 2012, inclusively), whereas in the period 2012-2014 the reduction was approximately of 9,540 persons. The adjustment recorded in the period 2009-2016 took place principally at the level of local executive authorities (-67.089 positions filled), pre-university education (-45.884 positions filled), Ministry of Internal Affairs (-20.157 positions filled), health system, including Ministry of Health (-14.502 positions filled), other institutions entirely financed from their own revenues (-12.042 positions filled), Ministry of Public Finance (-6.728 positions filled), Ministry of National Defense (-5.213 positions filled) and Ministry of Agriculture (-4.464 positions filled). On the other hand, during the same period, increases were recorded at the Ministry of Justice (+2.963 positions filled), Ministry of Economy, Commerce and Tourism (+1.316 positions filled), Ministry of European Funds (+1.221 positions filled), Ministry of Labour, Family and Social Protection and Elderly Persons (+1.217 positions filled) and Public Ministry (+1.076 positions filled).

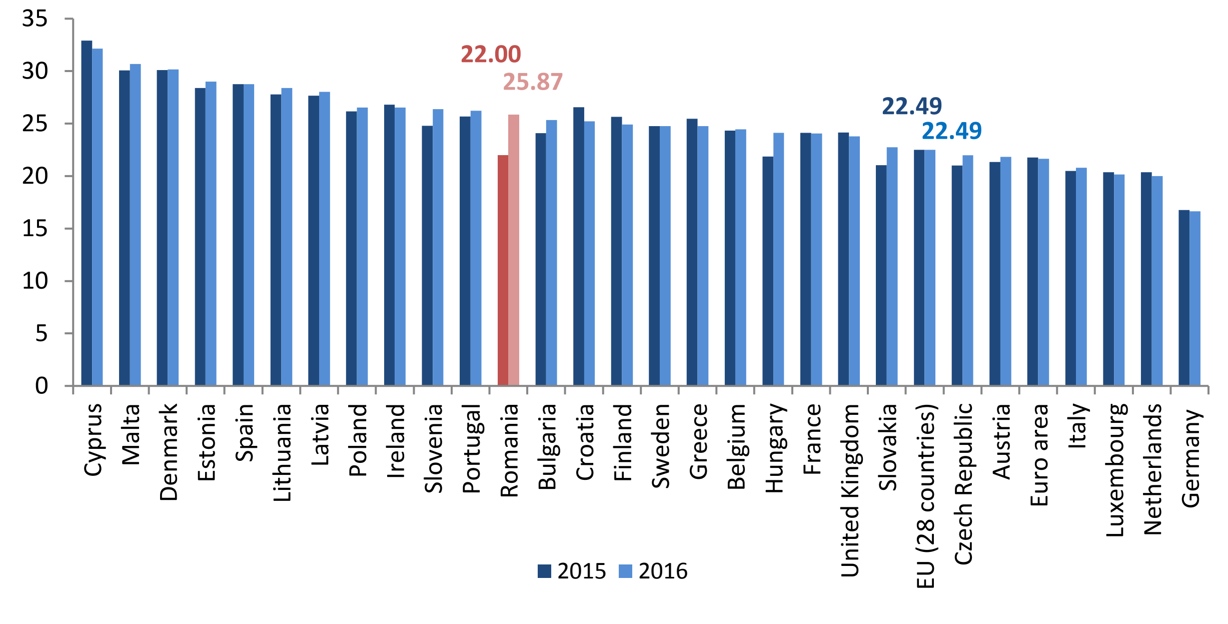
Figure 19: The evolution of the public sector employment in the period 2005-2016



Source: MPF

The adjustment made in the period 2009-2012 is mainly the result of applying the rule of "one new employee to 7 departures from the system" given that most of the exit from the system was 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 20: Wage bill as a share of total budget revenues in EU28 countries



Source: Eurostat

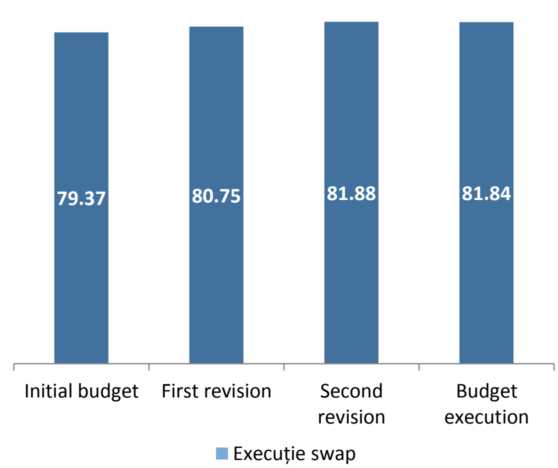
Compared to other European Union's countries, Romania's position in terms of the wage bill in the public sector as a percentage of the total collected revenues has sharply deteriorated in 2016, following a good development starting 2011 due to the fiscal consolidation measures undertaken since mid-2010. If until 2010, the wage bill as a share of total budgetary revenues placed Romania in the first half of the ranking (on the 6th position out of 27 countries in 2008 and on the 10th position in 2010), in 2011 accordingly to ESA 2010 data, revealed a better ranking for our country, respectively 20th position out of 28 countries, following the 19th position in 2013, on the background of the recovery of wages and wage increases for some categories of state employees. In 2015, Romania is on the best position in the last decade, namely the 20th position out of 28 countries, due to a slight increase of the revenues to the budget and to preserving the share of the wage bill in GDP. But then, in 2016 the situation has deteriorated and Romania ascents abruptly on 12th position, as a result of both the increase in the share of wages and salaries in GDP (by 0.5 pp compared to the previous year[45]), and a lower share of revenues collected in GDP (by 3.3 pp compared to 2015[46]).

[45] Representing the largest growth in the EU28, followed by Hungary with an increase of 0.4 pp and Estonia, Latvia and Slovenia with an increase of 0.3 pp compared to the previous year.

[46] Romania ranks the second in the EU28 in terms of decreasing the share of budget revenues in GDP. The largest decrease (by 3.5 pp) compared to the previous year was registered in Bulgaria, and Hungary was the third, with a decrease of 2.9 pp.

Social assistance spending in 2016 was above the one projected in the draft budget, being revised upwards on the occasion of the two budget rectifications. Estimated in the initial budget at 79.37 billion lei, they recorded a final value, net of the impact of the compensation schemes, of 81.84 billion lei, by 3.1% (the equivalent of about 2.46 billion lei) more than in the initial program. Social assistance spending was much higher than planned, mainly as a result of registering a higher budgetary impact in execution than initially estimated for the fiscal policy measures decided in 2015, but also due to introducing additional measures on the occasion of the two budget adjustments for the year 2016.

Figure 21: Social assistance expenditure in 2016 (billion lei)



Source: MPF

Thus, on the occasion of the first budget rectification was increased the allowance granted to adults with visual impairment seriously by increasing with 25% the net salary of the debutant social assistant with medium education within the social assistance units in the budgetary sector, and by the increase of the number of persons under various types of disabilities (Order 707/538/2014), Law no. 293/2015 , with an estimated budgetary impact of 150 million lei and the increase in the number of beneficiaries of social aid by excluding the state allowance from the family income to the social assistance, Law no. 342/2015 with an estimated budgetary impact of 140 million lei. At the same time, the impact of the increase of the state child allowance (Law no 125/2015) was revised up by 293.96 million lei and the method of setting the monthly child-raising allowance and the insertion incentive was increased and modified by Law no. 66/2016 (in force since 1 July 2016) with an estimated budgetary impact of 304.70 million lei. The increase of the social assistance expenses on the occasion of the second budget rectification was motivated by the recalculation of the special pensions and the restitution of the differences between the amounts of pensions due for December 2010 and those established under Law no. 119/2010 (through the budgets of the Ministry of Internal Affairs, the Ministry of National Defense and the Romanian Intelligence Service) with a budgetary impact of 336.70 million lei, by providing the funds necessary for the financing of the rights for the disabled in the budget of the Ministry of Labor, Family, Social Protection And the Elderly, with an estimated budget impact of 110 million lei and by the financing of the allowances of disabled persons who give up the attendant with an estimated budget impact of 562,30 million lei.

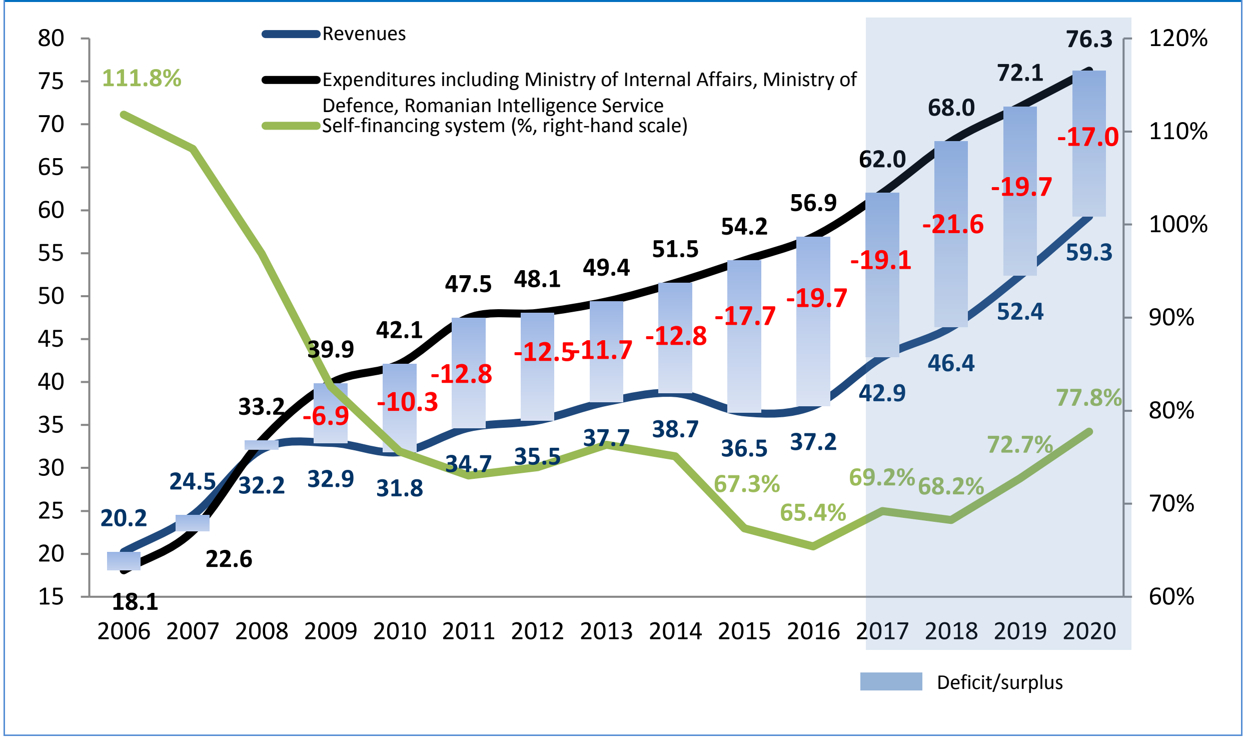
Compared to 2015, the social assistance expenditure increased by 7.76% (also due to the increase of the pension point indexation by 5% compared to 3.76% in 2014), their share in GDP rising by 0.07 pp, respectively to a level of 10.75%, while nominal GDP advanced by 7.1%. The share of the social assistance expenditure in Romania is significant, however, and the problem of the structural deficit of the public pension system is not yet solved. In consequence, pension expenses are unsustainable in relation to the contributions collected, even if some measures were undertaken in order to improve this shortcoming in the medium and long run[47].

Since 2009, the deficit of the social security budget has widened significantly up to a value of 19.7 billion lei in 2016, and the estimated trend for the following years (2017-2020) shows a slight reduction in 2017 (-19.1 billion lei), an increase in 2018 (21.6 billion lei), maintaining the same level in 2019 and decreasing to -17.0 billion lei in 2020. It is worth mentioning that in 2016 has been a major widening of the SSC deficit, respectively of 2 billion lei, due to the measure regarding the abolishing of the compulsory SSC payment for the employer in the case of employees in police, army and special services in the context of the return to special pension system existing before 2010. Although the budgetary impact on GCB is neutral, while the public sector will record savings of the same amount at the level of the personnel spending, regarding the state social insurance budget balance, the measure creates an additional deficit equal to the reduction of the SSC revenues.

From the perspective of the deficit as a percentage of GDP, the execution indicates a decrease from 2.27% in 2011 to 1.92% in 2014, followed by a new increase up to 2.49% in 2015 and to 2.58% in 2016. The estimates for the following years show a slight decrease in 2017 (2.34%) and an increase in 2018 (2.46%), reaching 2.08% of GDP in 2019 and 1.67% in 2020. In essence, compared to the previous version of the Fiscal Council's Annual Report, the forecasted deficit for the period 2016-2019 increased by about 13.6 billion lei, on average by 3.40 billion lei per year.

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

Figure 22: The evolution of revenues and expenditures of the social security budget (billion lei)



Source: MPF, cash standard data

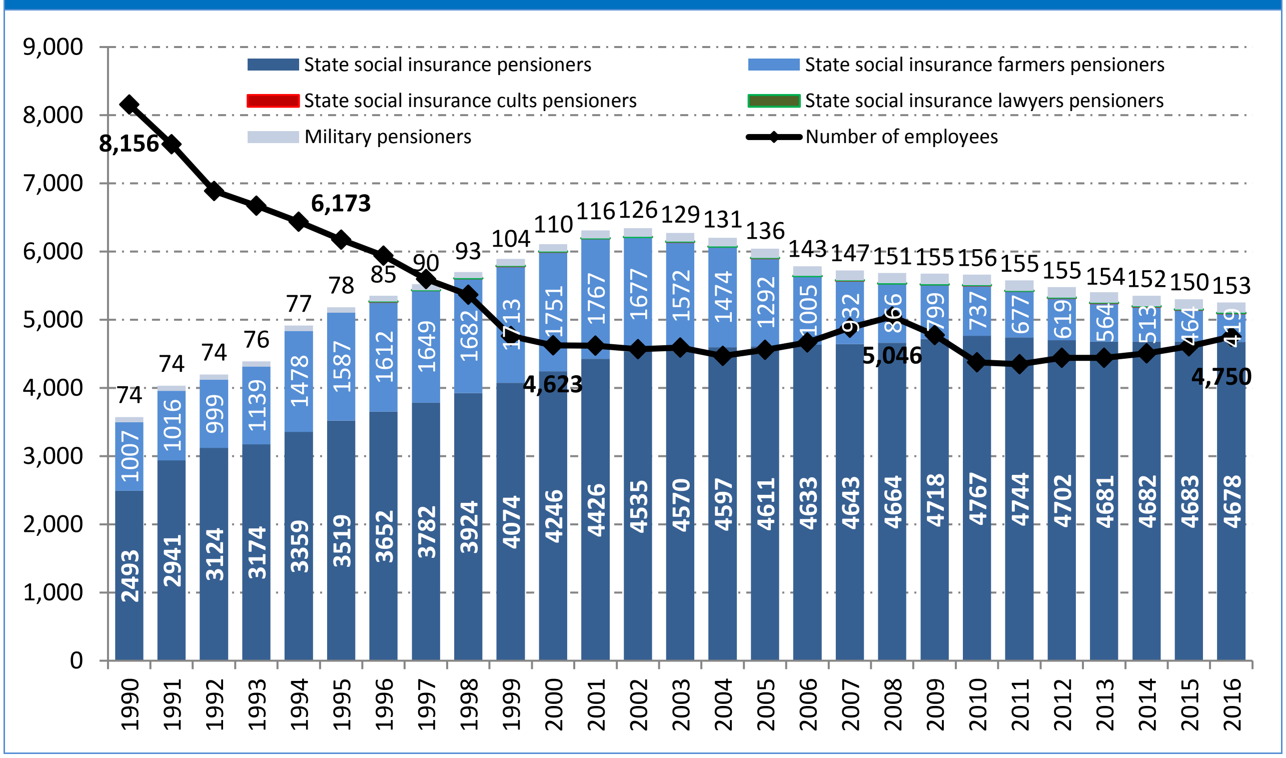
Note: In addition to the spending of the state social insurance budget for the period 2016-2019 were included spending with military pensions. According to Law no. 223/2015 from 1 January 2016, the funds necessary to pay military pensions and other social insurance rights due to military pensioners are provided from the state budget, through the budgets of the institutions: Ministry of Defense, Ministry of Internal Affairs, and Romanian Intelligence Service.

The deficit of the state social insurance budget has occurred on the account of excessive social security budget expenditure in the period 2007-2009 (+75.8%) in the context of a favorable dynamics of the social contribution revenue during the period preceding the financial crisis, as a result of the economic boom and also anticipating to maintain this trend in the future. Unfortunately, a significant share of the social contributions revenue augmentation has proven to be of cyclical nature, the further developments invalidating the optimistic forecasts that led to the significant increase of the pension point. The self-financing of the system has fallen sharply from 2006 (from 118.81%) to 2011 (73.02%), reaching the historical minimum in 2016 (65.41%). A slight recovery is expected in the future (up to 77.76% in 2020), but far from the funding needs.

Thus, the decision to increase certain permanent expenditures such as those related to pensions should take into account the trend of contributions revenues, as well as the forecasts regarding the employees-pensioner’s ratio, especially in the context of amplified demographic aging, as, for instance, from 1st of January 2016 the elderly population of 65 years and over outnumbered the young people of 0-14 years (3,436 thousand compared to 3,064 thousand) according to the NIS. It also became evident the need to find an indexation rule to ensure long-term sustainability of social insurance budget instead of discretionary approach of the past. On revenue side, the measure regarding the reduction of the social security contributions paid by the employer by 5 pp from 1st of October 2014, contributed significantly (-7.40 billion lei) to the widening of the pension system deficit in 2015.

The ratio between the number of contributors and the number of beneficiaries fell very sharply in the last 26 years, from 2.28 employees per retiring in 1990 to only 0.90 employees per retiring in 2016, the number of the state social insurance pensioners having an increasing trend, while the number of employees had a decreasing trend, especially until 1999-2000. However, in recent years, the ratio has improved from 0.77 employees per retiring in 2010 to 0.84 employees per retiring at the end of 2014, being placed in 2015 at 0.87, slightly below the level registered in 2008 (0.88).

Figure 23: The evolution of the number of pensioners versus the number of employees (thousands persons)



Source: NIS, less the number of employees for 2016 for which the source is NCEF, Spring Forecast 2017

A measure aiming to improve the medium and long term financial situation of the social insurance budget is the new pension law (Law no. 263/2010 on the unified public pension system, updated) through which it has been pursued a number of objectives designed to correct the imbalances recorded in the pension system and can support in long-term achieving this objective under the condition of legislative stability and the rigorous implementation of its provisions:

- decoupling the evolution of the pension point from the evolution of the nominal wage[48], by indexing the pension point with 100% of the inflation rate, plus 50% (this percentage drops to 45% starting with 2021 and subsequently decreases by 5 pp per year until 2030, when it reaches 0%) of the real increase in gross average wages, achieved during the previous year;
- integration in the unified public pension system of the persons belonging to special systems (military pensions), as well as of the persons who obtain income from liberal professions;
- introduction of more stringent requirements regarding the access to early pension and to disability pension;
- calculating all pensions based on the contribution principle, respectively in a direct correlation with the level of the income for which social security contributions were paid;
- increase of the retirement age due to increased life expectancy of the population and the gradual equalization – until 2030 – of the complete contribution period for women and men.

Nevertheless, returning to the special pension system eliminated in 2010 and the emergence of new special pensions jeopardize the sustainability of reforms initiated earlier and could generate new pressures on social security budget deficit. The recently adopted laws introduce new rules, ensuring better conditions for early retirement and generous computing formulas based on the salary earned before retirement. It should be noted, however, that the unitary pension system currently applied provides better conditions for some categories of workers, in order to compensate for particularly risky working conditions and shorter occupations.

Starting with 2015, special pensions were reintroduced. Thus, the Law 85/2015[49] amending the Law no. 223/2007 regarding the status of civil aeronautical professional personnel in the civil aviation in Romania reestablishes the service pensions for this category of employees. Civil

[48] The value of a pension point as previously established by Law 19/2000 was updated by indexing with at least the inflation rate, but the pension point value could not be less than 37.5% of the gross average wage used for drafting the social security budget, starting 1st January 2008, respectively, not less than 45% of the gross average wage used for drafting the social security budget, starting with 1st January 2009.
[49] Into force since May 22, 2015.

servants and employees of Parliament (Law 215/2015), as well as diplomatic and consular staff (Law 216/201536) are also benefiting from the special pension legislation, both entered into force starting August, 21, 2015. The Law 215/2015 reintroduces increased pensions for employees of Parliament, and another category of special pensions, is that for deputies and senators, introduced by the Law 357/2015 (into force starting January 28, 2016), that amended the Law no 96/2006 regarding the Statute of parliamentarian.

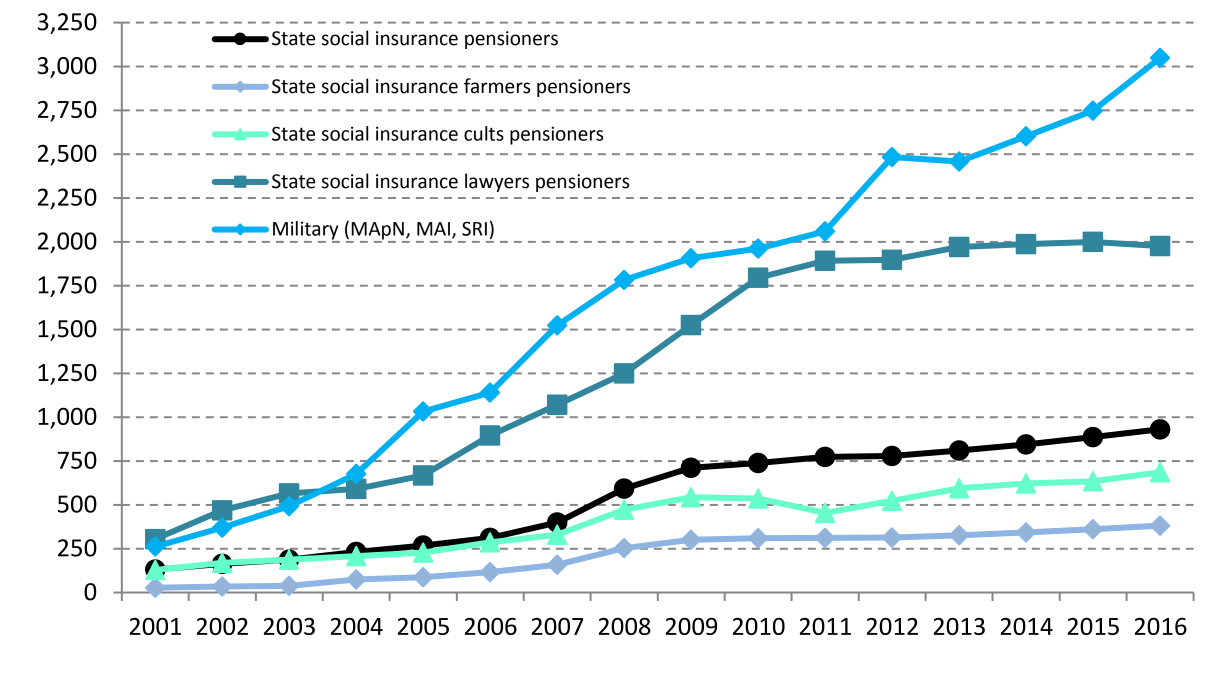
The Law 223/2015 (entering into force starting January, 1st, 2016) establishes military pension scheme[50], the main objective being the reconfirmation of military pensions system, considering the special status of the military, the soldiers, and gradation professionals, the police officers and other employees of the defense system, public order and national security. This change will basically imply the reoccurrence of the provisions of the Law no. 164/2001 regarding the military pensions which was repealed on the 1st January 2011 with the entry into force of Law no. 263/2010 on the unitary public pension system. The necessary funds to pay military pensions and other social insurance rights due to military pensioners are provided from the state budget, through the budgets of the following institutions: Ministry of Defense, Ministry of Internal Affairs, and Romanian Intelligence Service.

Thus, it can be noted that a reduction of the link between pension contributions and future accrued pension rights which has the potential to generate a negative impact on long-term sustainability of the pension system, especially since other professional groups will be also encouraged to push for the restoration/establishment of privileges.

Moreover, the renunciation of the pension indexation formula expected from 2017 affects substantially the sustainability of the pension system, the discretionary approach and the abandonment of the rules having the potential to contribute to the widening of the state social insurance budget deficit and maintaining the self-financing of the state social security budget far below required.

[50] The amount of the service pension is determined at 65% of the aggregate basis for a cumulative seniority of at least 25 years. For each year exceeding 25 years, 1% of the calculation base is added. At the same time, an increase of 3%, 6% or 9% is granted depending on the contribution to the Supplementary Pension Fund and/or the individual contribution to the budget. The pension established, recalculated and updated under Law no. 223/2015, may not be higher than 85% of the calculation basis. To the amount obtained, according to the order of "Military Merit" owned, is added an increase of 10%, 15% and 20% respectively, provided under art. 11 par. 3 of the Law no. 80/1995 on the Status of Military Staff, as amended and supplemented.

Figure 24: The evolution of the average pension (lei) in the period 2001-2016

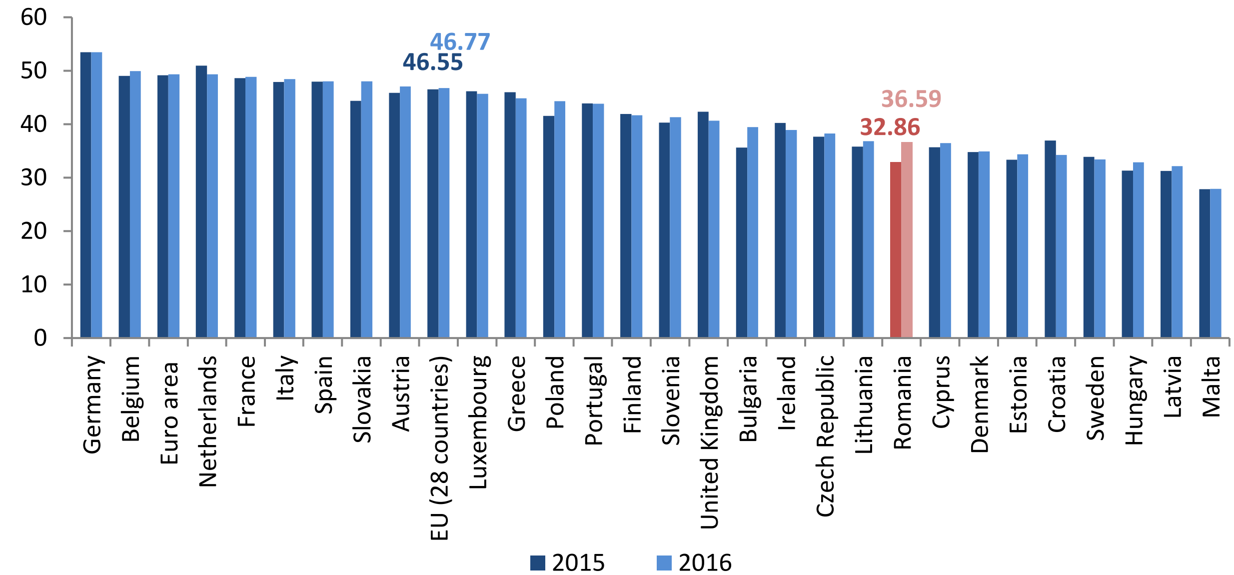


Source: NIS

According to NIS data, in 2016, the average monthly pension was 949 lei, higher by 6.24% over the previous year, as a result of the pension point indexation by 5%, respectively by 41.5 lei. Pensions paid from the social insurance budget were situated at an average level of 931 lei, while those for farmer's pensioners were on average 382 lei. However, military pensions reached a monthly average equal to 3,048 lei, by 10.95% more than in 2015. It is worth noting that the average monthly pension corresponding to beneficiaries from defense system, public order and national security increased by approximately 55.47% during 2010-2016, subsequently the recalculation according to Law no. 119/2010 and Government Emergency Ordinance no. 1/2011, even in the circumstances that the initial forecasts indicated a decline in the value of these pensions after applying the contribution principle.

Article 121 of Law no. 223/2015 on state military pensions stipulates that the differences between the amounts of pensions due for December 2010 and those established under Law no. 119/2010 and GEO no. 1/2011, approved by Law no. 165/2011, as subsequently amended and supplemented, shall be returned to the beneficiaries, at their request, in a staggered manner, for a maximum period of 2 years from the date of entry into force of the Law, and until June 30 the beneficiaries can express their option with regard to the period of time envisaged for the recalculation of the pension. The Government Decision no. 146/2016 approved the Norms for the application of the provisions of this Article, specifying that in November 2016 the payments will be made for the differences for which applications were submitted until September 30, 2016, differences corresponding to the years 2011 and 2012. For the other requests and periods payments will be made in November and December 2017. The budgeting will continue in the coming period and, although the pensions recalculation will be made during 2016 and 2017, they are due from 1 January 2016.

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



Source: Eurostat

In the year 2016, Romania has ascended five places[51] compared to 2015 regarding the share of social security expenditures in total revenues, placing in the second half of the EU member states ranking. However, even this category of expenditure has a lower share in total budgetary revenues compared to the EU average, and the share of social assistance expenditures in GDP increased by only 0.1 pp in 2016 compared to the previous year, the social assistance expenditure registered a significantly lower level compared to the financing sources (especially in the case of the SSC). The decrease in the share of budget revenues in GDP to 31.7%, a level similar to 2009, compared with 35% in 2015, contributes significantly to the deterioration of Romania's position in the ranking.

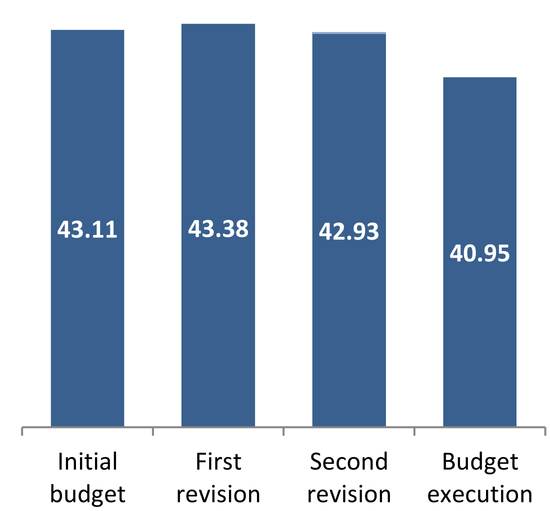
The Fiscal Council notes the manifestation of an obvious trend reversing the pension reforms designed to ensure long-term financial sustainability and pleads strongly in the favor of maintaining the progress made in recent years, both in terms of the principles introduced (exclusive use of the principle of contribution in determining the pension value) and in terms

[51] Placed on 20th position out of 28 countries, after being placed on 25th position in 2015.

of a strict compliance with the pension's indexation mechanism as introduced by the new pension law.

III.4.2. Goods and services expenditures

Figure 26: Goods and services expenditures in 2016 (billion lei)



Source: MPF

The execution of goods and services expenditures registered a lower level than the one envisaged in the draft budget (-2.2 billion lei), as well as the ones projected during the two budget amendments made in 2016. Initially estimated at 43.1 billion lei, the final amount of this category of expenditure reached a level of 41.0 billion lei, namely 5.4% of GDP, being the minimum of the period 2011-2016, decreasing by 0.3 pp compared to the year 2015. As can be seen from the figure, expenditures on goods and services were revised upwards during the first budget amendment introduced in 2016, despite the fact that the increase in this area of expenditure, after the budget approval and without the operation of a reduction of the same amount in other budget expenditure, is prohibited by the FRL no. 69/2010 republished. On the occasion of the second budget amendment, expenditures on goods and services were revised downward, both compared to the level assumed in the draft budget and relative to the value projected during the first budget amendment.

In the past, the additional spending at the level of this budgetary aggregate was justified by the use of the additional receipts from the clawback tax in the public health system, but since 2014 they have been included in the initial budget, and this argument cannot longer be invoked. It should also be noted that the under-execution recorded at the level of goods and services expenditure, respectively about 2 billion lei, can be justified by the underperformance of both revenues from the clawback tax (-1.46 billion lei), and the budget revenues from the contribution owed for the cost-volume/cost-volume-outcome contracts signed by the National House of Health Insurance with counterpart on goods and services expenditures (-0.6 billion lei). Neither in 2016 the motivation for the changes made during the draft budget amendments was not explained by the Government in the substantiation notes accompanying the proposals for the budget revisions, the only reference being in the substantiation note attached to the second budget amendment, stating an additional allocation to the defense sector. Compared to the previous year, in 2016 the goods and services expenditure net of the impact of compensation schemes grew by 0.34%, respectively by 140 million lei.

In the previous years, the estimates regarding the goods and services expenditure were increased during the budget amendments, this aggregate proving to be difficult to control: thus, in 2011-2013, the amount spent on goods and services constantly recorded levels higher than originally budgeted or even those already upward revised during budget amendments, beyond what could be explained by the impact of the compensation schemes for the outstanding payments of the budget, or the additional receipts from the clawback tax, while 2014- 2016 was characterized by a different situation, the final execution recording a lower level of spending compared to the last iteration of the budget.

Table 13: Evolution of goods and services expenditures in the period 2011-2016 (billion lei)

	Fiscal Strategy	Initial budget	First revision (without *swap*)	First compensation scheme	Second revision (without *swap*)	Second compensation scheme	Budget execution (without *swap*)	Budget execution (without *swap*) %GDP	Swap execution
2011	28.54	28.62	29.32	0.00	29.98	0.13	31.64	5.6	0.13
2012	31.26	31.74	32.78	0.25	33.18	0.50	34.04	5.7	0.41
2013	33.88	37.25	39.27	0.50	38.52	1.00	38.30	6.0	0.28
2014	36.97	39.36	40.19	0.22	41.50*	0.28*	39.10	5.9	0.49
2015	40.04	40.04	40.93	0.00	41.86	0.00	40.81	5.7	0.00
2016	43.11	43.11	43.38	0.00	42.93	0.07	40.95	5.4	0.00

Source: MPF

* *The amounts refer to the third revision.*

In the Opinion relating to the first budget revision made in 2016, the Fiscal Council noted that the upward revision appeared as surprising given that, according to the half-year execution the amounts spent represented only 40% of the initial allocation for the whole year, and the nominal pace of growth of goods and services expenditures at the end of June stood at 1.5%, while the initial budget allocation involved a nominal rate of growth for this category of expenditures of 5.6% compared with the execution of 2015. Also, during the second budget amendment, the Fiscal Council noted that, in essence, the fiscal space relative to the annual deficit target created by the reduction of the estimations related to the annual goods and services expenditure is used to significantly increase allocations for social assistance and capital expenditure.

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

III.4.3. Public investment expenditures

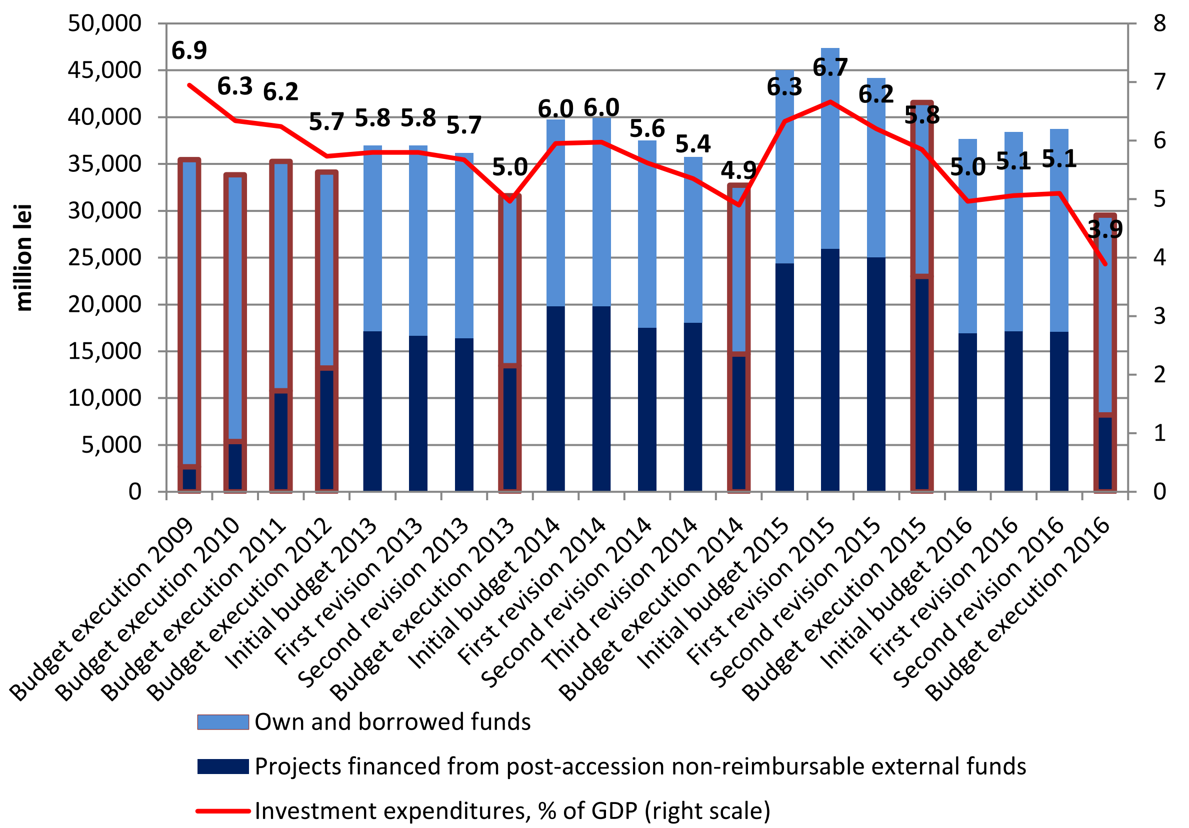
Investment expenses include, according to the budget classification, capital expenditures (non-financial assets), projects funded by external post-accession grants, expenditure for reimbursable programs, capital transfers and other transfers related to investments.

Compared to the previous year, in 2016, the public investment spending, considering all budget items of this category, including swap compensation schemes, significantly decreased by 28.9% in nominal terms, respectively from 41.6 billion lei to 29.5 billion lei in cash standards, while in real terms the investments reduction was 30.4[52]%, the share of public investment spending in GDP reducing by 1.97 pp (from 5.85% of GDP to 3.88% of GDP). Compared to the previous 5 years' development, the execution of investment spending as percentage of GDP recorded the lowest level, by 1.64 pp below the average of the years 2011-2015 (5.54% of GDP), and by 1.02 pp below 2014 considered as a minimum of that period of time (in 2014 investment spending represented 4.90% of GDP). The main cause of this development was given by the extremely slow pace of attracting EU funds for the financial year 2014-2020.

The analysis of the actual execution compared to the planned investment expenditures from the initial budget or established through revised budgets during 2012-2016 persistently reveals significant deviations, in the sense that the executions are invariably below the estimates of the initial and the revised budgets. Thus, the negative gap relative to the initial budget of amounts actually investment spending expressed as a percentage of GDP reached in 2016 1.07% of GDP, being significantly higher than in the previous year (0.48% of GDP), 2015 representing the year with the highest investment expenditure as a percentage of GDP in the period 2012-2016, while year 2016 represents the minimum of this period.

[52] Using the GDP deflator as price index.

Figure 27: Investment expenditures in 2016 (million lei)



Source: MPF

The 2016 budget was elaborated by preserving the same approach of the previous years (2013-2015) regarding the financing of investment spending with priority from non-reimbursable European funds, and thus limiting the allocations from the state budget. In this respect, for the 2016 budget it was envisaged a higher share of the external sources (by increasing EU funds absorption from both the financial year 2007-2013[53] and the new financial year 2014-2020) in the total investment expenditures, respectively, reducing the share of internal sources (capital expenditure), a correct and welcomed approach in the opinion of the Fiscal Council, thus freeing financing resources that could be used for fiscal consolidation.

[53] For the programming period 2007-2013, it was possible to engage eligible expenditure from EU funds until December 31, 2015, and before 30 June 2016 the Ministry of EU funds could transmit to EU and to the audit authority the latest applications for intermediate payments. The time limit by which the EU funds could be received on the basis of correctly made expenditure for the financial year 2007-2013 is 31 March 2017.

Nonetheless, the initial plan to substitute capital expenditures with non-reimbursable EU funds did not functioned also in 2016, revealing a major underachievement with a much higher magnitude compared to that registered in the previous year, investment spending being by 8.12 billion lei lower than the amount estimated in the initial budget for 2015 (respectively a gap expressed as share of GDP of 1.07% of GDP, compared with the gap of only 0.48% of GDP registered in 2015), mainly as a result of the non-materialization of the expenditure forecast for projects financed by external non-reimbursable EU funds related to the new financial year 2014-2020, where the difference between the execution value and the initial budgetary plan was -8.7 billion lei, respectively -1.14% of GDP. Furthermore, if we analyze the evolution of the ratio: capital expenditure/projects funded by external post-accession non-reimbursable funds for the period 2011-2016, it is noted that after a steep fall in this ratio from 210% in 2011 to 74% in 2015 (the year in which external funding was much higher than that of internal sources, this year being the deadline for attracting European funds for the financial year 2007-2013), in the year 2016 it was recorded the highest ratio in the analyzed period, respectively 232%, representing the largest share of internal sources (capital expenditure) for financing the investments.

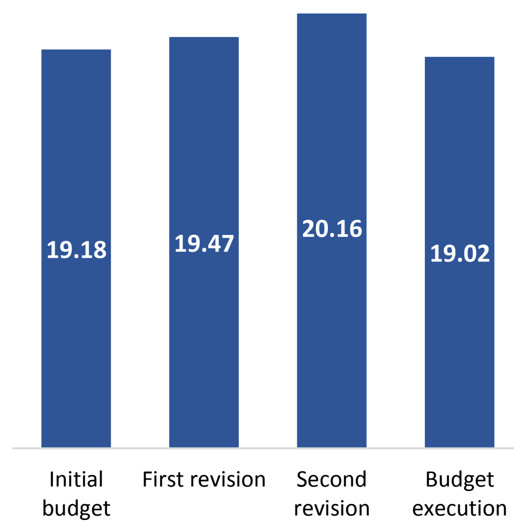
As well in 2016, the quarterly evolution of the investment spending shows a concentration in the last quarter (41.3% of the total year), which put into question the effectiveness of the budgetary programming both in terms of the management of investment projects and of defining their importance and utility. Specifically, in the last quarter the investment spending was about by 2.1 times more than the average of the three previous quarters (given that the degree of achievement compared to the level programmed through the second budget rectification is 57%), which highlights serious deficiencies in programming this budgetary aggregate characterized by an extremely high volatility of the quarterly distribution of the programmed spending compared to the actual ones. the evolution of the difference between the quarterly programming and execution, it is noted that this was more noticeable in the first half of the year (a ratio of the quarterly execution over the program below 30% in the first quarter and 37% in the second quarter, reaching 79% in the third quarter of 2015), in line with the developments of the ratio of the quarterly execution over the program for the projects funded by external post-accession funds. Thus, analyzing the quarterly evolution of the share of investment expenditure in the total execution, we notice that it fluctuated between about 15% in the first quarter and 22.4% in the second quarter (and 21.3% in the third quarter), reaching 41.3% in the last quarter[54] of 2016), roughly in line with the quarterly evolution of flows related to projects funded by non-reimbursable funds (except in the last quarter when they reached a minimum compared to the previous three quarters - 35% of their average – the investment financing being realized through

[54] In December, investments worth 7.6 billion lei (about 63% of the total quarter) were attracted.

capital expenditures that accelerated almost 3 times compared to the average of the previous 3 quarters).

In 2016, the capital expenditure for investment spending[55], were projected in the initial budget at a higher level (by 2.14 billion lei) compared with the actual spending from the previous year, but the final execution (excluding swap scheme) registered a level by 185 million lei less than the initially programmed level (-0.97%), respectively, by about 1.95 billion lei more than in 2015 (+11.4%).

Figure 28: Capital expenditures in 2016 (billion lei)



Source: MPF

The projects financed by post-accession external funds (NREF) for investment spending, were projected in the initial budget at a lower level than the 2015 execution (-6,1 billion lei, respectively, -26,5%) having in view the inherent difficulties for attracting EU funds at the beginning of the new financial year 2014-2020, but even so, they had a development much below the expectations, being significantly inferior to the level estimated in the initial budget (by -8.7 billion lei, respectively -51.5%), representing the main cause of the underperformance of the investment spending related to the initial program. Even if this under-execution had no impact on the deficit, as the decline of investment projects implied savings in terms of co-financing and ineligible expenditure, but the major failure in reaching the programmed level for the European funds in this year induces negative effects on economic growth both in terms of direct effects (the reduction of public investment) as well as propagated effects[56], and correspondingly, the perspective of maintaining a low absorption rate in the beginning of this new financial exercise also.

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

[56] The contribution of investment to potential growth is crucial, ensuring a non-inflationary economic growth and counterbalance the expansionary fiscal policy.

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

Compared to previous years, starting with 2016, the aggregate projects financed by external funds (NREF) post-accession (out of which, mostly for investment) includes also funds for agriculture, which in the previous years were not included in NREF (subsidies for agriculture, respectively, the EAGF and the complementary national direct payments (CNDP)), because these funds were considered not to transit the state budget being destined for the private sector. Thus, out of the total of 10.35 billion lei for the payments related to post-accession NREF projects (out of which 6.35 billion lei represents NREF 2014-2020), about 3 billion lei were allocated to agricultural payments (included In the NREF for the financial year 2014-2020). For comparability with the previous year, it follows that in 2016, the payments related to the projects financed through post-accession NREF were 10.35 billion lei, of which 8.2 billion lei for investments (79% of the total NREF post-accession). In the year 2015, the projects financed by NREF post accession amounted to 24.57 billion lei (of which 0.46 billion lei for NREF 2014-2020), of which 23 billion lei were allocated for investment expenditures (94% of the total NREF post accession).

Missing the target for the projects funded through external post-accession grants is correlated with the EU funds absorption rate, mainly those related to the new financial year 2014-2020, for which the underachievement of the revenues in 2016 compared to the initial budget accounted for -6.9 billion lei (-0.9% of GDP).

The expenditure regarding the projects funded by reimbursable programs that have a very small share in the total investment spending were below both the level in the previous year (by about 12 million lei, respectively by -2.5%), and of the initial budget projection, respectively by 88 million lei (representing only 83% of the program).

Figure 29: Projects funded by external post-accession grants in 2016 (billion lei)

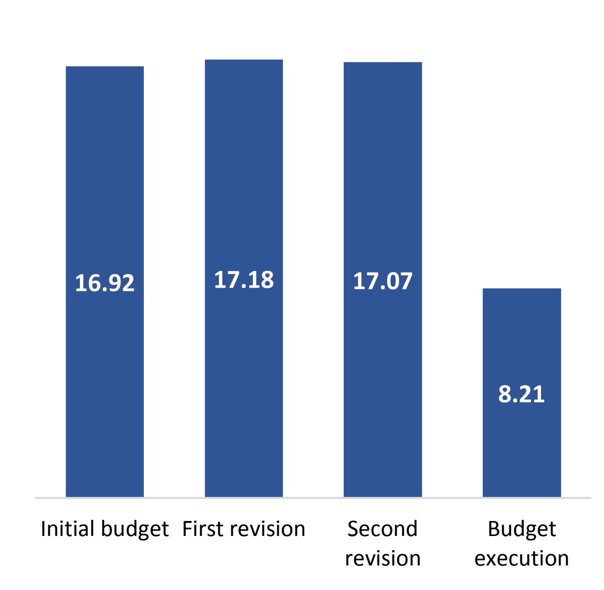
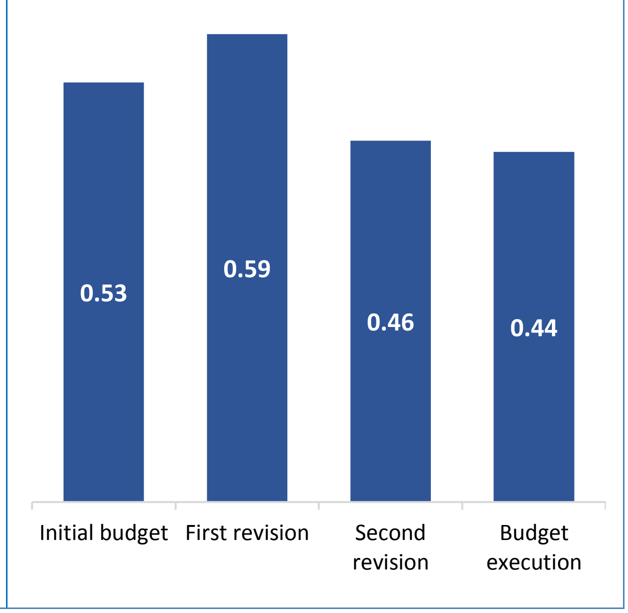


Figure 30: Expenditure funded from reimbursable funds in 2016 (billion lei)



Source: MPF

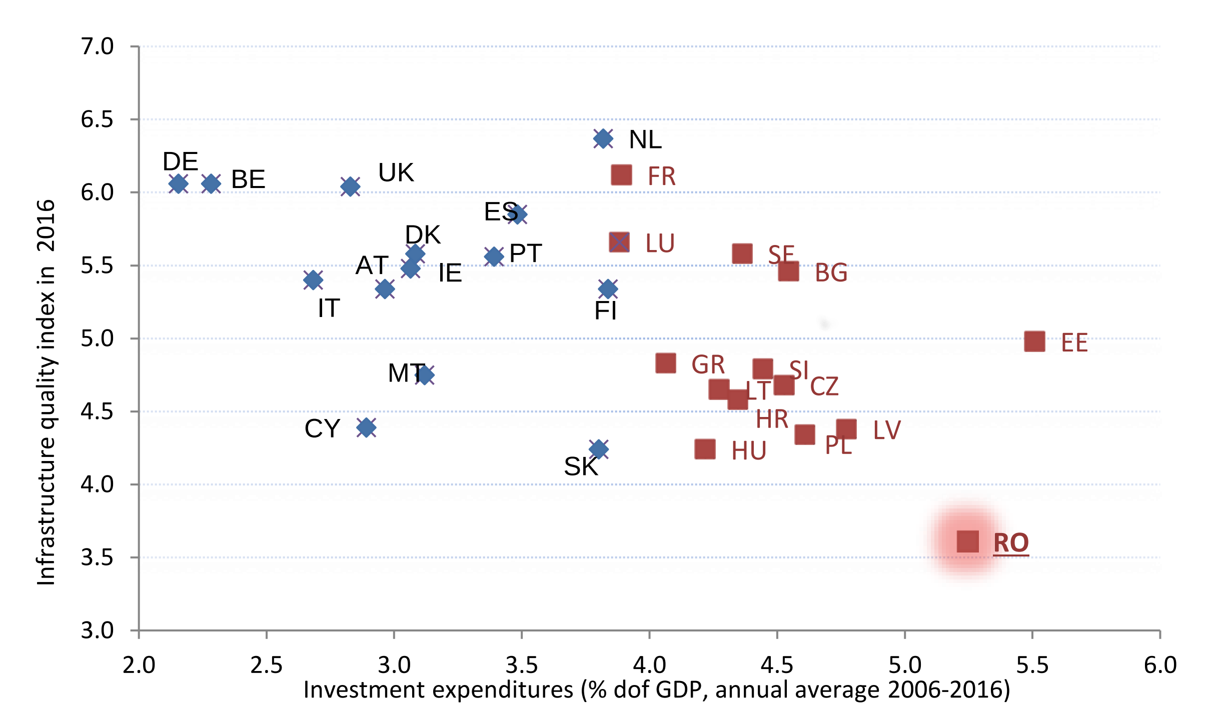
From another perspective, considering the average spending for public investment as a share of in GDP over the last decade, Romania ranked the second among EU member states (after Estonia), while in terms of the share of public investment in total budget revenues Romania ranked on the fourth position, but the infrastructure quality places our country on the last position within the same group of countries. *Figure 31* shows for all EU Member States the correlation between the average of the last 10 years of the share of investment expenditure in GDP and the index of infrastructure efficiency[57]. Countries are grouped according to the median of the share of investment expenditure in GDP over the period 2006-2016 and the infrastructure efficiency index in 2016, in countries with this ratio above the median (characterized by a high efficiency of investment expenditures relative to the quality of the resulting infrastructure and represented in blue), respectively, in countries with a ratio equal to or less than the median, characterized by a lower efficiency of investment expenditures relative to infrastructure quality (represented in red). It is worth mentioning Romania's placement in this latter group of countries in a position that suggests that, from this perspective, the investment expenditures related to the quality of the infrastructure have the lowest efficiency in the EU. Thus, according to the Global Competitiveness Report 2016-2017 Romania is ranked on the 99th[58] position (out of 138

[57] It is taken from the 2016-2017 edition of the Global Competitiveness Report.

[58] A lower position compared with the assessment in Global Competitiveness Report 2015-2016 (place 91/140).

countries) in terms of the overall quality of infrastructure, respectively on the 128th[59] position (out of 138 countries) regarding the quality of roads. Compared with the assessment in the previous year, Romania has continued in 2016 to record a setback on indicators that compose the infrastructure pillar, highlighting chronic problems on the failure to spend adequately the fund for public investment. For comparability with the situation of the other NMS10 countries, Estonia, which in 2015 was the only country positioned ahead of Romania in terms of the share of public investment in GDP over the past 10 years, was ranked in the Global Competitiveness Report 2016-2017 on the 22th position in terms of overall quality of infrastructure (rising compared with 2015-2016 Report, placed on 28th position) and on 45th position for road quality (also ranked higher than last year, 48 position). According to the same report, Bulgaria occupies 79th place for the overall quality of infrastructure, 94th place for road quality (both upwards compared to the 2015-2016 Report[60]), Hungary placed on 49th position, respectively on 69th, Poland on 65th, respectively on 72th and the Czech Republic placed on 36th position for the overall quality of infrastructure, respectively, on 65th for the quality of roads.

Figure 31: Public investment expenditures and infrastructure quality



Source: EUROSTAT, World Competitiveness Report 2016-2017

[59] A lower position compared with the place 120/140, according to the previous year's Report.

[60] In the previous year's edition ranked 89 for the overall infrastructure quality, respectively, 99 for road quality.

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[61]. 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 was 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 88/2013[62] and GD 225/2014)

For the year 2016 we consider that some improvements were made regarding the communication of the achievements in this area, the list with the prioritized investment projects being made public only at the beginning of 2016 (22 February) on the MPF website, at the chapter "Transparency in public investment projects related to the 2016 State Budget Law". The list with the prioritized investment projects included updated information related to the present value of the projects, physical state, financial state, completion date and budget allocations for the year 2016 under budget law, for the projects valued above 100 million lei.

The Fiscal Council advocates for the effective application of the legal framework of the public investment management and notes that some progress was made regarding the reform of the public investment management, the transparency of the prioritization process being in an early stage, similar with the efficiency of the allocation and spending of public money for the strategic public investments.

Moreover, as highlighted in the Country Report of the EC for 2016[63], the rate of public investment is among the highest in the EU in the last decade, but at the same time, the quality of infrastructure is among the lowest, due to management deficiencies, changes in priorities and difficulties in absorbing EU funds. EC considers that the failure of systematic using the assessment tools for determine the legislative impact, poor strategic planning investments, delays in the recent reforms and possible reversal of the administrative sector reforms constitute an impediment to the investment growth. Also, the Court of Auditors Report for 2016[64] highlights

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[61] 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 of Romania's commitments to international financial institutions.

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

[63] https://ec.europa.eu/info/publications/2017-european-semester-country-reports_en.

[64] According to the Synthesis of the Court of Auditors Report for 2016 on the review of legality of substantiation, endorsement and approval of the state budget law for 2016 and normative acts regarding

among the reasons for not realizing investment projects: major difficulties in public procurement procedures (late implementation due to legislative changes, cancellation or running over a long period of time (over 6 months) due to complaints or failure to complete them by the beneficiary public administrations); lack of the endorsement for the project financing contracts, or their late decision in December; cancellation of the contracts with entrepreneurs, disputes between the contractor and the beneficiary; failure to finalize the expropriations and land claims during the investment phase; lack of building permits; non-observance of the contractual terms by entrepreneurs; failure to ensure, at the requested level, the funds from the state budget; changes of the technical solutions, by exceeding the value of the initial contract; non issuance of the completion certificate at the ending of the works; late issuing of the invoices for the investment costs payment at the end of December; lack of specialized staff from some beneficiary investment structures, the lack of construction workforce in certain areas of the country and so on.

Moreover, considering the developments from 2012-2016, it was maintained the under-execution pattern of their performance compared with initial annual planning, which reflects not only an easy way to achieve fiscal consolidation, but seems to reflect an administrative inability to perform the planned investment projects, especially in the case of those funded by non-reimbursable funds.

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

According to the Public Finance Law no. 500/2002, article 30 paragraph (2), the contingency reserve fund at the Government's disposal is allocated to line credit 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, 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 allocations allowed destinations and their manner of use.

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the budget rectifications, and on the use and management of the state financial resources http://www.curteadeconturi.ro/Publicatii/Sinteza%20Raport%20FINAL_13.02.2017.pdf.

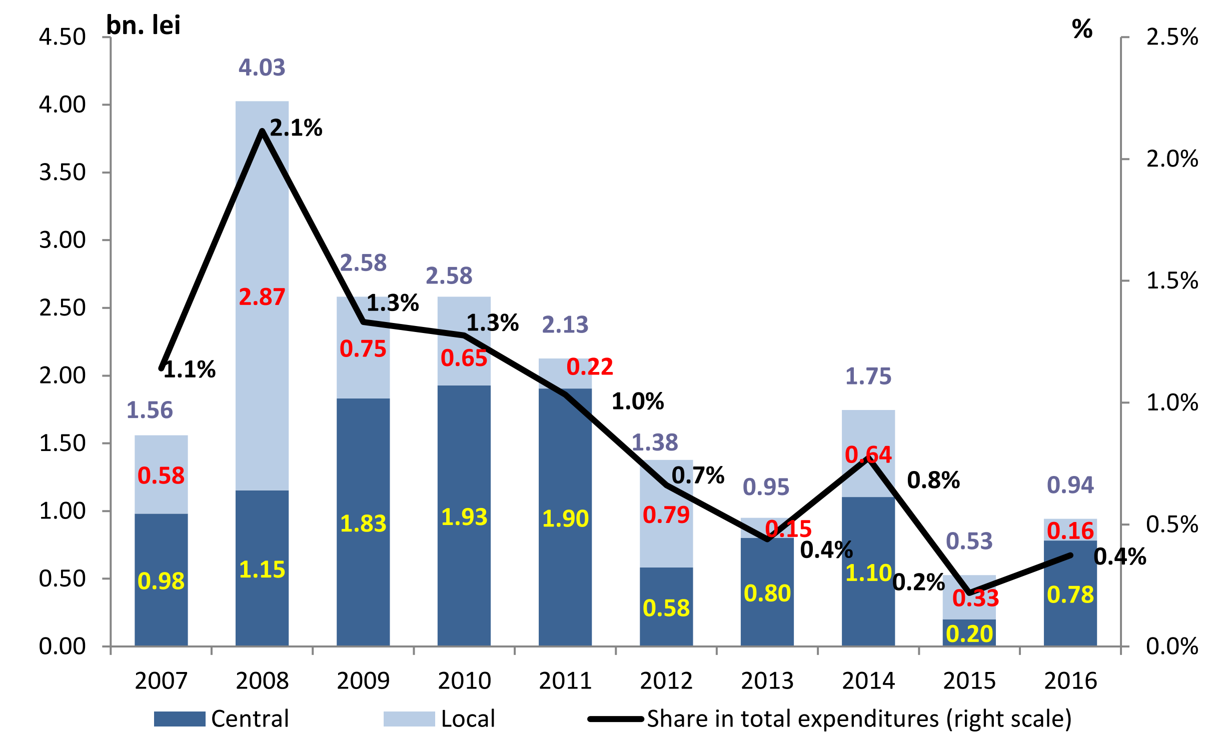
Also, we draw again attention to the emergency ordinances issued by the Government which established the use of money from the contingency reserve fund beyond the framework enforced by the Public Finances Law no. 500/2002, respectively for spending that cannot be classified as urgent or unforeseen expenditures. Thus, during 2016 were issued derogations from art. 30 paragraph (2) of Law no. 500/2002, repeatedly supplementing thus the expenditures of line credit officers from the reserve fund. GEO no. 57/2016 allowed allocations from the contingency reserve fund at Government's disposal towards the Ministry of Economy, Trade and the Business Environment for it to take all necessary measures to ensure compliance of Romania to some environmental obligations laid down by Directive 2006/21/EC of the European Parliament. Also, GEO no. 93/2016 established, by derogation from art. 30 paragraph (2) of Law no. 500/2002, from the contingency reserve fund at Government's disposal can be allocated amounts towards Ministry of Labor, Family and Social Protection for it to finance expenses related to some liabilities representing social assistance benefits, which cannot be met from the budget approved. These expenses can not be considered unexpected and should have been considered when making 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 for the year 2015, identified the following problems regarding the use of the contingency reserve fund: illegal request of amounts which no longer meet the quality of arrears or had already been paid under other legal provisions, given that previously was allowed the use of allocations from the reserve fund for this purpose; the under-evaluation of the necessary budgetary credits in the initial moment of drafting the budgets of the line credit officers which subsequently led to the need of using resources from the contingency reserve fund available to the Government.

This report studies the use of the contingency reserve fund at the Government's disposal during 2016, based on the Government decisions published in Romania's Official Journal by which are allocated amounts to line credit officers and to specific destinations.

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

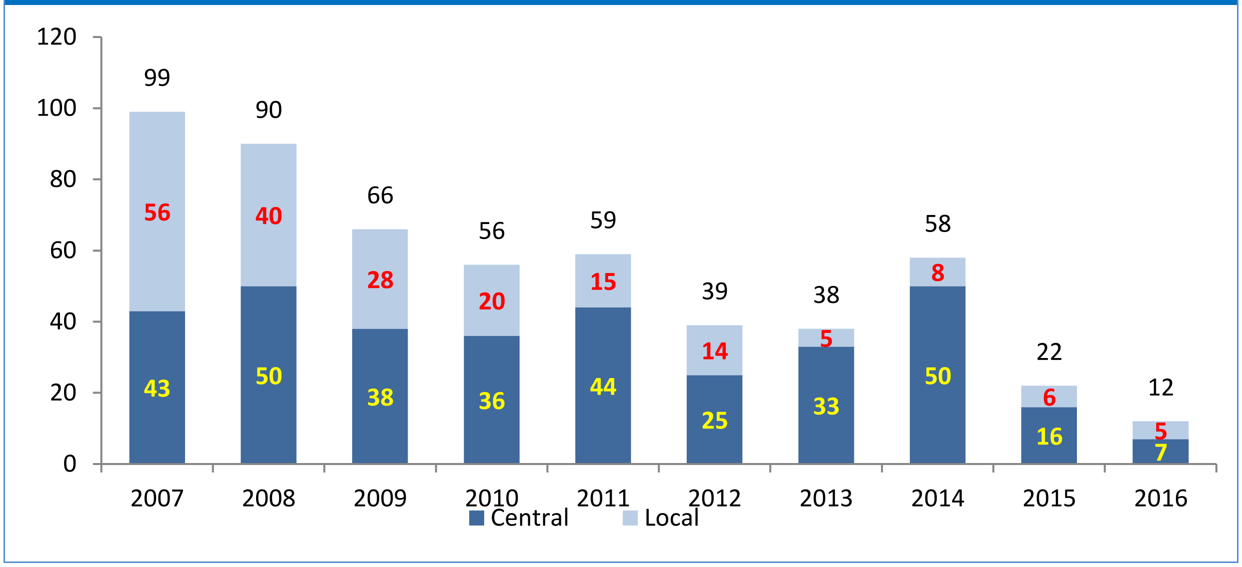


Source: Fiscal Council's calculations based on Government decisions regarding the contingency reserve fund allocations

In 2016, there were allocated from the contingency reserve fund approximately 942.3 million lei (0.4% of the total spending), of which about 781.7 million lei to the central administration and 160.6 million lei to the local authorities. Compared to the previous year, the contingency reserve fund was increased by 414.2 million lei, 78.43% respectively, on account of the increase in transfers to the central administration of about 579.9 mil. lei, while the amounts received by the local authorities decreased by 165.7 million lei. However, in the year 2016 is recorded the second lowest level of the period analyzed, standing at around half of the 2014 allocations.

The number of Government decisions regarding contingency reserve fund allocations reached in 2016 the minimum of the analyzed period. The tendency of the preceding years to employ most spending from the contingency reserve fund in the last month of the year was maintained, 7 out of the 12 decisions were approved in December of 2016.

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

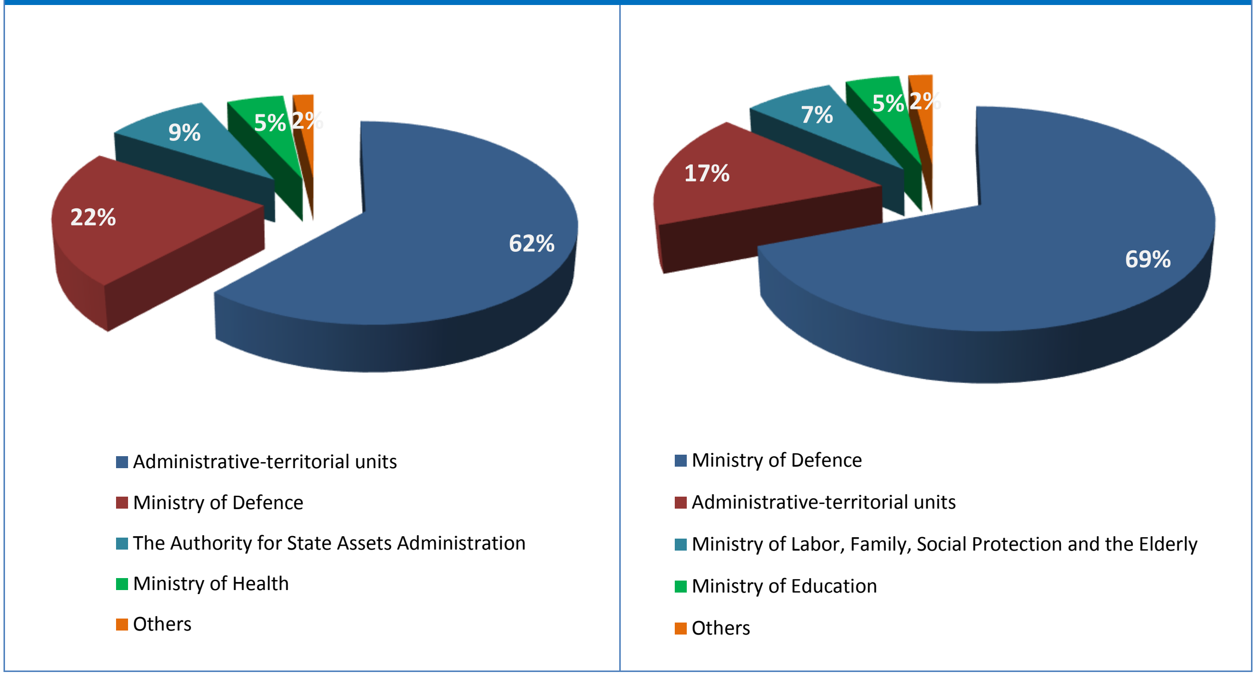


Source: Fiscal Council's calculations based on Government decisions regarding the contingency reserve fund allocations

From the perspective of the destinations for the allocations from the contingency reserve fund at the Government disposal, in 2016, they were mainly directed to the central authority, 83% of total, the main beneficiaries being the Ministry of National Defence that received 69% of the total, along with the Ministry of Labor, Family and Social Protection that received 7% of the total, the Ministry of Education, Research, Youth and Sports that received 4% of the total and Ministry of Administration and Interior that received 2% of the total amounts allocated from the contingency reserve fund. The local authorities received in 2016 17% of the total allocations from the contingency reserve fund. Comparatively, in 2015, the local authorities were the main beneficiary, receiving 326 million lei (or 62%), while the central authority received 201.9 million lei (38%).

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

2015 | **2016**



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

Based on the analyses elaborated in the 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. In 2016, it is obvious the massive use of this fund in December, in the amount of 923.7 million lei, representing 98% of the allocations of the whole year. These issues make it extremely difficult to track the amounts spent from the budget reserve fund and constitutes an additional argument for the discretionary nature of the formation and utilization of this fund.

Fiscal Council maintains its recommendations made in previous years about increasing the degree of transparency and changing the legislation to establish an explicit use of the reserve fund. Also, we resume the recommendation about more detailed allowed destinations of allocations from the contingency reserve fund, stating the conditions and the criteria for allocation, as well as a disaggregation on line credit officers and a possible capping of the amounts that can be allocated and used from the contingency reserve fund, as a percentage of total expenditure, a level of 1% being apparently adequate for the urgent expenses, given previous developments.

According to the article 30, paragraph (4) of the Public Finance Law no. 500/2002, the intervention reserve fund at Government's disposal is allocated, based on government decisions, to line credit 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 2016, the amounts allocated from the intervention reserve fund at Government's disposal amounted 562 million lei, their destinations being in accordance with the Public Finance Law no. 500/2002.

III.5. The public debt

The interest expenses increased in 2016 by 436.6 million lei (respectively with 4.6%) compared to 2015, their share in GDP decreasing from 1.35% to 1.31%, in the conditions of a 7.1% nominal GDP advance. This development can be explained by the increase in the stock of debt (7.45%), as debt issued in the past will reach maturity and will be refinanced at the more favorable current costs. The final value of this expenditure chapter was lower than projected in the original budget by 1,061 million lei (0.14% of GDP) suggesting an overvaluation of this budgetary aggregate at the moment of drafting the budget given that the interest expenses can be predicted with a high degree of accuracy for the next calendar year.

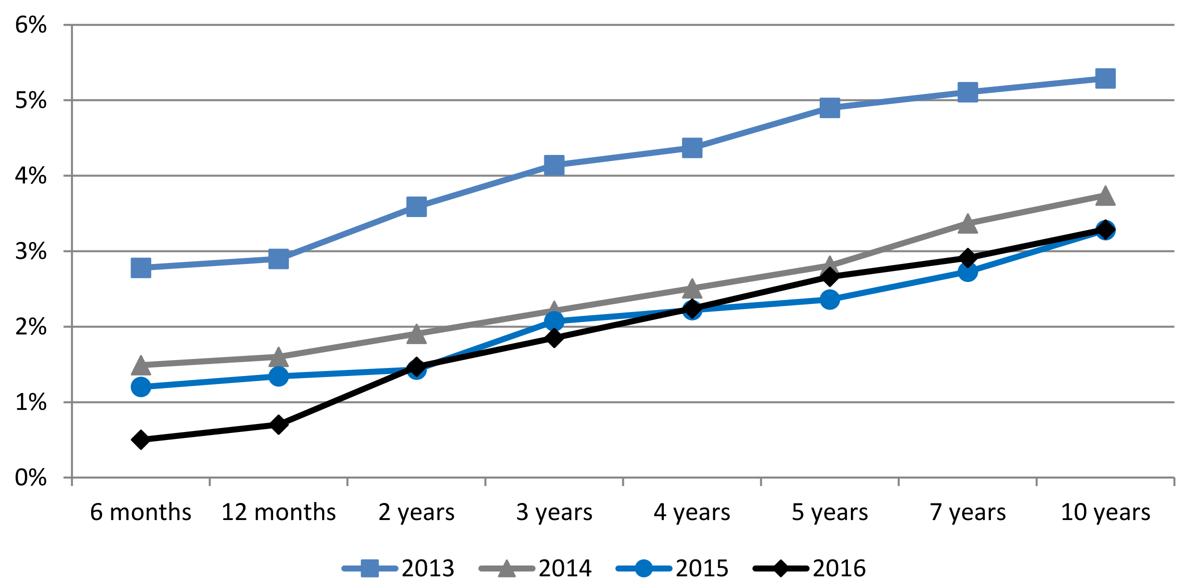
The public debt decreased in 2016, its share in GDP decreasing, according to ESA 2010 methodology, to 37.6%[65] from 38.0% at the end of 2015, as a result of sustained economic growth and a reduction in real terms of the interest paid for contracting loans. According to national standards, the public debt increased to 44.5% of GDP at the end of 2016, compared to 44.4% in 2015.

The average interest rate paid on public debt declined from 4.0% in 2015 to 3.9% in 2016, and this decline should continue in the coming years given the much lower current expenses for debt refinancing and the relatively low average maturity of the public debt. The cost of attracting new resources in national currency registered a positive development in 2014-2016, the government

[65] GDP for 2016: 761.5 million lei.

bonds yields dropping significantly compared to the level of about 6% at the end of 2012, due to the inclusion, starting with July 2014, of bonds issued by the Romanian State in the calculation of the GBI-EM Global Diversified index series by JP Morgan, the extension of the average maturity of public debt, due to loose monetary policy measures adopted by the central bank, to obtaining of a BBB- rating from Standard & Poor's in May 2014[66], but also due to a liquidity surplus in the financial markets. Considering the conditions at the end of 2016, a decline in bond yields can be observed for short-terms maturities (less than 1 year) at about 0.7% from 1.34% a year before, as well as for those with longer-term maturities, financing costs for a term of 5 years increased to 2.66% from 2.36%, while the interest rate for 10-year maturity remained relatively constant around 3.3% at the end of 2015. Regarding the cost of attracting new resources in foreign currency from the external markets[67], the state was able to finance itself cheaper in 2016 compared to 2015 for the issuances of the government bonds denominated in euro, the yields obtained for a maturity of 10 years were 2.55% compared to the level of 2.85% in 2015, or 3.9% for a maturity of 20 years compared to 3.93% in 2015.

Figure 35: The evolution of financing costs in national currency in the period 2012-2016



Source: NBR

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

[67] In February 2016, Romania attracted 750 million euro from the foreign markets for a period of 9 years and 500 million euro with a residual maturity of 19 years, plus a 1 billion eurobonds issuance in May 2016 with a maturity of 12 years and a 1 billion eurobonds issuance in October 2016 with a residual maturity of 12 years.

The central administration debt[68] represented at the end of 2016 95.4% of the total public debt, compared to 94.7% in 2015, while local debt represented only 4.65%, slightly decreasing from the level of 5.26% registered in the previous year. Government bonds have the largest share in total debt, cumulating 34.4% of the total (compared to 34.6% in 2015), followed by euro-bonds with 24.7% (compared to 23.7% in 2015), state loans which represents 20.5% (compared to 22.4% in 2015) and treasury bills that provided 3.5% of total public debt financing (compared to 2.9% in 2015).

Regarding the maturity structure of government securities newly issued in 2016, the trend of attracting longer-terms resources initiated in the last years did not continue. Therefore, the treasury bills with maturities lower than 1-year totals approximately 26.1% of new loans in 2016, decreasing compared to the share of 32.5% recorded last year. Under these conditions, the average residual maturity of government securities issued on domestic market increased in 2016, compared to 2015 (to 4.08 years from 3.68 years). Thus, the share of funding over longer periods has advanced compared to the period 2009-2012 (the share of treasury bills with maturities lower than 1 year totaled 65% of new loans in 2009), while the bonds with maturities longer than 1 year accumulating 73.9% of the new loans, of which bonds with a maturity of 2 to 5 years have the largest share in total (46% in total issued securities), while those with a maturity of 5 to 10 years have a share of 39% in total, and those over 10 years have a share of 5.4%. The preference in the last years of the state for funding longer-term yields was favored both by lower yields, excess liquidity in the financial markets as well as an improved risk perception regarding Romania.

The debt structure by currencies revealed an increase in the share of loans in national currency to 53% in 2016 from 50% in 2015, while the euro financing registered a decrease to 38% of total in 2016, from about 41% in 2015, the declared intention for the next period of Ministry of Public Finance being to increase the amounts attracted in national currency from domestic market. In 2016, the state didn’t contracted loans from the U.S. market, but the share of debt denominated in U.S. dollars was located at the level recorded in 2015, respectively about 9% of the total government debt, under the significant appreciation of the US dollar in 2016.

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

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

[68] According to the national methodology.

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

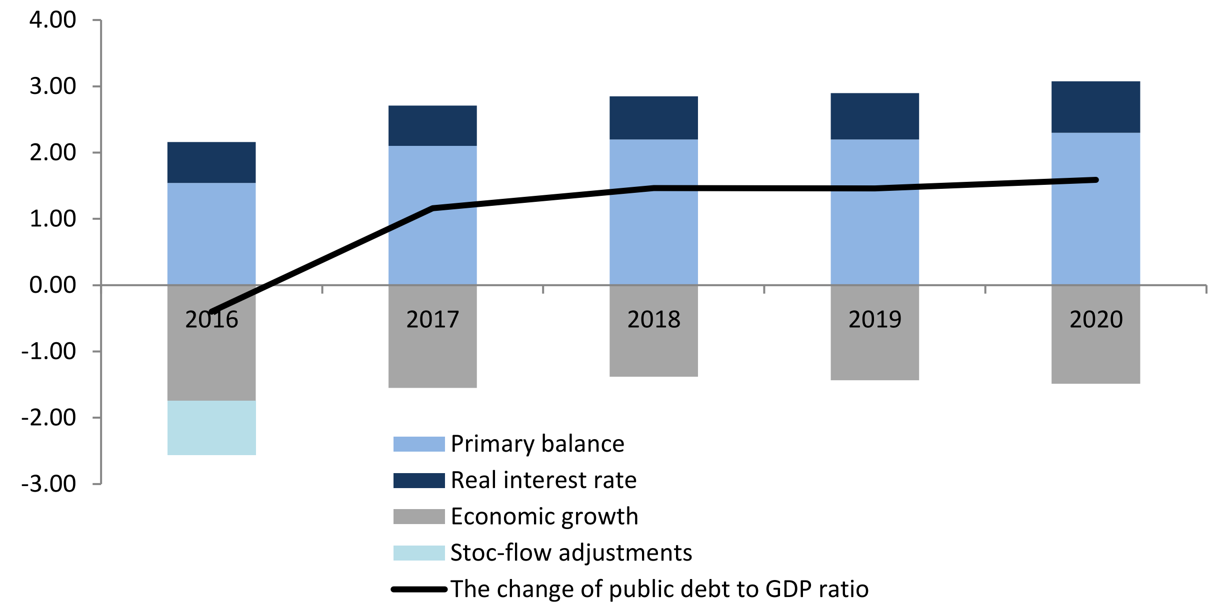
$$1 + \lambda_t = \frac{1 + i_t}{(1 + \pi_t) * (1 + \gamma_t)}$$

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

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

Analyzing the contributions to the public debt variation as share of GDP of -0.4 pp in 2016, favorable contributions can be observed, from real economic growth (-1.74 pp), inflation (-0.78 pp) and stock-flow adjustment (-0.82 pp), while the primary deficit contributed to an increase in the debt to GDP by 1.54 pp, in the same direction acting also the real interest rate, respectively with a contribution of 0.62 pp. The stock-flow adjustment in 2015 had a positive contribution, due to the fact that some amounts from EU funds, although registered as revenues in 2015, were not actually received from EU resorting to loans until the amounts were actually received. Given that these funds were received during 2016, the need for loans diminished, and the contribution of this factor in 2016 acted in the direction of decreasing the share of public debt in GDP. In essence, in 2016, the negative impact on the public debt path of the high budget deficit was overshadowed by a very high growth rate and by the influence of the stock-flow adjustment. An unfavorable influence (about 0.55 billion lei) on the level of public debt was also exercised by the depreciation of the leu against other currencies, especially against the US dollar, which in 2016 continued to appreciate (+3.75% against the leu, considering the parity at the end of 2016 compared to the same period of the previous year), this factor being recorded at the level of the stock-flow adjustments. It should also be noted that the economic growth of 4.8% registered in 2016 was higher than the real interest rate of 1.71%, which involved a negative value for the coefficient λ_t that being a favorable development in terms of the dynamics of public debt as share of GDP.

Figure 36: Contributions to changes in public debt as share of GDP in the period 2016-2020



Source: NCEF, MPF, Fiscal Council's calculations

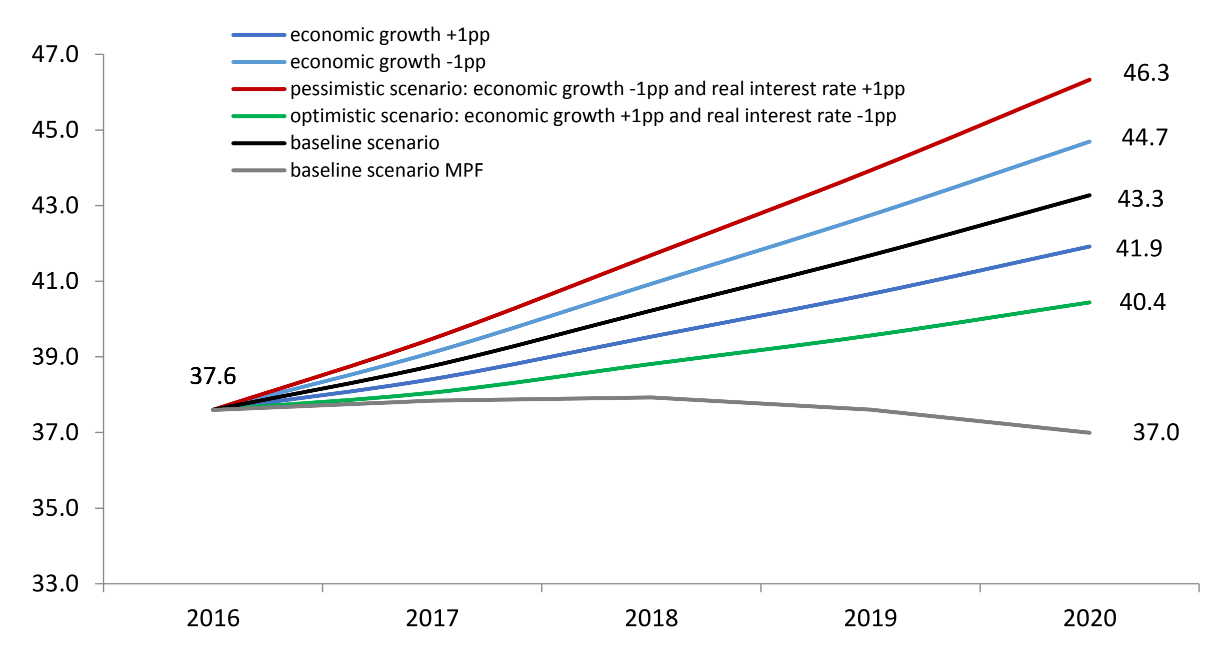
For the estimation of the contributions to changes in public debt as share of GDP in the period 2016-2020 we used the official EC[69]forecasts for real GDP growth and the share of the budget deficit in GDP - which differs significantly from those of the Government, but which are closer of those of the Fiscal Council - and a stock-flow adjustment equal to zero was assumed. Thus, in the period 2017-2020, according to the baseline scenario, public debt is projected to progress gradually from 37.6% in 2016 to 43.3% at the end of the period, as rates of economic growth forecast by the EC is far below those predicted by the Government, and budget deficits are assessed by the EC at a higher level than those in the Convergence Program. Thus, the Government's estimates of the budget balance in 2017 of -2.9% of GDP differ significantly from those of the EC, which anticipates a deficit of 3.5% of GDP, while maintaining unchanged policies, while significant fiscal consolidation considered for the end of 2020, which adds 1 pp of GDP to the Convergence Program forecast, is not accompanied by concrete measures to support it. In the absence of such measures, the budget deficits for the period 2019-2020, not covered by the EC forecast, were assumed at the level of those in 2018. Thus, public debt will be placed on an upward path, assuming that policies are maintained, even considering the high anticipated growth rates for the coming years.

The above results depend to a large extent on the forecasts used for the real interest rate and

[69] Spring forecast of May 2017; For the years 2019 and 2020, the projected values for 2018 were maintained.

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

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



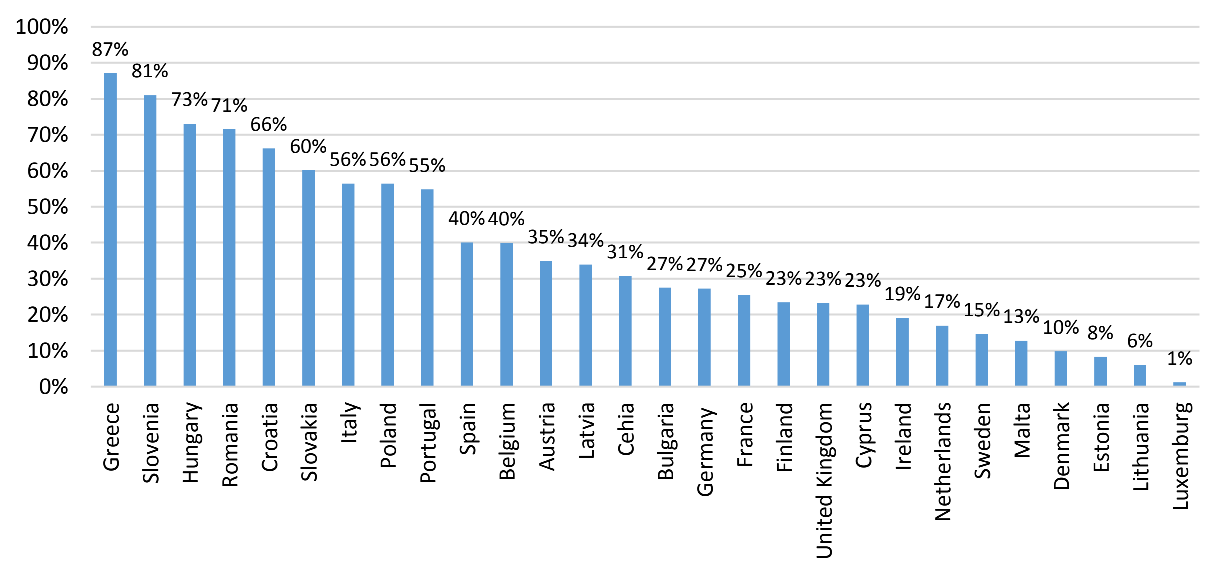
Source: NCEF, MPF, Fiscal Council's calculations

For the construction of the scenarios we used the MPF projections from the Convergence Program 2017-2020 and the EC spring 2017 forecast. Thus, there are two baseline scenarios: one in which the Government's forecasts were used exclusively and lead to a fall in debt at the end of 2020 compared to the current level, and one in which the EC's projections for the EC budget deficit and economic growth were used (for the years 2019-2020, not covered by the EC forecast, the same values were assumed as in 2018), which leads to a much higher level of public debt, respectively 43.3% of GDP at the end of 2020. The difference of more than 6 pp between the two underlying scenarios results from the higher projections of EC of the budget deficits (-3.5% in 2017 and respectively -3.7% in 2018, compared to -2.9% in both 2017 and 2018), as well as a lower economic growth rate forecast predicted by the EC compared to MPF (4.3% in 2017 and 3.7% in 2018, compared to 5.2% in 2017 and 5.5% in 2018). These differences clearly show both the sensitivity of the public debt path to the assumptions used and the increasing risks to the evolution of public indebtedness.

Starting from the baseline scenario built with EC data - also taking into account the Fiscal Council's budget deficits estimates for the following period, which are closer to the EC's ones - several scenarios were built among which: an optimistic one, characterized by an economic growth higher than projected by 1 pp (and thus closer to government forecasts) and a lower real interest rate with the same value, which leads to a debt level of 40.4% of GDP in 2020 and a pessimistic one in which the real GDP growth rate is lower by 1 pp, coupled with a real interest rate higher by 1 pp, in which the share of government debt in GDP would reach 46.3% - above the attention threshold of 45%, defined by the FRL. Even in the optimistic scenario, the debt-to-GDP ratio at the end of 2020 is significantly higher than the one calculated in the baseline scenario that starts from the government forecasts, also increasing relative to the current level. Moreover, additional risks arise from potential negative shocks in the exchange rate, given the relatively high share of public debt denominated in foreign currencies.

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

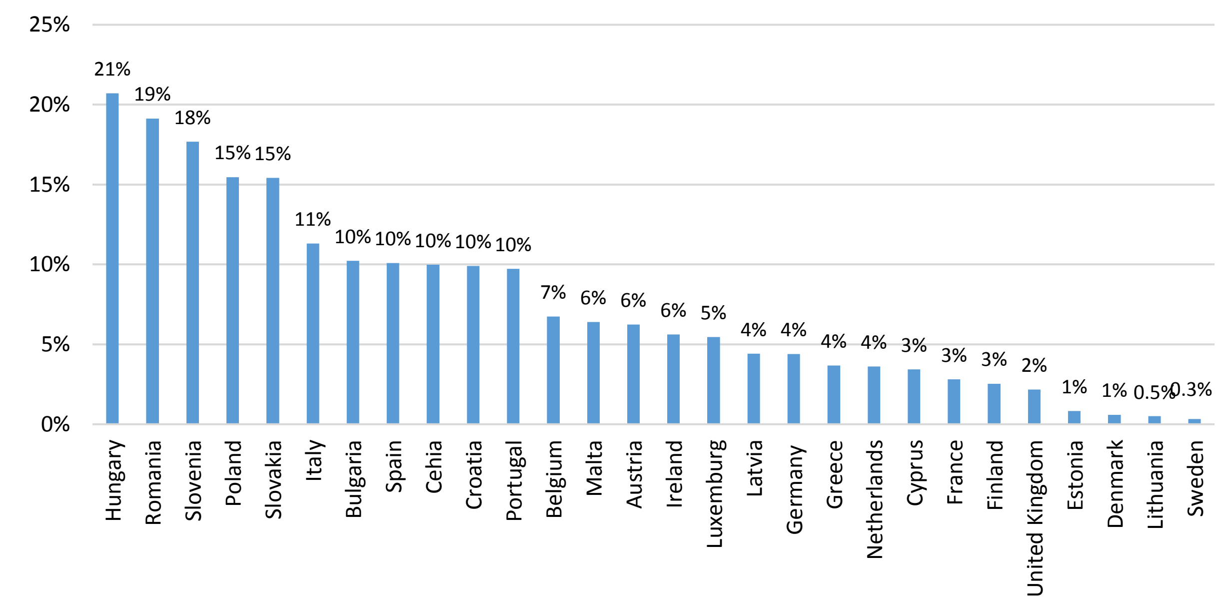
Figure 38: Share of government debt in total banking assets



Source: AMECO, ECB, Fiscal Council's calculations

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

Figure 39: Share of government credit in total banking assets



Source: AMECO, ECB, Fiscal Council's calculations

The Fiscal Council considers that the next period, which coincides with the upward phase of the economic cycle, should be used to reduce indebtedness, the current trajectory of the government debt ratio in GDP may lead to the accumulation of excessive vulnerabilities that would become fully visible in a future downward phase of the economic cycle. Fast GDP growth largely conceals the rise in public debt as a percentage of GDP, with vulnerabilities having the potential to be quickly unveiled in the context of adverse cyclical developments. In addition, the continuing growth of public debt above 40% of GDP may become problematic at the current level of development of the economy and its limited absorption capacity by local financial markets.

IV. The absorption of EU funds

For the **2007-2013 financial framework**, as shown by the data provided by the Ministry of European Funds (MEF), structural and cohesion funds in amount of 19.06[70] billion euro have been allocated to Romania, plus a 13.8 billion euro from the Common Agricultural Policy. Co-ordinated through EU cohesion policy, the structural and cohesion Funds are financial instruments (Cohesion Fund - CF, European Regional Development Fund - ERDF, European Social Fund - ESF) designed to eliminate economic and social disparities between regions, supporting the convergence of member countries, increasing competitiveness and employment. Considering these aspects, this report examines the absorption of EU funds in Romania considering only the structural and cohesion funds.

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

In the 2016 NRP submitted by Romania to the European Commission in April 2016, there are defined the reforms and development priorities for a period of 12 months, taking into account the priorities set out in the Annual Growth Survey 2016, the Country Report's recommendations for Romania in 2015 and the measures taken in the context of the Europe 2020 strategy. According to the NPR 2016, MPF aims to implement public spending transparency and efficiency mechanisms that will help to increase the fiscal space for investments, improve the medium and long-term sustainability of public finance, increase the absorption capacity of European funds and increase the predictability of medium-term budgetary policy.

The closing calendar of the operational programs 2007-2013[71] includes three stages: by December 31, 2015 - the deadline for the eligibility of the expenditure incurred by beneficiaries; by June 30, 2016, the MEF must submit to the EC and the Audit Authority the last application for

[70] According to the latest data provided by the MEF (April 2017), the SOP HRD allocation was reduced, lowering also the total amount to 18.78 billion euro.

[71] According to Government Decision 678/2015 on the closure of operational programs financed during 2007-2013 through the European Regional Development Fund, the European Social Fund, the CF and the European Fisheries Fund.

interim payment; by March, 31 2017, Romania must submit to the EC, through the SFC 2007[72], the payment application of the final balance and the final statement of expenditure, this being the final deadline by which the EU funds can be received based on the eligible expenditure related to the programming period 2007-2013.

The results of the sustained efforts have been seen in increasing Romania's capacity to absorb the European structural funds. Thus, at the end of March 2017, Romania absorbed 90.44% of the total funds allocated under the 2007-2013 framework, a significant increase compared to January 2016 when the absorption rate was 69.91%.

Analyzing the data provided by the MEF, the highest absorption rate (95%) is located at the Operational Programme Administrative Capacity Development under an initial allocation of only 208 million euro, the Operational Programme Technical Assistance with an initial allocation of 161.72 million euro, these being the programs with the lowest amounts allocated, but also the Sectoral Operational Programme Economic Competitiveness, while the lowest absorption rate is located at the Sectoral Operational Programme Transport, with 86.88% and a 13.51 pp growth compared to January 2016 and an initial allocation of 4,288.13 million euro and 3,200.09 million lei being spent until February 2017,.

Although Romania faced major problems, progress has been visible in the past two years. Most of the increased absorption rate was for the Sectoral Operational Programme Economic Competitiveness (by 26.87 pp), with an attracted amount of 2,179.93 million euros and an initial allocation of 2,536.64 million euros. With payments of 3,463.04 million euro, the Sectoral Operational Programme Environment has an increase in the absorption rate of 20.56 pp compared to January 2016.

The Regional Operational Programme had a consistent growth from the beginning, the absorption rate advancing in the last year with 21.13 pp, reaching 93.50% in February 2017, this program being in the second position in terms of the absorption of structural funds in Romania, immediately after the programs with a 95% absorption rate.

The Sectoral Operational Programme Human Resources accelerated its growth rate, reaching an absorption rate of 87.49%, the allocation for this operational program being reduced to 3,200.03 million euro.

[72] System for Fund Management in the European Community for the period 2007-2013.

Table 14: Structural funds absorption by operational programs for the period 2007-2013 (million EUR)						
	Total allocations 2007-2013 (cumulative)	Payments March 2017			Absorption rate Mar. 2017	Absorption excl. pre-financing Mar. 2017
		Total, out of which:	Pre-financing [73]	Refunds UE		
Regional Development	3,966.02	3,708.20	335.34	3,372.86	93.50%	85.04%
Environment	4,412.47	3,983.81	520.77	3,463.04	90.29%	78.48%
Transportation	4,288.13	3,725.70	525.61	3,200.09	86.88%	74.63%
Competitiveness	2,536.64	2,409.80	229.87	2,179.93	95.00%	85.94%
Human Resources[74]	3,200.03	2,799.72	451.89	2,347.83	87.49%	73.37%
Administrative Capacity Development	208.00	197.60	27.04	170.56	95.00%	82.00%
Technical Assistance	170.23	161.72	15.32	146.4	95.00%	86.00%
Total	**18,781.55**	**16,986.55**	**2,105.87**	**14,880.74**	**90.44%**	**79.23%**

Source: MEF, Fiscal Council's calculations

Compared to other new EU Member States, according to the data released by the European Commission, the absorption rate in Romania remains the lowest, being only 90.44% in October 2016[75] (However, there is a significant increase from 70.93% in 2015) excluding Croatia which joined the EU in 2013 (with an absorption rate of 80.68%). All the other new EU member states have absorption rates between 94.03% (Hungary) and 95% (Estonia, Latvia, Lithuania, Poland and Slovenia have reached this threshold since 2015).

[73] According to GEO no. 64/2009, prefinancing is the amount transferred to the beneficiaries of structural instruments through direct payments or through indirect payment in the initial stage to support start carrying out projects and/or the implementation thereof, as provided in the agreement/ decision/order financing between a beneficiary and the managing authority/intermediate body responsible/accountable to ensure the proper conduct of the projects financed under the operational programs.

[74] The allocation of SOP HRD was reduced from 3,476.14 million euro, according to the latest change in the operational program.

[75] The latest available data.

Table 15: Absorption of structural funds for the period 2007-2013 – comparison with other EU member states					
	Total allocations 2007-2013 billion EUR	Payments 2016 billion EUR	Absorption rate 2016 %	Total allocations /inhabitant 2007-2013 EUR	Total payments /inhabitant 2016 EUR
Bulgaria	6.60	6.27	95.00%	932.88	875.80
Croatia	0.86	0.69	80.68%	204.82	165.25
Estonia	3.40	3.23	95.00%	2,586.33	2,457.01
Latvia	4.53	4.30	95.00%	2,300.94	2,185.89
Lithuania	6.78	6.44	95.00%	2,345.63	2,228.35
Poland	67.16	63.83	95.00%	1,769.57	1,681.09
Czech Republic	25.82	24.32	94.55%	2,513.43	2,304.24
Romania	**18.78**	**16.99**	**90.44%**	**950.47**	**859.63**
Slovakia	11.49	10.91	95.00%	2,119.02	2,010.34
Slovenia	4.10	3.90	95.00%	1,986.76	1,887.42
Hungary	24.92	23.10	94.03%	2,535.09	2,349.41

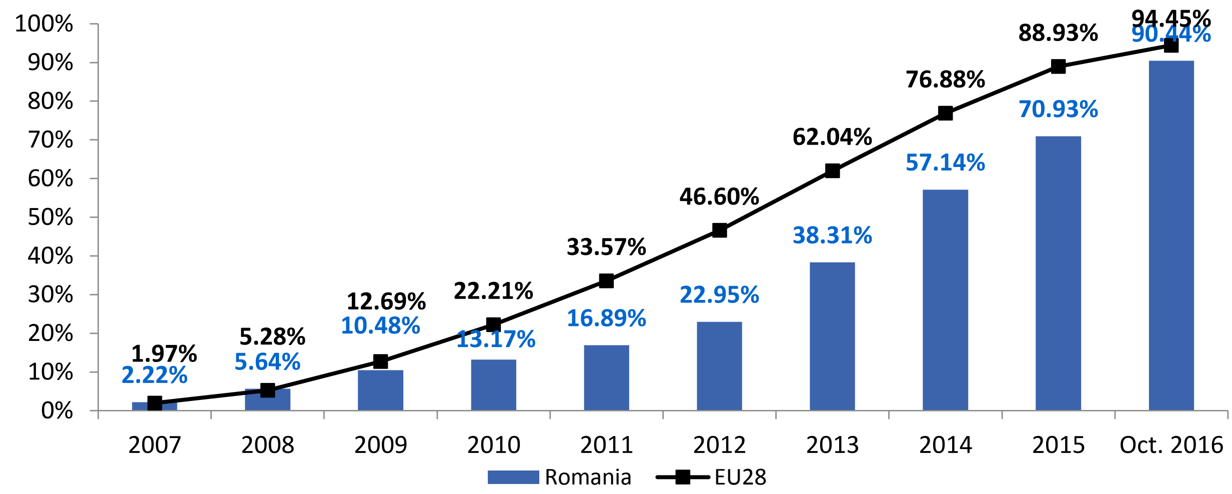
Source: EC (structural funds, https://cohesiondata.ec.europa.eu, last update 10 October 2016) and Eurostat (population at 1st January 2016)

Note: The absorption rate calculated by the European Commission on interim payments and pre-financing.

The low level of absorption of the past years is explained also by the blockages occurred in attracting European funds in 2011-2013. To minimize the risk of losing these funds, Romania and Slovakia have received an additional year for drawing European funds for the financial year 2007-2013, until the end of 2015.

The EU funds absorbed by Romania in terms of the number of inhabitants are also the smallest of the new Member States of EU, reaching in 2016 to 670.47 euro/inhabitant compared to 2.462 euro/inhabitant in Estonia or 780.50 euro/inhabitant in Bulgaria.

Figure 40: Evolution of EU funds absorption rate: Romania versus EU 28 average, 2007-October 2016 (financial exercise 2007-2013)



Source: EC, Fiscal Council's calculations

If at the end of 2015, the absorption rate was almost 20 pp below the EU28 average, Romania's performance on absorption of European funds improved considerably, with the level of absorption reaching just 4 pp lower than the average of the other countries. Progress has also been made in recent years in attracting European funds, materialized in increasing the absorption rate by 15.36 pp in 2013 compared to the end of 2012, by 18.83 pp in 2014 compared to the end of 2013 by 13.79 pp in 2015 as compared to the end of 2014 and by 19.51 pp in 2016 as compared to the end of 2015, according to data published by the EC. The improvement of performance in recent years has also been helped by the operating group, created by the EC in 2015, which aimed at addressing the difficulties that have arisen for the eight member states which faced problems in attracting European funds, lowering the risk of disengagement of the European funds and increasing the absorption capacity of these funds. In this way, it was possible to implement major projects at risk, generally by project phasing. Phasing is a measure to save significant funds allocated to a country, reducing the number of potentially malfunctioning projects and those to be finalized from national sources. A second category of projects included in this programming period, which was concluded to increase the absorption rate for the 2007-2013 funding period, is the retrospective projects[76], that could be identified and analyzed by June 2016, the related

[76] Retrospective projects are completed or advanced-stage investments financed from the state budget or from loans with international financial institutions (EIB / EBRD) for which Romania has been able to claim reimbursement provided that they meet the eligibility conditions applicable to the programs Operational Program 2007-2013.

amounts which could be included in the final payment applications that Romania had to submit until 31 March 2017.

At the end of the period, there was a risk of decommitment of about 2 billion euro for Romania, but more than one billion euros were saved through retrospective projects, and phasing of some delayed projects, while another 2 billion euros were transferred for the 2014-2020 financial framework.

For the **financial framework 2014-2020**, there was a shift in the EU policy orientation towards fulfilling the objectives derived from Europe 2020 strategy, according to the Commission services position paper and Country-specific recommendations. The Partnership Agreement between a Member State and the European Commission which set funding priorities, referred to the management of EU funds programming by: CF, European Regional Development Fund, European Social Fund, European Agricultural Fund for Rural Development (EAFRD) and European Maritime and Fisheries Fund (EMFF). The total budget for the cohesion policy 2014-2020 was established in December 2013 and amounts to 352 billion EUR. More than half of this budget (54.72%, respectively 192.64 billion EUR) is allocated to new EU Member States (Bulgaria, Czech Republic, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Hungary). In the period 2014-2020, according to the data from the Ministry of European Funds, Romania will receive a total allocation of about 22.98 billion euro in structural and cohesion funds for operational programs, increasing against the budget for 2007-2013 amounting to 19.06 billion euro (updated to 18.78 billion euro). To these allocations are added other 19.43 billion euro[77] for Common Agricultural Policy (financed by both financial instruments, EAFRD and the European Agricultural Guarantee Fund - EAGF) and 168.42 million euro for the Operational Programme for Fisheries and Maritime Affairs - OPFMA (funded by European Maritime and Fisheries Fund - EMFF). The above-mentioned allocations for Romania are complemented by the National Programme for Rural Development (NPRD - 8.12 billion euro), the Cross-Border Cooperation programs (approximately 452.70 million euro), but also other programs managed directly by the EC, with a budget of 33.24 billion euro allocated to all Member States.

Under the Partnership Agreement proposed by Romania and approved by the European Commission on August 6, 2014 for the programming period 2014-2020, there are 6 Operational Programmes on Cohesion Policy, compared to 7 in the period 2007-2013. Sectoral Operational Programme Transport and Sectoral Operational Programme Environment were united and together with the funding for energy sector constitute the Operational Programme Large Infrastructure with a budget of about 9.42 billion euro. The Operational Programme Human Resources changed its name in the Operational Programme Human Capital, further comprising a

[77] According to Ministry of Foreign Affairs, a substantial increase over the previous allocation period, 13.8 bln. euro.

new initiative "Jobs for Youth" and having allocated a total sum of 4.32 billion euro. There was also added a new program, namely the Operational Programme Helping Disadvantaged People, the first Romanian program for the period 2014-2020, a program through which in the financial period 2014-2020 Romania will dispose of 441 million euro. The Operational Program Technical received allocations amounting to 212.77 million euro and for the Operational Program Competitiveness is allocated an amount of 1.33 billion euro. The Operational Programs Regional Development and Administrative Capacity Development received allocations amounting to 6.7 billion euro and, respectively, 553.19 million euro.

In general, the financial allocations for future programs are bigger than those in the period 2007-2013, except for the Sectoral Operational Programme Increase of Economic Competitiveness, which received only 1.33 billion euro, compared with 2.54 billion euro in the previous period, the allocations for the period 2014-2020 being halved. The operational Programmes with the highest rates of absorption in the previous financial period (2007-2013) received funding higher by more than 65% (the Operational Programme Regional Development - 6.7 billion euro, compared to 3.97 billion euro and the Operational Programme Administrative Capacity Development - 553.19 million euro, compared to 208 million euro).

Table 16: Comparison between the allocations in 2007-2013 and 2014-2020 (million EUR)

Total allocations 2014-2020 according to Operational Programs and Partnership Agreement			Total allocations 2007-2013	
	European funds	**Total, including cofinancing**		**European funds**
Regional Development	6.70	8.25	**Regional Development**	3.97
Large Infrastructure	9.42	11.88	**Environment**	4.41
			Transportation	4.29
Competitiveness	1.33	1.58	**Competitiveness**	2.54
Human Capital	4.33	5.06	**Human Resources**	3.20
Administrative Capacity Development	0.55	6.58	**Administrative Capacity Development**	0.21
Technical Assistance	0.21	2.51	**Technical Assistance**	0.17
Helping Disadvantaged People	0.44	0.52		
Total	**22.98**	**36.38**	**Total**	**18.78**

Source: MEF

Romania, like other new Member States, has received for the period 2014-2020 a higher allocation for the structural and cohesion funds, compared with the previous financial period (22.98 billion euro compared 19.06 billion euro, the initial allocation for the precedent year), exception to this rule, being the Czech Republic (21.98 billion euro compared to 26.53 billion euro), Slovenia (3.07 billion euro compared to 4.10 billion euro), and Latvia, which received almost the same amount for the next period (namely 4.51 billion euro, compared to 4,53 billion euro).

With regard to allocations for 2014-2020 relative to the number of inhabitants, Romania is still on the second lowest position with 1,163.64 euro/inhabitant, exceeding only Bulgaria (1,060.75 euro/inhabitant). It can be seen that the Baltic countries have among the highest allocations per inhabitant for the next period, respectively 2,728.08 euro in Estonia, 2,291.47 euro in Latvia, and 2,362.11 euro in Lithuania. Allocations relative to population increased significantly in the case of Slovakia (from 2,119.02 euro compare to 2,578.52 euro) and Poland (from 1,769.57 euro to 2,043.00 euro) and decreased in the case of Czech Republic (from 2,513.43 euro to 2,082.93 euro), Slovenia (from 1,986.76 euro to 1,489.59 euro) and Hungary (from 2,535.09 euro to 2,228.36 euro).

Table 17: Situation of the allocations of the European funds for the period 2014 – 2020, comparison with other EU countries

	Total allocations for EU Cohesion Policy 2014-2020 billion EUR	Total allocations/ inhabitant 2014-2020 EUR
Bulgaria	7.59	1,060.75
Croatia	8.61	2,054.42
Estonia	3.59	2,728.08
Latvia	4.51	2,291.47
Lithuania	6.82	2,362.11
Poland	77.57	2,043.00
Czech Republic	21.98	2,082.93
Romania	**22.99**	**1,163.64**
Slovakia	13.99	2,578.52
Slovenia	3.07	1,489.59
Hungary	21.91	2,228.36

Source: EC (European funds) and Eurostat (population at 1st January 2016)

Note: The amounts allocated to each Member State include, in addition to the Structural and Cohesion Funds, the funds earmarked for cross-border and transnational cooperation as well as *the funds allocated under the Youth for Work initiative, according to the data available on the EC website*[78]*.*

The new multiannual financial framework 2014-2020 has begun with difficulties not only in Romania but also in other EU countries. The legal framework for this period was finalized with a delay by the EC, the European Parliament and EU Member States, predominantly affecting countries which have a lack of experience and administrative capacity to recover delays.

According to the Governance Report on the European Funds Portfolio in December 2016, in 2016, 2.5 billion euro were attracted for the current financial year, out of which 636.04 million euro from structural and cohesion funds, 374.95 million euro from rural development and fisheries funds, 1.18 billion euro from the EAGF and 296.06 million from other funds. Calls for 40% of the financial allocation for 2014-2020 have also been launched and funding contracts worth more than 1.5 billion euro have been concluded.

At the end of 2016, out of the 36 *ex-ante* conditionalities imposed by the EC, 11 were closed at the signing of the partnership agreement, 9 were lifted by the EC in 2016, 11 were in the final evaluation with the mid-term final assessment period 2017, and for 5 there were negotiated priority action plans agreed with the EC for their fulfillment in 2017. In case of non-compliance there is a risk that operational programs that are targeted to be suspended before they start, the EC can stop the associated costs. The areas where these ex-ante conditionalities have the biggest problems are public procurement, waste management and transport.

The absorption of EU funds remains an objective of national interest and a solution for stimulating the economy, especially in the context of the constraints imposed by the new Fiscal Compact. For the 2007-2013 programming period, given the special measures that have been taken, substantial progresses were made in recent years, which led to an absorption rate of over 90%. Thus, even if substantial amounts from the initial allocations have been lost, which represents, undoubtedly, a negative element, compared to the situation from a few years ago, the final result contains positive elements. For a better implementation of programs for the period 2014-2020, it is imperative that the issues identified in the previous financial period to be settled and Romania must overcome the difficulties which caused a low absorption rate in the past.

Early preparation of projects and increasing the administrative capacity for planning and management of European funds constitute key factors for the implementation of EU funded projects. Considering the level of European funds absorption for 2007-2013, but also the slow start of the implementation of the 2014-2020 programming period, although improvements have

[78] Data available in April 2017.

been made regarding the designation of the management and control authorities and the fulfillment of *ex-ante* conditionalities, the Fiscal Council considers that the pace of absorption needs to be stepped up, European funds being an engine for sustaining the national economy.

V. The sustainability of public finance

V.1. Arrears of the general consolidated budget

The evolution of the GCB's[79] stock of arrears to the private sector in 2016 indicates that it currently does not represent a major problem, in the recent years being registered an improvement in terms of financial discipline, both at central and local level. At the end of 2016, the arrears amounted 201.8 million lei, increasing, however, by about 116 million lei compared to the previous year.

As regards the outstanding payments with a delay of less than 90 days, that do not fall in the category of arrears according to the Public Finance Law no. 500/2002, although they have reached a level of 477.4 million lei at the end of 2016, are by 21.3% lower than the previous year level (606.8 million lei), significantly decreasing compared to 2014 (841.3 million lei) and 2013 (1.7 billion lei). Compared to 2015, the decrease was mainly located at the level of the local budgets' outstanding payments (-72.7 mil. lei, respectively a decrease of 14.2%) and at the level of the state budget (-54.2 million lei, respectively a decrease of 60%).

GCB's total outstanding payments to the private sector have reached a level of 679.2 million lei at the end of 2016, being lower by 13.6 million lei compared to the same period of the previous year, when they recorded a level of 692.8 million lei, this decrease being mainly due to the decline recorded in the arrears with a delay of less than 90 days. It may be noted, however, a relative volatility during the year, the stock of outstanding payments increasing by about 200-300 million lei in the second and third quarter, but the deterioration was reversed in the last quarter of 2016.

Table 18: Quarterly evolution of GCB arrears in 2016 (million lei)

	QIV 2015	QI 2016	QII 2016	QIII 2016	QIV 2016
State budget	**103.3**	**81.0**	**92.2**	**106.2**	**59.8**
Under 90 days	90.4	60.9	77.4	72.5	36.2
Over 90 days	1.6	9.0	1.4	13.4	10.7
Over 120 days	9.1	8.6	9.5	15.2	5.6
Over 360 days	2.2	2.5	3.9	5.1	7.4
Local authorities	**583.1**	**605.4**	**789.9**	**844.8**	**615.7**
Under 90 days	510.2	489.1	648.2	673.2	437.5

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

	QIV 2015	QI 2016	QII 2016	QIII 2016	QIV 2016
Over 90 days	41.3	72.1	47.7	72.0	76.3
Over 120 days	20.8	36.4	84.1	79.2	71.0
Over 360 days	10.8	7.8	10.0	20.4	30.8
Social security budget	**6.4**	**8.2**	**3.5**	**3.6**	**3.7**
Under 90 days	6.3	8.1	3.4	3.6	3.7
Between 90 and 360 days	0.1	0.1	0.1	0.0	0.0
Total	**692.8**	**694.6**	**885.5**	**954.5**	**679.2**
Under 90 days	606.8	558.2	728.9	749.2	477.4
Over 90 days	42.9	81.2	49.0	85.4	87.0
Over 120 days	30.1	44.9	93.6	94.4	76.6
Over 360 days	13.1	10.3	13.9	25.5	38.2
Total arrears (90-360 days)	**86.1**	**136.4**	**156.5**	**205.3**	**201.8**

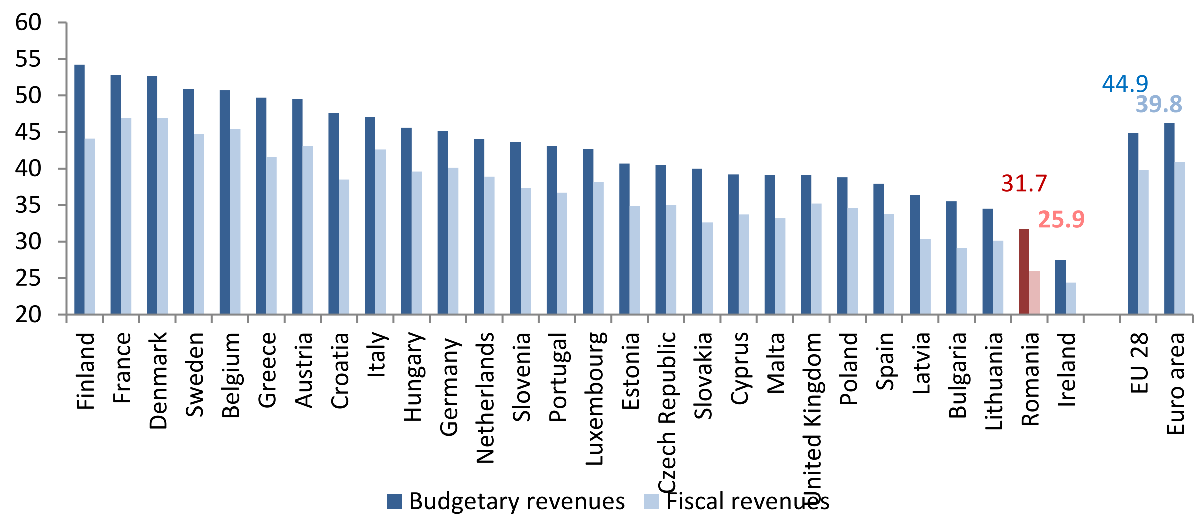
Source: MPF

The considerable reduction of the GCB's outstanding payments in the last 4 years (from 3.8 billion lei in 2012 to 0.5 billion lei in 2016) is explained mainly by the implementation of the EU Directive no. 7/2011 on combating late payment in commercial transactions (Law no. 72/2013) and other legislative measures taken in the recent years which aimed to reduce the stock of arrears (GEO no. 29/2011 governing the granting of payment rescheduling, GEO no. 3/2013 which restrict the local authorities' possibility of contracting new loans strictly to extinguish the arrears, GEO no. 12/2013 which introduced a mechanism of mutual extinction of payment obligations).

V.2. Tax collection in Romania – international comparisons

Romania recorded in 2016 a share of government revenues (tax and non-tax revenue) to GDP of 31.7% of GDP, by 13.2 pp lower than the EU average (44.9% of GDP), among the lowest in relation to the EU Member States, being succeeded only by Ireland. The level of tax revenues to GDP (taxes and social contributions) in Romania reached 25.9% of GDP in 2016, being placed on the second to the last position, with a difference of 13.9 pp compared to the EU average, which is 39.8% of GDP. Analyzing the data according to the ESA 2010 methodology, compared to 2016, the gap between Romania and the EU average deepened significantly, both in the case of the total budget revenues by other 3.3 pp of GDP (from a gap of 9.9 pp of GDP in 2015), and in the case of the tax revenues by another 2.9 pp of GDP (from a gap of 11.6 pp of GDP in 2015). The share of tax revenue to GDP is significantly lower than in similar economies like Hungary (39.6%), Slovenia (37.3%), Czech Republic (35.0%) and Poland (34.6%).

Figure 41: Budgetary revenues and fiscal revenues in 2016 (% of GDP, ESA 2010)



Source: Eurostat; Tax revenues include social contributions.

The structure of tax revenue in Romania has changed from 2014, given the cuts in VAT rates, but, even if declining compared to the previous year[80], still reveals a high share of revenues from indirect taxes, respectively 43.6% of total tax revenue compared to the EU28 average of 33.7%, while the share of revenue from social security contributions was 31.3% (by 2.4 pp below the average EU28) and from direct taxes - only 25.1% (7.6 pp below the EU28 average). The indirect taxes represent the main component of tax revenues, in fact, a specificity of the developing countries, their weight being significantly above the EU average (by 10 pp), although in 2016 were applied significant reductions in indirect taxes (decreasing the standard VAT rate by 4 pp and extending the application scope of the reduced VAT rates) which significantly reduced the gap between Romania and the EU average compared to the period 2010-2015. Moreover, the fiscal consolidation initiated in 2010 aimed at increasing indirect taxes that contributed to increasing their share in total tax revenues. It can be assessed, however, that indirect taxation is less discretionary to long-term economic growth, direct taxation having a more discouraging effect on the mobilization of the production factors. At the European level, there is a tendency to balance direct taxes, indirect taxes and social contributions, and the states with the highest shares of budgetary revenues in GDP benefit also from high shares of direct taxes in total revenues.

[80] A 3.9 pp decrease in the indirect revenue share in total tax revenues; in 2015 the share of indirect revenue in tax revenues was 47.5% compared to the EU28 average of 33.8%.

In 2013 was launched a wide-ranging reform process of the Romanian tax administration, on May 8, 2013 being signed the Loan Agreement between Romania and the International Bank for Reconstruction and Development (IBRD), the loan value, of 70 million euro[81], following to be used for the Revenue Administration Modernization Project (RAMP), initially implemented for a period of 5 years[82] (since the fourth quarter of 2013). Given the delays in carrying out the program, at the request of the National Agency for Fiscal Administration (NAFA), the Romanian authorities requested in 2016 an extension for the contract, and thus, in December 2016, the project was prolonged for another two years (until September 2020). The central pillar of the tax administration reform under this program is to redesign and increase the capacity of the IT system in order to manage a centralized huge database, including data and information on all taxpayers in Romania, implementing RAMP aiming at developing the management function, improved technology and IT upgrading, as well as better services for taxpayers. On this purpose, the RAMP was structured on four components: institutional development; increasing efficiency and operational effectiveness; modernizing services for taxpayers; coordination and project management.

The main objectives for RAMP refers to increasing the effectiveness and efficiency in tax collection, taxes and social contributions and also increasing tax compliance and as tangible results in improving voluntary tax compliance at declaration and payment are expected (targets for 2018: VAT– 83.5%; personal income tax – 86.0%; social contributions – 82.5%) like lowering the collection costs (from 1.1% la 0.9%) and increasing the satisfaction of taxpayers regarding the integrity and quality of the services offered (by 15% until December 2018) by modernizing the information and communication technology system and redesigning NAFA's business processes. Another very important aspect of this program is the involvement of the institution's employees in a complex training program. If during 2014-2015 the activities focused on strengthening central and local financial administrations, in parallel with actions aiming to increase efficiency of activity by growing the staff allocated for prevention and inspection purposes, in 2016, both implementation and procurement activities continued for each component of the project, as well as the development of the initiatives for short-term improvement of the Agency's functional

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

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

areas[83]. Consequently, in order to put into operation, the new Integrated Income Management System (COTS-RMS), consultancy contracts were concluded during 2016 and the procedure for acquiring the IT system was started, but its implementation is much delayed compared to the obligations assumed under the loan agreement, with a negative impact on the functioning of the IT system in relation to the current needs, generating bottlenecks in the peak periods. Compared with the previous year, the degree of the voluntary compliance at declaration, and the degree of voluntary compliance at payment (in value) increased each by 0.5 pp (from 94.8 to 95.3 in 2015, and, respectively, 84.0 compared to 83.5 in 2015), while the administrative expenditures increased by +5.1% (expressed by the indicator lei spent on one million lei net budget revenues), rising from 10,526.0 lei in 2015 to 11,061.7 lei in 2016[84].

In order to improve voluntary compliance, NAFA also launched a campaign to promote the use of electronic services, called "Virtual Private Space" and promoted the payment of tax obligations through electronic payment methods.

From the perspective of tax revenue collection, it can be appreciated that in recent years, the administrative tax collection has undergone an extensive transformation process following which it has become easier and more effective, the number of financial administrations being considerably reduced at the central level, but it also should be diminished at the local structures level, because Romania still ranks above the average of the new EU countries regarding the number of financial administration related to the number of inhabitants[85].

Simplifying the tax system and reducing bureaucracy occurred gradually, and progress was highlighted by the report conducted by PricewaterhouseCoopers (PwC) and the World Bank (WB), Paying Taxes 2017[86] (that considers 2015 as the reference year), according to which, in terms of ease of payment of taxes, Romania ranks on 50th place, a better position compared to the previous year (and a significant improvement if we consider the 43th position for 2015, as resulting from calculating the global index with the similar methodology used for the 2014

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[83] In the last quarter of 2016, the "Quick Wins" – a quick benefits program- was implemented to facilitate voluntary compliance by taxpayers, aiming to increase the efficiency of internal tax administration processes.

[84] According to the NAFA Performance Report for 2016 (https://static.anaf.ro/static/10/Anaf/Informatii_R/Raport_performanta2016_07042017.pdf).

[85] According to the sixth edition of the report Tax Administration 2015 elaborated by the OECD, in 2014 Romania was placed second after Poland (similarly for the number of employees in the tax collection administration), while for the indicator "fiscal revenue/GDP per 1,000 employees", Romania was placed on the penultimate position in NMS10.

[86] The 2017 Report is based on the data last updated at July 1, 2016 and covers the fiscal year 2015 (data on tax revenues for companies are available after the financial statements consolidation)

ranking[87], in which case Romania should be placed on 55th position). Compared to 2012 (see *Table 23*) it can be noticed a significant leap in Romania's position in terms of ease of paying taxes, as currently are required only 14 payments (compared with 41 in 2012) for the fulfillment of the tax obligations, but also due to the improvement of other indicators (such as the number of hours per year spent for the fulfillment of the tax obligations), mostly determined by the measures taken by the fiscal authorities during 2010-2013, in order to facilitate the electronic payments and filing the tax statements online, followed by the expansion of online payment services (payment by bank card to the POSs installed at the territorial units of the State Treasury or to the use of the facilities provided by the "ghişeul.ro" platform).

Box 2: Calculation methodology used by the PricewaterhouseCoopers and the World Bank in the *Paying Taxes* 2016-2017 Report

Paying Taxes report realized by the PwC and the WB analyzes the ease of paying taxes in 190 economies worldwide by examining three indicators at the level of medium-sized companies: the total tax rate (the share of taxes and contributions paid by a firm as a percentage of profit), the time required to comply with tax laws (number of hours allocated by a company to fulfill its reporting obligations and payment of taxes imposed), and number of payments that a company must make to fulfill tax obligations. The report considers all taxes and social security contributions that a medium-sized company has to pay to the State during the year including: corporate income tax, social contributions and labor taxes paid by the employer, property taxes, property transfer taxes, dividend tax, capital gains tax, financial transactions tax, waste collection fees, taxes on vehicles, road tax and other taxes.

Starting 2015, the methodology used for ranking the countries considers the so-called measure distance to the frontier (DTF). The frontier is practically the best performance observed at the level of the each analyzed indicators in all economies from the sample. The distance to the frontier of an economy is reflected on a scale of 0 to 100, where 0 represents the lowest performance and 100 is the frontier and the score is a measure of how far is an economy from the best performance at that time. With DTF is assessed the level of the performance recorded regarding the environment of the tax legislation and how it improves over time. The general score is calculated as a simple average of the DTF scores for each sub-indicator (number of payments, time and total tax rate). For instance, regarding the time required for the payment of taxes, the frontier is defined as the lowest recorded time taking into account all the economies that perceive the three major taxes: income tax, employment taxes and mandatory contributions and other taxes (that include VAT).

[87] The methodology used in the last year's report - Paying taxes 2016 - did not take into account the sub-index of ex-post compliance.

A novelty in comparison to the 2016 report is the introduction of a sub-index measuring the distance to the frontier for the ex-post compliance with two specific processes related to VAT reimbursement and, respectively, the audit of firms in case of correction the errors in the tax return filling for the corporate income tax. The new index changes the value of the global indicator calculated with the previous methodology and is determined by the distance from the frontier for the two processes, the best performing economies being considered the ones with the shortest VAT reimbursement period, namely checking the correctness of the tax return with the minimum effort from the firm's perspective. For each process, two sub-indicators are considered for the first process: (1) the time for the VAT refund statement (measured in hours), (2) the time to obtain the refunded VAT (measured in weeks) and for the second process: (3) the time required to complete the corporate income tax audit statement (in hours) and (4) the time to complete the audit to verify the correctness of the corporate income tax return - if applicable (in weeks).

Compared to the data released last year, the Paying Taxes 2017 report notes for Romania that in 2015 as compared to 2014, the number of hours required to pay taxes has increased to 161 hours (from 159 hours), the number of annual payments that a company should carry out for paying taxes remained constant and 14 payments and the share of taxes in total profit decreased significantly from 42.0% to 38.4% (3.6 pp, due to lower social state contributions paid by the employer from 20.8% to 15.8%).

Thus, a medium-sized company in Romania has carried out during one year a number of 14 tax payments (higher than the European average of 11.8 annual payments, but well below the global average of 25.0 annual payments) and consumes for the calculation, the completion and the submission of tax returns 161 hours of work (below the European average of 164 hours, respectively, the global average of 251 hours). From the perspective of the overall tax rate (the share of taxes and social contributions in the profit of a medium-sized company), Romania had 38.4% in 2015, below the European average of 40.3%, respectively below the level of 40.6% recorded globally.

From the perspective of the ease with which a company can initiate VAT reimbursement processes and the necessary audits to correct eventually errors in the profit tax returns, Romania is among the countries whose procedures are considered to be performing more difficult, but, compared to other European countries, it is better positioned compare to Italy, Bulgaria and Hungary.

Overall, in 2015, Romania has made a progress on improving the efficiency of paying taxes, being positioned in the middle of the ranking for the countries in Central and Eastern Europe, ahead of the Czech Republic (53th position in the ranking at global level), Slovakia (56) Hungary (77), Bulgaria (83), but after Latvia (15), Estonia (21), Lithuania (27), Slovenia (39) and Poland (47).

In the table below, for comparability with the ranking for the years 2012-2014 on the ease for paying taxes, giving to the previous methodology (according to the Paying Taxes reports 2014, 2015 and 2016), the positions for the year 2015 that are determined without taking into account the new sub-index, are placed between brackets. It can be noticed a slight deterioration in Romania's position within NMS10 in 2015 as compared to 2014 as a result of the methodology change.

Table 19: The efficiency of tax system

	Estonia	Latvia	Slovenia	Lithuania	Bulgaria	Slovakia	Poland	Czech R.	Hungary	Romania
Year	**Ease of paying taxes (rank)**									
2012	32	49	54	56	81	102	113	122	124	**134**
2013	28	40	42	20	89	100	87	119	88	**52**
2014	30	27	35	49	88	73	58	122	95	**55**
2015	21(32)	15(26)	39(67)	27 (50)	83(99)	56(72)	47(62)	53(80)	77(89)	**50 (43)**
	Number of payments per year to pay tax liabilities *									
2012	7	7	11	11	13	20	18	8	12	**39**
2013	7	7	11	11	13	20	18	8	11	**14**
2014	8	7	10	11	14	10	7	8	11	**14**
2015	8	7	10	11	14	8	7	8	11	**14**
	Number of hours per year to pay tax liabilities **									
2012	81	264	286	175	454	207	286	413	277	**200**
2013	81	193	260	175	454	207	286	413	277	**159**
2014	81	193	245	171	423	188	271	405	277	**159**
2015	84	161	245	171	453	192	271	234	277	**161**
	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**

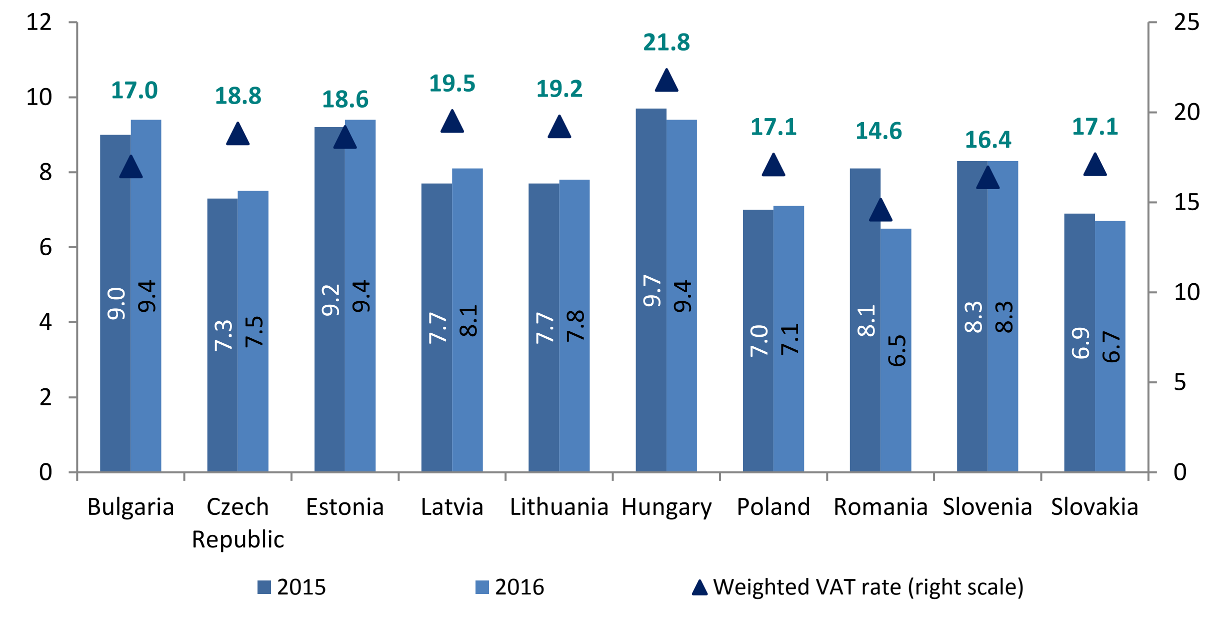
Source: WB

* Indicator reflecting the total number of fees and paid contributions, the method of payment, the frequency of payments, the frequency of tax returns and the number of agencies involved in

the tax collection process for companies in the second year of activity. Where payment is made electronically, regardless of the frequency of payments, only one payment is recorded.
** Indicator that reflects the time needed for the preparation, completion and payment of the main tax obligations: profit tax, social contributions and labor taxes, other taxes.
*** Indicator reflecting the share in the commercial profit of the amounts related to compulsory taxes and social contributions paid by a company starting with the second year of activity.

Compared to similar economies, Romania enjoys an average tax collection from VAT receipts. (see *Figure 42*). For example, although in the year 2016 in terms of VAT-weighted average (based on HICP weights and characterized by the limitations described in subchapter III.3.1), it was ranked the last of the new EU Member States (14.6%), Romania collected 6.5%[88] of GDP from VAT, being close to countries with a higher average weighted rate, such as Slovakia (6.7% of GDP at a VAT-weighted average VAT rate of 17.1%) and Poland (7.1% of GDP at the VAT weighted average VAT rate of 17.1%). It is worth mentioning Bulgaria, having a structure of the economy similar to that of Romania and a 17.0% VAT-weighted rate, which collected 9.4% of GDP for VAT receipts in 2016, similar to countries with higher VAT-weighted rate (Estonia with 18.6% or Hungary with 21.8%) and well above the level of countries with close weighted average rates (such as Poland or Slovakia).

Figure 42: VAT revenues in 2016 (% of GDP)

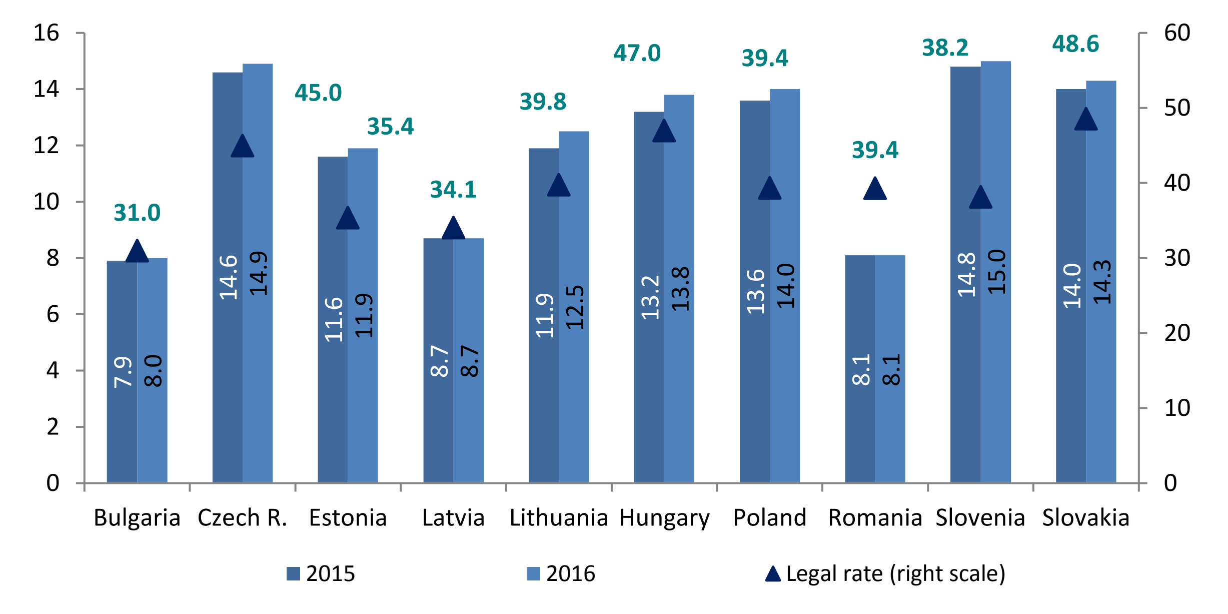


Source: EC, Eurostat

[88] The level of this indicator decreased by 1.6 pp compared to 2015, when 8.1% of GDP was collected from VAT.

Comparing with the other selected countries regarding the share in GDP of the revenues from social security contributions paid by employees and employers relative to the legal quota of social contributions, for Romania it is highlighted the low level of the collection (see *Figure 43*). Thus, the revenues from the contributions collected by Romania in 2016 remained at the value recorded the previous year (8.1% of GDP), corresponding to the statutory rate of 39.35% for the social contributions, one of the lowest values in the NMS10, surpassing only Bulgaria (8.0% of GDP), but in the context of a much lower social contribution rate of only 31%. Slovenia (15.0% of GDP), Estonia (11.9% of GDP) and Latvia (8.7% of GDP) recorded higher revenues for this budget category than Romania, while the statutory social contribution rates are significantly lower. Compared to Poland, which collected from social contributions 14.0% of GDP, the statutory social contribution rate in Romania is only by 0.02 pp lower, while compared to Lithuania (with 12.5% of GDP social contributions revenue), the statutory rate in Romania is lower by 0.63 pp.

Figure 43: Social contributions revenues in 2016 (% of GDP)



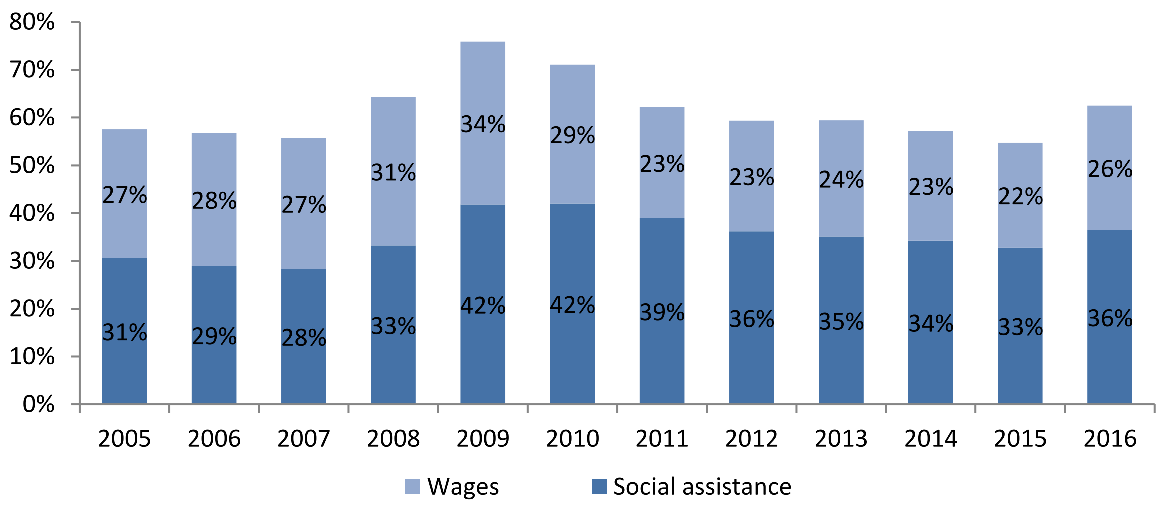
Source: EC, Eurostat

Concluding, it can be noticed an improvement in terms of efficiency and simplifying the administrative apparatus of tax collection, from both the perspective of decreasing the number of financial administrations (even if it can be noticed an increase in the number of employees in these structures), but also in terms of ease of paying taxes. The reform initiated in Romania in this field seems, however, seems to have led to positive results but under the initial expectations. The assessment made by the World Bank in February 2016 characterized as "moderately unsatisfactory" both the progress of the project achievement and the overall implementation, which represents a decline compared to the rating for the previous year (as "moderately satisfactory"), so the risk of failure to complete its objectives is higher. Thus, even if it is considered that the first steps towards the goal of the RAMP project have been made, the successful completion of the NAFA reorganization being considered critical to the modernization of the project, the initial commitments were respected at a very slow pace and with delays, since the date of completion was established for March 2019 while the targets should be achieved by the end of 2018, which implies the need to extend the program for another two years. Therefore, the reform has the potential to lead to significant long-term positive effects, but we consider that further efforts are required for achieving this project, which has been successfully implemented in Bulgaria, with significant results if we consider the evolution of tax collection in this country.

V.3. Public expenditure – structure and sustainability

In Romania, the structure of the budgetary expenditures is characterized by the dominance of personnel and social assistance expenditure (pensions, social aids, and so on). Although their relative importance has declined significantly in 2011 – 2015 period as a result of the fiscal consolidation, 2015 representing the minimum of the analyzed period, the year 2016 recorded the reversal of this evolution (*Figure 44*), the personnel and social assistance expenditure strongly increasing, respectively by 7.8 pp, from 54.7% of budgetary revenues in the previous year, to 62.5% in 2016, though this level being significantly lower than the average of 70.4% registered in 2008-2010. This development can be attributable to the nominal increase of these expenditure categories, respectively by 14.9% for the expenses related to the compensation of the employees and 7.7% for the social assistance expenditures, as well as to the decrease in public revenues by 3.2% compared to the previous year, as a result of the fiscal easing introduced by the new Fiscal Code. If the share of personnel expenditure in total budgetary revenues in 2016 (26.0%) is close to that registered during 2005-2007 (27.4%), social assistance expenditure (36.5%) represents a significant share of government revenue, much higher than in 2005-2007 (29.3%), even in the context of the adjustments made in recent years. Compared to the previous year, the share of social assistance expenditure in the total budgetary revenues increased by 3.7 pp, a similar evolution being observed at the level of personnel expenditure, its share in total revenues increasing by 4.1 pp.

Figure 44: Social assistance and personnel expenditure as share of total budget revenues (%)



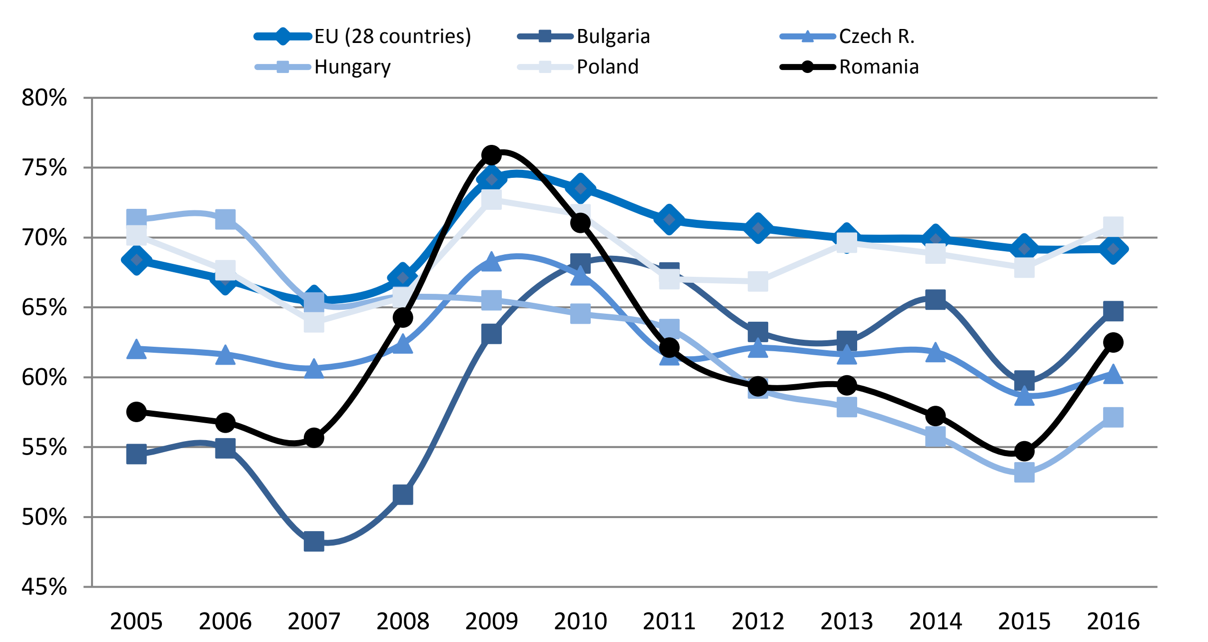
Source: Eurostat

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

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

After a relatively stable evolution in items of the expenditure share in the budgetary revenues, before 2007, the personnel and pension expenditure strongly increased during 2008 and 2009, in the last year of this period, Romania recording the largest share of personnel and social assistance expenditures in total budget revenues at the level of CEE countries, also a level much higher than the EU28 average. Following the implementation of the fiscal consolidation program, the share decreased significantly, falling below the level recorded in the CEE countries, with the exception of Hungary, in the period 2013-2015 (*Figure 45*). However, in 2016 Romania reversed this trend, ranking the third highest level of personnel and pension expenditure in the region, namely 62.5%, after Poland (70.8%) and Bulgaria (64.7%), the level being below the EU28 average (69.2%) (*Figure 45*).

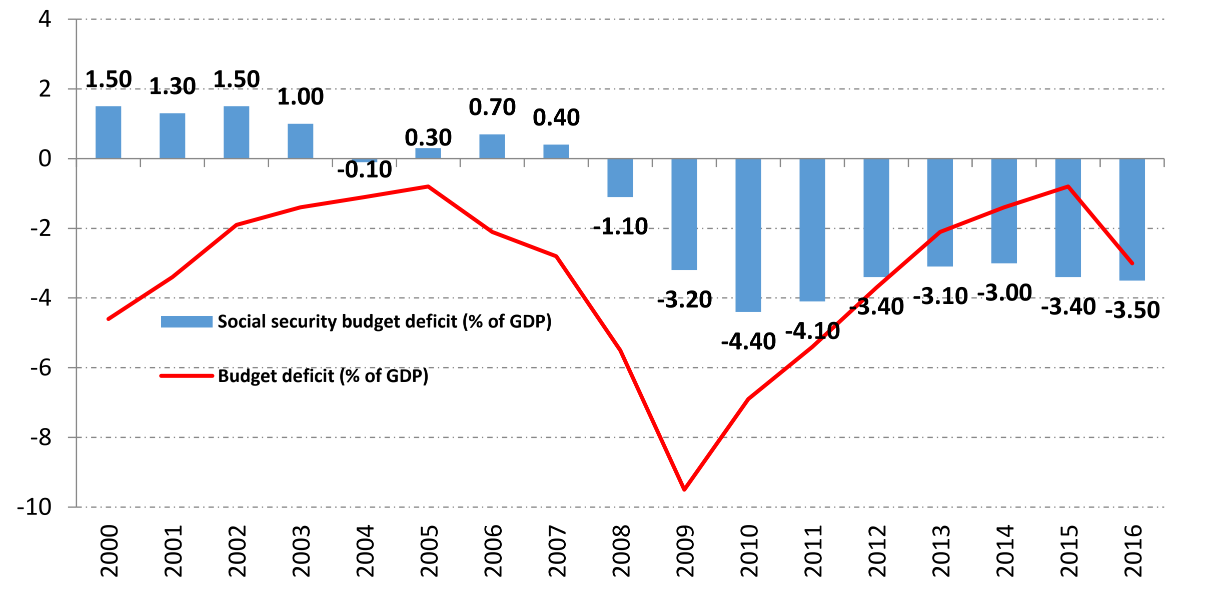
Figure 45: Social assistance and personnel expenditure (including pensions) share in total budgetary revenues in EU 28 and CEE during 2005-2016



Source: Eurostat

If in the period 2000–2007, social security budget (pensions, unemployment and health) were characterized by a relatively equilibrated or even positive balance, after 2008 the deficits have represented an important component of the general consolidated budget deficit, respectively between 64% and 117% in the period 2010 – 2016. Essentially, 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 (2.34% of GDP in 2016), the most important part of this budget, significantly affects the public finance position, representing a relevant risk to the sustainability of fiscal policy in the medium and long-term.

Figure 46: Social security budget deficit (pensions, unemployment and health) and total budget deficit – ESA 2010 (% of GDP)



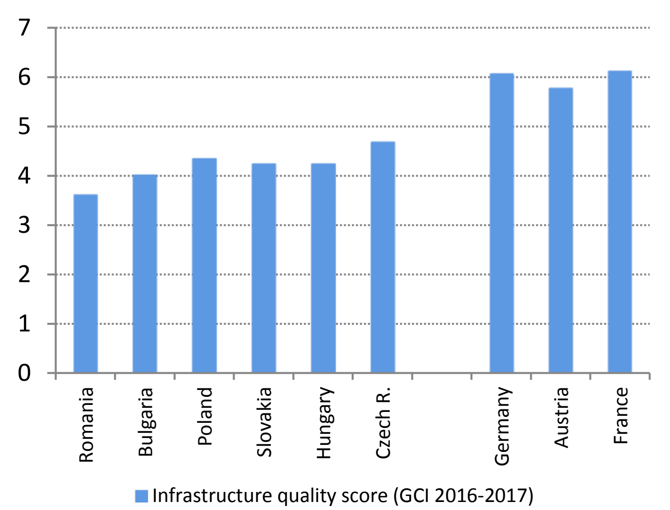
Source: Eurostat

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

The efficiency reserves on the side of budgetary expenditure are still very high. For instance, Romania had the second largest allocation for investment expenditure as a share of GDP from all European countries during 2008–2016; however, the results were modest, as Romania is still characterized by the weakest infrastructure in the EU.

According to the Global Competitiveness Report 2016-2017, with a score of 3.61, Romania ranks 88th out of 138 countries regarding the Infrastructure Pillar, the road quality being its weakest component, respectively ranking on 128th position. The score concerning infrastructure is only a part of the global competitiveness index for

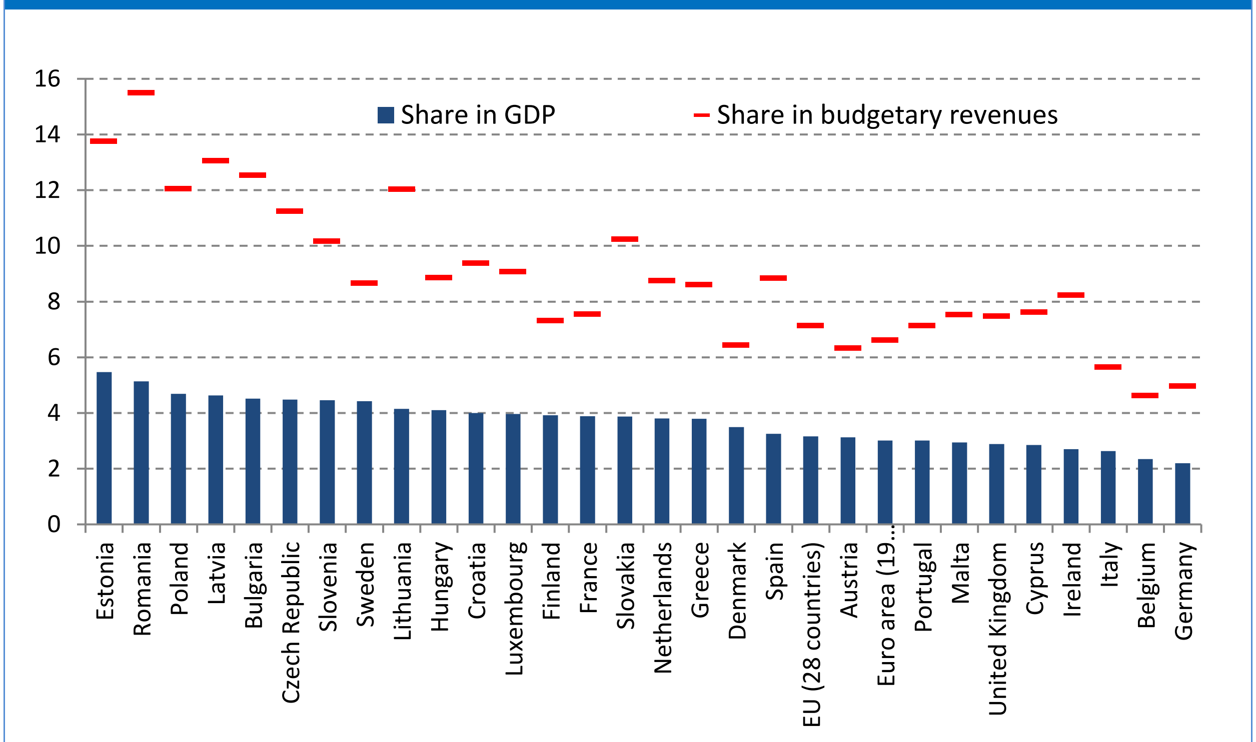
Figure 47: Infrastructure quality



Source: World Economic Forum, The Global Competitiveness Report 2015-2016 which Romania has a score of 4.30, being ranking 62th out of 138 countries, where Switzerland has the highest position, however a worse position than the previous year (53th).

However, the investment expenditures have been significantly reduced in the last period, in 2016 Romania ranking 6th in the EU in terms of allocations to this destination as a percentage of GDP and second in the CEE countries, after Estonia. It should be noted that, after 2015, that represented the first year after 2008 in which spending on public investments as a percentage of GDP increased compared to the previous year, given that 2015 was the last year for the absorption of EU funds for the financial framework 2007-2013, 2016 recorded the return to the evolution observed during the period 2009-2014, namely the decrease of this category of expenditures (both relative to GDP: -1.6 pp compared to the previous year, and to the budget revenues: -3.5 pp compared to 2015), remaining below the pre-crisis level. Under these circumstances, increasing the efficiency of public spending is more necessary given that it is unlikely that high levels of the past allocations for this destination can be sustained in the near future.

Figure 48: The share of investment expenditure in GDP and in total budgetary revenues (average 2008-2016)



Source: Eurostat

In the Convergence Program 2017-2020, the Ministry of Public Finance examines also the risks posed by an aging population and the rising cost of health services. It notes that in Romania there is a pronounced reverse age structure which will change the ratio of working to retired population. Aging, migration and low birth rate are factors with negative implications on the labor market. Long-term forecast pension expenditure shows that Pillar 1 will represent 8.4% of GDP in 2040 from a level of 8.2% in 2013, while Pillar 2 will have an increasingly share in total pension expenditure, reaching 0.8% at the end of the forecasting period, in 2060. The long-term projection of age-related expenditures shows an increase of 2.2 pp of GDP for the period 2013-2060, slightly above the EU average of 1.8 pp.

The Fiscal Council considers that there has been some progress in both the structure and sustainability of public spending, given the fact that the share in total budget revenue of the "mandatory" expenditure (respectively those with salaries and pensions) decreased significantly compared to 2008-2010 period, thus correcting the previously accumulated imbalances, although in the last period there have been pressures to reverse this trend, also partly increasing their transparency, given the ongoing reform of the management of public investment which was analyzed in more detail in the section dedicated to public investment. However, the reserves on the efficiency of the use of public money are still high, being absolutely necessary to conduct a wide-ranging reform in this regard. An important step in this direction may be represented by the new law on public procurement, which can contribute to increasing transparency and reducing inefficiency of the public spending.

VI. Fiscal transparency

In the Annual Report 2014, the Fiscal Council carried out an assessment of the fiscal transparency in Romania, having in view both the Fiscal Responsibility Law no. 69/2010, as well as the theoretical framework offered by the 2014 version of the "Code of Good Practices on Fiscal Transparency" developed by IMF, being the first initiative of this kind for Romania. The 4 pillars of this Code contain 36 principles, focusing on results rather than on processes, considering the classification of practices in basic, medium or advanced, to support less developed countries, highlighting the analysis and management of fiscal risks and complementing other fiscal standards. In the case of Romania, were used the first three pillars of this code, namely Fiscal Reporting, Fiscal Forecasting and Budgeting and Fiscal Risk Analysis and Management, the last one, Budgetary Resources Management being designed for countries rich in natural resources. In addition, each principle of the three pillars has been analyzed taking into account both the explanations provided by the Code on the classification of practices as basic, medium or advanced, as well as by national legislation.

The main results achieved at that time regarding the assessment of fiscal transparency have shown that, certainly, in recent years Romania has taken important steps in order to increase the transparency of fiscal policy, but additional effort is necessary in this regard. Thus, the Fiscal Council considered it necessary at that time that fiscal reporting transparency should be optimized so as to reduce fragmentation of fiscal reporting at the entire public sector's level. In addition, the transparency of macroeconomic variables forecasts should have been improved by publishing the explanations of the assumptions that these forecasts are based upon. Also, budgetary documentation transparency should have been enhanced through the existence of regular presentations of the total value of liabilities for multi-annual investment projects, the publication of cost-benefit analyses before approval, and through the existence of a regularly published reports regarding accomplishments against stated objectives. Furthermore, the Fiscal Council considered necessary the significant improvement of reports on fiscal risks, given that at that time they were still at an incipient level.

The present analysis envisages an update of the developments in fiscal transparency in the light of new initiatives in this area, starting with 2014, the relevance of the analysis being that fiscal transparency is a key point in determining fiscal and budgetary policy decisions, the global trend being to strengthen the fiscal surveillance as a result of the economic and financial crisis. An increased level of fiscal transparency allows for a reduction in information asymmetry, providing both policy-makers and the general public with clear information on the conduct of fiscal policy. In addition, it facilitates the highlighting of fiscal risks, a high degree of fiscal transparency being able to improve the country's fiscal credibility, contributing to the consolidation of a stable economic environment.

Thus, on March 11, 2016, the Ministry of Public Finance launched the "Fiscal Transparency" program, the http://www.transparenta-bugetara.gov.ro/ platform representing a tool to monitor the budget execution of over 13,700 public institutions, including state owned enterprises and autonomous administrations, which are obliged to publish their revenues, expenditures and budget execution on this platform. In addition, information on the number and structure of public institutions, financial reports and other aggregated information are available, the system facilitating the real-time monitoring of financial operations and the dynamic redistribution of resources between institutions within the same credit release authority.

In this way, fiscal transparency has been strengthened in view of the fact that the same type of information held by the central government becomes public, anyone having the opportunity to know how the funds are distributed and spent by a public administration, either central or local. This process should also allow the removal of certain risks related to tax fraud, by launching this platform more efficiency being gained by improving the management of budgetary resources and by introducing a complete and automated monitoring tool.

The platform's information are automatically taken from the FOREXEBUG system, the national system for verification, monitoring, reporting and control of the financial statements, legal commitments and budgets of public entities in Romania, implemented by the MPF through the project "Increasing the accountability of the public administration through the modernization of the information system for the reporting of financial statements of public institutions ", for which MPF received in 2012 a grant from the European Social Fund through the Operational Programme Administrative Capacity Development 2007-2013, its overall objective being to increase the efficiency of central and local public administration, as well as the administrative transparency by making available to public institutions of the modern and standardized tools for reporting financial statements and publishing detailed information about the use of public funds, in accordance with the budget classification.

The MPF launched in 2017 the platform www.datoriepublica.mfinante.gov.ro, a site that aims to improve access to relevant information in the field of public debt management and to increase the level of transparency of the Treasury and Debt Department by publishing in a more structured format the information and statistics on government securities issued by Romania on the domestic and foreign financial market, the legal framework governing the public debt at the level of central and local government, the medium-term debt management strategy, information on Government Programs with state guarantee, respectively the First Home Program, First Machine, Thermal Rehabilitation, SME Loans, Program to support the beneficiaries of programs in priority areas, and Increasing Architectural and Environmental Quality of Buildings, the data being available both in Romanian and in English.

The platform also provides a guide for investors, information on the government securities available to the public, the government securities in circulation, primary dealers in the current year, the monthly issue calendar, as well as the official communications with auction results. With regard to the secondary capital market, the site provides information on the volume of transactions in this market, the most traded government securities and the investor structure within this market, but also on the holdings of government securities issued on the domestic market denominated in lei and euro. In addition, are provided information and conditions for participation in the electronic trading platform implemented by Bloomberg, EBND, as well as data on national government securities in circulation, thus contributing to the increased transparency of quotations and, implicitly, the formation of prices for government securities, providing the premises for reducing transaction costs for participants in the secondary market. Within this platform, statistics on government debt and local debt are also available, with a country presentation available. On this site, there is also the country rating history provided by the main rating agencies, namely Standard & Poor's, Fitch, Moody's and Japan Credit Rating Agency.

Between 2013 and March 2014, a major reform was launched to improve public investment management, ensuring a greater transparency in formulating public investment priorities, as well as an increased transparency in formulating the investment budget through an analysis of the existing portfolio of projects and its rationalization by identifying the priority ones, together with the multi-annual allocation of the related funding. The components of this reform were the adoption of GEO no. 88/2013 on the adoption of fiscal measures for the fulfillment of the commitments agreed with the international bodies, as well as for the modification and completion of normative acts, which provide the necessary legal framework for the prioritization of public investments, as well as for the assessment of the completion degree of the public investment projects prior to being included for funding in the annual budget laws; the establishment of a public investment assessment unit within the MPF, directly subordinated to the Deputy Minister for Budget; as well as the adoption of Decision no. 225/2014 for the approval of the methodological norms regarding the prioritization of public investment projects, thus consolidating a transparent process regarding the formulation of the investment budget and increasing the efficiency of the mechanism for prioritizing the public investment objectives, having as object the central and local public institutions, self-financed public companies, state-owned companies, as well as public-private partnerships, with investments over 100 million lei and, where appropriate, between 30-100 million lei.

However, in practice, as it is outlined in the EC’s Country Report 2016, the selection and prioritization of investment projects is fragmented (at the level of ministries, local authorities or public institutions (National Company of Motorways and National Roads in Romania - CNADNR)), as the centralization at MPF level - the Public Investment Assessment Unit is only formal, as long as this unit does not act based on a coherent strategy, it cannot refuse or monitor the proposed projects, and thus cannot contribute with strategic proposals to change the financing decision in relation to the projects' performance.

At the level of 2015, it may be appreciated that improvements have been made in communicating the results obtained in this area, the list of prioritized investment projects being made public at the beginning of 2016 on the MPF's website under the heading "Transparency in public investment projects", related to the State Budget Law for 2016, which included updated information on the list of 120 projects worth over 100 billion lei for December, 2015. Also, in 2015, was made a report analyzing the existing portfolio of public investment projects for the main credit release authorities during January, 1 – December, 31, which adds a gain of transparency to the process in question by providing information on the public investment program approved by Law no. 186/2014 on the state budget for 2015. As regards 2016, it can be seen the continuation of the process initiated in 2015, the list of prioritizations for investment projects being made public, including updated information on the list of 119 significant prioritized projects, worth over 124 billion lei.

In the years that followed the global financial crisis, the spending review process has seen a widespread use among advanced economies, examples being given by countries such as the United Kingdom, Ireland, France, Denmark, the USA or Canada, being considered as a tool to reduce the aggregate spending, in order to achieve the fiscal consolidation goal. Specifically, this process involves the elaboration of specific measures aimed at saving at the level of the budget expenditures, on the background of a systematic control of the latter in the medium term, being generally implemented and managed by the ministries of finance, but being based on the line ministries.

The spending review process represents a set of organizational and analytical processes that support the systematic examination of public expenditures and the identification of potential areas where savings can be made from low priority, inefficient expenditures, as opposed to *ad-hoc* savings exercises, designed to meet the short-term fiscal objectives, spending reviews systematically evaluating all areas of expenditure or selected spending areas.

The objectives of spending review process are both to reduce the dynamics or level of public expenditure towards fiscal consolidation, but also to improve allocation efficiency by allocating budgetary resources to sectors with higher priority. Moreover, the spending review process can be a tool to ensure a better prioritization of budgetary spending, but also to bring a gain of transparency to the budgetary process, specifically to expand the available fiscal space for new priority expenditure, in the context of firmly limiting the aggregate expenditures. Given the difficult fiscal environment faced by many governments in the medium and long term, it is essential that the spending review process becomes a permanent feature of the budgeting process; its use should not be limited to the context of recessions.

We can notice the start of such a process in Romania, given the MPF's initiative to institutionalize the expenditure analysis process in order to increase the efficiency of the public expenditures in the medium term, to integrate the analyzes in the budgetary process and to align them with the budget calendar, the first step in this direction being the establishment of the Directorate for Public Expenditure Analysis and Efficiency within the Directorate General for Expenditure and Public Investment Management, responsible for carrying out these analyzes and elaborating pertinent recommendations, which can lead to an optimal allocation of the budget revenues.

The Fiscal Council advocates in favor of an increased fiscal transparency, appreciating the recent developments concerning the launching of the two platforms for monitoring the budget execution of more than 13,700 public institutions, respectively for improving the access to relevant information in the field of public debt management, as well as launching a process of spending review by the MPF and reorganizing the activity in the field of public investment projects' management. The Fiscal Council also considers that some progress has been made in reforming public investment management, but the transparency of the prioritization process is still in the beginning, as well as the efficiency of the process of allocating and spending the public money for the prioritized public investments.

VII. EU regulations on fiscal governance - implications for Romania

Fiscal governance is represented by those rules, regulations and procedures that affect how fiscal policy is planned, approved, managed and monitored.

The components of fiscal governance:

- Numerical fiscal rules;
- Independent fiscal institutions;
- Medium-term budgetary frameworks.

The structure of the EU's economic governance is based on three main elements:

- **The European Semester** for macroeconomic policy coordination, aiming at a synchronized evolution of EU economies without significant macroeconomic differences, with budget deficits below 3%;
- **The six legislative package on economic governance and the Fiscal Compact**, reinforcing the SGP and introducing macroeconomic surveillance;
- **The two economic governance packages**, which intend to discover the potential fiscal problems in an early stage, and then provide a legal framework for countries in difficulty (only for the euro area)

The objectives of fiscal governance are:

- Achieving strong budgetary positions by removing the tendency to adopt unsustainable fiscal policies leading to high deficits and debt growth; (deficit bias);
- Reducing the pro-cyclicality of fiscal policies;
- Improving the efficiency of public spending.

European fiscal rules are applied in the context of the European Semester, an annual cycle of economic policy coordination and surveillance in the EU. The European Semester contains a clear timetable according to which Member States receive advice from the EU. The first European Semester took place in 2011, in the first half of the year.

Table 20: The calendar of the European semester

	European Commission	European Council / Council	Member States	European Parliament
November[89]	The *Annual Growth Survey* (AGS) and the *Alert Mechanism Report* (AMR) are published			
	Commission Recommendations for the euro area			
	Commission *opinion on draft budgetary plans* (euro area)			
December/ January		The Council discusses the *Commission's opinions* on the draft budgetary plans (the euro area)		Dialogue on the *Annual Growth Survey*
	Bilateral meetings with Member States		Member States adopt budgets (the euro area)	
		The Council adopts the *recommendations* for the euro area		
		The Council adopts *conclusions* on AGS and AMR		
	Investigation missions in the Member States			
February[90]	*Country Report* per Member State [91]			
March		The European Council adopts *economic priorities* based on the CSR		
April	Bilateral meetings with Member States			
			Member States present their *National Reform Programs*	
			Member States submit their *Stability Programs* (euro area) or *Convergence Programs* (States that have not adopted the euro)	
May[92]	The Commission proposes *country-specific recommendations* (CSR)			
June/July		The Council is *discussing* CSR		*Dialogue on the CSR proposal*
		The Council *adopts* CSR		
September			Member States submit their draft budgetary plans (the euro area)	*Debate / Resolution* on the *European Semester* and *CSR*
October				Dialogue on current growth analysis

Source: Processing after EC (http://ec.europa.eu)
Note: Orange-colored areas describe specific activities only for countries in the euro area. Blue-colored areas describe specific activities only for countries outside the euro area.

[89] EC publishes Autumn Economic Forecasts.

[90] EC publishes winter economic forecasts.

[91] EC publishes country reports that include analysis of the economic situation and macroeconomic imbalances.

[92] EC publishes Spring Economic Forecasts.

If imbalances are discovered, the EC may advise the Council to intervene. In the European Semester, the Council may then adopt a recommendation requiring the concerned Member State to take action to correct the imbalances identified. If an excessive imbalance is identified, the Commission may recommend to the Council to apply for the concerned country the corrective arm of the macroeconomic imbalances procedure: Excessive Imbalances Procedure. The macroeconomic imbalances procedure was introduced with the economic governance package adopted in 2011.

VII.1. The European Semester - the experience of the last years and the positioning of Romania

The European Semester 2016 followed the program drafted by the Presidency of the EU Council and introduced a revised approach, starting from the lines of action identified in the EC Communication on the measures to be taken to complete the EMU. A novelty was the publication of the euro area specific recommendations in November 2015, together with the Annual Growth Survey 2016, thus allowing for a coherent approach to euro area challenges through debates taking place before the adoption of specific recommendations for each Member State. Thus, a new framework has been created which includes a better integration of the euro area dimension and national dimensions, with a stronger focus on employment and social performance, as well as enhanced support for reform and convergence economic.

Romania's country report for 2016, published on February 26, 2016, assessed the economy's situation in terms of the EC's annual growth survey for 2016. It is noted that Romania has made limited progress in implementing country-specific recommendations in 2015. At the same time, it was mentioned that Romania maintained its medium-term objective in 2015, but it is expected to deviate significantly from it in 2016 and 2017, starting in the second half of 2014, the signs of fiscal loosening are becoming more and more visible. In the area of tax compliance, limited progress has been made. Tax revenues were relatively low, but their composition was generally favorable to growth. It was found that spending decisions and priorities could be changed relatively easily during the year, with the budgetary process suffering from the lack of appropriate targeting.

In the context of the comprehensive review on the prevention and correction of macroeconomic imbalances, it is stated that the expansionary budgetary policy in a strong economic growth environment is a source of concern. In January 2016, new expansionary budgetary measures entered into force, several of which are planned for 2017. The EC estimated that the budget deficit would increase more than three times as a percentage of GDP in only two years. In the matrix corresponding to the macroeconomic imbalances procedure, the main challenge in the fiscal area was to identify a pro-cyclical budgetary policy that, together with a deviation of output gap starting in 2017, risking the overheating of the economy in the medium term. The EC confirmed in its *Communication on the European Semester 2016* of 8 March 2016 that Romania does not face macroeconomic imbalances.

The European Semester 2017 began on November 16, 2016, with the publication by the EC of the *Autumn Package* on the European Semester, which includes the Annual Growth Survey for 2017. In the European Semester 2017, the focus will be on further simplifying the coordination process of the *ex-ante* economic and fiscal-budgetary policies, deepening the dialogue with the Member States and focusing on the implementation of country-specific recommendations.

Romania's country report for 2017, published on February 22, 2017, assessed the state of the economy. According to a pro-cyclical fiscal policy, economic growth reached a peak in 2016 compared to the post-crisis period (4.9%), with the upward trend in the coming years (4.4% in 2017 and 3.7% in 2018). In Romania, tax revenues depend more on consumption taxes and less on taxes on income and on salaries, the general structure of the tax regime being thus favorable to economic growth. Fiscal policy became pro-cyclical in 2016, with the public deficit currently estimated at 2.8% of GDP as a result of significant tax cuts and a sharp increase in spending, with the deficit continuing to grow in the coming years. The EC underlines that the growth forecast for the structural deficit predicts it will deepen from below 1% in 2015[93], to around 4% in 2017 well above the MTO. It also states that there has been no progress in ensuring the implementation of the national fiscal framework and limited progress has been made in respecting tax obligations and improving tax collection.

VII.2. Consequences of non-compliance with EU rules on fiscal governance

VII.2.1. Excessive Deficit Procedure - recent regulations and experiences

The SGP is the fundamental element of the EU's budgetary discipline. The Corrective Component of the SGP governs the Excessive Deficit Procedure (EDP), which supports the early correction of excessively high public deficits or excessive public debt. Under the strengthened SGP, the EDP is applied in two cases:

[93] It reached about 2.6% of GDP in 2016.

- budget deficit is exceeding 3% of GDP;
- public debt is exceeding 60% of GDP, and does not diminish at a satisfactory pace.

Stages of EDP

For the EU country whose deficit or debt exceeds the defined limits, the EC prepares a report assessing whether to launch an EDP. Subsequently, the EC shall notify the country concerned and shall inform the Council if it considers that the deficit is excessive. On the basis of the EC's proposal, the Council decides by a qualified majority whether, on the basis of the country's observations, the deficit is excessive. If the Council decides that a deficit is excessive, it makes recommendations to the country and prescribes a maximum deadline for it to take effective measures (three or six months). If a country continues to fail to implement the recommendations, the Council may decide to send a formal notification to take measures to reduce the deficit within a specified period of time. If the country does not comply with the Council's decision, it may decide to impose penalties.

Penalties

Penalties are imposed unless the deficit is reduced. For euro area countries, these penalties are progressively imposed, starting with: the obligation to submit to the EC an interest-bearing deposit of 0.2% of GDP in the preventive stage; the obligation to submit a zero-interest deposit of 0.2% of GDP in the corrective stage. This deposit is converted into a fine of up to 0.5% of GDP if the recommendations for correcting the excessive deficit are not respected. In addition, all EU countries (with the exception of the United Kingdom) may be subject to a suspension of commitments and payments from the European structural and investment funds. Sanctions are also imposed in cases of statistical manipulation.

Recent experiences

Among the most recent EDP-related decisions was the Council's decision (August 8, 2016) to notify Spain and Portugal to take deficit-reducing measures, considered necessary to remedy the situation of excessive deficit and to cancel the imposition of a fine for failure to taking effective action, these countries not taking sufficient measures in response to the Council recommendations of June 21, 2013. Another Council's decision (June 17, 2016) was to repeal the EDP decision for Cyprus, Ireland and Slovenia. One month earlier (May 17, 2016), the EC reported on the fiscal situation of Belgium, Ireland and Finland, checking compliance with the Treaty's debt criterion.

Table 21: Excessive Deficit Procedures in progress			
Country	Date of Commission report (Art.104.3/126.3)	Council Decision on the existence of an excessive deficit (Art.104.6/126.6)	Current date for correction
Croatia	15 November 2013	21 January 2014	2016
Portugal	7 October 2009	2 December 2009	2016
France	18 February 2009	27 April 2009	2017
Greece	18 February 2009	27 April 2009	2016
Spain	18 February 2009	27 April 2009	2018
United Kingdom	11 June 2008	8 July 2008	Financial year 2016/17

Source: EC

Countries with closed EDPs: Austria, Belgium, Bulgaria, Czech Republic, Cyprus, Denmark, Germany, Hungary, Italy, Ireland, Finland, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Romania, Slovenia and Slovakia.

Countries without EDPs: Estonia, Sweden.

In the case of *Romania*, the EC's report of May 13, 2009 establishes that the excess over the reference value[94] was not qualifying as exceptional in the sense of the SGP and could not be considered as temporary. In the same year, it was decided the need to ensure surveillance under the EDP. This procedure was closed on June 21, 2013, when the ECOFIN Council closed the EDP for Romania, confirming that the budget deficit was reduced to below 3% of GDP.

VII.2.2. Sanctions - stages and application

With the SGP's reform in 2011 (known as the Package of six legislative measures on economic governance), the possibility of including financial sanctions for euro area Member States was also introduced in the case of repeated non-compliance with the recommendations of the SGP's preventive arm (when the significant deviation procedure was launched), based on Article 136 of the Treaty on the Functioning of the European Union (TFEU). Thus, sanctions become faster, financial penalties apply earlier and can be gradually increased. This would ensure the

[94] Budgetary deficit of 5.4% and 5.1% (according to the EC's 2009 Spring Forecast) in 2008 and 2009.

effectiveness of the sanctions and apply at a time when Member States are able to react. The fines can amount to a maximum of 0.5% of GDP if statistical manipulation is detected.

The adoption by the Council of a decision of non-compliance with the obligation to take corrective action is the start of the penalty procedure[95] for the euro area countries. Within 20 days of the decision being taken by the Council, the EC issues a recommendation for a new Council's decision requiring the Member State concerned to deposit an interest-bearing deposit equal to 0,2% of GDP recorded in the previous year. Although the standard value of the deposit is equal to 0.2% of GDP, the amount can be adjusted. For this, the Member State concerned must issue a reasoned request to the EC within 10 days of the Council's decision on the lack of effective measures. Following the receipt of this request, the EC may recommend to the Council the reduction or the cancellation of the interest-bearing deposit.

The interest-bearing deposit will bear an interest rate that reflects the EC's credit risk and a relevant investment period. It will be returned to the Member State with the interest accrued when the situation that led to an ineffective action decision no longer exists. If a country that has deposited an interest-bearing deposit enters under EDP[96], the deposit will be converted into a non-interest-bearing deposit following the Council's decision on the existence of an excessive deficit.

The launch of the EDP requires compliance with Council's recommendations by the Member State concerned to correct the deficit within a certain timeframe. The next stage implies stricter requirements and possible financial sanctions for the euro area countries, while the application of macroeconomic conditionality may also lead to a suspension of commitments or payments under the European structural and investment funds for all Member States[97].

As long as the Member State continues to fail to comply with the notification submitted under Article 126 paragraph (9), it may face an annual penalty equal to 0,2% of GDP of the preceding year plus a variable component determined by the size of the deficit, reaching a maximum of 0.5% of GDP. For *non-euro area Member States*, a reiteration of the steps mentioned in Article 126 paragraph (8) followed by a *new recommendation* according to Article 126 paragraph (7) is made as long as the Member State is not on the path of correcting the excessive deficit; and did not take effective actions. For *all countries* except the UK, any decision on the lack of effective

[95] These sanctions are covered by Regulation (EU) 1173/2011 of the Parliament and the Council, which is based on Article 136 TFEU.

[96] The corrective arm of the SGP.

[97] Except for the United Kingdom, which, under Article 23 (13), is exempted from any suspension of commitments or payments of funds under Protocol 15 of TFEU on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland.

action should be accompanied by an EC proposal either to suspend (or increase the size of the penalty) of commitments under European structural and investment funds, or suspend of payments (or increase the size of the penalty).

Regarding the *EU funds* from 2014, a new regulatory framework entered into force and links for the first time the economic surveillance and the procedures for all structural funds and European investment, **being applicable to all Member States**. Previously, a macro-fiscal conditionality clause existed for the Cohesion Fund since its inception in 1994 linked to the fund's initial purpose of delivering the growth-oriented investments necessary for real convergence for Member States setting implementing a budget consolidation in order to meet the Maastricht criteria.

The conditionality clause introduced from 1 January 2014 is based on the notion that the effectiveness of cohesion policy should not be compromised by inappropriate fiscal and macroeconomic policies. There are two mechanisms for suspending funding under the structural funds.

The first appears after a lack of effective action following a request from the Commission to revise and propose amendments to the Partnership Agreement and the relevant programs. The EC can therefore require a Member State to reprogram[98] some of its funding when justified by the economic and employment challenges identified in the various economic governance procedures. Such a request can be made to support reforms stemming from Council recommendations in the European Semester or EDP or to maximize the impact of funds for countries receiving financial assistance[99]. This mechanism is not directly linked to the quantitative assessments of the SGP, although it is linked to the country specific recommendations issued under the preventive component of the SGP.

The second mechanism is both automatic and directly related to the corrective part of the SGP. It provides for European structural and investment funds to be suspended in the event of non-compliance with the specific elements of the EDP and the adjustment programs related to financial assistance. With regard to EDP, a Council decision on the lack of effective action under Articles 126 paragraph (8) or 126 paragraph (11) TFEU will automatically lead to an EC proposal for a part or the total amounts of Structural Funds commitments and European investment to be suspended. If immediate action is requested or if there has been significant non-compliance, the

[98] Reprogramming in accordance with Article 23 is only possible from 2015 until 2019.

[99] According to the EC Communication to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions. Guidelines on the application of correlation measures between the effectiveness of European structural and investment funds and good economic governance in accordance with Article 23 of Regulation (EU) No. 1303/2013.

EC may propose that a part or the total payments to be suspended rather than of the commitments.

As far as the Fiscal Compact is concerned, countries that do not adequately incorporate the provisions under their national law may face financial sanctions of up to 0.1% of GDP imposed by the Court of Justice of the European Union (CJEU). Under Article 3 paragraph (1) letter (e) of the Fiscal Complaint, where a significant deviation from the MTO or from the adjustment path towards it, a correction mechanism is automatically triggered. The mechanism includes an obligation on the contracting party concerned to implement measures to correct deviations within a specified period. Pursuant to Article 3 paragraph (2), the contracting parties shall establish at national level the correction mechanism referred to above on the basis of common principles proposed by the EC relating to the type, magnitude and duration of the corrective action to be taken, including in the case of exceptional circumstances, as well as the role and independence of the institutions responsible for monitoring compliance with the rules at national level. This correction mechanism fully respects the prerogatives of national parliaments. In the next stage, under Article 8, the EC shall report to the contracting parties on the provisions adopted by each of them. After the party concerned has had the opportunity to submit its observations and the EC concludes that the contracting party concerned has not complied with Article 3 paragraph (2), one or more contracting parties may refer the matter to the CJEU[100]. The decisions taken by the CJEU in such cases are binding. If a contracting party considers that the necessary measures have not been taken to comply with CJEU decisions, it may address the CJEU with the request to impose financial penalties (which may not exceed 0.1% of GDP).

VII.3. Conclusions

The EC report presented on February 22, 2017, based on Article 8 of the intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG) makes an evaluation of the implementation of budgetary rules in national legislation. According to this assessment, the national provisions adopted by Romania through FRL no. 69/2010 republished, comply with the requirements of Article 3 paragraph (2) of the TSCG, thus fulfilling the formal commitments.

On the other hand, in the short term, Romania does not meet the requirements of European regulations. According to the EC forecasts, the budget deficit would exceed the 3% of GDP threshold imposed by European regulations in 2013, reaching 3.6% of GDP, and the structural

[100] This may also be the case if, independent of the EC report, one or more contracting parties consider that the provisions of Article 3 (2) have not been respected.

deficit (corresponding to the MTO[101]) would rise spectacularly to 3.9% Of GDP. In the Convergence Program of Romania in April 2016 there were mentioned expectations for growth of these deficits (up to 2.9% of GDP in 2017, both for the headline budget deficit and for structural deficit), mainly driven by the tax cuts in the new Fiscal Code and salary or social assistance rights increases approved even since 2015.

Although there are penalties for breaching the European rules, the experience of other countries that have deviated from the European fiscal governance standards shows that first are issued warnings and are made attempts to correct the slippages in a certain period of time. It is, for example, the case of France, which was warned with sanctions[102] in November 2014 and committed itself to reduce the deficit below 3% of GDP by 2017. Another example of a country with high deficits is Hungary, which was threatened with a cut of one-third from the allocation for European funds, but after the introduction of taxes cut and a deficit reduction below 3% of GDP in 2014, the EC renounced at this sanction. It was also the EC that proposed to the European Parliament in October 2016 the suspension of allocations from European structural and investment funds for Spain and Portugal[103], but the majority of European parliamentarians considered that this decision could affect the most vulnerable citizens and regions.

However, penalties for breaches of EU rules on fiscal governance by Romania are not excluded in the future. A possible postponement of projects that can be financed from structural funds and European investments, given that Romania should recover quickly the delays in the new financial framework (2014-2020), would put further pressure on the budget and on the economic growth forecasts. In addition, if an increase in the deficit may occur in a short time, reducing it will take time and involves costs, and even will affect the future generations.

[101] Set at 1% of GDP for Romania.

[102] Which could reach 4 billion euro.

[103]In July 2016, the Council decided that Spain and Portugal failed to take effective actions in response to the recommendations on the correction of the excessive deficit.

VIII. 2017 – Macroeconomic and fiscal perspectives

VIII.1. Macroeconomic framework

2017 represents the fifth year of recovery and moderate growth of the European economy, following a geopolitically tensed 2016[104], but benefiting from a high pace of consumption growth, low oil prices, accommodative monetary policies and fiscal positions largely in balance. In the Spring Economic Forecast published in May 2017, the EC estimate for 2017 a real GDP growth of 1.9%[105] in the EU and 1.7% in the euro area, and for 2018 an economic growth of 1.9 % for the EU and 1.8% for the euro area. The achievement of a moderate rate of economic growth is based on a number of positive factors, including: sustainable macroeconomic policies, a sustained pace of job creation, increasing consumer and business confidence and a low exchange rate for the euro. Even though the balance of risks is seen to be more balanced compared to the EC's Economic Forecast published in February 2017, when major economic risks to the EU's economic growth were estimated, it is considered that risks may appear in the sense of registering a growth below expectations, in a context of geopolitical tension (the impact of Brexit, tensions in Turkey, Russia and the Middle East), uncertainties about the evolution of investments on the background of the financial statements adjustments at the level of banks and firms, generated by the still high rates of public and private debt in many European countries. Although compared with the February Economic Forecast, the outlook for international trade and financial markets is more optimistic, there are still uncertainties about the medium-term impact regarding the financial markets and the global trade of the stimulus policies promoted by the US and China, the vulnerability of banking systems in some Member States regarding the possible worsening of the financial market conditions, the inequality of labor market recovery and investment in the euro area, and the political risks generated by the electoral processes[106] announced for this year in a number of EU Member States.

The European Commission estimates positive growth rates in all EU countries. The best performing countries in terms of projected real GDP growth are Malta (4.6%), Romania and Luxembourg with 4.3%, Ireland (4.0%), Hungary (3.6%), Poland (3.5%) and Slovenia (3.3%). In

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[104] The UK's decision to leave the EU, a long series of terrorist attacks in some EU Member States, the increasing the number of protests against globalization.

[105] Slightly higher compared to the estimate for 2017 in the of Winter Economic Forecast, i.e. an increase of 1.8% for the EU and 1.6% for the euro area.

[106] The Brexit (the United Kingdom's decision to leave the EU) has spurred the rise of euro-skeptic political formations in many other European countries, which, by denying the European project, promotes the exit from the EU and its dissolution.

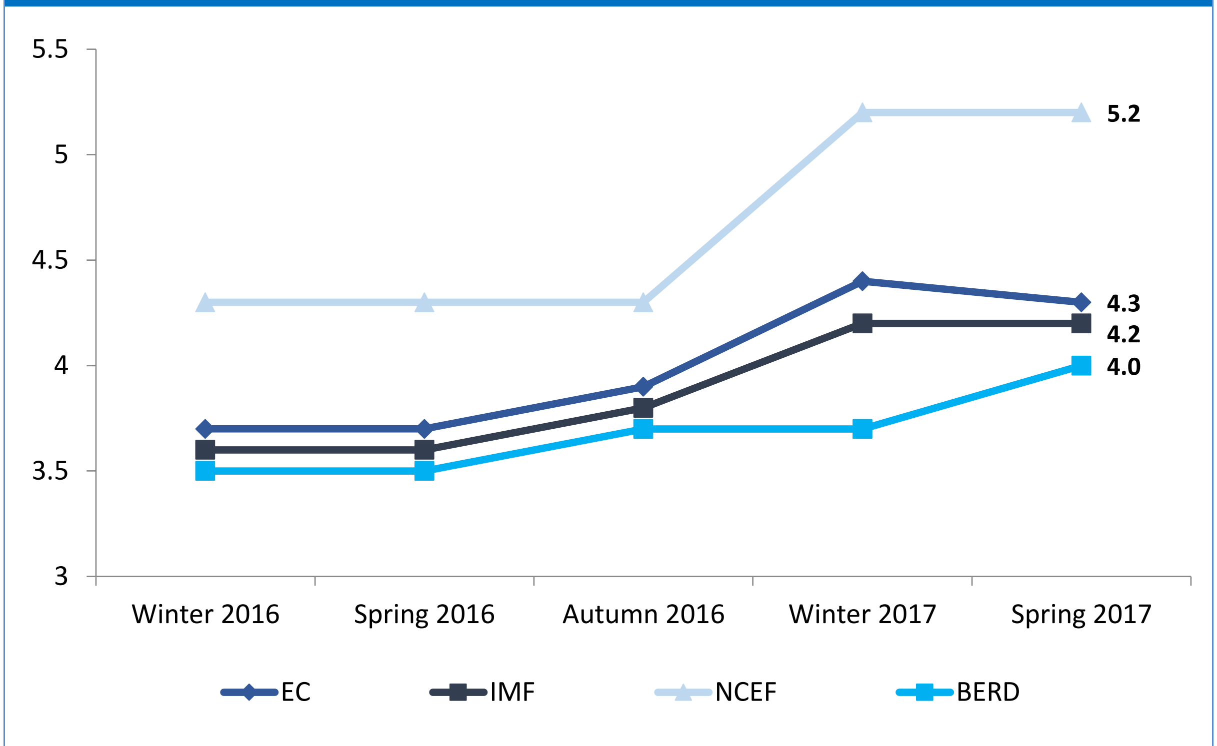
contrast, Italy will be expected to record the lowest rate of positive growth in the EU (0.9%), followed by Finland (1.3%), France (1.4%), Belgium (1.5%) and Germany (1.6%). The average economic growth in the EU is expected to be lower in 2017 than in the United States (2.2%) and below the level of global economic growth (3.4%). From the perspective of the gap compared with the pre-crisis GDP level, is worth mentioning that in real terms about one third of EU countries still has to recover to reach the level before the crisis. Thus, in 2016, the Greek economy was at a level of only 73.8% of the real GDP registered in 2008, while another seven European countries stand, on average, at about 95% of the GDP level in 2008. In contrast, significantly higher levels of real GDP compared to 2008 were recorded in Ireland (+40.2%), Malta (+34.2%), Poland (+27.2%), Luxembourg (+22.0%). Thus, it can be noticed a heterogeneous development of the economic activity and partly divergent among the EU member states in the period 2008-2016, the crisis affecting in different ways the economies of these countries, in conjunction with preexistent domestic imbalances. Also in 2017, the economic divergence of economic growth among the Member States is expected to increase, influenced by the degree of external competitiveness, the degree of stability of the banking system, the continuation of the disintermediation process and the implementation of structural reforms. A possible aggravating factor may be represented by the materialization of the possibility of winning the elections scheduled for this year in 13 EU Member States (excluding the UK) by Euro skeptics, which can generate negative consequences, such as financial market tensions (rising aversion to risk will lead to increases in CDS[107] and interest rates), reduced foreign investment in EU countries, depreciated local currencies.

For 2017, the Harmonized Index of Consumer Prices (HICP) is expected to return on an upward trend, respectively at a level of 1.8% for the EU and 1.6% for the euro area (the previous forecast, from the winter of 2017, estimated for this year a slightly higher level of inflation for the euro area, respectively of 1.7%). Inflation rate is expected to rise gradually as a result of narrowing the GDP gap, a slight increase in wages and a moderate recovery in oil prices and raw materials prices. Thus, the expected level of the inflation rate in the EU is 1.7% for 2018, while for the euro area is projected to 1.3%. In Romania, following a year in which the HICP inflation rate had negative values (-1.1%), due to the reduction in the standard VAT rate and low import prices, in the first months of 2017 were recorded positive and rising HICP values, respectively from 0.3% in January (as compared to January 2016) to 0.4% in March and 0.7% in April 2017 (as compared to the same month in 2016), the average projected by the EC for 2017 being 1.1%, given the strengthening of the domestic demand, driven by the fiscal relaxation measures and by the wage increases promoted this year.

[107] Credit Default Swap.

For Romania, the EC spring forecast predicts a GDP growth rate of 4.3% in 2017, a value lower than the previous year (4.8%), when it was recorded the highest value of this indicator since the beginning of the crisis in 2008, and also from the EU. Moreover, the advance of the Romanian economy is significantly superior to both the European average (1.9%) and the global average (3.4%). Relying on a growing trend of private consumption stimulated by the fiscal loosening and higher income for some social categories, Romania will register in 2017 the second highest rate of the projected economic growth in the EU (after Malta). As regards the composition of the economic growth, the private consumption will grow by 6.9%, with a contribution to GDP growth of +5.1%, the gross capital formation will advance by only 1.3%, while net exports will have a negative contribution (-0.8%). It is expected that Romania will record a current account deficit of 2.8% of GDP due to a faster growth rate of imports (+8.6%) compared to the one recorded by exports (+6.9%). For 2018, the EC estimates for Romania a slowdown of the economic growth to 3.7%, but remains one of the highest values compared to the majority of EU Member States.

Figure 49: The evolution of the Romania's economic growth forecasts for 2017, %



Source: EC, IMF, NCEF, EBRD

When analyzing the dynamics, the economic growth forecasts for Romania in 2017 have been revised upwards for this year by all three international financial institutions, the estimate for the economic advance increasing from a value of 3.5 – 3.7% in early 2016 to 4.0 – 4.3% in the spring of 2017 (but slightly below the estimate made in early 2017). Thus, on the background of increasing optimism regarding the economic recovery in a sustainable way, the international institutions have modified upwards by more than 0.6 pp the estimate of real GDP growth in 2017. The factors that contributed to the need for these adjustments were represented by the decisions regarding the fiscal loosening and the wage increases planned for 2017. Is worth mentioning that the GDP growth estimated by the NCEF is much more optimistic (5.2% in the spring 2017 forecast, maintained at the level of the winter 2017 forecast), both compared to the estimates of the three international financial institutions, as well as its estimate from autumn 2016 (of 4.3%, respectively +0.9 pp).

According to the Inflation Report published by the NBR in May 2017, the consumer price index (CPI) development will be affected by the measures contained in the set of stimulus fiscal measures adopted at the beginning of the year. According to the baseline scenario of the macroeconomic projection, the annual CPI inflation rate will be 1.6% at the end of 2017, and 3.4% at the end of 2018[108], values located in the lower half, respectively, in the upper half of the variation interval of ± 1 pp associated with the stationary target of 2.5%. The upward trend at the level of the first four months of the current year, which was driven by the gradual fade away of the statistical effect associated with the reduction in the standard VAT rate from January 2016 (by 4 pp), coupled with unfavorable external developments on fuel and food price dynamics, partly offset by the elimination of some taxes and reductions in the indirect taxes (non-fiscal taxes, VAT and excise taxes), will be maintained throughout the year. The volatility of the inflation rate over the analyzed period is determined by the increase in the surplus of demand, in the context of the expansionary fiscal policy and the advance of the disposable income, the evolution of the import consumer prices, given the projected dynamics of external prices and, under the impact of these factors, the increasing trend of the inflation expectations. It should be noted that the successive reductions in the VAT rate had the potential to counteract the price pressures generated by the increase in the aggregate demand and the disposable income in the period 2016-2017. Looking ahead, the wage increases announced for 2017, both in the public sector and regarding the gross minimum wage, as well as the projected increases in the private sector wage, are expected to maintain a high annual dynamic of the unit wage costs in both industry and at the level of the economy. In 2018, inflationary pressures are projected to increase, in the context of the import prices' trend returning on an upward slope for the main raw materials (energy, agri-food). The risks in a negative sense arise primarily from the fiscal policy stance, thus, achieving a European absorption rate inferior to that considered in the baseline scenario may result in a structure of budgetary expenditures in which investment expenditure would be reduced in favor

[108] In the Spring Forecast 2017, the EC predicts an HICP inflation rate of 3.0% for 2018, given the return of the GDP gap to a positive territory starting from 2017, combined with a robust domestic demand growth, revenue growth for some social categories and the oil prices recovery, and considers the balance of risks tilted to an upward trend in inflation if other stimulus measures are applied.

of the current expenditure, and, implicitly, a more alert dynamics of consumer prices compared to the baseline scenario, affecting also the competitiveness potential of the Romanian economy.

One of the relevant risk sources for inflation in the next period may be the implementation of the Law on the remuneration of personnel paid from public funds, with the potential to increase the excess demand in the economy and, implicitly, generate additional inflationary pressures, superior in terms of amplitude to those in the baseline scenario, as well as to the deterioration of the current account balance, as the additional wage incentives induced by the application of this Law could imply the increase of imports to accommodate the rise in the domestic demand.

In the Fiscal Council's opinion, the balance of risks to real GDP growth in 2017 is rather negative, in relation to the value estimated by the NCEF. Possible risks can arise from the uncertainties surrounding the external environment or a under-expectation evolution of the projects financed from European funds for the financial framework 2014-2020, as well as from the imminent possibility of placing the budget deficit above the 3%[109] reference value corresponding to the SGP, which may lead to a deterioration in the economy's external position and the reassessment of the risk degree associated with the domestic economy by the foreign investors. Coupled with domestic and foreign political tensions, this could slow down economic activity, increase the cost of government borrowing and put pressure on the exchange rate. Another risk, which can act in both directions, comes from labor market tensions, in a negative way, given the increase in wages at a much higher rate than labor productivity, threatening Romania's competitiveness, and in the sense of an advance over estimates, from the perspective of an additional impulse on the aggregate demand dynamics.

VIII.2. The fiscal framework

The initial budget for 2017 envisaged a general consolidated budget deficit target of 2.96% according to cash methodology, respectively of 2.98% of GDP according to ESA 2010 standard, given that at the moment of preparing the budget for the current year (January 23, 2017) the impact of a new round of fiscal relaxation measures under the new Fiscal Code adopted in 2015, as well as the public-sector wage increases adopted in the last part of 2016 and in January 2017 were incorporated. Estimates of budget balance for 2016 at that time indicated a level of -2.41% of GDP in cash terms and -2.82% of GDP according to ESA 2010. However, data on the budget execution for 2016, published in April 2017 by Eurostat, shows a deficit of 3.0% of GDP according

[109] The EC estimates for Romania a budget deficit of 3.5% of GDP in 2017 and 3.7% of GDP in 2018 (Spring Forecast 2017).

to the European methodology, achieved under a nominal GDP value slightly above the estimated value when the draft budget was elaborated.

According to its opinion on the state budget law, drawn up at February 3, 2017, the Fiscal Council noticed that the draft budget for 2017 and its associated medium term are characterized, as in the case of last year's budget, by a deliberate and large deviation from all fiscal rules imposed by both national legislation and the European treaties signed by Romania. Moreover, the intention of targeting a budget deficit very close to 3% of GDP (according to ESA 2010 methodology) is not benign, being likely to lead to a weakening of the position of public finances and to a complication in their management in the event of some adverse shocks, thus keeping fiscal policy in the trap of pro-cyclical behavior. Regarding the fiscal position in structural terms, following the accelerated fiscal consolidation in 2010-2015, in 2016 the structural budget balance deteriorated to -2.6% of GDP (from -0.7% of GDP in 2015), and for 2017 the Convergence Program 2017-2020 estimates an increase to 2.9% of GDP, reaching 3.0% in 2018, but the document does not indicate the convergence path towards the MTO as required by FRL. Thus, it can be appreciated that the automatic correction mechanism established by the FRL and the Fiscal Compact is not functional in this moment.

Furthermore, the EC spring forecast published in May 2017 indicates levels of the budget deficit for 2017 higher than those of the Government's projection, respectively 3.5% of GDP for both the headline and structural deficit. This projection is consistent with that of the Fiscal Council, thus the risk of re-entering the country into the EDP appears to be significant. In its opinion on the draft budget, the Fiscal Council also identified a high probability of a negative income gap resulting in according to the highly optimistic[110] macroeconomic scenario for 2017 and the medium term which underlies the budgetary projection, having an impact on the path of the budget revenues, as well as a significant potential subdimension of the non-discretionary budget expenditures, indicating a balance of risks predominantly inclined to higher deficits than expected, most likely requiring corrective measures on revenues or expenditures, in order to avoid exceeding the 3% of GDP threshold during the budget execution in 2017. Based on the information available at this time, the Fiscal Council maintains this assessment.

The Fiscal Council has repeatedly drawn attention to the fact that a large-scale fiscal easing in the context of a production gap close to zero in 2016 and subsequently positive in the period 2017-2020 is counterproductive because the measures adopted accentuate the pro-cyclicality character of the fiscal policy, with a permanent negative impact on the budget deficit. This slippage, whose subsequent correction through fiscal consolidation in the downward phase of

[110] For 2017 the Government estimates in the Convergence Program 2017-2020 a 5.2% economic growth, above the EC assessment of 4.3% in May 2017 (Decreasing compared to the 4.4% estimate of the winter forecast 2017)

the economic cycle is likely to generate economic and social costs that will offset the positive short-term effects of the fiscal relaxation as shown by the economic theory, the empirical evaluations at the international level and also by the Romanian experience of the last 10 years. In fact, the Fiscal Council has expressed serious concerns about the potential positive implications for the long-term economic growth of the measures adopted by the new Fiscal Code, focusing on reducing the consumption taxation, the most likely scenario being a temporary plus of aggregate demand, unaccompanied by a similarly significant impact on the long-term economic potential growth[111].

Both revenues and expenditures were at the end of March 2017 under the quarterly program of the initial GCB. Thus, the GCB's total revenues are less than the planned amount with about 3.43 billion lei (a minus equivalent to 0.4% of GDP), having a degree of achievement compared to the program of 94.5%, while the expenditures are lower by 6.49 billion lei (-0.8% of GDP), being at 89.9% of the program, so that in the budgetary balance the impact is favorable, in order to achieve a budget surplus of about 1.5 billion lei compared to the quarterly target, which estimated a deficit of the same value.

Regarding the budgetary revenues, the achievement under the targets was due both to the poor performance of the *amounts received from the EU*[112] (-1.5 billion lei under the program[113], respectively 64.6%, mainly due to the non-achievement of the program for the financial framework 2014-2020, which recorded a negative gap compared to the target of about 1.2 billion lei, respectively 71.3%), as well as the under-program receipts in the case of *current revenues*, namely those directly related to the evolution of the economy, with an achievement degree of 97.1%, respectively by 1.7 billion lei less than the program. Regarding the current revenues, compared to the first quarter of this year's program, quarter-on-quarter revenue surpluses were recorded at the level of *property tax*[114] (+295 million lei), *SSC* (+249 million Lei), *tax on foreign trade and international transactions* (+25 million lei) and *personnel income tax* (+17 million lei),

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[111] The literature indicates that reducing consumption tax does not improve the internal and external competitiveness of national economy products. In addition, the effect of reducing consumption taxes on long-term economic growth is relatively modest.

[112] In the case of the amounts related to grants for the 2014-2020 financial framework, in the period January-March 2017, there were raised sums mainly for the financing of projects in the field of agriculture, namely 2.7 billion lei out of the total 2.9 billion lei.

[113] In the case of the amounts related to the 2007-2013 financial framework, compared to a program of 82 million lei, 53 million lei were returned, plus another 171.9 million lei returned to the operational programs financed under the convergence.

[114] The growth of 11.2% compared to the program, explained by the fact that only until the end of the quarter (which represents the first payment term for the annual tax on buildings and land to the local budget) a 10% bonus is granted.

while quarterly targets were not achieved at the level of *VAT receipts* (-732.5 million lei), *non-tax revenues*[115] (-513 million lei), *excises* (-330 million lei), *corporate income tax* (-281 million lei) and *other taxes on income, profit and capital gains* (-138 million lei). In the case of VAT revenues, it is worth mentioning that in the first quarter of the program, a sum of 747.8 million lei was provided for the swap scheme, out of which only 130.4 million lei were actually made, which implies a 99% degree of achievement.

On the expenditures side, all categories of expenditure, without exception, are lower than those programmed for the end of the first quarter. The largest share of the total expenditures underperformance against the initial planning by 6.5 billion lei belongs to the *projects funded by external non-reimbursable finds* (-1.8 billion lei, of which -1.6 billion lei for the financial framework 2014-2020), followed by *subsidies*[116](-1.0 billion lei) and *capital expenditures*, whose level is only 63.3% of the quarterly program (-0.62 billion lei). Other significant deviations compared to the planned levels for the first quarter were recorded in *interests* (-0.56 billion lei), *goods and services* (-0.54 billion lei), *transfers between public administration units* (-0.51 billion lei).

Essentially, the budget execution for the first quarter of 2017 shows a significant underachievement for the revenue from European funds, but also a relevant one for the current revenues, while on the expenditure side, the underachievement is much higher compared to the initial planning, especially for the projects funded by external post-accession funds and capital expenditures. Under these circumstances, this year, the intention to reduce the inter-quarterly volatility of budget execution, especially at the level of investment expenditures, has not been materialized up to now.

In the context of maintaining the current fiscal-budgetary policy parameters, the 2017 risk balance appears to be significantly leaning towards exceeding the 3% budget deficit target, requiring corrective measures in revenues or expenditures, to avoid entry into the EDP. In the direction of registering a deficit close or below the deficit target, it could act, without being a desirable evolution, an underachievement of the investment spending as a result of a low absorption of EU funds for financial framework 2014-2020 given the actual evolution of the investments financed from this source. Under these circumstances, the Fiscal Council recommends to the Government to accelerate structural reform measures with an impact on the rate of revenue collection and on the efficiency of public money spending, in particular, to speed up the implementation of the program to modernize the system of budget revenue management. The Fiscal Council also reiterates its recommendation on the fast operationalization of the public investment prioritization process and a real reform of the public administration aimed at

[115] Amid the fall under program of the receipts from the NBR net income and interest income.

[116] The failure was due to delays in payment of subsidies for transport.

management performance on various levels, which could generate significant gains in efficiency at the level budgetary expenditure.

Regarding the medium-term budget construction, in the context of the major budgetary impact generated by the Law on Unique Remuneration (LUR) in the form proposed at this moment, the Fiscal Council expresses serious concerns regarding both the compliance with the budgetary targets assumed by the Government and the possibility of return to the MTO trajectory starting 2019, without major corrective measures such as the reduction of other budget expenditures or tax increases. Thus, if through the 2018-2020 Convergence Program, the Romanian authorities forecast budget deficits (expressed in terms of ESA2010) decreasing from 2.9%[117] in 2018 to 2% of GDP in 2020 based on a growth scenario of 5.6% on average, the EC estimates in the spring forecast an ESA deficit of 3.7%[118] of GDP for 2018, adding an estimated impact of the LUR implementation of -2% of GDP, the estimated economic growth for 2018 being only 3.7%.

The Fiscal Council notes that the construction of the budgetary framework for the period 2017-2020 is in flagrant contradiction with the principles and rules established by the FRL and with the fiscal governance treaties at the European level at which Romania adhered observing a *de facto* failure of the fiscal framework based on rules, which have not been able to exert strong constraints on fiscal policy makers, revealing on the medium term a major bugetary slippage generated by a mix of aggressive tax cuts, especially on consumption combined with significant increases in budget expenditures, in particular related to wages. In this context, on 22 May 2017, in accordance with Article 121 (4) of the TFEU and Article 10 (2) of Regulation (EC) no. 1466/97, the European Commission (EC) issued a warning to Romania regarding the observation of a significant deviation from the MTO in 2016 and the lack of correction by at least 0.5% of GDP in 2017, following to be initiated the procedures laid down in EU law.

Moreover, since 2016, Romania has one of the lowest share of the budget revenues in GDP at the European level, which will greatly complicate the budget construction in the medium-term, especially in the context of the implementation of the Law on Unique Remuneration in the public sector, which foresees substantial increases in the public sector wages in the coming years. **The persistence in the next period of high budget deficits implies, in the upswing phase of the economic cycle, maintaining public debt expressed as a share of GDP on an upward trajectory, instead of using such a period, in a prudential manner, to reduce indebtedness, which would make possible to accommodate vulnerabilities from an inevitable downward phase of the**

[117] Respectively, a structural deficit of 3% of GDP.

[118] Respectively, a structural deficit of 4% of GDP.

economic cycle[119]. Once again, we emphasize that the idea that it would be sufficient to keep the budget deficit below 3% of GDP is incorrect; this level is not a "target", but rather a ceiling that is allowed to be attained only under adverse cyclical effects of deep recession, which is obviously not the case for Romania, having the second highest economic growth rate in EU (after Malta). Moreover, according to the EC projections, Romania is among the few EU countries that have reversed the fiscal consolidation trend and the magnitude of the increase in the structural budget deficit in the period 2017-2020 is the highest in the EU. The Fiscal Council considers that there is a major qualitative difference between having high structural / headline deficits following a less steep fiscal adjustment path than would be required, as is the case with many EU countries, and the achievement of a high structural/headline deficit following a deliberate fiscal slippage, in flagrant contradiction with both the principles and rules established by the European Treaties and adopted in national legislation, as well as economic theory and experience at national and international level. Moreover, it is noted that the limit associated with the budget deficit is exceeded, together with the deterioration of the quality of public spending, in the sense of increasing the share of wage and social assistance expenditure, to the detriment of those generating long-term economic growth, like investment, education or health expenditures.

[119] According to a study by the NBR, at a level of 40-45% of GDP for public debt, there is an adverse effect on the economic growth. According to FC calculations, based on EC projections for medium term economic growth, the public debt will be maintained within this interval.

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Appendix – Glossary of terms

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Disinflation - process of reducing inflation.

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

Economic growth - annual growth rate of the real GDP

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Nominal variables – variables expressed in current prices.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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