Fiscal Council of Romania

Note on the Medium-Term Fiscal-Structural Plan (MTP)

Introduction

In April 2024, the European Union (EU) adopted the new economic governance framework. It maintains the two thresholds from the Maastricht Treaty: a budget deficit no higher than 3% of GDP and public debt no higher than 60% of GDP. However, to simplify the rules and increase transparency, it introduces a single operational indicator – the net expenditure trajectory – to ensure the sustainability of the budget deficit and public debt.

In EU documents, there are two references to net expenditures. On the one hand, in Regulation (EU) 2024/1263, net expenditures are defined as public expenditures excluding interest payments, discretionary revenue measures, expenditures related to EU programs that are fully covered by EU funds, national expenditures for co-financing EU-funded programs, cyclical elements of unemployment benefits expenditures, exceptional measures, and other temporary measures. On the other hand, in the debt sustainability analysis report[1], the determination of the net expenditure trajectory is based on the structural primary balance. The existence of two calculation methods for net expenditures raises some questions regarding the comparability of the results obtained.

Each member state will develop a medium-term fiscal-structural plan (MTP)[2] based on the net expenditure trajectory, including measures, reforms, and investments that will anchor the budget deficit and public debt. States may opt for an additional set of reforms and investments, provided they meet certain criteria, in which case the MTP period can be extended from four to seven years.

Compliance with the net expenditure trajectory must ensure that, after the MTP implementation period, under a no-policy-change scenario, the public debt-to-GDP ratio follows a plausibly

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[1] *Debt Sustainability Monitor 2024*, p. 114.

[2] According to the regulations of the new economic governance framework, the MTP includes the macroeconomic assumptions underlying it; the planned fiscal-structural measures to comply with the limits and requirements regarding public debt and budget deficit; how the member state will ensure the implementation of reforms and investments; actions taken to address country-specific recommendations; the impact of reforms and investments already implemented by the respective member state, with particular attention to their effect on budget revenues and expenditures; other information regarding key macroeconomic and budgetary assumptions, the impact of reforms and investments, public investment needs etc.

declining trajectory or remains below 60% of GDP in the medium term, while the budget deficit falls below 3% of GDP during the adjustment period and remains under this level in the medium term.

On March 6, 2025, the EU decided to adopt a plan to strengthen its defense capacity, amounting to €800 billion (the main milestones of which are described in Annex 1). Of this amount, €650 billion will come from increased national defense expenditures, while €150 billion will be raised by the EU through bond issuance and subsequently lent to member states. To support the increase in defense spending, the activation of the national derogation clause, included in the new economic governance framework regulations, has been proposed. Thus, additional defense expenditures of up to 1.5% of GDP may not be considered deviations from the net expenditure trajectory. However, the exemption mechanism has not yet been detailed. Under these conditions, member states' MTPs could be revised to incorporate the EU's defense capacity strengthening measures and their financial impact.

Romania's Medium-Term Fiscal-Structural Plan

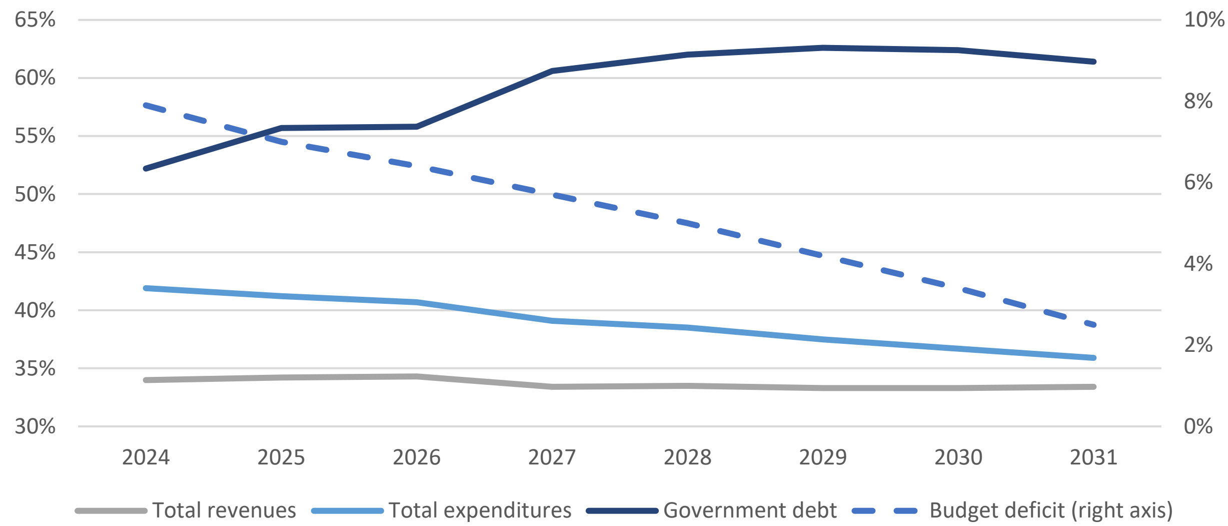
Romania published its MTP in October 2024, and in November 2024, it was approved by the Council. Since the budget deficit exceeded the reference value, Romania included in the MTP the net expenditure trajectory established by the European Commission.

The Romanian authorities defined in the MTP the necessary measures, reforms, and investments to reduce and maintain the budget deficit below 3% of GDP and to decrease public debt, requesting a seven-year adjustment period in exchange for committing to additional reforms and investments. This extension of the adjustment period was approved by the European Commission. Strict adherence to the commitments in the MTP is essential for the success of fiscal consolidation and for stabilizing the public debt-to-GDP ratio according to the current timeline.

Over a seven-year horizon, the MTP projects an adjustment of the ESA budget deficit from an estimated 7.9% of GDP in 2024 to 2.5% of GDP in 2031, with an average annual adjustment step of approximately 0.77 percentage points (Figure 1). The budget execution for 2024 indicates a cash deficit of around 8.7%. However, considering the annualization of the impact of pension recalculations, the starting point for 2025 is around 9.5% of GDP. In this context, to reach the deficit target set in the MTP, the adjustment step in 2025 would need to be approximately 2.5 percentage points!

Although the seven-year consolidation horizon implies a more balanced fiscal effort, it entails several risks related to the duration of the electoral cycle, a steeper upward trajectory of public debt during the MTP implementation period compared to a four-year period, and potential market pressures for a faster correction.

Figure 1: Budget deficit, total revenues, total expenditures, and public debt according to the MTP (% of GDP)



Source: MTP

Additionally, the historical analysis of budget deficit projections reveals a high risk of deviation from targets, especially over a longer projection horizon (Figures 2 and 3). A review of the budget planning documents of the Ministry of Finance (MF) shows a significant deviation of the actual deficit from the assumed targets over a four-year horizon (t + 4). Moreover, since 2016, there has been a sharp increase in the actual budget deficit compared to the targets set for a four-year horizon. These historical trends negatively impact the credibility of medium-term fiscal and budgetary commitments.

Figure 2: Budget deficit target in year t+1 and actual budget deficit

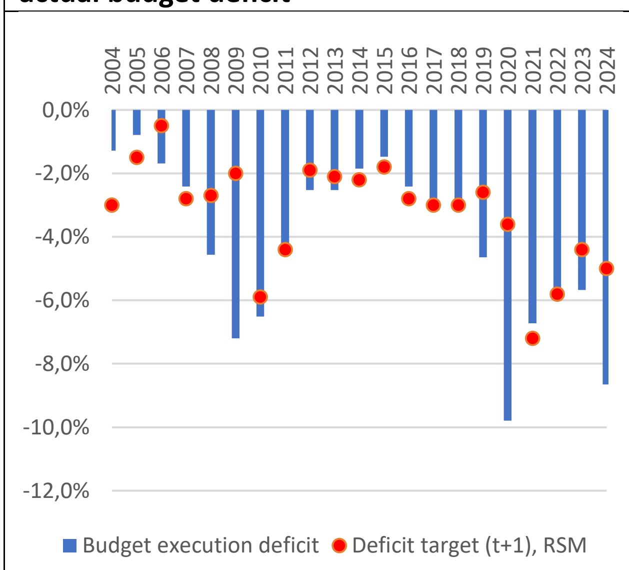
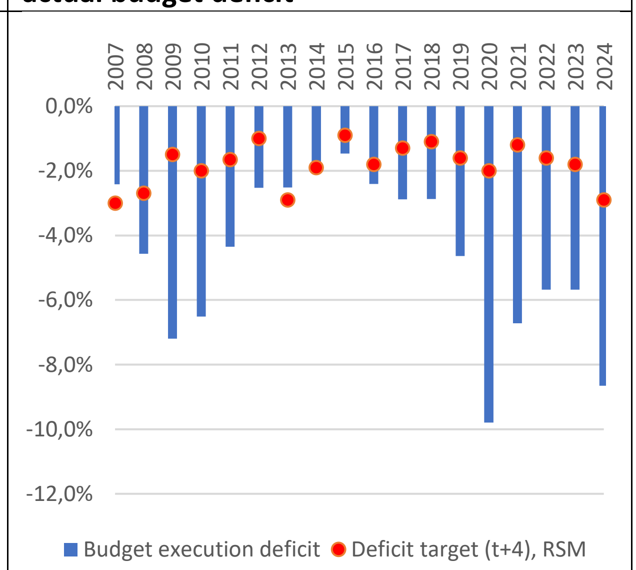


Figure 3: Budget deficit target in year t+4 and actual budget deficit

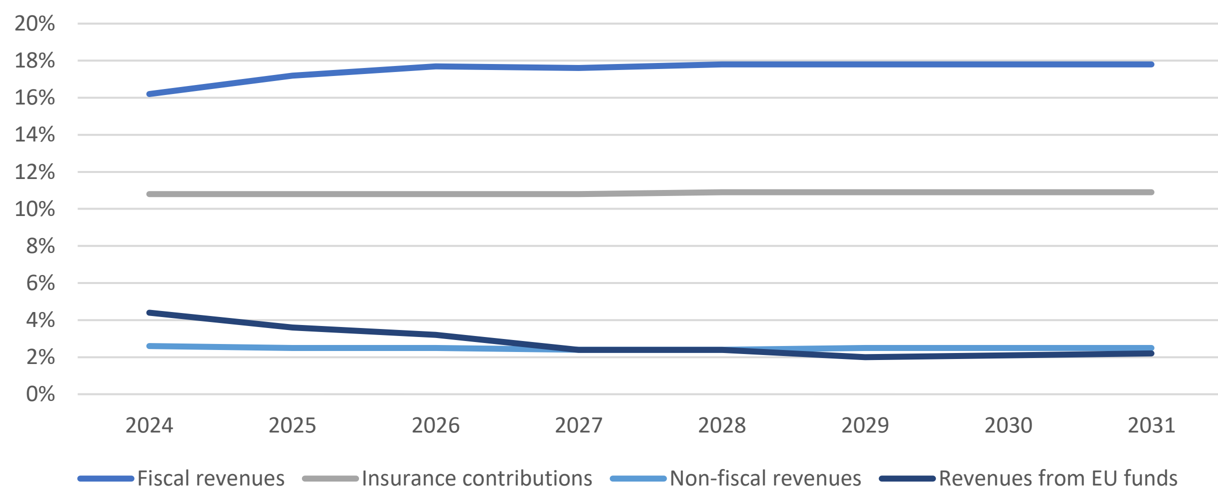


Source: MF reports on the macroeconomic situation, 2004-2024

Projection of the main categories of budget revenues included in the MTP

On the revenue side, the MTP anticipates a decrease in the share of total revenues in GDP by 0.6 percentage points, from 34% in 2024 to 33.4% in 2031. The following changes are projected for the main revenue categories (Figure 4): tax revenues, increase of 1.6 pp (from 16.2% of GDP in 2024 to 17.8% of GDP in 2031); social security contributions, increase of 0.1 pp (from 10.8% of GDP in 2024 to 10.9% of GDP in 2031); non-tax revenues, decrease of 0.1 pp (from 2.6% of GDP in 2024 to 2.5% of GDP in 2031); EU funds received, decrease of 2.2 pp (from 4.4% of GDP in 2024 to 2.2% of GDP in 2031), due to the completion of the National Recovery and Resilience Plan (NRRP) and a reduction in EU agricultural funds. Thus, the most significant changes in budget revenue categories are observed in tax revenues (+1.6 pp during the adjustment period) and EU funds (-2.2 pp during the adjustment period).

Figure 4: Projection of the main revenue categories according to the MTP (% of GDP)



Source: MTP

The increase in tax revenues is planned to be achieved through the implementation of tax reform, as outlined in milestones 207[3], 208[4], and 237[5] of NRRP, with a minimum impact of 1.1% of GDP in 2025, net of the effect of raising the tax-exempt threshold for pension income. It is important to note that in the MTP the 1.1% of GDP increase is not broken down by tax revenue categories, with

[3] It provides for the revision of the fiscal framework through the entry into force of: (i) amendments to the Fiscal Code (Law No. 227/2015) aimed at reducing and/or eliminating certain tax incentives to simplify the tax system, making it more efficient, transparent, and fair; (ii) legislation extending environmental taxation. The new law will amend the Fiscal Code by implementing the recommendations resulting from the review of the tax system to ensure that the tax system contributes to promoting and maintaining sustainable economic growth.

[4] It provides for the revision of the fiscal framework through the entry into force of amendments to the Fiscal Code (Law No. 227/2015) that gradually reduce tax incentives for employees in the construction sector.

[5] It provides for technical assistance for the revision of the fiscal framework, specifically for the creation of an operational IT system that enables the implementation of an automated property valuation model for properties subject to property taxes. These values will be used to determine the tax base for property taxation.

the document stating that specific measures will be determined based on scenarios developed by the World Bank under milestone 205. These scenarios are included in the World Bank's report on Romania's tax system, published in March 2023, with a brief summary provided in Annex 2. Given that transparency is one of the objectives of the new economic governance framework, it would have been advisable for the MTP to include the specific fiscal measures along with their expected impact. This would also have upheld the principle of predictability, considering that these measures aim to increase tax revenues by 1.1% of GDP in 2025.

In addition to fiscal measures, the MTP projects an improvement in tax revenue collection, with an impact of 0.5% of GDP starting in 2026.

The 2025 budget proposal has already been built on the assumption of improved tax revenue collection, with an anticipated effect of approximately 0.5% of GDP. Additionally, measures have been adopted to lower the revenue threshold for micro-enterprises, eliminate tax incentives for employees in the construction, agriculture, food industry, and software development sectors, increase the dividend tax, and introduce a special construction tax. The budgetary impact of these measures is estimated by the Ministry of Finance at approximately 0.4% of GDP. However, the tax reform, which was expected to generate an increase in revenues of 1.1% of GDP, was not included in the 2025 budget proposal. To meet the revenue targets set in the MTP, a tax reform could be adopted in 2026, but at this time, there is no commitment from the authorities in this regard.

The decrease in EU funds received (-2.2 pp during the adjustment period) is mainly driven by the reduction in agricultural funding (-1.6 pp during the adjustment period) and the conclusion of the NRRP in 2026 (-0.9 pp). On the other hand, EU funds from the cohesion policy are projected to increase by 0.3 pp (1.6% of GDP in 2031 compared to 1.3% of GDP in 2024).

Current data indicate that the absorption of EU funds is significantly delayed. As of the end of December 2024, according to data from the Ministry of Finance, the actual absorption rate[6] of structural and cohesion funds (SCF) from the 2021-2027 Multiannual Financial Framework (MFF) (excluding SCF advances) was only 2%[7]. To meet the targets set in the MTP, it is essential for Romania to maximize the absorption of SCF related to the 2021-2027 MFF, with total allocations amounting to €31 billion, leveraging the experience from the previous financial period, when, under the n+3 rule, a nearly 100% absorption rate was achieved[8].

Romania has also been allocated approximately €28.4 billion through the National Recovery and Resilience Plan. By December 2024, Romania had received pre-financing of €4.1 billion (€2.14 billion in grants and €1.94 billion in loans) and managed to obtain European Commission approval for only two payment requests totaling €5.3 billion (€3.6 billion in grants and €1.7 billion in loans).

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[6] The actual absorption rate represents the ratio between reimbursements from SCF by the European Commission and the total allocated funds. SCF advances, even if partially or fully used (as shown in Table 1), represent expenditures that are yet to be validated (or not) by the European Commission and therefore cannot be considered in the calculation of the actual absorption rate.

[7] https://mfinante.gov.ro/static/10/Mfp/buget/sitebuget/BFN_2024_12_31.pdf

[8] https://mfe.gov.ro/stadiul-absorbtiei-fondurilor-ue/

This low level of progress over a four-year period, compared to the deadline for completing all milestones and targets under the NRRP, is concerning. By the end of December 2024, only 14% of milestones and targets had been met[9], making it unlikely that delays can be recovered in just a year and a half. This raises the risk of losing significant EU funds and failing to implement crucial reforms and investment programs that could have helped keep Romania on a path of sustainable development – by accelerating the green and digital transition, restructuring the economy, modernizing infrastructure, and increasing competitiveness. These efforts would have implicitly supported fiscal consolidation. This situation is even more concerning given the significant deterioration of the international environment.

Moreover, despite the low actual absorption rate, data from the Ministry of Investments and European Projects (MIEP) on the timeline of competitive and non-competitive calls under the NRRP indicate the launch of calls totaling approximately €19.8 billion[10]. Additionally, MIEP data on the list of the 100 largest projects contracted under the NRRP, as of September 25, 2024, show a cumulative value of approximately €15.1 billion[11]. These figures, along with other available data, suggest that the total value of contracts signed under the NRRP exceeds €40 billion, including contributions from national funds. Given the significant delays in implementing the NRRP, there is a high degree of uncertainty regarding the financing of already contracted projects. Completing these projects using national funds poses a significant risk of deviation from the budget deficit adjustment trajectory assumed by Romania in the MTP.

Another important factor that may influence the dynamics of EU funds during the adjustment period of the MTP is the 2028-2034 Multiannual Financial Framework (MFF). There is a possibility that, as per capita income increases, the share of GDP represented by the structural and cohesion funds allocated to Romania may decrease.

Given these factors, along with the high pressures on public spending (for defense, education, and healthcare), we emphasize the importance of adopting fiscal policies that more consistently support the fiscal consolidation trajectory by increasing tax revenues. The share of tax revenues in GDP should move closer to the regional average (27% of GDP in Romania, compared to 34% in the Czech Republic, 35% in Hungary, and 36% in Poland, and an EU average of 40% in 2023). This approach would offset the reduction in EU funds and support the implementation of public policies in the current context, marked by significant economic, social, political, and geopolitical tensions.

The need to increase tax revenues is further emphasized by the recent EU decisions to invest €800 billion in strengthening defense capacity. In this context, Romania has announced a gradual increase in defense spending, which is expected to reach approximately 3% of GDP over the next

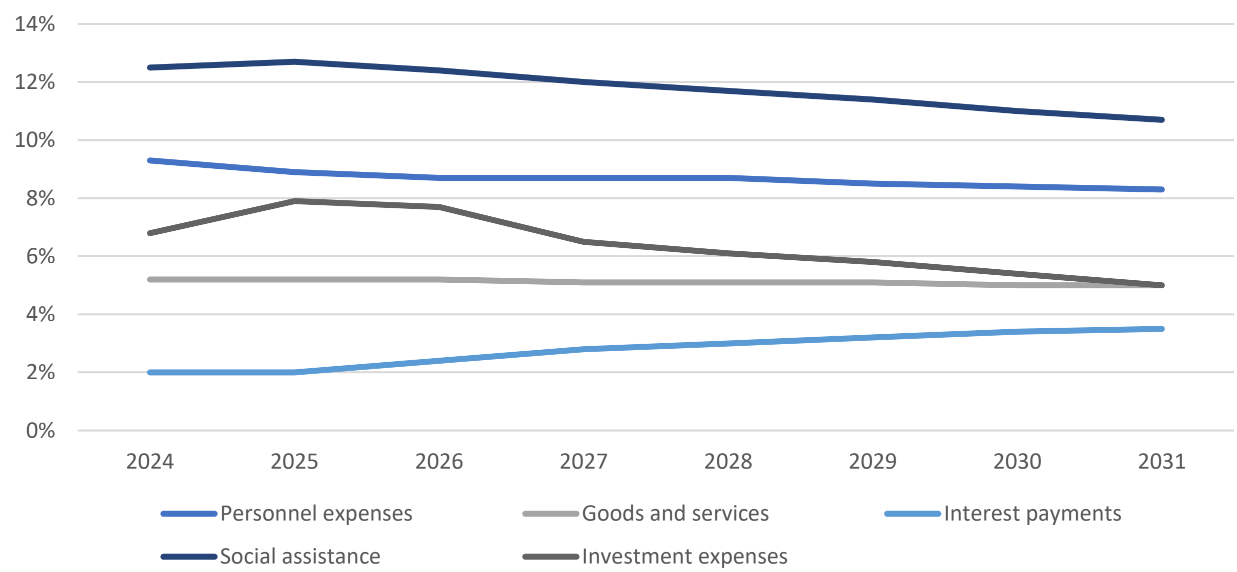
[9] https://ec.europa.eu/economy_finance/recovery-and-resilience-scoreboard/country_overview.html?lang=en
[10] https://mfe.gov.ro/wp-content/uploads/2023/10/c8c4f4c9e85ecdb40aef8d352d3bd1b1.xlsx
[11] https://mfe.gov.ro/wp-content/uploads/2024/10/b5cdbd808d7f9973463f49782956f28a.xlsx

two years[12]. Even if the national derogation clause were activated, defense investments would still impact budget execution, contributing to a higher actual deficit and increased public debt. Therefore, additional defense expenditures must be supported through fiscal consolidation measures.

Projection of the main categories of budget expenditures included in the MTP

On the expenditure side, the MTP projects a significant reduction in the share of expenditures in GDP, by approximately 6 pp, from 41.9% of GDP in 2024 to 35.9% of GDP in 2031, as follows (Figure 5): personnel expenditures, decrease of 1 pp (from 9.3% of GDP in 2024 to 8.3% of GDP in 2031); social assistance expenditures, decrease of 1.8 pp (from 12.5% of GDP in 2024 to 10.7% of GDP in 2031); investment expenditures, decrease of 1.8 pp (from 6.8% of GDP in 2024 to 5% of GDP in 2031); interest expenditures: increase of 1.5 pp (from 2% of GDP in 2024 to 3.5% of GDP in 2031), due to the rise in public debt.

Figure 5: Projection of the main expenditure categories according to the MTP (% of GDP)



Source: MTP

Regarding personnel expenditures, except for 2025, the projected levels for the 2025-2031 period assume an annual nominal increase higher than the estimated average annual inflation rates for the same period: 2025, increase of 3.1% vs. an average inflation of 4.2%; 2026, increase of 5.1% vs. an average inflation of 3.3%; 2027, increase of 7.3% vs. an average inflation of 3%; 2028, increase of 7% vs. an average inflation of 3%; 2029, increase of 4.3% vs. an average inflation of

[12] https://www.caleaeuropeana.ro/ilie-bolojan-sustine-ca-bugetul-romaniei-pentru-aparare-ar-putea-creste-etapizat-si-sa-ajunga-la-3-din-pib-intr-un-an-sau-doi/

3%; 2030, increase of 5.3% vs. an average inflation of 3%; 2031, increase of 5.1% vs. an average inflation of 3%.

For 2025, the analysis of MTP data indicates a freeze on public sector salaries, with the 3.1% nominal increase resulting from the carryover of salary increases granted in 2024 throughout the entire year 2025. This finding is confirmed by the general consolidated budget adopted for 2025.

Over the period covered by the MTP, the annual growth rates of personnel expenditures remain below the nominal GDP growth rates: 7.7% in 2025, 7.5% in 2026, 7.3% in 2027, 7% in 2028, 6.8% in 2029, 6.6% in 2030, and 6.4% in 2031. Under these conditions, the share of personnel expenditures in GDP is projected to decrease. The realization of this trajectory depends on keeping personnel expenditures within the planned limits, as well as on the materialization of MTP forecasts regarding economic growth and inflation trends.

The share of social assistance expenditures in GDP is projected to decrease by approximately 1.8 pp by 2031. For this expenditure category, the following nominal growth rates are forecasted: 9.4% in 2025, 5% in 2026, 3.8% in 2027, 4.3% in 2028, 4.1% in 2029, 2.9% in 2030, and 3.5% in 2031. Similar to personnel expenditures, the annual growth rate of social assistance expenditures is higher than the projected average annual inflation rate, but – except for 2025 – it remains lower than the annual nominal GDP growth rate.

It should be noted that the projected level of social assistance expenditures in 2025 includes the annualized impact of pension recalculations. Thus, by adjusting the baseline social assistance expenditures (as recorded in 2024) to account for the annualized impact of pension recalculations, it becomes evident that the MTP has effectively projected a freeze on social assistance expenditures in 2025. This finding is confirmed by the general consolidated budget adopted for the current year.

Considering the state pension indexation formula, the MTP projections for the average inflation rate, the dynamics of social security contribution revenues, and the real growth of the gross average wage projected by NCSF, calculations suggest that the indexation percentage for SSIB (State Social Insurance Budget) pensions will be capped over the entire projection horizon by the average annual inflation rate of the last two years. As a result, state pensions should be indexed as follows: 8% in 2026, 4.9% in 2027, 3.8% in 2028, 3.2% in 2029, 3% in 2030, and 3% in 2031. Taking into account the provisions of the new pension law regarding the application of the indexation mechanism, as well as the fact that other categories included in social assistance are adjusted based on different rules, which typically imply a lower indexation rate than pensions' budget, the data suggest that starting from 2026, public system pensions will be indexed in accordance with the provisions of the new pension law.

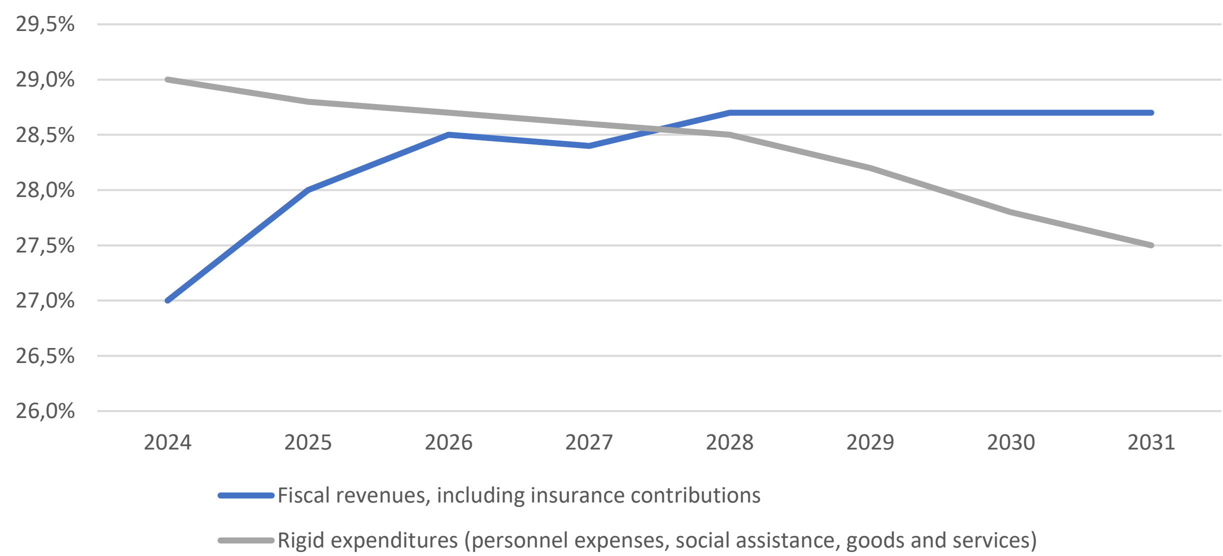
The evolution of expenditures on goods and services reflects an adjustment of 0.2 pp of GDP during the MTP implementation period. The annual growth rate of these expenditures is higher than the projected average annual inflation rate but lower than the GDP growth rate in 2027 and

2030. Compared to historical data, starting in 2027, the share of this aggregate in GDP is projected below the average level of expenditures on goods and services during 2020-2024, which stood at approximately 5.2% of GDP. This projection raises risks regarding compliance with the expenditure ceilings set in the MTP.

The share of interest expenditures in GDP is projected to increase by 1.5 pp. This trajectory is driven by the upward projection of public debt during the adjustment period and the persistence of high financing costs. Public debt is expected to rise from 55.7% of GDP in 2025 to 62.6% of GDP in 2029, before decreasing slightly to 61.4% of GDP in 2031. Notably, at the end of 2024, the public debt-to-GDP ratio reached 54.6%[13], which is 2.4 pp higher than the MTP estimate for 2024.

Investment expenditures are projected to decrease significantly compared to 2024, by 1.8 pp of GDP. According to the MTP, investment expenditures are expected to peak in 2025 at 7.9% of GDP, before following a downward trajectory until the end of the adjustment period, reaching 5% of GDP in 2031. The decline in investment expenditures is primarily driven by the reduction in EU fund allocations, due to the completion of the NRRP, as well as a slight decrease in public investments financed from national funds.

Figure 6: Projection of tax revenues and rigid expenditures according to the MTP (% of GDP)



Source: MTP

Summarizing the projected evolution of the MTP for the main categories of budget revenues and expenditures, it is observed that, excluding the impact of EU funds, the adjustment is expected to be achieved through an increase in tax revenues by 1.6 pp of GDP, alongside a reduction in the GDP share of personnel, social assistance, and goods and services expenditures, which are projected to reach minimum levels towards the end of the adjustment period. However, by 2031, tax revenues are anticipated to be only 1.2 pp of GDP higher than rigid expenditures (which

[13] https://mfinante.gov.ro/static/10/Mfp/buletin/executii/EvdatguvconformUERo122024.pdf

include personnel, social assistance, goods and services, and interest payments – Figure 6). Under these conditions, the expected decline in investment expenditures (-1.8 pp of GDP), due to reduced EU fund allocations, is not offset by the evolution of tax revenues, considering the anticipated increase in interest expenditures (+1.5 pp of GDP). To support an adequate level of public investments that meets Romania's development and defense needs, it is essential to increase the gap between tax revenues and rigid expenditures.

Conclusions

The MTP analysis shows that it is built on the assumption of strict control over budget expenditures and slower progress in tax revenue growth. At the same time, the share of public investments in GDP is projected to decline. Maintaining the budget deficit reduction trajectory requires a significant increase in tax revenues, which are currently very low relative to Romania's investment needs and compared to other EU countries. Increasing tax revenues is crucial for the domestic economy to: build fiscal buffers, offset the anticipated decline in EU funds with own resources, meet the rising defense spending needs, address other challenges and adverse shocks.

In the absence of fiscal policies that more strongly support the fiscal consolidation trajectory on the revenue side, the balance of risks is tilted towards higher deficits than those projected in the MTP. This observation is particularly relevant given the evolution of the international environment and the major challenges facing economic policies.

The fiscal-budgetary outlook projected in the MTP involves a series of risks and uncertainties, considering both the domestic and external context.

Historical data indicate that budget execution has generally deviated systematically from the medium-term targets set in fiscal planning documents. Moreover, since 2016, the budget deficit deviation from medium-term targets has followed an upward trend, weakening the credibility of the commitments made by the authorities.

Additionally, there is a lack of coherence between the MTP, the measures actually adopted for 2025, and the projections for 2026-2028 outlined in the Fiscal Strategy (FS) and the Macroeconomic Situation Report (MSR), with differences analyzed in Annex 3. These discrepancies increase uncertainty regarding Romania's commitment to complying with the rules of the new economic governance framework and anchoring the budget deficit on a downward trajectory.

Additionally, the MTP outlines general measures regarding the trajectory of revenues and expenditures. However, the lack of concrete measures and detailed data on revenue categories makes it difficult to assess the feasibility of meeting these targets. Committing to clear measures and adhering to them, although it may entail short-term political costs, ultimately strengthens investor confidence in Romania in the long run.

In 2023 and 2024, discretionary fiscal measures, amplified by the political and electoral context, led to substantial deviations of the budget deficit from the assumed targets, while public confidence in institutional governance declined significantly. Furthermore, multiple derogations from national fiscal rules[14] exacerbated the effects of the electoral cycle on budget execution and discretionary policies. The national fiscal rules and the rules of the new economic governance framework, as incorporated into the MTP, can serve as credible anchors around which realistic annual budgets can be built.

With the adoption of the 2025 budget, the authorities have committed to a series of efficiency-enhancing and expenditure-restricting measures, which have been highlighted in public communications during the first months of 2025. These measures represent a step forward; however, given the underfunding of education, healthcare, and national defense, fiscal adjustment solely through expenditure cuts is not feasible.

Regarding the level of tax revenues, their share in GDP is low compared to other countries in the region (27% of GDP in Romania, compared to 34% in the Czech Republic, 35% in Hungary, and 36% in Poland in 2023). Additionally, the structure of the tax burden – such as high tax pressure on low wages, imbalances between labor and capital taxation, and the lack of strong measures to support demographic, educational, and healthcare policies – affects economic and social resilience.

The high and increasing budget deficits in recent years, fiscal uncertainties, and political tensions have led to a rise in Romania's borrowing costs. Without tangible progress in fiscal consolidation, the adjustment of the deficit will be left to financial markets. However, if markets drive the adjustment – especially given that 51% of Romania's public debt is denominated in foreign currency – the process will be swift and extremely painful. Its effects could simultaneously require both tax increases and additional restrictions on public spending.

Beyond domestic factors, external tensions have intensified, potentially having broad negative effects on Romania's economy. The new US administration has signaled the possibility of raising tariffs on EU products and the need for NATO member states to increase defense spending to 5% of GDP. At the same time, the US has imposed additional tariffs on China, Mexico, and Canada.

The imposition of tariffs on US imports by the Trump administration has triggered retaliatory measures from affected countries, exacerbating tensions, reducing investments and market efficiency, weakening economic growth prospects, and once again fragmenting global supply chains. As noted in a recent IMF report[15], the greatest risk is the resurgence of aggregate inflation, which would force central banks to raise benchmark interest rates and tighten monetary policies. It is also important to note that if the EU becomes subject to increased US tariffs, the automotive sector is expected to be the most affected. Germany – the EU's largest exporter to the US in the

[14] http://www.fiscalcouncil.ro/8.%20FC%20-%20Position%20Note%20on%20the%20Public%20Budget%20and%20Fiscal%20Rules.pdf

[15] https://www.imf.org/en/Publications/WEO/Issues/2025/01/17/world-economic-outlook-update-january-2025

automotive sector ($17 billion in vehicle exports) – is already facing significant challenges in this industry, which could have both direct and indirect effects on Romania's exports.

The declining trend of the automotive industry – a pillar of the development model in many European countries and a key factor in global competition – is being further exacerbated by the technological advancements of China's automotive sector. Unfortunately, European business models do not currently point to another sector capable of offsetting this slowdown. Additionally, in the semiconductor and artificial intelligence competition, which are emerging as the new drivers of economic growth, Europe lags behind both the US and China.

As a result, medium-term fiscal plans should incorporate risk scenarios that consider both domestic and external risks. If these risks materialize, the new economic governance framework should include mechanisms for revising fiscal plans in line with evolving realities.

This note was approved by the Chairman of the Fiscal Council, in accordance with the provisions of Article 56, paragraph (2), letter d) of Law No. 69/2010, republished, following its adoption by the Council members through a vote in the meeting held on March 24, 2025.

March 24, 2025 Chairman of the Fiscal Council

Professor Daniel DĂIANU

Annex 1: The European Union's Defense Capacity Strengthening Plan

On March 6, 2025, the EU announced a defense capacity strengthening plan worth €800 billion[16]. The proposal comes in response to growing concerns regarding security and defense autonomy.

The mobilization of the €800 billion is planned to take place over the next four years. Of this amount, €650 billion is expected to come from increased national defense expenditures, requiring member states to raise their defense spending by approximately 1.5% of GDP (the current EU average defense spending is around 2% of GDP). The remaining €150 billion will be financed through EU-guaranteed loans, raised via bond issuance and subsequently lent to member states. These funds will be primarily allocated to finance air and missile defense acquisitions, artillery systems, missiles, and ammunition, drones and anti-drone systems, as well as to cover other defense needs, including cybersecurity and military mobility.

A key pillar of the plan is the relaxation of fiscal rules. To support the increase in defense spending, the activation of the national derogation clause from the new economic governance framework has been proposed. This would allow additional defense expenditures of up to 1.5% of GDP to not be considered deviations from the net expenditure trajectory.

In addition to the common borrowing instrument and fiscal rule relaxation, the European Commission has proposed three additional measures to support the European defense capacity strengthening plan: i) encouraging defense investments from the EU budget; ii) adapting the mandate of the European Investment Bank (EIB) to facilitate defense-related financing; iii) mobilizing private capital to support defense industry growth.

In the short term, the EU encourages member states to redirect funds from cohesion programs – which aim to reduce economic disparities between EU regions – toward defense and security. To facilitate this, the European Commission proposes relaxing the rules of cohesion programs, particularly by removing restrictions on financial support for defense companies and introducing incentives for their financing.

At the European Investment Bank, a working group has been established to develop an action plan aimed at increasing financing for European defense companies. Another key objective of this plan is to ensure that the EIB's current financing capacity is not reduced.

Mobilizing private capital is another key objective of the European defense capacity strengthening plan. This goal could be achieved by retaining a greater share of European household savings within the EU's internal market. In 2023, available data indicated that a significant portion of European household savings was invested in external markets, reflecting the EU's current account surplus of approximately €330 billion. To encourage investment of these savings within the EU, authorities have announced a plan to establish a European Union of Savings and Investments.

[16] https://ec.europa.eu/commission/presscorner/detail/en/ip_25_684

This initiative aims to boost venture capital and promote seamless capital flows across the EU, removing barriers to investment within the internal market.

It is important to note that in the coming period, the details of the European defense capacity strengthening plan will be discussed and finalized. However, its architecture is not without risks.

The burden of financing additional defense expenditures falls primarily on member states, impacting budget balances and public debt. An S&P analysis indicated that raising defense spending to 3.3% of GDP (the level in the US) would push the budget deficit above 3% of GDP in most EU countries[17]. Although the national derogation clause has been announced for the medium term, in the long term, additional defense expenditures must be covered either by increasing national revenues or by reducing other categories of budget expenditures.

The increase in defense spending will be directed toward the European defense industry, with the goal of supporting economic growth. However, in the EU, the multiplier effect of defense expenditures is lower than in the US, as the European arms industry relies heavily on imports. A report by the Stockholm International Peace Research Institute (SIPRI) indicates that 64% of the arms imports of European NATO countries come from the US[18]. Additionally, the European defense industry is highly fragmented, as each country tends to favor its own national producers, limiting economies of scale and cooperation across the EU.

Military acquisitions represent an important step toward strengthening Europe's defense capacity, but human resources are another crucial element. Demographic projections for the EU population, along with high immigration rates in developed EU countries, could pose a challenge in identifying sufficient human resources to support defense capabilities.

[17] https://www.spglobal.com/ratings/en/research/articles/250213-european-defense-funding-what-are-the-options-13399615

[18] https://www.sipri.org/media/press-release/2025/ukraine-worlds-biggest-arms-importer-united-states-dominance-global-arms-exports-grows-russian

Annex 2: Recommendations of International Financial Institutions on Fiscal Framework Reform

In the NRRP, under the pillar on Smart, Sustainable, and Inclusive Economic Growth, a key component is represented by fiscal reforms and the pension system reform.

Regarding fiscal reforms, the most important measures focus on reforming National Agency of Fiscal Administration (NAFA) through digitalization, modernizing the customs system and implementing electronic customs, improving the budget programming mechanism, revising the fiscal framework, creating and operationalizing the Investment and Development Bank, enhancing tax administration processes, and ensuring that the Ministry of Finance and NAFA have the capacity to respond to current and future informational challenges. According to the NRRP, the implementation of these measures is expected to increase the share of tax revenues in GDP by 3 pp, and reduce the VAT collection gap by 5 pp. Both indicators are measured relative to the average values of 2019 and 2020.

An important set of measures focuses on the digitalization of NAFA. According to the NRRP, the milestones included in this component are expected to lead to an increase in revenues collected by the tax administration by at least 2.5 pp of GDP, and a reduction in the VAT collection gap by 5 pp.

As part of the fiscal framework revision component, four measures are included: i) analysis of Romania's tax system to formulate recommendations ensuring that the tax system supports sustainable economic growth; ii) amendments to the Fiscal Code to gradually reduce the scope of the special tax regime for micro-enterprises; iii) amendments to the Fiscal Code to reduce and/or eliminate other tax incentives aimed at simplifying the tax system, making it more efficient, transparent, and fair, as well as the implementation of legislation extending environmental taxation; iv) amendments to the Fiscal Code to gradually reduce tax incentives for employees in the construction sector.

The first step in the tax system revision was achieved through the completion of milestone 205, which involved the analysis of Romania's tax system. This analysis was conducted by the World Bank (WB) and was published in March 2023. It is important to note that in the description of the milestone regarding amendments to the Fiscal Code, it is stated that these modifications will be made considering the recommendations formulated in the analysis of Romania's tax system.

The objectives of the recommendations formulated by the World Bank aim to: improve the structure of tax revenues, increase the share of tax revenues in GDP, eliminate loopholes in the tax system, simplify tax regulations, create a more efficient and equitable tax system, modify property taxation. The following table summarizes the tax framework revision recommendations proposed by the World Bank in the mentioned study.

Table 1: Recommendations Proposed by the World Bank for the Revision of the Fiscal Framework

Review Domains	Proposed Reforms	Scenarios	Impact and Observations
Personal Income Tax and Social Security Contributions	• Introduction of a progressive tax rate system for personal income tax. • Elimination of exemptions for personal income tax (construction, agriculture, and IT). • Removal of the health contribution (funding healthcare through general taxation) and/or introduction of a refundable earned income tax credit for low-income workers.	• Scenario 1: Maintaining the current tax rates, eliminating exemptions for personal income tax, and increasing the basic allowance (personal deduction). The fiscal impact is neutral, as the increase in deduction is offset by the elimination of exemptions. • Scenario 2: Increasing the income tax rate from 10% to 13% and introducing a refundable tax credit for low-wage earnings. • Scenario 3: Eliminating the deductibility of social security contributions, introducing three progressive tax rates for labor income (6% for incomes up to 80,000 RON/year; 12% for incomes between 80,001 RON/year and 189,000 RON/year; 18% for incomes over 189,000 RON/year), and introducing a refundable tax credit for low-wage earnings. • Scenario 4: Eliminating health insurance contributions, eliminating the deductibility of social security contributions, and introducing three progressive tax rates for labor income (10% for incomes up to 42,000 RON/year; 20% for incomes between 42,001 RON/year and 100,000 RON/year; 25% for incomes over 100,000 RON/year).	• All scenarios are designed to ensure neutrality of impact. • The proposed measures ensure a fairer distribution of the tax burden, encourage labor market participation, and reduce the number of people in the informal sector.
Capital tax	• Introduction of a fair taxation system for capital gains.	• Taxing all capital gains at 10%. • Granting exemptions for capital gains from owner-occupied properties. • Eliminating the tax on residential property sale transactions.	• No data is presented.
Corporate income tax	• Simplification of tax incentives for research and development. • Elimination of current tax exemptions. • Conducting a review of the efficiency of the tax exemption for reinvested profits.	• Simplification of tax incentives for research and development into a single deduction. • Elimination of the tax exemption for newly established enterprises. • Removal of the corporate tax reduction for companies that increase their share capital. • Replacement of the tax exemption for reinvested profits with an investment tax credit.	• No data is presented.
Microenterprise regime	• Lowering the eligibility threshold for microenterprises. • Reassessing the appropriate turnover tax rate and adjusting it if necessary.	• Gradual reduction of the microenterprise threshold towards the VAT registration threshold. • Measures to prevent the artificial splitting of microenterprises. • Simplification of the regime by transitioning to a pure turnover tax without allowing adjustments. • Assessment of the average profit margins of microenterprises to adjust tax rates accordingly.	• No data is presented.

Energy taxation	• Increasing excise rates on fossil fuels. • Gradual elimination of fossil fuel subsidies. • Additional carbon taxation. • Compensation for vulnerable groups.	• Scenario 0: Complete and gradual elimination of all fossil fuel subsidies, exemptions, and price controls. • Scenario 1: Introduction of a carbon price that covers both climate and non-climate externalities. • Scenario 2: Introduction of a carbon price that covers non-climate externalities (local air pollution, congestion, accidents, and road damage). • Scenario 3 (illustrative): Introduction of a carbon price of $185 per ton of CO2 in 2023 (in line with the Paris Agreement).	• Impact on revenues between 0.4% of GDP (Scenario 0) and 2% of GDP (Scenario 3). • These revenues should be redirected into the economy (in the form of cash transfers) to offset the negative impact on GDP due to higher carbon prices.
Property taxation	• Transition to a property taxation system based on market value. • Limiting the use of tax incentives for property tax. • Reevaluating the entire rate structure to increase total property tax revenues beyond the current level.	• Updating the market value of properties every 3-6 years. • Merging land and building taxes into a single property tax. • Equalizing tax rates for residential and non-residential buildings. • Setting tax rates to increase property taxation from 0.5% of GDP to approximately 1% of GDP (the EU average). • Granting targeted and clearly defined exemptions (for elderly individuals, low-income individuals, government buildings, and public utility buildings).	• Approximately 0.5% of GDP, if rates are set to increase the share of property taxation towards 1% of GDP - the EU average - compared to the current 0.5% of GDP.
VAT	• Elimination of reduced VAT rates.	• A single VAT rate on the broadest possible base.	• No data is presented.

Source: Report on Romania's Tax System, including Comparative Analysis and Recommendations for Fiscal Framework Reform, World Bank, March 2023.

Annex 3: Medium-Term Fiscal-Budgetary Outlook included in the Fiscal Strategy and the Macroeconomic Situation Report and differences compared to the Medium-Term Fiscal-Structural Plan

Currently, in Romania, the medium-term fiscal-budgetary framework is guided by three strategic documents: i) The Macroeconomic Situation Report (MSR)[19], ii) The Fiscal Strategy (FBS)[20], and iii) the National Medium-Term Fiscal-Structural Plan (MTP). A brief analysis of the elements included in the MSR, FS, and MTP highlights a significant overlap of information among these documents. To simplify and enhance the efficiency of the medium-term fiscal-budgetary framework, it is necessary to harmonize legislation. This would: increase transparency in the underlying assumptions, make deficit targets easier to track, and ensure clearer commitments to reforms and investments.

The fiscal-budgetary framework projected in the FS and MSR for the 2026-2028 period indicates a planned budget deficit adjustment, following the trajectory set in the MTP: 6.4% of GDP in 2026, 5.7% of GDP in 2027, and 5.0% of GDP in 2028.

The adjustment is primarily planned on the expenditure side. Compared to 2025: the share of total revenues in GDP is projected to decrease by 3.4 pp by 2028 (from 34.9% of GDP in 2025 to 31.5% in 2028). The share of budget expenditures in GDP is projected to decline by approximately 5.4 pp by 2028, compared to 2025 levels (from 41.9% to 36.5% of GDP)[21].

The analysis of the main categories of budget revenues reflects a marginal decrease in the share of current revenues in GDP and a more significant decline in the share of EU funds. More specifically: the share of tax revenues in GDP is projected to decrease by 0.15 pp in 2028 compared to 2025, the share of social security contributions remains relatively constant, non-tax revenues are estimated to decline by 0.2 pp of GDP. In contrast, EU funds received are projected to decline significantly, from 4.6% of GDP in 2025 to 1.5% in 2028, due to the completion of the NRRP. It is evident that in the FS and MSR, the reduction in EU fund allocations is not offset by an increase in the share of tax revenues in GDP.

[19] The Macroeconomic Situation Report (MSR) is drafted based on Article 35, paragraph 2, of Public Finance Law No. 500/2002. According to this provision, the draft state budget law must be accompanied by an MSR for the budget year for which the budget is being prepared, along with a macroeconomic outlook for the following three years. The MSR includes: a summary of macroeconomic policies within which the budget drafts were developed and the Government's strategy on public investments.

[20] The Fiscal Strategy is drafted based on Article 26 of the Fiscal Responsibility Law No. 69/2010. The FS includes: the macroeconomic framework and the fiscal-budgetary framework, including budget forecasts and fiscal-budgetary policy over a three-year period. According to the specified legislation, the FS must be prepared by the Ministry of Finance by July 31 of each year.

[21] A detailed analysis of the revenue and expenditure projections from the FS and MSR can be found in the Fiscal Council's Opinion on the State Budget Law for 2025, the Social Security Budget Law for 2025, and the Fiscal Strategy for the 2025-2027 period, available at: http://www.fiscalcouncil.ro/8.%20FC%20-%20Position%20Note%20on%20the%20Public%20Budget%20and%20Fiscal%20Rules.pdf.

Both the Fiscal Strategy and the Macroeconomic Situation Report list a series of measures planned for adoption during 2025-2028. However, considering the marginal decline in the share of tax revenues in GDP, the overall effect of these measures appears to be neutral. In comparison, the MTP projects an increase in the share of tax revenues by approximately 1.6 pp of GDP between 2025 and 2031, relative to 2024.

The downward trajectory of budget expenditures as a share of GDP is reflected in the dynamics of most expenditure categories: personnel expenditures decrease by 0.4 pp (from 8.9% of GDP in 2025 to 8.5% in 2028); social assistance expenditures decrease by 0.9 pp (from 12.7% of GDP in 2025 to 11.8% in 2028); investment expenditures decrease by 2.5 pp (from 7.8% of GDP in 2025 to 5.3% in 2028); expenditures on goods and services decrease by 0.5 pp (from 5% of GDP in 2025 to 4.5% in 2028); interest expenditures increase by 0.8 pp (from 2.2% of GDP in 2025 to 3% in 2028). A more significant decrease is also observed in EU-funded project expenditures. By 2028, compared to 2025, the share of EU funds in GDP decreases by approximately 4 pp, due to the completion of the NRRP.

The budget deficit projection and macroeconomic assumptions included in the Macroeconomic Situation Report and the Fiscal Strategy indicate a significant upward trajectory of public debt. By 2028, the last year covered in these two documents, the public debt-to-GDP ratio is projected to reach 63.4% of GDP.

The analysis of the medium-term fiscal-budgetary outlook described in the Fiscal Strategy and the Macroeconomic Situation Report, compared to the MTP, indicates that during 2026-2028, the intention is to follow the deficit reduction trajectory established in accordance with the rules of the new economic governance framework. However, differences arise in the volume of budget revenues and expenditures. The MTP projections for 2026-2028 are, on average, 1.6 pp of GDP higher than those in the FS and MSR, specifically: 1.3 pp higher in 2026, 1.6 pp higher in 2027, 2.0 pp higher in 2028.

On the revenue side, this difference is mainly reflected in tax revenues, which are on average 1.1 pp of GDP higher in the MTP compared to the FS and MSR. This discrepancy likely corresponds to the expected impact of the tax reform that was initially planned for 2025, with an anticipated budgetary impact of 1.1 pp of GDP. Additionally, the MTP revenue projections also factored in an additional 0.5% of GDP, expected to be achieved through improved tax collection efficiency starting in 2026. However, these hypothetical additional revenues are already incorporated into the revenue projections of the FS and MSR for 2026-2028, as they were included in the budget adopted for 2025. Beyond tax revenues, a notable difference is also observed in EU funds received, which are, on average, 0.6 pp of GDP higher in the MTP projection. While the MTP projected a revenue trajectory supported by tax reform and improved tax collection efficiency, the new fiscal-budgetary framework for 2026-2028 (as reflected in the FS and MSR) appears to retain only the efficiency improvement component (already expected to take effect from 2025), alongside a reduced projection of EU funds received.

On the expenditure side, the difference is primarily reflected in investment expenditures, which are, on average, 0.8 pp of GDP higher in the MTP compared to the FS and MSR. This most likely corresponds to the more optimistic projection in the MTP regarding EU funds received, as mentioned earlier[22]. Additionally, there is a 0.5 pp difference in expenditures on goods and services, which are also higher in the MTP than in the FS and MSR. On the other hand, personnel expenditures and social assistance expenditures – which are the largest components of budget expenditures – do not show significant differences between the two projections. While the MTP planned budget expenditure adjustments mainly through personnel expenditures, social assistance, and investments, the new fiscal-budgetary framework for 2026-2028 (as presented in the FS and MSR) maintains these adjustments but also introduces a larger reduction in investment expenditures and an additional adjustment in expenditures on goods and services. This strategy aims to offset the lower projected revenues in the FS and MSR (as discussed earlier), ensuring that the budget deficit targets for 2026-2028 remain identical in both documents. Lastly, the public debt trajectory differs between these documents, primarily due to the starting point.

At the time the MTP was drafted, public debt for 2024 was expected to be 52.2% of GDP, whereas the latest estimates in the FS and MSR place it at 54.9% of GDP, resulting in a 2.7 pp gap. However, this gap gradually narrows until 2028, when public debt is projected at: 62% of GDP according to the MTP, and 63.4% of GDP according to the MSR. This difference is most likely due to the more optimistic projection in the MSR regarding real GDP growth for 2026-2028, which is, on average, 0.3 pp higher than in the MTP.

[22] In both the MTP and the FS and MSR, investment expenditures follow a downward trajectory compared to 2025 (a decrease of 1.8 pp in the MTP, and a decrease of 2.5 pp in the FS and MSR). This reduction is driven by the declining absorption of EU funds, due to the completion of the NRRP. The differences in trajectory are explained by the fact that the FS and MSR project a sharper decline in EU funds compared to the MTP, leading to a larger reduction in investment expenditures by 2028.