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REPORT FROM THE COMMISSION TO THE COUNCIL

Commission report to the Council pursuant to Article -11(2) of Regulation (EC) No 1466/97 on the enhanced surveillance mission in Romania of 25 September 2019

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This report on an enhanced surveillance mission to Romania is transmitted to the Council pursuant to Article -11(4) of Regulation (EC) No 1466/97[1]. As foreseen by Article -11(5) of Regulation (EC) No 1466/97, the provisional findings of that mission have been previously transmitted to Romanian authorities for comments.

Romania – Significant Deviation Procedure
enhanced surveillance mission, 25 September 2019

Report

1. Introduction

Romania has been under significant deviation procedures since spring 2017. Both in June 2017 and June 2018 the Council found, in accordance with Article 121(4) of the Treaty, that there had been a significant observed deviation from the medium-term budgetary objective and from the adjustment path towards it in 2016 and 2017, respectively. The Council issued recommendations asking Romania to take the necessary policy measures to address these deviations. Both recommendations were revised six months later, when the Council concluded that Romania had taken no effective action in response to the June recommendations. Romania took no action to address the revised recommendations either[2].

As a consequence of the significant deviation in 2018, a new significant deviation procedure has been launched in spring 2019. On 5 June 2019, the Commission issued a warning to Romania that in 2018 it had again deviated from the adjustment path to its medium-term budgetary objective and proposed to the Council to launch a new significant deviation procedure. In its new recommendation, approved on 14 June, the Council asked Romania to take the necessary measures to ensure that the nominal growth rate of net primary government expenditure does not exceed 4.5% in 2019 and 5.1% in 2020, corresponding to an annual structural adjustment of 1.0% of GDP in 2019 and 0.75% in 2020. .

This report presents the findings from the enhanced surveillance mission to Romania that took place on 25 September 2019. The mission was based of Article -11(2) of Regulation (EC) 1466/97. The mission met Ms Daniela Pescaru and Mr Tiberiu Valentin Mavrodin, secretaries of state at the Ministry of Finance, Ms Mirela Călugăreanu, head of tax administration (ANAF), Mr. Mugur Isărescu, governor of the National Bank of Romania, and Mr. Daniel Dăianu, President of the Fiscal Council of Romania, accompanied by their respective staff. As with previous similar missions, the aim was to discuss the fiscal measures planned by the authorities, stress the existence of fiscal risks, and encourage compliance with

[1] Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, OJ L 209, 2.8.1997, p. 1

[2] The Council recommendations and other relevant significant deviation procedure documents are available at: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/preventive-arm/significant-deviation-procedure_en#romania

the significant deviation procedure recommendation. This report is based on information obtained until and during the mission.

2. Findings of the mission

The authorities do not intend to act upon the significant deviation procedure **recommendation.** The representatives of the Ministry of Finance explained that the government does not plan a structural adjustment in 2019 or in 2020. The Romanian authorities continue to focus on maintaining the headline deficit below the 3% of GDP reference value of the Treaty, thus aiming to avoid the corrective arm of the Stability and Growth Pact. The 2019 budget amendment, adopted in August 2019, maintained the headline deficit target of 2.76% of GDP in cash terms (2.78% of GDP in ESA terms). The Romanian government already approved the expenditure ceilings for the upcoming 2020 budget and provided estimates for the medium term. The headline deficit targets are 2.92% of GDP in 2020, 2.99% in 2021, 2.74% in 2022 and 2.40% in 2023. The Ministry did not provide the structural deficit targets during the mission, but explained that these headline deficit targets imply that structural adjustment would start only in 2022. The line ministries are preparing concrete spending plans within the approved expenditure ceilings.

There are risks to achievement of the 2019 budget target. Public deficit in cash terms in January-August 2019 was 0.6 percentage points of GDP higher than in the equivalent period of the previous year (public deficit in cash terms amounted to 2.9% of GDP in 2018 as a whole). According to the Fiscal Council, there are significant risks of exceeding the 2019 deficit target and even the 3% of GDP reference value of the Treaty. This is due to overestimated revenues (in particular, revenues from VAT and from social contributions) and underestimated expenditures on social benefits and on goods and services. The Fiscal Council estimates that, provided if no credible additional compensatory measures are adopted, the budget deficit could be between 3.4% and 3.7% of GDP in 2019. The Fiscal Council observed that the government would probably try to control the headline deficit through cutting public investment, which is already close to record-low levels, and other measures of lesser impact.

The new pension law poses a significant upward risk to public deficit in 2020 and beyond. The law, in force since June 2019, contains significant ad-hoc annual increases of the pension point (the main parameter used for old-age pension indexation) in 2019-2021, including a 40% increase in September 2020. It also contains generous changes to the standard pension indexation formula and an upward recalculation of existing pensions from 2022. According to the official government estimates from the accompanying explanatory memorandum, the law will increase government expenditure by 0.8% of GDP in 2019, 2.3% in 2020 and 4.9% in 2021, compared to the nominal level from 2018. The Ministry of Finance staff stated that the fiscal strategy for the upcoming years provides sufficient fiscal space to accommodate these costs, thanks to improved tax compliance and expenditure freezes. Staff offered to share the details during the upcoming Commission forecast visit. The mission participants stressed that it is unclear how the new pension law (in particular the 40% pension increase) can be accommodated without changing its implementation schedule. According to the Fiscal Council and the National Bank of Romania, the implementation of the pension law in the legislated timeframe is not compatible with maintaining the headline deficit within the 3% of GDP reference value of the Treaty.

The president of the tax administration (ANAF) gave an overview of planned actions and objectives to increase tax collection. They include the appointment of a new advisory council, simplification of tax declarations and payments, measures on transfer pricing, development of criteria for differentiated treatment of taxpayers based on fiscal risk, reorganisation of the tax administration **(**ANAF) resources towards regional offices that need them most (e.g. Bucharest), new tax audits based on integrated risk analysis, aggregation and analyses of data collected from electronic cash registers, increased digitalisation of the tax administration (ANAF), development of monitoring system of transported goods and estimation of VAT gap. The mission participants welcomed these efforts but cautioned that improving tax compliance takes time and in any case it might not be enough to finance the enacted increases in pensions. The Fiscal Council considers that as a matter of principle of fiscal prudence, the potential positive budgetary impact of measures aimed at improving tax collection should not be taken into account ex ante in the projection of budgetary revenues.

The Fiscal Council expressed concerns over the structure of public finances and the National Bank of Romania expressed worries over the impact of budget deficits on monetary policy. The Fiscal Council is worried that budgetary revenues are not sufficient to finance the necessary public spending. Fiscal revenues are very low, driven by low statutory tax rates and weak tax compliance, as evidenced by the high VAT gap. Romania should learn from good experiences of regional peers, such as Bulgaria and Poland, in improving tax collection. The National Bank of Romania concurs with this analysis, pointing to low tax revenues and low quality of public spending as the main structural problems of public finances. The National Bank of Romania is worried that high fiscal deficits and an expansionary fiscal policy complicate the conduct of monetary policy.