EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 21 March 2007
ECFIN/G3(2007)REP/51256

ECONOMIC ASSESSMENT OF THE CONVERGENCE PROGRAMME OF ROMANIA (JANUARY 2007)

The Stability and Growth Pact requires each EU Member State to present a medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not and annual updates thereof. Romania joined the European Union on 1 January 2007 and submitted its first convergence programme on 25 January.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 21 March 2007. Comments should be sent to Lorena Ionita (lorena.ionita@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 7 March 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 March 2007.

* * *

All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

Table of contents

SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as Romania, has to submit a convergence programme and annual updates thereof. Romania joined the European Union on 1 January 2007 and submitted its first convergence programme on 25 January 2007.

Romania enjoyed strong economic growth over the past five years, but its GDP per capita (expressed in purchasing power standards, PPS) is still low at 34% of the EU-25 average in 2005. In this respect, the scope for catching up remains ample and represents Romania's overriding challenge for the medium- and long-term. In 2001-2005 macroeconomic stability improved, as reflected by the sharp and sustained decline in inflation and the consolidation of public finances. Investment accelerated and was reinforced by a notable increase in net FDI which helped shift production into more technology-intensive sectors. Therefore, the structure of industrial output and exports changed towards higher value-added products, preserving external competitiveness despite the increase in unit labour costs. The notable recovery of economic activity only resulted in a marginal increase in the employment rate, which is fairly low at around 58%. At the same time, Romania witnesses steady emigration and the ageing of its population. The introduction of the flat tax on personal income in January 2005 contributed to a reduction of the large informal labour market, but full benefits could not be reaped due to the still high payroll taxes.

In the light of this assessment, the following key medium- and long-term challenges in the area of public finances seem relevant for Romania. First, efficiency appears to be the main challenge for the Romanian public finances. While fiscal reforms and buoyant economic activity contributed to quickly rising budget revenues, efforts to restructure the expenditure side of the budget are lagging behind. Budgetary execution in recent years revealed major weaknesses in implementing investment projects and the under-spending on capital projects was reallocated to a large extent to current spending such as wages, government consumption and social transfers. An improvement of budgetary planning and execution as well as an efficient spending of public funds would enhance the growth potential of the economy within a budgetary envelope that ensures macroeconomic stability and a competitive business environment. Second, the long-term sustainability of public finances faces serious challenges with regard to the pension and health-care systems. Financial pressures are likely to mount due to the ageing population and the need to increase the low replacement rate in the pension system and ensure higher medical standards. Speeding up the finalisation of reforms in the pension and health-care systems appears necessary. In addition, accelerating the reduction of the high payroll taxes could help further reduce the size of the large informal labour market, which weighs on tax collection.

The macroeconomic scenario underlying the convergence programme envisages that real GDP growth will decelerate progressively from a well-above potential rate of 8% in 2006 to a still sustained 5.9% in 2009. Assessed against currently available information, this

[1]The analysis takes into account (i) the Commission services' autumn 2006 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

scenario appears to be based on plausible growth assumptions. The programme's projections for inflation appear to be on the low side since they assume a sustained deceleration of credit and private consumption growth which may not materialise. Unlike the programme, the Commission's services 2006 autumn forecast projects a further widening of the external deficit in 2007 and 2008 on the basis of imports that continue to outpace exports as a result of strong private consumption and investment.

The macroeconomic outlook can be qualified as "economic good times". The Commission services project a declining, but positive output gap throughout the programme period, against the backdrop of strong domestic demand, rapid credit growth and fairly high external deficits, and also a gradual fall of the unemployment rate.

For 2006, the Commission services' autumn 2006 forecast estimated the general government deficit at 1.4% of GDP against a target of 0.7% of GDP set in the December 2005 pre-accession economic programme (PEP). The convergence programme estimates the deficit at 2.3% of GDP. The slippage compared to the original target reflects significant additional expenditure, notably current spending partly due to a reallocation of unspent investment expenditures, which more than offset stronger revenue growth than expected.

The programme targets a small reduction of the general government deficit from 2.3% of GDP in 2006 to 2% in 2009, after a rise to 2.7% in 2007. The planned adjustment, which is marginal and back-loaded is achieved through an increase in the revenue-to-GDP ratio that is somewhat higher than the increase in the expenditure-to-GDP ratio (almost 4 percentage points compared to 3½ percentage points). On the revenue side, most of the increase comes from taxes (especially in 2007) and from "other revenues" (presumably associated with EU funds inflows). The rise in the expenditure ratio stems to a large extent from a very significant increase in public investment, which is planned to more than double as a percentage of GDP due to an assumed substantial increase in the absorption of EU funds. Compared with the PEP, budgetary targets are far less ambitious although the underlying growth assumptions are similar.

The structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to deteriorate further from 3% of GDP in 2006 to around 3½% of GDP in 2007 before improving to 2¼% of GDP in 2009. The medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 0.9% of GDP, which the programme aims to achieve by 2011, i.e. beyond the programme period. The MTO is in line with the Pact.

The risks to the budgetary projections in the programme appear broadly balanced in 2007, but budgetary outcomes could be worse than projected in the programme thereafter. In 2007, both expenditure and revenues might be lower than planned: the former because public investment plans are unlikely to be achieved and the latter because the assumed tax intensity of economic activity appears to be very favourable. From 2008 onwards, the budgetary strategy is insufficiently specified, with a volatile path for several expenditure items and an unsubstantiated tightening in 2009. Expenditure slippage in recent years through frequent budgetary amendments, the uncertainty regarding the total amount of compensation to be paid by general government to citizens for the non-return of properties nationalised during the communist regime and potential cancellations of public enterprises' unpaid liabilities towards general government point to a risk of expenditure overruns, even though the level of planned spending on investment will likely be undershot. In addition, over-budgeted resources allocated to investments might be shifted to consumption as happened in the past, with a negative impact on the quality of public spending.

In view of this risk assessment, the budgetary stance in the programme does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. The pace of the adjustment towards the MTO implied by the programme is insufficient and should be strengthened significantly to be in line with the Stability and Growth Pact, which specifies that the adjustment should be higher in good economic times and could be lower in bad economic times. In particular, in a context of good times, the structural improvement is marginal and fully back-loaded, with a deterioration in 2007, while the planned adjustment, notably in 2009 is not supported by measures.

In the absence of the long-term projections of age-related expenditures, based on the common macroeconomic assumptions as carried out by the EPC/Commission, it is not possible to assess the impact of population ageing in Romania on a comparable and robust basis as it is currently done for the other Member States, for which the projections on this basis are available. However, a significant impact of ageing on expenditure cannot be excluded given the current demographic structure. The initial budgetary position, with a large structural deficit, is not sufficient to stabilise debt even before considering the long-term budgetary impact of ageing. Improving the structural budgetary position over the medium-term would contribute to containing risks to the sustainability of public finances.

The overall conclusion is that, in a context of strong growth prospects and a widening external deficit, the programme envisages a pro-cyclical loosening in 2007 and insufficient and back-loaded progress towards the MTO, which is targeted to be reached only beyond the programme period. Moreover, there are risks to the achievement of the budgetary targets from 2008 onwards.

Comparison of key macroeconomic and budgetary projections[1]

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Jan 2007**	**4.1**	**8.0**	**6.5**	**6.3**	**5.9**
	COM Nov 2006	4.1	7.2	5.8	5.6	n.a.
	PEP Dec 2005	*5.7*	*6.0*	*6.3*	*6.5*	*n.a.*
HICP inflation (%)	**CP Jan 2007**	**9.1**	**6.6**	**4.5**	**4.3**	**3.2**
	COM Nov 2006	9.1	6.8	5.1	4.6	n.a.
	PEP Dec 2005	*9.0*	*7.0*	*5.0*	*3.6*	*n.a.*
Output gap (% of potential GDP)	**CP Jan 2007[2]**	**0.2**	**2.1**	**2.2**	**1.9**	**1.1**
	COM Nov 2006[6]	0.4	1.9	1.5	1.0	n.a.
	PEP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Jan 2007**	**-1.5**	**-2.3**	**-2.7**	**-2.6**	**-2.0**
	COM Nov 2006	-1.5	-1.4	-2.6	-2.6	n.a.
	PEP Dec 2005	*-0.4*	*-0.7*	*-1.0*	*-1.6*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2007**	**-0.4**	**-1.2**	**-1.6**	**-1.5**	**-1.0**
	COM Nov 2006	-0.3	-0.4	-1.7	-1.7	n.a.
	PEP Dec 2005	*0.8*	*0.4*	*0.0*	*-0.6*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Jan 2007[2]**	**-1.5**	**-3.0**	**-3.4**	**-3.2**	**-2.3**
	COM Nov 2006	-1.6	-2.0	-3.1	-2.9	n.a.
	PEP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2007[4]**	**-1.5**	**-3.0**	**-3.4**	**-3.2**	**-2.3**
	COM Nov 2006[5]	-1.6	-2.0	-3.1	-2.9	n.a.
	PEP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2007**	**15.9**	**12.8**	**13.5**	**12.6**	**11.7**
	COM Nov 2006	15.9	13.7	13.9	14.4	n.a.
	PEP Dec 2005	*17.1*	*15.1*	*14.6*	*14.6*	*n.a.*

Notes:
[1]The government accounts of Romania have not yet been officially subject to a complete quality assessment by Eurostat. Eurostat will publish and validate government balance and debt figures shortly after the data notification of 1 April 2007.
[2]Commission services calculations on the basis of the information in the programme.
[3]Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.
[4]There are no one-off and other temporary measures in the programme.
[5]There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.
[6]Based on estimated potential growth of 5.6%, 5.7%, 6.1% and 6.2% respectively in the period 2005-2008.
Source:
Convergence programme (CP); Pre-accession economic programme (PEP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

Following its accession to the EU on 1 January 2007, Romania submitted its first convergence programme, covering the period 2006-2009 on 25 January 2007[2]. The programme was submitted to the Romanian Parliament for consultation and information. During its preparation, other stakeholders were also consulted (non-governmental organisations, trade unions and employers' associations and academic experts). Overall, the programme is based on the same macroeconomic scenario and contains the same budgetary targets for 2007 as the 2007 budget.

[2] The English translation of the programme was submitted on 31 January 2007.

The programme broadly follows the model structure for stability and convergence programmes specified in the code of conduct. It has gaps in the compulsory[3] and optional data prescribed by the code of conduct.[4] Annex 3 provides a detailed overview of all aspects of compliance with the code of conduct.

2. ECONOMIC TRENDS AND POLICY CHALLENGES

This section is divided into five parts. The first provides a brief overview of the macroeconomic performance of the Romanian economy over the past ten years. The second part presents the results of a growth accounting exercise and tries to identify the main reasons for low or high average annual economic growth vis-à-vis the EU-10. The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. Based on the picture outlined in the first four parts, the fifth identifies major economic challenges with implications for public finances.

2.1 Economic performance

The growth performance of the Romanian economy was markedly uneven over the past ten years. On average the economy grew by only 2.7%. This is 1.4 percentage points below the performance of the EU-10 economies, but the evolution masks two contrasting periods. The second half of the 1990s was characterised by a significant downturn in which gross domestic product shrunk by a cumulated 12.1% in real terms from 1997 to 1999. This severe downswing was followed by a sustained recovery at an average growth rate of 5.7% between 2001 and 2005, compared to 0.2% on average in the first period.

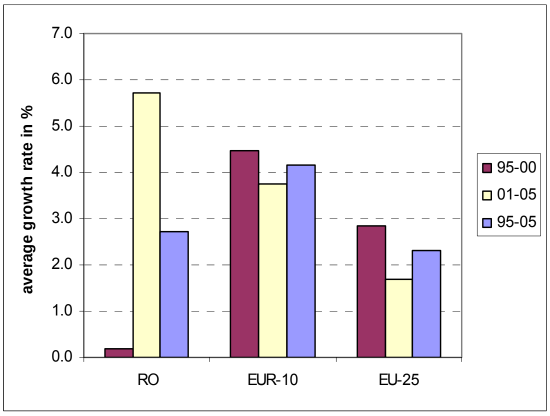
The asymmetrical output developments reflect the nature of the transition process to a market economy in Romania. The approach of successive governments to macroeconomic stabilisation and structural reforms was rather hesitant and gradual until the end of the 1990's. The main reasons rest with the difficult starting conditions. On the one hand, the rigid centrally planned economy displayed an obsolete stock of capital and a massive misallocation of resources towards energy-intensive industries and agriculture. On the other hand, the necessary restructuring and privatisation of inefficient state-owned enterprises (SOEs) was difficult because of vested interests and eventually occurred amidst large social costs.

---

[3] Regarding the compulsory data, in table 1a "Macroeconomic prospects", changes in inventories and net acquisition of valuables are not shown and in table 8 "Basic assumptions", data on short-term interest rate and long-term interest rate are missing.

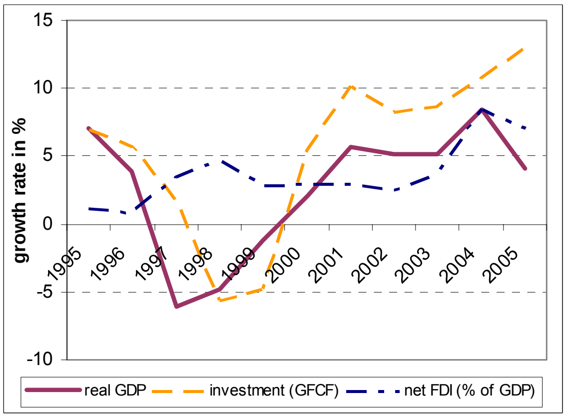
[4] Regarding the optional data, the following data are missing: in Table 1c "Labour market developments", data on employment, (hours worked) and labour productivity (hours worked), in Table 2 "General government budgetary prospects", the decomposition of social transfers into "in kind" and "other than in kind", Table 3 "General government expenditure by function" is not provided, Table 7 "Long-term sustainability of public finances", data on social security pension, old-age and early pensions, other pensions, occupational pensions, long-term care, other age-related expenditures, interest expenditure, property income from pension contributions, pension reserves fund assets.

Figure 1: Average GDP growth: Romania vs. EU-10 and EU-25



Source: Commission services

Figure 2:Real GDP and investment



Source: Commission services

The beginning of the transition during 1990-1992 led to an initial output contraction of more than 27% of GDP accompanied by triple-digit inflation rates, as a result of the disorganisation that followed the end of central planning. In 1994 the growth performance improved, inflation started to decline and the economy grew steadily until 1996. However, the upswing was based on large subsidies to unviable SOEs, rising fiscal and quasi-fiscal deficits[5] and growing external imbalances that eventually proved to be unsustainable. In 1997, when a newly elected government further liberalised prices and the exchange regime, discontinued quasi-fiscal subsidies through the National Bank of Romania and started the reforming of the SOEs, a second phase of output contraction ensued. Whereas most of the other Central-East European Countries had finished to a large extent the first phase of transition reforms focusing on macro-economic stabilisation and dismantling of unviable SOEs by 1995, and resumed growth on a sustainable basis afterwards, Romania was only starting to pursue bolder reforms after 1996, hence the difference in growth patterns.

Box 1: Monetary policy and exchange rate regimes of ROMANIA	
Managed float(1991- September 2000)	Romania operated a managed float without a pre-announced reference rate after unification of the foreign exchange market in November 1991. From June 1992 onwards, the exchange rate was determined daily by auctions channelled through commercial banks. However, a market-clearing price was not ensured and the auction mechanism was modified in 1994. From August 1994, a decentralised direct dealing inter-bank market was in operation, with the official reference exchange rate published by the National Bank of Romania calculated as an average of reported inter-bank and client transactions. The market was dismantled in March 1996, when the NBR revoked the

[5] The IMF's *Manual on Fiscal Transparency* defines quasi-fiscal activities as operations conducted by the central bank, public financial institutions, and non-financial public enterprises which are fiscal in nature, but are not recorded in budgets or budget reporting and typically escape legislative and public scrutiny.

	licenses of the 22 dealer banks (including all foreign banks), leaving only four state-controlled dealer banks. Functioning of the market was restored in February 1997 when licenses were re-issued.
Crawling band *(September 2000 – July 2005)*	The arrangement was officially a managed float with no pre-announced objective for the exchange rate. De facto, Romania followed an unannounced crawling band implying an annual real appreciation of the currency by 2-4 percent against a euro-US dollar basket. It contributed to gradual disinflation while maintaining external competitiveness. From November 2004, in the light of persistent higher capital inflows and further steps of capital account liberalization, higher exchange rate flexibility was allowed.
1 July 2005: introduction of new leu (RON)	On 1 July 2005 the Romanian Leu (ROL) was replaced by the new leu (RON), with a conversion of 1 RON = 10,000 ROL.
Inflation targeting combined with managed float (*since August 2005)*	Inflation targeting was introduced in order to foster disinflation. The end-of-year inflation targets for 2006 and 2007 were set at 5% and 4% respectively, within a +/-1% band. Officially, the exchange rate regime remains a managed float. However, the gradual removal of capital controls in the run-up to EU accession and the preparation for inflation targeting moved the exchange rate towards a freer float already as of November 2004. The NBR has stopped interventions on the foreign exchange market since October 2005.

The implementation of structural reforms started in earnest in 1997. Despite two rounds of "mass privatisation" during the first years of transition in Romania, the sale of large SOEs only started in 1997 and proceeded very slowly thereafter. Efforts were made to reduce losses from quasi-fiscal activities, and about 4% of GDP in quasi-fiscal activities were curtailed during 1996-2000. Nonetheless, state-owned energy providers continued to sell energy below cost-recovery levels as a means to subsidise households and energy-intensive enterprises. Notable progress in reducing new arrears to the general government has only occurred since 2003. The determinants of the output contraction from 1997 to 1999 were not only driven by the reduction of economic activity of unviable enterprises. A loose fiscal and wage policy combined with a weakening current account deteriorated investor confidence, already affected by the Asian and Russian crisis and led to substantial reserve losses in late 1998. The ensuing currency crisis and exchange rate depreciation undermined disinflation efforts and further depressed economy activity until 1999. In addition, the recapitalisation of the two largest state-owned banks in order to cover their non-performing assets led to a massive injection of liquidity in the banking sector and a substantial increase in domestic public debt.

The economic reforms in the previous years and macro-economic stabilisation laid the foundation for the substantial economic upturn during 2001-2005. The sharp currency depreciation from 1999 and the reduction of the overall tax burden, notably on profits from export activities, contributed to an export-led recovery in 2000. Also gross fixed capital formation recovered and grew by 5.5% after having contracted by a cumulative 10.5% in 1998 and 1999. Export volumes expanded by 10.5% in 1999 and 23.4% in

2000. Consequently, the external deficit almost halved to 3.6% of GDP from 1998 to 2000.

In 2001-2005, growth became increasingly driven by domestic demand, as both consumption and investment grew strongly at around 8 and 10% respectively, on average. The expansion of household consumption reflected real wage growth and surging consumer credit, while the ongoing upgrade and development of Romania's capital stock and the healthy growth of exports were sustained by increasing inflows of net FDI and access to foreign savings. The inflow of net FDI grew from 2.7% of GDP on average in 1995-2000 to 4.7% of GDP in 2001-2005, reflecting the improved macroeconomic stability and acceleration of structural reforms since 2001. Restructuring and privatisation of large SOEs and banks progressed more rapidly and the improvement of public administration, market entry and exit conditions, enforcement of property rights and stability of the financial system created a more attractive business environment, further strengthened by the prospects of EU accession. The increase of foreign and domestic investment raised gross fixed capital formation from less than 18% of GDP in 1999 to more than 23% of GDP in 2005. At the same time the weight of the private sector increased substantially from around 61% of GDP in 1998 to more than 70% of GDP in 2005. From 2000 to 2005 the catching-up process resumed as GDP per capita (expressed in Purchasing Power Standards (PPS)) grew from around 25% of the EU-25 average in 2000 to close to 35% in 2005, but the level remains low and points to a significant scope of further real convergence.

Over the last ten years unemployment remained fairly low due to the subdued economic restructuring. However, after a slight decline at the beginning of the period, the unemployment rate increased gradually to an average of 7.5% in 2001-2005 as the restructuring and privatisation of SOEs advanced more rapidly. The recovery of economic activity witnessed a decline of the unemployment rate to 7.2% in 2005, after it had peaked at 8.4% in 2002. Over the decade both the active population and the employment decreased due to substantial emigration flows and an increase in the number of pensioners after the implementation of early retirement schemes that were meant to alleviate lay-offs in SOEs. Based on The Labour Force Statistics (LFS), the employment rate came down from above 65% in 1997 to below 58% in 2005. It has to be added, however, that registered employment represented only about half of the LFS employment in 2005, with the rest of the work force being active in subsistence farming or in the still large informal sector of the labour market.

Faced with the slow pace of structural reforms the authorities chose a gradual disinflation strategy that resulted in a double-digit annual increase of the Consumer Price Index (CPI) for most of the decade. In the beginning of the 1990s Romania experienced massive inflation reaching an average increase of CPI of 256% in 1993 following price liberalisation and an expansionary monetary stance. In 1995 and 1996, CPI inflation declined to an annual average increase of below 40%. However, once prices were further liberalised and the exchange rate devalued after removal of controls in 1997, inflation went up again to 155%. The subsequent disinflation process was fairly slow as monetary policy continued to accommodate fiscal and quasi-fiscal deficits until 2000. Since 2001, the largest part of monetary expansion came from not fully sterilised foreign exchange monetary interventions, following the need to rebuild the depleted foreign exchange reserves. In August 2005 the central bank switched its monetary policy regime to inflation targeting, and a single-digit annual inflation rate was achieved in 2005.

The external deficit widened between 1995 and 1998. A correction occurred in the form of a substantial depreciation of the domestic currency in 1999, after difficulties to repay external debt obligations were experienced. On the basis of a double-digit growth of exports, the external deficit narrowed to around 4% of GDP on average between 1999 and 2002. Since 2003, the external deficit has widened again up to 7.9% of GDP in 2005, also driven by strong inflows of net FDI fuelling imports. In 2005, net FDI covered around 90% of the external deficit. After a mild appreciation from 1999 to 2004, the unit labour cost (ULC) based real exchange rate appreciated strongly against the EUR in 2005. The good performance of exports, which grew by 18% in 2005 and the notable improvement of the composition of exports towards higher value-added products indicate that the external competitiveness was largely preserved[6].

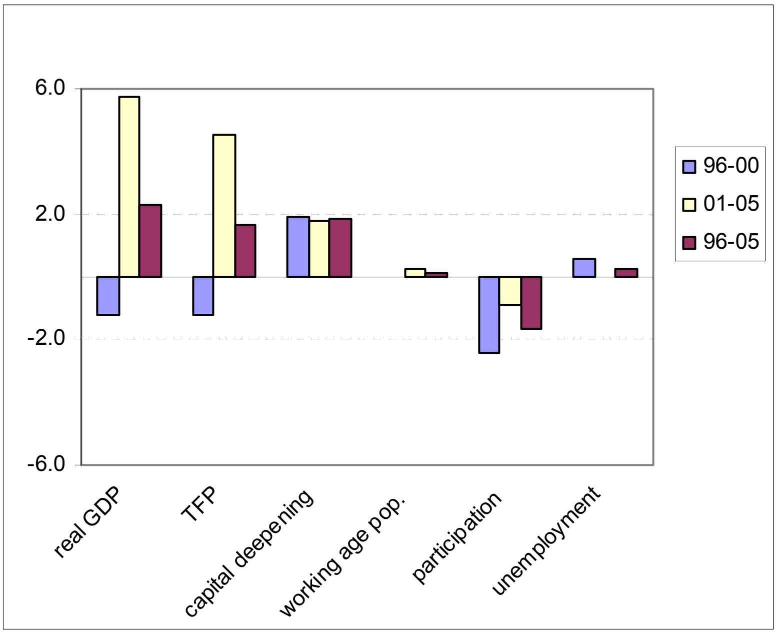
2.2 Anatomy of medium-term growth

Within the framework of a growth accounting exercise, this section dissects the sources of growth, as well as possible differences in economic growth vis-à-vis the EU-10. From 1996 to 2005, average annual economic growth of around 2.3% was mainly driven by rising TFP and capital deepening. The increase of the TFP appears as a natural consequence of the large-scale restructuring and privatisation of the public sector which occurred since 1997. The capital deepening resulted both from the growth of the capital stock, as illustrated by the increase of gross fixed capital formation in excess of 5% on average during the decade, and the decline in employment. Labour input had a strong negative contribution to growth, attributable to a fall in labour participation, largely offsetting the slightly positive effect of the increasing working age population and roughly stable unemployment rate.

The unequal growth performance across the past ten years is also mirrored in the relative contributions of the growth determinants. In 1996-2000, the decline in economic activity is explained by the sharp reduction in employment and the negative contribution of TFP. In that period, economic restructuring was accompanied by a large drop-out from the labour force, reinforced by the introduction of early retirement schemes meant to alleviate unemployment. The decline in TFP reflects the significant temporary loss of output due to the closure of several SOEs. Despite the almost stagnation of gross fixed capital formation, capital deepening had a positive impact on growth due to the large decline in labour force participation. The robust economic upswing during the period 2001-2005 was driven to a large extent by a resumption of TFP growth. The acceleration of the transition process in the second half of the 1990's was based on deregulation, and improving the business environment as well as enterprise restructuring and privatisation. Together with increasing FDI inflows and transfer of technologies this led to a more efficient use of production factors and hence an increase in TFP from 2001 to 2005. Capital deepening also played a positive role, while the negative contribution from labour force participation was much reduced compared to the previous period.

[6] See also International Monetary Fund (2006), Romania - Selected Issues and Statistical Appendix, IMF Country Report No. 06/169, which concludes that the leu still remains undervalued, even after the substantial appreciation recorded in 2005 and 2006.

Figure 3: Real GDP growth and its components



Note:

Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP*, *L* employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L}\right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1-ur)$ where *WP* stands for working age population, *PART* denotes the participation ratio as a share of *WP* and *ur* the rate of unemployment. In terms of growth rates *g* this is:

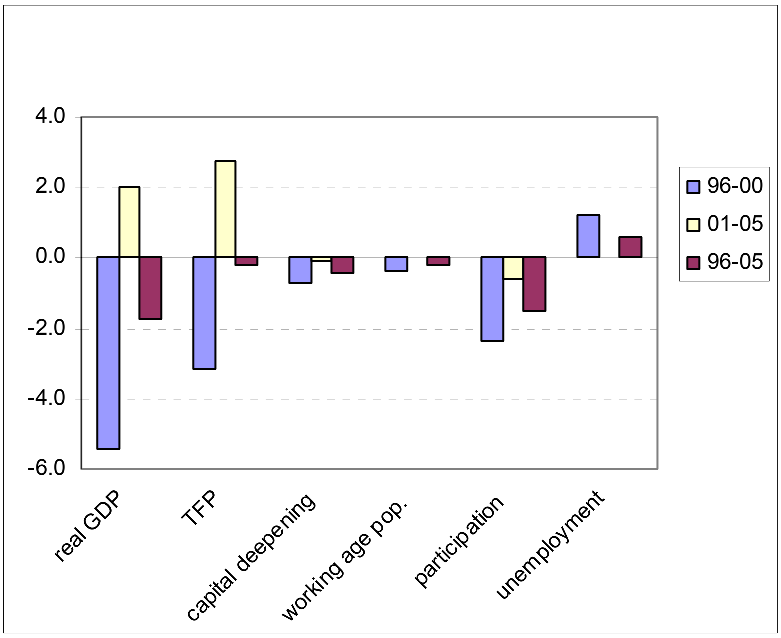
$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source: Commission services

The average growth rate was lower in Romania than in the EU-10 over the last ten years, but two periods can be distinguished. In 2001-2005, the increase in real GDP was by almost 2% points higher than in the EU-10, while there was a large negative difference in the previous five years. Romania's weaker economic performance over the decade is largely due to the negative contribution of labour participation and less robust capital deepening, while the lower unemployment rate in Romania reduced the growth differential. The evolution of working age population hardly influenced the different growth patterns in Romania and the EU-10.

Figure 4: Real GDP growth and its components: Difference vis-à-vis the EU-10



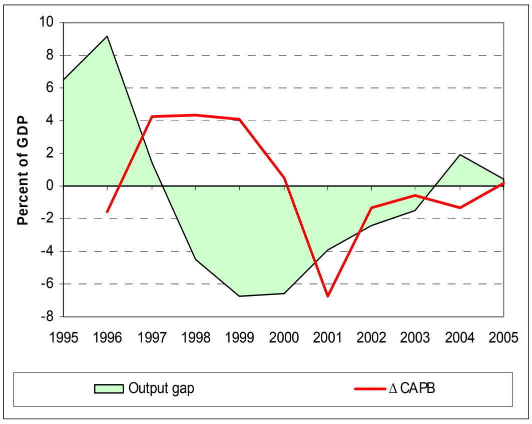
<u>Note</u>: See note of Figure 3
<u>Source</u>: Commission services

2.3 Macro-policies against the backdrop of the economic cycle

Prior to 1997 the positive output gap was a result of lax fiscal and monetary policies which fuelled economic growth above potential. After 1997, the acceleration of structural reforms led to a sharp contraction of output and a large negative output gap ensued which was only closed in 2004. The impact of macroeconomic policies on the economic cycle needs to be viewed in the wider context of economic efficiency and structural changes triggered by the transition to a market economy. The relative fiscal tightening from 1997 to 1999, as reflected in the cyclically adjusted primary balance and the reduction of quasi-fiscal deficits had a pro-cyclical impact on the economic recession during that period. However, tight budget was used to limit subsidies to loss making enterprises and provided a sound basis for economic recovery and efficiency afterwards. The wide fluctuations of the real short-term interest rate between 1996 and 2000 occurred against the background of an expansionary monetary policy until 1997, high and volatile inflation rates and the sharp exchange rate depreciation in late 1998 and1999.

In 2000-2005, monetary policy was fairly neutral and at times counter-cyclical, helping reduce the large negative output gap. Also the decline in the cyclically adjusted primary balance in 2001-2003 worked towards closing the negative output gap, but turned pro-cyclical in 2004 when growth moved into a higher gear. The impact of the fiscal policy was rather neutral in 2005. The assessment of fiscal policy against the cycle is blurred by the existence of quasi-fiscal activities which should be added to the government balance. Over the analysed period quasi-fiscal activities were gradually reduced. Previously unrecorded transfers and subsidies were increasingly captured by the official budget, which apparently worsened government balances.

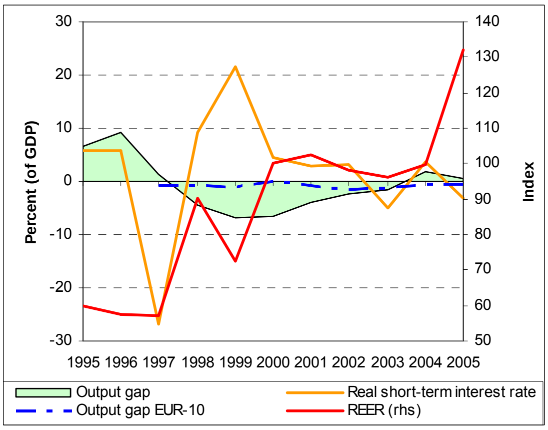
Figure 5: Output gap and fiscal stance



Note: ΔCAPB denotes the change in the cyclically-adjusted primary budget balance

Source: Commission services

Figure 6: Output gap and monetary conditions

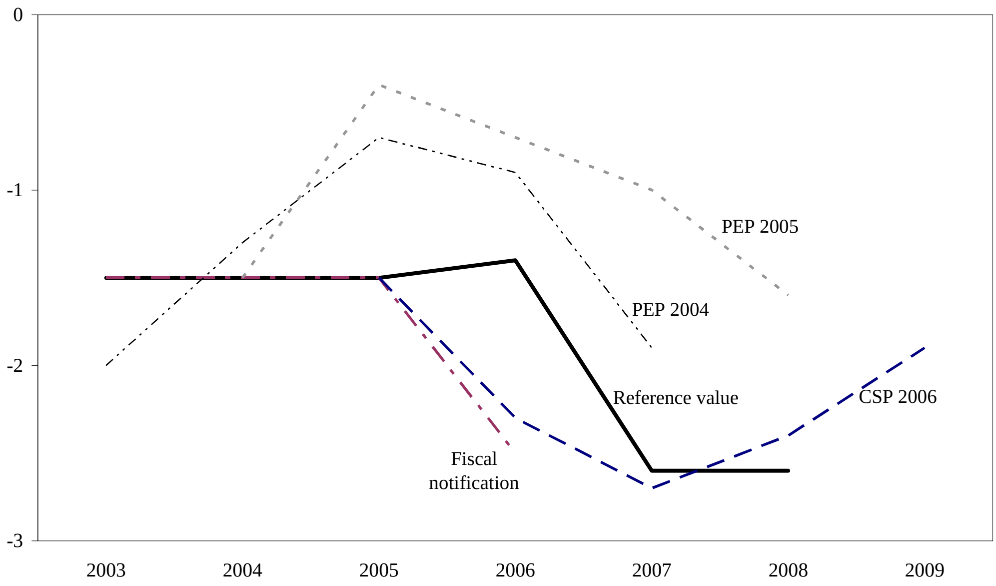


Source: Commission services

2.4 Public finances

During the period 1996-2005 Romania consolidated its public finances, as witnessed by the decline of quasi-fiscal deficits, budget deficits and public debt relative to GDP. The general government deficit was reduced from an average of 3.2% of GDP in national accounting standards in the first half of the decade to an average of 2% of GDP in the second half of the period. The bulk of the adjustment was carried out after 2000 when economic activity recovered and Romania engaged firmly on the road to EU accession. In national accounting standards, the budget deficit gradually fell from 4% of GDP in 2000 to 0.8% of GDP in 2005. Also in terms of the European System of Accounts (ESA 95), the general government deficit fell from 4.5% of GDP in 2000 to 1.5% of GDP in 2005, although the consistency of the data suffers from repeated revisions. Large quasi-fiscal deficits were an endemic phenomenon during Romania's economic transition with an important impact on stock-flow adjustment. Since 2003, the restructuring of state-owned enterprises, the partial privatisation of energy distributors and a stricter enforcement of overdue claims resulted in a reduction of the arrears stock. Hence the accumulation of new arrears to general government has significantly declined, thereby improving fiscal transparency and reducing the hidden subsidies provided to households and companies.

Figure 8: General government balance projections in successive Pre-accession Economic Programmes (% of GDP)



Source: Commission services and national Pre-accession Economic Programmes

Fiscal consolidation took place mostly on the expenditures side of the budget, whereas the revenue-to-GDP ratio fluctuated only marginally around a level of 30% over the past ten years. The assessment of the composition of budget in 1996-2005 is mainly based on data in national accounting standards due to the time inconsistency of data in ESA 95, as a result of repeated revisions. While the dynamics of the budgetary components in the two accounting standards should not differ much, their absolute levels vary, mainly because the delimitation of general government is different in the two accounting systems. In 2005 the levels of the revenue and expenditure-to-GDP ratios were 2% of GDP higher in ESA 95 terms as compared to the national accounting system.

The reduction of the expenditure-to-GDP ratio occurred mainly in 2001-2005 and was driven to a large extent by the interest payments on public debt declining by more than 4% of GDP between 1999 and 2005. In addition, the public sector wage bill was reduced by around 1% of GDP over the decade and capital spending shrunk from 5.2% of GDP in 1996 to around 3% of GDP in the second half of the decade. As the quasi-fiscal deficits were gradually reduced, some of the subsidies to the corporate sector were transferred on the budget and the respective budget chapter increased almost ten-fold to 1.9% of GDP from 1996 to 2005.

On the revenue side of the budget a gradual shift from direct to indirect taxation occurred. Between 1996 and 2005 revenues from indirect taxes increased by around 3.5% of GDP, with VAT and excises being the largest contributors. In 1998 a hike of the VAT standard rate from 18% to 22% increased the collected revenues by 1.4% of GDP. Revenues from VAT continued to increase by 1.8% of GDP between 1999 and 2005 due to the robust economic recovery and consumption growth and despite the introduction of a lower single VAT rate of 19% in 2000. The gradual increase in the excise taxes led to higher revenues of 2.2% of GDP over the decade while revenues from customs duties almost halved to 0.7% of GDP in 2005, following the steady liberalisation of the trade.

Attempts to increase revenues by augmenting direct taxation were unsuccessful as they shifted a significant part of economic activity to the informal sector. This was the combined result of high taxation of labour and of corporate profits. Until 2004, a progressive income tax was in place with the top rate of 40% being applied for monthly salaries higher than EUR 250. In addition, payroll taxes represented more than 50% of the gross wage. As a consequence, revenues from personal income taxes almost halved from 6.1% of GDP in 1996 to 2.9% of GDP in 2004. In 2005, a major tax reform was implemented with the introduction of a flat 16% tax rate on personal income, while other income sources (dividends, interest and capital revenues) were also subjected to the 16% rate. As a result, personal income tax revenue declined further to 2.3% of GDP in 2005, but recovered to around 2.9% of GDP in the following year, also due to the increase in formal employment. The formalisation of labour contracts also contributed to an increase in revenues from social contributions to 9.5% of GDP in 2005, ending a decline from 10.8% of GDP in 2000 to 9.1% of GDP in 2004. Revenues from corporate profit taxes declined from a peak of 4.3% of GDP in 1997 to 3.1% of GDP in 1999. In early 2000 the profit tax rate was reduced from 38% to 25% with a lower rate of 5% for income derived from export activities, and the respective revenues declined to 1.9% of GDP in 2001 and recovered afterwards to 2.3% of GDP until 2004. After the introduction of the 16% corporate profit tax in January 2005 the level of collected revenues remained constant at 2.3% of GDP in 2005.

Romania started the transition towards a market economy with no government debt, but later the debt-to-GDP ratio increased gradually due to the widening of fiscal and quasi-fiscal deficits. The subsequent recovery of economic growth in 2001-2005, consolidation of the fiscal position and the use of privatisation revenues to redeem debt resulted in a notable decline of the debt ratio by around 9% of GDP from 2002 to 2005. At the end of 2005 Romania's government debt was fairly low, representing only 15.9% of GDP, but challenges for the long-term sustainability of public finances stem from the pension and health-care systems. The pension fund was in deficit for the most part of the decade and the financial balance of the health fund was also negative in recent years.

2.5 Medium and long-term policy challenges for public finances

Romania enjoyed strong economic growth over the past five years, but its GDP per capita (expressed in purchasing power standards, PPS) is still low at around 35% of the EU-25 average in 2005. In this respect, the scope for catching up remains ample and represents Romania's overriding challenge for the medium- and long-term. In 2001-2005 macroeconomic stability improved, as reflected by the sharp and sustained decline in inflation and the consolidation of public finances. Investment accelerated and was reinforced by a notable increase in net FDI which helped shift production into more technology-intensive sectors. Therefore, the structure of industrial output and exports changed towards higher value-added products, preserving external competitiveness despite the increase in unit labour costs. The notable recovery of economic activity only resulted in a marginal increase in the employment rate, which is fairly low at around 58%. At the same time, Romania witnesses steady emigration and the ageing of its population. The introduction of the flat tax on personal income in January 2005 contributed to a reduction of the large informal labour market, but full benefits could not be reaped due to the still high payroll taxes.

The following key medium- and long-term challenges in the area of public finances seem relevant for Romania:

Sustainability: The long-term sustainability of public finances faces serious challenges with regard to the pension and health-care systems. Financial pressures are likely to mount due to the ageing population and the need to increase the low replacement rate in the pension system and ensure higher medical standards. Speeding up the finalisation of reforms in the pension and health-care systems appears necessary. In addition, accelerating the reduction of the high payroll taxes could help further reduce the size of the large informal labour market, which weighs on tax collection.

Efficiency: Efficiency appears to be the main challenge for the Romanian public finances. While fiscal reforms and buoyant economic activity contributed to quickly rising budget revenues, efforts to restructure the expenditure side of the budget are lagging behind. Budgetary execution in recent years revealed major weaknesses in implementing investment projects and the under-spending on capital projects was reallocated to a large extent to current spending such as wages, government consumption and social transfers. An improvement of budgetary planning and execution as well as an efficient spending of public funds would enhance the growth potential of the economy within a budgetary envelope that ensures macroeconomic stability and a competitive business environment.

Table 1: Key economic indicators

	Romania						EU-10					
	Averages			2003	2004	2005	Averages			2003	2004	2005
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.3	-1.2	5.7	5.2	8.4	4.1	4.0	4.3	3.7	4.0	5.1	4.6
Contributions to real GDP growth:												
Domestic demand	4.4	0.0	8.8	8.8	13.0	9.1	4.3	5.3	3.4	4.1	5.6	3.0
Net exports	-2.1	-1.2	-3.1	-3.6	-4.5	-5.0	-0.3	-1.0	0.4	0.0	-0.5	1.6
Prices, costs and labour market												
HICP inflation (% change)	43.7	68.9	18.6	15.3	11.9	9.1	n.a.	n.a.	3.3	1.9	4.1	2.5
Labour productivity (% change)	3.6	0.7	6.4	5.5	8.0	3.9	4.2	4.6	3.7	4.3	4.5	2.9
Real unit labour costs (% change)	1.9	5.0	-1.2	-5.7	-1.7	8.2	-0.8	-0.6	-1.0	-0.7	-2.5	-1.8
Employment (% change)	-1.3	-1.9	-0.6	-0.3	0.4	0.2	-0.1	-0.3	0.0	-0.2	0.6	1.7
Unemployment rate (% of labour force)	6.5	5.5	7.5	7.0	8.1	7.2	12.8	11.3	14.2	14.3	14.2	13.4
Competitiveness and external position												
Real effective exchange rate (% change) (1)	8.3	10.8	5.7	-2.1	3.9	32.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	4.4	0.7	8.2	3.9	5.9	2.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	-5.3	-5.2	-5.4	-5.5	-7.5	-7.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances												
General government balance (% of GDP)	-1.3	-0.9	-1.7	-1.5	-1.5	-1.5	n.a.	n.a.	-4.2	-5.1	-3.7	-3.3
General government debt (% of GDP)	n.a.	n.a.	20.9	21.5	18.8	15.9	38.0	35.8	40.1	39.9	43.4	41.3
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-4.5	-3.4	-3.0
Financial indicators (4)												
Long term real interest rate (%) (5)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3.5	2.2	2.2
Household debt (% of GDP) (6)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

More detailed tables summarising the economic performance of the country are included in Annex 4.

(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.

(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.

(4) Data available up to 2004.

(5) Using GDP deflator.

(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.

(7) Non-financial corporate sector debt, defined as loans and securities other than shares.

Source:

Commission services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, economic activity, potential output growth, the labour market, costs and prices and sectoral balances. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic ‘good’ or ‘bad’ times.

3.1 External assumptions

The programme's external assumptions are based to a large extent on the external outlook of the Commission's 2006 autumn forecast. Economic activity in the EU is expected to expand strongly in 2006 and return to potential in 2007 and 2008. The economic recovery which is driven by domestic demand is considered as supportive for the robust growth of the Romanian economy in 2007-2008.

The programme assumes a similar evolution of the global real GDP growth and fairly similar conditions for global trade. Commodity and oil price assumptions are also in line with the Commission's autumn forecast, but the exchange rate assumptions are somewhat different. The exchange rate of the RON against the euro differs in 2006 and more so in 2007 and 2008, when the programme projects a stronger RON than the Commission's autumn forecast by around 2.5% and 6.5% respectively.

3.2 Economic activity

The programme estimates a real GDP growth of 8% in 2006 and forecasts robust economic activity for the rest of the programme period. Real GDP growth projections decline to 6.5% in 2007 and 6.3% in 2008, but remain slightly above potential as estimated by the Commission services. The upbeat macroeconomic outlook for 2006-2009 exceeds the economic performance from the previous five years, but gradually converges to potential growth towards the end of the programme period (Table 2). In 2009, real GDP growth is expected to return below potential at 5.9%. High growth should allow Romania reduce the economic development gap vis-à-vis the other Member States and the programme foresees that the Romanian GDP per capita (in PPS) will reach about 40% of the EU-27 average by 2009.

Domestic demand will remain the driver of growth during the programme period, but the annual growth of private consumption is expected to ease from 11.8% in 2006 to 6.7% in 2009. This is supposed to be the consequence of a more moderate credit growth and conducting a prudent wage policy in the public sector (see section 3.5). On the other hand, the increase in government consumption expenditures will reach 3.7% in 2008, but level off to 3.1% in 2009. Gross fixed capital formation is foreseen to expand most strongly, by rates ranging from 14% in 2007 to 11% in 2009, as a result of the planned public investment projects and notable flows of domestic and foreign private investment. The growth of both exports and imports is projected to decelerate during the programme period, but imports will continue to grow faster than exports. The negative contribution to growth of net exports is projected to gradually decline.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	7.2	8.0	5.8	6.5	5.6	6.3	5.9
Private consumption (% change)	11.5	11.8	9.0	8.1	7.5	7.2	6.7
Gross fixed capital formation (% change)	10.0	15.0	10.5	14.0	9.0	11.5	11.0
Exports of goods and services (% change)	14.6	11.8	10.7	10.9	12.2	7.6	7.3
Imports of goods and services (% change)	20.7	20.8	16.0	15.0	14.3	11.2	10.3
Contributions:							
- Final domestic demand	10.9	12.3	9.4	9.6	8.2	8.6	8.0
- Change in inventories	0.4	0.8	0.0	0.0	0.0	0.2	0.1
- External balance on g&s	-4.1	-5.1	-3.6	-3.1	-2.6	-2.5	-2.2
Output gap[1]	1.9	2.1	1.5	2.2	1.0	1.9	1.1
Employment (% change)	0.2	0.6	0.2	0.3	0.1	0.3	0.2
Unemployment rate (%)	7.6	6.8	7.5	6.7	7.6	6.6	6.5
Labour productivity growth (%)	7.0	7.4	5.5	6.2	5.5	6.0	5.7
HICP inflation (%)	6.8	6.6	5.1	4.5	4.6	4.3	3.2
GDP deflator (% change)	10.9	9.8	8.3	6.8	5.8	5.0	3.9
Comp. of employees (% change)	16.4	15.6	14.2	11.8	12.6	9.9	9.4
Real unit labour costs (% change)	-2.1	-	-0.4	-	0.8	-	-
External balance (% of GDP)	-10.3	-10.2	-11.8	-8.9	-13.3	-8.3	-7.8

Note:

[1]In percent of potential GDP, with potential GDP growth as reported in Table 4 below.

Source :

Commission services' autumn 2006 economic forecasts (COM); Convergence programme

The central bank tightened monetary conditions, by increasing its key interest rate by 100 basis points in February 2006 and by further 25 basis points at the end of June 2006.The required reserve ratio for RON liabilities was also raised by 4% points in order to counter the rapid credit expansion. The relatively restrictive monetary stance contributed to a further reduction of the end-of-year inflation rate to 4.9% in 2006, well within the band of +/- 1% of the 5% target. In 2007, the central bank started lifting some of the administrative regulations which restrict lending, such as the foreign exchange lending ceiling of 300% of own capital of commercial banks as of 1 January 2007. Nonetheless, it will continue to maintain a firm control over liquidity by using the key policy interest rate and open market operations.

The programme's macroeconomic scenario is more optimistic than the Commission's autumn forecast, the rate of real GDP growth being higher by 0.7%-0.8% in 2006-2008. Nonetheless, it can be considered realistic because real GDP grew by 7.8% y-o-y in the first nine months of 2006, which is above the Commission's autumn forecast of 7.2%. Moreover, economic activity continued to be strong in the fourth quarter of 2006, as shown by the evolution of industrial output, retail sales and other lead indicators. A stronger than expected output in 2006 is likely to trigger a sizeable carry-over for 2007 and together with the robust net FDI inflows makes possible a more optimistic forecast for 2007 and 2008. In addition, Commission services foresee an increase in potential growth from 5.7% in 2006 to 6.2% in 2008 and the declining real GDP growth rates in the programme are close to potential in 2008. There are important differences regarding the projected composition of growth between the programme and the Commission's autumn forecast. Although the programme foresees higher real GDP growth, it assumes a slower growth of private consumption in 2007 and 2008, which represents a tax-rich component of GDP. In the same vein, the government's macroeconomic scenario projects lower growth of government consumption in 2007 and 2008, but more rapid increase of gross fixed capital formation.

Cyclical conditions, as measured by the output gap recalculated by the Commission services on the basis of the data provided in the programme using the commonly agreed method are positive. The output gap is expected to widen to 2.2% of GDP in 2007 and 1.9% of GDP in 2008 which is about 0.9%-points higher than the projection of the Commission services. Towards the end of the programme period, the output gap declines to 1% of GDP in 2009, close to the level foreseen by the Commission services for 2008. This results mainly from the higher growth rates assumed by the more favourable macroeconomic scenario in the programme.

3.3 Potential growth and its determinants

The estimate of potential output growth, as recalculated by Commission services on the basis of the information provided in the programme according to the agreed methodology, is higher than the projections of the Commission services by 0.3%-points on average in 2006-2008, due to higher contributions to potential output growth both by labour and capital accumulation.

Table 3: Sources of potential output growth

	2006		2007		2008		2009
	COM	CP[2]	COM	CP[2]	COM	CP[2]	CP[2]
Potential GDP growth[1]	5.7	5.9	6.1	6.4	6.2	6.6	6.8
Contributions:							
- Labour	-0.2	-0.1	0.0	0.1	-0.1	0.1	0.2
- Capital accumulation	2.0	2.2	2.2	2.5	2.3	2.6	2.8
- TFP	3.7	3.7	3.8	3.8	3.8	3.8	3.8

Notes:

[1]based on the production function method for calculating potential output growth

[2]Commission services' calculations on the basis of the information in the programme

Source :

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

The contribution of TFP is constant at 3.8% during the programme period, but the contributions of both TFP and capital accumulation are substantially higher in comparison with the 2001-2005 period.

3.4 Labour market developments

The programme foresees an increase in employment by an annual average of around 0.3% in 2007-2009, which is broadly in line with labour market developments in 2004-2005 and the Commission's autumn forecast. In 2006, employment is projected to grow by 0.6% as a result of the buoyant economic activity and an increase in net FDI. The programme expects an improvement of the relatively low employment rate by 1.3 percentage points in 2006-2009, mainly due to fiscal incentives and creation of stable jobs. The large migratory labour flows from recent years represent a serious risk to the programme's labour market forecast which does not seem to be fully captured by the scenario. Labour productivity expressed as growth of real GDP per employed person is expected to register healthy growth rates of around 6% annually in 2007-2009, following the positive impact of the introduction of new technologies and the development of human capital. The programme expects a small reduction of the unemployment rate from 6.8% in 2006 to 6.5% in 2009, which corresponds to the positive output gap anticipated for the programme period.

3.5 Costs and price developments

The disinflation process accelerated in 2006 as a result of a more restrictive monetary stance and positive contributions from the appreciation of the exchange rate, the softer adjustment of certain administered energy prices and the decline of prices for vegetables and other food products. The average inflation rate decreased to 6.6% in 2006 from 9.1% in 2005. The programme foresees a further reduction of the annual average inflation rate to 4.5% in 2007 and 4.3% in 2008. This is broadly in line with the projections of the central bank and somewhat more optimistic than the Commission's autumn forecast. In 2007, the expected upward adjustment of the natural gas price would trigger further increases of energy prices, preserving inflationary pressures. On the other hand the appreciation of the domestic currency and the lifting of import duties for food products from the EU should alleviate such pressures. The main risks to the inflation prognosis come from the rapid credit growth and the evolution of wages, particularly in the public sector in 2007 and 2008. Despite a prudent wage policy advocated by the programme, several slippages can already be noticed – a double-digit increase in wages agreed for 2007 and 2008 for several groups of public sector employees and a nominal increase in the public sector wage bill of around 36% in 2006. The rather optimistic projection of an average inflation rate of 3.2% in 2009 seems to be based on a sustained deceleration of credit and private consumption growth which may not materialise. Moreover, a significant improvement of the terms of trade, including a reduction of import prices, is foreseen that is not fully consistent with the development of prices abroad and the evolution of the exchange rate.

3.6 Sectoral balances

The programme estimates a widening of the external deficit (net borrowing vis-à-vis the rest of the world) to 10.2% of GDP in 2006 from 7.9% in 2005. This is consistent with the Commission's autumn forecast and reflects mainly an increase in the deficit of the balance of goods and services due to a strong surge in imports. At the same time, the savings-investment balance widened both in the private and the government sector, in particular as a result of a higher investment ratio in the government sector and declining savings relative to GDP in the private sector. The financing of the deficit has improved since 2005, with net FDI almost completely covering the net borrowing gap. For 2007-2009 the programme foresees a reduction of the external deficit relative to GDP by 2.4 percentage points, mainly due to a declining savings-investment balance in the public sector after 2007. The programme also expects a recovery of savings in the private sector from 9% of GDP in 2007 to 11.9% of GDP in 2009, which corresponds to the foreseen steady deceleration of private consumption. The reduction of the external deficit is partly linked to an anticipated substantial increase in the positive balance of the capital account from 0.2% of GDP in 2006 to 2.1% of GDP in 2009, which seems to be mainly triggered by an increase in EU transfers. The sharp increase in capital transfers expected by the programme for 2007-2009 is less likely to materialise in light of the current weak absorption of EU funds. Unlike the programme, the Commission's autumn forecast projects a marked widening of the external deficit in 2007 and 2008 (the difference amounts to around 3 percentage points and 5 percentage points respectively) on the basis of imports that continue to outpace exports as a result of strong private consumption and investment. The reduction in the external deficit in the programme appears optimistic and in contrast to the RON appreciation assumption.

3.7 Assessment

The assessment of the macroeconomic outlook covers two issues: first, whether the macroeconomic scenario is plausible, and, second whether the economy should be considered to be in "good" or "bad" times.

5.1.1 Plausibility of the macroeconomic scenario

The programme's macroeconomic scenario foresees robust economic growth in 2006-2009 which is driven by strong domestic demand. This reflects a steady increase in investments and a vibrant growth of private consumption, although the latter is optimistically assumed to ease towards the end of the programme period. The programme mentions certain domestic or external risks that could impact negatively economic growth or external balances. However, the probability of a significant deceleration of growth and worsening of the external position is perceived as low as a result of the improved capacity of domestic supply to cover aggregate demand which remains strong. The programme's macroeconomic outlook is more favourable than the Commission services' autumn forecast, but appears broadly plausible in light of the GDP data released for the first nine months of 2006 and the Commission services' projection of potential growth.

5.1.2 Economic good vs. bad times

The Commission services project a declining, but positive output gap throughout the programme period, against the backdrop of strong domestic demand, rapid credit growth and fairly high external deficits, and also a gradual fall of the unemployment rate. This qualifies the macroeconomic outlook as "economic good times".

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the programme, including the medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country’s position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1 Budgetary implementation in 2006

The programme estimates the outcome for the 2006 deficit to be at 2.3% of GDP, compared to a target in the December 2005 pre-accession economic programme (PEP) of 0.7% of GDP and an estimated outturn of 1.4% of GDP in the Commission services’ 2006 autumn forecast.

The original budget plan for 2006 targeted a deficit of 0.5% (in national accounting methodology). The target was revised upwards several times during the year and was ultimately set at 2.5% of GDP partly due to higher expenditures allocated for investment projects and despite higher revenues thanks to stronger growth. Despite a surplus of 1.2% of GDP recorded at the end of November, a substantial increase in current expenditures (of about 3% of GDP in December) turned the budget balance for the whole 2006 into a deficit of 1.7% in terms of domestic budgetary aggregates. This deficit does not include a sizable debt cancellation for state owned-companies (of around 0.8% of GDP), decided in December 2006. The allocations for capital expenditures were under-spent because of delays in implementing investment projects and reallocated to a large extent to current spending such as wages, government consumption of goods and services and social transfers. On the revenues side, stronger-than-expected growth generated higher direct tax revenues than budgeted, although better tax collection and an increase in formal employment following the 2005 tax reform also played a role. VAT also played a positive contribution and grew by 0.2% of GDP compared to the original 2006 plan due to higher consumption and a better tax collection.

Table 4: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009
General government balance (% of GDP)	**CP Jan 2007**	**-1.5**	**-2.3**	**-2.7**	**-2.6**	**-2.0**
	PEP Dec 2005	-0.4	-0.7	-1.0	-1.6	n.a.
	PEP Dec 2004	*-0.7*	*-0.9*	*-1.9*	*n.a.*	*n.a.*
	COM Nov 2006	-1.5	-1.4	-2.6	-2.6	n.a.
General government expenditure (% of GDP)	**CP Jan 2007**	**33.6**	**36.2**	**39.2**	**39.6**	**39.8**
	PEP Dec 2005	33.7	33.6	33.2	33.5	n.a.
	PEP Dec 2004	*33.6*	*34.1*	*37.2*	*n.a.*	*n.a.*
	COM Nov 2006	38.2	38.8	39.8	40.4	n.a.
General government revenues (% of GDP)	**CP Jan 2007**	**32.1**	**33.9**	**36.5**	**37.1**	**37.8**
	PEP Dec 2005	33.4	32.9	32.2	31.9	n.a.
	PEP Dec 2004	*32.9*	*33.2*	*35.3*	*n.a.*	*n.a.*
	COM Nov 2006	36.8	37.5	37.1	37.8	n.a.
Real GDP (% change)	**CP Jan 2007**	**4.1**	**8.0**	**6.5**	**6.3**	**5.9**
	PEP Dec 2005	5.7	6.0	6.3	6.5	n.a.
	PEP Dec 2004	*6.0*	*6.1*	*6.3*	*n.a.*	*n.a.*
	COM Nov 2006	4.1	7.2	5.8	5.6	n.a.

Source:
Pre-accession economic programme (PEP); Convergence programme (CP); Commission services' autumn 2006 economic forecasts (COM)

4.2 The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

4.2.1. The main goal of the programme's budgetary strategy

The main goal of the programme is to pursue fiscal consolidation so as to achieve the medium-term objective (MTO) for the budgetary position (a general government structural deficit, i.e. a deficit in cyclically-adjusted terms net of one-off and other temporary measures, of 0.9% of GDP) in 2011, i.e. beyond the programme period (see also Section 4.2.3 below).

The programme targets a small reduction of the general government deficit from 2.3% of GDP in 2006 to 2% of GDP in 2009 going through a widening of the deficit in 2007 (to 2.7%). The primary deficit is expected to follow a similar path and to stand at 1% of GDP at the end of the programme period. The most significant deficit reduction is planned to occur in 2009. Compared with the December 2005 PEP, budget targets are far less ambitious in 2007 and 2008 although, the growth assumptions for these two years are similar.

Table 5: Composition of the budgetary adjustment

(% of GDP)	2005	2006	2007	2008	2009	Change: 2009-2006
Revenues	32.1	33.9	36.5	37.1	37.8	**3.9**
of which:						
- Taxes & social contributions	27.9	29.2	31.3	31.1	31.7	**2.5**
- Other (residual)	4.2	4.7	5.2	6.0	6.1	**1.4**
Expenditure	33.6	36.2	39.2	39.6	39.8	**3.6**
of which:						
- Primary expenditure	32.5	35.1	38.1	38.5	38.8	**3.7**
of which:						
Collective consumption	8.8	8.3	8.8	8.3	8.6	**0.3**
Total social transfers	10.0	9.6	9.9	10.3	9.6	**0.0**
Subsidies	1.7	1.5	1.0	0.9	0.9	**-0.6**
Gross fixed capital formation	3.8	6.1	9.7	9.3	8.7	**2.6**
Other (residual)	8.2	9.6	8.7	9.7	11.0	**1.4**
- Interest expenditure	1.1	1.1	1.1	1.1	1.0	**-0.1**
General government balance (GGB)	**-1.5**	**-2.3**	**-2.7**	**-2.6**	**-2.0**	**0.3**
Primary balance	**-0.4**	**-1.2**	**-1.6**	**-1.5**	**-1.0**	**0.2**
One-offs[1]	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**-1.5**	**-2.3**	**-2.7**	**-2.6**	**-2.0**	**0.3**

Note:
[1]One-off and other temporary measures.
Source :
Convergence programme; Commission services' calculations

4.2.2. The composition of the budgetary adjustment

The adjustment, which is marginal and fully back-loaded, is done through an increase in the revenue-to-GDP ratio that is somewhat higher than the increase in the expenditure-to-GDP ratio (3.9 percentage points compared to 3.6 percentage points).

On the revenue side, the increase is frontloaded with a 2.6 percentage points higher revenues-to-GDP ratio in 2007 followed by more moderate increases afterwards. Over the programme period, most of the change comes from taxes (2.8 percentage points) with both direct and indirect taxes increasing by 1.4 percentage points. "Other revenues" rise by 1.4 percentage point of GDP, which seems to be associated with an increase in EU funds inflows, while social contributions are set to decrease slightly as a result of a gradual lowering of the social contributions to be paid by employers and employees (by around 2 percentage points per year over 2007-2009, down from 48.2% in 2006).

Tax revenues are expected to record an upward trend over the programme period due to an improved tax collection as a result of the i) tax reform undertaken in 2005; ii) the fiscal administration reform; iii) the broadening of the tax base with respect to both direct and indirect taxes foreseen in the new fiscal code. With respect to the tax reform enacted in January 2005, the programme recalls the introduction of a flax tax rate of 16% which replaced a profit tax of 25% and a progressive five-bracket scales personal income tax. With respect to fiscal administration reform the programme also presents the main actions envisaged (IT system development, faster information sharing, improved auditing, speeding up tax arrears recovery process, allocation of more resources at local level). With respect to the new fiscal code which came into force on 1 January 2007, the programme describes the main measures concerning various taxes (profit tax, personal income tax, excise duties, local taxes and duties, microenterprise taxation). The new code aims mainly at broadening the tax base and aligning provisions in the fiscal field with the EU regulation (such as the elimination of fiscal facilities and exemptions with respect to the profit tax and VAT which were not compatible with EU rules).

The programme does not specify the estimated budgetary impact of the tax reform, the fiscal administration reform and the new measures in the fiscal code. It only provides more detailed information regarding 2007: direct taxes are expected to increase by 0.9% of GDP mainly due to higher personal income taxes generated by an estimated 12.4% wage increase and a 1.8% increase of the number of employees; profit taxes are expected to contribute by 0.2% of GDP to the increase in direct taxes in 2007 thanks to improved corporate profitability; higher indirect taxes (by 0.9% of GDP) are driven by an increase in VAT revenues as a result of improved collection, a broadening of the tax base (due to the removing of exemptions which were not compatible with EU legislation) and higher consumption. For 2008 the programme foresees a slightly lower tax burden as a share of GDP due to lower social contributions, while the direct and indirect taxes are foreseen to remain stable as a share of GDP despite measures with respect to better tax administration and broadening of the tax base. The higher tax-to-GDP ratio in 2009 compared to 2008 seems to be the result of an improvement in tax administration and collection.

On the expenditure side, the expenditure to GDP ratio is expected to increase sharply by 3 percentage points (from 36.2% of GDP to 39.2% of GDP) in 2007 followed by a slight increase afterwards. The changes stem to a large extent from a very significant increase in public investment, estimated to more than double over the programme period (from 3.8% of GDP to 8.7% in 2009) due to an assumed significant increase in the absorption of EU structural funds. The path of some expenditure categories seems volatile, which raises questions concerning the credibility of the planning. Both investment and social transfers jump (to 9.7% of GDP in 2007 and 10.3% of GDP in 2008 respectively) before falling. Past experience suggests that there may be again a substantial over-budgeting of investment spending. Within the category "government consumption", the wage bill is estimated to remain constant as a share of GDP, marking a departure, which is not substantiated, from what has been observed in the past: the wage bill increased by 19% in 2005 and 36% in 2006 in nominal terms and from 5.3% of GDP in 2005 to 6.3% of GDP in 2006. The same holds for subsidies which are estimated to decrease as a percentage of GDP whereas their level remained constant over the last years. Interest expenditures are set to remain relatively stable over the whole period. The "other expenditures" category is large (at around 10% of GDP). Both its composition and the increase of 1.4 percentage point over the programme period are not explained.

Box 2: The budget for 2007

The Romanian government adopted the draft budget for 2007 on 13 October 2006 and the Parliament approved it on 19 December 2006. The budget targets a general government deficit of 2.7% of GDP in 2007 in ESA 95 terms (2.8% in national accounting methodology).

Total revenues are projected to increase by around 25% compared to 2006. The main revenue-increasing items are expected to be VAT and personal income taxes due to an increase in the respective tax base as well as an increase in excise duties. A reduction of 2 percentage points in the social contributions rate (down from a level of around 50% in 2006) and lower customs duties (which are now to be transferred to the EU budget) are the main revenue-decreasing categories.

Total expenditure is planned to increase by 28.8%. A sizable increase in public investment (by around 3.6 percentage points of GDP) is foreseen, notably in transport infrastructure, education, housing and public services. The public sector wage bill is projected to increase by about 14% in 2007 (but to be stable as a percent of GDP), social benefits by around 18% and spending on public goods and services by more than 20% The main expenditure-decreasing item is expected to be the subsidies.

Table: Main measures in the budget for 2007

Revenue measures*	Expenditure measures**
o Increased VAT tax base (+1% of GDP)	o Increased public investment (+3.6% of GDP)
o Personal income tax related measures (+0.5%)	o Higher social transfers (+0.3% of GDP)
o Excises increases (+0.4% of GDP)	o Lower subsidies (-0.5% of GDP)
o Customs duties (-0.4% of GDP)	
o Lower social contributions (-0.3% of GDP)	

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services, the 2007 budget and the January 2007 convergence programme.

4.2.3. The medium-term objective (MTO) and the structural adjustment

The medium-term objective (MTO) for the budgetary position put forward in the programme is a structural deficit of 0.9% of GDP, which is expected to be achieved by 2011 (i.e. beyond the programme period).

Box 3: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances.

The MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

The MTO is more demanding than the minimum benchmark (a deficit of around 1¾% of GDP for Romania), which is the estimated budgetary position in cyclically adjusted terms that provides a safety margin for automatic stabilisers to operate freely during normal economic downturns without breaching the 3% of GDP deficit reference value. The MTO is appropriate in view of the debt ratio and average potential growth in the long run.

Based on Commission services' calculations according to the commonly agreed methodology, the structural deficit is estimated to have deteriorated from 1½% of GDP in 2005 to 3% of GDP in 2006. The structural balance is projected to further deteriorate to around 3½% of GDP in 2007 (the underlying deterioration is larger once the debt cancellation is taken into account) before declining to 2¼% of GDP in 2009. The structural improvement between 2006 and 2009, by about ½ percentage points of GDP occurs against the background of favourable cyclical conditions as measured by a large positive output gap although gradually declining towards the end of programme period (see also section 3.7.2 above).

The adjustment is fully back-loaded. After a deterioration of around ½% of GDP in 2007, the structural balance as recalculated by the Commission services is planned to improve on average by around ½% percentage points of GDP per year over 2008-2009 with a higher effort is 2009 (of almost 1%).

The fiscal stance based on the recalculation by the Commission services seems expansionary in the first two years of the programme (2006 and 2007), broadly neutral in 2008 and restrictive in 2009.

Table 6: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005		2006		2007		2008		2009	Change: 2009-2006
	COM	CP[1]	COM	CP[1]	COM	CP[1]	COM	CP[1]	CP[1]	CP[1]
Gen. gov't balance	-1.5	-1.5	-1.4	-2.3	-2.6	-2.7	-2.6	-2.6	-2.0	0.3
One-offs[2]	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Output gap[3]	0.4	0.2	1.9	2.1	1.5	2.2	1.0	1.9	1.1	-1.1
CAB[4]	-1.6	-1.5	-2.0	-3.0	-3.1	-3.4	-2.9	-3.2	-2.3	0.6
change in CAB	0.5	:	-0.4	-1.4	-1.2	-0.4	0.2	0.2	0.9	:
CAPB[4]	-0.4	-0.4	-1.0	-1.9	-2.2	-2.3	-2.0	-2.1	-1.3	0.5
Structural balance[5]	-1.6	-1.5	-2.0	-3.0	-3.1	-3.4	-2.9	-3.2	-2.3	0.6
change in struct. bal.	:	:	-0.4	-1.4	-1.2	-0.4	0.2	0.2	0.9	:
Struct. prim. bal.[6]	-0.4	-0.4	-1.0	-1.9	-2.2	-2.3	-2.0	-2.1	-1.3	0.5

Notes:

[1]Output gaps and cyclical adjustment according to the convergence programme (CP) as recalculated by Commission

[2]One-off and other temporary measures. See Table 6 above.

[3]In percent of potential GDP. See Table 2 above.

[4]CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance.

[5]CAB excluding one-off and other temporary measures

[6]Structural primary balance = CAPB excluding one-off and other temporary measures

Source :

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

4.3 Risk assessment

This section presents an assessment of possible risks attached to the achievement of the budgetary targets. It also compares the programme's budgetary projections to those in the Commission services' autumn 2006 forecast, which are derived under the usual no-policy change assumption[7].

The programme's macroeconomic outlook is more favourable than the Commission services' autumn 2006 forecast, but appears plausible (see Section 3.7.1 above). Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point lower real GDP growth than in the programme over the 2006-2009 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2009, the cyclically-adjusted balance is around 1½ percentage point of GDP below the central scenario. Hence, in the case of persistently lower real growth, additional measures of around 1½ percentage point of GDP would be necessary to keep public finances on the path targeted in the central scenario.

[7] The levels and the composition in terms of revenues and expenditure in the convergence programme and Commission services' forecast is different. The differences stem from a change in reporting by the Romanian authorities under the ESA95 with respect to the consolidation of transactions between government subsectors. The government accounts of Romania have not yet been officially subject to a complete quality assessment by Eurostat. Eurostat will publish and validate government balance shortly after the data notification of 1 April 2007.

In previous years, the budgets included an over-budgeting of investment spending which was subsequently, at least in part, reallocated to current expenditure, in particular goods and services, and wages. The budgetary strategy in the programme seems to continue the pattern of over-budgeting of investment spending assuming it would increase from 6.1% of GDP in 2006 to 9.7% in 2007 and 8.7% in 2009. Given that past levels of absorption, the capital spending assumed in the programme, notably in 2007, is unlikely to be reached. Consequently, there are risks that resources allocated to investments would be at least in part shifted to consumption purposes as seen in the past, with a further negative impact on the quality of public spending. Such potential over-budgeting is also detrimental to establishing budget credibility and discipline.

The increase in expenditure-to-GDP ratio in 2007 might be lower than planned given that it relies on a significantly higher level of public investment which is unlikely to be achieved. This is however unlikely to lead to a lower deficit since the assumed tax intensity of economic activity appears to be very favourable notably in 2007. As a result, the budget deficit in 2007 might still be around the level foreseen in the programme.

The risks to the budgetary targets beyond 2007 are as follows:

- Although the notable increase in nominal revenues in 2005 and 2006 (17.5% and 23% respectively) provided sufficient fiscal room, the deficit targets set in the December 2005 PEP were overshot by a margin in the range of 1%-1½% of GDP. This was due in part to the tradition of having several budgetary amendments during the year to revise upwards the level of expenditures as a share of GDP.

- Recent slippages with respect to expenditures such as the increase in the public wage bill in 2006 (of 36% compared to a original planned increase of 14%) and the recourse to debt cancellations for loss-making state-owned companies (the last one in December 2006 amounted to around 0.8% of GDP) pose risks of expenditures overruns, notably in 2008 and 2009 which are election years.

- The erratic path in the evolution of some categories of expenditures foreseen in the programme, notably public investment, consumption and social transfers raises questions concerning the credibility of the expenditures planning.

- The uncertainty regarding the total amount of compensations by general government to owners of properties nationalised during the communist regime under the so-called property fund scheme and the timeframe for recognising citizens' claims is also an additional risk factor[8].

- The fiscal tightening foreseen in 2009 is not sufficiently substantiated with measures in the programme. The increase in the revenue ratio seems rather optimistic.

[8] The increase in the deficit is triggered in the moment when the liability is recognised by the government (through issuing of compensation titles which gives a citizen a claim on the general government) and not by the actual pay-out.

In view of this assessment, risks could be assumed to be broadly balanced in 2007, but outcomes could be worse than targeted in 2008 and 2009.

Table 7: Comparison of budgetary developments and projections

(% of GDP)	2005	2006		2007		2008		2009
		COM	CP	COM	CP	COM[2]	CP	CP
Revenues	36.8	37.5	33.9	37.1	36.5	37.8	37.1	37.8
of which:								
- Taxes & social contributions	28.8	29.5	29.2	29.8	31.3	30.0	31.1	31.7
- Other (residual)	7.9	7.9	4.7	7.3	5.2	7.8	6.0	6.1
Expenditure	38.2	38.8	36.2	39.8	39.2	40.4	39.6	39.8
of which:								
- Primary expenditure	37.1	37.8	35.1	38.8	38.1	39.5	38.5	38.8
of which:								
Collective consumption	9.2	9.3	8.3	9.4	8.8	9.5	8.3	8.6
Total social transfers	18.1	18.0	9.6	18.2	9.9	18.3	10.3	9.6
Subsidies	1.5	1.4	1.5	1.3	1.0	1.2	0.9	0.9
Gross fixed capital formation	2.9	3.1	6.1	3.2	9.7	3.3	9.3	8.7
Other (residual)	5.3	6.0	9.6	6.7	8.7	7.0	9.7	11.0
- Interest expenditure	1.1	1.0	1.1	1.0	1.1	0.9	1.1	1.0
GGB[3]	-1.5	-1.4	-2.3	-2.6	-2.7	-2.6	-2.6	-2.0
Primary balance	-0.3	-0.4	-1.2	-1.7	-1.6	-1.7	-1.5	-1.0
One-offs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GGB[2] excl. one-offs	-1.5	-1.4	-2.3	-2.6	-2.7	-2.6	-2.6	-2.0

Notes:

[1]The levels and the composition in terms of revenues and expenditure in the convergence programme and Commission services' forecast is different. The differences stem from a change in reporting by the Romanian authorities under the ESA95 with respect to the consolidation of transactions between government subsectors. The government accounts of Romania have not yet been officially subject to a complete quality assessment by Eurostat. Eurostat will publish and validate government balance shortly after the data notification of 1 April 2007.

[2]On a no-policy change basis.

[3]General government balance

Source :

Commission services' autumn 2006 economic forecast (COM); convergence programme (CP); Commission services' calculations

Table 8: Assessment of tax projections

	2007			2008			2009
	CP	**COM**	**OECD[3]**	**CP**	**COM[1]**	**OECD[3]**	**CP**
Change in tax-to-GDP ratio (total taxes)	2.4	0.3	0.2	0.6	0.2	0.2	0.2
Difference (CP – COM)	2.1		/	0.3		/	/
of which[2]:							
- discretionary and elasticity component	4.5		/	2.0		/	/
- composition component	-1.0		/	-1.0		/	/
Difference (COM - OECD)	/	0.2		/	0.1		/
of which[2]:							
- discretionary and elasticity component	/	-0.1		/	-0.3		/
- composition component	/	0.5		/	0.7		/
p.m.: Elasticity to GDP	1.6	1.1	1.1	1.2	1.1	1.1	1.1

Notes:

[1]On a no-policy change basis.

[2]The decomposition is explained in Annex 5.

[3]OECD ex-ante elasticity relative to GDP.

Source:

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)

4.4 Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

Table 9: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	not within programme period	not within programme period
b. Achievement of the MTO	not within programme period (2011)	not within programme period
c. Adjustment towards MTO in line with the Pact[2]?	is insufficient and should be strengthened significantly	is insufficient and should be strengthened significantly

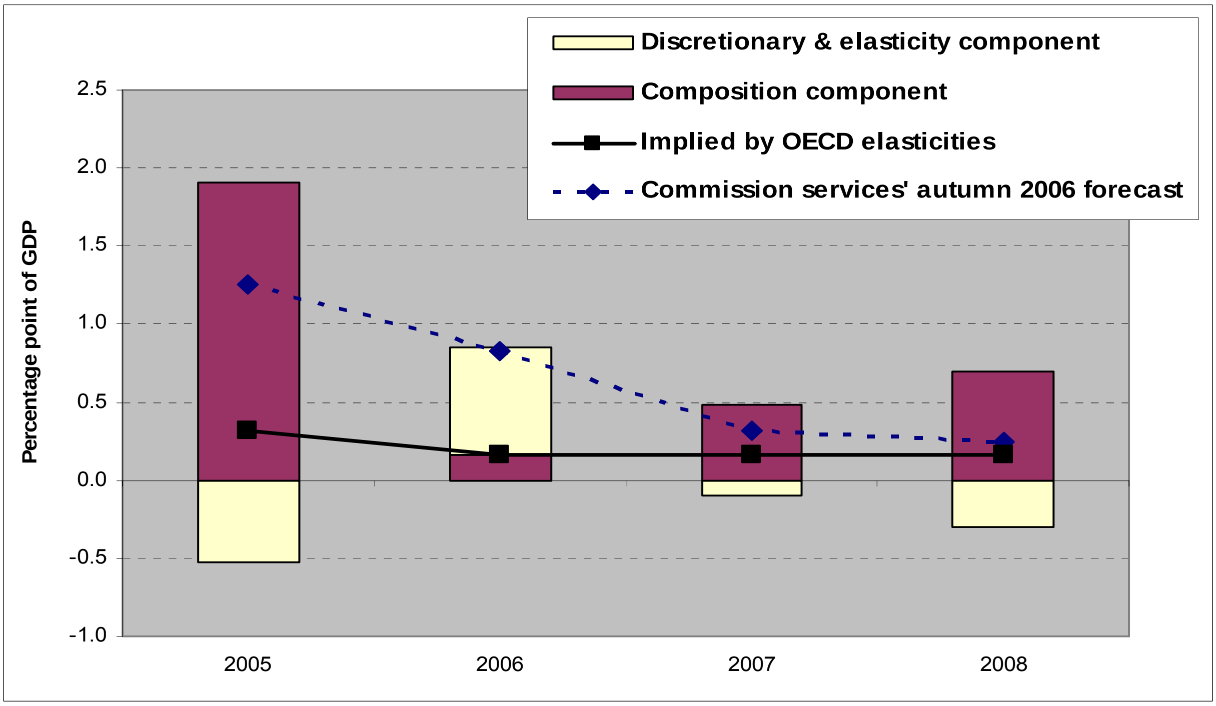
Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1¾% of GDP for Romania). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

Taking into account the risks identified above, Romania does not respect the requirement of the Stability and Growth Pact regarding the condition of providing a safety margin against breaching the 3% of GDP deficit reference value because the structural deficit will exceed the minimum benchmark in every year. The MTO would not be achieved within the programme period, as also envisaged in the programme.

After a deterioration in the structural deficit of around ½% of GDP in 2007 (which becomes larger if the sizable debt cancellation for state owned-companies in 2006 is taken into account), the planned adjustment path towards the MTO averages about ½% of GDP per year with most of the effort made in 2009. However, in view of the risks identified above, especially the fact that the programme does not contain sufficient measures which would support the adjustment effort in 2009, the structural adjustment is likely to be slower than expected by the programme. Given the favourable cyclical conditions (economic "good times", cf. Section 3.7.2 above), as broadly confirmed by the assessment of tax elasticities (the tax system can be expected to yield more than implied by the OECD ex-ante elasticities and the prevailing effect comes from a favourable composition of growth according to the Commission services’ forecast), the adjustment path is insufficient and should be strengthened significantly.

Figure 8: Changes in the tax-to-GDP ratio: actual/projected changes vs. changes implied by OECD elasticity



Note:
The dashed line displays the change in the tax ratio in the Commission services' 2006 autumn forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:Commission services

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role.[9] The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the convergence programmes targets, compares them with the Commission services' forecasts and assesses the

9 On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005*, European Economy, N°3/2005.

associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1 Recent debt developments and medium-term prospects

5.1.1 Debt projections in the programme

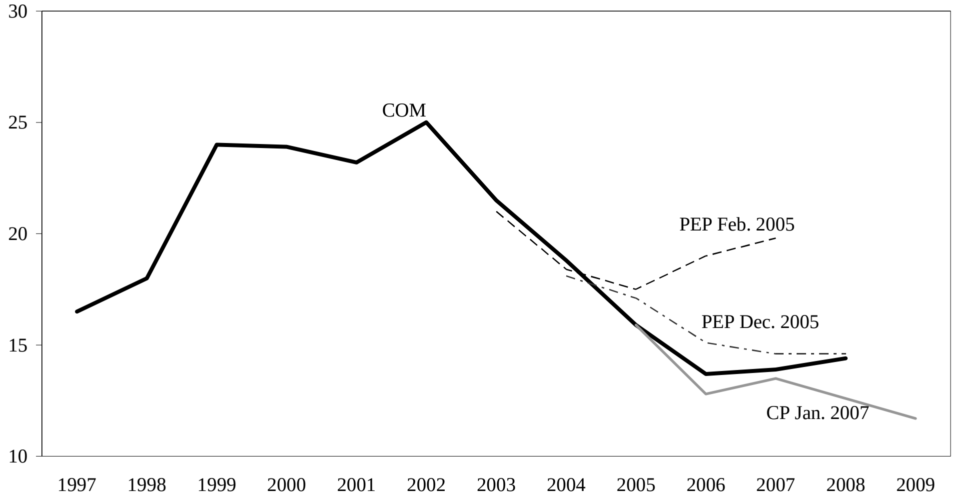
The programme estimates that the gross debt-to-GDP ratio has fallen to around 13% by end-2006, as compared to around 16% by end-2005. From 2002 to 2006, the debt ratio is estimated to have fallen by 10 percentage points of GDP.

The estimated gross debt outturn for 2006 compares with a projected ratio of 15% in the December 2005 Pre-Accession Economic Programme (PEP). The outcome is also slightly lower than projected in the Commission services' autumn 2006 economic forecast, notably due to a negative stock-flow adjustment that is significantly larger than planned. This difference pertains mainly to the appreciation of the national currency vis-à-vis all major currencies, thus reducing the value in national currency of foreign-currency debt.

The better outturn for the debt ratio in 2006 compared to the previous programme extends the experience of recent years in that previous programmes' debt projections have been regularly undershot, with more rapid debt-ratio reductions than expected (Figure 9). Besides the above described valuation effect on the foreign-currency debt, the reduction in the debt ratio is explained by the record of government primary balances and nominal GDP growth, which have been regularly stronger than anticipated in earlier programmes, as well as lower than expected interest expenditure.

Looking ahead, the programme projects a minor increase in the debt ratio in 2007, apparently due to a debt-increasing valuation effect, which seems not to be in line with the projected nominal appreciation. Therefore, the debt ratio for 2007 may be somewhat overestimated. Over the following years, the programme projects the debt ratio to be gradually reduced; by the end of 2009, the debt ratio would be 11.7% of GDP. Due in particular to projected higher primary deficits, the Commission services' autumn forecast pointed to a moderately increasing debt ratio throughout the programme period.

Figure 9: General government debt projections in successive programmes (% of GDP



Note: PEP = pre-accession economic programme.

Source: Commission services' autumn 2006 forecast (COM), January 2007 convergence programme and successive PEPs

Table 10: Debt dynamics

(% of GDP)	average 2002-04	2005	2006		2007		2008		2009
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**18,8**	**15,9**	**13,7**	**12,8**	**13,9**	**13,5**	**14,4**	**12,6**	**11,7**
Change in the ratio	-2,4	-2,9	-2,2	-3,1	0,2	0,7	0,5	-0,9	-0,9
Contributions[2]:									
Primary balance	-0,2	0,3	0,4	1,2	1,7	1,6	1,7	1,5	1,0
“Snow-ball” effect	-3,5	-1,5	-1,5	-1,4	-0,8	-0,5	-0,5	-0,3	-0,2
Of which:									
Interest expenditure	1,9	1,1	1,0	1,1	1,0	1,1	0,9	1,1	1,0
Growth effect	-1,2	-0,7	-1,0	-1,1	-0,7	-0,7	-0,7	-0,8	-0,7
Inflation effect	-4,2	-2,0	-1,6	-1,4	-1,1	-0,8	-0,8	-0,6	-0,5
Stock-flow adjustment	1,3	-1,7	-1,0	-2,9	-0,7	-0,4	-0,6	-2,1	-1,7
Of which:									
Cash/accruals diff.	-0,1	-1,3	-	0,0	-	-	-	-	-
Acc. financial assets	0,5	-0,1	-	2,7	-	-	-	-	-
Privatisation	0,0	0,0	-	2,7	-	-	-	-	-
Val. effect & residual	0,8	-0,4	-	-5,7	-	-	-	-	-

Notes:
[1]End of period.
[2]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t}-\frac{D_{t-1}}{Y_{t-1}}=\frac{PD_t}{Y_t}+\left(\frac{D_{t-1}}{Y_{t-1}}*\frac{i_t-y_t}{1+y_t}\right)+\frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the “snow-ball” effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:
Convergence programme (CP); Commission services’ autumn 2006 economic forecasts (COM); Commission services’ calculations

5.1.2 Assessment

In 2007 and 2008, the impact of the primary balance and the "snow-ball" effect is broadly similar in the programme and in the Commission services' autumn forecast. Nevertheless, the programme expects a further reduction in the ratio over the programme period compared to the Commission services' projection of a moderately increasing gross debt ratio until 2008.

The debt-to-GDP ratio could decline if the substantial general government deposits (both in national and foreign currencies)[10] would be used for redeeming public debt. The government seems, however, to consider their use for other purposes than debt redemption, namely to finance the planned pension reform and infrastructure investments.

The Romanian authorities have sought to develop the primary and secondary securities markets and consolidate the use of debt instruments with longer maturities. Although this has contributed to developing the financing capacity of domestic securities markets and their improved functioning by extending the interest rate curve, the government bond market remains weakly developed and is characterised by an irregular and small amount of issues as well as limited number of transactions on the secondary market. No bond issue has been established as a benchmark so far. Therefore, and reiterated by the fact that Romania's public debt stock still consists of roughly one third of government securities and two thirds of loans, the objective of further developing the domestic securities market is important and would help improve the risk management of public debt. Currently, more than three quarters of government debt (that is 12.7% of GDP) is denominated in foreign currencies, mainly euro and USD. Although the programme contains a useful sensitivity analysis of the impact of a currency depreciation on main macroeconomic variables, it refrains from estimating the effect on the debt ratio of unplanned currency movements.[11] The programme is not revealing on the extent to which further foreign financing will be resorted to over the programme period, but states that general government financing needs will be covered primarily from domestic sources.

The programme does not contain data on contingent liabilities, such as guarantees, as was the case in the pre-accession economic programmes. Presumably, this is due to the fact that this risk has declined substantially over recent years due to more restrictive provisions in the Public Debt Law on State guarantees and tightened financial discipline of public enterprises, notably in the energy sector. The stock of State guarantees is declining and the issuing of new guarantees has been reduced, but the amount of guarantees outstanding remains substantial (around 4% of GDP by end-2006). Due to a pernicious practice of using State guarantees as a financing instrument for loss-making entities, the ratio of called stated guarantees was very high at around 70% until 2003, but the situation has since improved significantly even if the failure ratio remained around 20% in 2005.

---

[10] These deposits stem mostly from privatisation receipts of past years.

[11] The programme's exchange projection of an annual nominal appreciation of around 2% therefore contributes to reducing the debt ratio.

5.2 Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[12]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (See box 4), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2010, the final year of the stability programme; it is called the "2006 scenario". The second scenario assumes that the macroeconomic and budgetary plans until 2010 provided in the stability programme will be fully respected. This is the "programme scenario". In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

In the absence of the long-term projections of age-related expenditures, based on the common macroeconomic assumptions as carried out by the EPC/Commission, it is not possible to assess the impact of population ageing in Romania on a comparable and robust basis as it is currently done for the other Member States, for which the projections on this basis are available.[13]

Table 11: Long-term age-related expenditure: main projections

(% of GDP)	2005	2010	2020	2030	2050	changes
Total age-related spending	13.8	16.3	16.3	16.4	15.2	1.4
Pensions	6.7	7.3	7.3	7.8	7	0.3
Healthcare	3.5	3.7	3.7	3.6	3.5	0.0
Long-term care	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education	3.6	5.3	5.3	5.0	4.7	1.1
Unemployment benefits	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Romania's Government, Convergence programme 2006-2009, January 2007.

The convergence programme projections, based on relatively optimistic long-term economic growth assumptions, show an increase of 1.4% points of GDP from 2005 up to

[12] For a detailed analysis of long-term sustainability issues, see "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

[13] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, healthcare, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1, 2006.

2050, a bulk of which is projected to come from education expenditures. The expenditure on health-care is projected to stay at the current levels throughout the projection period, while pension expenditures are expected to increase only slightly.

Based on these long-term budgetary projections, sustainability indicators can be calculated.

Table 12: Sustainability indicators

	2006 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	1.7	1.9	-0.5	0.9	1.3	-0.5
of which:						
Initial budgetary position	2.1	2.1	-	1.5	1.5	-
Debt requirement in 2050	-0.8	-	-	-0.9	-	-
Future changes in budgetary position	0.3	-0.2	-	0.3	-0.2	-

Source: Commission services.

Table 12 shows that the current initial budgetary position is insufficient to stabilise debt throughout the projection period ("2006 scenario"). The budgetary plans in the programme imply some improvement in the structural balance between 2006 and 2009. While the projected budgetary impact of ageing is very modest according to the national projections, the projected increase in the structural primary balance over the programme period has a positive impact on the sustainability gap (“programme scenario”) showing the importance of improving the structural budgetary position to contain risks to the sustainability of public finances.

On the basis of the presented long-term macroeconomic assumptions and expenditure projections, the required primary balance (RPB) is about -0.5% of GDP, higher than the structural primary balance of about -2¼% of GDP in the last year of the programme’s period.

Box 4 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the***: (i) **Initial Budgetary Position (IBP)**; and, (ii) **Long-Term Change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2011-2015) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability.. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa

5.2.2. Additional factors

The programme presents national long-term macroeconomic assumptions on the basis of which a number of the expenditure items are projected (pension, health-care and education expenditure). Comparing the macroeconomic assumptions with the EU-10 average derived from the EPC/Commission common projection exercise, the real growth of GDP and labour productivity growth for the entire projection period in the programme are significantly more optimistic than those agreed by the EPC.[14] As a consequence, the expected rise in the total long-term age-related expenditures (of 1.4% of GDP over 2010-2050) and in particular the part related to pension and health care expenditures may be tilted towards the optimistic side.

Moreover, it is important to note that the ongoing second stage of the pension reform consists of establishing a multi-pillar pension system, with introduction of the privately managed compulsory second pillar in 2008 and private managed voluntary third pillar

[14] The long-term economic growth projections indicate growth rate in 2010 to be 6.5% (against the EU10 average of 4.6%), in 2020 5.5% (2.9%), in 2030 4.6% (2.1%) and in 2050 3.7% (0.6%).

this year. A successful implementation of the private pillars would according to the programme contribute to offset the projected significant decrease in the public pension scheme replacement rates in the future, which are projected to decline from close to 45% in 2010 to 33% in 2050.

5.2.3. Assessment

In the absence of the long-term projections of age-related expenditures, based on the common macroeconomic assumptions as carried out by the EPC/Commission, it is not possible to assess the impact of population ageing in Romania on a comparable and robust basis as it is currently done for the other Member States, for which the projections on this basis are available. However, a significant impact of ageing on expenditure cannot be excluded given the current demographic structure.

The initial budgetary position, with a large structural deficit, is not sufficient to stabilise debt even before considering the long-term budgetary impact of ageing. Improving the structural budgetary position over the medium-term would contribute to containing risks to the sustainability of public finances.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The programme devotes attention in expenditure policy to improving the quality of physical and human capital over the programme period. Increased public investments is foreseen in education, research and development and infrastructure (environment, transportation and housing), and even if the programme is not lucid in presenting the budgetary impact of the various measures in detail, it presents both aggregate spending targets and a list of priority actions to underpin these priorities, which appear appropriate in order to strengthen the competitiveness and supply-side response of the Romanian economy. A certain discrepancy seems, at the same time, to exist between the spending targets in the various sectors and the very substantial increase in total public investment, which is programmed to reach an unprecedented level of close to 10% of GDP in 2007. Moreover, the limited information in the programme regarding the allocation of public expenditure according to the functional and economical classifications makes it difficult to verify that the composition of expenditures would live up to the programme's awareness of the role that public finances can play in enhancing potential output. Given the limited success in recent years in implementing the government's public investment programmes, the planned surge in investment activity is doubtful. Moreover, the budget execution over recent years has exhibited a strong increase in wage expenditure and transfers at the expense of capital spending, and did in this way not live up to the aim of making the allocation of public expenditure more conducive to the real convergence process.

The programme describes in some detail the envisaged reform of the pension and health systems with a view to improving efficiency of spending and long-term financial sustainability. The programme underlines that reform steps are taken to improve the financial balance of the public pension system in view of expected demographic developments and the projected widening of the deficit currently recorded in the public pension system (see section 5.2). These steps include setting up third-pillar private pension funds as of 2007, for which participation will be optional, and the establishment of a privately managed second pillar pension system based on compulsory participation for younger employees, which is now envisaged for 2008 after having been postponed several times. Finally, the statutory retirement age is being gradually lifted for both men and women. As regards the need for further reform, the programme does not present any concrete measures, which could be taken to prevent a progressive lack of financing of the first and second pillar. In view of the structural imbalance of the public pension system, which already today requires significant transfers from the state budget to the social security budget to cover the shortfall of financing, this appears to be insufficient and a more pro-active and comprehensive strategy would be required to put the first pillar back on a sound footing. Moreover, the programme seems to assume a persistently low replacement rate, which would cause increasing disparity in living standard between the working and the retired population. Both financial and social reasons therefore accentuate the need to further reform the pension system with the twofold purpose of improving its financial sustainability and providing an adequate pension level. Consideration should also be given to reforming the access to early retirement and disability schemes, which are important in explaining the past growth in the number of beneficiaries.

The programme presents reform of the health system as a central issue, notably with respect to improving the low efficiency of spending, which currently impacts negatively on the population's perception of responsibility and accountability of government services. Health care reforms going in this direction appear to be a highly relevant priority, for example in view of the health fund having suffered from a lack of control over hospitals' expenditures. This has caused a substantial increase in expenses over recent years and implied severe difficulties for the health fund in meeting its payment obligations towards medical suppliers. However, the programme would have stood out as more convincing if it had also considered the challenges in the health system from a budgetary point of view and presented measures to ensure its longer-term financial balance. The current low standards and coverage of medical care in combination with the impact of ageing and growing real incomes make it likely that a significant expenditure pressure may occur in this field, which seems not to be factored into the programme's budgetary projections.

The programme aims to further build on a number of institutional and legal measures taken over recent years to strengthen the budgetary framework and tax administration. These include more transparent Fiscal Code and Fiscal Procedures Code, aimed at ensuring greater stability of tax legislation and administration, as well as the improved functioning of the National Agency for Fiscal Administration, which is responsible for the unified collection, audit and enforcement of tax and social security contributions. These measures have led to some results in improving revenue collection, although a large upside potential is recognised to still exist, notably to be released by strengthened enforcement and improved voluntary compliance.

The programme openly recognises the need to improve prioritisation, programming and transparency of the expenditure policy, and explains that the use of expenditure programmes and multi-annual budgeting will facilitate such improvements. This is clearly a first step forward towards establishing a clear and binding medium-term expenditure framework, which can support the re-allocation of public expenditure towards human capital, infrastructure and administrative capacity. The programme also envisages to modernise the budgetary framework for central government by implementing a two-staged strategic planning system. This could, if consequently and successfully implemented, be important to improve the capacity to plan and execute the expenditure policy. Increasing the role of the multi-annual budgetary framework would, for example, facilitate the decision-making process, improve time consistency and contribute to sufficient flexibility on the expenditure side of the budget.

A further strengthening of the control mechanisms with regard to line ministries' budget execution is not directly addressed in the programme. Currently, line ministries' expenditure estimates, notably for investment programmes, seem not to be particularly reliable, while the Ministry of Finance appears to not be well positioned to cross-check the trustworthiness of planned expenditure and exert influence over line ministries' budget execution over the course of the budget year. This is one reason for the accumulation of sizeable budgetary surpluses over the course of the year, followed by massive spending of more than 2% of GDP in the month of December. The current executive shortcomings also show in the recourse to frequent budgetary rectifications, which in a pro-cyclical manner have been used to distribute unbudgeted revenue gains to priority areas or to cover expenditure overruns. The programme also aims at pursuing the process of fiscal decentralisation, which increases the fiscal autonomy of local authorities in terms of raising revenues, allocating expenditure and financing investments via loans. While there may be clear advantages of such decentralisation, it also seems to require that the control mechanisms for local public finances are further developed. The importance of planning capacity, implementation efficiency and adequate control mechanisms at central and local level are also of crucial importance for a successful use of available EU funds, and further improvements in these respects would increase the likelihood that the programme's projection of absorbing more than 3% of GDP of EU funds in 2009 is achieved.

7. CONSISTENCY WITH THE BROAD ECONOMIC POLICY GUIDELINES

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 4.4. above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2. and 0.

Overall, the budgetary strategy in the convergence programme is partly consistent with the broad economic policy guidelines. In particular, the budgetary adjustment is insufficient and should be strengthened significantly over the programme period. Moreover, the fiscal strategy put forward in the programme, notably the loosening of the fiscal stance until 2008 and the limited consolidation thereafter add to aggregate demand management concerns, including those regarding the need to maintain sustained high growth. More caution in the fiscal stance is warranted in order to not to jeopardise the sustainability of the external balance.

Table 13: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].			X	
– Member States should avoid pro-cyclical fiscal policies[2].				X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.			X	
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)		X		
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X		

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”.
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

* * *

Annex 2: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of .44high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance, structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance, primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme, code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance, budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt.*

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values*, in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a "safety margin" that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

Table 1a. Macroeconomic prospects

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	**256,7**	**4,1**	**8**	**6,5**	**6,3**	**5,9**
2. Nominal GDP	B1*g	**288**	**16,9**	**18,6**	**13,8**	**11,6**	**10,1**
Components of real GDP							
3. Private consumption expenditure	P.3	**186,8**	**9,6**	**11,8**	**8,1**	**7,2**	**6,7**
4. Government consumption expenditure	P.3	**43,4**	**9**	**3,7**	**3,5**	**3,8**	**3,1**
5. Gross fixed capital formation	P.51	**60,6**	**12,6**	**15**	**14**	**11,5**	**11**
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	**-2,2**	**-**	**-**	**-**	**-**	**-**
7. Exports of goods and services	P.6	**95,7**	**8,1**	**11,8**	**10,9**	**7,6**	**7,3**
8. Imports of goods and services	P.7	**129,3**	**16,6**	**20,8**	**15**	**11,2**	**10,3**
Contributions to real GDP growth							
9. Final domestic demand		**-**	**10,8**	**12,3**	**9,6**	**8,6**	**8**
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	**-**	**-2,2**	**0,8**	**0**	**0,2**	**0,1**
11. External balance of goods and services	B.11	**-**	**-4,5**	**-5,1**	**-3,1**	**-2,5**	**-2,2**

Table 1b. Price developments

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		**-**	**12,2**	**9,8**	**6,8**	**5**	**3,9**
2. Private consumption deflator		-	7,1	5,9	4,3	3,1	2,5
3. HICP[1]		**-**	**9,1**	**6,6**	**4,5**	**4,3**	**3,2**
4. Public consumption deflator		-	20,9	10,2	4,9	3	2,3
5. Investment deflator		-	9,7	9,5	6	4	3
6. Export price deflator (goods and services)		**-**	**-0,9**	**2,8**	**3,3**	**2,9**	**2,6**

7. Import price deflator (goods and services)		**-**	**-3,6**	**-0,8**	**-0,7**	**-0,8**	**-0,5**

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2005	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		**9147**	**-0,1**	**0,6**	**0,3**	**0,3**	**0,2**
2. Employment, hours worked[2]		-	-	-	-	-	-
3. Unemployment rate (%)[3]		-	**7,2**	**6,8**	**6,7**	**6,6**	**6,5**
4. Labour productivity, persons[4]		-	**4,2**	**7,4**	**6,2**	**6**	**5,7**
5. Labour productivity, hours worked[5]		-	-	-	-	-	-
6. Compensation of employees	D.1	-	**17,4**	**15,6**	**11,8**	**9,9**	**9,4**

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis rest of the world	B.9	**-7,9**	**-10,2**	**-8,9**	**-8,3**	**-7,8**
of which: - Balance on goods and services		-10,3	-11,8	-11,7	-11,5	-11,4
- Balance of primary incomes and transfers		1,6	1,4	1,4	1,3	1,5
- Capital account[1]		0,8	0,2	1,4	1,9	2,1
2. Net lending/borrowing of the private sector	B.9	-7,2	-8,1	-7,6	-7,6	-7,9
3. Net lending/borrowing of general government	EDP B.9	-1,5	-2,3	-2,7	-2,6	-2,0
4. Statistical discrepancy		-	-	-	-	-

[1]Based on Autumn forecasts of 6 November 2006. For 2009 a technical extrapolation of the historical trend.

Table 2. General government budgetary prospects

	ESA code	2005	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	**-4205,1**	**-1,5**	**-2,3**	**-2,7**	**-2,6**	**-2**
2. Central government	S.1311	**-4262,1**	**-1,5**	**-3**	**-3**	**-3**	**-2,4**
3. State government	S.1312	-	-	-	-	-	-
4. Local government	S.1313	**-150,5**	**-0,1**	**0,2**	**0,1**	**0,1**	**0,04**
5. Social security funds	S.1314	**207,5**	**0,1**	**0,5**	**0,2**	**0,4**	**0,3**
General government (S13)							
6. Total revenue	TR	**92297,5**	**32,1**	**33,9**	**36,5**	**37,1**	**37,8**
7. Total expenditure	TE[1]	**96503**	**33,6**	**36,2**	**39,2**	**39,6**	**39,8**
8. Net lending/borrowing	EDP B.9	**-4205,5**	**-1,5**	**-2,3**	**-2,7**	**-2,6**	**-2**
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	**3281,1**	**1,1**	**1,1**	**1,1**	**1,1**	**1**
p.m.: 9a. FISIM		-	-	-	-	-	-
10. Primary balance	[2]	**-924,4**	**-0,4**	**-1,2**	**-1,6**	**-1,5**	**-1**

Selected components of revenue								
11. Total taxes (11=11a+11b+11c)		**52334,8**	**18,2**	**19,8**	**21,7**	**21,7**	**22,6**
11a. Taxes on production and imports	D.2	**36348**	**12,7**	**13,5**	**14,4**	**14,5**	**14,9**
11b. Current taxes on income, wealth, etc	D.5	**15986,8**	**5,6**	**6,3**	**7,2**	**7,2**	**7,7**
11c. Capital taxes	D.91	**0**	**0**	**0**	**0**	**0**	**0**
12. Social contributions	D.61	**27882,1**	**9,7**	**9,4**	**9,6**	**9,4**	**9,1**
13. Property income	D.4	**4036,8**	**1,4**	**1,5**	**1,5**	**1,5**	**1,4**
14. Other (14=15-(11+12+13))		**8043,7**	**2,8**	**3,2**	**3,8**	**4,5**	**4,7**
15=6. Total revenue	TR	**92297,5**	**32,1**	**33,9**	**36,5**	**37,1**	**37,8**
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[3]		**80217**	**27,9**	**29,2**	**31,2**	**31,1**	**31,7**
Selected components of expenditure							
16. Collective consumption	P.32	**25382,3**	**8,8**	**8,3**	**8,8**	**8,3**	**8,6**
17. Total social transfers	D.62+D.63	**28744,2**	**10**	**9,6**	**9,9**	**10,3**	**9,6**
17a. Social transfers in kind	P.31=D.63	-	-	-	-	-	-
17b. Social transfers other than in kind	D.62	-	-	-	-	-	-
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	**3281,1**	**1,1**	**1,1**	**1,1**	**1,1**	**1**
19. Subsidies	D.3	**4820,6**	**1,7**	**1,5**	**1**	**0,9**	**0,9**
20. Gross fixed capital formation	P.51	**10984**	**3,8**	**6,1**	**9,7**	**9,3**	**8,7**
21. Other (21=22-(16+17+18+19+20))		**23290,8**	**8,1**	**9,6**	**8,7**	**9,8**	**11**
22=7. Total expenditure	TE[1]	**96503**	**33,6**	**36,2**	**39,2**	**39,6**	**39,8**
p.m.: Compensation of employees	D.1	-	-	-	-	-	-

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

[3]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2004	2009
1. General public services	1	-	-
2. Defence	2	-	-
3. Public order and safety	3	-	-
4. Economic affairs	4	-	-
5. Environmental protection	5	-	-
6. Housing and community amenities	6	-	-
7. Health	7	-	-
8. Recreation, culture and religion	8	-	-
9. Education	9	-	-
10. Social protection	10	-	-
11. Total expenditure (=item 7=26 in Table 2)	TE[1]	-	-

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP		2005	2006	2007	2008	2009
1. Gross debt[1]		**15,9**	**12,8**	**13,5**	**12,6**	**11,7**
2. Change in gross debt ratio		**-2,9**	**-3,1**	**0,8**	**-0,9**	**-0,9**
Contributions to changes in gross debt						
3. Primary balance[2]		**-0,4**	**-1,2**	**-1,6**	**-1,5**	**-0,9**
4. Interest expenditure (incl. FISIM)[3]		**1,1**	**1,1**	**1,1**	**1,1**	**1**
5. Stock-flow adjustment		**-3,6**	**-3**	**1,3**	**0,5**	**-1**
of which:						
- Differences between cash and accruals[4]		0,11	0,03	-0,02	-0,01	-0,02
- Net accumulation of financial assets[5]		0,15	2,68	0,31	0,09	0,08
of which:						
- privatisation proceeds		0,08	2,68	0,26	0,09	0,08
- Valuation effects and other[6]		-3,9	-5,7	1	-0,6	-1,1

p.m.: implicit interest rate on debt[7]		**7,8**	**9,1**	**8,7**	**8,9**	**9**
Other relevant variables						
6. Liquid financial assets[8]		0,6	3,9	3,6	3,1	2,8
7. Net financial debt (7=1-6)		15,3	8,8	10,2	9,6	8,9

[1]As defined in Regulation 3605/93 (not an ESA cncept).

[2]Cf. Item 10 in Table 2.

[3]Cf. Item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

[8]AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments

% of GDP	ESA Code	2005	2006	2007	2008	2009
1. Real GDP growth (%)		**4,1**	**8**	**6,5**	**6,3**	**5,9**
2. Net lending of general government	EDP B.9	**-1,5**	**-2,3**	**-2,7**	**-2,6**	**-2**
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41 incl. FISIM	**1,1**	**1,1**	**1,1**	**1,1**	**1**
4. Potential GDP growth (%)		5,29	5,51	5,98	6,25	6,6
contributions:						
- labour		0,11	-0,07	0,10	0,07	0,26
- capital		1,79	2,07	2,30	2,58	2,75
- total factor productivity		3,39	3,51	3,58	3,60	3,59
5. Output gap		0,73	1,99	2,31	2,17	1,33
6. Cyclical budgetary component		0,2	0,57	0,69	0,65	0,41
7. Cyclically-adjusted balance (2-6)		-1,7	-2,86	-3,39	-3,25	-2,41
8. Cyclically-adjusted primary balance (7-3)		-0,6	-1,76	-2,29	-2,15	-1,41

Table 6. Divergence from previous update

	ESA Code	2005	2006	2007	2008	2009
Real GDP growth (%)						
Previous update		**5,7**	**6**	**6,3**	**6,5**	**-**
Current update		**4,1**	**8**	**6,5**	**6,3**	**5,9**
Difference		**-1,6**	**2**	**0,2**	**-0,2**	**-**
General government net lending (% of GDP)	EDP B.9					
Previous update		**-0,4**	**-0,7**	**-1**	**-1,5**	**-**
Current update		**-1,5**	**-2,3**	**-2,7**	**-2,6**	**-2**
Difference		**-1,1**	**-1,6**	**-1,7**	**-1,1**	**-**
General government gross debt (% of GDP)						
Previous update		**17,1**	**15,1**	**14,6**	**14,6**	**-**
Current update		**15,9**	**12,8**	**13,5**	**12,6**	**11,7**
Difference		**-1,2**	**-2,3**	**-1,1**	**-2**	**-**

Table 7. Long-term sustainability of public finances

% of GDP	2000	2004	2010	2020	2030	2050
Total expenditure[1]		33,4	39	39	38,4	-
Of which: age-related expenditures		-	-	-	-	-
Pension expenditure		6,7	7,3	7,3	7,8	-
Social security pension		-	-	-	-	-
Old-age and early pensions		-	-	-	-	-
Other pensions (disability, survivors)		-	-	-	-	-
Occupational pensions (if in general government)		-	-	-	-	-
Health care		3,2	3,7	3,7	3,6	-
Long-term care *(this was earlier included in health care)*		-	-	-	-	-
Education expenditure		3,4	5,3	5,3	5,0	-
Other age-related expenditures		-	-	-	-	-
Interest expenditure		-	-	-	-	-
Total revenue[1]		31,9	37,5	38,0	37,4	-
Of which: property income		-	-	-	-	-
of which: from pensions contributions (or social contributions if appropriate)		-	-	-	-	-
Pension reserve fund assets		-	-	-	-	-
Of which: consolidated public pension fund assets (assets other than government liabilities)		-	-	-	-	-
Assumptions						
Labour productivity growth		9,3	6,1	5,4	4,6	-
Real GDP growth		8,5	6,5	5,5	4,6	-
Participation rate males (aged 15-64)[2]		70,2	69,2	70,9	71,4	-
Participation rates females (aged 15-64)[2]		56,2	56,9	59,3	59,4	-
Total participation rates (aged 15-64)[2]		63,2	63	65,1	65,4	-
Unemployment rate		8	6,4	5,5	5,2	-
Population aged 65+ over total population		14,5	15,6	16,5	17,5	-

[1] These figures have not been published by the AWG. The method is known from the sustainability report 2006: the non-age related revenues and expenditures are kept constant at the 2005 level (taken from tabel a.3.5 of Public Finance Report 2006). Therefore, in this table the non-age related revenues and expenditures are set equal to the 2005 level from the latest economic outlook (MEV 2007). The age related revenues and expenditures are then added to reach the grand total.

[2]In the Code of conduct the age limits are 20-64

Table 8. Basic assumptions

	2005	2006	2007	2008	2009
Short-term interest rate[1] (annual average)	-	-	-	-	-
Long-term interest rate (annual average)	-	-	-	-	-
for countries in euro area or ERM II: **USD/€ exchange rate (annual average)**					
Nominal effective exchange rate					
for countries not in euro area or ERM II: **exchange rate vis-à-vis the € (annual average)**	**3,62**	**3,52**	**3,45**	**3,38**	**3,32**
World excluding EU, GDP growth	**5,6**	**5,7**	**5,2**	**5,2**	**5,2**
EU GDP growth	**1,7**	**2,8**	**2,4**	**2,4**	**2,4**
Growth of relevant foreign markets	**5,5**	**8,5**	**6,5**	**6,4**	**6,3**
World import volumes, excluding EU	**7,3**	**8,8**	**8,2**	**7,7**	**6,9**
Oil prices (Brent, USD/barrel)	**54,1**	**65,6**	**66,3**	**68**	**69**

[1]If necessary, purely technical assumptions.

Annex 3: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements.

Guidelines in the code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December[1].			Not applicable
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.		X	
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).	X		The government accounts of Romania have not yet been officially subject to a complete quality assessment by Eurostat. Eurostat will publish and validate government balance and debt figures shortly after the fiscal notification of 1 April 2007.
4. Other information requirements			
a. Involvement of parliament			
The programme mentions its status vis-à-vis the national parliament.	X		
The programme indicates whether the Council opinion on the previous programme has been presented to the national parliament.			Not applicable
b. Economic outlook			
Euro area and ERM II Member States uses the "common external assumptions" on the main extra-EU variables.			Not applicable
Significant divergences between the national and the Commission services' economic forecasts are explained[2].		X	

The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.	X		
c. Monetary/exchange rate policy			
The convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			Not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.		X	
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		X	Quantitative effects of measures not indicated from 2008. The information provided for 2009 is insufficient.
Information is provided on one-off and other temporary measures.			Not applicable
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			Not applicable
e. “Major structural reforms”			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible ‘major structural reforms’ over time.		X	Except for reform of pension system
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.		X	Except for reform of pension system
f. Sensitivity analysis			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	X		The sensitivity analysis presented in the programme covers mainly the impact of wage development, agricultural output and a depreciation of the exchange rate
In case of “major structural reforms”, the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.		X	
g. Broad economic policy guidelines			

The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
h. Quality of public finances			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
i. Long-term sustainability			
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.	X		
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (…) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.		X	
j. Other information (optional)			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.	X		
Notes: [1]The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. [2]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme. *Source:* *Commission services*			

Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the EU10.

Romania- Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	2.3	-1.2	5.7	5.2	8.4	4.1
Private consumption % change	4.7	0.6	8.9	8.4	14.2	9.7
Government consumption % change	2.5	0.4	4.5	7.7	4.2	4.5
Investment % change	5.3	0.5	10.1	8.6	10.8	13.0
Exports % change	10.5	9.1	11.9	8.4	13.9	7.6
Imports % change	13.9	10.6	17.2	16.0	22.1	17.2
Contributions to real GDP growth						
Demand						
Domestic demand	4.4	0.0	8.8	8.8	13.0	9.1
Net exports	-2.1	-1.2	-3.1	-3.6	-4.5	-5.0
Output gap	-1.3	-1.4	-1.1	-1.5	1.9	0.4
Prices and costs						
HICP inflation % change	43.7	68.9	18.6	15.3	11.9	9.1
Unit labour costs % change	46.7	72.7	20.7	16.8	13.0	21.2
Labour productivity % change	3.6	0.7	6.4	5.5	8.0	3.9
Real unit labour costs % change	1.9	5.0	-1.2	-5.7	-1.7	8.2
Comparative price levels (EUR25=100)	n.a.	n.a.	38.8	37.1	38.4	45.0
Labour market						
Employment % change	-1.3	-1.9	-0.6	-0.3	0.4	0.2
Employment % of pop work age	61.0	64.0	58.6	57.6	57.7	57.6
Unemployment rate in %	6.5	5.5	7.5	7.0	8.1	7.2
NAIRU in %	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate in %	66.0	68.9	63.6	62.2	63.0	62.3
Working age population % change	0.2	0.0	0.3	0.3	0.2	0.4
Competitiveness and external position						
Real effective exchange rate % change (1)	8.3	10.8	5.7	-2.1	3.9	32.5
Export performance % change (2)	4.4	0.7	8.2	3.9	5.9	2.2
Extern.a.l balance of g & s	-7.4	-6.8	-8.1	-7.5	-9.1	-10.4
Net borrowing v-à-v RoW	-5.3	-5.2	-5.4	-5.5	-7.5	-7.9
FDI	n.a.	n.a.	4.7	3.1	8.5	6.6
Public fin.a.nces						
Total expenditure % of GDP	n.a.	n.a.	39.3	38.1	38.3	38.2
Total revenue % of GDP	n.a.	n.a.	37.1	36.5	36.8	36.8
General government balance % of GDP	-1.3	-0.9	-1.7	-1.5	-1.5	-1.5
General government debt % of GDP	n.a.	n.a.	20.9	21.5	18.8	15.9
Structural budget balance % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	1.6	2.8	0.3	-5.0	3.6	-3.3
Long term real interest rate (4)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household credit % change	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector credit % change (5)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

EU-10 - Key economic indicators

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	4.0	4.3	3.7	4.0	5.1	4.6
Private consumption % change	4.2	4.7	3.8	3.9	4.1	3.7
Government consumption % change	2.5	1.9	3.1	5.0	1.8	2.0
Investment % change	5.6	8.4	2.9	1.7	7.2	6.2
Exports % change	10.0	11.0	9.0	9.1	14.5	10.3
Imports % change	10.2	12.7	7.8	8.5	14.6	6.9
Contributions to real GDP growth						
Demand						
Domestic demand	4.3	5.3	3.4	4.1	5.6	3.0
Net exports	-0.3	-1.0	0.4	0.0	-0.5	1.6
Output gap	n.a.	n.a.	-1.0	-1.4	-0.5	-0.4
Prices and costs						
HICP inflation % change	n.a.	n.a.	3.3	1.9	4.1	2.5
Unit labour costs % change	5.7	9.2	2.3	1.3	1.4	0.7
Labour productivity % change	4.2	4.6	3.7	4.3	4.5	2.9
Real unit labour costs % change	-0.8	-0.6	-1.0	-0.7	-2.5	-1.8
Comparative price levels (EUR25=100)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour market						
Employment % change	-0.1	-0.3	0.0	-0.2	0.6	1.7
Employment % of pop work age	58.0	59.4	56.6	56.1	56.2	57.0
Unemployment rate in %	12.8	11.3	14.2	14.3	14.2	13.4
NAIRU in %	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate in %	66.4	66.7	66.1	65.7	65.6	65.8
Working age population % change	0.3	0.4	0.3	0.4	0.4	0.3
Competitiveness and external position						
Real effective exchange rate % change (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance % change (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s	-3.4	-4.2	-2.6	-3.0	-2.6	-1.2
Net borrowing v-à-v RoW	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances						
Total expenditure % of GDP	n.a.	n.a.	44.2	44.9	43.4	43.6
Total revenue % of GDP	n.a.	n.a.	40.0	39.9	39.6	40.3
General government balance % of GDP	n.a.	n.a.	-4.2	-5.1	-3.7	-3.3
General government debt % of GDP	38.0	35.8	40.1	39.9	43.4	41.3
Structural budget balance % of GDP	n.a.	n.a.	n.a.	-4.5	-3.4	-3.0
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	n.a.	n.a.	3.5	3.3	1.8	1.8
Long term real interest rate (4)	n.a.	n.a.	n.a.	3.5	2.2	2.2
Household credit % change	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector credit % change (5)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

Annex 5: Assessment of tax projections

Table in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[15].

Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i-th* tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY}\frac{Y}{T_i} - 1\right)\frac{T_i}{Y} = \left(\frac{dT_i}{dB_i}\frac{B_i}{T_i}\frac{dB_i}{dY}\frac{Y}{B_i} - 1\right)\frac{T_i}{Y} = (\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1)\frac{T_i}{Y}$$

where ε_{T_i,B_i} and $\varepsilon_{B_i,Y}$ denote the elasticity of the *i-th* tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i,B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity[16]. By contrast, if

[15] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

[16] The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i,B_i\,ex\,ante}\frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i,B_i\,ex\,post}\frac{dB_i}{B_i}$.

ε_{T_i,B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i,Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i-th* tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_I \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\varepsilon'_{T_i,B_i}\varepsilon'_{B_i,Y} - 1\right)\frac{T_i}{Y} - \left(\varepsilon_{T_i,B_i}\varepsilon_{B_i,Y} - 1\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$$

If $(\varepsilon'_{T_i,B_i} - \varepsilon_{T_i,B_i}) = \alpha_i$; $(\varepsilon'_{B_i,Y} - \varepsilon_{B_i,Y}) = \beta_i$,

then $d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[\left(\alpha_i\varepsilon_{B_i,Y} + \beta_i\varepsilon_{T_i,B_i} + \alpha_i\beta_i\right)\frac{T_i}{Y}\right]\frac{dY}{Y}$

where $\alpha_i\varepsilon_{B_i,Y}\frac{T_i}{Y}\frac{dY}{Y}$ determines the elasticity component and $\beta_i\varepsilon_{T_i,B_i}\frac{T_i}{Y}\frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i\beta_i\frac{T_i}{Y}\frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i\varepsilon_{T_iB_i}\varepsilon_{B_iY}$ with w_i the share of the *i-th* tax in the overall tax burden.

Assessment of tax projections by major tax category

	2007			2008			2009
	CP	COM	OECD[1]	CP	COM[2]	OECD[1]	CP
Taxes on production and imports:							
Change in tax-to-GDP ratio	1.0	0.1	0.0	0.1	0.1	0.0	0.4
Difference SP/CP – COM	0.9			0.0			/
of which [3]:							
- discretionary & elasticity component	3.0			1.2			/
- composition component	-0.8			-0.7			/
Difference COM – OECD [1]	/	0.1		/	0.1		/
of which [3]:							
- discretionary & elasticity component	/	0.1		/	0.0		/
- composition component	/	0.0		/	0.1		/
p.m.: Elasticity							
- of taxes to tax base[4]	2.6	1.1	1.0	1.7	1.0	1.0	2.0
- of tax base[4] to GDP	0.6	1.0	1.0	0.6	1.0	1.0	0.7
Social contributions:							
Change in tax-to-GDP ratio	0.3	-0.1	-0.4	0.4	0.0	-0.4	-0.8
Difference SP/CP – COM	0.4		/	0.4		/	/
of which [3]:							
- discretionary & elasticity component	0.7		/	0.9		/	/
- composition component	-0.2		/	-0.3		/	/
Difference COM – OECD [1]	/	0.4		/	0.4		/
of which [3]:							
- discretionary & elasticity component	/	0.0		/	-0.1		/
- composition component	/	0.4		/	0.5		/
p.m.: Elasticity							
- of taxes to tax base[5]	1.5	1.0	1.0	1.6	0.9	1.0	0.3
- of tax base[5] to GDP	0.9	1.0	0.7	0.9	1.1	0.7	0.9
Personal income tax[6]:							
Change in tax-to-GDP ratio	0.5	0.1	0.4	0.0	0.1	0.3	0.3
Difference SP/CP – COM	0.4		/	-0.1		/	/
of which [3] :							
- discretionary & elasticity component	0.5		/	0.0		/	/
- composition component	-0.1		/	-0.1		/	/
Difference COM – OECD [1]	/	-0.2		/	-0.2		/
of which [3] :							
- discretionary & elasticity component	/	-0.4		/	-0.4		/
- composition component	/	0.3		/	0.4		/
p.m.: Elasticity							
- of taxes to tax base[5]	2.5	1.4	2.7	1.2	1.1	2.7	1.9
- of tax base[5] to GDP	0.9	1.0	0.7	0.9	1.1	0.7	0.9
Corporate income tax[6] :							
Change in tax-to-GDP ratio	0.5	0.1	0.2	0.0	0.1	0.2	0.3
Difference SP/CP – COM	0.4		/	-0.1		/	/
of which [3] :							
- discretionary & elasticity component	0.3		/	-0.1		/	/
- composition component	0.0		/	0.1		/	/
Difference COM – OECD [1]	/	0.4		/	0.4		/
of which [3] :							
- discretionary & elasticity component	/	0.0		/	-0.1		/
- composition component	/	0.4		/	0.5		/
p.m.: Elasticity							
-of taxes to tax base[7]	2.0	1.3	1.0	0.9	1.3	1.0	1.7
-of tax base[7] to GDP	1.1	1.0	0.7	1.1	1.0	0.7	1.0

Notes:

[1]Based on OECD ex-ante elasticities
[2]On a no-policy change basis
[3]The decomposition is explained in the text above
[4]Tax base = private consumption expenditure
[5]Tax base = compensation of employees
[6]Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period
[7]Tax base = gross operating surplus

Source :

Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)