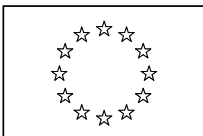

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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ROMANIA: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE DECEMBER 2007 UPDATE OF THE CONVERGENCE PROGRAMME

(Note for the Economic and Financial Committee)

The Stability and Growth Pact requires each EU Member State to present an annual update of its 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. The most recent update of Romania's convergence programme was submitted on 5 December 2007.

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 (DG ECFIN) of the European Commission, was finalised on 12 February 2008. Comments should be sent to Lorena Ionita and Stefaan Pauwels (lorena.ionita@ec.europa.eu and stefaan.pauwels@ec.europa.eu). The main aim of the 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.

The analysis takes into account (i) the Commission services' autumn 2007 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. Technical issues are explained in an accompanying "methodological paper" prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 30 January 2008. The ECOFIN Council adopted its opinion on the programme on 12 February 2008.

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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

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SUMMARY AND CONCLUSIONS

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. The most recent programme, covering the period 2007-2010, was submitted on 5 December 2007.

Romania has experienced strong economic growth averaging 6½% annually between 2003 and 2006. However, the strongly performing economy is showing clear signs of overheating with a high and growing external account deficit (projected at close to 13% of GDP in 2007) which is increasingly financed by non-FDI and potentially more volatile sources, following the slowdown of the privatization process. Growing labour shortages, strong wage growth hampering competitiveness and rapid increases in household borrowing are other signs of overheating. The depreciation of the RON and other supply-side factors (notably the weather-related poor performance of the agricultural sector), against the backdrop of domestic demand dynamics and non-restrictive fiscal and public wage policies have triggered a sudden increase in inflation after a long period of successful disinflation. For Romania to maintain its fast convergence track towards the average EU27 per capita GDP, it will be crucial to address the growing external imbalances. In this context, fiscal policy can play a key role by cooling down internal demand, while also improving the quality of public finance, in particular through a shift towards growth-enhancing investment and ensuring a solid tax base, which is not subject to continued erosion and tax evasion.

The macroeconomic scenario underlying the programme envisages real GDP growth to accelerate from 6.1% in 2007 to 6.5% in 2008 and to ease towards 5.8% in 2010. Assessed against currently available information[1], projected growth in 2008 and 2009 is on the high side. In particular, it is unclear how the sharp reduction of the negative contribution of net exports to growth will be achieved in a context of rising unit labour costs and strong demand pressures, exacerbated by a non-restrictive fiscal policy. The size and the fast deterioration of the external imbalances is a reason for concern as witnessed by the depreciation trend of the RON since mid-2007, against the background of a general risk-repricing in international financial markets. The programme's projections for inflation also appear to be on the very low side. The strong inflationary pressures from wage developments (including public wages), rapid increases in international food and commodity prices and the weaker exchange rate (after a long period of appreciation), suggest a more pronounced slow-down of the rapid disinflation process. The inflation (HICP) differential with the EU-27 is thus expected to stabilize or to narrow only slightly over the forecast period. Overall, the policies in the programme might not lead to progress towards convergence.

According to the updated programme, the projected 2007 general government deficit is 2.9% of GDP, 0.2 percentage point higher than the Commission services' autumn 2007 forecast and the target of the previous programme. The positive base effect from the lower than expected deficit in 2006 was offset by the increase in expenditure outweighing the increase in revenue in 2007. Budgetary implementation in 2007 is therefore not in line with the invitation in the Council opinion of 27 March 2007 on the

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[1] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the July 2007 national reform programme.

previous convergence programme to "exploit the good times to significantly strengthen the pace of adjustment towards the MTO by aiming for more demanding budgetary targets in 2007 (…)".[2]

The update confirms the previous programme's main objective to achieve the medium-term objective (MTO) for the budgetary position, a structural deficit (i.e. a deficit in cyclically-adjusted terms net of one-off and other temporary measures) of 0.9% of GDP, by 2011 (i.e. beyond the programme period). The programme targets a stabilisation of the headline deficit at 2.9% of GDP over the period 2007-2009 and a reduction to 2.4% of GDP in 2010. The primary balance follows a similar path. No fiscal policy effort is made between 2007 and 2009 when the structural deficit is estimated to remain constant at around 3½% of GDP and only in 2010 a ¾% adjustment towards the MTO is envisaged. Compared with the previous convergence programme, which targeted a relatively gradual rather than fully back-loaded adjustment to the MTO, the budgetary targets are less ambitious despite the programme's more favourable growth assumptions in 2008-2009. The adjustment in the update is driven by a significant increase in the revenue-to-GDP ratio (by 3½ percentage points, mostly relying on optimistic revenue-base projections) outpacing a marked increase in the expenditure-to-GDP ratio (by close to 3 percentage points). The largest contribution to the revenue increases (1.4 percentage points of GDP) is made by taxes due to an assumed buoyancy of direct taxes (income taxes are expected to increase due to a favourable evolution of average earnings and the number of employees and corporate taxes would benefit from a positive effect of the employers' social contribution cuts), but also due to VAT measures (concerning the timing of some VAT receipts), though not sufficiently spelled out in the programme. "Other revenues" rise by a similar amount which also reflects an assumed increase in EU funds. Social contributions are subject to several reform measures in 2008 with an assumed net positive effect (6 percentage points rate cuts, introduction of the second pension pillar and broadening of the pension contribution base by removing the ceiling of five times the average wage and by including bonuses in the tax base). On the expenditure side, the change stems to a large extent from a substantial increase in public investment due to an assumed significant increase in the absorption of EU funds, which seems overly ambitious. Also, social payments (especially pensions) are expected to substantially increase. This increase will only be partly offset by a sharp decline in compensation of employees and subsidies (both not substantiated in the programme).

The budgetary outcomes could be worse than projected in the programme. In particular, given the favourable tax elasticity assumed by the programme and the most recent information regarding budgetary execution, the planned level of revenue in 2007 is unlikely to be achieved. This would imply a negative base effect for revenue over the programme period, implying worse budgetary outcomes than projected for the period 2008-2010. This could be amplified by favourable growth assumptions retained for the years 2008-2009. The buoyancy of especially social contributions and indirect taxes may also be overestimated. On the expenditure side, the programme seems to continue the pattern of over-budgeting of investment spending. Consequently, there are risks that resources allocated to investments will be, at least partly, shifted to current spending as seen in the past, in particular to those items which seem under-budgeted in the programme, namely the compensation of employees, social transfers and subsidies. Although the programme expects a more prudent public wage policy over 2008-2010,

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[2] OJ C 89, 24.4.2007, p. 19.

this is not substantiated in the programme and does not seem realistic in the light of past public wage overruns: in 2006 and 2007, wage bill increases were more than twice as high as originally planned. Taking this expenditure risk into account, the expenditure-to-GDP ratio may be higher than planned in particular for the years 2009-2010. Additional risk factors are considerable weaknesses in budgetary planning and execution, expenditure pressures in the election years 2008 and 2009 and uncertainty regarding the amount of compensations by the general government to owners of properties nationalised during the communist regime under the so-called "property fund". Moreover, the fiscal tightening foreseen in 2010 is not sufficiently substantiated with measures.

In view of this risk assessment, the budgetary stance in the programme is insufficient to ensure that the MTO is achieved by 2011, as envisaged by the programme. A safety margin against breaching the 3% of GDP deficit reference value would not be provided by the end of the programme period and thus there is a serious risk that the reference value will be breached in the near term. After a sharp deterioration in the deficit in 2007, no adjustment towards the MTO can be expected before 2010 despite the fact that the economy is showing signs of overheating. This is not in line with the Stability and Growth Pact. The budgetary stance does not help addressing the macroeconomic imbalances identified above, in particular the high and growing external deficit and domestic demand pressures, which put at risk macroeconomic and financial stability.

In the absence of 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. While a significant impact of ageing on expenditure cannot be excluded given the current demographic structure, the 2007 budgetary position in the programme, 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 thus contribute to containing risks to the sustainability of public finances.

Romania’s July 2007 national reform programme (NRP) identifies as key challenges: improving the quality and management of government expenditure in the context of prudent macroeconomic policies; improving the functioning of markets; further improving the business environment; increasing employment and activity rates on the labour market; sustainable management of resources; and an overarching challenge of improving administrative capacity. Against the background of strengths and weaknesses identified, the Commission recommended in its December 2007 strategic report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of Romania’s NRP, that Romania is recommended to give highest priority to the challenges in the areas of: administrative capacity, public finances and macroeconomic stability, business environment, labour market and education. Against the background of progress made, the Commission recommended that Romania is encouraged to also focus on the areas of: long-term sustainability of public finances, R&D and innovation, infrastructure and ICT, tackling undeclared work and public employment services. The convergence programme seems to be consistent to some extent with the July 2007 national reform programme (NRP). In particular, it confirms the main government policy priorities such as improving the quality and management of government expenditure, the business environment and the public administration and the main reforms directly affecting public finances in particular in the areas of labour market, pensions, health care and education. It also confirms the expenditure priorities in the fields of education, research, health, infrastructure, environment and agriculture. On the other hand, the convergence

programme does not provide systematic information on the direct budgetary costs associated with the main reforms envisaged in the NRP.

The overall conclusion is that the budgetary strategy outlined in the programme is not in line with a prudent fiscal policy, necessary to contain the growing external deficit and inflationary pressures which put at risk macroeconomic and financial stability and the convergence process. The programme envisages high deficits, entailing a clear risk of an excessive deficit. Progress towards the MTO is insufficient and fully back-loaded despite strong growth prospects. In view of the risks to the budgetary targets and the significant adjustment that would be necessary after the programme period, the MTO is unlikely to be achieved by 2011 as planned.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Dec 2007**	**7.7**	**6.1**	**6.5**	**6.1**	**5.8**
	COM Nov 2007	7.7	6.0	5.9	5.8	n.a.
	CP Jan 2007	*8.0*	*6.5*	*6.3*	*5.9*	*n.a.*
HICP inflation (%)	**CP Dec 2007**	**6.6**	**4.8**	**5.7**	**4.0**	**3.3**
	COM Nov 2007	6.6	4.7	5.6	4.6	n.a.
	CP Jan 2007	*6.6*	*4.5*	*4.3*	*3.2*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Dec 2007**	**2.2**	**2.1**	**2.1**	**1.8**	**1.1**
	COM Nov 2007[2]	2.4	2.1	1.3	0.3	n.a.
	CP Jan 2007	*2.1*	*2.2*	*1.9*	*1.1*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Dec 2007**	**-10.3**	**-12.6**	**-10.5**	**-10.1**	**-10.2**
	COM Nov 2007	-10.3	-12.8	-14.5	-15.3	n.a.
	CP Jan 2007	*-10.2*	*-8.9*	*-8.3*	*-7.8*	*n.a.*
General government balance (% of GDP)	**CP Dec 2007**	**-1.9**	**-2.9**	**-2.9**	**-2.9**	**-2.4**
	COM Nov 2007	-1.9	-2.7	-3.2	-3.9	n.a.
	CP Jan 2007	*-2.3*	*-2.7*	*-2.6*	*-2.0*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2007**	**-1.0**	**-2.0**	**-2.1**	**-2.1**	**-1.6**
	COM Nov 2007	-1.0	-1.8	-2.3	-3.0	n.a.
	CP Jan 2007	*-1.2*	*-1.6*	*-1.5*	*-1.0*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Dec 2007**	**-2.6**	**-3.6**	**-3.6**	**-3.5**	**-2.8**
	COM Nov 2007	-2.6	-3.3	-3.6	-4.0	n.a.
	CP Jan 2007	*-3.0.*	*-3.4*	*-3.2*	*-2.3*	*n.a.*
Structural balance[3] (% of GDP)	**CP Dec 2007**	**-2.2**	**-3.4**	**-3.4**	**-3.4**	**-2.7**
	COM Nov 2007	-2.6	-3.3	-3.6	-4.0	n.a.
	CP Jan 2007	*-3.0*	*-3.4*	*-3.2*	*-2.3*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2007**	**12.4**	**11.9**	**13.6**	**14.2**	**14.9**
	COM Nov 2007	12.4	12.5	12.8	13.5	n.a.
	CP Jan 2007	*12.8*	*13.5*	*12.6*	*11.7*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2]Based on estimated potential growth of 5.7%, 6.4%, 6.7% and 6.9% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. According to the most recent programme, one-off and other temporary measures are 0.4% of GDP in 2006, 0.2% in 2007, 0.2% in 2008, 0.1% in 2009 and 0.1% in 2010 (all deficit-increasing), while there are no one-offs in the Commission services' autumn forecast. Since the measures claimed to be one-offs in the programme do not seem to qualify as such, the structural balance would be worse (i.e. equal to the cyclically-adjusted balance).

Source:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The December 2007 update of the Convergence Programme was submitted on 5 December 2007. It covers the period 2007 to 2010. The programme, which was drafted with the participation of the main government agencies, was approved by the government and sent for information to the parliament. The programme is broadly consistent with the 2008 budget, promulgated in December 2007.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Romania, with a particular focus on the impact of the 2005 tax reform on employment and budgetary revenues. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON FISCAL SURVEILLANCE AND CATCHING UP: THE IMPACT OF THE 2005 TAX REFORM ON EMPLOYMENT AND BUDGETARY REVENUES

The assessment of Romania's January 2007 convergence programme concludes that, with a GDP per capita income of only slightly above one third of the EU average, the scope for catching-up remains ample and represents Romania's overriding challenge for the medium and long run. Fiscal policy can play a key role in fostering real convergence. This is not only through its contribution to macroeconomic and financial stability by complying with the Stability and Growth Pact and avoiding pro-cyclicality in the context of large external imbalances, strong internal demand and rapid credit expansion. It is also through an improved quality of public finances. The latter consists, on the one hand, of a growth-optimal expenditure size and composition embedded in a credible medium-term fiscal framework and, on the other hand, of a solid tax base that sets the right incentives for work and job creation and is not subject to continued erosion and tax evasion[3].

Romania is characterised by a low employment rate and a relatively large informal labour market. An employment-friendly tax policy would lead to an increase in the formal employment, in particular by a "formalisation" of undeclared work. This, in turn, would contribute to the strengthening of government revenues, necessary for financing

[3] See European Commission (2005), part IV, for a more detailed discussion on the role of fiscal policy during convergence.

the investment needs of a catching-up economy, while keeping the pre-accession structural reform momentum going. The increase in labour market participation rates will also help improve fiscal sustainability, which is challenged by the ageing population, leading to increased spending on pensions and health care. Moreover, formal employment relations also contribute to creating a more reliable businesses environment, characterised by legal certainty and improved quality standards, with a positive effect on investment, including from abroad.

In 2005, Romania implemented a major tax reform with the introduction of a flat 16% tax rate on personal and corporate income. This chapter examines to what extent the 2005 tax reform has been more successful than previous efforts in terms of incentive compatibility and employment creation and as regards the effects on revenue. It also identifies further reform challenges to enhance the effectiveness of the 2005 tax reform.

Subsection 2.1 gives a brief presentation of the Romanian 2005 tax reform. Subsection 2.2 examines its incentive and supply side effects by looking in particular at labour market and employment developments. Subsection 2.3 looks at recent revenue developments. Subsection 2.4 puts the tax reform in the broader context of other policies and developments. Subsection 2.5 indicates possibilities and challenges for enhancing the tax reform's effectiveness by exploiting synergies with other ongoing and future reforms.

2.1. The 2005 tax reform

In 2005, Romania has undertaken a major overhaul of the direct tax system, introducing a 16% flat tax on personal and corporate income. The reform mainly envisaged increasing the tax base and boosting competitiveness. By lowering the tax rates and simplifying the tax system, Romania aimed at reinforcing compliance and creating incentives for workers to enter into the formal economy[4]. It was expected that lowering the tax rates would generate supply-side effects, thus partially or entirely outweighing the direct negative impact of the tax cut on government revenue. Furthermore, in a context where many neighbouring economies had already reduced personal and corporate income taxes (see Box 1), the 2005 tax reform was intended to further strengthen Romania's position in terms of attracting foreign investment.

The main characteristics of the 2005 reform, effective from 1 January 2005, are the following:

- The 5-bracket progressive personal income tax system (with tax rates of 18%, 23%, 28%, 34% and 40%) has been replaced by a 16% flat income tax rate. In addition, the tax-free threshold has been increased from 200 RON to 250 RON per month. The additional 100 RON allowance per dependent has remained unchanged.

- The corporate income and capital gains tax was cut from 25% to 16%.

- The profit tax rate for micro-enterprises was increased from 1.5% to 3% of the turnover.

[4] The informal economy is estimated to represent about 20% of GDP in 2006 (see section 2.2 for further details).

– Many tax exemptions have been eliminated (e.g. abolition of the possibility for enterprises to deduct annual depreciation expenditures of up to 20% of the value of fixed assets; removal of the deductibility of private health insurance contributions).

– The VAT rate remained unchanged at 19%, but some VAT exceptions were removed as well.

– The 2005 fiscal reform did not change social security contributions[5].

– The changes in the tax rates have been accompanied by administrative measures to improve tax collection.

The 2005 tax reform followed earlier attempts to increase government revenues by changing taxes or social security contributions, which were many times rapidly reversed. For example in 1998 the VAT standard rate was increased from 18% to 22%, but was again decreased to 19% in 2000.

Box 1: Overview of recently introduced flat tax schemes in other EU countries

Among the EU countries, the following adopted a flat income tax system: Estonia and Lithuania in 1994, Latvia in 1997, Slovakia in 2004 and Romania in 2005.

- In personal income tax systems, different tax brackets have been replaced by one flat rate. Some progressivity has been maintained based on tax-free income thresholds, which in all cases (except Latvia) have been increased. The levels of the new flat tax rate differ substantially: while in Estonia, Lithuania and Latvia the new flat tax rate equals or is close to the highest previous tax bracket, in Slovakia it is closer to the previously lowest tax rate, and in Romania it is even below.
- In all cases the corporate income tax has been set to equal the personal income tax rate, except in Lithuania.

	Adoption flat tax	**Personal Income Tax rate**		**Corporate Income Tax rate**	
		Before	*After*	*Before*	*After*
Estonia	1994	16-33	26	35	26
Lithuania	1994	18-33	33	29	29
Latvia	1997	10 and 25	25	25	25
Slovakia	2004	10-38	19	25	19
Romania	2005	18-40	16	25	16

Source: IMF (2006).

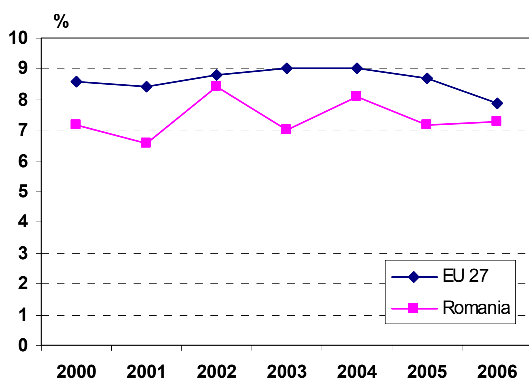
[5] However, in subsequent years, the employer's contribution has been lowered by 2 pp annually from 33.24% in 2005 to 29.24% in 2007, while leaving the employee's contribution stable at 17%. A further cut by 6 pp is envisaged in 2008, reducing the employer's contribution by 4.5 pp and the employee's contribution by 1.5 pp. Furthermore, the five-time average salary cap for social contributions will be removed as from 2008.

2.2. Incentive and supply side effects in the labour market

2.2.1. Key characteristics of the labour market in Romania

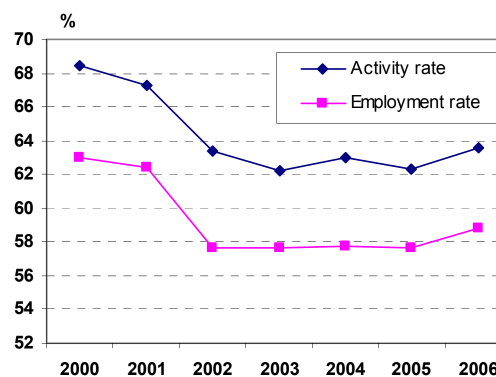
Over the last seven years unemployment has remained fairly low, averaging 7.5% between 2000 and 2006. Following the accelerated privatization and restructuring of state-owned companies, unemployment reached a peak of 8.5% in 2002, but declined to 7.3% by 2006 (see Figure 1).

Figure 1. Recent trends in the unemployment rate in Romania and EU27



Source: Eurostat, Labour Force Statistics

Figure 2. Employment and activity rates in Romania and EU27



Source: Eurostat, Labour Force Statistics

The Romanian labour market is characterized by low employment and activity rates. The employment rate came down from 63% in 2000 to an average of 57.6% between 2002 and 2005 (see Figure 2). Despite a recent upturn in 2006 to 58.8%, which could partly be a consequence of the tax reform (see section 2.2.2), it is still relatively low compared to an EU27 average of 64.4% (2006) and well below the Lisbon target of 70%. The activity rate stood at 63.6% in 2006, compared to the EU27 average of 70.6%.

The relatively low employment, activity and unemployment rates in Romania have to be seen against the pattern of economic restructuring and lay-offs in state-owned companies, resulting in the following phenomena:

- Early retirement schemes have been set-up to alleviate the consequences of lay-offs, making part of the older workforce inactive. In 2006, the employment of older workers (aged between 55 and 64) was low at 41.7% compared to the EU27 average of 43.5% and the Lisbon target of 50% and down from 48.2% in 2001. The effective retirement age was relatively low at 59.4 in 2004 compared with an EU average of 60.5 and the EU target of 65.

- Emigration has been on an ascending trend since the early nineties. It is estimated that about 2 million people have emigrated.

- Many workers returned to the agricultural sector, which plays the role of the "employer of last resort". As in other countries with high agricultural employment, when the process of job destruction in the industrial sector has not been accompanied by job creation elsewhere, laid-off workers have turned to small-scale farming as an

alternative to open unemployment. Thus in Romania, employment in agriculture has risen from 28% to 42% between 1989 and 2001. After 2001, this figure decreased significantly to around 30% in 2006, reflecting partly a successful reallocation across sectors but also emigration. In addition, part of the agricultural sector employment is informal, e.g. family members working unofficially.

Besides these phenomena, one major factor explaining the weak labour market performance is indeed the existence of a relatively large rural and urban informal labour market, which depresses the official employment and activity rates. According to Commission estimates, this "grey economy" represents about 20% of GDP[6].

The relatively large informal sector and low level of formal employment could in part be caused by a relatively high tax wedge[7] on low-paid workers (with an income of 67% of average earnings or lower in the case of a single person). Although according to Commission calculations (Directorate General Taxation and Customs Union) this tax wedge decreased from 44.7% in 2000 to 42.9% in 2004 (pre-tax reform) and 42.4% in 2005 (after the reform), it nevertheless remains high and well above the EU average of 37.4%. This is to a large extent due to high social security contributions which counted for around 46% of the gross wage in 2006 (combined for employers and employees) and remain the fifth highest in the EU, despite recent cuts (by 2 percentage points in both 2006 and 2007).

2.2.2. Labour market developments and the 2005 tax reform

Both activity and employment rates improved after the tax reform, albeit only in 2006 (see Figure 2 above). Total employment grew by some 3% between 2004 and 2006, which is the highest increase since the beginning of the transition. However, also other factors may have been at play, apart from the tax reform (see section 2.4).

Evidence as to whether the increase in formal employment has led to a decrease in informal employment is mixed. On the one hand, the fact that the total population at working age and the unemployment rate have remained broadly constant seems to suggest that the employment creation (roughly corresponding to 250 000 full-time jobs) between 2004 and 2006 is at least partially the result of a formalization of workers previously active in the grey economy.

On the other hand, estimates by the National Commission for Economic Forecasting (NCEF) show a reduction of the informal labour market only in 2005, followed by an increase in 2006. The NCEF compares the outcome of two methods of measuring the number of employees[8] (see Table 1: one is a survey of enterprises (known as the "Workforce Balance", in short "BFM") and the other one is a survey on households (called "Survey on the Workforce in the Households", in short "AMIGO"). The latter measures the number of employees based on information from households, which

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[6] European Commission (2004).

[7] The tax wedge is the difference between the wage paid by employers and the take-home wage received by employees.

[8] The analysis is restricted to employees and hence excludes the self-employed and contributing family members (both are mainly concentrated in the agricultural sector) and employers. Employees are estimated to represent about 2/3 of total employment.

includes both declared and undeclared work. According to the NCEF, the difference of salary earners declared in the two surveys is a good proxy of the size of the hidden labour market. Based on this methodology, one observes a reduction by around 155 000 of informal employees between 2004 and 2005. However, this is offset by an increase in the subsequent period, when the number of informal employees increased by 290 000. The latter seems to be linked to the boom in the construction sector, counterbalancing the potential effects of the tax reform.

Table 1: Number of employees in the hidden economy (thousand persons)

	2004	2005	2006
1. Average number of "AMIGO employees"	6036	5921	6167
2. Average number of "BFM employees"	4469	4559	4615
3. Differences (1 - 2)	1567	1362	1552
- employees in the non-civil sector [a] (defence, persons under compulsory military service)	250	200	100
- employees in the hidden economy	1317	1162	1452
4. Evolution of employees in the hidden economy (difference as compared to the previous year)	N.A.	-155	290

Note: (a) Estimate by the National Commission for Economic Forecasting

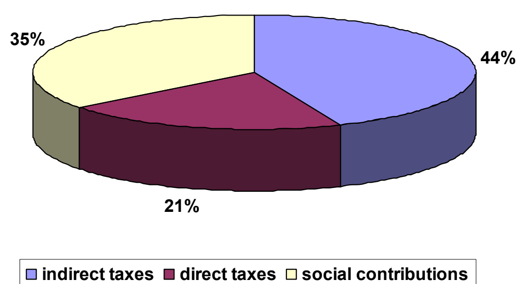
Source: National Institute of Statistics (INS)

In sum, several datasets confirm the increase in the official employment and activity rates after the tax reform. This finding indicates that the reform may well have created incentives for workers to enter into the formal labour market, although there is no solid evidence that the formal employment creation has led to a sustained reduction of the informal economy. Equally, the question as to whether this represents a "turning point" in the performance of the formal labour market can only be answered when further data become available.

2.3. Impact on government revenue

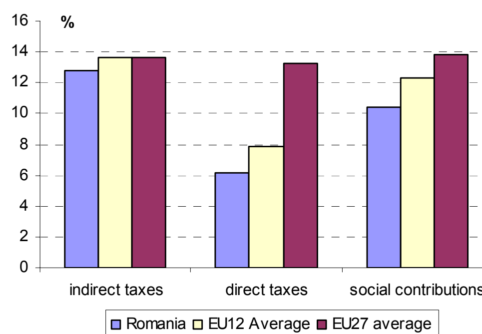
The 2005 tax reform accentuated the Romanian tax system's reliance on indirect taxes, which represented 44% of all tax and social contribution revenues in 2006. They are followed by social contributions at 35% and direct taxes at 21% (see Figure 3). The predominance of indirect taxes in government revenue is a characteristic of most recently acceded Member States (EU12), as shown in Figure 4. This is in sharp contrast with the EU27 average, where all three components are broadly equivalent.

Figure 3: Composition of tax and social contribution revenue in 2006 (% of total)



Source: Eurostat

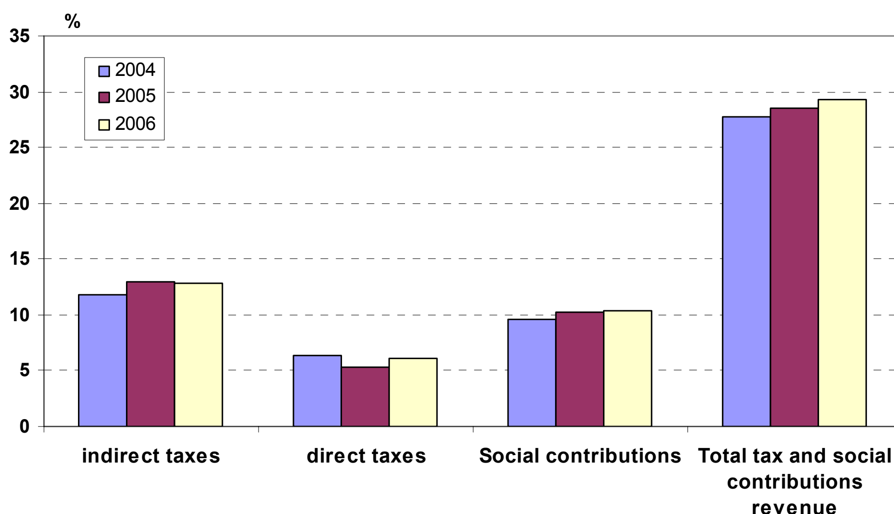
Figure 4: Composition of tax and social contribution revenue in 2006 (% of GDP)



Source: Eurostat

In nominal terms, total tax and social contributions revenue has soared by an average of 22% annually since 2003, increasing from 27.8% of GDP in 2004 to 29.3% of GDP in 2006, fuelled by buoyant economic growth (see Figure 5).

Figure 5. Tax and social contribution revenues before (2004) and after the tax reform (2005-2006), as percentage of GDP



Source: Eurostat

When breaking down total tax and social contribution revenue in its main components, one observes that after the reform, revenues from direct taxes initially declined as a share of GDP but rebounded in 2006. Indirect taxes and social contributions show an upward trend between 2004 and 2006. These developments will be further analysed based on tax elasticities, which allow a breakdown into (i) the elasticity of taxes with respect to the tax base and (ii) the elasticity of the tax base relative to GDP.

The following conclusions can be drawn (see Table 2)**:**

- As to the **personal income tax**, revenues as a share of GDP initially declined in 2005 but rebounded in 2006, as shown by the change in tax-to-GDP ratio. There are also signs that the tax base has broadened and some incentive and supply side effects may

have kicked in as compensation of employees has grown more than GDP. Whereas this growth is partly due to an increase in wages, this result is also consistent with the main findings in section 2.2 concerning the increased employment rates, indicating that the broadening of the tax base is also the result of more workers having joined the formal labour market.

- With respect to **corporate income tax**, the share in GDP initially declined in 2005, following the reduction of the corporate income tax rate from 25% to 16%. As in the case of personal income tax, this is reflected in the negative elasticity of taxes with respect to the tax base. However, this reduction was offset in 2006.

- The growing wage and formal employment volume has also led to an increase in the GDP share of **social contributions** in 2005 and, to a lesser extent, in 2006. The impact on 2006 has likely been dampened by the 2 pp. cut in the contribution rates.

- Revenues from **taxes on production and imports** have increased as a share of GDP. This result is likely to be at least partly linked to the removal of many exemptions in 2005.

Although the figures available so far seem to suggest that the 2005 tax reform may not have lowered the tax-to-GDP ratio in a very broad sense, i.e. including revenue developments in social contributions and also VAT, a longer time series is needed to sustain these findings. Furthermore, the effects of the tax reform cannot be disentangled from the ones of positive economic growth, as argued in section 2.4.

Table 2: Assessment of tax collection based on elasticities

	2004	2005	2006
Taxes on production and imports			
Change in the tax-to-GDP ratio	-0.9	1.3	-0.1
Elasticity of tax relative to GDP	0.7	1.6	0.9
Elasticity of tax vis-à-vis tax base (consumption)	0.6	1.6	0.9
Elasticity of consumption relative to GDP	1.2	1.0	1.0
Social contributions			
Change in the tax-to-GDP ratio	-0.2	0.7	0.2
Elasticity of tax relative to GDP	0.9	1.4	1.2
Elasticity of tax vis-à-vis tax base (compensation of employees)	0.9	1.4	0.9
Elasticity of compensation of employees relative to GDP	1.0	1.0	1.3
Personal income tax			
Change in the tax-to-GDP ratio	0.4	-0.6	0.5
Elasticity of tax relative to GDP	1.6	-0.1	2.0
Elasticity of tax vis-à-vis tax base (compensation of employees)	1.6	-0.1	1.5
Elasticity of compensation of employees relative to GDP	1.0	1.0	1.3
Corporate income tax			
Change in the tax-to-GDP ratio	0.4	-0.5	0.5
Elasticity of tax relative to GDP	1.5	-0.1	1.9
Elasticity of tax vis-à-vis tax base (gross operating surplus)	1.5	-0.1	2.4
Elasticity of gross operating surplus relative to GDP	1.0	1.0	0.8
Source: Commission services calculation			

The available data also seem to suggest that the tax reform has not significantly altered automatic stabilizers. Despite the replacement of a progressive income tax system based on different tax brackets by a flat tax, some progressivity has been maintained thanks to the increase in the tax-free threshold for personal income. This hypothesis is supported by the development of the elasticity of personal income tax (PIT) with respect to the tax base, which is higher than 1. Furthermore, in terms of the composition of tax revenues, the share of indirect taxes, which have a weak stabilising effect, in total tax and social contribution revenue, has only increased marginally from 43% in 2004 to an average of 45% in 2005 and 2006.

2.4. Can these trends be ascribed to the tax reform alone?

The available data suggest to a certain extent incentive and supply side effects of the 2005 tax reform and a broadening of the tax base. However, it is not possible to ascertain that these effects have solely been generated as positive knock-on effect of the tax reform, as also other factors have been at play.

Firstly, it needs to be stressed that the tax reform and the observed win-back effects have taken place against the background of above-potential economic growth (7.7% in 2006), fuelled by robust consumption, record FDI inflows, the flood repairs after 2005 and the acceleration of public investment projects. Indeed, the job creation process leading to a 3% hike in official employment figures between 2004 and 2006 is undoubtedly also the result of increased economic activity, while foreign investors have been attracted by Romania's market potential, the improving business environment and the perspective of EU membership. This process may in itself have created new employment opportunities, potentially acting as an incentive on workers to move out of the informal economy, although the foreign direct investment may have been positively influenced by the tax reform as well.

Furthermore, in 2006 the Romanian government has revised the labour code, aiming at reducing the employment barriers through more flexible labour contracts and simplifying procedures for hiring employees. In addition, social contribution rates were lowered in 2006.

Finally, the 2005 tax cuts have also been accompanied by the removal of exemptions as well as measures to improve compliance. Undeniably, not just the tax cut itself but also the improved transparency of the taxation rules and the strengthening of controls on evasion may have contributed to the broadening of the tax base and increased tax compliance.

In sum, although one could reasonably assume that tax cuts have contributed to better incentives and increased employment, the available data do not allow to make an unequivocal distinction between the effects of the tax reform and other contextual factors.

2.5. Conclusions and challenges ahead

Evidence available so far seems to suggest that the 2005 tax reform contributed to increased incentives for work and job creation as reflected in the improving activity and employment rates. With respect to the budgetary impact, the share of tax and social security contribution revenues in GDP remained broadly constant. However, it remains difficult to disentangle the effects of the tax cuts from other revenue-increasing developments.

In addition, it seems that the benefits of the tax reform have not been yet fully reaped. In order to further enhance the impact of the tax reform on incentives and employment and to optimise its fiscal impact, one should foster its long-term sustainability and credibility and exploit the synergies with other fiscal reforms, in particular on the expenditure side, and other structural reforms.

Public expenditure. In Romania, relatively high current spending, notably on social transfers and government consumption, puts an increasing burden on public resources and leaves less room for growth-enhancing investments. In addition, the budget plans

often include an over-budgeting of investment expenditure, which is subsequently shifted, through budget amendments during the year, to current expenditure. All this could have a negative impact on the efficiency of the tax reform. The tax reform should therefore go hand in hand with a restructuring of the expenditure side of the budget. Efforts should be stepped up to increase the quality of public finances by improving the budgetary planning and execution and by reviewing the composition of public expenditure in order to favour growth potential enhancing investments. This is fully in line with the recommendation made to Romania in the Commission December 2007 Strategic Report on the renewed Lisbon strategy for growth and jobs, which assesses the Romanian National Reform Programme 2007-2010. Furthermore, apart from the need to reassess the composition of expenditure, it will also be crucial to contain additional pressures to increase spending, in order to avoid a procyclical fiscal stance, which would add to the current large external imbalances experienced by Romania.

In terms of other incentive-compatible structural reforms, the key areas are labour markets, pensions and health care.

Labour market. In spite of potential positive effects of the tax reform on employment, the Romanian employment rate remains far below the EU average and the Lisbon target. Despite some progress during the last two years, efforts in this respect need to be increased if Romania is to sustain economic growth on the one hand and to meet the long-run fiscal challenges posed by the ageing of the population on the other hand. A potential for a further enhancement of incentives to work and for leaving the informal sector lies in a reduction of the tax burden on labour. Successive cuts in social contributions were implemented in 2006 and 2007 and a further reduction by 6 pps. will be implemented in the course of 2008. This can lead to a positive effect on the reduction of undeclared work and boost formal employment. However, these win-back effects may not come automatically and are only credible and have sustainable positive effects if the social contribution cuts are fiscally affordable. The following policy actions could help in this respect. Firstly, the reduction of labour costs should go hand in hand with efforts to restructure the expenditure side of the budget in a growth-optimal way, as explained above. Secondly, revenue collection should be improved (notably by a better enforcement of compliance).

Pensions. While the planned reduction in social security contributions in 2008 is likely to benefit formal employment creation, careful consideration should also be given to the potential risks this reform entails for the long-term sustainability of the pension system, especially against the perspective of ageing population and migration. Furthermore, in addition to the cut in contribution rates, the pension budget will also have to absorb the loss of revenue associated with the introduction of the second pension pillar as from January 2008. Both factors clearly underscore the need to speed up further reforms in the area of pensions. In particular, a further increase in the retirement age (the government planned to gradually increase the statutory retirement age to 60 for women and 65 for men by 2013) and measures to reduce early retirement could be considered. Furthermore, the government needs to address the lack of clear benefit indexation rules, which creates uncertainty about the contribution-benefit link for participants as well as for the country's fiscal outlook. In addition, a thorough analysis of implicit liabilities and long-term sustainability of the pension system would be highly needed.

Health care. One important expenditure area directly associated with social contributions is health care. Reforms could aim in particular at stronger incentives to contribute to the

health care system by strengthening the link between contributions and benefits and improving the institutional framework.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes macroeconomic vulnerabilities and how they are expected to develop according to the programme.

3.1. Economic activity

The programme estimates a real GDP growth of 6.1% in 2007 and forecasts robust economic activity for the rest of the programme period. Real GDP growth is expected to increase to 6.5% in 2008, after a relatively weaker performance in 2007, following the drought-induced supply shortfall and rising international fuel and food prices. By 2010 real GDP is expected to ease towards 5.8%.

Domestic demand will remain the driver of growth, although its contribution will decrease somewhat from 12.9 pps. in 2007 to 8.9 pps. in 2010. Due to the boom in the construction sector and the acceleration of public infrastructure works, gross fixed capital formation is expected to record high growth rates, reaching 18% in 2007 and gradually decelerating to 11% in 2010. Strong credit growth, real wage increases and rising employment are projected to fuel private consumption, with growth rates exceeding GDP growth, reaching 10.9% in 2007, but gradually decelerating to 7.3% in 2009.

Table 3: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010
	COM	CP	COM	CP	COM	CP	CP
Real GDP (% change)	6.0	6.1	5.9	6.5	5.8	6.1	5.8
Private consumption (% change)	11.0	10.9	9.4	9.2	8.4	8.2	7.3
Gross fixed capital formation (% change)	18.5	18.0	14.2	13.0	11.2	11.5	11.0
Exports of goods and services (% change)	8.2	8.3	8.9	10.3	8.9	10.9	10.7
Imports of goods and services (% change)	22.3	21.5	17.4	16.1	14.2	14.9	13.9
Contributions to real GDP growth:							
- Final domestic demand	13.2	12.9	11.3	10.8	10.0	9.6	8.9
- Change in inventories	0.0	0.0	-0.1	-0.1	0.0	0.0	0.0
- Net exports	-7.3	-6.8	-5.3	-4.2	-4.2	-3.5	-3.1
Output gap[1]	2.1	2.1	1.3	2.1	0.3	1.8	1.1
Employment (% change)	1.2	1.5	1.0	1.4	0.8	1.1	0.6
Unemployment rate (%)	7.1	7.1	7.0	6.9	6.9	6.8	6.6
Labour productivity (% change)	4.7	4.5	4.9	5.0	4.9	4.9	5.2
HICP inflation (%)	4.7	4.8	5.6	5.7	4.6	4.0	3.3
GDP deflator (% change)	7.7	7.5	5.7	6.4	5.2	5.2	4.4
Comp. of employees (per head, % change)	15.3	19.5	16.1	n.a.	13.4	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-12.8	-12.6	-14.5	-10.5	-15.3	-10.1	-10.2

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source :

Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP)

The programme expects that the decelerating demand dynamics will result in a significant drop in import growth and that export growth will accelerate, leading to a

reduction in the negative contribution of net exports to growth and to a reduction of the net borrowing vis-à-vis the rest of the world as from 2008.

The output gap as recalculated by the Commission services based on the information in the programme will remain positive over the programme period, but will gradually narrow from 2.1% of potential output in 2007 to 1.1% in 2010.

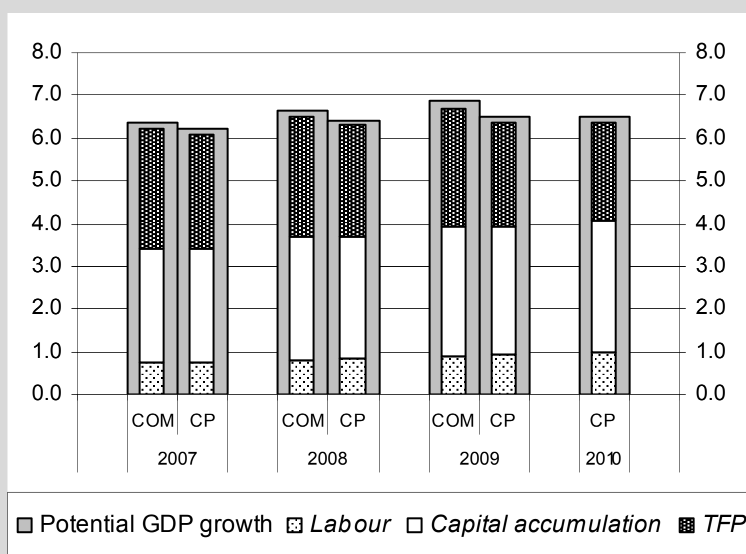
The external assumptions behind the programme's macroeconomic scenario are broadly in line with that in the Commission services' autumn 2007 forecast, except for the exchange rate developments of the RON vis-à-vis the euro: whereas the Commission services anticipate a broadly constant exchange rate over the programme period, the authorities project a slightly appreciating trend, of about 1% annually between 2008 and 2010. No interest rate assumptions are mentioned.

Whereas the Commission and the programme project a broadly similar GDP growth rate for 2007 (6.0% by the former, against 6.1% by the latter), the programme is more optimistic about real GDP growth in 2008 and 2009. The Romanian authorities forecast a rebound of GDP growth in 2008, reaching 6.5%, while the Commission projects a deceleration (to 5.9% in 2008 and 5.8% in 2009), which sets in later according to the programme (6.1% in 2009). For 2010, the programme's growth projection is below the estimate of potential growth in the autumn 2007 forecast for the period 2007-2009 of 6.6%.

Box 2: Potential growth and its determinants

Potential growth, as recalculated by the Commission services using the commonly agreed methodology based on the information provided in the programme is estimated to gradually increase from 6.2% in 2007 to 6.5% in 2009 and 2010.

Potential growth and its determinants



The average growth projection for the programme period is slightly better than the 2001-2005 average, thanks to an acceleration of potential growth. Romania has benefited from significant investment growth, especially since 2004, driving up capital accumulation. In addition, qualitative gains, associated with foreign direct investment inflows and improvements in the business environment have driven TFP growth. Over the programme period, the potential growth calculations are broadly in line with the Commission services' autumn 2007 forecast.

Although both the Romanian authorities and the Commission expect broadly similar domestic demand developments (strong but decelerating), the main difference in GDP growth is that the programme assumes a stronger reduction of the negative contribution from net exports, leading to more favourable real GDP growth projections as from 2008. In particular, the programme assumes a more optimistic export performance and a faster reduction of the growth rate of imports, in spite of the assumed appreciation of the RON (against a constant exchange rate over the forecast period by the Commission). Consequently, the programme also envisages more favourable developments in the net borrowing vis-à-vis the rest of the world, assuming a reduction from 12.6% of GDP in 2007 to 10.1% in 2009, against the Commission forecast of a widening net borrowing to 15.3% in 2009. The programme does not describe how this improvement in the external deficit will be achieved in a context of strong domestic demand dynamics, an expansionary fiscal policy and rising unit labour cost, negatively affecting Romania's international competitiveness (see section 3.2 and 3.3).

Assessed against currently available information, this scenario appears to be based on plausible growth assumptions in 2007 and 2010 and favourable ones in 2008-2009. Projected growth in 2008 and 2009 is on the high side as the anticipated sharp reduction of the negative contribution of net exports to growth may not materialise. This also makes the programme's projected reduction in the external deficit look very optimistic.

The positive output gaps for 2008 and 2009, as recalculated by the Commission services on the basis of the data provided in the programme using the commonly agreed method are around 1 and 1½ percentage points higher than the output gaps indicated in the Commission services' autumn 2007 forecast. Yet, both series show a positive albeit gradually narrowing gap.

3.2. Labour market and cost and price developments

The programme expects employment growth to decrease gradually from 1.5% in 2007 to 0.6% in 2010, with the unemployment rate slightly decreasing from 7.1% to 6.6% in the same period. This is broadly in line with the average performance in 2005 and 2006, with the current cyclical conditions (positive but closing output gap) and with the Commission services' autumn 2007 forecast, although the latter is slightly less favourable on the employment growth rates. Overall, the employment outlook is markedly better than the average labour market performance between 1996 and 2005 which showed a negative employment growth and rising unemployment. The labour content of GDP growth is slightly decreasing over the programme period, which is in line with the Commission forecasts.

The programme projects an improvement in the relatively low employment rate from 58.8% in 2006 to 62.1% by 2010, mainly owing to fiscal incentives and further structural reform. The proposed measures should also contribute to reducing the size of the informal labour market, which is currently estimated to represent about 20% of GDP (see section 2.2.1). Furthermore, the programme envisages increasing the activity rate by 1.1 percentage points annually, among others through measures to restrict early retirement.

Strong domestic demand pressures, compounded by the drought-induced agricultural supply shortfall, by increasing international food and commodity prices and by the sudden RON depreciation, have caused an upturn in inflation, which reached 6.7% on an annual basis in December 2007. This development comes after a long period of sustained disinflation, reaching a historic low of 3.7% in March 2007, helped by an appreciating domestic currency against the euro. The 2007 end-year inflation rate will thus exceed the

upper limit of the Central Bank's inflation target of 4 +/-1%. For the whole year, the programme projects a 4.8% average inflation rate. Due to the carry-over effect of high food and international commodity prices, the programme expects inflation to edge up to 5.7% in 2008, after which it will decline to 4.0% and 3.3% in 2009 and 2010 respectively.

In the light of recent developments, this projection appears to be on the very low side. Against the background of higher world oil prices compared to the assumptions in the programme, the higher-than expected end-year inflation and a further depreciation of the exchange rate in December 2007, inflation in 2008-2010 is likely to become higher than anticipated in the programme. Furthermore, the non-restrictive fiscal policy projected for 2008-2009 and the risks of a continuation of a loose wage policy are likely to further add to domestic demand and cost pressures. In addition, there are risks that the assumed RON appreciation in the programme may not materialize in the light of the growing external imbalances, the heightened risk aversion in international financial markets and the limited fiscal policy response.

The programme expects labour productivity to grow by 4.5% in 2007, gradually increasing to 5.2% in 2010. This is broadly in line with the Commission services autumn 2007 forecast and is better than the 3.6% average in 1996-2005. However, labour productivity growth is most likely outstripped by wage growth, leading to increasing unit labour cost over the programme horizon and strong cost pressure on inflation.

3.3. Macroeconomic challenges

With the economy showing clear signs of overheating, it will be crucial to address the growing external imbalances, if Romania is to maintain growth and fast convergence towards average EU27 per capita GDP.

Fuelled by strong wage increases, increasing employment and rapid credit growth, domestic demand has outstripped supply, resulting in a sharp increase in net borrowing vis-à-vis the rest of the world, from 10.3% in 2006 to an estimated 15.3% in 2009 according to the Commission autumn 2007 forecast. The size and the fast deterioration of the external imbalances is a reason for concern as witnessed by the RON depreciation since mid-2007, against the backdrop of a general risk-repricing in international financial markets. Furthermore, the external deficit is likely to increasingly rely on non-FDI and potentially more volatile financing sources over the programme period, following the slowdown of the privatization process of state-owned companies.

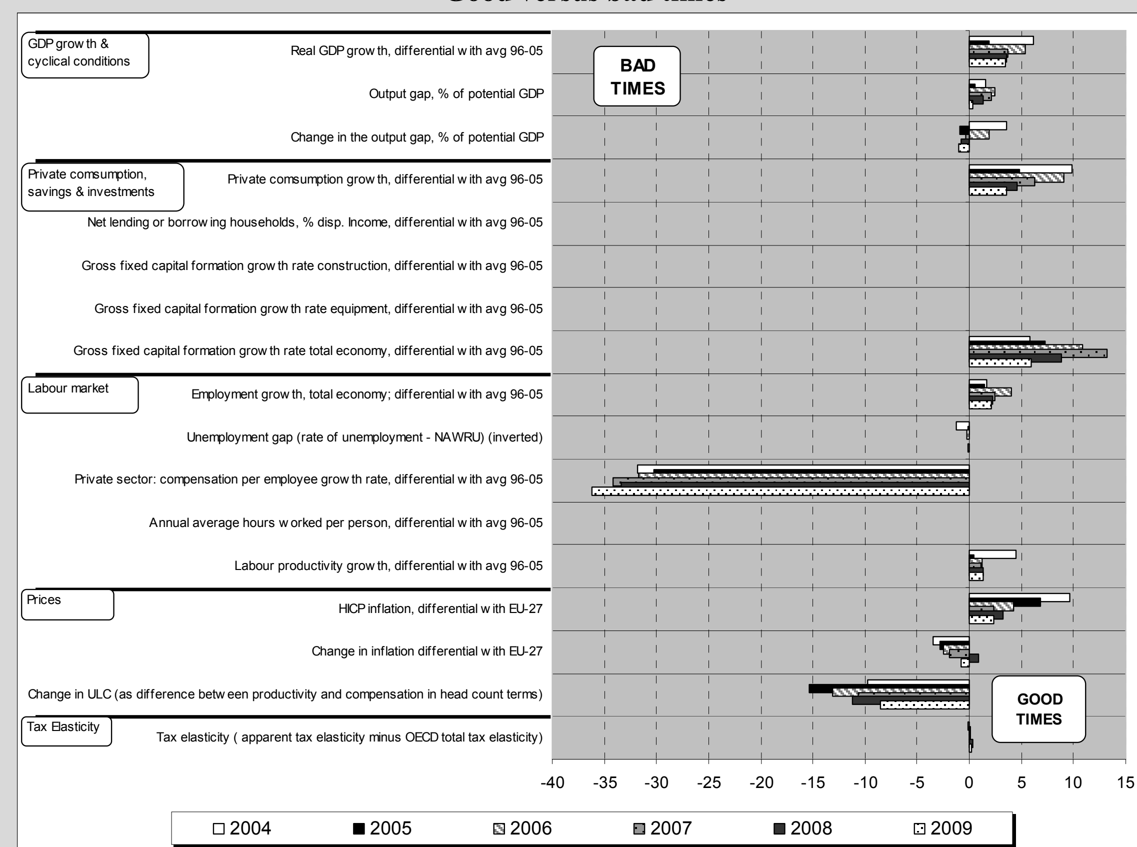
Although the programme describes several structural policy measures to upgrade labour skills and to improve the business environment, which are likely to ease supply constraints, it also envisages a non-restrictive fiscal policy (see Section 4.2 below), thereby further exacerbating domestic demand pressures. In general, it is unclear how the improvement in net borrowing vis-à-vis the rest of the world, as envisaged by the programme as from 2008, will be achieved. As highlighted in section 2.5, improving the quality of public expenditure, by enhancing budgetary planning and reviewing the expenditure composition in favour of growth-enhancing investments, will play a key role to assure the long-term sustainability of public finances and to foster real convergence.

Box 3: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times, taking into account tax elasticities in the period 2007-2009.

The Commission services project a positive but gradually narrowing output gap over the forecast horizon to 2009. Fuelled by strong credit growth, private consumption and gross fixed capital investment are projected to remain robust, although gradually decelerating, resulting in a further widening of the external deficit. GDP growth is expected to become increasingly constrained by tightening labour market conditions, as witnessed by steady employment growth and the closing unemployment gap. Skill shortages are becoming more prevalent and are driving up wages above productivity developments, resulting in rapidly increasing unit labour cost, threatening Romania's international competitiveness. The strong inflationary pressures from wage developments, high international food and commodity prices and the stabilization of the exchange rate (after a long period of appreciation), explain the slow-down of the rapid disinflation process. The inflation (HICP) differential with the EU-27 is thus expected to stabilize or to narrow only slightly over the forecast period. Finally, the change in the tax-to-GDP ratio is expected to remain higher than the one implied by the OECD elasticities, which confirms the qualification of "economic good times".

Good versus bad times



4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme.

The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 4 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous update of the convergence programme with the results of the Commission services' autumn 2007 forecast. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect and a revenue / expenditure growth effect[9]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of revisions to the GDP series.

- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections turning out higher or lower than anticipated in the previous update of the programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).

- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

The general government deficit target of 2.7% of GDP in 2007 set in the January 2007 programme is identical to the estimated outcome in the Commission services' autumn 2007 forecast. The positive base effect from the lower than expected deficit in 2006 was offset by the increase in expenditure outweighing the increase in revenue in 2007. In addition, it is worth mentioning that although there is no deviation between the previous programme's 2007 target and the Commission forecast, the underlying aggregate and individual revenue and expenditure developments are different. The Commission expects that both the revenue and expenditure targets set in the January 2007 programme will likely be undershot due to a combined effect of lower-than-planned GDP ratios in 2006 as well as lower-than-planned nominal growth of both revenue and expenditure in 2007.

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[9] A fourth, residual component is usually small, except if there are very large differences between the autumn forecast and the target (the full mathematical decomposition is in the methodological paper mentioned above).

Table 4: Budgetary implementation in 2007

	2006		2007	
	Planned CP Jan 2007	Outcome COM	Planned CP Jan 2007	Outcome COM
Revenue (% of GDP)	33.9	33.2	36.5	33.9
Expenditure (% of GDP)	36.2	35.0	39.2	36.6
Government balance (% of GDP)	-2.3	-1.9	-2.7	-2.7
Nominal GDP growth (%)			13.8	14.1
Nominal revenue growth (%)			22.5	16.7
Nominal expenditure growth (%)			23.2	19.2
Revenue surprise compared to target (% of GDP)			**-2.6**	
Of which [1] : 1. Base effect			-0.8	
2. GDP growth effect on the denominator			-0.1	
3. Revenue growth effect			-1.5	
Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than1 [2]			*-1.6*	
Expenditure surprise compared to target (% of GDP)			**-2.6**	
Of which [1] : 1. Base effect			-1.3	
2. GDP growth effect on the denominator			-0.1	
3. Expenditure growth effect			-1.1	
Government balance surprise compared to target (% of GDP)			**0.0**	
Of which: 1. Base effect			0.5	
2. GDP growth effect on the denominator			0.0	
3. Revenue / expenditure growth effect			-0.4	

Notes:

[1]A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2]Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source :
Commission services

While the projected 2007 deficit in the update of the programme is only 0.2pp higher than in the Commission autumn 2007 forecast, it results from much higher levels of both revenue and expenditure to GDP (by 3.5 pps. and 3.7 pps.respectively), even higher than in the previous programme. Consequently both revenue and expenditure are likely to be over-estimated. On the revenue side, in the light of the most recent available data, it is unlikely that the revenue projections in the programme will be met, notably due to under-performance of VAT. The expenditure side includes an over-budgeting of public investment, which is unlikely to be achieved and which has been reallocated to higher compensation of employees and social payments than planned. Regarding the actual outturn for the 2007 deficit, preliminary estimates indicate that the deficit will be around 2.7-2.8% in ESA95 terms despite announcements of a much lower deficit by the authorities (still on 20 December 2007). The high degree of uncertainty regarding the end-year size of the deficit comes from the fact that traditionally a large spending is operated at the end of the year. Over the period January-October 2007 the general government budget recorded a surplus of 0.8% of GDP, which turned to an estimated deficit of 2.4% of GDP for the whole year (in *domestic accounting* terms).

In its 27 March 2007 opinion the Council invited Romania to "exploit the good times to significantly strengthen the pace of adjustment towards the MTO by aiming for more demanding budgetary targets in 2007 […]". Despite strong revenue growth and the positive base effect from the better-than-expected 2006 deficit, the new programme does not foresee a more demanding target for 2007, but one that is 0.2 pp. of GDP worse. In

structural terms, as recalculated by the Commission services, the target remained at the level of the previous programme at 3.4% of GDP in 2007.

The Council also invited Romania to “control the envisaged high increase in public spending and review its composition so as to enhance the growth potential, as well as improve the planning and execution of public expenditures within a binding medium-term framework.” Compared to the previous version, the new programme foresees a higher increase in expenditure, both in nominal terms and as a share of GDP. In addition, as witnessed in previous years, under-spent public capital expenditure due to low execution of investment plans has been shifted to current spending through successive budget amendments. While a medium-term framework is under implementation, progress is slow and in addition, the framework is not binding (see also Section 6 below).

4.2. The programme’s medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

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

The new programme’s main objective is to pursue a fiscal policy which supports disinflation and external sustainability and achieves the MTO, a structural deficit of 0.9% of GDP, by 2011 (i.e. beyond the programme period), unchanged from the previous programme. For the period 2007-2009, the headline general government deficit is projected to stay stable at 2.9% of GDP, followed by an improvement: the deficit is set to decline to 2.4% of GDP in 2010. The primary balance follows a similar path with a small deterioration from 2% in 2007 to 2.1% of GDP for the period 2008-2009, followed by the same ½ pp. consolidation in 2010. No fiscal policy effort is made between 2007-2009, when the structural deficit as recalculated by the Commission services according to the common methodology based on the information in the programme is estimated to remain constant at around 3½% of GDP and only in 2010 a ¾% adjustment towards the MTO is envisaged.

The fiscal stance based on the recalculation by the Commission services is broadly neutral in 2008-2009 and restrictive in 2010.

Compared with the January 2007 convergence programme, the budgetary targets are less ambitious from 2007 to 2009 despite more favourable growth assumptions in 2008 and 2009. In addition, while the previous programme foresaw a more gradual adjustment towards the MTO starting in 2008, the update further backloads the planned structural adjustment towards 2010 and beyond.

Table 5: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010
General government balance (% of GDP)	**CP Dec 2007**	**-1.9**	**-2.9**	**-2.9**	**-2.9**	**-2.4**
	CP Jan 2007	*-2.3*	*-2.7*	*-2.6*	*-2.0*	*n.a.*
	COM Nov 2007	-1.9	-2.7	-3.2	-3.9	n.a.
General government expenditure (% of GDP)	**CP Dec 2007**	**35.0**	**40.3**	**42.7**	**42.8**	**43.2**
	CP Jan 2007	*36.2*	*39.2*	*39.6*	*39.8*	*n.a.*
	COM Nov 2007	35.0	36.6	39.0	40.9	n.a.
General government revenue (% of GDP)	**CP Dec 2007**	**33.2**	**37.4**	**39.8**	**39.9**	**40.8**
	CP Jan 2007	*33.9*	*36.5*	*37.1*	*37.8*	*n.a.*
	COM Nov 2007	33.2	33.9	35.8	37.0	n.a.
Structural balance[1] (% of GDP)	**CP Dec 2007**	**-2.2**	**-3.4**	**-3.4**	**-3.4**	**-2.7**
	CP Jan 2007	*-3.0*	*-3.4*	*-3.2*	*-2.3*	*n.a.*
	COM Nov 2007	-2.6	-3.3	-3.6	-4.0	n.a.
Real GDP (% change)	**CP Dec 2007**	**7.7**	**6.1**	**6.5**	**6.1**	**5.8**
	CP Jan 2007	*8.0*	*6.5*	*6.3*	*5.9*	*n.a.*
	COM Nov 2007	7.7	6.0	5.9	5.8	n.a.

Note:
[1]Cyclically-adjusted balance excluding one-off and other temporary measures. Cyclically-adjusted balances according to the programmes as recalculated by the Commission services on the basis of the information in the programmes. One-off and other temporary measures are 0.4% of GDP in 2006, 0.2% of GDP in 2007 and 2008 and 0.1% of GDP in 2009 and 2010; all deficit-reducing according to the most recent programme and zero according to the Commission services' autumn forecast.

Source :
Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)

4.2.2. The composition of the budgetary adjustment

The adjustment is fully back-loaded and revenue-driven (the 3.4 pps. increase in the revenue-to-GDP ratio outpacing the 2.9 pps. increase in the expenditure-to-GDP ratio). Both revenue and expenditure-to-GDP ratios are planned to increase sharply in 2007 and more moderately thereafter.

On the revenue side, the revenues-to-GDP are 4.2 pps. higher in 2007 and 2.4 pps. in 2008, followed by a smaller increase afterwards.

- Over the programme period, the largest contribution to the revenue increases comes from taxes (1.4 pps of GDP) due to an assumed tax buoyancy, but also to some measures, in particular with respect to VAT, though the programme could have spelled them out more clearly. Income taxes are expected to increase due to a favourable evolution of average earnings and the number of employees, whereas corporate taxes would benefit from strong profitability (also due to a positive effect of the cuts in social contributions) as well as from an assumed recovery of arrears. The indirect tax revenue is projected to rise by 1 pp. of GDP mainly due to measures aiming at changing the timing of some VAT receipts (such as the removal of delayed collection of VAT in the construction sector and the collection of VAT for imports from countries outside the EU at the border instead of at the destination of the goods). However, the programme is not sufficiently clear why these or other measures should lead to structurally higher revenues.

- Social contributions are subject to several reform measures with an assumed net positive effect of 0.7 pp. On the one hand, a 6 pps. cut in social contributions rate will be implemented in 2008 in three steps (in January, June and December) and part of the pension contributions will be shifted to the second pension pillar to be introduced as of January 2008 (this part will gradually increase from 2 pp. in 2008 by 0.5 pp. annually, up to 6 pps. in 2016). On the other hand, in 2008 some measures aimed at broadening the pension contribution base will be implemented (e.g. by removing the ceiling of five times the average wage and by including bonuses in the tax base).

Table 6: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	Change: 2010-2007
Revenue	**33.2**	**37.4**	**39.8**	**39.9**	**40.8**	**3.4**
of which:						
- Taxes on production and imports	12.8	14.0	14.0	14.5	15.0	**1.0**
- Current taxes on income, wealth, etc.	6.1	7.6	7.9	8.0	8.0	**0.4**
- Social contributions	10.4	10.3	11.6	11.2	11.0	**0.7**
- Other (residual)	3.9	5.5	6.3	6.2	6.8	**1.3**
Expenditure	**35.0**	**40.3**	**42.7**	**42.8**	**43.2**	**2.9**
of which:						
- Primary expenditure	34.2	39.4	41.8	42.0	42.4	**3.0**
of which:						
Compensation of employees	9.1	9.1	8.6	7.8	7.3	**-1.8**
Intermediate consumption	6.3	7.8	8.2	8.2	8.5	**0.7**
Social payments	9.6	10.0	11.5	12.0	11.9	**1.9**
Subsidies	1.8	1.7	1.4	1.2	0.9	**-0.8**
Gross fixed capital formation	4.9	7.0	8.2	8.6	9.2	**2.2**
Other (residual)	2.3	3.9	4.0	4.2	4.5	**0.6**
- Interest expenditure	0.8	0.9	0.9	0.8	0.8	**-0.1**
General government balance (GGB)	**-1.9**	**-2.9**	**-2.9**	**-2.9**	**-2.4**	**0.5**
Primary balance	**-1.0**	**-2.0**	**-2.1**	**-2.1**	**-1.6**	**0.4**
One-off and other temporary measures	-0.4	-0.2	-0.2	-0.1	-0.1	**0.1**
GGB excl. one-offs	**-1.5**	**-2.7**	**-2.7**	**-2.8**	**-2.3**	**0.4**
Output gap[1]	2.2	2.1	2.1	1.8	1.1	**-1.0**
Cyclically-adjusted balance[1]	-2.6	-3.6	-3.6	-3.5	-2.8	**0.8**
Structural balance[2]	**-2.2**	**-3.4**	**-3.4**	**-3.4**	**-2.7**	**0.7**
Change in structural balance		*-1.2*	*0.0*	*0.0*	*0.7*	
Structural primary balance[2]	-1.4	-2.5	-2.5	-2.6	-1.9	**0.6**
Change in structural primary balance		*-1.1*	*0.0*	*-0.1*	*0.7*	

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence programme; Commission services' calculations

- "Other revenues" also rise by 1.3 pps. of GDP reflecting an assumed increase in EU funds.

Box 4: The budget for 2008

The Romanian government adopted the draft budget for 2008 on 10 October 2007 and the Parliament approved the budget on 20 December 2007. The budget targets a general government deficit of 2.9% of GDP in 2008 in ESA95 terms (2.7% in domestic accounting methodology). Total revenues are projected to increase by around 20% compared to 2007 and the ratio of revenue to GDP would amount to 39.8% of GDP, up by 2.4 pps. compared to 2007. Most of the increase comes from social contributions, partly due to some recently approved measures aimed at broadening the contribution base (e.g. the pension contributions will be paid not only on wages but also on other work-related income such as bonuses and will also be paid on the whole salary as opposed to the current situation where there is cap on the salary base equivalent to five times the economy-wide average wage). Other increasing revenue items are the personal income tax and to a lesser extent VAT. A reduction of social contributions by 6 pps. (down from around 46% of the gross wage) in three steps (in January, July and December) and the introduction of a second pension pillar in January 2008 shifting revenues from the first to the second pillar (2% of the gross wage), are the main revenue decreasing measures.

Total expenditure is planned to increase by 19.6% and as a share of GDP ratio, it would represent 42.7% of GDP, up by 2.4 pps. of GDP compared to 2007. The increase stems to a large extent from a substantial increase in social benefits, due to a 43% nominal increase in pensions and an important increase in the public investments (by 1.2 pps. of GDP). The wage bill is planned to decrease as a share of GDP, which is a reversal of the trend seen in the past.

Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Broadening of the social contribution base (+0.7% of GDP)	o Pension increases (+2% of GDP)
o Social contributions shifted to 2nd pension pillar (-0.2% of GDP)	o Increased public investment (+1.2% of GDP)
o Reduction social security contributions (-0.7% of GDP)	

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: Commission services, the 2008 budget, Romanian Ministry of Finance and the convergence programme.

On the expenditure side, the expenditure-to-GDP ratio is expected to sharply increase by 5.3 pps. in 2007 followed by another rather high increase of 2.4 pps. in 2008, after which the rise is rather moderate (0.5 pp. over 2009-2010).

- The changes stem to a large extent from a substantial increase in public investment of 2.2 pps. over the programme period (from 7% of GDP in 2007 to 9.2% of GDP in 2010, up from 4.9% of GDP in 2006) due to an assumed significant increase in the absorption of EU structural funds, which seems ambitious.

- Social payments are also an expenditure increasing item. Most of the 1.9 pps. increase over 2007-2010 is implemented in 2008 (+1.5 pps.), due to a substantial increase in pensions. The programme explains that as of 1 November 2007 the pension benefits have been increased (the pension is calculated based on points which are now worth 37.5% of the average gross wage instead of 31.2%), but does not provide an estimation of the budgetary impact of this measure. In this respect, the 1.5 pps. increase in social payments in 2008 seems on the low side. In addition, although in June 2007 a further pension increase starting in 2009 has been decided by

law (the pension point is set to increase to 45% of the average gross wage), this is not mentioned in the programme. It could nevertheless explain the increase by 0.5 pp. in social payments in 2009, although the budgetary impact is likely to be much higher.

- On the other hand, the share of the compensation of employees to GDP is set to sharply fall by 1.8 pps. over the programme period, which is not substantiated.
- Subsidies are also set to record an unsubstantiated decrease of their ratio to GDP.
- Expenditure-increasing "one-off and other temporary measures" (in the range of 0.1-0.2% of GDP over 2007-2010) consist of the compensation titles issued by the government to reimburse properties confiscated before 1989 under the so-called "property fund " (see also section 4.3. below).

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 7 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

The programme's macroeconomic outlook is more favourable than the Commission services' autumn 2007 forecast in 2008 and 2009 and growth could turn out lower (see Section 3.1 above). Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 1 percentage point lower real GDP growth than in the programme over the 2008-2009 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 2010, 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.

Given the very favourable tax elasticity assumed by the programme and the most recent information regarding the budgetary execution, the planned level of revenue in 2007 is unlikely to be achieved. This would imply a negative base effect for revenue over the programme period, which could therefore turn out lower than expected. In addition, in 2008 the programme relies on a significant increase in the elasticity of social contributions to compensation of employees, despite a significant cut in the contribution rates and the introduction of the second pillar, which would be only partly offset by revenue-increasing measures.

On the expenditure side, the increase in spending stems to a large extent from an over-budgeting of gross fixed capital formation, assumed to increase from 8.2% of GDP in 2008 to 9.2% in 2010 (up from 4.9% of GDP in 2006 to 7% in 2007). Given the past levels of absorption of EU funds, the capital spending assumed in the programme is unlikely to be reached. However, there are risks that resources allocated to investment would be at least in part shifted to current spending as seen in the past, in particular to those items, which the programme seems to have under-budgeted namely the compensation of employees, social transfers and subsidies. Regarding the compensation of employees, the government foresees a decrease by 1.8 pps. of GDP by 2010 compared to the level of 2006, which is not substantiated in the programme and does not seem

realistic in the light of historic trends: in 2006 the compensation of employees increased by 0.2 pp. of GDP compared to the previous year and in 2005 by 0.8 pp. of GDP. In addition, the public wage bill is often subject to slippages: in 2006 its nominal increase has been 36% compared to an originally planned increase of 14%, in 2007 it was revised upwards to around 25% during the budgetary amendments compared to an initially planned increase of around 14%. With respect to social payments, the budgetary impact of the substantial increase in pensions might be underestimated in 2008 and 2009. Lastly, as regards subsidies their significant decrease as a share of GDP is not substantiated.

Table 7: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010
	COM	COM	CP	COM	CP	COM[1]	CP	CP
Revenue	**33.2**	**33.9**	**37.4**	**35.8**	**39.8**	**37.0**	**39.9**	**40.8**
of which:								
- Taxes on production and imports	12.8	12.5	14.0	12.9	14.0	13.1	14.5	15.0
- Current taxes on income, wealth, etc.	6.1	7.0	7.6	7.8	7.9	8.5	8.0	8.0
- Social contributions	10.4	10.4	10.3	10.8	11.6	10.7	11.2	11.0
- Other (residual)	3.8	4.0	5.5	4.4	6.3	4.7	6.2	6.8
Expenditure	**35.0**	**36.6**	**40.3**	**39.0**	**42.7**	**40.9**	**42.8**	**43.2**
of which:								
- Primary expenditure	34.2	35.7	39.4	38.1	41.8	40.0	42.0	42.4
of which:								
Compensation of employees	9.1	9.6	9.1	10.1	8.6	10.5	7.8	7.3
Intermediate consumption	6.3	6.2	7.8	6.2	8.2	6.2	8.2	8.5
Social payments	9.6	10.5	10.0	12.2	11.5	13.5	12.0	11.9
Subsidies	1.8	1.7	1.7	1.4	1.4	1.2	1.2	0.9
Gross fixed capital formation	4.9	4.7	7.0	4.8	8.2	5.0	8.6	9.2
Other (residual)	2.3	3.1	3.9	3.4	4.0	3.6	4.2	4.5
- Interest expenditure	0.8	0.9	0.9	0.9	0.9	0.9	0.8	0.8
General government balance (GGB)	**-1.9**	**-2.7**	**-2.9**	**-3.2**	**-2.9**	**-3.9**	**-2.9**	**-2.4**
Primary balance	**-1.0**	**-1.8**	**-2.0**	**-2.3**	**-2.1**	**-3.0**	**-2.1**	**-1.6**
One-off and other temporary measures	0.0	0.0	-0.2	0.0	-0.2	0.0	-0.1	-0.1
GGB excl. one-offs	**-1.9**	**-2.7**	**-2.7**	**-3.2**	**-2.7**	**-3.9**	**-2.8**	**-2.3**
Output gap[2]	2.4	2.1	2.1	1.3	2.1	0.3	1.8	1.1
Cyclically-adjusted balance[2]	-2.6	-3.3	-3.6	-3.6	-3.6	-4.0	-3.5	-2.8
Structural balance[3]	**-2.6**	**-3.3**	**-3.4**	**-3.6**	**-3.4**	**-4.0**	**-3.4**	**-2.7**
Change in structural balance		*-0.7*	*-1.2*	*-0.3*	*0.0*	*-0.4*	*0.0*	*0.7*
Structural primary balance[3]	-1.8	-2.5	-2.5	-2.7	-2.5	-3.1	-2.6	-1.9
Change in structural primary balance		*-0.7*	*-1.1*	*-0.2*	*0.0*	*-0.3*	*-0.1*	*0.7*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

In sum, while the expenditure-to-GDP ratio in 2008 might be lower then planned due to a lower 2007 level, for 2009-2010, the programme relies on a rather moderate increase of the expenditure-to-GDP ratio (of 0.5 pp. of GDP), which seems unrealistic given the country's track record in terms of expenditure overruns and when compared to the envisaged increase of 7.7 pps. over the period 2006-2008.

Moreover, there are additional risk factors to the targets from 2008 onwards as follows:

- The budgetary policy lacks predictability in terms of planning and execution, which undermines budget credibility and discipline. With respect to planning, the deficit has been systematically revised upwards in successive programme (see figure 6) and the expenditure-and revenue-to-GDP ratio is also frequently revised upwards through budgetary amendments during the year. In addition, the composition of the spending is altered during these budget rectifications: part of unspent funds on investment are shifted to current spending. As far as execution is concerned, there is a high degree of uncertainty and policy discretion and in the past large expenditure has been operated in the last one/two months of the years, a pattern which seems to have returned in 2007.

Table 8: Assessment of tax projections

	2008			2009			2010
	CP	**COM**	**OECD[3]**	**CP**	**COM[1]**	**OECD[3]**	**CP**
Change in tax-to-GDP ratio (total taxes)	1.8	1.6	0.3	0.2	1.0	0.3	0.3
Difference (CP – COM)	0.2		/	-0.8		/	/
of which [2] :							
- discretionary and elasticity component	*1.0*		/	*-0.4*		/	/
- composition component	*-0.5*		/	*-0.3*		/	/
Difference (COM - OECD)	/	1.4		/	0.7		/
of which [2] :							
- discretionary and elasticity component	/	*1.0*		/	*0.5*		/
- composition component	/	*1.7*		/	*1.3*		/
p.m.: Elasticity to GDP	1.4	1.5	1.1	1.1	1.3	1.1	1.1

Notes:

[1]On a no-policy change basis.

[2]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 and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

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

Source :
Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

- 2008 and 2009 are election years (local and parliamentary elections in 2008 and presidential elections in 2009) and therefore public expenditure could come under pressure. This could already be seen in June 2007 when a law which foresaw an almost doubling of pensions over 2008-2009 was adopted as well as during the debates on the 2008 budget in the Parliament, where the left-wing opposition party asked for more social spending.

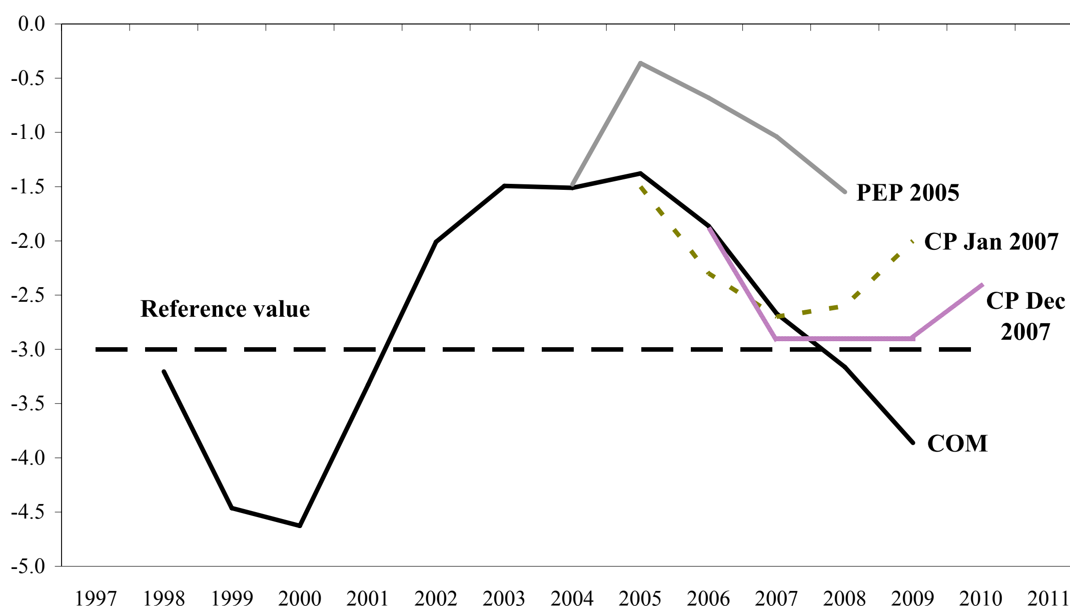
- The programme claims that the compensations by general government to owners of properties nationalised during the communist regime under the so-called property

fund scheme are "one-off and other temporary measures" increasing the deficit[10]. Nevertheless, given that the impact operates over several years as well as the uncertainty regarding the timeframe for recognising citizens' claims[11], the duration of this measure could be substantial. The Commission does not consider these government obligations as "one-off and other temporary measures". In addition, there is a risk that the total amount of the compensations could be higher than envisaged.

- The fiscal tightening foreseen in 2010 is not sufficiently substantiated with measures in the programme.

To sum up, the budgetary targets seem at risk from 2008 onwards.

Figure 6: Government balance projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM), the pre-accession economic programme (PEP) and successive convergence programmes

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 and, second, the final assessment also taking into account risks.

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[10] By 0.4% of GDP in 2006, 0.2% of GDP in 2007 and 2008 and 0.1% in 2009 and 2010.

[11] 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.

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

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the 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 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

In view of this risk assessment, the budgetary stance in the programme seems insufficient to ensure that the MTO is achieved by 2011, as envisaged by the programme. A safety margin against breaching the 3% of GDP deficit reference value would not even be provided by the end of the programme period. Indeed, there is a serious risk that the reference value will be breached in the near term.

After a sharp deterioration in the structural deficit of around 1¼ % of GDP in 2007, no adjustment towards the MTO can be expected before 2010 even though the economy is enjoying good times, which is not in line with the Stability and Growth Pact. The adjustment path is therefore insufficient and should be strengthened significantly. The budgetary stance also does not address the macroeconomic imbalances identified above, in particular the high and growing external deficit and domestic demand pressures.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

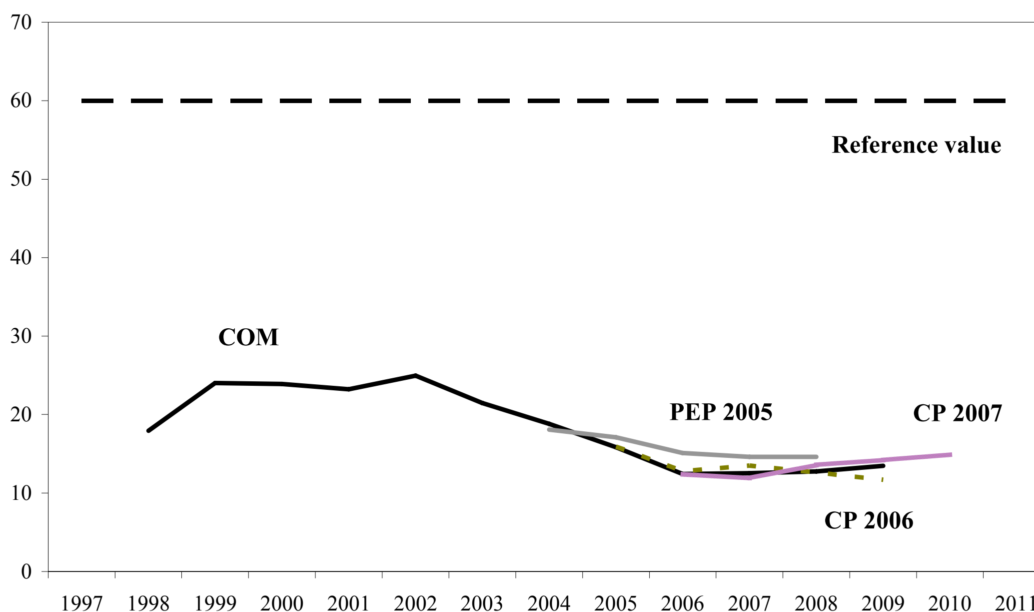
5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The programme estimates Romania's general government debt ratio to have decreased from 12.4% of GDP in 2006 to 11.9% in 2007. This is both lower than projected in the Commission services' autumn 2007 forecasts as well as below the target presented in the

previous programme, notably due to a stronger debt reducing contribution of the stock-flow adjustment. The debt ratio is expected to increase by 3 pps. over 2007-2010, driven by high primary deficits.

Figure 7: Debt projections in successive programmes (% of GDP)



Source: Commission services' autumn 2007 forecast (COM), pre-accession economic programme (PEP) and successive convergence programmes

5.1.2. Assessment

For 2008-2009 the programme expects a faster increase in the debt-to-GDP ratio compared to the Commission services autumn 2007 forecast debt projections. While the "snow-ball" effect is broadly similar in the programme and the Commission forecast, according to the programme the primary balance plays a smaller debt-increasing contribution, whereas the stock-flow adjustment contribute less to contain the debt increase. Details about the stock-flow adjustment are not provided by the programme.

The programme highlights some measure to improve the legal framework of the government debt management. In particular according to legislative changes undertaken in 2007 state guarantees will be issued by the Ministry of Economy and Finance only based on a special law adopted to this purpose. In addition, state guarantees will only be issued for major projects and with the approval of the Competition Council in order to ensure compliance with the EU rules on state aid. Similarly, from now on only the Ministry of Economy and Finance can contract loans. While these are step in the right direction, the actual positive impact of these new rules on state guarantees and debt can only be seen after the measures are implemented.

Table 10: Debt dynamics

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010
			COM	CP	COM	CP	COM	CP	CP
Gross debt ratio[1]	**20.3**	**12.4**	**12.5**	**11.9**	**12.8**	**13.6**	**13.5**	**14.2**	**14.9**
Change in the ratio	-1.8	-3.4	0.1	-0.5	0.2	1.7	0.7	0.6	0.7
Contributions [2] *:*									
Primary balance	**0.0**	**1.0**	**1.8**	**2.0**	**2.3**	**2.1**	**3.0**	**2.1**	**1.6**
"Snow-ball" effect	**-2.7**	**-1.6**	**-0.6**	**-0.6**	**-0.4**	**-0.5**	**-0.4**	**-0.6**	**-0.5**
Of which:									
Interest expenditure	1.6	0.8	0.9	0.9	0.9	0.8	0.9	0.8	0.8
Growth effect	-1.0	-1.0	-0.6	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Inflation effect	-3.3	-1.4	-0.8	-0.8	-0.6	-0.7	-0.6	-0.6	-0.6
Stock-flow adjustment	**1.1**	**-2.7**	**-1.0**	**-1.9**	**-1.6**	**0.2**	**-1.8**	**-0.9**	**-0.4**
Of which:									
Cash/accruals diff.	0.1	-0.8							
Acc. financial assets	0.2	-0.6							
Privatisation	*-0.6*	*-2.5*							
Val. effect & residual	0.3	-1.3							

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 2007 economic forecasts (COM); Commission services' calculations

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

5.2.1. Sustainability indicators and long-term debt projections

In absence of long-term projections of age-related expenditure, based on the common macroeconomic assumptions as carried out by the EPC and the 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.

Table 11 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the 2007/08 convergence programme.[12]

[12] The convergence programme only provides long-term projections of total expenditure. More detailed data were sent by the Ministry of Finance after the submission of the programme.

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

(% of GDP)	2005	2010	2020	2030	2050	Change 2010-50
Total age-related spending	14.4	18.5	18.1	18.2	17.4	-1.1
- Pensions	6.8	8.2	8.3	8.9	8.5	0.3
- Healthcare	3.3	4.3	4.3	4.2	4.1	-0.2
- Long-term care	-	-	-	-	-	-
- Education	4.3	6.0	5.5	5.1	4.8	-1.2
- Unemployment benefits	-	-	-	-	-	-
Property income received	-	-	-	-	-	-

Source: *Economic Policy Committee and Commission services.*

According to the programme, age-related expenditure is quite dynamic from 2005 up to 2010, increasing by around 4 pps. of GDP. In particular, pension expenditure is expected to increase by 1 pp. of GDP more than in last year's programme, notably due to the recent increase in the replacement rate which took place in November 2007. After 2010, age-related expenditure would decrease by 1.1 pps. of GDP up to 2050.

The increase in pension expenditure after 2010 is significantly below the average of the EU in the Ageing report (around 2.5 pps. of GDP between 2010 and 2050). Health-care expenditure decreases as a share of GDP between 2010 and 2050 while, with the common methodology to estimate the effect of ageing population on health care, it increases for all EU countries (on average by 1pp. of GDP for EU10 and 1.3 pps. of GDP for EU25). The decrease of education expenditure as a share of GDP between 2010 and 2050 (-1.2 pps. of GDP) is also larger than the EU10 average (-0.5 pp. of GDP) over the same period.

According to the programme[13], the share of the people aged over 65 years-old in the total population is projected to increase from 15% in 2010 to 31.4% in 2050, which is close to the increase projected for the EU as a whole in the Ageing report (17.6% to 29.4% for EU25).

Table 12: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	1.5	1.9	-0.5	0.8	1.3	-0.5
of which:						
Initial budgetary position (IBP)	2.7	2.7		2.1	2.1	
Debt requirement in 2050 (DR)	-0.8			-0.8		
Long-term change in the primary balance (LTC)	-0.5	-0.8		-0.5	-0.8	

Source: *Commission services.*

NB: calculations are based on a interest/growth rate differential of 1.5%.

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 12 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the

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programme period and the programme scenario assumes that the programme's budgetary plans are fully attained.

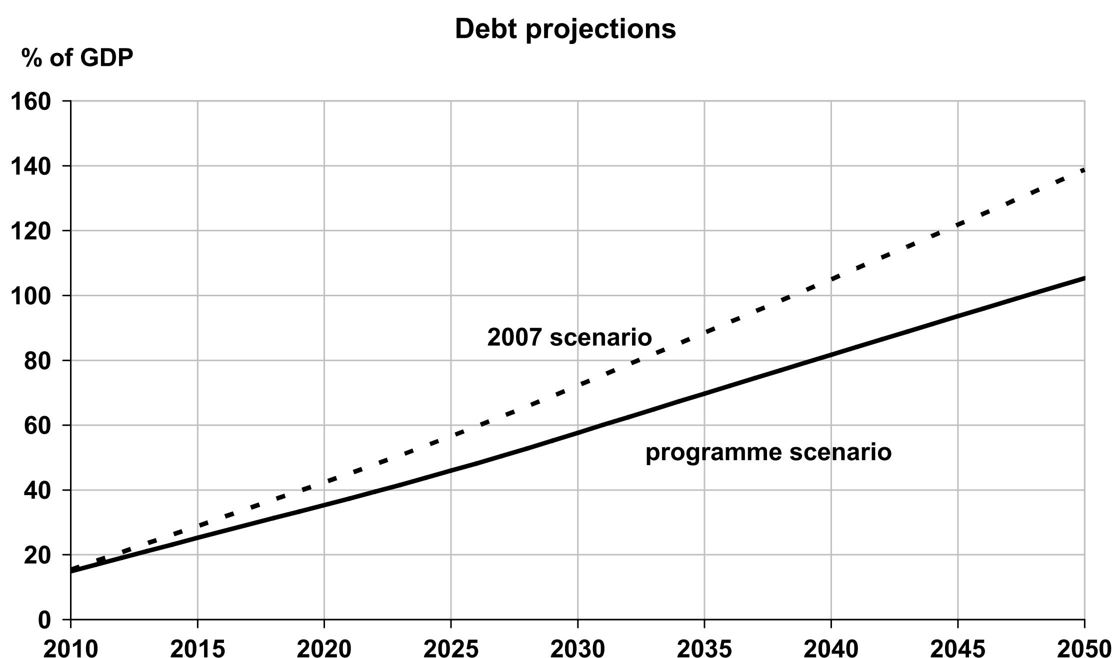
In the “2007 scenario”, the sustainability gap which satisfies the intertemporal budget constraint (S2) would be 1.9% of GDP.[14] This is close to the previous assessment as the deterioration of the structural primary balance has been compensated by somewhat less dynamic age-related expenditure after the programme period.

The initial budgetary position is not sufficiently high to stabilize the debt ratio over the long-term and entails a risk of unsustainable public finances before considering the long-term budgetary impact of ageing. According to both sustainability gaps, the long-term budgetary impact of ageing is slightly negative due to the reduction of age-related expenditure in GDP after the end of the programme period.

The programme plans a structural primary budgetary consolidation of 0.6 pp. of GDP between 2007 and 2010. If achieved, such a consolidation would reduce risks to long-term sustainability of public finances by reducing the S2 sustainability gap (“programme scenario”). The difference between the initial budgetary position in the "2007 scenario" and the "programme scenario" illustrates how the full respect of the convergence programme targets, would contribute to tackling the budgetary challenges raised by the demographic developments.

The required primary balance (RPB) is close to balance, due to the low level of the initial debt ratio and the negative impact of ageing population.

Figure 8: Long-term projections for the government debt ratio



14 The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 1.5% of GDP.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 8. The gross debt ratio is currently significantly below the 60% of GDP reference value, estimated in the programme at close to 12% of GDP in 2007. According to both scenarios, the debt ratio is projected to increase throughout the projection period and breach the reference value by 2030, reaching more than 100% of GDP in 2050.

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, the current level of debt is very low in Romania at around 12% of GDP; maintaining a low level of debt would contribute to containing the risks to the long-term sustainability of public finances.

Second, 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.[15] As a consequence the expected decrease in the age-related expenditures as a share of GDP between 2010 and 2050 and in particular the part related to pension and health care expenditures may be tilted toward the optimistic side.

5.2.3. Assessment

In the absence of 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 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 2007 budgetary position in the programme, 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.

[15] On average, for EU10 MS, potential is projected to be 3.0% of GDP over the period 2011-2030 and 0.9% over the period 2031-2050. By contrast, the projections in the programme projects a GDP growth which is over 3.5% over the period 2010-2050 (being 5.5% in 2020, 4.6% in 2030 and 3.7% in 2050).

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

As discussed in section 2, an improved quality of public finances can play a key role in fostering real convergence. Quality consists, on the one hand, of a growth-optimal expenditure size and composition and, on the other hand, of a solid tax base, which is not subject to continued erosion and tax evasion. In that context, section 2 examines the impact of the 2005 tax reform on government revenues and concludes that its benefits could be enhanced by exploiting the synergies with other fiscal reforms, in particular on the expenditure side, and other structural reforms. The programme describes measures in those areas. It highlights the main structural reforms, notably of the pension and health systems as well as initiatives to improve the quality and the institutional framework of public finances.

In the area of pensions, on the one hand measures have been taken to increase the long-term financial sustainability of the pension system. These include setting up a voluntary third pension pillar as of 2007 as well as a second pension pillar (compulsory for those aged under 35) as of 2008, the gradual increase of the statutory retirement age (to 60 for women and 65 for men by 2014) and of the minimum contribution period (from 10 to 15 years also by 2014). On the other hand, pension expenditure will come under increased pressure. Firstly, the government has decided in June 2007 measures resulting in an almost doubling of pensions over 2008-2009. Secondly, the pension budget will have to absorb the loss of revenues associated with a cut by 2.2 pps. in pension contributions in 2008 as well as the costs related to the introduction of the second pension pillar. Careful consideration should therefore be given to the potential risks these reforms entail for the long-term sustainability of the pension system, especially against the perspective of ageing population and migration. This clearly underscores the need to speed up further reforms in the area of pensions. In particular, a further increase in the retirement age and measures to reduce early retirement could be considered. In addition, a more thorough analysis of implicit liabilities and long-term sustainability of the pension system would be highly needed.

In the area of health, the programme describes the reforms aiming notably at improving the quality and efficiency of the health services. However, it presents neither the challenges in the health system from a budgetary point of view, nor the measures to ensure its longer-term financial balance, notably in the light of the cut by 1.8 pps of health contributions as of 2008.

With respect to expenditure policy, the programme focuses on improving the quality of physical and human capital. Increased public investment is foreseen in education, research and development and infrastructure and even if the programme does not show the budgetary impact of the various measures in detail, it presents both aggregate spending targets and a list of actions to underpin these priorities. Given the limited success in recent years in implementing the government's public investment programmes, the planned surge in investment activity may not be realistic. Moreover, the budget execution over recent years has exhibited a reallocation to wage expenditure and transfers from 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 aims to build on a number of institutional and legal measures taken over recent years to strengthen the budgetary framework and tax administration. On the expenditure side, in 2006, Romania has started the implementation of a medium-term expenditure framework and of the principle of budgetary allocation based on programmes. These are steps in the right direction, but efforts should be stepped up to effectively implement these instruments. Improving expenditure management is also important for achieving a better absorption of EU funds. It would also enhance the government's capacity to plan and execute expenditure policy, if it addressed: frequent budgetary rectifications, which have been used to redirect over-performing revenue to cover expenditure overruns, and a volatile budget execution (the accumulation of sizeable budgetary surpluses over the course of the year, followed by massive spending in the last one/two month of the year).

On the revenue side, the programme emphasises measures to simplify and improve fiscal procedures, prevent and combat tax evasion and financial discipline, increase compliance and modernise the fiscal administration. These measures have already led to progress in improving revenue collection, although a large potential is recognised to still exist.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

The reform measures described in the update of the convergence programme are broadly in line with those included in the National Reform Programme (NRP) submitted by Romania in July 2007. The update confirms the main government policy priorities addressed in the NRP: labour market and education reform, improvement of business environment, public administration, pension and health care reforms as well the expenditure priorities in the fields of education, research, health, infrastructure, environment and agriculture.

The convergence programme does not contain a qualitative assessment of the overall impact of the NRP within the medium term fiscal strategy. In addition, the convergence programme does not provide systematic information on the direct budgetary costs associated with the main reforms envisaged in the NRP. On the other hand the budgetary projections in the convergence programme seem to take into account the public finance implications of the reforms envisaged in the NRP. As a result, the two programmes seem to be integrated to some extent.

The table below provides an overview of whether the strategy and policy measures in the convergence programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs, in particular the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005.

Box 5: The Commission assessment of the July 2007 national reform programme

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of Romania's July 2007 national reform programme[16]. This can be summarised as follows.

Romania's national reform programme identifies as key challenges: improving the quality and management of government expenditure in the context of prudent macroeconomic policies; improving the functioning of markets; further improving the business environment; increasing employment and activity rates on the labour market; sustainable management of resources; and an overarching challenge of improving administrative capacity.

Against the background of strengths and weaknesses identified, the Commission recommends that Romania is recommended to take action in the areas of administrative capacity, public finances and macroeconomic stability, business environment, labour market and education.

Against the background of progress made, the Commission recommends that Romania is encouraged to also focus on the areas of: long-term sustainability of public finances, R&D and innovation, infrastructure and ICT, tackling undeclared work and public employment services.

Table 13: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated 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		X		Progress is very slow

[16] Communication from the Commission to the European Council, 'Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)', 11.12.2007, COM(2007)803.

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
policy objectives and ensure the overall coherence of reform packages.				

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

* * *

References

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Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The update adheres to the code of conduct as far as its table of contents is concerned.

(ii) Data requirements

The programme has some gaps regarding the compulsory data, namely in the Table 8 "Basic assumptions", the data on short-term and long-term interest rates are missing. With respect to 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 1d "Sectoral balances", the statistical discrepancy; in Table 2 "General government budgetary prospects", the item "government consumption" for the period 2007-2010; Table 3 "General government expenditure by function" is not provided; and in 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, pension reserves fund assets.

The tables on the following pages show the data presented in the December 2007 update of convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other data requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.		X	
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.			Not applicable
… explains significant divergences with Commission services' forecasts[1].		X	
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		Partly
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.		X	Not beyond 2008
… specifies state of implementation of measures.	X		

The SCP…	Yes	No	Comments
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.		X	
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.		X	
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		The sensitivity analysis presents the impact on the balance of changes in average gross wage and employment as well as the impact on debt of changes in the GDP, exchange rate and interest rates developments.
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.		X	
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.		X	
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.	X		
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).		X	There are no common projections for Romania
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]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

Table 1a. Macroeconomic prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g	*310.1*	7.7	6.1	6.5	6.1	5.8
2. Nominal GDP	B1*g	*342.4*	18.9	14.1	13.1	11.5	10.5
Components of real GDP							
3. Private consumption expenditure	P.3	*227.8*	13.9	10.9	9.2	8.2	7.3
4. Government consumption expenditure	P.3	*53.7*	2.5	5.4	4.3	2.8	2.6
5. Gross fixed capital formation	P.51	*77.2*	16.1	18.0	13.0	11.5	11.0
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*0.3*	0.3	0.0	-0.1	0.0	0.0
7. Exports of goods and services	P.6	*104.9*	10.6	8.3	10.3	10.9	10.7
8. Imports of goods and services	P.7	*153.3*	23.0	21.5	16.1	14.9	13.9
Contributions to real GDP growth							
9. Final domestic demand		-	13.8	12.9	10.8	9.6	8.9
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	0.3	0.0	-0.1	0.0	0.0
11. External balance of goods and services	B.11	-	-6.4	-6.8	-4.2	-3.5	-3.1

Table 1b. Price developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator		*n.a.*	10.4	7.5	6.4	5.2	4.4
2. Private consumption deflator		*n.a.*	5.1	4.0	4.1	3.3	2.8
3. HICP[1]		*n.a.*	6.6	4.8	5.7	4.0	3.3
4. Public consumption deflator		*n.a.*	14.8	6.8	5.0	4.2	3.5
5. Investment deflator		*n.a.*	9.1	7.0	5.5	4.5	4.0
6. Export price deflator (goods and services)		*n.a.*	5.7	1.1	3.3	2.1	1.7
7. Import price deflator (goods and services)		*n.a.*	-0.6	-3.3	-1.6	-2.6	-3.0

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*9313*	1.8	1.5	1.4	1.1	0.6
2. Employment, hours worked[2]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
3. Unemployment rate (%)[3]		*n.a.*	7.3	7.1	6.9	6.8	6.6
4. Labour productivity, persons[4]		*n.a.*	5.8	4.5	5.0	4.9	5.2
5. Labour productivity, hours worked[5]		*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
6. Compensation of employees	D.1	*85690*	19.6	22.1	14.6	11.6	10.8
7. Compensation per employee		*18360*	16.8	19.5	optional	optional	optional

[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	**2006**	**2007**	**2008**	**2009**	**2010**
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-10.3	-12.6	-10.5	-10.1	-10.2
of which : - Balance on goods and services		-12.1	-14.7	-15.4	-15.3	-15.0
- Balance of primary incomes and transfers		1.8	1.4	1.8	1.9	2.0
- Capital account		0.0	0.7	3.1	3.3	2.8
2. Net lending/borrowing of the private sector	B.9	-8.4	-10.5	-10.7	-10.6	-10.6
3. Net lending/borrowing of general government	EDP B.9	-1.9	-2.9	-2.9	-2.8	-2.4
4. Statistical discrepancy		n.a.	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*-6378.5*	-1.9	-2.9	-2.9	-2.9	-2.4
2. Central government	S.1311	*-9949.1*	-2.9	-3.3	-3.1	-3.2	-2.6
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*-82.4*	0.0	0.0	0.1	0.1	0.1
5. Social security funds	S.1314	*3653*	1.1	0.4	0.1	0.2	0.2
General government (S13)							
6. Total revenue	TR	*113512.4*	33.2	37.4	39.8	39.9	40.8
7. Total expenditure	TE[1]	*119890.9*	35.0	40.3	42.7	42.8	43.2
8. Net lending/borrowing	EDP B.9	*-6378.5*	-1.9	-2.9	-2.9	-2.9	-2.4
9. Interest expenditure	EDP D.41	*2806.9*	0.8	0.9	0.9	0.8	0.8
10. Primary balance[2]		*-3571.6*	-1.0	-2.0	-2.1	-2.1	-1.6
11. One-off and other temporary measures[3]		*-1446.4*	-0.4	-0.2	-0.2	-0.1	-0.1
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*64877*	18.9	21.6	21.9	22.5	23.0
12a. Taxes on production and imports	D.2	*43911.3*	12.8	14.0	14.0	14.5	15.0
12b. Current taxes on income, wealth, etc	D.5	*20965.7*	6.1	7.6	7.9	8.0	8.0
12c. Capital taxes	D.91	*0*	0.0	0.0	0.0	0.0	0.0
13. Social contributions	D.61	*35604.2*	10.4	10.3	11.6	11.2	11.0
14. Property income	D.4	*3324.1*	1.0	1.3	1.6	1.4	1.3
15. Other[4]		*9707.1*	2.8	4.2	4.7	4.8	5.5
16=6. Total revenue	TR	*113512.4*	33.2	37.4	39.8	39.9	40.8
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			29.3	31.9	33.5	33.7	34.0
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*52963.6*	15.5	16.9	16.7	16.0	15.8
17a. Compensation of employees	D.1	*31268.1*	9.1	9.1	8.6	7.8	7.3
17b. Intermediate consumption	P.2	*21695.5*	6.3	7.8	8.2	8.2	8.5
18. Social payments (18=18a+18b)		*33017.9*	9.6	10.0	11.5	12.0	11.9
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*2659.5*	0.8	0.2	0.3	0.3	0.3
18b. Social transfers other than in kind	D.62	*30358.4*	8.9	9.8	11.2	11.7	11.7
19=9. Interest expenditure	EDP D.41	*2806.9*	0.8	0.9	0.9	0.8	0.8
20. Subsidies	D.3	*6302.5*	1.8	1.7	1.4	1.2	0.9
21. Gross fixed capital formation	P.51	*16930*	4.9	7.0	8.2	8.6	9.2
22. Other[6]		*7870*	2.3	3.9	4.0	4.2	4.5
23=7. Total expenditure	TE[1]	*119890.9*	35.0	40.3	42.7	42.8	43.2
p.m.: Government consumption (nominal)	P.3	*57215.3*	16.7	n.a.	n.a.	n.a.	n.a.

[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, item 9).

[3]A plus sign means deficit-reducing one-off measures.

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

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

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	n.a.	n.a.
2. Defence	2	n.a.	n.a.
3. Public order and safety	3	n.a.	n.a.
4. Economic affairs	4	n.a.	n.a.
5. Environmental protection	5	n.a.	n.a.
6. Housing and community amenities	6	n.a.	n.a.
7. Health	7	n.a.	n.a.
8. Recreation, culture and religion	8	n.a.	n.a.
9. Education	9	n.a.	n.a.
10. Social protection	10	n.a.	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	n.a.	n.a.

[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	ESA Code	2006	2007	2008	2009	2010
1. Gross debt[1]		12.4	11.9	13.6	14.2	14.9
2. Change in gross debt ratio		-3.4	-0.5	1.7	0.6	0.7
Contributions to changes in gross debt						
3. Primary balance[2]		-1.0	-2.0	-2.1	-2.1	-1.6
4. Interest expenditure[3]	EDP D.41	0.8	0.9	0.9	0.8	0.8
5. Stock-flow adjustment		-3.2	0.6	2.9	1.9	1.5
of which:						
- Differences between cash and accruals[4]		0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets[5]		2.7	0.1	0.2	0.1	0.1
of which:						
- privatisation proceeds		2.6	0.0	0.0	0.0	0.0
- Valuation effects and other[6]		-5.9	0.6	2.8	1.8	1.4
p.m.: Implicit interest rate on debt[7]		6.2	7.3	7.1	6.3	5.8
Other relevant variables						
6. Liquid financial assets[8]		3.9	2.8	2.6	2.3	2.1
7. Net financial debt (7=1-6)		8.5	9.1	11.0	11.9	12.8

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

[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 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	**2006**	**2007**	**2008**	**2009**	**2010**
1. Real GDP growth (%)		7.7	6.1	6.5	6.1	5.8
2. Net lending of general government	EDP B.9	-1.9	-2.9	-2.9	-2.9	-2.4
3. Interest expenditure	EDP D.41	0.8	0.9	0.9	0.8	0.8
4. One-off and other temporary measures[1]		-0.4	-0.2	-0.2	-0.1	-0.1
5. Potential GDP growth (%)		5.7	6.3	6.5	6.6	6.6
contributions:						
- labour		-0.1	0.0	0.1	0.1	0.1
- capital		2.4	2.9	3.1	3.2	3.3
- total factor productivity		3.4	3.4	3.3	3.3	3.2
6. Output gap		2.4	2.3	2.3	1.9	1.1
7. Cyclical budgetary component		0.7	0.7	0.8	0.7	0.4
8. Cyclically-adjusted balance (2 - 7)		-2.6	-3.6	-3.7	-3.6	-2.8
9. Cyclically-adjusted primary balance (8 + 3)		-1.8	-2.7	-2.8	-2.8	-2.0
10. Structural balance (8 - 4)		-2.2	-3.4	-3.5	-3.5	-2.7

[1]A plus sign means deficit-reducing one-off measures.

Table 6. Divergence from previous update

	ESA Code	**2006**	**2007**	**2008**	**2009**	**2010**
Real GDP growth (%)						
Previous update		8.0	6.5	6.3	5.9	n.a.
Current update		7.7	6.1	6.5	6.1	5.8
Difference		-1.7	-0.4	0.2	0.2	n.a.
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.3	-2.7	-2.6	-2.0	n.a.
Current update		-1.9	-2.9	-2.9	-2.9	-2.4
Difference		0.4	-0.2	-0.3	-0.9	n.a.
General government gross debt (% of GDP)						
Previous update		12.8	13.5	12.6	11.7	n.a.
Current update		12.4	11.9	13.6	14.2	14.9
Difference		-0.4	-1.6	1.0	2.5	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	33.6	35.0	43.2	41.0	39.0	37.0
Of which: age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension expenditure	6.7	6.8	8.19	8.3	8.9	8.5
Social security pension	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Old-age and early pensions	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other pensions (disability, survivors)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	3.5	3.3	4.3	4.3	4.2	4.1
Long-term care *(this was earlier included in the health care)*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education expenditure	3.4	4.3	6.0	5.5	5.1	4.8
Other age-related expenditures	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Interest expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenue	32.1	33.2	40.8	40.5	38.5	37.0
Of which: property income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : from pensions contributions (or social contributions if appropriate)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions						
Labour productivity growth	2.2	8.6	5.0	5.1	4.4	3.6
Real GDP growth	2.1	5.7	6.4	5.5	4.6	3.7
Participation rate males (aged 20-64)	75.4	69.5	72.6	75.1	78.1	80.5
Participation rates females (aged 20-64)	61.8	55.3	60.7	63.1	64.9	70.8
Total participation rates (aged 20-64)	68.7	62.4	66.6	69.1	71.5	75.7
Unemployment rate	6.9	7.2	6.6	4.8	4.6	4.5
Population aged 65+ over total population	13.6	14.7	15.5	17.0	18.5	22.0

Table 8. Basic assumptions

	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
Long-term interest rate (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.26	1.36	1.42	1.42	n.a.
Nominal effective exchange rate	n.a.	n.a.	n.a.	n.a.	n.a.
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	3.53	3.31	3.30	3.25	3.20
World excluding EU, GDP growth	5.4	5.1	4.7	4.8	n.a.
EU GDP growth	3.0	2.9	2.4	2.4	n.a.
Growth of relevant foreign markets	9.5	7.3	6.8	6.6	n.a.
World import volumes, excluding EU	8.0	7.8	7.1	7.7	n.a.
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	n.a.

[1] If necessary, purely technical assumptions.

Annex 2: Key indicators of past economic performance

This annex displays key economic indicators that summarise the past economic performance of Romania. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the recently acceded Member States (EU12).

Table: Key economic indicators

	Romania						Recently acceded Member States					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.3	-1.2	5.7	4.1	7.7	6.0	3.8	3.6	4.1	4.8	6.3	6.0
Contributions to real GDP growth:												
Domestic demand	*4.4*	*0.0*	*8.7*	*8.7*	*14.1*	*13.2*	*4.4*	*4.6*	*4.1*	*4.1*	*7.3*	*7.8*
Net exports	*-2.1*	*-1.2*	*-3.0*	*-4.5*	*-6.4*	*-7.3*	*-0.5*	*-1.0*	*-0.1*	*0.8*	*-0.9*	*-1.8*
Real GDP per capita (PPS; EU27 = 100)	29	28	30	33	35	36	47	45	49	52	54	56
Real GDP per capita (% change)	2.8	-1.0	6.5	4.4	7.8	6.3	4.1	3.8	4.4	4.9	6.4	6.1
Prices, costs and labour market												
HICP inflation (%)	43.7	68.8	18.6	9.1	6.6	4.7	7.8	12.9	5.7	3.8	3.4	4.0
Labour productivity (% change)	3.6	0.7	6.4	3.9	4.7	4.7	4.2	4.3	4.1	3.3	3.6	3.5
Real unit labour costs (% change)	0.9	5.0	-3.2	2.2	1.9	2.3	-1.3	-1.4	-1.3	-0.6	-1.5	0.4
Employment (% change)	-1.2	-1.9	-0.6	0.2	2.8	1.2	-0.3	-0.6	0.0	1.4	2.6	2.4
Unemployment rate (% of labour force)	6.5	5.5	7.5	7.2	7.3	7.1	11.3	9.7	12.9	11.9	9.9	7.8
Competitiveness and external position												
Real effective exchange rate (% change)	9.3	14.4	4.2	25.4	15.0	15.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change)[1]	4.5	0.7	8.3	2.9	2.4	2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-4.9	-5.2	-4.5	-8.0	-10.3	-12.8	-4.5	-4.8	-4.3	-4.3	-5.0	-6.1
Public finances												
General government balance (% of GDP)	-2.8	-4.1	-1.9	-1.4	-1.9	-2.7	-4.2	-3.8	-4.4	-3.5	-3.3	-2.7
General government gross debt (% of GDP)	21.3	22.0	20.9	15.8	12.4	12.5	37.7	35.4	39.0	39.6	38.8	37.9
Structural balance (% of GDP)[2]	n.a.	n.a.	-1.5	-1.6	-2.6	-3.3	n.a.	n.a.	-3.8	-3.3	-3.6	-3.0
Financial indicators												
Short-term real interest rate (%)[3]	1.5	2.8	0.2	-3.4	-2.1	-1.2	3.9	6.3	2.9	1.4	1.0	0.5
Long-term real interest rate (%)[3]	n.a.	n.a.	n.a.	n.a.	-2.9	0.0	n.a.	n.a.	n.a.	n.a.	1.6	1.1

Notes:

[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.

[3]Using GDP deflator.

Source :
Commission services