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Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Romania

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with a view to bringing an end to the situation of an excessive government deficit in Romania

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union, and in particular Article 126(7) thereof,

Having regard to the recommendation from the Commission;

Whereas:

(1) According to Article 126 of the Treaty on the Functioning of the European Union (Treaty) Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact (SGP) is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) Following a recommendation from the Commission of 4 March 2020[1] on the basis of an excessive deficit planned in 2019, the Council decided on 3 April 2020, in accordance with Article 126(6) of the Treaty that an excessive deficit existed in Romania[2] and issued a recommendation to correct the excessive deficit by 2022 at the latest[3], in accordance with Article 126(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97[4].

(4) On 20 March 2020, the Commission adopted a Communication on the activation of the general escape clause of the Stability and Growth Pact (SGP)[5]. That clause, as set out in Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97[6] and Articles 3(5) and 5(2) of Regulation (EC) 1467/97, facilitates the coordination of budgetary policies in times of severe economic downturn. In its Communication, the Commission set out its view that, given the severe economic downturn resulting from the COVID-19 outbreak, the conditions to activate the general escape clause were met. On 23 March 2020, the Ministers of Finance of the Member States agreed with the assessment of the Commission.

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1 COM/2020/91 final.
2 OJ L 110, 8.4.2020, p. 58.
3 OJ C 116, 8.4.2020, p. 1.
4 Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209, 2.8.1997 p.6).
5 COM/2020/123 final.
6 Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (OJ L 209 2.8.1997, p. 1).

(5) On 15 September 2020, Romania submitted its report on action taken in response to the Council recommendation of 3 April 2020. That report pointed to a major deterioration of the public finances during 2020, mainly due to the COVID-19 pandemic.

(6) On 18 November 2020, the Commission adopted a Communication on Romania's fiscal situation[7]. In light of the continued exceptional uncertainty created by the COVID 19 pandemic and its extraordinary macroeconomic and fiscal impact, the Commission considered that no decision on further steps in the excessive deficit procedure (EDP) initiated for Romania could be taken at that juncture. In particular, the exceptional uncertainty, including for designing a credible path for fiscal policy, did not allow the Commission to put forward a recommendation for a Council recommendation under Article 126(7) of the Treaty at that stage. The Commission stated that it would reassess Romania's budgetary situation in spring 2021, based on the 2020 outturn data, 2021 budget and the Commission 2021 spring forecast and that, if appropriate, it would propose new steps under the EDP, taking into account the continued application of the general escape clause of the SGP in 2021.

(7) On 3 March 2021, the Commission adopted a Communication providing further policy orientations to facilitate the coordination of fiscal policies and the preparation of Member States' Stability and Convergence Programmes[8]. The Communication of 3 March 2021 announced the Commission's view that the decision on the deactivation or continued application of the general escape clause should be taken as an overall assessment of the state of the economy, with the level of economic activity in the EU or euro area compared to pre-crisis levels (end-2019) as key quantitative criterion. On 2 June 2021 the Commission adopted a Communication on Economic policy coordination in 2021[9]. According to that Communication, the general escape clause of the Stability and Growth Pact will continue to be applied in 2022 and is expected to be deactivated as of 2023.

(8) According to an update of the Commission's Debt Sustainability Monitor 2020 to reflect the latest Commission 2021 spring forecast, Romania's medium and long-term fiscal sustainability risks remain high. Those risks need to be addressed by an adequate medium-term fiscal plan backed by structural measures.

(9) In light of the deep contraction in economic activity linked to the COVID-19 pandemic and of the related need for fiscal policies to support the recovery in 2021 and 2022, the Council recommendation of 3 April 2020 does no longer provide a relevant basis for fiscal policy guidance for Romania.

(10) Pursuant to the last sentence of Article 3(5) of Regulation (EC) No 1467/97, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) of the Treaty in the event of a severe economic downturn in the euro area or in the Union as a whole, provided that this does not endanger fiscal sustainability in the medium term.

(11) In accordance with Article 126(7) of the Treaty and Article 3 of Regulation (EC) No 1467/97, the Council is required to make a recommendation to the Member State concerned which also establishes a deadline to bring the situation of an excessive deficit to an end. The recommendation is to establish a maximum deadline of six

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[7] COM/2020/752 final.

[8] COM/2021/105 final.

[9] Communication from the Commission on Economic policy coordination in 2021: overcoming COVID-19, supporting the recovery and modernising our economy, Brussels, 2.6.2021, COM(2021)500 final.

months for effective action to be taken by the Member State concerned to correct the excessive deficit, which can be reduced to three months when warranted by the seriousness of the situation. Furthermore, in a recommendation to correct an excessive deficit the Council is to request the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0.5% of GDP as a benchmark.

(12) Real GDP in Romania contracted by 3.9% in 2020. According to the Commission 2021 spring forecast, real GDP growth is forecast to rebound to 5.1% in 2021 and 4.9% in 2022. Private consumption is expected to recover as the vaccination roll-out progresses and social distancing measures are gradually lifted, while wage growth is also expected to remain robust. The phasing in of projects under the Recovery and Resilience Plan (RRP) is set to lend new impetus to investment growth. The contribution of net exports, that is export minus imports, is expected to remain negative over the forecast horizon. This is because imports are expected to be spurred by the recovery of private consumption as well as by growing investments. Exports are expected to be supported by a recovery in external demand but remain less dynamic than imports. The growth outlook is subject to balanced risks. On the one hand, a credible medium-term fiscal strategy can help dispel concerns about fiscal sustainability, in particular when combined with ambitious reforms (including those contained in the RRP). This would help address Romania's macroeconomic imbalances, mitigate financial stability risks and contribute to sustainable growth, including by improving the investment climate. On the other hand, uncertainty with regard to public policy-making and delays or inefficiencies in the implementation of the RRP could result in negative confidence effects.

(13) On 2 March 2021, the Romanian Parliament adopted Romania's 2021 budget and medium-term fiscal strategy. That fiscal strategy, together with information on the profile of non-repayable financial support and loans under the Recovery and Resilience Facility (Facility), has been taken into account in the 2021 Convergence Programme, which was submitted to the Commission on 5 May 2021. Starting with a general government deficit of 9.2% of GDP in 2020, the Convergence Programme targets a general government deficit of below 3% of GDP by 2024 in the following steps: 8.0% of GDP in 2021, 6.2% of GDP in 2022, 4.4% of GDP in 2023 and 2.9% of GDP in 2024. The fiscal adjustment set out in the Convergence Programme is mostly expenditure-based. Expenditure control (reduction as a percentage of GDP) is envisaged in particular for public sector wages (down by 1.4 pps between 2022 and 2024) and social transfers (down by 0.9 pps between 2022 and 2024).

(14) The Commission 2021 spring forecast, extended up to 2024, projects a general government deficit of 8.0% of GDP in 2021, 7.1% of GDP in 2022 and 6.8% of GDP in 2023 and 2024. That forecast takes into account expenditures expected to be financed by non-repayable financial support and loans from the Facility, as presented in the Romanian Convergence Programme and in additional information provided by Romania. The decrease of the general headline government deficit projected by the Commission is mostly driven by the gradual expiry of emergency measures adopted in response to the COVID-19 pandemic, by higher revenues driven by the projected economic recovery, and by the additional positive impact of investments and reforms expected to be financed by the Facility. Moreover, the Romanian government has decided to freeze public sector wages in 2021 and 2022, to postpone pension increases

in 2021 and to increase pensions moderately in 2022, which contribute to an improved outlook as compared to the one in the Commission 2020 autumn forecast. These changes have already been legislated. In addition, the government intends to adopt a new pension legislation that would keep pension expenditure as percentage of GDP broadly stable. The higher deficit projection in the Commission 2021 spring forecast, compared to Romania's Convergence Programme, stems from the fact that the planned consolidation is not fully supported by enacted, or as yet credibly announced, measures and could therefore not be taken into account in the Commission forecast. The structural deficit is projected by the Commission to improve by 0.7 pps of GDP in 2021, by 0.5 pps of GDP in 2022 and to deteriorate by 0.1 pps of GDP in 2023 and 0.4 pps of GDP in 2024.

(15) General government debt stood at 34.7% of GDP at end-2018, 35.3% of GDP at end-2019 and 47.3% of GDP at end-2020. According to the Commission 2021 spring forecast, it is projected to increase to 49.7% of GDP at end-2021, 52.7% of GDP at end-2022 and 59.5% of GDP at end-2024, thus approaching for the first time the 60% of GDP Treaty reference value in the absence of additional corrective measures than those already enacted or credibly announced.

(16) The analysis of medium to long-term debt sustainability, updated after the Commission 2021 spring forecast, confirms that risks to sustainability are high in the medium term. According to a baseline 10-year projection, the general government debt-to-GDP ratio would continue increasing over the projection period and reach a level close to 90% of GDP. Risks to debt sustainability are driven by large fiscal deficits, costs of ageing, and vulnerability of the debt path to macro-fiscal shocks. Pension increases, legislated in summer 2019, and for the time being postponed until the end of 2022, are the predominant source of the debt sustainability risks. The debt structure, with a high share of foreign denominated debt and a significant share of debt held by non-residents, further adds to the debt sustainability risks, although interventions by the National Bank of Romania on the secondary market have helped keep government borrowing costs at favourable levels in 2020. Moreover, there are risks linked to contingent liabilities stemming from state guarantees (of 1.4% of GDP) granted to firms and the self-employed during the COVID-19 crisis. Gross financing needs are projected to increase. Conversely, reforms and investments under Next Generation EU, if effectively implemented, are expected to have a positive impact on GDP growth in the coming years, thereby contributing to debt sustainability.

(17) Under Article 3(4) of Regulation (EC) No 1467/97, the correction of the excessive deficit is to be completed in the year following its identification unless there are special circumstances. The adjustment path should be determined in line with Regulation (EC) No 1467/97, taking into account the economic and fiscal position of the Member State.

(18) In the present situation, such special circumstances exist in Romania. Granting Romania one additional year, which would be in line with the rule established in Article 3(4) of Regulation (EC) No 1467/97, would require a very sharp fiscal adjustment and result in significant output losses, thus risking compromising the economic recovery after the COVID-19 pandemic. An adjustment path with a deadline for correcting the excessive deficit by 2024, while still requiring substantial annual adjustments, would imply a more gradual effort and strike a good balance between fiscal consolidation and supporting the economic recovery. The new adjustement path also takes into account the changed fiscal situation, including budgetary developments in 2020 and the new budgetary strategy put in place by the Romanian government.

Reforms, including those that improve the management of public finances, would be instrumental in ensuring a durable correction of the excessive deficit. In light of these considerations, and consistent with the fiscal policy orientations set out in the Commision Communication of 3 March 2021, setting a deadline to correct the excessive deficit by 2024 is justified.

(19) A credible and sustainable adjustment path under this deadline would require Romania to achieve a headline general government deficit target of 8.0% of GDP in 2021, 6.2% of GDP in 2022, 4.4% of GDP in 2023, and 2.9% of GDP in 2024, in line with the government's own targets. This, based on the Commission forecast, is consistent with a nominal growth rate of net primary government expenditure of 3.4% in 2021, 1.3% in 2022, 0.9% in 2023 and 0.0% in 2024.[10] Such growth rates of net primary government expenditure will be the primary indicator used to assess the fiscal effort if a careful analysis is needed. The corresponding annual fiscal adjustment in the structural balance is 0.7% of GDP in 2021, 1.8% of GDP in 2022, 1.7% of GDP in 2023 and 1.5% of GDP in 2024.

(20) To assess the potential impact of overall fiscal policy on output, at the current juncture, the sizeable payments from the European Union budget (under the Facility and other Union funds) should be included in the relevant expenditure aggregate, as a measure of fiscal stance.[11] On this basis, Union funds are expected to have a significant positive impact on the Romanian economy in the coming years. Specifically, investments and reforms supported by the Facility provide an opportunity for Romania to improve its underlying fiscal position in the medium term while still supporting growth and job creation.

(21) Budgetary consolidation measures should secure a lasting correction on the excessive deficit, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. Reforms of a fiscal and broader economic nature, including reforms of the pension system, tax administration, public sector wages and state-owned enterprises governance, should support the fiscal consolidation effort and make it sustainable.

(22) Since 2016, Romania has systematically and repeatedly derogated from its national fiscal rules and the timeline for the adoption of the medium-term fiscal strategy, enshrined in the national fiscal framework. Going forward, Romania's budgetary adjustment would be supported by the full application of the national fiscal framework.

HAS ADOPTED THIS RECOMMENDATION:

(1) Romania should put an end to the excessive deficit situation by 2024 at the latest.

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10 Net primary government expenditure comprises total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

11 The overall fiscal stance is measured by comparing the change in primary expenditure (net of discretionary revenue measures but including changes in expenditure financed by the Facility and other non-repayable financial support by the European Union) to the 10-year average potential growth rate. However, this estimate does not include the impact of the reforms that are part of the Recovery and Resilience Plan and can boost Romania's economic potential growth. A negative sign of the indicator corresponds to an excess of the primary expenditure growth compared with medium-term economic growth, which indicates an expansionary fiscal policy.

(2) Romania should reach a headline general government deficit target of 8.0% of GDP in 2021, 6.2% of GDP in 2022, 4.4% of GDP in 2023, and 2.9% of GDP in 2024, which is consistent with a nominal growth rate of net primary government expenditure of 3.4% in 2021, 1.3% in 2022, 0.9% in 2023 and 0.0% in 2024. This corresponds to an annual structural adjustment of 0.7% of GDP in 2021, 1.8% of GDP in 2022, 1.7% of GDP in 2023 and 1.5% of GDP in 2024.

(3) Romania should fully implement the measures already adopted for 2021. It should specify and implement the additional measures that are necessary to achieve the correction of its excessive deficit by 2024. Budgetary consolidation measures should secure a sustainable correction in a growth-friendly manner. Any windfall gains should be used to reduce the general government deficit.

(4) The Council establishes the deadline of 15 October 2021 for Romania to take effective action and, in accordance with Article 3(4a) of Regulation (EC) No 1467/97, to report the consolidation strategy that is envisaged to achieve the targets. Thereafter, Romania should report on progress made in the implementation of this recommendation at least every six months until the excessive deficit has been corrected.

Furthermore, Romania should ensure the full and effective application of the national fiscal framework. To ensure the success of the medium-term fiscal strategy, it will also be important to support the fiscal consolidation with comprehensive reforms.

This Recommendation is addressed to Romania.

Done at Brussels,

For the Council
The President