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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
Bulgaria**

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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 European Commission;

Whereas:

- (1) According to Article 126 of the Treaty Member States shall avoid excessive government deficits.
- (2) The Stability and Growth Pact 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) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.
- (4) The Council has decided on [13 July 2010], in accordance with Article 126(6) of the Treaty, that an excessive deficit exists in Bulgaria.
- (5) In accordance with Article 126(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure¹ (which is part of the Stability and Growth Pact), the Council is also required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The recommendation has to establish a deadline of six months at the most for effective action to be taken by the Member State concerned to correct the excessive deficit as well as a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. In deciding whether special circumstances exist, “relevant factors” as clarified in Article 2(3) of Regulation (EC) No 1467/97 should be taken into account.

¹ OJ L 209, 2.8.1997, p. 6.

Furthermore, in a recommendation to correct an excessive deficit the Council should request the achievement of a minimum annual improvement in the structural balance, i.e. the cyclically-adjusted balance excluding one-off and other temporary measures, of 0.5% of GDP as a benchmark.

- (6) In the case of Bulgaria, the relevant factors, as clarified in Article 2(3) of Regulation (EC) No 1467/97 and examined in the Commission's report under Article 124(3), were considered favourable. However, they do not suggest the existence of special circumstances warranting a departure from the standard deadline for correcting the deficit. Taking into account both the Commission services' spring 2010 forecast and the authorities' latest EDP notification of June 2010 Bulgaria is recommended to correct the excessive deficit by 2011.
- (7) In the years prior to the crisis and in the context of a very tax-rich growth structure Bulgaria has maintained a relatively strong budgetary position and markedly reduced the general government gross debt ratio. In 2009, however, the budgetary situation deteriorated significantly. Large revenue shortfalls resulted from a fall in GDP of 5% (against an expected growth of 4.7% underlying the budget) and the growth structure becoming much less tax intensive with a sizable contraction in domestic demand. At the same time expenditure increased because in addition to the working of the economic stabilizers sizable payment commitments undertaken by the outgoing government ahead of the mid-year parliamentary elections were uncovered in the second half of the year. As a result, the budget balance swung from a surplus of 1.8% of GDP in 2008 to a deficit of 3.9% of GDP in 2009. Given the need to maintain macro-economic stability under the currency board arrangement, the government did not adopt fiscal stimulus measures in response to the downturn. In the April 2010 EDP notification the Bulgarian authorities expected the general government budget deficit to fall below the reference value to 2% of GDP already in 2010 underpinned by a recovery in real GDP growth to 1% and the additional consolidation package to the tune of 2¼% of GDP from 31 of March 2010. The Commission services' spring 2010 forecast published on 5 May projected the general government budget deficit to improve to 2.8% of GDP in 2010 and further to 2% of GDP in 2011, based on a no-policy change assumption, on an expected gradual improvement in the growth outlook, and on a prudent assessment of the budgetary impact of the announced consolidation measures. In June the Bulgarian authorities undertook a mid-year revision of the 2010 budget and increased their planned government deficit to 3.8% of GDP. The revision was initiated as a result of a significant downward adjustment of projected government revenues, in the wake of very weak tax data in the first few months of 2010. It aims at ensuring the proper functioning of automatic stabilizers and a more accurate reflection of the domestic and international economic challenges. On the basis of the Commission services' forecast and the latest budgetary and economic developments, the correction of the excessive deficit in 2011 implies a structural fiscal effort of around ¾ percentage points of GDP in that year, assuming that the 2010 deficit target is met.
- (8) The deficit surprise in 2009, in addition to the negative budgetary impact from the downturn, appears also to be related to procedural weaknesses with expenditure planning and implementation control on an accrual basis. The large payment commitments uncovered under annexes to contracts signed by the predecessor government ahead of the July 2009 elections were not planned in the budget and led to additional deterioration of the budgetary position. The negative outcome reflects also

the fact that the recent economic good times were not fully used as an opportunity to undertake substantial reforms to improve the efficiency of public spending. In the pre-crisis period Bulgaria has benefited from significant revenue windfalls resulting from buoyant activity and a very tax-intensive growth structure. However, part of these revenue windfalls, instead of being fully saved, have been used to finance relatively high ad-hoc pension increases and public sector wage increases, far above productivity gains, as well as for tax and social security rate cuts.

- (9) The non-binding nature of the medium-term fiscal framework in the three-year budgetary planning horizon and the lack of effective spending control mechanisms and expenditure rules have prevented the fiscal position from becoming even stronger, thus further cushioning the negative impact from the downturn on public finances. In addition, the existing budgetary framework allows for certain discretionary spending powers of the government which undermines fiscal transparency and accountability. The lack of reforms in the healthcare sector has repeatedly led to accumulation of hospital arrears and subsequent expenditure overruns. Successive reduction of pension contribution rates combined with pension increases and the absence of offsetting reform measures have brought about a substantial rise in pension spending, posing risks to the sustainability of the system and public finances. Furthering reforms in the education system and public administration would contribute to improving administrative capacity and the level of skills and to increasing the efficiency of public spending thus achieving the needed budgetary consolidation.
- (10) In the past years the government gross debt-to-GDP ratio has followed a downward trend, decreasing from around 38% in 2004 to 14% in 2008, while at the same time the government has accumulated financial assets that accounted to around 12% of GDP in 2008. The data in the April 2010 EDP notification shows that the general government gross debt remains well below the 60% of GDP reference value and stood at 14.8% of GDP in 2009. The Commission services' spring 2010 forecast projects the debt ratio to increase over the 2010-2011 period, but to remain below 19% of GDP. In a notification submitted on 22 June 2010, the Bulgarian authorities further revised the planned debt to 15.3% of GDP.
- (11) Enhanced surveillance under the EDP will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. In this context, a separate chapter in forthcoming updates of the Bulgaria convergence programme could usefully be devoted to this issue.
- (12) In general, in the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy,

HAS ADOPTED THIS RECOMMENDATION:

- (1) The Bulgarian authorities should put an end to the present excessive deficit situation by 2011 at the latest.
- (2) The Bulgarian authorities should bring the general government deficit below 3% of GDP in a credible and sustainable manner. Specifically, to this end, the Bulgarian authorities should:
 - (a) take necessary measures to avoid a deterioration of the 2010 deficit beyond the planned 3.8% of GDP;
 - (b) ensure a fiscal effort of at least $\frac{3}{4}$ % of GDP in 2011;
 - (c) specify and implement the measures that are necessary to achieve the correction of the excessive deficit by 2011.
- (3) To limit risks to the adjustment, Bulgaria should strengthen fiscal governance and transparency by reinforcing the Ministry of Finance's spending controls, strengthening the binding nature of its medium-term budgetary framework as well as improving the monitoring of the budget execution throughout the year.
- (4) The Council establishes the deadline of [13 January 2011] for the Bulgarian government to take effective action and to specify measures that will be necessary to correct of the excessive deficit. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' spring 2010 forecast.

The Bulgarian authorities should report on progress made in the implementation of these recommendations in a separate chapter in the forthcoming updates of the convergence programme until the abrogation of the excessive deficit procedure.

In addition, the Council highlights the importance of achieving the medium-term objective (MTO) for appropriate budgetary management of economic downturns. It therefore invites the Bulgarian authorities to ensure that budgetary consolidation towards the medium-term objective for the budgetary position – a general government structural balance of $\frac{1}{2}$ % of GDP – is sustained after the excessive deficit will have been corrected. The efficiency of public spending should be improved by fully implementing the planned structural reforms in the area of public administration, healthcare, education, and pensions.

This recommendation is addressed to the Republic of Bulgaria.

Done at Brussels,

*For the Council
The President*