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Analysis by the Commission services of the action taken

by Bulgaria

in response to the Council Recommendation of 13 July 2010 with a view to bringing an end to the situation of excessive government deficit

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1. INTRODUCTION

The budgetary impact of the economic downturn and expenditure increases stemming from sizable commitments undertaken by the outgoing government ahead of the mid-year parliamentary elections in 2009 led to a swing in the general government balance in Bulgaria from a surplus of 1.8% of GDP in 2008 to a deficit of 3.9% in 2009[1]. Against this background, on 13 July 2010, the Council decided that an excessive deficit existed and addressed recommendations to Bulgaria in accordance with Article 126(7) TFEU with a view to bringing an end to the situation of an excessive government deficit by 2011.[2] In its recommendations, the Council established a deadline of 13 January 2011 for effective action to be taken.

In particular, the Council recommended to Bulgaria to: (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 ¾% of GDP in 2011; and (c) specify and implement the measures that are necessary to achieve the correction of the excessive deficit by 2011. To limit risks to the adjustment, Bulgaria was recommended to 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.

This paper reviews the actions taken by Bulgaria to meet the above recommendations in light of the economic and budgetary developments since the Council recommendations were issued on 13 July 2010. In particular, it reviews the budgetary implementation in 2010 by comparing the projected budgetary developments in 2010 according to the Commission services' autumn 2010 forecast with the economic and budgetary scenario underpinning the Council recommendations. The latter was based on the Commission services' spring 2010 forecast published on 5 May 2010 and the budgetary projections underlying the subsequent mid-year revision of the 2010 budget adopted by the Bulgarian parliament on 8 July.[3] For 2011, the basis for the assessment of action taken towards the correction of the excessive deficit is again the Commission services' autumn 2010 forecast, which incorporates the main policy changes

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[1] With the October 2010 EDP notification the general government balance outcomes in 2008 and 2009 were revised to a surplus of 1.7% and a deficit of 4.7% of GDP, respectively. The main reasons included methodological changes with respect to introducing time-adjusted cash recording of certain tax revenues as well as some additional government liabilities in the second half of 2010.

[2] All EDP-related documents for Bulgaria can be found at the following website: http://ec.europa.eu/economy_finance/sgp/deficit/countries/bulgaria_en.htm

[3] Given that the 2010 budget update took place in the middle of the year, the revised budgetary projections were not incorporated in the Bulgaria' convergence programme update of January 2010.

in the draft 2011 budget, approved by the Bulgarian government on 30 September and adopted by the parliament on 2 December 2010.

2. ECONOMIC DEVELOPMENTS

Bulgaria entered into recession somewhat later than its neighbours. Economic activity contracted by 4.9% in 2009, compared to 4.2% for the EU average, and the deterioration continued into the first quarter of 2010, when the economic activity appears to have bottomed out. Underpinned by strong exports, GDP growth resumed in the second quarter and gained momentum in the second half of the year. The Commission services' autumn 2010 forecast expects real GDP to have remained broadly flat for 2010 as a whole.

The outlook for the Bulgarian economy has remained broadly unchanged since the Commission services' spring 2010 forecast underpinning the Council recommendations of 13 July 2010 (Table 1). The recovery is set to become more broad-based and accelerate in 2011 and 2012, with real GDP growth reaching 2.6% and 3.8%, respectively. Growth will be underpinned by both strong external demand as well as a pick-up of domestic demand. While the recovery might be slightly stronger than in the other EU countries, growth will remain well below the pre-crisis average.

Table 1: Comparison of macroeconomic developments and forecasts

	2009	2010		2011	
	outturn	COM SF10	COM AF10	COM SF10	COM AF10
Real GDP (% change)	-4.9	0.0	-0.1	2.7	2.6
Contributions to real GDP growth:					
Final domestic demand	-13.1	-3.3	-5.2	2.2	2.3
Changes in inventories	-2.7	0.1	0.5	0.2	0.1
Net exports	10.9	3.3	4.6	0.3	0.3
Employment (% change)	-2.7	-1.2	-5.2	0.6	0.7
GDP deflator (% change)	4.1	0.1	2.4	3.0	2.6

Source: COM SF10 - Commission services' spring 2010 forecast; COM AF10 - Commission services' autumn 2010 forecast.

The Bulgarian authorities have revised their economic projections several times during the course of the year: in the convergence programme update of January 2010 economic activity was expected to expand by 0.3% and 3.8% in 2010 and 2011, respectively; the projections underlying the revised 2010 budget in July envisaged real GDP to grow by 1% in 2010, while according to the macroeconomic scenario underpinning the 2011 budget real GDP was expected to grow by 0.7% and 3.6% in 2010 and 2011, respectively[4].

3. BUDGETARY IMPLEMENTATION IN 2010

According to the Commission services' autumn 2010 forecast, the general government budget deficit will come down to 3.8% of GDP in 2010, from 4.7% of GDP in 2009, in line with the

4 According to additional information provided in early January 2011, the authorities have revised their projection for real GDP growth in 2010 further down to 0.2%.

target set in the revised 2010 budget underpinning the July 2010 Council recommendations.[5] The latest forecast of the Ministry of Finance projects a slightly better deficit ratio at 3.6% of GDP.

The initial 2010 budget, approved in December 2009, targeted a small general government budget deficit of 0.7% of GDP on a cash basis. However, the budget execution in the first quarter of 2010 showed that the deficit target was unrealistic. By end-March, the accumulated budget deficit increased to 2.4% of the full-year GDP compared to a surplus of 0.8% of GDP in the first quarter of 2009. The increase in the budget deficit was due to lower-than-expected tax revenues, largely as a result of the continued change in the growth structure and the associated higher VAT and excise tax refunds, as well as to increased social expenditure on pensions and unemployment benefits.

In the April 2010 EDP notification the Bulgarian authorities still 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 an additional consolidation package to the tune of 2¼% of GDP approved on 31 March 2010. The Commission services' spring 2010 forecast, published on 5 May 2010, 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, an expected gradual improvement in the growth outlook, and an assessment of the budgetary impact of the announced consolidation measures.

In June 2010, however, in view of the deteriorating fiscal situation, the government decided to revise the 2010 budget. Despite an improved macro-economic scenario of real GDP growth of 1% against a decline of 2% in the original budget, the general government deficit target was raised to 4.8% of GDP on a cash basis (3.8% of GDP in ESA95 terms) against 0.7% in the initial budget and balanced budget in the January 2010 update of the Convergence Programme. The budget revision reflected a significant downward adjustment of projected government revenues – by BGN 2.1 bn or 2.9% of GDP while overall expenditure was increased by around 0.7 bn or 1% of GDP. In addition to ensuring the proper functioning of automatic stabilizers, the increase in budgeted expenditure reflected the need to offset overdue liabilities from the previous year. The government decided to finance the resulting budget deficit mainly through the use of accumulated fiscal reserves instead of resorting to the bond markets.

Most recent public finance data shows that Bulgaria is on track to meet its revised fiscal target for 2010. At the end of November 2010, the accumulated general government cash deficit increased to 2.7% of the estimated full-year GDP with revenues having dropped by 5.0% y-o-y and expenditures having increased by 1.4% y-o-y in nominal terms.

Budget revenue continued to underperform throughout 2010. For the year as a whole, the authorities expect the overall revenue-to-GDP ratio to be around ⅓ percentage points below the level projected in the revised annual budget. In the Commission services' autumn 2010 forecast the revenue ratio is projected to be somewhat above the authorities' current estimate, largely due to a denominator effect. The main reason for the revenue underperformance is the continued weaker-than-expected economic activity with an on-going contraction in the direct and indirect tax bases and a higher than expected decline in employment. To prevent a further

[5] The expected 3.8% of GDP fiscal deficit outcome for 2010 includes a one-off deficit increasing item of 0.1% of GDP related to cancellation of third countries' debt.

drop in revenues, the authorities have undertaken a number of measures to improve collection rates, such as tighter external border controls, intensified tax audits and customs checks, and greater efforts to collect arrears owed to the government.

On the expenditure side, overall spending growth was constrained to below nominal GDP growth through September 2010, thus contributing to containing the widening in the budget deficit. However, in line with the practice of previous years, spending is expected to have accelerated significantly in the last two months of 2010 when the government settled its liabilities incurred earlier in the year as well as accumulated arrears, mainly in the hospital sector. Nevertheless, for the year as a whole, the authorities expect the expenditure-to-GDP ratio to be around ⅔ percentage points below the annual budgeted level, mainly due to savings in subsidies and capital spending. In the Commission services' autumn 2010 forecast the expenditure ratio is projected to be slightly above the authorities' estimate. This is explained by higher current primary expenditure in the Commission services projections, partly compensated for by lower capital expenditure.

Table 2: Composition of the budgetary adjustment

	2009		2010						2011			
	outturn	CP Jan 2010	CP Jan 2010		Budget 2011		COMAF 2010		Budget 2011		COMAF 2010	
	% of GDP	% of GDP	% ch yoy	% of GDP	% ch yoy	% of GDP	% ch yoy	% of GDP	% ch yoy	% of GDP	% ch yoy	% of GDP
Revenue	35.9	37.5	12.2	39.2	-4.4	33.4	-2.9	34.1	9.5	34.3	5.4	34.1
of which:												
- Taxes on production and imports	15.1	16.0	18.7	17.4	-2.8	14.2	-4.9	14.0	6.5	14.2	4.5	13.9
- Current taxes on imcome, wealth, etc.	5.6	6.3	11.1	6.0	-2.5	5.3	-1.9	5.3	12.8	5.6	4.4	5.3
- Social contributions	7.7	8.0	3.0	7.7	-5.9	7.0	-6.0	7.1	11.7	7.4	7.6	7.2
- Other (resedual)	7.6	7.2	9.5	8.1	-7.3	6.9	3.6	7.7	10.8	7.1	5.8	7.7
Expenditure	40.6	39.4	-0.7	39.2	-6.2	37.0	-4.4	38.0	6.0	36.8	2.9	37.1
of which:												
- Primary expenditure	39.8	38.6	-1.1	38.3	-6.3	36.3	-4.3	37.3	5.8	36.0	2.5	36.3
of which:												
- Compensation of employees	9.4	9.5	-3.5	8.8	0.9	9.2	-3.0	8.9	0.2	8.6	0.0	8.4
- Intermediate consumption	7.1	n.a	n.a.	n.a	-4.4	6.6	-9.7	6.3	6.0	6.6	6.4	6.4
- Social payments	13.7	n.a	n.a.	n.a.	6.4	14.1	6.1	14.2	0.4	13.3	1.5	13.7
- Subsidies	0.9	0.7	43.7	1.2	24.3	1.0	9.0	0.9	50.0	1.5	7.5	0.9
- Gross fixed capital formation	4.9	5.1	6.4	5.1	-4.0	4.6	-6.6	4.5	-0.9	4.3	2.9	4.4
- Other (residual)	3.9	4.0	-14.9	3.2	-81.4	0.7	-34.3	2.5	168.1	1.8	4.8	2.5
- Interest expenditure	0.8	0.8	17.5	0.9	-3.0	0.7	-9.0	0.7	14.6	0.8	21.0	0.8
General government balance (GGB)	-4.7	-1.1		0.0		-3.6		-3.8		-2.5		-2.9
Primary balance	-3.9	-1.3		0.9		-2.9		-3.1		-1.7		-2.1
One-off and other temporary measures	0.0	n.a		n.a		n.a.		0.1		n.a.		0.0
Real GDP growth	-4.9	-4.9		0.3		0.2		-0.1		3.6		2.6

Source: CP Jan 2010 - Convergence Programme January 2010; Budget 2011 - Bulgaria's Budget for 2011 and additional information provided by the authorities about the expected execution of the budget 2010; COMAF10 - Commission services' autumn 2010 forecast.

4. PROJECTED BUDGETARY DEVELOPMENTS IN 2011 AND 2012

For 2011 and 2012, the Commission services' autumn 2010 forecast projects deficits of 2.9% and 1.8% of GDP, implying annual deficit reductions of 0.9% and 1.1% of GDP, respectively, based on a no-policy change assumption, an expected improvement in the economic outlook and a prudent assessment of the fiscal consolidation measures envisaged in the 2011 budget. In structural terms, the expected 2011 and 2012 fiscal outcomes imply a gradual adjustment and a contractionary fiscal policy stance with annual consolidation efforts of ¾% and ½% of GDP, respectively.

Bulgaria will target slightly lower deficits of 2.5% and 1.5% of GDP in 2011 and 2012, respectively, both on cash and accruals (ESA 95) basis, with the difference mostly explained by a projected more buoyant and more broad based economic recovery. The main reasons for the 0.4 pps and 0.3 pps higher deficit projections in the Commission services' autumn 2010 forecast for 2011 and 2012, respectively, compared to those of the authorities are mostly twofold. Firstly, in the Commission services' forecast the underlying less buoyant growth scenario implies also a less revenue-rich composition of growth with a lower increase of indirect and direct tax bases than that of the authorities. Secondly, the projected lower increase in budget revenue in the Commission services' forecast is based on a more conservative assessment of the budgetary impact of the envisaged revenue-enhancing measures with respect to tax policy and tax collection.

The 2011 fiscal target would represent an improvement of 1.3% of GDP in the general government budget balance with respect to the expected 2010 budget execution. The authorities plan to reach the 2011 fiscal target mostly as a result of the expected economic recovery, better revenue collection, revenue-enhancing measures, increased spending efficiency and a containment of major expenditure items broadly at their 2010 level in nominal terms.

On the revenue side, the 2011 increases in excise tax rates on some energy products, cigarettes and tobacco are expected to result in 0.09% of GDP higher revenue, while the delayed effect of the 2010 increases in excise tax rates on tobacco products is expected to be 0.07% of GDP. The increase by 1.8 pps. of the pension contribution rate should bring in 0.5% of GDP additional revenue. In addition, the authorities expect to raise 0.15% of GDP by increasing the minimum mandatory insured income thresholds for main economic activities and professional groups by 5.6% compared to 2010. They also plan to levy a 10% withholding tax on income of foreign-controlled legal entities established in preferential tax regime areas (off-shore zones) with a source in Bulgaria. A new tax on insurance premiums will be introduced that is estimated to yield 0.02% of GDP. Furthermore, a set of measures are aimed at improving tax enforcement and collection of tax arrears, i.e. the incrimination of the non-payment of social security contributions as well as an increase in the number and frequency of tax audits.

On the expenditure side, total expenditures are projected to decline by 1.3 pps., from 37% of GDP in the expected 2010 budget execution to 36.8% of GDP in 2011 mostly as a result of the increase in nominal GDP. In nominal terms, the authorities will aim at maintaining compensations of employees in the public sector, subsidies, social expenditure and maintenance outlays at their levels in the 2010 revised budget, while capital expenditure is set to decline to its 2009 level[6]. Pensions will not be increased in accordance with the so called "Swiss rule"[7] both in 2011 and in 2012. Additional expenditure-containment measures are also planned, namely improved spending efficiency and limiting the number of new recruits in the public sector.

For 2012, according to the medium-term fiscal projections, Bulgaria aims to scale back the deficit to 1.5% of GDP, benefiting from further improvement in the economic outlook as well as additional consolidation measures still to be specified and adopted. Changes in the main

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6 The main total expenditure sub-components policy objectives are defined on a cash basis and do not correspond directly to the fiscal figures on an accruals (ESA95) basis.

7 It mandates pension adjustments equal to 50% of the increase in inflation and 50% of the increase in the annual insured income.

direct and indirect taxes are not envisaged except further harmonization of excise tax rates in line with the EU requirements.

The Commission services see risks to the achievement of the 2011 and 2012 deficit targets mainly stemming from the strength and broadness of the expected economic recovery, possible underperformance with respect to revenue collection, difficulties to contain the build-up of expenditure in line with the projections underlying the achievement of the fiscal targets as well as a less than optimal improvement in expenditure control mechanisms.

5. FISCAL GOVERNANCE AND THE QUALITY OF THE PUBLIC FINANCES

The Bulgarian fiscal framework performed relatively well in the favourable economic environment prior to the crisis; as the government consistently met its fiscal targets and accumulated sizeable fiscal buffers. The negative 2009 deficit surprise, however, appears to have been related also to procedural weaknesses regarding expenditure planning and commitment control on an accruals basis, in addition to the negative impact of the downturn on the budget balances.

The Commission services' assessment of the convergence programme update of January 2010[8] highlighted the importance of addressing the shortcomings of the fiscal framework related to the existence of certain discretionary powers of the central government which could undermine the transparency of the budget procedures and democratic control by parliament. In addition, it was emphasized that the framework does not incorporate multi-annual rules, and that the expenditure ceilings (set in the course of the medium-term fiscal planning) are only binding in the short-term. The existence of administrative inefficiencies in tax collection contributed to the large revenue shortfalls in 2009-2010 in addition to the negative revenue impact of the crisis. At the moment, no independent institution is involved in the formulation of the macroeconomic assumptions underlying the ex-ante budgetary projections.

Bulgaria undertook several initiatives to improve expenditure control, monitoring and reporting systems in order to limit the risk of expenditure overruns in 2011 and reappearance of accrued liabilities. A special clause in the 2011 State Budget Law will give to the Council of Ministers the exclusive power to define and update ceilings for the contractual obligations of central government institutions and entities. This will increase the central control at the planning and approval stages, and thus help reducing the deficit bias, while preserving some flexibility at the budgetary execution stage permitting to shift resources between different programs in order to ensure efficiency gains. In addition, a limit on the incurred liabilities to suppliers has been defined. As a general principle, the authorities plan to decrease the differences between public finance data in accruals (ESA 95) terms and according to the national (cash based) methodology. Consequently, the 2011 and 2012 fiscal targets are set to coincide for both reporting methodologies. A number of recently initiated and approved structural reforms in the areas of public administration, social security and pensions are expected to increase the efficiency of public expenditures and to improve public finances sustainability both in the medium and in the long-run.

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[8] Bulgaria's Macro Fiscal Assessment can be found at: http://ec.europa.eu/economy_finance/sgp/pdf/20_scps/2009-10/02_technical_assessment/bg_2010-03-31_ta_en.pdf

At the same time, no specific measures have been outlined by Bulgarian authorities to strengthen the binding nature of the medium-term budgetary framework, while the budgetary adjustment might come to a large extent at the expense of capital expenditures preserving some of the budgetary rigidities in the current primary expenditures.

Table 3: Comparison of key macroeconomic and budgetary projections

		2008	**2009**	**2010**	**2011**	**2012**
Real GDP (% change)	COM	6.2	-4.9	-0.1	2.6	3.8
	BG	6.2	-4.9	0.2	3.6	4.7
	CP	6.0	-4.9	0.3	3.8	4.8
Output gap (% of potential GDP)	COM	4.9	-2.9	-4.8	-4.2	-2.7
	BG	n.a.	n.a.	n.a.	n.a.	n.a.
	CP	4.8	-3.5	-5.7	-4.7	-2.5
General government balance (% of GDP)	COM	1.7	-4.7	-3.8	-2.9	-1.8
	BG	1.7	-4.7	-3.6	-2.5	-1.5
	CP	1.8	-1.9	0.0	0.1	0.1
Primary balance (% of GDP)	COM	2.5	-3.9	-3.1	-2.1	-1.0
	BG	2.5	-3.9	-2.9	-1.7	-0.2
	CP	2.7	-1.3	0.9	1.0	1.1
Cyclically-adjusted balance (% of GDP)	COM	-0.1	-3.6	-2.1	-1.4	-0.9
	BG	n.a.	n.a.	n.a.	n.a.	n.a.
	CP	0.2	-0.7	1.9	1.7	1.0
Structural balance (% of GDP)	COM	-0.1	-3.6	-2.2	-1.4	-0.9
	BG	n.a.	n.a.	n.a.	n.a.	n.a.
	CP	0.2	-0.7	1.9	1.7	1.0
Government gross debt (% of GDP)	COM	13.7	14..7	18.2	20.2	20.8
	BG	13.7	14.7	15.9	19.5	18.2
	CP	14.1	14.7	14.6	14.5	14.4

Source: COM - Commission services' 2010 autumn forecast; BG - Bulgaria's Budget for 2011 and additional information provided by the authorities in January 2011; CP -Convergence Programme January 2010.