# REPUBLIC OF BULGARIA

# CONVERGENCE PROGRAMME
# (2011–2014)

15 APRIL 2011
SOFIA

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# LIST OF THE ABBREVIATIONS USED

BDB – Bulgarian Development Bank

BNB – Bulgarian National Bank

CB – Central Budget

CFP – Consolidated Fiscal Programme

CMD – Council of Ministers Decision

CoM - Council of Ministers

DR – Dependency ratio

EIB – European Investment Bank

EC – European Commission

ECB – European Central Bank

EDP – Excessive Deficit Procedure

ERM – Exchange Rate Mechanism

ESA – European System of Accounts

EU – European Union

FLSU – First-level spending unit

FDI – Direct foreign investments

GDP – Gross Domestic Product

GIL – Government Investment Loans

GS – Government Securities

HICP – Harmonised Index of Consumer Prices LFS - Labour Force Survey

ICMs – International Capital Markets

IMF – International Monetary Fund

LALEDTW - Law on the amendment of the Law on the Excise Duties and Tax Warehouses

LALSBRB – Law on the amendment of Law on State Budget of the Republic of Bulgaria

LEDTW - Law on the Excise Duties and Tax Warehouses

LSBRB – Law on State Budget of the Republic of Bulgaria

LGD – Law on Government Debt

LMD – Law on Municipal Debt

LTSSC – Large Taxpayers and Social Security Contributors

MF – Ministry of Finance

MH – Ministry of Health

MTSSC – Medium-sized Taxpayers and Social Security Contributors

MTFF – Medium-term Fiscal Framework

MTO – Medium-term Objective

NHIF – National Health Insurance Fund

NSI – National Statistics Institute

NSSI – National Social Security Institute

NRA – National Revenue Agency

NRP – National Reform Programme

OP HRD – Operational Programme “Human Resource Development”

OP RD – Operational Programme “Regional Development”

pp – percentage point

PPP – Private-Public Partnership

PSS – Public Social Security

REER – Real Effective Exchange Rate

SEPA – Single Euro Payment Area

SGP – Stability and Growth Pact

SLSU – Second-level spending unit

SNA – System of National Accounts

SRCA – State Receivables Collection Agency (

SSC – Social Security Code

SU – Spending unit

TBF – Three-year Budget Forecast

TD – Territorial Directorates

TFEU – Treaty on the Functioning of the European Union

(L)VAT – (Law on) Value Added Tax

ULC – Unit labour cost

# 1 OVERALL POLICY FRAMEWORK AND OBJECTIVES

The Convergence Programme for the period 2011–2014 outlines the key policies and priorities in connection with the achievement of the objective for accelerating the economic growth while maintaining macroeconomic and fiscal stability. This document is developed and presented as part of the process of multilateral fiscal surveillance, pursuant to the provisions of Articles 120 and 121 of the Treaty on the Functioning of the European Union and of the Stability and Growth Pact. The elaboration of the Programme was closely related to the procedure for adopting the 2012 national budget and the three-year budget forecast (2012–2014). The Programme also complies with the Europe 2020 Strategy, the Integrated Guidelines for the economic and employment policies of the Member States, as well as with the conclusions of the Annual Growth Survey. The current update takes into account the Council Decision as of 13 July 2010 regarding the existence of an excessive budget deficit in Bulgaria[1], and addresses the Council Recommendation with a view to bringing an end to the situation of excessive government deficit[2].

The Programme describes the main parameters of the macroeconomic policy and the reforms the government commits to implement within the programming period. The key reforms implemented and planned in support of the main objectives of the government are also in line with the Europe 2020 Strategy for smart, sustainable and inclusive growth and in response to the identified challenges facing the country.

To guarantee the macroeconomic stability, Bulgaria will maintain its currency board arrangement, preserving the current level of the exchange rate (BGN 1.95583/EUR 1) until the country becomes a member of the Euro Area.

The government will continue implementing a conservative and disciplined fiscal policy. By the end of the programming period a close to balanced fiscal position is targeted.

The long-term stability of public finances is the next most important priority of the government, which sets a medium-term fiscal objective under the Stability and Growth Pact at deficit of 0.6% of GDP. Thus defined, it meets the three objectives set in the Pact. In particular, it ensures a decrease in the government debt as a share of GDP in the long term and entirely pre-finances the future expenditures related to the population ageing.

In a situation of limited financial resources, the Bulgarian government commits itself to implement a policy of enhanced efficiency and effectiveness of budgetary expenditure. An important component of the process of optimisation of budgetary expenditure is the implemented administrative reform which, in addition to reducing the number of civil servants, aims at introducing a new, performance-based remuneration of officials in the public administration. Optimisation of budgetary expenditure will be also realised with regard to the financing of the main social responsibilities of the state by supporting the continuation of structural reforms in the field of the pension and the social security system, healthcare and education. The pursuance of a prudent fiscal policy also contributes to the long-term sustainability of public finances with a view to the challenges resulting from the population ageing. Bulgaria will continue undertaking the reforms necessary for stimulating and enhancing the economic growth while, at the same time, for maintaining the macroeconomic stability.

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[1] 2010/422/EU, Promulgated in Official Journal L 199/26 as of 31 July 2010.
[2] 11307/10, Brussels, 9 July 2010.

The objective of the income policy is to link income growth with the labour productivity growth, which will positively influence competitiveness, as well as with the capacity of the economy and the budget. The government implements policies for increasing the productivity and for restructuring the economy with the objective of increasing the share of sectors with high value added to achieve a balanced growth and sustainable convergence. Better linking the labour market and the educational system will result in increasing labour productivity and competitiveness of the economy, promoting growth and increasing incomes in the long term. In order to avoid abrupt changes in incomes during the economic recovery and to mitigate the negative consequences from the global crisis on the economy and the employment, the tax strategy aims at maintaining a uniform and low level of taxation of different types of incomes.

The positive expectations and assessments of the international rating agencies confirm the internationally established view of the stability of the public finances of Bulgaria. In October 2010 the Japan Credit Rating Agency (JCRA) confirmed the sovereign rating of the country at BBB and changed its outlook from “negative” to “stable”. In December 2010 the international rating agency Standard & Poor’s confirmed our rating at BBB/A-3, with a stable outlook. In its regular reviews of the economic situation in the country the international rating agency Moody’s also gives its moderately-optimistic assessment of the Bulgarian economy - the Baa3 credit rating with positive outlook remained unchanged throughout 2010 and at the beginning of April the agency put it under review with a possible upgrade.

Among the new elements in the Programme is the synchronising of the budgetary cycle for the next three-year period (2012–2014) with the work on the Convergence Programme and the National Reform Programme in connection with the implementation of the new instrument for ex-ante coordination of economic policies, the so-called “European semester”. The beginning of the budgetary procedure was brought forward and the three-year budgetary forecast was adopted together with the approval of the Convergence Programme on part of the Council of Ministers. Another new element in the Programme is related to the new fiscal rules under the draft Pact for Financial Stability, which aims at ensuring restrictions with regard to the fiscal policy. Limiting of the size of the public sector and its preservation in the long term will allow for more effective allocation of expenditures, as well as for the implementation of reforms for enhancing their efficiency and effectiveness. The introduction of fiscal rules also ensures continuity in the fiscal policy and guarantees compliance with Article 126 of the Treaty on the Functioning of the European Union on the reference values of general government deficit and government debt.

The presented in the Programme policies for further enhancing the sustainability of public finances, as well as the policies for promoting the competitiveness of the economy, presented in the Programme, also address the objectives of the so-called “Euro-Plus Pact”.

The Programme consists of seven parts. The first part presents an analysis of the macroeconomic developments of the country in 2010 and the first months of 2011, as well as forecasts of the key macroeconomic indicators, including alternative macroeconomic scenarios, and the effects of the planned structural reforms on growth and employment. The second part describes the strategic objectives of the fiscal policy with regard to the budget balance and government debt.

A sensitivity analysis of the forecasts in the baseline macroeconomic scenario is presented in the third part, which also contains three alternative scenarios with outlined main fiscal risks for the realisation of the forecasts. In the fourth part of the Programme the strategy of the government policy for enhancing the quality of public finances, as well as the development of the revenue and expenditure side of the budget are presented.

The public finances sustainability, with a focus on the long-term budgetary outlook related to the manifestation of the effects from the population ageing, is presented in the fifth part. The sixth part of the Programme makes an overview of the institutional characteristics of the public finances in Bulgaria – budgetary procedures, fiscal rules with a focus on the characteristics of the draft Pact for Financial Stability, reforms in the field of the revenue administration, institutional changes related to the improving the tax revenue collection, as well as fiscal decentralisation.

A review of the measures and policies undertaken by the government in response to the excessive deficit procedure and the Council Recommendations in accordance with Article 126 (7) of the Treaty on the Functioning of the European Union with a view to correcting the excessive deficit by 13 January 2011, is presented in the last part of the Programme.

# 2 ECONOMIC OUTLOOK

The Convergence Programme includes the macroeconomic framework for the period 2010–2014, based on the medium-term macroeconomic model of the Ministry of Finance with key assumptions for the external environment as of March 2011, provided by the European Commission, the IMF and the Ministry of Finance of the Republic of Bulgaria (Table 8 of Annex 1). The estimates of the National Statistical Institute and the National Health Insurance Fund were also used. When the medium-term macroeconomic forecast was developed, the effects from policy changes, envisaged in the National Reform Programme of the Republic of Bulgaria (2011–2015), were not taken into account.

The macroeconomic forecast was developed before the EC assumptions were received, however it is based on similar medium-term expectations concerning the economic environment, the main differences being along the lines of:

- the expectations concerning the growth of the global and the European economy (insignificant differences in the range of 0.1 – 0.2 pps) during the period 2011–2012;
- dynamics of the crude oil prices (relatively small deviations) and the prices of non-energy goods (for 2012);
- interest rates and exchange rate (lower in the national forecast).

The slightly lower expectations concerning the external demand and the more expensive Euro, which were included in the national forecasts, are expected to result in lower expectations concerning exports and economic growth. This could be offset by the lower expected interest rates and international prices.

The expectations in the current forecast are for a moderate recovery of consumption. The consumption growth of 2.8% that we envisage for 2011 is supported, on the one hand, by the low base following the cumulative decline of 8.4% realised during the previous two years. On the other hand, the short-term indicators of the economic activity currently demonstrate good signals for the consumption development. Consumer confidence registers a constant growth over the last few quarters and at the beginning of 2011 reached its pre-crisis levels. The balance of expectations for the financial position of households also demonstrated a trend of improvement. Recovery is also observed in retail trade, both in terms of the turnovers in the sector and in the responses of the surveyed entrepreneurs in the sector.

## 2.1 Cyclical Development and Economic Prospects

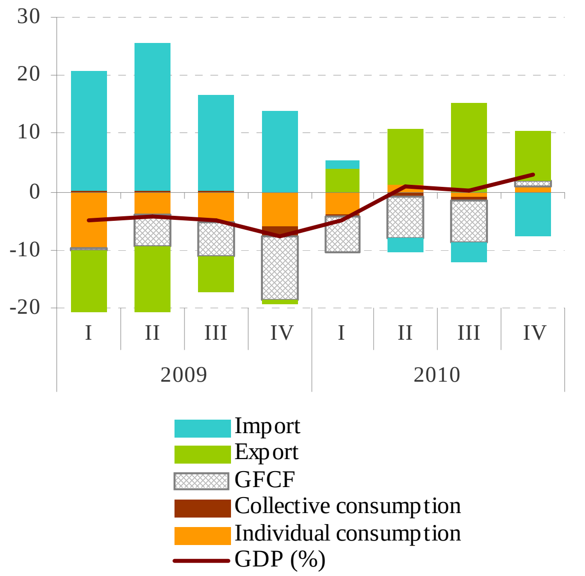
### *2.1.1 Economic Growth*

In 2010 the GDP dynamics was determined by the strong exports growth, which compensated the continuing, although at lower rates, shrinking of domestic demand. After the first quarter of the year the economic activity in the country started improving and during the whole year 2010 GDP increased by 0.2% as compared to the decline of 5.5% in 2009.

On the demand side (Figure 1), the largest negative contribution to GDP growth in 2010 belonged to investments, which shrank by 14%, but at decelerating rate since the beginning of 2010. The investment activity registered improvement[3] and the gross fixed capital formation registered annual growth of 4% during the last quarter. The individual consumption declined by 0.6% in 2010, but the consumer confidence indicator registered growth both on an annual and on a quarterly basis. The public consumption declined by 1% as a result of the fiscal consolidation. The contribution of external trade was positive. The real exports growth accelerated to 16.2%. As a result of the domestic demand decrease, the recovery of the imports was more moderate, by 4.5%.

**Figure 1. Contribution to the GDP growth[4]**

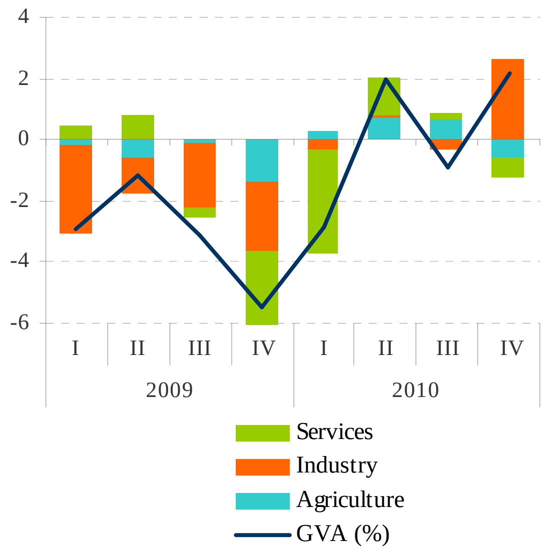
(pp, on an annual basis)




*Source: NSI, MF*

**Figure 2. Contribution to the GVA growth[4]**

(pp, on an annual basis)




*Source: NSI, MF*

In terms of economic sectors, a stable recovery is observed in industry which had a pronounced positive contribution to the GVA growth (Figure 2). The recovery of the industry was initially supported by the external demand, but afterwards was also supported by the stronger sales on the domestic market (Figure 3). In 2010 the condition of the industry started improving and registered an average annual growth of 1.9%. The data on the turnover in industry, which started increasing on annual basis in March 2010, also point to the revival of the industry. The main contribution belongs to the annual sales on the external market, which increased by 34%. The surveyed managers in the industry sector see positive prospects for the sector (figure 4) and expect the exports growth to continue over the next months[5].

In 2010 the services sector shrank by 0.9%. The main negative contribution had trade, tourism, general government and education. Transport and communication, and financial

[3] Growth in investments in real estate activities; Wholesale and retail trade, transportation and storage, accommodation and food service activities.

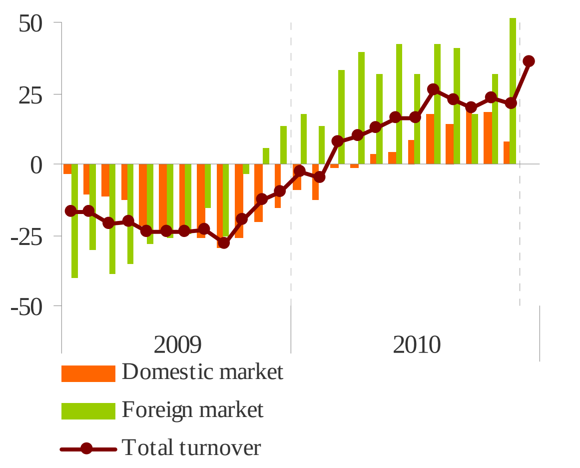
[4] Seasonally adjusted data.

[5] Survey of Business Tendencies in Industry (NSI) as of the first quarter of 2011.

intermediation, however, reported a positive growth during the last year. The development of the services sector is strongly dependent on the employment rate and the incomes, which remained suppressed in 2010 and had a negative impact on the consumption of services. The data from the short-term business indicators show decelerating rate of decline of the retail trade turnover since the beginning of 2010, but the average annual value remained at around 7%. The expectations of managers in the sales branch for sales during the next few months are optimistic.

**Figure 3. Changes in the turnover of industry**

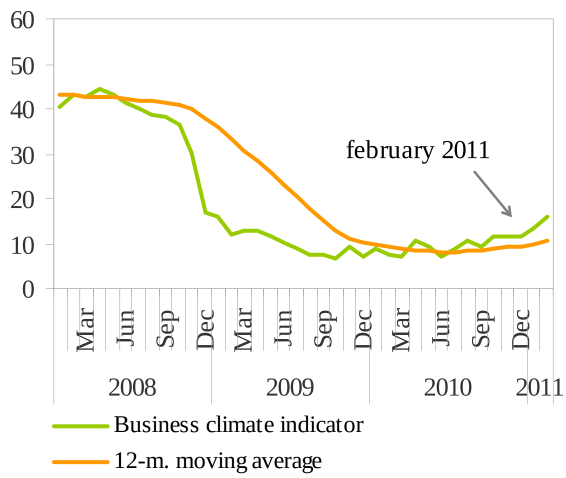
(%, on an annual basis)




*Source: NSI*

**Figure 4. Overall business climate**

(balance of opinions)




*Source: NSI, MF*

### *2.1.2 Cyclical Position*

In 2010 the potential growth of the Bulgarian economy slowed down to 1.6%. The low economic activity, which lead to a decline in the capital accumulation, was the main factor determining this development. In 2011 the potential growth is expected to reach 2.5% and the output gap to shrink to 3.8%. In terms of production factors, the negative contribution of employment is decreasing; the total factor productivity has the largest contribution (1.5 percentage points, pps), followed by the capital (1.1 pps).

In the medium term, by 2014, the Bulgarian economy is expected to expand at growth rates of over 4%, and the output gap is to narrow but will remain negative until 2013. This will be partly due to the potential growth increase supported by both the accumulation of capital in the economy and the increase of the total factor productivity (Table 5 of Annex 1).

## 2.2 Medium-term Scenario

A moderate but sustainable economic growth of 3.6–4.4% is envisaged for the period 2011–2014 (Table 1a in Annex 1). The consumption and investments growth rates will accelerate in the medium term, but their share in GDP will remain lower as compared to the pre-crisis levels. After 2011 the net exports will have a negative contribution to growth due to the increasing pressure of domestic demand on imports.

The forecast for GDP growth of 3.6% in 2011, which is set in the Law on State Budget for 2011, is confirmed by the consumption and investments dynamics observed in October–December 2010. The current forecast for a 4.1% economic growth in 2012 is relatively close to the Autumn Economic Forecast of the EC for 3.8%. The differences might be due to differences in assumptions.

After the reported decrease in household consumption in 2009 and 2010, a growth of 3.1% is expected this year as a result of the discontinuance of the negative labour market trends , the economic confidence restoration, and, therefore, the lower propensity to precautionary savings of households and the stronger credit activity in the economy. The household consumption will continue increasing moderately during the period 2011–2014 and will stabilise at levels around 4%.

The good exports performance and the recovery of the domestic market will also have a positive impact on investments. They are expected to recover, but at lower growth rates as compared to those reported before 2009. In 2011, as a result of the stronger demand and the exports expansion in terms of both geographical and product structure, a more active investment activity and, therefore, gross capital formation increase by 5.6% in real terms, is expected. This would be due to several factors. On the one hand, this would reflect the low comparison base after 2009 and 2010, which is being observed since the end of 2010 (during the fourth quarter of the last year investments increased by 4% on an annual basis). On the other hand, the latest investment survey demonstrated positive expectations of entrepreneurs for an 18.1% growth in investments in 2011. During the whole forecast period the share of investments in GDP will increase, reaching 28% in 2015, but the gross capital formation growth will remain at levels below 8%.

The recovery of the economies of Bulgaria's main trading partners in 2010 and the low comparison base of 2009 resulted in an accelerated increase in exports of goods and services, which reached 16.2% in real terms for the previous year. This growth reflected mainly the increase in the exports of goods, while the exports of services registered a growth of 5.5%. The growth of exports of goods and services is expected to slow down during the period 2011–2014, stabilising at levels slightly above 7%. This deceleration will result from the slowing down real growth of exports of goods, while the exports of services are expected to increase moderately.

In 2011 the recovered domestic demand is expected to lead to an increase in imports of both goods and services. The exports growth deceleration has the opposite impact on the imports of goods, which limits the growth in total imports to 7.8%.

## 2.3 Sectoral Balances

### *2.3.1 Labour market, incomes and labour productivity*

The development of the labour market over the last two years changed considerably as compared to the trends observed in the period 2003–2008. In 2010 a considerable decrease in employment and a rapid increase in unemployment were observed.

During the second and third quarters of 2010 the usual for the pre-crisis years seasonal dynamics of employment was observed, characterised by an increase in the employed people (by 6.9% and 1.2%[6] respectively) on quarterly basis. The seasonal revival in activities such as agriculture, tourism, construction and trade supported the gradual decrease in unemployment rate, which reached an average value of 9.5%[7] during the third quarter. The usually low activity of the private sector during the winter months related to the dismissal of seasonal workers, together with the still small opportunities for hiring new workers, predetermined the decrease in the number of employed people at the end of the year, while the unemployment rate exceeded 11% during the last three months.

Although in 2010 the annual decline in the number of the employed people slowed down to 4.4% in the fourth quarter, the average annual rate of decline of 5.9% was considerably higher than that registered in 2009 (2.6%).

The annual employment decrease continued in the three aggregated economic sectors. Since the second quarter of 2010 the annual decline in employment is slowing down in industry. The recovery of the economic activity in the industrial branches is still not accompanied by job creation. A weak positive response to demand of labour was observed only in two activities, which registered an increase in the number of employed people during the last three quarters. The total employment in the processing industry is strongly dependent on some labour-intensive branches, such as production of textile and clothing, where the economic recovery started later in the year and the number of employed people is still decreasing at double-digit rates. In addition, the employment decline continued being strong in branches such as the production of basic metals and of machinery and equipment, which is related to the strive for increasing the companies' productivity and competitiveness on the external markets[8].

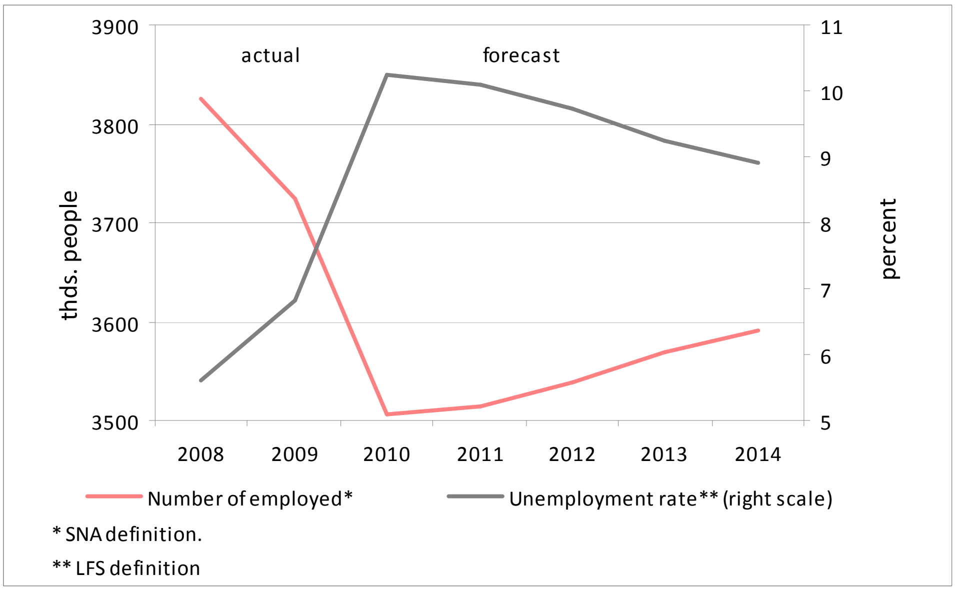
The services sector, which was affected by the crisis later, continued to be influenced by the still subdued domestic demand, and the rates of decline of the number of the employed people in 2010 were higher that these reported during the previous year when the dismissals were mainly focused in the industry branches.

In January 2011 the registered unemployment rate increased as compared to the end of the previous year to 9.8% and remained at the same level in February. For the first time since March 2009, however, a decrease of this indicator on an annual basis was reported, which reached 0.5 pps as compared to February 2010.

The limited abilities for hiring new employees influenced the reduction of the labour force over the last two years. The economic activity ratio of the population (15+) decreased by 0.8 pps in 2009 and by further 1 pp in 2010 to 52%.

[6] According to the definition of the System of National Accounts (SNA).
[7] According to the Labour Force Survey (LFS) data.
[8] The analysis in terms of disaggregated economic activities in the processing industry is based on the monthly data from the Enterprises Survey about the number of employed people.

**Figure 5. Number of employed* and unemployment rate****




*Source: NSI, MF*

In 2011 the negative trends in the development of the labour market from the previous two years are expected to come to an end. At the beginning of 2011 the unemployment rate is expected to settle around its value as of the end of 2010, and to start gradually decreasing thereafter, while the annual decline in this indicator will be observed during the second half of the year. Thus, the average decline of the unemployment rate in 2011 is expected to be insignificant (about 0.1 pps), and the employment growth this year is estimated at about 0.2%. The employment stabilisation will curtail the labour productivity growth, but the latter will remain close to and comparable to the growth rates from the pre-crisis years.

During the period 2012–2014 the labour productivity is expected to preserve a gradually accelerating growth trend. This will be accompanied by a moderate increase in employment rate and a decline in the unemployment rate to an average value of approximately 8.9% in 2014 (Table 1c of Annex 1). The current expectations concerning the unemployment rate remains more conservative as compared to the EC's Autumn Economic Forecast, which project the unemployment rate to decrease to 8% already in 2011.

The shrinking of the overall economic activity in the country hampered the labour incomes dynamics. Since the beginning of 2009 the average wage growth registered a considerable slowdown, which continued also in 2010. In 2009 the average wage[9] in the Bulgarian economy increased by 11.8% in nominal terms and by 9.1% in real terms[10], while in 2010 – by 6.3%[11] and 3.2% respectively. The labour income growth restrain was clearly tangible in both the public and the private sector of the economy. In 2010 the average wage in the public sector increased in nominal terms by 4.9% as compared to the previous year, considerably slowing down its growth rate reported for the whole 2009 (9.6%). In the private sector of the economy the growth in the labour income amounted to 6.2% as compared to 12.6% in 2009.

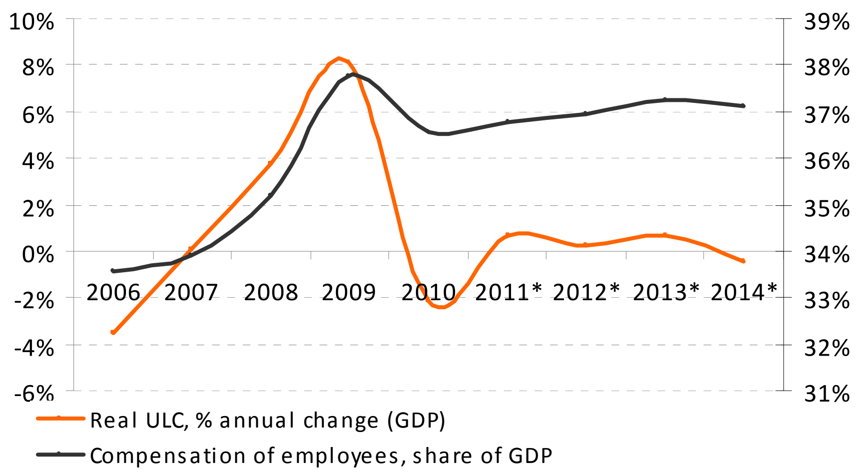
[9] According to NSI data, Enterprises Survey.
[10] The average wage is deflated by HICP.
[11] According to preliminary NSI data, Enterprises Survey.

After the middle of 2010 the monthly data on the average wage show certain acceleration of the annual growth rate of wages by quarters, which is possible to have resulted from the increased labour productivity and the started economic revival.

The processes of activities' optimisation, which started at the beginning of 2009, had gradual positive influence over the labour productivity dynamics[12]. In 2010 the real growth of the indicator reached 6.5% as compared to 2009. The recovery of the labour productivity growth in the Bulgarian economy, on the one hand, and the limited income growth, on the other, had a favourable influence on the dynamics of the unit labour costs of employers[13] (ULC). The impact of the lower economic activity on the labour market, with a several quarters time lag in the different economic activities, resulted in real ULC growth in 2009, but since the beginning of 2010 it started gradually slowing down and in the third and fourth quarter the indicator reported a decline of over 6% as compared to the corresponding quarters of the previous year. Thus, in 2010 the real ULC decrease by 2.1% on average. The most significant optimisation of labour costs was observed in industry, and since the second quarter of 2010 this trend spread also to the services sector.

The expected high unemployment rates will continue hindering the average wage growth. The latter is expected to increase at moderate rates within the programming period (2011–2014) and the gradual increase in demand for labour will result in continuing increase in the share of compensation of employees in GDP. The labour income growth, albeit expected to be slightly faster than the labour productivity growth during the next years, is to be close to the latter, which will not have a negative impact on the competitiveness of the economy.

**Figure 6. Dynamics of the real unit labour costs on an annual basis**




*Source: NSI, MF*

### *2.3.2 Inflation*

After a clearly pronounced downward trend, the Harmonised Index of Consumer Prices (HICP) started increasing on an annual basis at the end of 2009 influenced by the

[12] Labour productivity is calculated as a ratio between GDP at constant prices and the number of employed people, based on SNA data.
[13] Real unit labour cost is calculated as a ratio between GDP per person employed and the compensation of employees per employee, based on SNA data.

recovering international food and energy prices . The inflation accelerated to 4.4% at the end of 2010 and its average annual value was 3%.

**Table 1: Changes in prices (%) and contributions (pps) in terms of main HICP components (compared to the corresponding month of the previous year)**

| HICP components | December 2010 | |
|---|---|---|
| | Change in prices (%) | Contribution (pps) |
| **Total HICP** | **4.4** | |
| Food and non-alcoholic beverages | 3.9 | 0.79 |
| Alcohol and tobacco products | 25.5 | 1.39 |
| Non-energy industrial goods | -0.5 | -0.11 |
| Energy | 14.3 | 2.01 |
| Services | 1.0 | 0.37 |

Source: NSI

During the first half of 2010 the fuel prices increased considerably largely driven by the increasing oil prices on the international markets. The effect of international price dynamics was amplified by the single European currency depreciation vis-à-vis the US dollar. As a result, the contribution of energy goods to end-of-period inflation in 2010 reached to 2.01 pps.

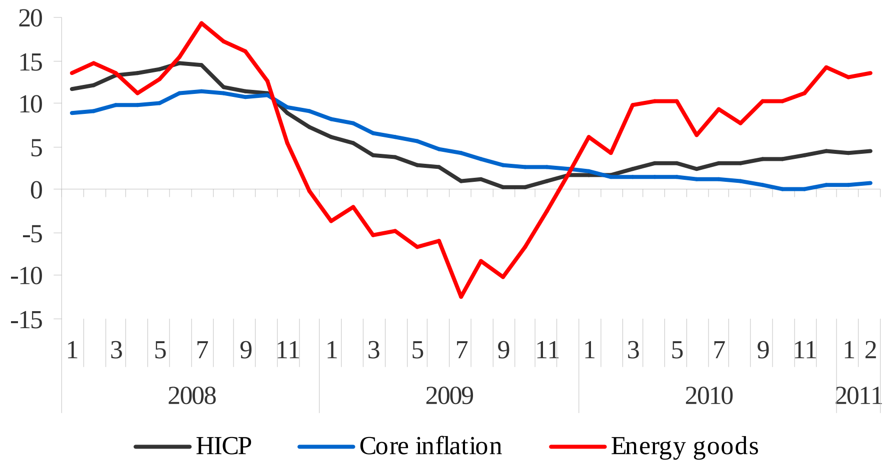
The negative annual inflation for foods was 4.2% at the beginning of 2010. During the year cereal production was adversely affected by unfavourable weather conditions in major producing countries, which pushed international food prices upwards in the second half of 2010. This had a relatively quick pass-through to domestic retail prices through higher production costs. Thus, the consumer prices of foodstuffs followed a clearly pronounced upward dynamics, and their annual inflation at the end of the year reached 3.9%.

The higher excise duties on cigarettes, introduced at the beginning of 2010, led to a 33.9% increase in their prices, and their contribution to the overall end-of period inflation is estimated at 1.3 pps. The regulated prices, which account for about 15% of the overall inflation, increased by 4.6%.[14]

The core inflation significantly decelerated since late-2008. In 2010 its level was below that of the total HICP index, as the shrinking in domestic demand resulted in historically low values of inflation of services and non-energy industrial goods.

[14] The main contribution to this had the adjustments in the administrative fees for issuing personal identity documents, heat energy and electricity.

**Figure 7. Harmonised Index of Consumer Prices**
**(percentage change compared to the corresponding month of the previous year)**




*Source: Eurostat, MF*

During the period 2011–2014 a relatively moderate and gradually slowing down inflation is expected (see Table 1b of Annex 1). The average annual inflation will follow similar developments, except for in 2011, when inflation acceleration is expected as a result of the upward dynamics in international prices of energy, food and metals, as well as in consumer prices of food and energy goods.

**Table 2: Inflation forecast for the 2011–2014 period**

| | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|
| | End of period | | | |
| **Total HICP** | **4.2** | **2.8** | **2.4** | **2.4** |
| Food and beverages | 7.1 | 2.6 | 2.5 | 2.5 |
| Alcohol and tobacco products | 1.0 | 0.7 | 0.7 | 0.7 |
| Non-energy industrial goods | 1.5 | 2.8 | 2.0 | 1.8 |
| Energy goods | 11.1 | 2.4 | 0.9 | 1.0 |
| Services | 2.8 | 3.6 | 3.8 | 4.0 |
| | Annual average | | | |
| **Total HICP** | **3.9** | **3.3** | **2.6** | **2.4** |

These developments will also affect core inflation. Over the next years no increase is expected in the international commodities prices in US dollar terms, and under the assumption of a stable Euro, no inflation acceleration triggered by external factors is expected.

The subdued consumer demand for non-essential durables and services will keep the core inflation at a relatively low levels during the first nine months of 2011. An additional factor limiting this demand will be the increase in food prices. At the end of 2011 the increase in the prices of services is expected to be about 2.8%, but this will reflect the prices of catering, which will increase under the pressure of the international and related domestic prices of foodstuffs.

In 2012–2014 the economic recovery on the supply side will limit the price increase, mainly of tradable goods, since a higher growth in production and, respectively, of labour productivity in industry as compared to that in construction and services are expected. This way higher relative consumer prices of services as compared to those of food and non-food goods are expected, since in the services sector the higher unit labour costs will create upward price pressures. During this period the core inflation is forecasted at about 3.2–3.4% and is expected to be higher than the overall inflation.

The contribution of administered prices to the headline inflation is expected to be moderate during the period 2011–2014 – at about 0.2–0.3 pps in the end of period inflation.

The influence of tax policy is also expected to have rather low contribution to inflation, since the level of direct taxes will remain unchanged and among the indirect taxes only the excise duties will have a low impact on consumer prices. In 2011 the direct effect from the higher excise tax rates on liquid fuels is estimated at 0.1 pps, and during the next two years the effect will be even lower. The envisaged adjustments in the excise duties on tobacco products in 2011 are related to such types, which are not included in the consumer basket for the purposes of calculating inflation.

The main risks related to the inflation forecast are related to the development of the international prices and the economic growth in Bulgaria. The international commodity prices might increase more substantially in response to the stronger global demand. The political unrest in North African countries is among the additional factors for their acceleration, especially for crude oil prices. The limited supply of some agricultural goods, similar to that currently observed for grain crops, might additionally result in higher inflation in the country. At the same time, a possibly lower economic growth of the Bulgarian economy will keep the core inflation at low levels in 2011, since households will adapt to the uncertain economic environment and will continue saving.

### *2.3.3 External Sector*

In 2010 the net foreign inflow of financial resources to the country was considerably lower as compared to the previous year. The balance of the current and the capital account of the balance of payments continued improving and in this way the stability of the external position was preserved. The current and the capital account were on a deficit of only EUR 65.4 million at the end of 2010 (as compared to a deficit of EUR 2.6 billion in 2009), which was mainly influenced by the high exports growth. In January 2011 the current and the capital account reported a surplus in the amount of EUR 155.5 million.

In 2010 the trade deficit improved by EUR 1.8 billion as compared to the previous year and amounted to EUR 2.4 billion, which is equal to 6.7% of GDP. During the first month of 2011 the trade balance was positive, in the amount of EUR 111.7 million. The exports of goods reported an annual nominal growth of 33.2% as compared to 2009. In January 2011 it reached 72.6% on an annual basis. The main contribution to the growth during the previous year had the groups of base metals and their products, machinery, transport vehicles and appliances, and mineral fuels and oils. The imports of goods also increased, although at lower rates. The main influence over the imports increase had the commodities and raw materials, as well as the mineral products and fuels, mainly as a result of the higher international prices. The negative growth rate of the imports of investment goods gradually slowed down, reaching a positive value of 23.9% during the last quarter of 2010.

The surplus of the services account in 2010 amounted to EUR 1.9 billion (as compared to a surplus of EUR 1.3 billion during the previous year). The “Other Services” and “Transport” contributed to this increase on the credit, while the “Travels” item - on the debit side.

As a result of increased FDI related payments and lower receipts from compensation of employees, in 2010 the income account deficit increased by EUR 192.1 million on an annual basis, reaching EUR 1.4 billion.

The increased transfers to the “General Government” sector (EUR 596 million more as compared to 2009) resulted in an increase in the balance of the “Net current transfers” to EUR 1.55 billion in 2010.

In 2010 the financial account of the balance of payments reported deficit in the amount of EUR 0.9 million, which is mainly due to the repayment of by banks (EUR 918 million) and the closure of deposits of non-residents in local banks (EUR 642 million).

In January 2011 the banks acquired foreign assets in the value of EUR 358.8 million and at the same time their foreign deposits decreased by EUR 229.5 million.

The Bulgarian economy is characterised by a low risk of potentially speculative withdrawal of capital. One of the indicators for this is the share of the portfolio investments in the gross international liabilities of the country, which amounted to 2.8% as of December 2010. Another indicator is the level of the short-term external debt, which declined in January–December 2010 by EUR 848.9 million and its share in the gross external debt decreased to 31.4% (as compared to 32.7% a year earlier). International foreign exchange reserves covered 112.8% of the short-term external debt as of December 2010. The sustainability of the external position is largely based on the structure of the capital inflows, which are mainly in the form of foreign direct investments and external loans of intra-company or long-term character.

The Foreign Direct Investments in the country amounted to EUR 1,638.6 million in 2010 as compared to EUR 2,412.2 million in 2009.

The direct investments inflow in 2010 was mainly in the form of equity capital (EUR 1,492.7 million) and to the banking sector, in the form of reinvested earnings (EUR 208.7 million).

After growing at high rates over the previous years, in 2010 the gross external debt decreased by EUR 1.1 billion to EUR 36.7 billion. The main contribution to this dynamics had the short-term debt of banks which decreased by EUR 929.9 million. The existence of a high liquidity in the banking sector, accompanied by a limited credit activity, allowed the banks to lower their gross external debt by EUR 1.5 billion in 2010 and, respectively, the share of banks in the gross external debt of the country decreased to 18.7%. In the medium term we expect the trend of declining of the gross external debt to continue.

### *2.3.4 Monetary Sector*

The main objective of the monetary policy of Bulgaria is to maintain price stability through securing the stability of the national currency. This objective is achieved within the framework of the Currency Board Arrangement and a fixed exchange rate of the national currency to the Euro.

As of the end of February 2011 the gross international reserves of the country reached EUR 12.3 billion and increased by 1.3% as compared to the same month of the previous year.

Currently the reserves cover 178.5% of the monetary base. As at the end of January the gross international reserves covered 6.2 months of imports of goods and non-factor services, and at the end of 2010 their ratio to the short-term external debt reached 113.7%.

In 2010 the monetary aggregates reported an upward dynamics reflecting the gradual stabilisation of the economic activity and the increased bank deposits of residents. As of the end of 2010 the broad money reported an annual growth of 6.2% as compared to annual growth of 4.2% as of December 2009. During the first month of 2011 the money supply annual growth accelerated to 7.1%, with the quasi money contributing the most. Credit demand remained subdued and the banks continued following cautious credit policy and applying tighter credit standards and conditions. The annual growth of the banks' claims on the non-government sector slowed down to 1.2% at the end of the previous year, and at the end of January slightly accelerated to 1.5% supported by the claims on the non-financial enterprises.

The increase in the deposits of residents and the limited credit activity in the conditions of a normally functioning interbank money market contributed to a permanent trend of decrease of the interest rate levels on deposits during the year. In December the weighted average interest rate on time deposits decreased to 4.6% and was by 1.4 pps lower as compared to the end of 2009. The high liquidity of banks and the decrease in the price of deposits had a small impact on the interest rates on loans. As of the end of December the weighted average interest rate on loans increased by 0.4 pps as compared to the end of 2009 - the average interest rate of the bank loans to households decreased by 0.9 pps and on the loans to enterprises increased by 0.7 pps.

The banking sector in Bulgaria remains stable, preserving the accumulated capital buffers and reporting good financial performance. The low credits demand and the increase in resident deposits allowed banks to accumulate significant funds, which they could use to repay their external liabilities. As of the end of 2010 the MFIs foreign liabilities decreased by EUR 1.2 billion (12.4%) as compared to the end of 2009. During the same period the liquid assets to total liabilities ratio of banks improved considerably and reached 24.4% at the end of 2010 as compared to 21.9% as of the end of December 2009, thus guaranteeing the stability of the financial intermediation. The banking system ended 2010 with a net profit of EUR 306.8 million.

In 2010 BNB continued the counter-cyclical policy in regulating banks' activities in Bulgaria. At the end of February the BNB Governing Council adopted the Ordinance on the Amendment to Ordinance No.8 on Capital Adequacy of Credit Institutions. These steps would contribute to streamlining the capital budgeting process in banks. The changes aim to harmonise the national requirements with those of the EU legislation and fully comply with the requirements of Directive 2006/48/EC which member-states must apply. The changes in the treatment of current profits and the profits from the previous year remove the requirement for holding a General Shareholders' Meeting for recognising these profits as a capital base element. The new ordinance removes the more severe treatment by other EU member-states, effective until now, of two basic classes of risk exposures under the standardised approach for credit risk – the risk weight of Retail Exposures changes from 100% to 75%; and the risk weight of Exposures Secured by Real Estate Property changes from 50% to 35%. The new changes also remove the BNB formal approval regime for the use of the standardised approach for operational risk, whereby encouraging banks to introduce improved methods for operational risk management.

## 2.4 Effects from Structural Reforms

The increase of the unemployment and the abrupt decline in investment activity during the economic crisis resulted in a decline in the potential growth in the EU. The estimates[15] of the European Commission show that if no structural reforms are undertaken, the potential growth in the EU over the next decade will remain low[16]. The structural reforms implemented in implementing the Europe 2020 Strategy and the European Semester are described in the National Reform Programme of the Republic of Bulgaria (2011–2015). An analysis of the effects from achieving the national targets on potential growth is also presented there. This section of the Convergence Programme describes the estimated effects of the pension reform on the labour market, while for other areas of the economy it also applies the results from international research.

### *2.4.1 Improving the administrative regulation*

Pursuant to the national objective, the administrative burden of informational obligations stemming from the national legislation, will be reduced by 20% at the end of 2012. An administrative burden reduction of 17% is expected to be achieved already in 2011. The expected benefits for the business are lower costs, respectively reduced administrative burden, in the amount of about EUR 13.3 million, and the benefit for the economy - GDP growth of 0.72% by 2025.

### *2.4.2 Pension and social security reform*

The population ageing is considered as one of the main reasons for the lower potential growth in the EU-27 economies during the period 2011–2020.

From a macroeconomic point of view, the undertaken pension reform (discussed in Part 6 of the Convergence Programme, as well as in Section III.2.2 of the National Reform Programme, NRP) envisages measures with different impacts on factors to growth. The effect is complex and concerns the public finances, the labour and capital markets, the redistribution of income, savings, investments and, respectively, the potential and real growth.

The undertaken gradual increase in the retirement age aims at increasing the supply of labour and incomes. This should increase the potential GDP, since it will have a positive impact on the labour factor, as confirmed by a number of international research – as a result of the pension reforms undertaken in the EU the supply of labour of employed people aged 55–64 is expected to increase by about 8 pps in 2020 and 13 pps in 2060.[17]

On the demand side, the consumption is expected to increase more substantially, which will also be reflected in an increase in the real GDP.

The pension reform will result in savings of budgetary funds, which will compensate for the 1.8 pps increase of the pension insurance contribution. These funds can be directed to investments in capital and innovation for the purpose of increasing the real sector productivity and improving the competitiveness of the economy in the long term.

[15] Annual Growth Survey, EC, 12.01.2011

[16] During the period 2011 – 2020 the average annual GDP growth is expected to be about 1.5% for EU-27.

[17] "Progress and key challenges in the delivery of adequate and sustainable pensions in Europe", European Economy, Occasional Papers 71, November 2010, Joint Report by the EPC, the SPC and DG ECFIN, DG Employment, Social affairs and Equal opportunities.

Increasing the investments, including in infrastructure and innovation, by 1% of GDP, can produce an additional sustainable growth of GDP per capita by 1%[18].

- ***Assessment of the effects on the supply of labour***

The baseline scenario for the development of the labour force in the long term is based on the Eurostat long-term demographic forecast for the number and structure of the population, under assumptions for growing economic activity and decreasing unemployment rate. The increase of the economic activity as a result of expectations for economic growth will not be able of offsetting the negative effect from the population ageing process and the labour supply is expected to decrease.

Under the alternative scenario, as a result of increasing the required length of service, in 2020 the labour force is expected to be by about 19 thousand people higher as compared to the baseline scenario. The expected decrease in the economically active population as compared to 2010 amounts to 0.7%, while in the baseline scenario it is estimated at 1.3%. Taking into account the increase in the retirement age after 2021, the difference in the number of active people in the two scenarios becomes higher - in 2030, taking the reforms into account, the labour force is by about 51 thousand people higher as compared to the baseline scenario. Accordingly, its decrease against 2010 is assessed at 8.2% as compared to 9.7% in the baseline scenario. The higher economic activity will be reflected into higher employment - the difference between the two scenarios in the number of employed people (2010 being the base year) is respectively 0.5 pps more favourable in 2020 and 1.3 pps more favourable in 2030 as compared to the first scenario. The unemployment rate is expected to be slightly higher than its level in the baseline scenario (Table 3)

**Table 3: Effects of the pension reform on the labour market development**

| **Years** | **Labour market development (baseline scenario)** | | | **Labour market development (scenario with changes in the pension – security system)** | | | **Effect of the changes in the pension – security system on the labour market (difference between the two scenarios, in pp)** | | |
|---|---|---|---|---|---|---|---|---|---|
| | **2010** | **2020** | **2030** | **2010** | **2020** | **2030** | **2010** | **2020** | **2030** |
| Labour force (15 – 64) % change as compared to 2010 | - | -1.3 | -9.7 | - | -0.7 | -8.2 | - | 0.6 | 1.5 |
| People employed (15–64), % change as compared to 2010 | - | 18 | -4.1 | - | 2.3 | -2.8 | - | 0.5 | 1.3 |
| Economic activity rate (15–64), (%) | 66.5 | 71.7 | 71.2 | 66.5 | 72.1 | 72.4 | - | 0.4 | 1.2 |
| Employment rate (15–64), (%) | 59.7 | 66.3 | 67.7 | 59.7 | 66.7 | 68.7 | - | 0.3 | 1.0 |
| Unemployment rate (15–64), (%) | 10.3 | 7.4 | 4.8 | 10.3 | 7.5 | 5.1 | - | 0.1 | 0.3 |

*Source: MF, NSSI*

### *2.4.3 Reforms on the labour market*

The reforms on the labour market are targeted at increasing the labour productivity and effective utilisation of the labour potential, which are the main prerequisites for economic

[18] “Responding to the crisis while protecting long-term growth”, Chapter 1, Part 1 in Economic Policy Reforms “Going for growth”, OECD 2010.

convergence in the EU. According to IMF simulations concerning the G20 countries and EC simulations[19], the measures on the labour market and in the services sector implemented during the period 2011–2015, which aim at decreasing the productivity gap from the three best performing economies in the EU by ½, would contribute for a 0.5 pps increase in the annual growth over the next 5 years. Given the needed time for implementing the structural reforms, the effect will be smaller at the beginning of the period and naturally increase over the years.

The structural reforms, which aim at decreasing the budgetary expenditure through amendments to the employment protection legislation have a stimulating effect on the replacement of the staff on the labour market, thus decreasing the unemployment duration.[20] At the same time, the proactive labour market policies, finding expression in additional expenditures on enhancing the quality of services provided by the employment offices, have a positive effect on employment.[21]

### *2.4.4 Effects from introducing fiscal rules*

The introduction of strict fiscal rules aims at ensuring the macroeconomic stability of the country. This will have a positive impact on the consumption and investments of all types of economic agents by limiting the accumulation of precautionary assets by financially unrestricted economic agents and will allow for a better smoothing of the inter-temporal consumption of financially restricted economic agents.[22] The support of domestic demand will stimulate economic growth.

[19] "Lifting euro area growth: Priorities for structural reforms and governance", Céline Allard and Luc Everaert with Anthony Annett, Ajai Chopra, Julio Escolano, Daniel Hardy, Martin Mühleisen, and Boriana Yontcheva, IMF Staff Position Note, 22 November 2010.

[20] "The impact of structural reforms on current account imbalances", OECD 2011, Economics Department Policy Notes, No. 3.

[21] "Responding to the crisis while protecting long-term growth", Chapter 1, Part 1 in Economic Policy Reforms "Going for growth", OECD 2010.

[22] "Fiscal rules in a volatile world: a welfare-based approach", C. Garcia, J. Restrepo and E. Tanner, IMF Working paper/11/56, March 2011.

# 3 GOVERNMENT BALANCE AND DEBT

## 3.1 Policy Strategy

Fiscal consolidation, tailored in a way to provide for flexibility against unexpected shocks, continues to be the main priority of the policy. According to the three-year budget projection for the period 2012–2014, the government will continue pursuing the three key objectives from the previous period, namely:

- Maintaining the stability of the Currency Board Arrangement with the current fixed exchange rate of the Bulgarian lev to the Euro;
- Allocating the public expenditures to activities aimed at stimulating and accelerating the economic growth in line with the Europe 2020 Strategy for smart, sustainable and inclusive growth;
- Improving the business environment and the investment climate.

The fiscal policy is considered in the context of the "European Semester", which resulted in the synchronisation of the budgetary cycle for the next three-year period (2012–2014) with the work on the Convergence Programme and the NRP. The start of the budgetary procedure was brought forward and the medium-term fiscal framework was adopted together with the approval of the Convergence Programme by the Council of Ministers.

In order to achieve the objectives of the fiscal and budgetary policies, the efforts to streamline the processes and to improve the quality of public finances through actual implementation of the programme budgeting and introducing sectoral approach to the financing of the public sector will continue. The progress achieved over the last years is a prerequisite for enhancing the quality of the individual policies and for achieving tangible results from their implementation in the medium term. The use of indicators for measuring the effects of the implementation and for systematic assessment of the cost and benefits of the government programmes and policies as a basis for taking political and managerial decisions, will be expanded. This way the public awareness and governance ownership will also increase.

The budgetary forecast also envisages further intensifying the process of fiscal decentralisation to achieve a stable own revenues base to the municipal budgets and higher-quality management of the municipal public services.

The tax policy aims at improving the business environment, promoting the investment activity, supporting employment, as well as curtailing the informal sector of the economy. A priority of the tax policy is the avoiding large fluctuations of incomes in times of a just starting economic recovery.

The improvement of public expenditures effectiveness and ensuring their reallocation of activities, which enhance the growth potential, are among the main challenges to growth in the medium and the long term.

The measures for fiscal consolidation are defined and combined in order to ensure a positive impact on growth while gradually reducing the consolidated expenditures and supported by public sector optimisation measures leading to higher expenditures' efficiency and effectiveness .

The 2011–2014 government issuance policy will be consistent with the measures for achieving the economy's stability and the main fiscal parameters, set in the 2011 Law on the State Budget of the Republic of Bulgaria and in the budget forecast. Moreover, it will also adhere to the strategic objective of the government debt management, which is aimed at ensuring the necessary sources for financing the state budget and refinancing the outstanding debt at the minimum possible price and an optimum level of risk.

In the aftermath of the global economic crisis and in view of the Currency Board Arrangement, the efforts of the government to manage its sovereign liabilities in the best possible way are key for ensuring access to market financing and increasing the confidence in the capital market in Bulgaria.

Given these limitations, the issuance policy directly corresponds to, maintains and, if deemed necessary, supports the liquidity in the financial system. The efforts are focused on utilising all the possible instruments for encouraging the development of the domestic government securities (GS) market accompanied by maximum possible smoothing of transactions for bringing in and withdrawing liquidity through government bonds maturities and issues for preventing possible market volatility and fragmentation. The investment class rating of the country along with its sound macroeconomic fundaments provide opportunities for market-oriented financing both on the domestic and the international capital markets.

## 3.2 Medium-term Objectives

### *3.2.1 Fiscal policy objectives*

The main objective of the fiscal policy is the gradual consolidation of the budget deficit over the next years. With a view to maintaining the public finance sustainability and the achieved macroeconomic stability, the government remains committed to the fiscal policy objective for a balanced general government budget position in the medium term and not allowing a deficit (in ESA 95 terms) above 2% of GDP.

With regard to the **budget balance**, the current fiscal framework envisages a balanced budget position in the medium term, consistent with the following annual deficit targets: deficit under the consolidated fiscal programme (CFP) of 1.5% of GDP in 2012, 1.0% of GDP in 2013, and 0.5% of GDP in 2014. The consolidation effort amounts to 0.5% of GDP for each year during the period with the exception for in 2011, when a frontloaded deficit adjustment of around 1% of GDP is targeted.

The planned deficit reduction over the three-year period will be achieved while keeping the direct tax rates unchanged, gradually increasing the rates of some excise duties with a view to reach the minimum EU rates within the agreed deadlines, and increasing the tax collection.

With regard to the **general government expenditure**, the government sets the objective of limiting its redistribution role at a level of up to 40% of GDP, which includes the contribution to the EU Budget, the expenditures related to EU financing and the corresponding national co-financing.

In order to ensure public finances sustainability both in the short and in the long term, the government will continue adhering to the achieved low levels of consolidated debt-to-GDP ratio. These levels, which are consistent with the national budget balance objectives, are considerably lower than the reference value of 60% of GDP as defined in the Maastricht criteria.

### *3.2.2 Medium-term budgetary objective*

The medium-term budgetary objective (MTO) of the Republic of Bulgaria is to reach a structural deficit of 0.6% of GDP at the end of the programming period (2014). It remains more ambitious than the requirements of the revised Stability and Growth Pact. The gap between the Programme's fiscal targets and the medium-term objective will be narrowing by 0.6, 0.1 and 0.3 pps in structural terms in 2011, 2012 and 2013 respectively, and will achieve it in 2014.

The defined medium-term budgetary objective for a deficit of 0.6% of GDP corresponds to the three objectives of the Stability and Growth Pact. At the same time it is more ambitious and pre-finances a larger part of the implicit liabilities against a case in which it is defined at the minimum required level of deficit of 1.75% of GDP or at the minimum required level of 1% of GDP for the Euro Area or the Exchange Rate Mechanism II (ERM II) Member States.

**Table 4: Sustainable structural budget balance, % of GDP**

| | Baseline scenario | Scenario with policy change[23] |
|---|---|---|
| Structural budget balance, necessary for 100% prefinancing of implicit liabilities | -1.00% | -1.72% |
| Structural budget balance meeting the requirement for the long-term sustainability of the fiscal policy | -1.98% | -2.22% |
| Structural budget balance, necessary for ensuring that the actual budget deficit is maintained below 3% of GDP | -1.75% | -1.75% |
| Minimum required level of the medium-term budgetary objective | -1.75% | -1.75% |
| **Medium-term budgetary objective of Bulgaria** | **-0.6** | **-0.6** |

*Source: MF calculations*

## 3.3 Budget Balance and Conclusions with Regard to the 2010 and 2011 Budget

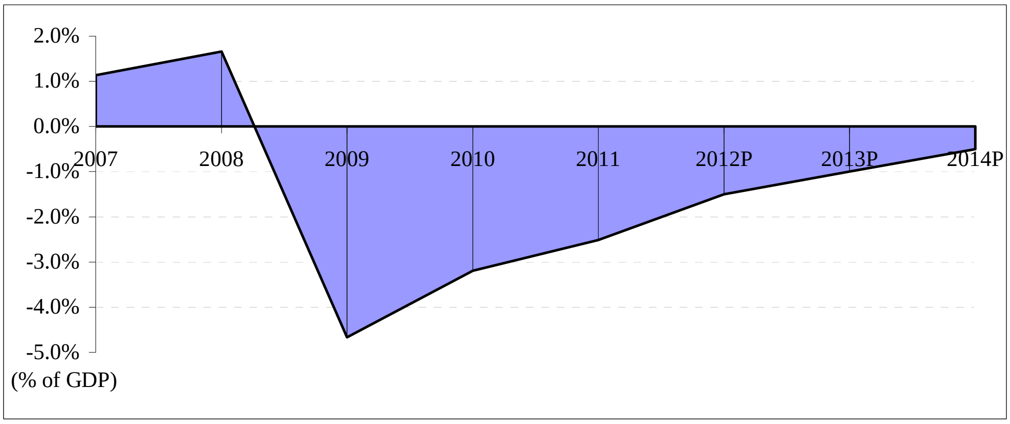
Following the decisive fiscal consolidation actions in 2010 the consolidated budget deficit registered a considerable improvement as compared to the previous year. **The 2010 objective of a deficit not exceeding 3.8% of GDP was achieved. The preliminary estimates of the deficit of the "General Government" Sector in the April EDP Notification Tables proved a 3.2% deficit[24], below the initial objective and** close to the Stability and Growth Pact reference value. The budgetary position corresponds to the EU Council Recommendations within the excessive deficit procedure for Bulgaria with a view

[23] See section 3.5.2.

[24] Eurostat accepted the April Fiscal Notifications on the general government deficit and debt on 26 April 2011 without any reservations - http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-26042011-AP/EN/2-26042011-AP-EN.PDF.

to bringing an end to the situation of an excessive government deficit, with regard to the developments for 2010 (see Chapter 8).

**Figure 8. General government balance (ESA 95, % of GDP)**




*Source: Notification tables, Eurostat, P- MF projections for 2012-2014*

The budgetary execution in 2010 went through several stages and in the course of the year the government updated the fiscal framework in line with the available at that time assessment of the main budgetary parameters and the tensions linked to the considerable deterioration of the liabilities on the balance sheet of the central and local governments and the social security funds in 2009. The weakened fiscal discipline coincided with the fall of the Bulgarian economy into recession, which worsened the fiscal position from a surplus of 1.7% of GDP in 2008 to a deficit of 4.7% of GDP in 2009. This necessitated the government to undertake immediate steps for fiscal consolidation in 2010 in order to stabilise the budgetary position while retuning the fiscal policy to the lower tax revenue intensity in the stage of gradual recovery of the economy from the crisis.

The restructuring of the economy and its transformation to a more export-orientated model dominated the revenue side parameters in 2010. This, on the one hand, considerably improved the external imbalances, but on the other, resulted in narrowing the indirect taxation base, mainly regarding the VAT. In contrast to three years ago, when imports accounted to almost 80% of GDP, in 2010 they shrunk to less than 60% of GDP. The imports decline led to a decrease in the VAT revenues from imports, while the gradual exports growth resulted in a respective increase in the declared tax credit for refunding to exporters. The economic growth in the period before the crisis, mainly driven by the domestic demand, expanded the indirect taxation base. During the period 2007–2008 the indirect tax revenues reported a double-digit annual growth, which was supported by the imports and domestic demand growth. The changed after the crisis GDP structure did not allow for indirect taxes, which had the highest share in the tax revenues, to grow rapidly, since exports are not taxable.

The fiscal consolidation was realised mainly along the lines of public expenditures with a view to ensuring stability of the budgetary position. The objective was to ensure the needed fiscal improvement and to bring the budgetary position in a credible and sustainable manner below the reference value of 3% of GDP, set in the Stability and Growth Pact. In this regard, a number of measures for fiscal consolidation were set within the updated programme for 2010. The measures on the expenditure side as compared to the initial programme for the year are as follows:

- The non-interest expenditure of the government authorities, ministries and institutions for 2010 and the expenditures and transfers/subsidies from the 2010 central budget were cut by up to 20%. The budget appropriations to the municipalities (except for the expenditure on functions education, social assistance and care, defence and security, as well as the funds approved for environmental projects) were reduced by up to 15% on an annual basis;
- Within the cash-based fiscal framework, EUR 337.5 million (0.9% of GDP) were allocated for the repayment of incurred from previous years liabilities;
- The expenditures were restructured and optimised in order to achieve better absorption of the funds from the EU Funds and Programmes. On the top of projects and programmes co-financed with EU funds, additional national resources were allocated for investments in infrastructure;
- Amendments to the Social Security Code (SSC) were adopted, among which postponing the planned increase of the pension supplement or the sum of pensions, received by the deceased spouse for 2010, postponing the planned increase in the supplements to the pensions of people aged over 75 years and of the surviving spouse, changes in the procedure for payment of compensation for temporary incapacity to work, etc.

The government actions in these lines, and keeping unchanged the main priority of the fiscal policy (the consolidated government deficit to be reduced to sustainable levels within the shortest possible time) already proved to be efficient. In 2010 the budgetary position (ESA 95) of Bulgaria improved by 1.5 pp of GDP as compared to the previous year. The expenditure restriction measures, included in the amended 2010 budget (including the repayment of the main part of the liabilities of the central government which occurred at the end of 2009, while abiding to the parameters of the amended fiscal framework for 2010), allowed the general government budget expenditures (in ESA 95 terms) to be reduced by 3 pps of GDP as compared to 2009.

On the revenue side, the most important principle included in the updated programme for 2010 was to keep unchanged the rates of the main taxes. This, on the one hand, ensured a predictable environment for business and investments and, on the other, was favourable for the gradual recovery of domestic demand and growth prospects. During the second half of 2010 the data about tax revenues execution show that the unchanged tax burden and the gradual recovery of the economic activity have started to play a positive influence on the tax revenues. The improved tax collection is further supported by the efforts of the revenue administrations in the fight against smuggling, tax crimes and the informal economy.

The ESA 95 general government fiscal position reports an improvement of over ½ pps of GDP (to 3.2% of GDP) as compared to the objective set for the year in the updated Notification Tables as of June 2010. This was achieved as a result of the measures for strengthening the fiscal discipline in the central government sector and the recommendations made to the autonomous budgets, including the municipalities. When the updated projections for 2010 were made, the estimates for the fiscal parameters of the local government sector and the state-owned enterprises was conservative. Now we report an improvement as compared to the estimated data for the healthcare sector (mainly for the medical institutions which are additionally consolidated into the “General Government” sector) and for the local government (improvement as compared to the estimate of the amount of liabilities and receivables in the balances of municipalities), as well as positive development in the revenues from taxes on production and imports. Given the dramatic deterioration of the government deficit in 2009, including as a result of strongly manifested negative effects particularly in these sectors, the estimates in the updated fiscal framework for 2010 were more cautious with a view to providing a buffer in the event of eventual materialisation of a pessimistic scenario in the course of the budget execution.

The fiscal consolidation will continue also in 2011, when the general government deficit is planned to be reduced to 2.5% of the forecasted GDP by continuing the implementations of measures with regard to expenditures, improving the control mechanisms, as well as the started gradual improvement on the revenue side following the economic recovery. The conservative revenue planning and the lower expenditure ceilings, freezing the expenditure on wages and pensions, the approved ceilings of the liabilities of the spending units at central level, as well as the implemented structural reforms in the healthcare, education, administration and other sectors, are the key features of the 2011 fiscal framework.

The fiscal framework with regard to revenues is planned conservatively. This, together with the unchanged expenditure ceilings, will allow achieving the required fiscal improvement. The main characteristics in the tax policy in 2011 are:

- Keeping unchanged the direct tax rates;
- Increasing some excise duties in accordance with the agreed schedule for reaching the minimum allowed rates for the EU;
- Raising the VAT rate for organised tourism services;
- Introducing tax on insurance premiums;
- Raising the social security contributions to the “Pensions” Fund by 1.8 pps;
- Raising the minimum insurance thresholds for the main economic activities and groups of professions by 5.6% as compared to 2010 and the average insurance income is expected to grow by 6.3% compared to 2010.

On the expenditure side, the payroll expenditures in the budgetary sector are to be frozen at the previous year levels. The administrative reform will continue and the focus will be shifted from reducing the staff numbers to the introduction of a performance-based approach in determining the individual remuneration while observing the overall payroll ceilings in the individual ministries. The expenditure framework does not envisage pension indexation in line with the so-called “Swiss rule”, and the maximum pension remains at the 2010 level. The SSC amendments with regard to the procedure for payment of benefits and compensations for temporary incapacity to work, disease and unemployment, remain valid.

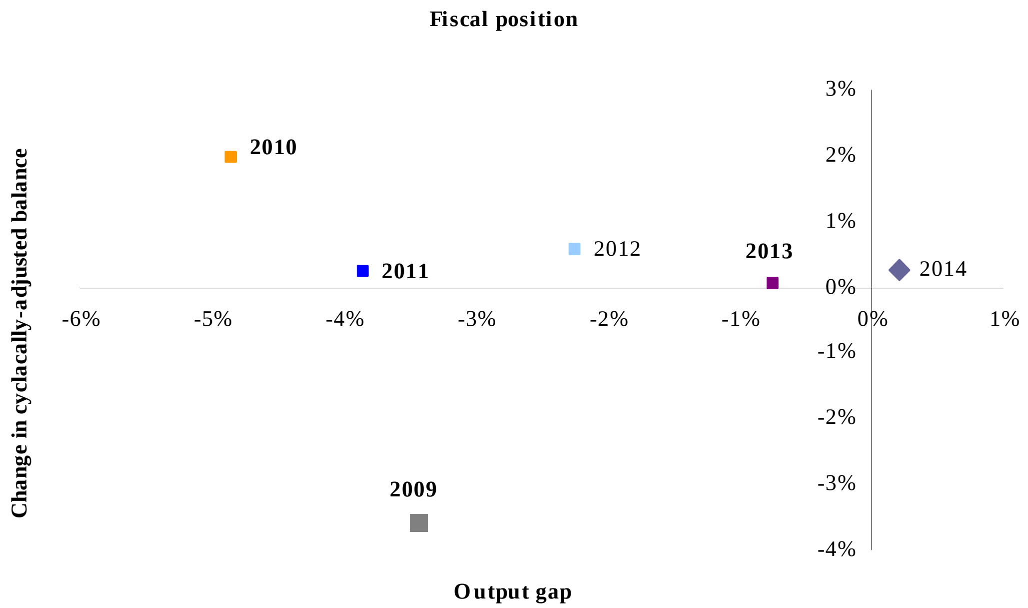
The efforts for strengthening the control and the responsibility in the process of budgetary management and execution, as well as for maintaining financial discipline will continue. With the provisions of the 2011 LSBRB a ceiling of the liabilities to suppliers and officials on long-term secondments as at 31 December 2011 for the government authorities, ministries and institutions were approved[25]. With the approval of this provision undertaking commitments in 2011 is linked to the framework of the approved budgetary appropriations for 2011, the accrued liabilities for 2010 and the estimate of the accrued liabilities as of the end of 2011.

[25] Article 17 of the 2011 LSBRB.

## 3.4 Structural Balance and Fiscal Position

In order to achieve the Maastricht criterion for budget deficit below 3% of GDP and to ensure the long-term fiscal sustainability of Bulgaria, the structural deficit will be reduced from 1.64% in 2010 to 0.56% of GDP in 2014. During the period 2010–2013 the economy will come closer to its potential, but will remain below it, and in 2014 it will slightly exceed it – by 0.2%. (Figure 9, Table 5 of Annex 1).

**Figure 9. Cyclical position and fiscal balances (2010-2014)**




*Source: MF*

## 3.5 Budgetary Aspects of Structural Reforms

The effects of the structural reforms generally complements the fiscal consolidation efforts of the government (Table 5).

The most significant effect in this regard have the programmes for improving the efficiency of public finances and for ensuring optimal reallocation of public expenditure towards areas enhancing growth potential of the economy (about 2.27% for the whole period), for better and more-effective utilisation of the labour potential of the economy (about 0.26%) and for achieving National target 5 "Reducing the number of people living in poverty by 260 thousand" (about 0.41%).

**Table 5: Net budgetary effect[26] from the implementation of some of the measures, included in the National Reform Programme of the Republic of Bulgaria (2011–2015)**

| Expenditures on the priorities and national targets of NRP as % of GDP | Change 2012/ 2011 | Change 2013/ 2012 | Change 2014/ 2013 | 2014/ 2011 |
|---|---|---|---|---|
| Improving the efficiency of public spending and ensuring a reallocation to growth-enhancing items | -1.90 | -0.14 | -0.23 | -2.27 |

[26] Change in expenditure as a percentage of GDP, in pps.

| | | | | |
|---|---|---|---|---|
| Better and more efficient utilisation of the labour potential and National target 1 “Reaching a 76% employment among the population aged 20 to 64 by 2020” | -0.21 | -0.05 | 0.00 | -0.26 |
| Improving the quality and efficiency of education and training systems[27] | -0.02 | -0.02 | -0.02 | -0.06 |
| National target 2 “Investments in R&D in the amount of 1.5% of the GDP” | 0.00 | 0.00 | 0.00 | 0.00 |
| National target 5 “Reducing the number of people living in poverty by 260 thousand” | -0.06 | -0.22 | -0.13 | -0.41 |
| **TOTAL:** | **-2.19** | **-0.44** | **-0.35** | **-2.98** |

*Source: MF, Programme budgets of the FLSU for 2012–2014*

## 3.6 General Government Debt Levels and Developments[28]

The general government debt to GDP ratio increased slightly from 14.7% in 2009 to 16.2% in 2010[29] Thus, Bulgaria remains among the EU countries with one of the lowest ratios, the reference value of which under the Stability and Growth Pact is 60%. According to the most recent data of the Ministry of Finance, in 2010 the general government debt in nominal terms increased by net EUR 580 million and is expected to reach about EUR 5,843 million. This indicator is expected to reach 16.4% (or about EUR 6,423.8 million in nominal terms) in 2011. In 2012 the ratio is expected to reach values of about 19% - this estimate takes into account the possibility for issuing debt on international markets. In contrast, in 2013 the indicator will decline as a result of the combined effect of the nominal GDP growth and the redemption of an issue of global Eurobonds in the amount of EUR 818 million - the decline will be by about 1.4 pps to 17.4%.

The central government debt accounts for 96% of the general government debt as of the end of 2010. Its nominal amount is EUR 5,385 million, of which EUR 2,011.5 million domestic debt (37.4%) and EUR 3,373.5 million (62.6%) external debt, and the “Government Debt to GDP” ratio is 14.9%.

In the structure of the government debt in terms of types of creditors the largest relative share belongs to domestic debt (GS) – 37.4%, followed by Global bonds – 30.4%, government investment loans – 15.1%, and government loans from the World Bank – 14.1%.

As at the end of December 2010 the nominal government guaranteed debt amounted to EUR 637.1 million. Thus the “government guaranteed debt to GDP” ratio remains at the 2009 level – 1.7%.

The payments made in 2010 for the government debt servicing (including repayments of principal and interest payments) amounted to EUR 684.5 million. In 2011 the total amount

[27] Source: approved expenditure ceilings of MEYS.
[28] According to the methodology for calculating debt, European System of Accounts 95 (ESA 95)
[29] The difference from the initially submitted forecast of 15.9% in connection with the measures and actions in response to the recommendations for Bulgaria to put an end to its excessive deficit as of 13 July 2010 is the inclusion of the Central Government debt for the funds in the amount of EUR 132.11 million, paid by the Bulgarian Development Bank under the mechanism for settling the liabilities, payable from the republican budget to the budgets of ministries and institutions – first-level spending units, second- and lower-level spending units, in pursuance of Council of Ministers Decision No. 197 as of 08.04.2010.

of principal repayments and interest payments are expected to be about EUR 440.88 million and EUR 280.16 million, respectively.

Pursuant to Article 8 of the Law on Government Debt (LGD) and in order to control the increase in the amount of the sovereign debt, in the 2011 LSBRB ceilings are set for: the maximum amount of the new government debt – EUR 2 billion, and the maximum amount of the new government guarantees that can be assumed during the year – EUR 0.24 billion, as well as for the maximum amount of the government debt as at the end of the budget year – EUR 7.5 billion. The debt ceilings correspond to the priorities set in the Government Debt Management Strategy, namely: controlled increase of the government debt as of the end of 2011 and ensuring stable sources for budget financing and government debt refinancing.

Pursuant to the LGD provisions, in 2012 a new Government Debt Management Strategy for the period 2012–2014, will be elaborated and adopted - it will outline the intentions of the government in the field of government debt management over the forthcoming three-year horizon. Its main purpose will be to assess and mitigate to a maximum extent the potential risks due to both external and domestic factors, including risks related to the debt structure and profile. The Strategy will also outline the main debt strategies, which would ensure stable sources of budget financing and sovereign debt refinancing. This necessitates the implementation of a flexible market-orientated borrowing policy, which takes into account the dynamics of the processes on the local and the global economy, adequate to the needs of the state budget and the liquidity of the financial system, in line with maintaining macroeconomic stability of the country and preserving stable outlook of the sovereign credit rating, while strictly observing the balance between objectives and restrictions.

In the process of elaboration of the new strategy both the current approach to government debt management and the Stability and Growth Pact requirements will be taken into account. Furthermore, the envisaged mechanisms, included in the draft Pact for Financial Stability of the Ministry of Finance, which aims at ensuring the long-term financial stability, will be also reflected.

### *3.6.1 Issuance policy*

In 2010 the GS issues on the domestic market were prioritised in the debt financing of the state budget with a share of 85%, which results from different factors – on the one hand, given the situation on the international markets and the existing high liquidity of the banking system throughout the year, the possibility for issues on the international capital markets (ICM), envisaged in §14 of the 2010 LSBRB, was not used. On the other, it conformed to the need for providing funds for the fiscal reserve in order to fulfil the provisions of §6 of the 2010 LSBRB, which sets the minimum amount of the fiscal reserve at the end of 2010 at BGN 6.3 billion (EUR 3.2 billion). These factors provided for a possibility for raising financial resources on a market principle at an acceptable for the issuer yield and optimum risk level on the local debt market. The gross internal financing with GS realised in 2010 amounted to BGN 1,508.1 million (EUR 771.1 million) - it comprised the issued government securities in the following maturity segments: GS with 10 years and 6 months maturity in a nominal value of BGN 313.1 million (EUR 160.1 million), 7-year GS in the amount of BGN 130 million (EUR 66.5 million), 5-year GS (from 2009) in the amount of BGN 130 million (EUR 66.5 million), GS maturing in 3 years and 6 months in the amount of BGN 30 million (EUR 15.3 million) and two issues of 1-year GS in a total value of BGN 150.8 million (EUR 77.1 million). This also includes the two issues Euros-denominated realised during the year: one with a 15 years maturity and a nominal amount of EUR 234.1 million, and one maturing in 2 years and 6 months in the amount of EUR 151.5 million.

During the year growing interest was observed in the offered government debt securities, which was accompanied by a clear trend of decline of the achieved yields at the auctions. Taking into account the expectations of the market players and the development of the financial system, as well as in line with the declared objective for achieving a flexible and adequate to the market issuance policy, the Ministry of Finance updated its issuance policy for 2010. The maturity and currency structure of the offered GS were diversified which increased the investment activity among all market players like banks, pension funds, insurance companies and other institutional investors.

At some auctions record coverage ratios were achieved as a result of the considerable excess of demand over supply of GS. Their annual average values by types of securities are as follows: for 1-year treasury bonds – 4.13, for Euro-denominated GS maturing in 2 years and 6 months – 3.82, for GS maturing in 3 years and 6 months – 3.01, for 5-year GS (from 2009) – 1.96, for GS with a term of 10 years and 6 months – 3.02, and for Euro-denominated GS with a term of 15 years – 6.92. The GS issuance with a term of 10 years and 6 months was in conformity with the need to maintain an appropriate instrument for the purpose of calculating a long-term interest rate for assessing the degree of convergence with the EU Member States.

### *3.6.2 Financing the central budget*

- Domestic market of GS

Taking into account the priorities set in the 2011 LSBRB, the objectives set in the current Government Debt Management Strategy 2009–2011 and the development trends of the local and international capital markets, the Ministry of Finance intends to continue implementing an active issuance policy on the domestic market. The plan is during the year to realise a positive net internal financing in the amount of approximately BGN 430 million (EUR 219.9 million), and the gross GS issuance on the local market will be about BGN 1,000 million (EUR 511.3 million).

The efforts will be focused on providing for an appropriate investment alternatives, which create opportunity for optimal management of the available money funds on part of a large circle of investors in the country, and, if deemed necessary, a policy, which directly corresponds to and maintains the liquidity of the financial system, will be pursued. All possible instruments to encourage the development of the domestic GS market, to promote the domestic issues of GS as a leading investment alternative with attractive yield to risk ratio, accompanied by a pursuit of maximum possible smoothing of transactions for bringing in and withdrawing liquidity through GS maturities and issues in the context of preventing possible market volatility and fragmentation, will be used.

- External financing:

In 2010 funds in the amount of EUR 133.1 million were absorbed under government and government investment loans. Of these, EUR 52.4 million were transferred to the central budget (CB) and represent the first tranche under the Structured Programming Loan from the European Investment Bank (EIB), while EUR 80.7 million were absorbed under government investment loans.

In 2011 about EUR 200 million worth of funds from external government loans are expected to be transferred to the central budget. These include disbursements under the Loan Agreement for Structural Programme Loan for Bulgaria – co-financing of the EU Funds 2007–2013, between the Republic of Bulgaria and the European Investment Bank, in 2011, amounting to approximately EUR 120 million; utilisation of the first Development Policy Loan from the World Bank in connection with the cooperation under the government programme for reform in the railway sector aiming to ensure financial sustainability of the railway sector in Bulgaria in the amount of EUR 80 million, as well as absorption of government investment loans (GILs), allocated to the ministries' budgets, in the amount of approximately EUR 210 million. In the 2011 LSBRB a possibility for an issue of global bonds in the international financial markets, if a need for budget financing appears and the situation in the international capital markets is favourable, is provided. The same possibility was envisaged in the 2010 LSBRB, but was not utilised since the alternative of internal financing through GS issues was preferred.

The introduction of innovative debt mechanisms is subject to analysis. The possibility for applying the special mechanism for buying back bonds from the EIB for financing investment projects is being explored. This financial instrument differs from the standard government loans extended by the EIB to members, but contains all components and conditions for avoiding risks included in the EIB standard framework agreement for extending loans to EU Member States. The Bank requires that all joint actions shall be linked to certain achieved preliminary agreements and the identification of specific investment projects in the main fields of financing by EIB – infrastructure, environment, energy, healthcare, education, social sphere and others.

With a view to continue the beneficial cooperation between the Republic of Bulgaria and the World Bank, a draft of a new Partnership Strategy for the period 2011-2013 financial years will be elaborated. The Strategy will be focused on three directions for assistance – reform policies falling within the scope of the Europe 2020 Strategy, strengthening the institutional capacity for the EU funds absorption, and financing, complementing that under the operational programmes.

In order to cover the financial shortage of municipalities, other budgetary organisations and state-owned enterprises under Article 62, paragraph 3 of the Commercial Law, which are beneficiaries of projects under Operational Programmes "Transport", "Environment" and "Regional Development", the 2011 LSBRB envisages the possibility for extending loans by the Bulgarian Development Bank (BDB) on the basis of the reimbursable funds provided from the central budget. The funds are part of the "Loan Agreement for Structural Programme Loan" (Bulgaria, co-financing of the EU Funds 2007–2013) between the Republic of Bulgaria and the EIB and are provided to BDB in the form of guarantee deposits. Pursuant to the requirements of the Loan Agreement, the projects must be also approved by the EIB.

### *3.6.3 Government debt sensitivity analysis*

In 2011 the risks related to the domestic debt servicing are minimised with a view to the issuance of GS with fixed interest coupons and denominated in Bulgarian leva and Euro. In pursuance of the current debt management strategy, the new loans are mainly in Bulgarian leva and Euro at fixed interest rates, as a result of which the influence on the interest payments over the next years is expected to decrease.

The liabilities with variable interest rates amount to 20.3% in 2010, and the trend is that this share will remain unchanged in 2011. The considerable preponderance of the debt with fixed interest rate (79.7%) in 2010 will be preserved and the trend is that in 2011 it will be at around 80% and will increase to 84% in 2012. This dynamics demonstrates the good predictability of the budgetary resources needed for the government debt servicing. By 2014 the share of debt with variable interest rate will decrease to 15.4%.

About 80.1% of the government debt in 2010 was in euro and Bulgarian leva, 17.1% – in US dollars, while 2.8% – in other currencies. The debt denominated in euro and Bulgarian leva is expected to reach 79.5% and 80.3% respectively in 2011 and 2012.

In order to assess the degree of influence of possible changes in the current exchange and interest rates levels on the amount of the forthcoming payments of the government debt, a sensitivity analysis was carried out for 2011–2013. Two scenarios were considered:

- baseline scenario with assumptions on the financing and levels of the exchange and interest rates, used within the 2012 budgetary procedure, and
- alternative scenario, including the assumption of expected upward movements in the interest and exchange rates levels.

The analysis confirms the relatively small influence from the changes of main market indicators on the government debt servicing. This is due mainly to the positive changes in the currency and interest rate structure of the debt over the previous years.

**I.** Under the assumption of a 10% USD appreciation vis-à-vis the BGN:

- The principal payments in 2011 will increase by 0.63%, and in 2012 and 2013 the change will be by 0.51% and 0.25%, respectively.
- The amount of the debt in 2011 will increase by 1.47%, respectively 1.31% in 2012 and 1.3% in 2013, which in absolute terms is about EUR 111 million on average for each of the years.
- The interest payments will increase by 1.44% in 2011, 2.22% in 2012 and over 1.91% in 2013.

**II.** Under the assumption of a 10% increase of the JPY exchange rate to the BGN:

- A small negative effect on the amount of the debt in the range of 0.73–0.79% during the period 2011–2013 is observed. In absolute terms this represents an increase in the debt value by EUR 56.6 million in 2011, EUR 62.3 million in 2012, and EUR 65.6 million in 2013.
- There is no significant impact on the amount of the interest and principal payments under the government debt; the effect will amount to 0.34% on average in each of the years.

The interest rate structure discussed above predetermines the relatively low risk in the event of interest rates changes. The biggest influence on the interest payments under the debt will have the simultaneous increase in the values of the 6-month euro LIBOR and the 6-month US dollar LIBOR. Over the forthcoming three-year period an increase of 100 basis points in the levels of these indicators will result in an increase in the interest payments by about 2% in 2011 and 3.7% in 2012. The effect on the needed resources for these two years is assessed at approximately EUR 20.5 million in absolute terms. With a view to the interest rate structure of the debt, the variable interest rates of the EUR-denominated debt have the highest contribution (about 94% of the debt with variable interest rate is denominated in euro).

# 4 SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

This Convergence Programme presents three alternative scenarios – higher crude oil prices, lower growth of the European economy and faster recovery of consumer confidence in Bulgaria.

## 4.1 Scenario 1: Higher crude oil prices

This alternative scenario reflects the uncertainty regarding the development of crude oil prices on the international markets. Technically it is manifested in the assumption for a 10% higher price of crude oil in 2011 as compared to the baseline scenario. This increase, in turn, will result in higher inflation, both along the lines of the increased prices of energy goods and as a result of secondary effects on the remaining prices in the consumer basket.

**Table 6: Comparison between the baseline and the alternative assumptions**

| | 2011 | | 2012 | | 2013 | | 2014 | |
|---|---|---|---|---|---|---|---|---|
| | Percentage change | Difference compared to the baseline scenario, pp | Percentage change | Difference compared to the baseline scenario, pp | Percentage change | Difference compared to the baseline scenario, pp | Percentage change | Difference compared to the baseline scenario, pp |
| Average spot price of oil (USD/barrel) | 49.1 | 13.6 | 0.8 | 0.0 | -2.3 | 0.0 | -0.9 | 0.0 |
| Harmonised consumer price inflation, end of period | 5.1 | 0.9 | 2.9 | 0.1 | 2.4 | 0.0 | 2.4 | 0.0 |
| Harmonised consumer price inflation. period average | 4.3 | 0.4 | 3.9 | 0.6 | 2.6 | 0.0 | 2.4 | 0.0 |

*Source: MF*

In such a development of the economic situation the higher inflation is expected to result in slower by 0.4 pps recovery of the private consumption during the current year. The subdued consumption will have a negative impact on the real growth of imports, which is expected to decrease by 0.2 pps. On the other hand, the oil price increase will have the opposite effect on imports. This effect will be expressed in a small increase in the real growth of exports of 0.1 pps in 2011 and a decline of 0.3 pps during the next year as a result of the lagging effect on export-orientated sectors on the supply side. In 2012 the exports' real growth in will return to the baseline scenario levels.

The oil price increase will have a negative impact on the current account balance of the country. The influence is mainly through the trade balance, which will increase to 7.3% of GDP during this year, as compared to 7.1% of GDP in the baseline scenario. The price increase of one of the main commodities for Bulgaria will result in a nominal increase in imports which will offset the real decline. Thus, the imports growth will surpass the exports growth and will result in higher trade deficit in 2011. The impact on the remaining components of the current account will be limited.

The relatively lower expected economic activity as compared to the baseline scenario during the programming period does not provide for any expected significant deviations in the labour market indicators development. In current alternative scenario the change in employment is lower by less than 0.1 pps during the first two years, while the unemployment rate gradually reaches 9% in 2014, as compared to 8.9% in the baseline scenario.

**Table 7: Effects from the oil price increase on the main macroeconomic indicators**

| Real growth rates | 2011 | | 2012 | | 2013 | | 2014 | |
|---|---|---|---|---|---|---|---|---|
| | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp |
| GDP | 3.5% | -0.1 | 3.9% | -0.2 | 4.4% | 0.0 | 4.2% | 0.0 |
| Final consumption | 2.4% | -0.4 | 3.5% | -0.1 | 4.2% | 0.0 | 3.3% | 0.0 |
| Private consumption | 2.8% | -0.4 | 4.0% | -0.1 | 4.7% | 0.0 | 3.5% | 0.0 |
| Gross capital formation | 5.5% | 0.0 | 6.9% | 0.4 | 7.5% | 0.0 | 7.4% | -0.2 |
| Exports | 8.3% | 0.1 | 7.5% | -0.3 | 7.6% | 0.0 | 7.2% | 0.0 |
| Imports | 7.6% | -0.2 | 8.0% | -0.2 | 8.5% | 0.0 | 7.3% | 0.0 |
| Current account balance (% of GDP) | -2.3% | 0.1 | -3.5% | 0.2 | -4.1% | 0.2 | -4.0% | 0.2 |
| Employed, % | 0.2% | 0.0 | 0.6% | -0.1 | 0.9% | 0.0 | 0.6% | 0.0 |
| Unemployment rate | 10.1% | 0.0 | 9.8% | 0.1 | 9.3% | 0.1 | 9.0% | 0.1 |

*Source: MF*

## 4.2 Scenario 2: Slower recovery of the European economy

The weaker growth of exports and domestic demand will result into lower growth of the Bulgarian economy during the first two years of the period under review. The slower development of the economies of Bulgaria's main foreign trading partners will have a negative impact on the Bulgarian exports of goods and services, both in nominal and in real terms. The subdued exports will hinder stronger growth of imports of commodities for the export-orientated industries. As a whole, the simulations demonstrate a weaker negative impact of the changed assumptions on exports as compared to that on imports, as a result of which an improvement in the trade balance and the current account balance as a whole is expected.

The negative influence of the subdued recovery of the European economy will result in an even greater cautiousness of investors and further slowdown of foreign capital inflow to the country, as well as a smaller financial account surplus. The weaker capital inflows to the country, in turn, will hinder stronger growth, mainly of investments, but also of consumption, albeit to a smaller extent.

**Table 8: Main macroeconomic indicators**

| Real growth rates | 2011 | | 2012 | | 2013 | | 2014 | |
|---|---|---|---|---|---|---|---|---|
| | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp |
| GDP | 3.2% | -0.4 | 3.9% | -0.2 | 4.4% | 0.0 | 4.2% | 0.0 |
| Final consumption | 2.4% | -0.4 | 3.4% | -0.2 | 4.2% | 0.0 | 3.3% | 0.0 |
| Private consumption | 2.8% | -0.4 | 3.9% | -0.2 | 4.6% | -0.1 | 3.5% | 0.0 |
| Gross capital formation | 4.3% | -1.3 | 5.6% | -0.9 | 7.4% | -0.1 | 7.3% | -0.3 |
| Exports | 7.3% | -0.9 | 7.7% | -0.1 | 7.6% | 0.0 | 7.2% | 0.0 |
| Imports | 6.6% | -1.2 | 7.6% | -0.6 | 8.5% | 0.0 | 7.3% | 0.0 |
| Current account balance (% of GDP) | -2.0% | 0.2 | -2.8% | 0.5 | -3.4% | 0.5 | -3.3% | 0.5 |
| Financial account (% of GDP) | 4.6% | -0.4 | 10.0% | -0.4 | 6.3% | -0.2 | 7.8% | 0.0 |
| Annual average inflation | 3.6% | -0.3 | 3.1% | -0.2 | 2.4% | -0.2 | 2.3% | -0.1 |
| Employed, % | 0.0% | -0.2 | 0.6% | -0.1 | 0.9% | 0.0 | 0.6% | 0.0 |
| Unemployment rate | 10.2% | 0.1 | 9.9% | 0.2 | 9.4% | 0.2 | 9.1% | 0.2 |

*Source: MF*

The slower economic growth of the main trading partners of Bulgaria will also impede the reversing of the trends on the labour market in 2011. The smaller exports and the lower investment activity will not allow a more tangible increase in the total employment in the country and the number of the unemployed people is expected to stabilise around its 2010 levels. Under this scenario, the unemployment rate is expected to start decreasing as of 2012, but by the end of the programming period it will remain by about 0.1–0.2 pps higher as compared to the baseline scenario. The increase in the number of employed people in 2012 is expected to be by 0.1 pps lower as compared to the baseline scenario, and during the next two years the rates of change are expected to be identical in the two scenarios.

## 4.3 Scenario 3: Faster recovery of consumption

The baseline scenario of this Convergence Programme is conservative with regard to the household consumption growth in order to ensure the revenue execution of the state budget for 2011. Under this scenario a faster recovery of consumer confidence is expected. This should have a positive impact on private consumption and should result in a real growth of the Bulgarian economy of 3.7% in 2011. The consumption growth in turn will lead to a slow inflation acceleration.

**Table 9: Main macroeconomic indicators**

| Real growth rates | 2011 | | 2012 | | 2013 | | 2014 | |
|---|---|---|---|---|---|---|---|---|
| | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp | Alternative scenario | Difference compared to the baseline scenario, pp |
| GDP | 3.7% | 0.1 | 4.2% | 0.1 | 4.4% | 0.0 | 4.2% | 0.0 |
| Final consumption | 3.2% | 0.4 | 3.9% | 0.3 | 4.3% | 0.1 | 3.3% | 0.0 |
| Private consumption | 3.7% | 0.5 | 4.6% | 0.5 | 4.8% | 0.1 | 3.5% | 0.0 |
| Gross capital formation | 5.8% | 0.2 | 7.4% | 0.9 | 7.5% | 0.0 | 7.4% | -0.2 |
| Exports | 8.2% | 0.0 | 7.7% | -0.1 | 7.5% | -0.1 | 7.2% | 0.0 |
| Imports | 8.2% | 0.4 | 8.5% | 0.3 | 8.5% | 0.0 | 7.3% | 0.0 |
| Current account balance (% of GDP) | -2.4% | -0.2 | -3.8% | -0.5 | -4.5% | -0.6 | -4.5% | -0.7 |
| Annual average inflation | 4.0% | 0.1 | 3.9% | 0.6 | 2.8% | 0.2 | 2.6% | 0.2 |
| Employed, % | 0.3% | 0.1 | 0.7% | 0.1 | 0.9% | 0.0 | 0.6% | 0.0 |
| Unemployment rate | 10.1% | 0.0 | 9.7% | 0.0 | 9.2% | 0.0 | 8.9% | 0.0 |

*Source: MF*

The improvement of consumer confidence in the economy will also have a positive impact on the intensification of the investment process in the country. The domestic demand increase, especially along the lines of consumption but also as a result of the higher investments, will produce an acceleration of growth of imports of goods and services, both in real and in nominal terms. On the other hand, the effect on exports is expected to be insignificant. The overall effect on economic growth is assessed at 0.1 pps in 2011.

The expectations concerning the employment and the unemployment follow the baseline scenario development, since no significant deviations of the indicators' dynamics are expected over the entire programming period. The rates of increase in the number of employed people are comparatively higher in 2011 and 2012, although the changes are below 0.1 pps per year as a result of the expected higher investment activity. The unemployment rate will remain at the levels of the baseline scenario.

## 4.4 Fiscal Risks

The international economy started recovering from the financial and economic crisis. However, since this process and its duration continue to be uncertain, the medium-term macroeconomic projection of the Ministry of Finance is rather conservative. The main risks for the budget execution in the medium term are related to:

- **Shifting the economic growth structure to a higher contribution of net exports and indications of lower tax collection**. The conservative approach in the planning of the revenue side of the budget significantly limits the possibility of this risk to materialise, but its effect cannot be entirely eliminated. Additionally, it is possible that risks related to the expenditure side of the budget will occur – in particular with a view to the still high unemployment rate, which will continue exerting pressure on the expenditures on welfare and unemployment benefits during the current and the next years.

- **Population ageing resulting in a pressure on the pension system.** With the pension system reform, which started in 2011, measures were undertaken for consolidating the NSSI budget and for stabilising the revenues of the PSS. These changes will result in lower burden from the population ageing on public finances through improvement of the NSSI budget, and the assessment of the risks for the public finances from the population ageing improves. Nevertheless, the demographic process continues being a serious challenge to maintaining the public finances sustainability and makes it necessary the additional improvement of the quality of public expenditures in the pension system, healthcare and education, as well as to maintain a conservative policy regarding the budget balance.
- **Double-dip recovery** as a result of the withdrawal of the fiscal and monetary stimuli, which could slow down the recovery of the Bulgarian economy by exercising pressure on both the revenue and the expenditure side of the budget.
- **Continuous influence of unfavourable price effects as a result of international prices increase**, in particular the oil prices, will also create prerequisites for a slower recovery from the crisis.

## 4.5 Sensitivity of the Budgetary Projections to the Alternative Scenarios

The alternative scenarios reveal some risks to the budgetary projections, which are related to changes in the structure and pace of economic recovery. The domestic demand dynamics and, in particular, that of final consumption, has a significant impact on the revenue side of the budget. The materialisation of the optimistic scenario, which envisages faster recovery of consumer confidence and higher growth of the Bulgarian economy as compared to the baseline scenario, will have a positive impact on the revenue side of the budget by generating additional revenues over the entire forecast period. The latter will provide an opportunity for speeding up of the budget consolidation process.

Despite the fact that in the pessimistic scenario for a slower recovery of the European economy the negative impact is mainly showed through the exports dynamics, the growth rate of almost all GDP components is lower as compared to the baseline scenario. The most serious impact on the revenue side of the budget is expected from the lower final consumption and imports of goods and services as compared to the baseline scenario. When the Law on the State Budget of the Republic of Bulgaria (LSBRB) for 2011 was drafted, the target values for the deficit under the consolidated fiscal programme as a percentage of GDP were set for the next three-year period. The deficit shall not exceed 2.5% of GDP in 2011, 1.5% of GDP in 2012 and 1.0% of GDP in 2013. In order to achieve these target values, under this scenario an additional tightening of the government expenditures in the range of 0.2%–0.3% of GDP is envisaged in the period under consideration as compared to the baseline scenario.

An increase in the crude oil price in 2010 by 10% as compared to the baseline scenario has a relatively limited impact on the total consolidated budget revenues as compared to the other two scenarios. This follows the operation of two main opposite factors influencing the budget revenue dynamics. On the one hand, the slower economic recovery as compared to the baseline scenario as a result of the negative price shock will to some extent limit the increase in tax revenues, mainly during the first year. On the other, the acceleration of the annual average inflation during the first two years of the forecasted period and the increase in the nominal value of imports will act in the opposite direction and will have a positive impact mainly on the nominal revenues from indirect taxes. In addition, the higher inflation in 2011 and 2012 is also likely to create certain pressures on the current budget expenditure.

In conclusion, in each of the alternative scenarios, if the expenditure components ceilings are observed during the forecast period, the consolidated general government deficit will be reduced below the reference value of 3% of GDP for the EU Member States.

## 4.6 Comparison with the Previous Update

The need for an update of the medium-term macroeconomic forecast reflected the changed external environment, mainly as a result of the faster than expected recovery of the European economy and the related higher exports growth in real terms in 2010. In addition, the previous update of the Convergence Programme was prepared on the basis of data as of the end of 2009. For comparison, at the time of preparing this Convergence Programme preliminary National Accounts data for 2010 is available, which outline a stronger than expected decrease of the gross fixed capital formation, to a large extent result from the 2009 data revision. Last, but not least, the published in September 2010 revisions of the National Accounts data since 1995, which have led to significant changes in their interpretation, shall also be noted. On the one hand, for the first time seasonally adjusted data were published. Moreover, in line with the Eurostat recommendations, the method for calculating the changes in physical volumes was changed. Other methodological changes related to the inclusion of different aspects of the shadow economy in GDP, the allocation of indirectly measured services provided by the financial intermediaries and change in the time reporting of some taxes, were also adopted.

**Table 10: Main macroeconomic indicators**

| **Real growth rates** | **2010** | | | **2011** | | | **2012** | | |
|---|---|---|---|---|---|---|---|---|---|
| | CP 2011 | CP 2009 | Difference, pp | CP 2011 | CP 2009 | Difference, pp | CP 2011 | CP 2009 | Difference, pp |
| GDP | 0.2% | 0.3% | -0.1 | 3.6% | 3.8% | -0.2 | 4.1% | 4.8% | -0.7 |
| Private consumption | -1.2% | -0.7% | -0.5 | 3.2% | 4.1% | -0.9 | 4.1% | 4.1% | 0.0 |
| Gross fixed capital formation | -16.5% | -5.6% | -10.9 | 5.6% | 1.8% | 3.8 | 6.5% | 6.2% | 0.3 |
| Exports | 16.2% | -3.3% | 19.5 | 8.2% | 4.9% | 3.3 | 7.8% | 6.1% | 1.7 |
| Imports | 4.5% | -1.9% | 6.4 | 7.8% | 4.0% | 3.8 | 8.2% | 6.6% | 1.6 |

*Source: MF*

During the first months of 2010 a serious lag of the main parameters of the budget revenue side behind the initial consolidated estimates, was observed. This made it necessary to update the annual plan and in July 2010 a Law on the amendment of the LSBRB for 2010 was adopted and entered into force. The changed fiscal framework for 2010 reflected the updated revenue estimates and defined specific limits on some expenditures. Under the changed budget parameters, an objective of 3.8% of GDP was set for the general government budget deficit on accrual basis for 2010 and the need to reduce the deficit below the reference value of 3% of GDP as already in 2011 was recognised.

The state budget execution as of 31.12.2010 demonstrates a very good revenue collection as compared to the updated estimates as well as a reduction of the general government budget deficit as a percentage of GDP considerably below the set for 2010 level. In the medium term the fiscal objective was revised from a balanced budget to a deficit under the consolidated fiscal programme, not exceeding 2.5% in 2011, 1.5% in 2012 and 1.0% in 2013. This revision was carried out with a view to ensuring the automatic stabilisers play and to taking into account their anti-cyclical role, while using all possibilities for fiscal consolidation and reaching a close to the balanced position towards the end of the programming period.

A direct comparison between the projection, included in this Convergence Programme, and the latest economic forecasts of the European Commission from the autumn of 2010 would not be indicative since the conditions in which the two projections were made are very different. The main difference is in the fact that the current projection of the Bulgarian government takes into account the international prices dynamics over the last months, related to the political tensions in some oil exporting countries, as well as to the natural disaster in Japan and its consequences.

As a general trend, however, the national projections for the economic growth in the medium term seem to be more optimistic. Historically, the data from the national statistics show that the 2010 data for a 0.2% GDP growth are more optimistic than the Autumn Economic Forecasts of the EC for a 0.1% GDP decrease but more pessimistic than the Bulgarian government projections for an economic growth of 0.7%. The latter projection was based on available data up to the second quarter of 2010, which demonstrated a positive trend for consumption recovery – it was assumed that this trend will continue. During the third quarter, however, the consumption decreased, which, regardless of the positive data from the last three months of 2010, had a negative impact on the annual economic growth.

# 5 QUALITY OF PUBLIC FINANCES

## 5.1 Expenditure Side Developments

The consolidated government expenditures were restructured with a view to achieving the government priorities for better absorption of the European Funds and for providing assistance to the most vulnerable groups in time of strengthened budgetary austerity.

### *5.1.1 Continued fiscal consolidation and strengthened control*

- Stricter control of the FLSUs expenditures

In order to avoid the reported in 2009 considerable (compared to the recent years) increase of the uncovered with financial resources accrued liabilities under made commitments, and to improve the management of budgetary resources in the first-level spending units (FLSUs) in line with the principles of the Law on Financial Management and Control in the Public Sector, in the Law on State Budget for 2011 a provision, which gives the Council of Ministers the capability to set and update limits for government authorities, ministries and departments for conclusion of contracts, was adopted. Measures are also envisaged for freezing the expenditure of the ministries and institutions, which are to accompanied by optimisation of the administration.

- Limiting the payroll in the budgetary sector

Keeping the nominal amount of the payroll unchanged as compared to that achieved in 2010, and determining of the individual remuneration in accordance with the remuneration reform in the budgetary sector, are among the main priorities of the expenditure policy in 2011[30].

- Introducing ceilings of the liabilities of the spending units (SUs) to suppliers I order to reduce the risk for a deterioration of the 2011 accrued-based budget balance – within the ceilings approved in 2010.
- Subsequent improvement of the procedures and rules for public finances management.
- Keeping the expenditure on maintenance and the capital expenditure at the levels of the updated 2010 budget.
- Postponing the pensions indexation and introducing stricter criteria for pension eligibility.
- Stricter criteria for budget appropriations to municipalities – only in case of no changes to approved budget; after 30.06.2011 funds can be transferred from one delegated item to another (except for education) only if there are no accumulated liabilities[31]. The municipalities can receive financing from the Fund for Local Authorities and Self-Government FLAG EAD of up to EUR 2 million if they are implementing projects co-financed by the European Funds[32].

[30] Linking the increase in individual remuneration of the people employed in the public sector to the labour productivity growth and the capacity of the economy and the budget.
[31] § 31 of the Transitional and Final Provisions of the 2011 Law on the State Budget.
[32] **§** 41 of the Transitional and Final Provisions of the 2011 Law on the State Budget.

### 5.1.2 Labour Market Policy and Social Inclusion

Under the 2010 budget EUR 33.2 million[33] were earmarked for active labour market policy. In implementing the anti-crisis measures of the government[34], additional funds in the amount of EUR 5 million were approved under the MLSP budget for financing the National Programme "From Social Benefits to Employment".

Stricter eligibility requirements for receiving monthly social benefits by the unemployed people in active age were introduced[35]. Consequently, as of March 2010 until March 2011 the National Social Security Institute stopped paying unemployment benefits in the amount of EUR 9 million.

In 2011 the financing of measures under the Law on Employment Promotion, which will ensure sustainable employment in the private sector, were raised three times as compared to 2009, to EUR 7.5 million.

The employment for people with disabilities will be financed mainly under Operational Programmes "Human Resources Development" and "Development of the Competitiveness of the Bulgarian Economy" and the total amount of the financing is EUR 20 million.

A new approach to prevent the social exclusion of children and families at risk will be introduced through a Social Inclusion Project, financed with loans from the World Bank in the amount of EUR 40 million.

Implementing the principles of decentralisation through the introduction of regional and municipal planning of social services, which are the main instrument for supporting the vulnerable groups, resulted in a 20% increase in the number of social services in the community, financed from the state budget, as compared to the number financed under the 2009 budget.

The successful implementation of the employment policy in the period 2012–2014 will also contribute to reducing the poverty level and, thus, the state social expenditure.

### 5.1.3 Pension and social security reform

After the changes in the pension system entered into force at the beginning of 2011, the influence of the negative demographic changes on the fiscal position of the country decreased. The implicit liabilities of the budget related to the population ageing declined to 0.9% of GDP. This, in turn, results in an improvement of the indicator of structural budget deficit, which Bulgaria will be able to maintain, while complying with the requirements for ensuring the long-term sustainability of fiscal policy.

The main parameters of the long-term reform of the pension system are described in Section III.2.2 of the National Reform Programme of the Republic of Bulgaria (2011–2015).

The successful implementation of the reform is expected to reduce the PSS deficit from EUR 1.031 billion in 2010 to EUR 0.7 billion in 2011; the raising of the social security

[33] According to MLSP data for the first half of 2010.

[34] Council of Ministers Decree No. 89 as of 11.05.2010.

[35] In case that they participate in community service for 14 days, 4 hours a day, in the programme for development and improving the environment, cleaning, planting, organised by the municipal administrations for provision of social services.

contribution to the "Pensions" Fund by 1.8 pps will improve the revenue side of the consolidated PSS budget by EUR 186.4 million in 2011.

The envisaged pensions' indexation of under the so-called "Swiss rule" in 2013 and 2014 by 4.3% and 4.4% respectively is expected to have a budgetary effect of EUR 84 million and EUR 89 million, correspondingly.

### *5.1.4 Education and science*

The reforms aim at enhancing the quality of and the access to education, while improving the expenditures' effectiveness.

In the 2011 Consolidated Fiscal Programme (CFP) EUR 1.317 billion are earmarked for education, which is 9.4% of the total budgetary expenditures. The efforts will be focused on attracting more private capital in the sector.

The earmarked for 2011 funds for the implementation of the National Programmes for the secondary education development amount of EUR 15.3 million, unchanged as compared to 2010.

Within the programmes for equal access to education and early school leaving prevention funds in the amount of EUR 84.2 million are earmarked for 2011.

In 2011 the implementation of the delegated budgets system will continue. The financial decentralisation model consists of internal optimisation mechanisms, generates positive effects and creates preconditions for schools' development. The expenditures on upbringing, preparing and training children in kindergartens and pupils in schools amount to almost EUR 0.732 million, of which EUR 0.709 million are the funds under uniform expenditure standards. The uniform expenditure standards for financing the secondary education are kept at their 2010 level.

The main part of the measures targeted at the educational system restructuring mobilise funds from the Structural Funds and the Cohesion Fund and the EU educational programmes.

In the field of higher education the efforts focus on further sustainable development of the system and on improving the higher education quality. The reforms implemented in 2010 and in the beginning of 2011 aim at introducing a rating system for higher schools, providing government guarantees in extending of student loans on part of banks and enhancing the qualification of the academic staff by adopting the Law on the Academic Staff Development.

Bulgaria plans to increase the total amount of public investments by using additional resources for scientific research and innovations under the European programmes and by higher absorption of the European Funds, as well as by increasing the investments in the private sector as a result of the economy's reorientation and restructuring towards more innovation-intensive sectors. On this basis the ambitious national target for investments in R&D in the amount of 1.5% of GDP by 2020 is set, of which 0.7% will be provided by the public sector and 0.8% are expected to come from the private sector.

### *5.1.5 Healthcare*

The healthcare expenditures in the 2011 budget reflect the prioritisation of the healthcare sector in the budgetary area, are in line the government policy in this area and the progress of the reform in the sector. In line with the execution of the 2010 budget of the Ministry of Healthcare, the approved for 2011 expenditures were increased by 20.1% as compared to 2010, i.e. to EUR 364.04 million. In 2011 the subsidies to hospitals, in view of their ongoing restructuring, were increased by 44.3% as compared to 2010, to EUR 106.9 million. In 2011 the expenditures on the function "Healthcare" are envisaged to be 10.9% of the budgetary expenditures[36], or EUR 1.66 billion, which is the largest amount of budgetary funds planned so far. European financing[37] in the amount of EUR 155.7 million will be used for modernisation of the diagnostics and treatment of oncological diseases, on the restructuring of the homes for medical and social care for children aged up to 3 years, as well as on the municipal hospitals.

## 5.2 Revenue Side Developments

The stable tax strategy aims at mitigating the negative consequences of the global crisis on the economy. The efforts are focused improving the business environment, promoting the investment activity and employment, as well as curtailing the informal sector of the economy. A priority of the tax policy is the avoiding sharp fluctuations of incomes in the start of the economic recovery.

The Direct taxes rates remain unchanged, and the process of consistent transferring of the tax burden to the indirect taxes through increasing the rates of some excise duties as of the beginning of 2011 in line with the commitments to reach the minimum European levels continues.

The revenue side has been conservatively planned in view of the planned cuts on the expenditure side.

***Tax and social security policy***

- Keeping the direct taxes rates unchanged;
- Continued consistent transfer of the tax burden to the indirect taxes through increasing the rates of some excise duties as of the beginning of 2011 in line with the commitments to reach the minimum European levels – the gradual increase in the rates on fuels[38] in 2012 and 2013 is expected to result in an annual revenues increase of EUR 27 million during each of the two years and by EUR 46.8 million[39] in 2014 as a result of the increase in the excise duties on natural gas and cigarettes;
- Introducing a 10% tax rate on the income of foreign legal entities, registered in preferential taxation zones, with a source in Bulgaria;
- Increasing the VAT rate on organised tourist services;
- Taxing the insurance premiums;
- Increasing the contribution rate to the "Pensions" Fund by 1.8 pps as of 2011;
- In 2011 the minimum insurance thresholds for the main economic activities and groups of professions were raised by 5.6% as compared to 2010. In 2011 the

[36] According to the 2011 LSBRB.
[37] Under OP RD and OP HRD.
[38] Natural gas and gas oil.
[39] EUR 39.2 million from cigarettes and EUR 7.6 million from natural gas.

additional NSSI revenues from contributions is expected to amount to EUR 55 million.

# 6 LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

## 6.1 Long-term Budget Outlook

A significant deterioration of the demographic structure of the population is projected in the long term, which represents a significant risk to the fiscal policy. The increased share of elder people is expected to lead to a noticeable pressure on budget expenditures on pensions and healthcare in the long term. This process poses a serious challenge for maintaining the public finances stability and necessitates reforms in the pension system, for improving the quality of public expenditures in healthcare and education systems, as well as to maintain a conservative policy with regard to the budget balance. These reforms will reduce the burden from the population ageing in the future.

**Table 11: Programme scenario (% of GDP)**

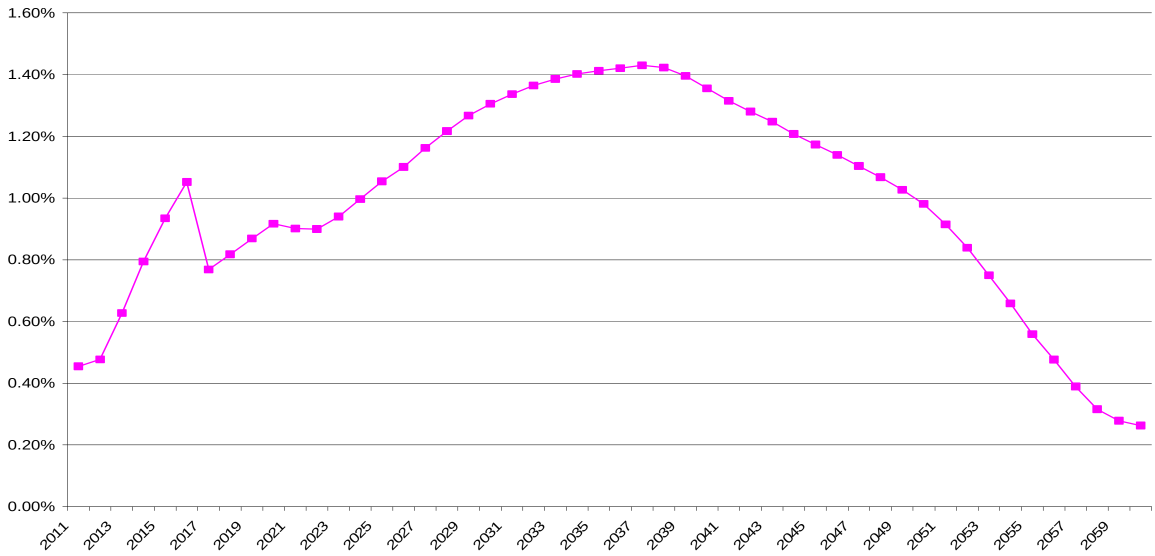
| | |
|---|---|
| Starting budget position 2010 | 0.50% |
| Effect from the population ageing | 1.46% |
| | |
| ***S1*** | ***-1.21%*** |
| ***S2*** | ***1.96%*** |

Source: MF

The breakdown of the indicator by components shows that the public finances sustainability is mostly negatively influenced by the effects of the population ageing, which reaches 1.46% of GDP. This is mainly due to the increased expenditures on pensions, which increase faster than the GDP growth rate. On the other hand, the demographic processes have a positive impact on the expenditures on education, but their decrease is more than offset by the increase in the expenditure on healthcare in the long term. Therefore, in order to maintain the sustainability of the budget position, a more rigorous fiscal policy over the next 2 years is necessary despite the fact that the economy will remain below its potential productivity level.

Within the pension system reform, which started in 2011, measures for consolidating the NSSI budget and for stabilising the PSS revenues were undertaken. These measures are described in detail in Section III.2.2 of the NRP. These changes have lead to a reduction of the population ageing burden on the public finances through improving the PSS budget.

**Figure 10. Effect of the changes in the pension system on the consolidated budget (% of GDP)**




Source: NSSI

As a result, the risk assessment of population ageing on public finances improves; the S2 indicator[40] declines from 1.96% to 1.25% of GDP. The S1 indicator[41] also improves from -1.21% to -2.21% of GDP in 2060.

**Table 12: Scenario with policy changes (% of GDP)**

| | |
|---|---|
| Starting budget position 2010 | 0.50% |
| Effect from the population ageing | 0.75% |
| | |
| ***S1*** | ***-2.21%*** |
| ***S2*** | ***1.25%*** |

Source: NSSI

## 6.2 Pension expenditures

Regardless of the indisputable successes of the 2000 pension reform, over the last years the pension system in Bulgaria faced a number of challenges related to:

- strong dependence on the state budget – in 2009 the state joined in the capacity of a “third insurer”, making a transfer to the “Pensions” Fund in the amount of 12% of the insurance income of each insured individual. In 2010 this transfer amounted to EUR 1.18 billion, or 34% of all pension expenditures;

[40] Interpreted as the difference between the current (projected) fiscal position for each year in the future and the position, which corresponds to the condition of sustainability over an indefinite future period.

[41] Interpreted as the difference between the current (projected) fiscal position for each year in the future and the position, which guarantees compliance with the Maastricht government debt criterion during the last year of the period (2060).

- the global economic crisis led to decreasing revenues from social security contributions as a result of the lower number of insured people and the lower insurance income;
- the unfavourable demographic developments in Bulgaria – decreasing population and labour force, coupled with increasing number of pensioners.

In order to overcome these negative trends, the Bulgarian government will implement measures for ensuring the long-term financial stability of the Bulgarian pension system and for improving the adequacy of pensions. These measures entered into force on 1 January 2011 and are described in Section III.2.2 of the NRP.

The changes in the pension system will influence the long-term pensions' projection. In order to monitor their impact, two main long-term projections were simulated. The first corresponds to the legislative framework provided for by the SSC in 2010, i.e. before the changes, and is assumed to be the baseline scenario. In the second projection the parameters of the 2011 SSC are introduced, which reflect the National Agreement on a new strategy for PSS financial stabilisation and on improving the pension legislation.

In addition, further three projections were simulated – they reflect the influence of the three main changes introduced with the 2011 SSC on the public pension system:

- increase in the social security contribution to the "Pensions" Fund by 1.8 pps;
- increase in the length of service and of the retirement age;
- increase in the weight of 1 year length of service – from 1.1 to 1.2.

When the long-term projection was prepared, both the Eurostat demographic projections EUROPOP 2008 and the MF macroeconomic forecasts and PSS-related assumptions, based on the 2010 and 2011 legislation, were used. The PSS funds long-term forecasting model[42], applied in the previous four updates of the Convergence Programme of the Republic of Bulgaria, was used.

**Conclusions about the PSS funds balance:**

- In the scenario with the 2010 SSC, the expenditure exceed revenues during the entire period. The revenue–expenditure ratio is the best for the period 2022–2032.
- In the scenario with the 2011 SSC (all legislative changes in force as of 2011 are included), the expenditures exceed revenues until 2019; until 2017 a gradual improvement is observed, but after the higher weight of 1 year length of service is included in 2017, the improvement slows down. As of 2020 until 2036 the revenues exceed expenditures, but after 2036 the expenditures are higher again. The revenue–expenditure ratio is the best for the period 2026–2031.

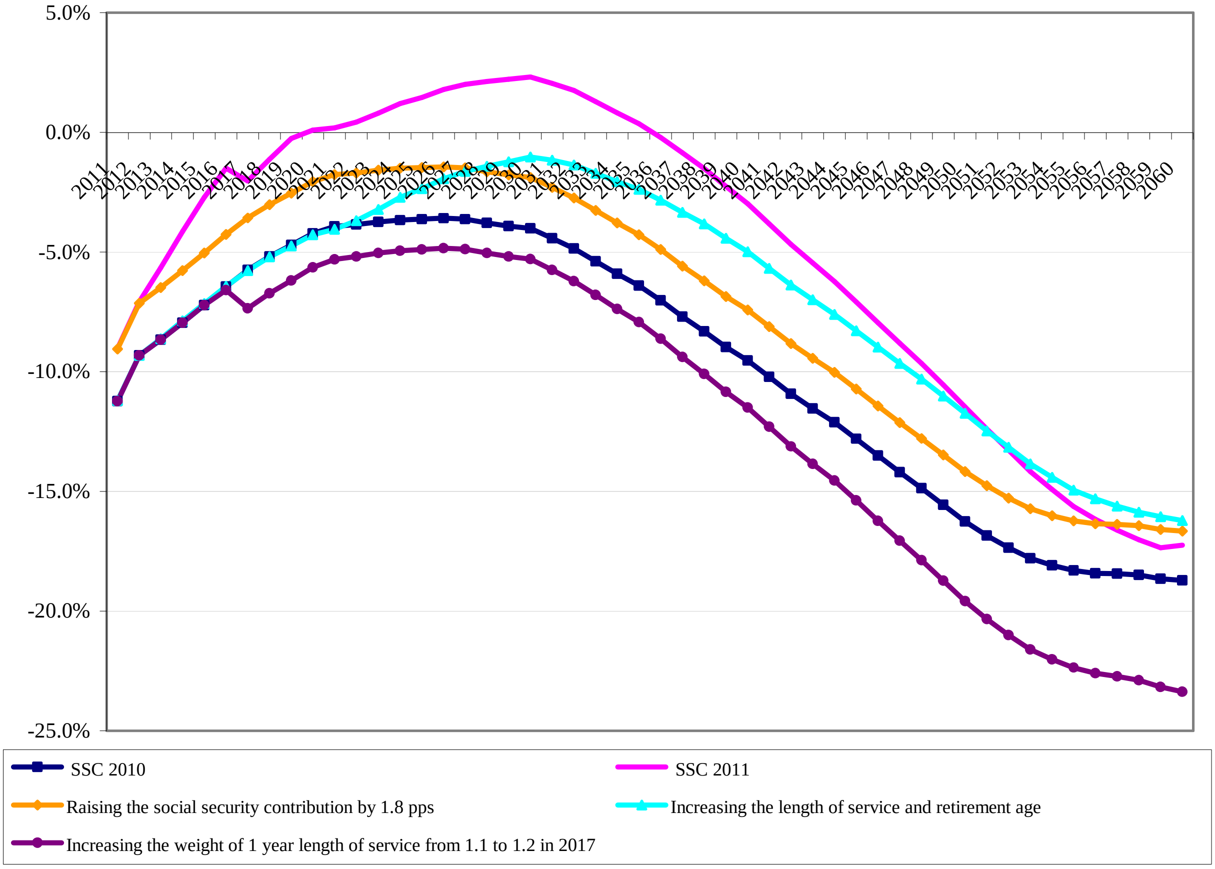
The increase of the social security contribution to the "Pensions" Fund has, of course, a positive impact on the financial condition of PSS (Figure 11).

The increase of the length of service and of the retirement age also has a positive impact on the PSS financial condition, but this is more clearly observed after 2020, when the retirement age starts gradually increasing.

[42] The model uses the Eurostat demographic projection EUROPOP 2008 and the national forecasts for the GDP developments.

The increase in the weight of 1 year length of service in the pension formula from 1.1 to 1.2 is related to increasing the adequacy of social security pensions, but if not supported by other measures, it will have a negative impact on the PSS financial condition (Figure 11).

**Figure 11. Balance of the PSS funds, 2011–2060 (% of GDP)**




*Source: NSSI, MF forecasts*

**Conclusions about the dependency ratio and the income-replacement rate from the first pillar:**

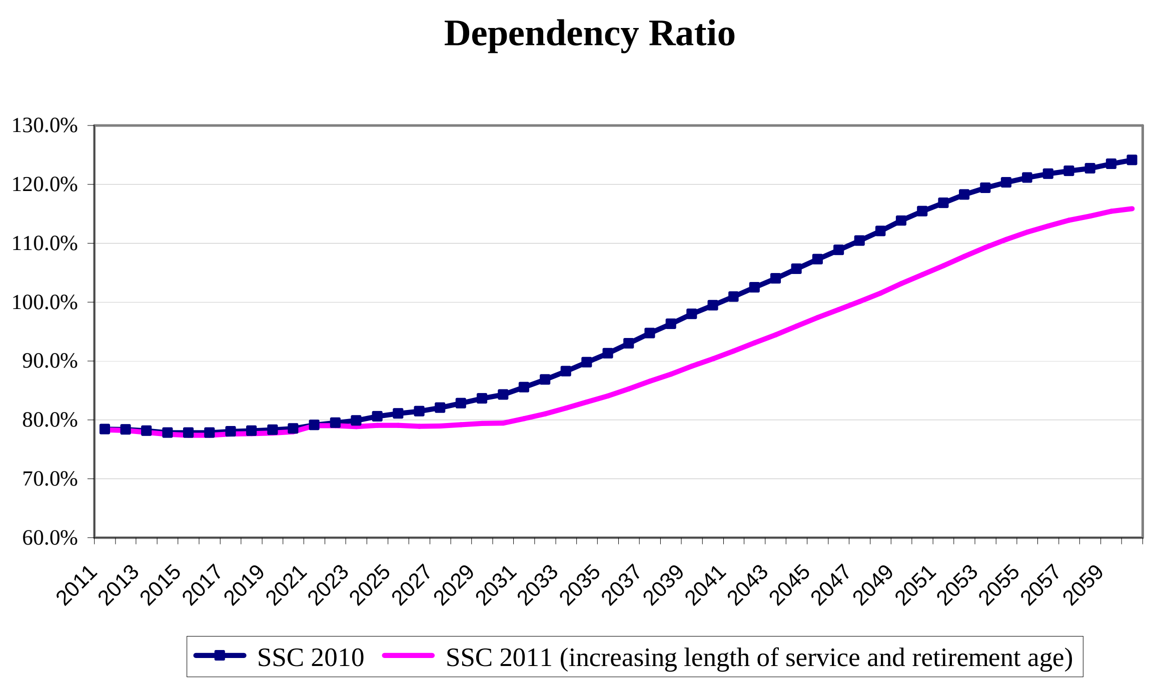
- In the 2011 SSC scenario, the dependency ratio (DR)[43] is lower as compared to the 2010 SSC.

In the 2010 SSC scenario, the DR level remains within the range of 80% by 2023, and in the 2011 SSC scenario this is shifted until 2031, since the retirement age increases to 65 for men and 63 for women. In the long term, however, the continuing low fertility rates and the increasing life expectancy find expression in an increase in the dependency ratio. And yet, while in the 2010 SSC scenario it grows to 124% in 2060, in the 2011 SSC it grows to 115%.

- From the additional simulations, only the increase in the length of service and the retirement age push down the dependency ratio, which is reflected in the 2011 SSC scenario (Figure 12).

[43] The ratio between the number of pensioners and the number of socially insured people.

**Figure 12. Dependency ratio (2011–2060) (%)**



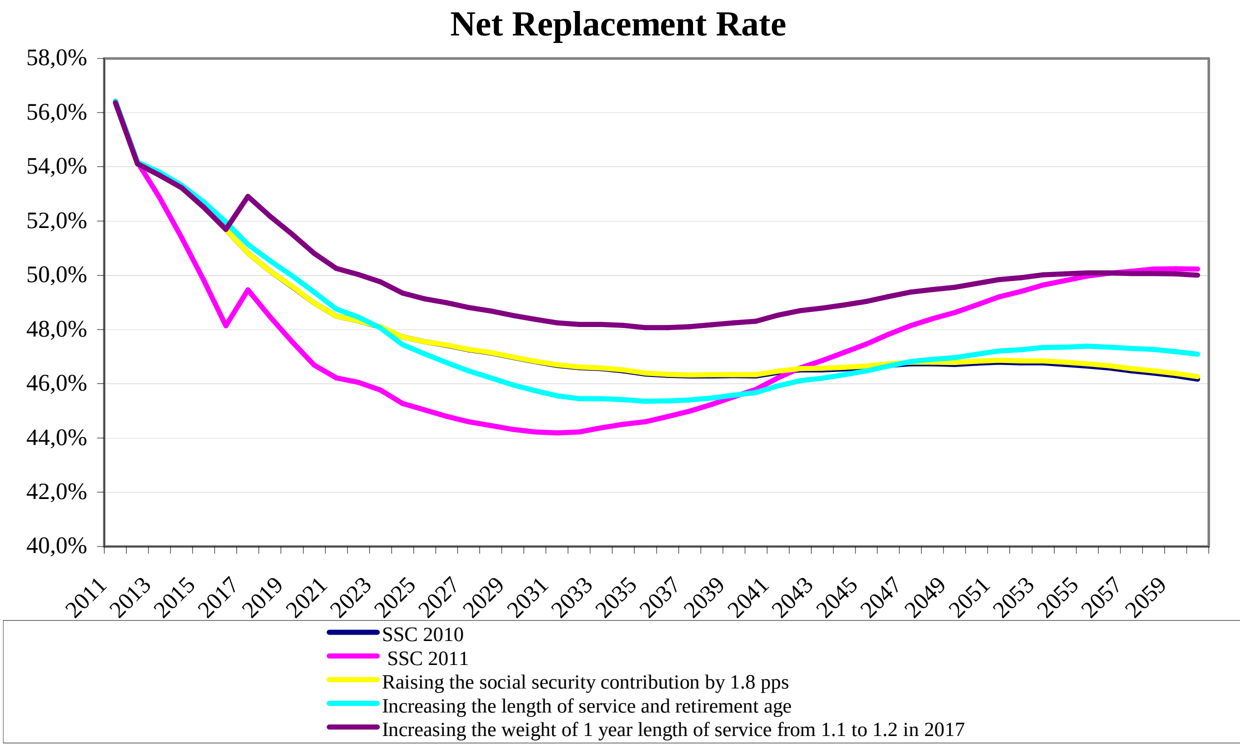

*Source: NSSI, MF forecasts*

The upward trend of the dependency ratio is accompanied by a long-term downward trend of the income replacement rate[44]. The replacement rates for the first pillar are expected to gradually decline, since the formula for calculating pensions changes from using an average value for the last insured period to using an average value for the entire insured period, and because of the decrease in the amount of the first-pillar pension when a second-pillar pension is also received. The larger the social security contribution to the second pillar, the greater the decrease in the first-pillar pension will be. The net replacement rates are proportionally higher by about 12%.

In order to improve the adequacy of pensions a special measure in the amendment of the SSC in force as of 2011, is envisaged – as of 2017 the weight of each year length of service will increase to 1.2. Thus, 37 years length of service are automatically equal to 44.4 points, and 40 years will be equal to 48 points. The objective is the net income replacement rate from the first and the second pillars to reach 65% in 2025.

[44] The ratio between the average pension and the average insurance income.

**Figure 13. Net replacement rate of gross income from the first pillar, 2011–2060**




*Source: NSSI, MF forecasts*

In the 2011 SSC scenario the gross income replacement rate[45] is expected to decrease more substantially during the first years of the projection, to increase considerably in 2017 as a result of the change in the weight of 1 year length of service, to continue declining by 2030 and after that to gradually and consistently increase by the end of the forecast period (2060). The reasons represent a combination of the pension indexation, the weight of 1 year length of service and the longer stay on the labour market, which results in the accumulation of insurance rights over a longer period of time.

The increase in the social security contribution to the "Pensions" Fund does not have an impact on the gross income replacement rate, which indicates the lack of links between the amount of the social security contribution for state pension and the amount of the pension itself.

The increase in the length of service and of the retirement age has different impacts on the gross income replacement rate during the different years of the period concerned.

The increase in the weight of 1 year length of service has the strongest impact on the gross income replacement rate. Almost during the entire period, under the basic version of the 2011 SSC, the gross income replacement rate is below the level achieved in the version with an increase only in the weight of 1 year length of service, but at the end of the period the rates from both versions become equal. It could be therefore concluded that a moderate pension indexation and strengthening the links between the social security contribution and

[45] Average pension to average insurance income.

the pension amount is possible without negatively affecting the financial stability of the state pension system.

## 6.3 Strengthening the Second and Third Pillars of the Pension System

Following the initiative of the Financial Supervision Commission measures for strengthening the second and the third pillars of the pension system are being discussed. This involves major amendments to the statutory regulations towards risk-based supervision, introducing more rigorous requirements on risk assessment, risk management and risk reporting on part of pension funds, as well as more stringent supervisory requirements on them.

# 7 INSTITUTIONAL FEATURES OF PUBLIC FINANCES

## 7.1 Implementation of the National Fiscal Rules

Despite the fact that the 2010 budget was prepared in taking into account the challenges and difficulties facing public finances due to the deteriorated economic environment and the uncertainty regarding the development of the global economy, at the beginning of July 2010 changes to the defined budgetary parameters and adoption of a Law on the amendment of the Law on the State Budget of the Republic of Bulgaria (LALSBRB) for 2010 on part of the National Assembly became necessary. The latter took into account the factors related to changes in the structure of some macroeconomic indicators, which pushed for restructuring the expenditures among the individual sectors, in order to balance the impact and burden of the crisis. With the adoption of this law by the National Assembly, the implementation of the rule from the previous Medium-term Fiscal Framework (MTFF) 2010–2013 for maintaining of a balanced budget, excluding the funds from the European Funds and Programmes, until 2013, was discontinued.

In the 2010 Law on the State Budget of the Republic of Bulgaria, for the first time after 5 consecutive years, a deficit under the CFP on cash basis in the amount of 0.7% of GDP was planned. With the 2010 LALSBRB the fiscal framework was changed. The deficit under the CFP was raised to 4.5% of the projected GDP, which comprises a deficit of 3.8% of the projected GDP under the national budget and a deficit of 0.8% of the projected GDP under the European Funds.

This also made it necessary to subsequently transform the fiscal rule concerning the balance; the new rule sets an objective of gradual decrease in the deficit under the CFP - it should fall below 3% of GDP in implementing the Stability and Growth Pact budget deficit criterion already in 2011.

With regard to the fiscal rules concerning the size of the public sector, the budget balance and the level of consolidated debt as a percentage of GDP, applied over the last years, the government increases their constraining role and prepares the necessary legislative amendments for their approval. The changes in the national fiscal rules aim at ensuring possibilities for fast economic recovery and effective protection of and support for the vulnerable social groups while pursuing rigorous fiscal discipline. Table 13 presents the development of the national numerical fiscal rules.

**Table 13: Development of the fiscal rules**

| INCOME | Until (including) 2011 | 2012 – 2014<br>DRAFT TBP |
|---|---|---|
| **Start of implementation** | No rule is applied | as of 2012 |
| **Grounds** | | Draft Pact for Financial Stability |
| **Scope** | | New types of taxes on incomes or profits and changes in the tax rates of the existing taxes on income or profits |
| **Target value** | | No target value is applied<br>Laws establishing new types of taxes on incomes or profits, or changes to the tax rates of the existing taxes on incomes or profits must be adopted with a majority of two-thirds of all Members of the National Assembly |
| **Time scope** | | Long-term |

| EXPENDITURE | 2009 | 2010 | 2011 | 2012 – 2014 DRAFT TBP |
|---|---|---|---|---|
| **Start of implementation** | as of 2006 | | | as of 2012 |
| **Grounds** | Government Programme | | | Draft Pact for Financial Stability |
| **Scope** | Consolidated expenditure | No numerical expenditure rule is applied | | Consolidated expenditure |
| **Target value** | 40% of GDP | | | up to 40% of GDP |
| **Time scope** | Annually | | | Annually |
| **BUDGET BALANCE** | **2009** | **2010** | **2011** | **2012 – 2014 DRAFT TBP** |
| **Start of implementation** | as of 2006 | as of 2010 | as of 2010 | as of 2012 |
| **Grounds** | Three-year Budget Forecast | Three-year Budget Forecast | Three-year Budget Forecast | Draft Pact for Financial Stability |
| **Scope** | Consolidated fiscal programme | The funds from the European Funds and Programmes are excluded from the CFP | Consolidated fiscal programme | Consolidated fiscal programme |
| **Target value** | Positive budget balance | Balanced national budget | Balance under the CFP – deficit of up to 2% of GDP | Balance under the CFP – deficit of up to 2% of GDP |
| **Time scope** | Annually | Annually | Annually | Annually |
| **DEBT** | **2009–2014** | | | |
| **Start of implementation** | as of 2003 | | | |
| **Grounds** | Law on Government Debt | | | |
| **Scope** | Consolidated government debt | | | |
| **Target value** | 60% of GDP | | | |
| **Time scope** | Annually | | | |

As of the beginning of 2011 the Ministry of Finance focuses on the preparation of new rules, incorporated in the so-called "Pact for Financial Stability", which to ensure the macroeconomic and financial stability of the country in the long term. The measures in the Pact are along three main directions. The first concerns the size of the public sector and is related to limiting the redistribution role of the state to 40% of GDP. The second concerns the budgetary position and sets a maximum admissible annual budget deficit (in ESA 95 terms) of not more than 2% of GDP. The third direction concerns the tax policy related to the direct taxes - the main measure envisages that Laws establishing new types of taxes on incomes or profits, or changing the tax rates of existing taxes on incomes or profits must be adopted with a majority of two-thirds of all Members of the National Assembly.

## 7.2 Budgetary procedures

The amendment in the 2010 Law on the State Budget of the Republic of Bulgaria made it necessary to amend the decree on its implementation, which was approved by the Council of Ministers within the deadlines envisaged in the Law on State Budget Procedures..

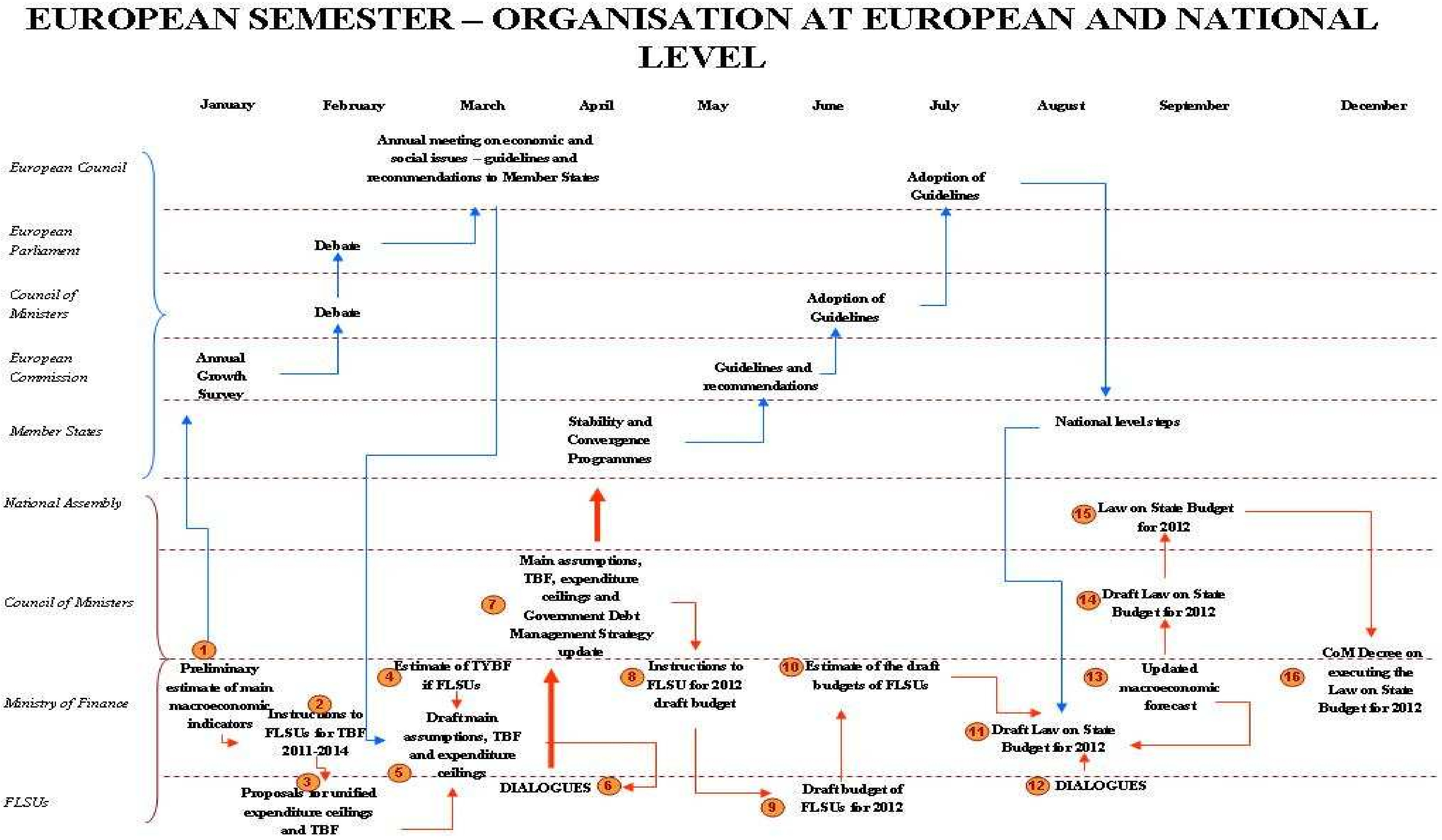
The adoption of these two statutory instruments did not result in significant changes in the steps planned in accordance with the Decision on the 2011 budgetary procedure, but had an impact on the basis for the development of the medium-term main assumptions for the period 2011–2013, the three-year budget forecasts and the expenditure ceilings of the FLSUs, excluding municipalities, and the Draft Law on the 2011 State Budget.

The 2011 budget was developed in line with the expenditure ceilings and main assumptions for the period 2011–2013 with regard to the tax and social security policy, the income policy, the public expenditure and the fiscal targets regarding the budget balance, adopted with a Council of Ministers Decision as of 29 July 2010. This way the first two stages of the budgetary procedure were unified.

By 2010 all governments complied with the deadline for submitting the draft state budget to the National Assembly, set in the Law on the State Budget Procedures – 31 October. Already in the first week of September 2010 the Ministry of Finance finalised the dialogues with the spending units on the draft 2011 budget. This allowed the government to fulfil the commitment made in the end of the spring of 2010, of submitting the Draft LSBRB at the National Assembly for discussion and approval before the deadline, and to be one month ahead of the deadline set in the Law on State Budget Procedures and the Council of Ministers Decision on the 2011 budgetary procedure. This provided more time for political debate as well as for predictability for the business and households with regard the economic situation and developments in 2011.

The 2012 budgetary procedures preserves the good practices introduced before, which concern the rules, responsibilities and “top-down” approach to decision-making process.

**Figure 14. Integrating the "Europeans Semester" in the 2012 national budgetary procedure**



A new important moment in the 2012 budgetary procedure is the integration of the European Commission initiative “European Semester” (Figure 14), which aims at reinforcing and strengthening the economic governance and the Member States f economic, fiscal and budgetary policies coordination by deepening and broadening the scope of the EC fiscal surveillance procedures.

This will allow for achieving a coherence between the three-year budget forecast and the expenditure ceilings for the period 2012–2014 with the commitments under the National Reform Programme of the Republic of Bulgaria (2011–2015) in pursuance of the Europe 2020 Strategy and the current Convergence Programme.

The main change in the 2012 budgetary procedure is the bringing forward of the main deadlines related to the adoption by the government of the three-year budget forecast and the expenditure ceilings of FLSUs, excluding municipalities, for the period 2012–2014 as key documents for the drafting of the 2012 budget.

Precisely this created the need for restructuring the steps and undertaking a two-staged budgetary procedure – preparation and approval of the three-year budget forecast and expenditure ceilings of FLSUs, except for municipalities, for the period 2012–2014 and of the update of the Government Debt Management Strategy, and drafting the 2012 Law on the State Budget of the Republic of Bulgaria and adopting the decree on its implementation.

The main tasks related to increasing the quality of public finances will focus on improving the principles and norms for compliance with budgetary discipline at all stages of the budgetary process, including widening the scope of the rules and standards for making commitments for expenditures, and improving the financial management and control. The efforts for improving the processes and enhancing the quality of public finances by extending the practice of using indicators for assessing the effects of and for systematic assessments of the costs and benefits of government programmes and policies, will continue.

The 2012 budgetary procedure is consistent with the projected financially-economic characteristics for 2011. The main components of the procedure, introduced over the last few years, were preserved. This aims at maintaining the stability and continuity of the processes and procedures for financial resources allocation and management. The main rules in the 2012 budgetary procedure are:

- Using the basic budgetary documents from the previous period, approved by the National Assembly and the Council of Ministers, as a basis for the development of the three-year budget forecasts (including by policies) and the expenditure ceilings for first-level spending units (FLSUs), excluding municipalities, for the period 2012–2014;
- Using the adopted during the first stage of the budgetary procedure fiscal and budgetary documents, the information on the current and expected budget execution, the updated forecast of the main macroeconomic indicators, as well as the guidelines and recommendations of the European Commission regarding the policies under the 2012 budget, as a basis for drafting the 2012 Law on the State Budget of the Republic of Bulgaria;
- Developing the government policies which will be included in the 2012 budget in line with the measures of the Programme of the Government of European Development of

the Republic of Bulgaria for the period 2009–2013, the National Reform Programme and the National Strategic Reference Framework;

- Ensuring conformity of the proposals for new investment projects for which financing agreements for external and domestic loans are to be concluded in 2012 and/or government guarantees are to be provided in 2012, with the requirements of the Ordinance on the Requirements to the Investment Projects Financed with Government Loans and the Projects Applying for Financing by a Sovereign Guarantee, and on the Procedure for their Consideration, adopted with Council of Ministers Decree No. 28 of 2003 (Promulgated, SG, No. 15 as of 2003; amended, SG, No. 27 of 2005).

## 7.3 Other Institutional Changes Related to Public Finances and Improving the Collection Rate of Tax Revenues

### *7.3.1 NRA*

New functions, structure and work organisation of the National Revenue Agency (NRA) were introduced as of the beginning of 2010 with the transfer of the functions and activities of the former State Receivables Collection Agency (SRCA). Before SRCA merger to NRA, SRCA personnel was reduced by 12% and NRA staff numbers - by 8%. At the same time NRA reduced the number of its Territorial Directorates (TDs) from 29 to 6[46] and its management levels - from 3 to 2. Four directorates for “Medium-sized Taxpayers and Social Security Contributors” (MTSSC) were established. New criteria for identifying the companies serviced by the LTSSC Directorate and the MTSSC Directorates were introduced in order that they can cover about 65% of the total revenue collected by NRA. Since the beginning of 2011 a structural unit at NRA’s TD LTSSC of for providing services to, control over and collecting the tax payments and social security contributions of large taxpayers – natural persons, was established.

The expected benefits of these changes are: increased collection rate thanks to focusing on large and medium-sized taxpayers and social security contributors; reduced corruption pressure on the personnel; flexibility in the resource allocation among the different directorates and allocating the available resources to the most significant risks; better management of control, communication and reporting.

In order to improve the effectiveness of collection of taxes and mandatory social security contributions, NRA undertakes a number of measures like centralising the management and audits’ assignment processes, strengthening the control over important for the treasury subjects, including focus on the current control and timely VAT refund, as well as carrying out mainly probes of compliance with tax and social security legislation, including increased presence in retail objects during the active tourism season, where the objective is, by the so-called “monitoring of sales”, to establish the actual turnovers of the retail objects. With the amendments to the Ordinance No. N-18 on the establishment of a constant connection between the fiscal devices and NRA server, a possibility for a much more efficient current and preventive control and for reducing the time necessary for physical monitoring of the objects of indebted people and entities, was created. The programme for control based on the information received via the remote connection between the fiscal

[46] 5 TDs with territorial coverage and one Directorate “Large Taxpayers and Social Security Contributors” (LTSSC) with a national coverage.

devices and the NRA was launched at the end of 2010, when the remote connection between the NRA information system and the fiscal devices of petrol filling stations was established. By 30 September 2011 this obligation will become mandatory for all retailers registered under the Law on VAT, and by 31 March 2012 – for all remaining retailers. Actions for increasing the audits effectiveness and for investigating special cases related to attempts at fraudulent and illegal practices, causing losses to the treasury, through administrative prosecution and partnership with the law-enforcement and security authorities, are being undertaken.

After the SRCA merged into the NRA, a full review was undertaken and actions were planned for improving the processes of administering private state receivables, participation and representation of the state in bankruptcy/insolvency proceedings, as well as in the sales of goods seized to the benefit of the state.

Under the Strategic Plan for the period 2011–2015 the measures related to providing better services to clients and for encouraging voluntary compliance, which are the main source of revenues, continue being priority. The other main priorities are for more efficient and effective tax and social security control and detecting tax frauds, and last, but not least, developing motivated human resources for achieving the objectives of the revenue administration.

### *7.3.2 Customs Agency*

The administrative reform in the Customs Agency started at the end of 2009 and continued throughout 2010. Amendments were adopted to the Law on Customs, finding expression in changes in the structure and organisation of the customs administration.

In order to optimise the structure and composition of the customs administration and to strengthen the capacity of units performing priority activities, and to coordinate the work of the customs authorities, amendments to the Statutes of the Customs Agency were made with CMD No. 166 of 06.08.2010. Pursuant to these amendments, the number of the Agency's staff was further reduced from 3 370 to 3 337 people, and that of the Central Customs Department – from 664 to 643. Thus, the total number of the Agency's staff was reduced by about 14.5%.

The ensuring of uninterrupted working capacity of the customs information systems is of importance for performing the commitments of the Agency in its capacity of customs administration of a EU Member State and participant in the “Electronic Customs” Initiative of the EU, as well as for implementing the measures for safety and security.

In 2010 new versions of the Customs Agency Internet portal were introduced, which enable the electronic submission of documents - New Computerised Transit System (NCTS), System for Control of Imports and the remaining modules of the Bulgarian Integrated Customs Information System (BICIS). By the end of January 2011, via electronic submission of documents in the customs and excise field, 3 550 registrations of natural persons, legal entities and sole proprietors were made.

**Box 1. Legislative amendments**

**Amendments to the Law on the Excise Duties and Tax Warehouses and to the Regulation on its implementation**

In 2010 two draft Laws on the amendment of the Law on the Excise Duties and Tax Warehouses were prepared and passed by the National Assembly and promulgated in the State Gazette, No. 55 of 20.07.2010 and No. 94 of 30.11.2010 (LALEDTW).

In order to improve the administrative regulation and to improve the tax collection, and in accordance with the Law on Limiting Administrative Regulation and Administrative Control on Economic Activity (LLARACEA), amendments were adopted to the LALEDTW[47] and the Regulation on its implementation. The amendments also aimed at improving the customs control, as well as at restricting the activity of the informal sector of the economy in the trade with excise goods. The zero rate of the excise duty on biodiesel used for heating purposes, was repealed. Another change for facilitating business and for reducing the corruption pressure on administration was the creation of possibility for using a combined between a bank guarantee and a money deposit collateral[48].

The second LALEDTW also regulated the conditions and procedure for issuing permits for trade in tobacco products. In order to optimise the process of administering excise duties, the possibility for the entities to submit their excise declarations electronically was introduced. In order to improve the customs control with a view to restricting the informal sector in trade in energy goods, on which a lower rate is levied or which are exempt from excise duties, was introduced the requirement that when transporting labelled energy products on the territory of Bulgaria, the entities shall install a global positioning system (GPS) on the transport vehicles at their expense, and that the shipment containers shall be equipped with measuring devices, meeting the requirements of the LEDTW, the Law on Measuring, and the statutory instruments implementing these laws.

**Amendments to the Law on the Value Added Tax**

In connection with Council Directive 2009/69/EC as of 25 June 2009, amending Directive 2006/112/EC on the common system of value added tax with regard to tax evasion linked to imports, the Customs Agency initiated an amendment to the provisions of Article 58, paragraph 1, sub-paragraph 6, letter “c” of the Law on the Value Added Tax (LVAT). It was related to the implementation of “allowing a free circulation” regime and, in particular, the “Simultaneous admission to free circulation and end consumption of goods which are subject to an VAT exempt deliveries to another Member State” regime. In this regard, the Customs Agency proposed a sample declaration which serves as evidence that the imported goods are intended for transportation or shipment to another Member State, which will be included as Annex No. 24 to the Regulation implementing the LVAT.

### *7.3.3 Control over the work of the state administration*

The establishment of a joint Inspectorate became possible with the Law on the amendment of the Law on Customs, Law on the amendments to the Law on the National Revenue Agency, by the amendments to the Statutes of the Ministry of Finance and of the Statutes of the Customs Agency.

In 2010 the Inspectorate carried out 27 planned inspections in pursuance of the 2010 Operational Plan on its activities and 96[49] (ad-hoc) inspections upon signals. Since the beginning of 2010 7 signals related to corruption behaviour of civil servants in SLSUs have

[47] Promulgated, SG, No. 94 as of 30.11.2010. The objective is the legal provisions to be achieved with fewer limitations and burdens for the taxable persons.

[48] Before the amendments in the law the collateral could be provided only in the form of a bank guarantee or only in the form of a money deposit.

[49] Breach of internal rules on the work organisation – 6 inspections; Breach of official duties and the Labour Code by officials in the public administration – 16 inspections; Illegal or wrong actions or omissions by officials - 70 inspections; Corruption of civil servants – 4 inspections.

been notified to the Inspectorate. Of these, 4 signals[50], which are not anonymous, were considered. With regard to the remaining 3 signals, related to corruption behaviour of civil servants in SLSUs, it was established that they are anonymous and no proceedings were opened on the grounds of Article 111, paragraph 4 of the Administrative Procedure Code.

Two signals of conflicts of interest were received, **relating to officials of SLSUs, as a result of which, pursuant to Article 25 of the Act on Prevention and Detection of Conflicts of Interest (LPDCI) the signals were sent to the appointing authority for carrying out an inspection.**

The inspections specified above (planned and based on signals) were carried out at the Ministry of Finance, the Customs Agency, the State Commission on Gambling and the National Revenue Agency.

In 2011 inspections in the Ministry of Finance and the SLSBA are planned:

- For compliance with the legislation regarding the work organisation and the activities performed in the structures inspected for the purpose of curbing negative phenomena and improving the activity of the administration of the Ministry of Finance and the SLSUs;
- On signals and proposals against illegal or incorrect actions or omissions on part of officials in the administration of the Ministry of Finance and the SLSUs;
- For compliance with the laws, secondary legislation and internal regulation on the work organisation on part of the officials of the Ministry of Finance and the SLSUs;
- For collecting and analysing information and performing own-initiative inspections for establishing violations and possible corruption practices by officials of the Ministry of Finance and the SLSUs;
- Follow-up inspections for compliance with the recommendations and proposals made by the Inspectorate.

Activities are also planned for:

- Reporting to the minister on the results from the carried out inspections and making proposals for eliminating the established omissions and violations.

[50] 1. In connection with the statements made in signal with incoming No. 94-00-677/16.04.2010, the Inspectorate sent a letter to the Chairperson of the Sofia Regional Prosecutors Office with a copy of the received signal enclosed. The person who made the signal was informed of the actions undertaken via a letter.
2. In pursuance of Order No. ZMF – 627/19.05.2010 of the Minister of Finance the Inspectorate carried out an inspection on signal with incoming No. 16-05-104/05.05.2010. A report on the results from the inspection was submitted to the Minister with outgoing No. 16-05-104 of 24.06.2010.
3. In pursuance of Order No. ZMF-1203/04.10.2010 of the Minister of Finance an inspection was carried out on a received signal for smuggling through two customs points. A report to the Minister of Finance with outgoing No. 93-18-68/28.10.2010 was prepared, in which the results from the inspection carried out were presented.
4. In pursuance of Order No. ZMF – 1423/03.11.2010 of the Minister of Finance the Inspectorate carried out an inspection on signals with incoming No. 94-00-2133/25.10.2010 and with incoming No. 26-00-2627/21.10.2010. The results are revealed in a report to the Minister of Finance with outgoing No. 94-00-2133/18.11.2010. A copy of the report was sent to the Chairperson of the Sofia District Prosecutors Office with letter with outgoing No. 94-00-2133/25.11.2010, and a reply with outgoing No. 94-00-2133/10.12.2010 was prepared to the person who made the signals.

- Carrying out activities related to assessing the corruption risk and to proposing measures for limiting the established vulnerable points in the administration of the Ministry of Finance and the SLSUs.
- Initiating proposals for amendments to statutory regulations with regard to omissions, weaknesses and errors in the activities of the administration of the Ministry of Finance and the SLSUs, established in the course of the inspections.
- Coordination and interaction with the "Chief Inspectorate" Directorate at the Council of Ministers, the other Inspectorates under Article 46 of the Law on Administration, the ombudsman, as well as with other authorities and structures of the legislative, executive and judicial authorities and with non-governmental organisations, within its powers.

### *7.3.4 Coordination and harmonisation of the financial management and control and internal audit in public sector organisations. Improving the control over the expenditure of public enterprises*

In April 2010 the Council of Ministers discussed **Measures for enhancing the efficiency in granting concessions**. The Ministry of Finance supported the initiative for legislative changes in the concessions field in order to optimise the process and to ensure higher effectiveness and efficiency in the implementation of investment projects and the related public expenditures. Later on proposals were made for **amendments to the Regulation on the implementation of the Law on Concessions**, which are expected to be adopted in 2011. The amendments concern mainly the planning of the financing of the activities related to state concessions, the minimum requirements (scope and contents) for the elaboration of financial and economic analyses as part of concession analyses, among others.

The **Law on Public-Private Partnership** is in process of public consultation and by the end of June 2011 it is to be adopted. The law defines a clear definition of the term "public-private partnership", outlines the main principles for its implementation, as well as defines the different legal forms of PPPs. The law enforcement will provide for easing the procedures for granting different forms of PPPs, as well as for attracting more private capital for the provision of public services.

In June 2010 the Council of Ministers adopted a **Decree on the monitoring and control of the financial condition of state enterprises and commercial companies with over 50% state ownership in the capital and the companies that they control**[51]. The Decree introduces a new mechanism for monitoring and control of the financial results, the financial discipline and fiscal risk of the business entities with state ownership, subject to monitoring. Under this mechanism, the commercial companies subject to control shall provide information to the line ministers and heads of institution within their sectoral competence. The latter, on their part, shall provide the same information to the Minister of Finance for publishing on the internet site of the Ministry of Finance.

The Ministry of Finance prepared and sent to the ministers, representing the state in the commercial companies and state enterprises advisable "**Guidelines on the implementation of best practices in the selection of contractors for providing financial services from financial or credit institutions pursuant to the Law on Credit Institutions**", with a

[51] CoM Decree No. 114 of 10.06.2010

proposal regarding the deadline for their introduction. The guidelines aim at creating prerequisites for a more efficient financial resources management of the commercial entities and at improving the conditions and effectiveness of the used financial services.

## 7.4 Fiscal Decentralisation

Improving the control over the municipalities' expenditure is reflected in the provisions of the yearly Laws on the State Budget of the Republic of Bulgaria (LSBRB). Both in 2010 and 2011 it was provided that the realised at the end of the year savings of expenditures for the delegated by the state activities, shall remain as a transitional balance in the municipality budget and shall be used to finance the same activities.

With the yearly LSBRB **a mechanism** for allocating the general balancing subsidy and the special-purpose subsidy for capital expenditures among the municipalities is being prepared and defined. The main objectives of this mechanism are the optimisation of the process of provision of funds from the central budget to the municipalities in the form of subsidies to and, at the same time, guaranteeing a minimum level of the services provided to the population, as well as creating conditions for efficient utilisation of the resources for rehabilitation and maintenance of the municipal infrastructure.

The financing of the delegated by the state activities is similar. Through the elaboration of **standards** for their financing, approved every year with a Council of Ministers Decision (for 2011 No. 715/01.10.2010, amended with CMD No. 850/29.11.2010), the municipalities are being guaranteed an optimal financing for the specified in the Decision activities and the inexpedient expenditures are limited while maintaining the quality of the public sector services.

The provision of § 82 of the Transitional and Final Provisions of the 2011 LSBRB amended the Law on the Municipal Debt. The amendments create conditions for limiting the expenditure and reducing the municipalities indebtedness. The possibilities for assuming long-term municipal debt are limited as long as the Municipal Council cannot decide to assume long-term municipal debt after the expiry of 39 months from its election.

It is regulated that since 1 January 2011 the annual debt payments in each year cannot exceed 15% of the total own revenues and the total balancing subsidy under the last audited annual financial report on the municipal budget execution. The municipalities, which annual servicing payments under the debt assumed by 31 December 2010, exceeds 15% of the total own revenues and the total balancing subsidy under the last annual financial report on the municipal budget execution, cannot assume new debt until this ratio is achieved.

The restriction of the annual debt payments does not apply to the debt assumed by municipalities to the Fund for Local Authorities and Self-Government FLAG EAD and the debt assumed under the "Loan Agreement for Structural Programme Loan (Bulgaria, co-financing under the EU Funds 2007–2013) between the Republic of Bulgaria and the European Investment Bank" (pursuant to §15 of the Transitional and Final Provisions of the 2011 LSBRB), nor to the loans bearing no interest from the central budget for financing expenditure on their recovery under projects approved under programmes co-financed by the EU (pursuant to Article 12, paragraph 3 of the LMD).

The 2010 LSBRB stipulates that the cash receipts from the sale of municipal non-financial assets can be used only for financing the development and general repairs of social and technical infrastructure. The LALSBRB for 2010 this provision was extended with the possibility to use these receipts for repaying loans used for financing projects for social and technical infrastructure, including the temporary loans bearing no interest from the central budget for financing of projects under the SAPARD Programme. In the 2011 LSBRB the scope of the possible financing was expanded to cover expenditures on current repairs. This restriction aims at avoiding the municipal assets decapitalisation.

Limiting of the municipalities expenditures in 2010 is also regulated in the Decree on the execution of the State Budget of the Republic of Bulgaria for the corresponding year. The provided during the corresponding quarter funds for the specialised institutions and social services in the EC, which have been declared but not established, shall be returned to the central budget.

Restrictions were also envisaged, both in 2010 and 2011, on the financing of facilities with the special-purpose subsidy for capital expenditure, approved with the annual budget law – this subsidy was not allowed to be used for purchasing vehicles for the municipal administration, office furniture, air-conditioning for the administrative buildings, and mobile phones.

Since 2008 all municipal schools implement the system of delegated budgets. Pursuant to the 2010 and 2011 LSBRB the municipalities were obliged to apply formulas for the funds allocation to education to individual school, kindergarten and servicing unit level.

During the 2011 budget preparation, the Ministry of Finance recommended to the municipalities that an assessment and analysis on the possibilities for including on the expenditure side funds for repayment of overdue liabilities from prior years (especially where transitional balances are available), to be carried out. The estimated by the municipalities actual receipts from overdue claims also shall be included in the budget.

# 8 MEASURES AND POLICIES IN RESPONSE TO THE EXCESSIVE DEFICIT PROCEDURE

The consequences of the economic decline and the increase in expenditure stemming from the serious commitments made by the previous government before the parliamentary elections in the middle of 2009 resulted in a deterioration of the public finances in Bulgaria. This, in combination with the change to a growth, based on lower tax revenues, resulted in a budget deficit of 4.7% of GDP in 2009 as compared to a surplus of 1.7% in 2008[52]. Against this background, on 13.07.2010 the Council decided that an excessive deficit existed and made recommendations to Bulgaria, under article 126(7) of the TFEU, for corrective action to be taken by the end of 2011[53]. The Council set the deadline of 13 January 2011 for the Bulgarian government to take effective action and specify measures that will be necessary for correcting the excessive deficit.

**Box 2. Council recommendations to Bulgaria**[54]

(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 0.75% 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 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 EDP.

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 MTO for the budgetary position – a general government structural balance of 0.5% 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.

[52] Before the October notification, for 2008 and 2009 respectively a surplus of 1.8% and a deficit of 3.9% of GDP were reported. The main reasons for the difference compared to the final data include changes in methodology with regard to time-adjusted cash recording under certain tax revenue items, as well as some additional government liabilities which were not covered during the second half of 2010.

[53] All documents related to the excessive deficit procedure against Bulgaria can be found at: http://ec.europa.eu/economy_finance/sgp/deficit/countries/bulgaria_en.htm

[54] 11307/10 of 9.07.2010

The main priority of the fiscal policy in 2010 was to bring the deficit of the consolidated government back to sustainable levels. The fiscal target set in the updated fiscal framework (Law on the amendment of the Law on the State Budget of the Republic of Bulgaria for 2010 (LSBRB), passed on 17 July 2010) was that the government deficit (in ESA 95 terms) shall not exceed 3.8% of the projected GDP for the year. The underlying fiscal improvement compared to the previous year amounted to at least 0.8 pps of GDP. The fiscal consolidation measures in 2010 were set in the updated programme for the year as follows:

➢ On the revenue side, the rates of the main taxes remained unchanged.

This, on the one hand, ensured a predictable environment for business and investments and, on the other, was favourable for the gradual recovery of domestic demand and improved growth prospects. Meanwhile, the revenue administrations measures focused on increasing the revenue collection and combating the tax and customs frauds were prioritised;

➢ On the expenditure side:

- the non-interest expenditure of government authorities, ministries and institutions for 2010 were cut, and the expenditure and transfers/subsidies from the 2010 central budget were reduced by up to 20%; the budget appropriations to municipalities (except for the expenditure on education, social assistance and care, defence and security functions and the funds approved for environmental projects) was reduced by up to 15% on an annual basis. The reduced expenditure ceilings were included in the Law on the amendment on the LSBRB for 2010, passed by the National Assembly;
- in the cash-based fiscal framework resources in the amount of EUR 337.5 million for repayment of incurred from previous years liabilities were provided;
- the expenditures were restructured and optimised in order to achieve better absorption of the funds from the EU Funds and Programmes. In addition to the projects and programmes, co-financed with EU funds, additional national resources were allocated for investments in infrastructure;
- amendments to the Social Security Code (SSC) were made, among which postponing the planned increase of the pension supplement or the sum of pensions, received by the deceased spouse for 2010, postponing the planned increase in the supplements to pensions of people aged over 75 years and the surviving spouse, changes in the procedure for payment of compensation for temporary incapacity to work, etc.

In addition to the active measures for ensuring stability of the budgetary position at reaching the bottom of the economic recession and the already started during the second half of 2010 gradual recovery, focus was put on improving the statutory framework and increasing the managerial responsibilities financial management, implementation and control. Guidelines containing requirements for regular preparation and submission of detailed information about the commitments made and the accrued liabilities on part of the budgetary organisations to the Ministry of Finance, as well as recommendations for coordinating and regulating the information flows between the respective FLSUs, directly involved in making specific commitments in concluding contracts and agreements, decision-making, statutory instruments, as well as in control over their implementation, were approved. To this end, the maximum admissible levels of liabilities to suppliers and officials on long-term secondments as of 31 December 2011, were approved with the 2011 LSBRB Act for the government authorities, ministries and departments and autonomous budgetary organisations.

On 13.01.2011 Bulgaria sent to the European Commission a non-paper with information about the measures taken in response to the Council recommendations as of July 2010 on putting the excessive deficit situation to an end.

The revision of the budget in 2010 ensured:

- Decrease in the share of government expenditure by 3.6 pps of GDP.
- Strengthening the control over the NSSI expenditures.
- Strengthening the control over the NHIF expenditures.
- In the cash-based fiscal framework a reserve in the amount of EUR 337.5 million was earmarked to cover the incurred from previous years liabilities. Considerable efforts were made for repaying these liabilities, including through detailed audit of the contracts, payments, negotiations for restructuring, and cancellation of contracts, where necessary. A special mechanism for repaying the liabilities accrued as of the end of 2009 under the republican budget was defined and implemented through the Bulgarian Development Bank EAD. At the end of 2010 the largest part of the liabilities accumulated in 2009 were repaid.
- Tightening the fiscal discipline, improving the legal framework for the budget execution and monitoring over the budget execution, as well as enhancing the financial management and control systems.

## 8.1 Development of the Expenditure Side of the 2011 Budget – Continuing Fiscal Consolidation and Strengthening the Control

- Tighter control on FLSUs expenditures

The Law on the State Budget for 2011 provides for the Council of Ministers to set and update limits for the conclusion of contracts for the government authorities, ministries and institutions to conclude contracts. Measures for freezing the administrative expenditures, combined with administration optimisation, are also envisaged.

- Expenditure ceilings on the payroll in the line ministries

Keeping the 2010 nominal payroll levels and the defining individual remuneration in line with the remuneration reform in the public sector, are among the main priorities of the expenditure policy in the 2011 budget[55].

- Subsequent improvement of the public finance management procedures and rules.
- Keeping the maintenance expenditure and the capital expenditure at the levels of the updated 2010 budget.
- Reducing pensions and benefits and tightening their eligibility criteria.

[55] Linking the increase in individual remuneration of the people employed in the public sector to the labour productivity growth and the capacity of the economy and the budget.

- More stringent criteria for transfers to municipalities – only in case of unchanged approved budget; after 30.06.2011 funds can be transferred from one delegated item to another (except for education) only if there are no accumulated liabilities[56]. Municipalities can receive financing from the Fund for Local Authorities and Self-Government FLAG EAD of up to EUR 2 million if they are implementing projects co-financed by the European Funds[57].

## 8.2 Development of the Revenue Side of the Budget – Tax Policy and Social Security Policy

- Keeping the rates of direct taxes unchanged;
- Ongoing consistent transfer of the tax burden to the indirect taxes through increasing the rates of some excise duties as of the beginning of 2011 in line with the commitments to reach the minimum European levels;
- Introducing a 10% tax rate on the income of foreign legal entities, registered in preferential taxation zones, with a source in Bulgaria;
- Increasing the VAT rate on organised tourist services;
- Taxing the insurance premiums;
- Increasing the contribution rate to the “Pensions” Fund by 1.8 pps as of 2011;
- In 2011 the minimum insurance thresholds for the main economic activities and groups of professions were raised by 5.6% as compared to 2010. In 2011 the additional revenue of the NSSI from contributions is expected to amount to EUR 55 million.

The government also undertook a number of structural reforms in the pension, healthcare and social security systems, education and administration, which were targeted at supporting the fiscal consolidation and increasing the long-term sustainability of public finances.

The European Commission assessed the actions undertaken by the government on 27.01.2011. The assessment was based on the EC 2010 Autumn Economic Forecasts which include the budgetary measures set in the 2011 budget, as well as the additional information provided by the Bulgarian government at the end of December 2010 and in January 2011. The European Commission concluded that:

- The data on the 2010 state budget execution is expected to be in line with the Council Recommendation for achieving the budget deficit objective of 3.8% of GDP, which was set in the revised in July 2010 state budget;
- Bulgaria has ensured a fiscal effort of 0.75 pps of GDP and has taken effective actions for putting to an end the current excessive deficit situation by 2011;
- Bulgaria has achieved a certain progress in fiscal management and the government has undertaken certain initiatives to enhance public finances;

[56] § 31 of the Transitional and Final Provisions of the 2011 Law on the State Budget.
[57] § 41 of the Transitional and Final Provisions of the 2011 Law on the State Budget.

- The government, in cooperation with the social partners, has taken additional measures for reform the pension system in the medium and long term.

Against this background, the European Commission concluded that no further steps in the excessive deficit procedure are needed at present, but underlined that it will continue to closely monitor the budgetary developments in the country in accordance with the Treaty on the Functioning of the European Union and the provisions of the Stability and Growth Pact.

At its meeting on 3 February 2011 the Economic and Financial Committee – the preparatory body of the EU Economic and Financial Affairs Council (ECOFIN), unanimously approved the assessment of the European Commission.

Regarding the recommendation for taking more effective measures for strengthening the binding nature of the medium-term budgetary framework, the government plans to introduce new fiscal rules as of 2012 by amending the Law on the State Budget Procedures. These rules will ensure:

- institutionalisation of the binding nature of the medium-term fiscal frameworks;
- medium- and long term fiscal stability – setting medium-term numerical deficit targets (including in structural terms), debt and expenditure ceilings;
- more rigorous ex-ante control over the expenditures and liabilities of FLSUs and companies with state participation.

The overall government strategy for implementing prudent fiscal policy and ensuring sustainable fiscal position will be included in the future Pact for Financial Stability (described in detail in Section 7.1 of this Programme), which will be proposed for approval to the National Assembly in June.

# ANNEX 1: TABLES

*Table 1a. Macroeconomic prospects*

| | ESA code | 2010 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| | | **Level**[58] | **Rate of change** | **Rate of change** | **Rate of change** | **Rate of change** | **Rate of change** |
| 1. Real GDP[59] | B1*g | 36,033 | 0.15% | 3.60% | 4.10% | 4.40% | 4.20% |
| 2. Nominal GDP | B1*g | 36,033 | 3.15% | 7.24% | 6.96% | 6.98% | 6.49% |
| **Components of real GDP** | | | | | | | |
| 3. Private consumption expenditure | P.3 | 22,044 | -1.17% | 3.22% | 4.08% | 4.65% | 3.51% |
| 4. Government consumption expenditure | P.3 | 5,694 | -0.97% | 1.26% | 1.60% | 2.54% | 2.58% |
| 5. Gross fixed capital formation | P.51 | 8,460 | -16.50% | 5.59% | 6.50% | 7.47% | 7.59% |
| 6. Change in inventories and net acquisition of valuables (% of GDP) | P.52+P.53 | 1.4 | 1.1 | 1.5 | 1.5 | 1.5 | 1.5 |
| 7. Exports of goods and services | P.6 | 20,827 | 16.25% | 8.19% | 7.79% | 7.62% | 7.18% |
| 8. Imports of goods and services | P.7 | 21,512 | 4.53% | 7.82% | 8.16% | 8.48% | 7.30% |
| **Contributions to real GDP growth**[60] | | | | | | | |
| 9. Final domestic demand | | - | -5.66 | 3.48 | 4.44 | 5.08 | 4.47 |
| 10. Change in inventories and net acquisition of valuables | P.52+P.53 | - | 0.64 | 0.06 | 0.06 | 0.12 | 0.06 |
| 11. External balance of goods and services | B.11 | - | 5.16 | 0.06 | -0.40 | -0.80 | -0.33 |

[58] In EUR million.
[59] At 2010 prices.
[60] In percentage points.

*Table 1b. Price developments*

| | ESA code | 2010 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| | | **Level** | **rate of change**[61] | **rate of change** | **rate of change** | **rate of change** | **rate of change** |
| 1. GDP Deflator | | 100 | 3.00% | 3.51% | 2.75% | 2.48% | 2.19% |
| 2. Private consumption deflator | | 100 | 1.09% | 3.85% | 3.55% | 2.54% | 2.58% |
| 3. HICP[62] | | 100 | 3.04% | 3.85% | 3.35% | 2.64% | 2.43% |
| 4. Public consumption deflator | | 100 | 0.95% | 3.57% | 2.51% | 2.18% | 2.37% |
| 5. Investments deflator | | 100 | 1.83% | 3.76% | 2.11% | 2.71% | 1.80% |
| 6. Export price deflator (goods and services) | | 100 | 7.96% | 7.71% | 6.24% | 5.00% | 4.23% |
| 7. Import price deflator (goods and services) | | 100 | 4.56% | 8.04% | 6.55% | 4.97% | 4.34% |

[61] In percentage points as compared to the previous year.
[62] Optional for Stability Programmes.

*Table 1c. Labour market developments*

| | ESA code | 2010 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| | | Level | rate of change | rate of change | rate of change | rate of change | rate of change |
| 1. Employment (thousand people)[63] | | 3,505.8 | -5.9% | 0.2% | 0.7% | 0.9% | 0.6% |
| 2. Employment (million of hours worked)[64] | | 5,787.8 | -6.1% | 0.4% | 0.7% | 0.8% | 0.6% |
| 3. Unemployment rate [65] (%) | | 10.2% | 3.4[66] | -0.1 | -0.4 | -0.5 | -0.3 |
| 4. Labour productivity (Euro per person employed)[67] | | 10,278.2 | 6.5% | 3.4% | 3.4% | 3.5% | 3.6% |
| 5. Labour productivity (Euros per hour worked) [68] | | 5.7 | 6.7% | 3.2% | 3.4% | 3.6% | 3.6% |
| 6. Compensation of employees | D.1 | 13,166,525.5 | -0.2% | 8.0% | 7.3% | 7.9% | 6.2% |
| 7. Compensation per employee | | 5,197.0 | 7.2% | 7.7% | 6.5% | 6.8% | 5.4% |

[63] Occupied population, domestic concept, national accounts definition.
[64] National accounts definition.
[65] Harmonised definition, Eurostat; levels.
[66] The change of the unemployment rate, is in percentage points.
[67] Real GDP per person employed.
[68] Real GDP per one hour worked.

*Table 1d. Sectoral Balances*

| % of GDP | ESA code | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| 1. Net lending/borrowing vis-à-vis the rest of the world | B.9 | -0.2 | -0.7 | -1.7 | -2.1 | -1.8 |
| *of which:*<br>- Balance of goods and services | | -1.4 | -1.8 | -2.6 | -3.3 | -3.7 |
| - Balance of primary incomes and transfers | | 0.4 | -0.3 | -0.8 | -0.6 | -0.2 |
| - Capital account | | 0.8 | 1.4 | 1.6 | 1.8 | 2.0 |
| 2. Net lending / borrowing of the private sector | B.9 | 3.0 | 1.8 | -0.2 | -1.1 | -1.3 |
| 3. Net lending / borrowing of the general government | EDP B.9 | -3.2 | -2.5 | -1.5 | -1.0 | -0.5 |
| 4. Statistical discrepancy | | - | - | - | - | - |

*Table 2. General government budgetary prospects*[69]

| | ESA code | 2010 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|
| | | Level in EUR million | % of GDP | % of GDP | % of GDP | % of GDP | % of GDP |
| **Net lending (EDP B.9) by sub-sector** | | | | | | | |
| 1. General government | S.13 | -1,151 | -3.2% | -2.5% | -1.5% | -1.0% | -0.5% |
| 2. Central government | S.1311 | -865 | -2.4% | -2.4% | -1.8% | -1.4% | -1.0% |
| 3. State government | S.1312 | 0 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| 4. Local government | S.1313 | 127 | 0.4% | -0.3% | 0.3% | 0.4% | 0.5% |
| 5. Social security funds | S.1314 | -413 | -1.1% | 0.1% | 0.0% | 0.0% | 0.0% |
| **General government (S13)** | | | | | | | |
| 6. Total revenue | TR | 12,416 | 34.5% | 34.6% | 35.3% | 35.4% | 33.8% |
| 7. Total expenditure | TE[70] | 13,567 | 37.7% | 37.2% | 36.8% | 36.4% | 34.2% |
| 8. Net lending / borrowing | EDP B.9 | -1,151 | -3.2% | -2.5% | -1.5% | -1.0% | -0.5% |
| 9. Interest expenditure | EDP D.41 | 217 | 0.6% | 0.8% | 0.9% | 1.1% | 0.9% |
| 10. Primary balance[71] | | -934 | -2.6% | -1.7% | -0.6% | 0.0% | 0.4% |
| 11. One-off and other temporary measures[72] | | 0 | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Selected components of revenue** | | | | | | | |
| 12. Total taxes (12=12a+12b+12c) | | **7,205** | **20.0%** | **19.5%** | **19.7%** | **19.6%** | **19.6%** |
| 12a. Taxes on production and imports | D.2 | 5,359 | 14.9% | 14.4% | 14.6% | 14.3% | 14.3% |
| 12b. Current taxes on income, wealth, etc. | D.5 | 1,759 | 4.9% | 4.9% | 4.9% | 5.1% | 5.1% |
| 12c. Capital taxes | D.91 | 87 | 0.2% | 0.2% | 0.2% | 0.2% | 0.2% |
| 13. Social contributions | D.61 | 2,538 | 7.0% | 7.3% | 7.1% | 7.0% | 7.1% |
| 14. Property income | D.4 | 217 | 0.6% | 0.9% | 0.7% | 0.7% | 0.7% |
| 15. Other[73] | | 2,456 | 6.8% | 7.0% | 7.8% | 8.0% | 6.5% |
| 16=6. Total revenue | **TR** | **12 416** | **34.5%** | **34.6%** | **35.3%** | **35.4%** | **33.8%** |
| Tax burden (D.2+D.5+D.61+D.91-D.995)[74] | | 9,743 | 27.0% | 26.8% | 26.8% | 26.7% | 26.6% |
| **Selected components of expenditure** | | | | | | | |
| 17. Compensation of employees + intermediate consumption | **D.1+P.2** | **5,606** | **15.6%** | **14.3%** | **13.8%** | **13.2%** | **12.7%** |
| 17a. Compensation of employees | D.1 | 3,377 | 9.4% | 8.6% | 8.3% | 8.0% | 7.9% |
| 17b. Intermediate consumption | P.2 | 2,229 | 6.2% | 5.7% | 5.5% | 5.2% | 4.8% |
| 18. Social payments (18=18a+18b) | | **5,166** | **14.3%** | **13.6%** | **12.8%** | **12.3%** | **12.2%** |

[69] The data were updated as of February, the new data, required for filling in Table 2, were received on 1 April 2011. As a result of this delay the data in Tables 3, 4 and 7 have not been updated either.
[70] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[71] The primary balance is calculated as (EDP B.9, item 8) minus (EDP D.41 incl. FISIM, item 9), and the differences are due to rounding.
[72] A plus sign means deficit-reducing one-off measures.
[73] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).
[74] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 18a. Social transfers in kind supplied via market producers | D.6311, D.63121, D.63131 | 637 | 1.8% | 1.7% | 1.6% | 1.6% | 1.6% |
| 18b. Social transfers other than in kind | D.62 | 4,529 | 12.6% | 11.9% | 11.2% | 10.7% | 10.6% |
| 19=9. Interest expenditure | EDP D.41 | 217 | 0.6% | 0.8% | 0.9% | 1.1% | 0.9% |
| 20. Subsidies | D.3 | 456 | 1.3% | 1.2% | 1.2% | 1.3% | 1.1% |
| 21. Gross fixed capital formation | P.51 | 1,659 | 4.6% | 4.3% | 5.6% | 5.6% | 4.5% |
| 22. Other[75] | | 463 | 1.3% | 3.0% | 2.7% | 3.0% | 2.8% |
| 23=7. Total expenditure | TE (see footnote on line 7) | 13,567 | 37.7% | 37.2% | 36.8% | 36.4% | 34.2% |
| Government consumption (nominal) | P.3 | 5,694 | 15.8% | 15.5% | 15.0% | 14.7% | 14.5% |

[75] 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*

| In % of GDP | COFOG code | 2009 | 2014 |
|---|---|---|---|
| 1. General public services | 1 | 6.5 | 3.3 |
| 2. Defence | 2 | 1.3 | 1.1 |
| 3. Public order and safety | 3 | 3.1 | 2.1 |
| 4. Economic affairs | 4 | 4.0 | 5.8 |
| 5. Environmental protection | 5 | 1.2 | 1.5 |
| 6. Housing and community amenities | 6 | 1.4 | 1.0 |
| 7. Health | 7 | 4.3 | 4.1 |
| 8. Recreation, culture and religion | 8 | 0.8 | 0.6 |
| 9. Education | 9 | 4.4 | 3.4 |
| 10. Social protection | 10 | 13.6 | 11.5 |
| 11. Total expenditure (= item 7 = 23 of Table 2) | TE[76] | **40.7** | **34.2** |

[76] 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 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| 1. Gross debt[77] | | 16.2 | 16.4 | 19.0 | 17.4 | 17.1 |
| 2. Change in gross debt ratio | | 1.6 | 0.2 | 2.6 | -1.6 | -0.3 |
| **Contributions to the changes in gross debt** | | | | | | |
| 3. Primary balance[78] | | -2.6 | -1.7 | -0.6 | 0.0 | 0.4 |
| 4. Interest expenditure[79] | EDP D.41 | 0.6 | 0.8 | 0.9 | 1.1 | 0.9 |
| 5. Stock-flow adjustment | | -1.3 | -1.1 | 2.4 | -1.3 | 0.3 |
| *of which*: | | | | | | |
| - Differences between cash and accruals[80] | | -0.3 | -1.2 | 3.9 | -3.1 | 0.1 |
| - Net accumulation of financial assets[81] | | -0.9 | 0.1 | -1.4 | 1.9 | 0.2 |
| *of which: privatisation proceeds* | | 0.1 | 0.6 | 0.2 | 0.1 | 0.0 |
| - Valuation effects and other[82] | | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| Implicit interest rate on debt[83] | | 5.4 | 4.2 | 3.9 | 5.2 | 5.7 |
| **Other relevant variables** | | | | | | |
| 6. Liquid financial assets[84] | | | | | | |
| 7. Net financial debt (7=1-6) | | | | | | |

77 As defined in Regulation 3605/93 (not an ESA concept).
78 Cf. item 10 of Table 2.
79 Cf. item 9 of Table 2.
80 The differences concerning interest expenditure, other expenditure and revenues could be distinguished when relevant.
81 Liquid assets, assets in third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.
82 Changes due to exchange rate movements and operation in secondary markets could be distinguished when relevant.
83 Proxied by interest expenditure divided by the debt level of the previous year.
84 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 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| 1. Real GDP growth (%) | | 0.15 | 3.6 | 4.1 | 4.4 | 4.2 |
| 2. Net lending of general government | EDP B.9 | -3.2 | -2.5 | -1.5 | -1.0 | -0.5 |
| 3. Interest expenditure | EDP D.41 | 0.6 | 0.8 | 0.9 | 1.1 | 0.9 |
| 4. One-off and other temporary measures[85] | | 0 | 0 | 0 | 0 | 0 |
| 5. Potential GDP growth (%) | | 1.6 | 2.5 | 2.4 | 2.8 | 3.2 |
| Contributions: | | | | | | |
| - labour | | -0.8 | -0.1 | -0.3 | -0.1 | 0.1 |
| - capital | | 1.0 | 1.1 | 1.2 | 1.3 | 1.4 |
| - total factor productivity | | 1.4 | 1.5 | 1.5 | 1.6 | 1.7 |
| 6. Output gap | | -4.8 | -3.8 | -2.2 | -0.7 | 0.2 |
| 7. Cyclical budgetary component | | -1.56 | -1.1 | -0.64 | -0.21 | 0.06 |
| 8. Cyclically-adjusted balance (2-7) | | -1.64 | -1.4 | -0.86 | -0.79 | -0.56 |
| 9. Cyclically-adjusted primary balance (8+3) | | -1.04 | -0.6 | 0.04 | 0.31 | 0.34 |
| 10. Structural balance (8-4) | | -1.64 | -1.4 | -0.86 | -0.79 | -0.56 |

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

*Table 6. Divergence from previous update*

| | ESA code | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| Real GDP growth (%) | | | | | | |
| Previous update | | 0.30 | 3.80 | 4.80 | - | - |
| Current update | | 0.15 | 3.60 | 4.10 | 4.40 | 4.20 |
| Difference | | -0.15 | -0.20 | -0.70 | - | - |
| General government net lending (% of GDP) | EDP B.9 | | | | | |
| Previous update | | 0.0 | 0.1 | 0.1 | - | - |
| Current update | | -3.2 | -2.5 | -1.5 | -1.0 | -0.5 |
| Difference | | -3.2 | -2.6 | -1.6 | - | - |
| General government gross debt (% of GDP) | | | | | | |
| Previous update | | 14.6 | 14.5 | 14.4 | - | - |
| Current update | | 16.2 | 16.4 | 19.0 | 17.4 | 17.1 |
| Difference | | 1.6 | 1.9 | 4.6 | - | - |

*Table 7. Long-term Sustainability of Public Finances*

| % of GDP | 2007 | 2010 | 2020 | 2030 | 2040 | 2050 | 2060 |
|---|---|---|---|---|---|---|---|
| Total expenditure | 39.7 | 37.7 | 35.1 | 35.4 | 37.1 | 39.3 | 40.5 |
| Of which: age-related expenditures | 15.5 | 18.2 | 15.7 | 15.9 | 17.6 | 19.9 | 21.1 |
| Pension expenditure | 7.8 | 9.9 | 8.1 | 8.3 | 9.6 | 11.3 | 12.0 |
| Social security pensions | 7.8 | 9.9 | 8.1 | 8.3 | 9.6 | 11.3 | 12.0 |
| Old-age and early pensions | 6.1 | 7.8 | 6.6 | 7.0 | 8.4 | 10.0 | 10.8 |
| Other pensions (disability, survivors) | 1.6 | 2.1 | 1.4 | 1.3 | 1.3 | 1.2 | 1.2 |
| Occupational pensions (if in general government) | - | - | - | - | - | - | - |
| Health care | 3.9 | 4.3 | 3.8 | 3.9 | 4.4 | 4.8 | 5.0 |
| Long-term care (this was earlier included in the health care) | - | - | - | - | - | - | - |
| Education expenditure | 3.6 | 3.8 | 3.7 | 3.6 | 3.5 | 3.6 | 3.8 |
| Other age-related expenditures | 0.1 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Interest expenditure | 1.2 | 0.6 | 0.7 | 0.2 | 0.3 | 1.4 | 3.3 |
| Total revenue | 40.8 | 34.5 | 34.5 | 34.5 | 34.5 | 34.5 | 34.5 |
| Of which: property income | 1.4 | 0.6 | 1.0 | 0.3 | 0.3 | 0.3 | 0.3 |
| *Of which:* from pension contributions (or social security contributions if appropriate) | 6.0 | 8.0 | 7.7 | 7.7 | 7.7 | 7.8 | 8.0 |
| Pension reserve fund assets | - | - | - | - | - | - | - |
| *Of which*: consolidated public pension fund assets (assets other than government liabilities) | - | - | - | - | - | - | - |
| **Assumptions** | | | | | | | |
| Labour productivity growth | 3.1 | 4.8 | 3.1 | 2.9 | 2.7 | 1.7 | 1.7 |
| Real GDP growth | 6.4 | 0.2 | 3.5 | 2.2 | 1.4 | 0.5 | 0.6 |
| Participation rate males (aged 20–64) | 78.3 | 77.3 | 83.0 | 83.3 | 82.4 | 82.7 | 84.1 |
| Participation rate females (aged 20–64) | 68.3 | 68.0 | 72.1 | 71.9 | 70.5 | 71.0 | 73.2 |
| Total participation rate(aged 20–64) | 73.3 | 72.6 | 77.5 | 77.6 | 76.4 | 76.9 | 78.7 |
| Unemployment rate | 6.9 | 10.2 | 7.3 | 4.7 | 4.7 | 4.7 | 4.7 |
| Population aged 65+ over total population | 17.3 | 17.6 | 20.3 | 23.3 | 26.7 | 31.3 | 34.2 |

*Table 8. Basic assumptions*

| | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|
| Short-term interest rate (annual average), 3-month EURIBOR, % | 0.81 | 1.39 | 2.11 | 2.71 | 3.18 |
| Short-term interest rate (annual average), 6-month USD LIBOR, % | 0.52 | 0.63 | 0.88 | 1.38 | 2.38 |
| Long-term interest rate (annual average), % | 6.0 | 5.3 | 5.1 | 4.5 | 4.1 |
| USD/EUR exchange rate (annual average) | 1.33 | 1.32 | 1.31 | 1.30 | 1.29 |
| Nominal effective exchange rate, percentage change, previous year = 100[86] | -2.0 | -0.1 | -0.3 | -0.3 | -0.3 |
| Exchange rate vis-à-vis the EUR (annual average) | 1.95583 | 1.95583 | 1.95583 | 1.95583 | 1.95583 |
| World economy ( excluding EU), GDP growth, % | 5.0 | 4.4 | 4.5 | 4.6 | 4.7 |
| EU GDP growth, % | 1.8 | 1.7 | 2.0 | 2.2 | 2.2 |
| Growth of relevant foreign markets, % | 4.6 | 5.1 | 6.2 | 6.4 | 6.4 |
| World import volumes, excluding EU, % | 11.5 | 7.2 | 6.8 | 6.9 | 7.0 |
| Oil price (weighted average spot price, Brent USD/barrel) | 79.0 | 107.2 | 108.0 | 105.5 | 104.5 |
| International prices of non-energy goods (%, on an annual basis) | 26.27 | 25.06 | -4.31 | -6.79 | -6.30 |
| International prices of food products (%, on an annual basis) | 11.43 | 24.09 | -4.72 | -6.42 | -5.40 |
| International prices of agricultural commodities (%, on an annual basis) | 33.24 | 24.78 | -11.53 | -7.34 | -3.31 |
| International prices of metals (%, on an annual basis) | 48.12 | 26.50 | -0.75 | -6.37 | -7.78 |

[86] The positive values reflect appreciation, the negative - depreciation.

# ANNEX 2. COMPETITIVENESS OF THE BULGARIAN ECONOMY

The assessment of the competitive position of the economy shall be based on a wide set of indicators, which also take into account specific circumstances related to the economic development of a country undergoing real and nominal convergence.

An objective assessment shall analyse the deviations from the equilibrium trend development of these indicators. In order to overcome the caveats of using the real effective exchange rate (REER) as a measure of competitiveness, the assessment must be based on an analysis of a wide range of indicators.

Important aspects and manifestations of the economy's competitiveness are the flexibility of the factor and product markets, the economy resilience to shocks, the labour productivity dynamics, the market share on export markets, the quality and the diversity of the exported products, as well as the exports dynamics as a whole.

In the long term, the local exchange rate depreciation does not lead to a sustainable improvement of the competitive position of the country. The depreciation of the national currency makes the import component of the production activities more expensive, which results in higher costs for enterprises and deteriorates the competitive positions of exports. The higher price of imports directly influences also the inflation in the country. The higher inflation, on its part, exercises pressure for nominal increase of wages and thus additionally increases the costs of enterprises. For this reason, the labour market flexibility is much more important factor for maintaining the competitive position of the economy than the possibilities for a nominal change of the exchange rate. The local exchange rate depreciation also has a direct negative impact on the enterprises' financial position, since servicing the obligations in foreign currencies becomes more expensive (effect on the balances).

The observed over the last 10 years trend of the real effective exchange rate development in the new EU Member States is in appreciation direction. The analyses show that this is mostly due to fundamental factors and to the successful nominal and real economic convergence, achieved through higher labour productivity growth as compared to the EU average (weighted against the trade volumes realised by the trading partners). The real appreciation of the Bulgarian lev shall be considered to be an equilibrium movement, justified by fundamental factors and not as loss of competitiveness.

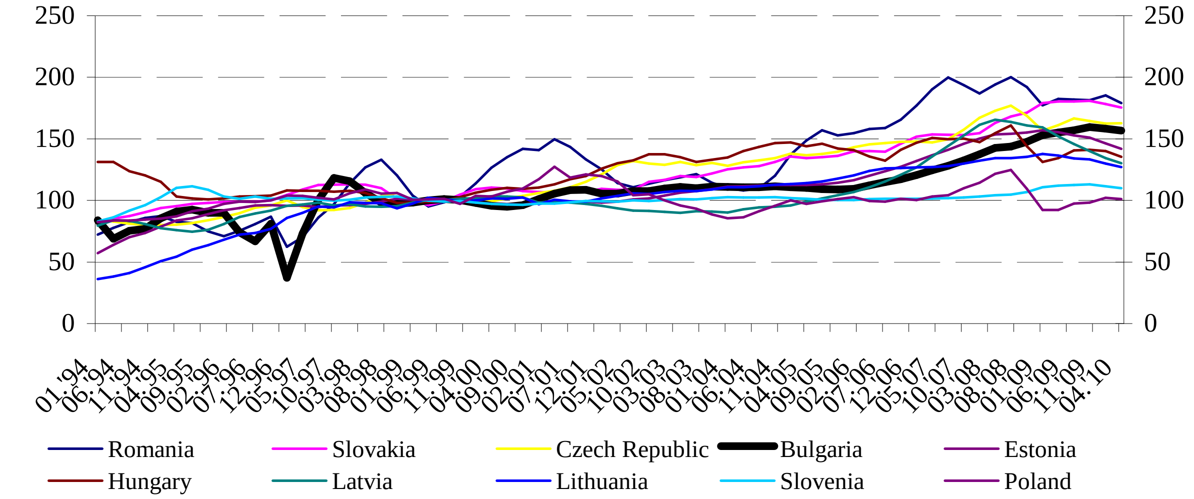
The REER data for the economy as a whole (based on the nominal unit labour costs), as well as about the REER in manufacturing (based on the nominal unit wage costs in manufacturing) show that compared to 1999 the exchange rate of Bulgaria has appreciated, but not as much as in other countries, including those with independent monetary policy in the conditions of a floating exchange rate. This shows that the choice of a nominal exchange rate regime has no influence on the REER development. In the medium term REER in the new EU Member States is expected to continue appreciating as a result of and depending on preservation of a positive differential between the labour productivity growth and the economic convergence pace.

The analysis of the response of the individual CEE economies to the global economic and financial crisis does not support the advantage of floating exchange rates in the conditions of aggravated situation. The trend of the market shares in the EU imports is similar in all Member States regardless of their exchange rate regime – fixed or floating. An increase in these shares was observed during the third quarter of 2010. Bulgaria maintained a favourable trend in its market share and the value of the base index reached 214% (2000 = 100).

The dynamics of the total exports in Euros of the new EU Member States also does not differ significantly in the countries with fixed and floating exchange rate. The international trade in all countries shrunk in a synchronised manner since the end of 2008 and in 2009. This is explained by the general shock from the global crisis – the significant decline in external demand. In December 2010 Bulgaria realised one of the highest increases in the exports as compared to the remaining new EU Member States.

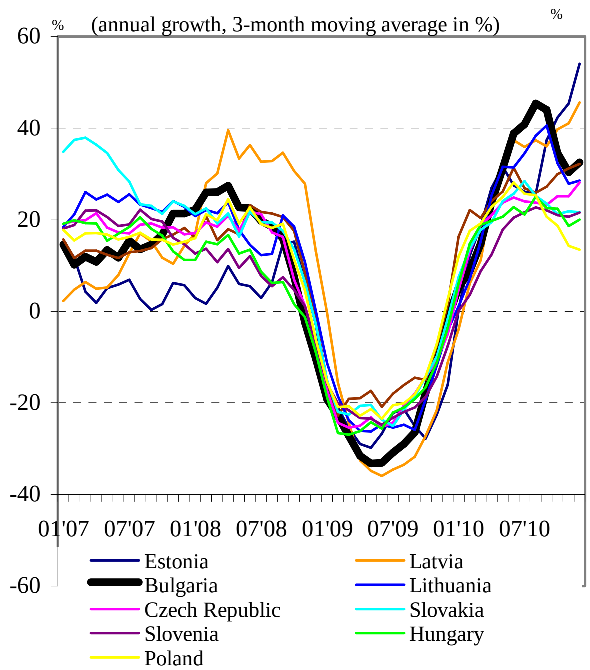
An evidence of the improving export competitiveness is also the stable trend of gradual increase in the technological level and quality of the exported products. The share of the medium- and high-technology production in exports has increased from 20.7% to 25.8% between 2000 and 2009. During the same period Bulgaria registered the highest among the new EU Member States increase in the value of a unit of exported production. This, considered in conjunction with the strong dynamics of exports, is an evidence of the improving quality of products.

**Real Effective Exchange Rate, based on ULC, 1999=100**




Source: European Commission, Price and Cost Competitiveness
Note: The REER index for each of the countries is calculated relative to a basket of 36 industrial countries

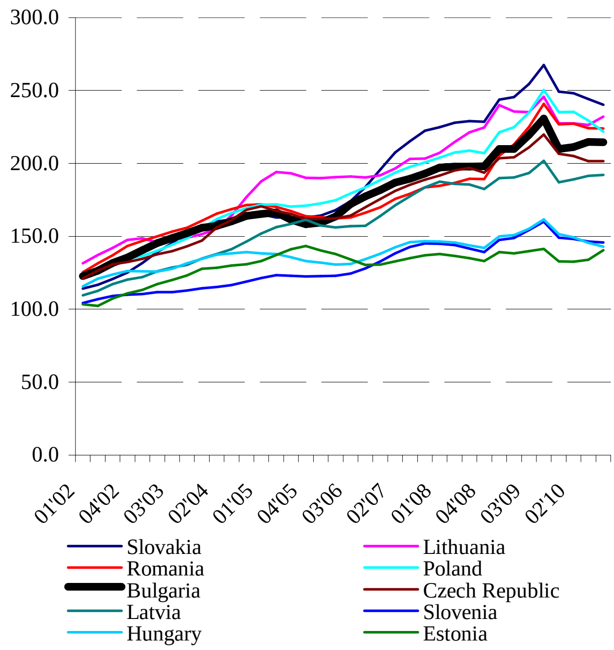
**Exports of New EU member countries in euro**




Source: Eurostat
Note: Countries sorted in descending order according to latest value

**Export shares of CEE countries in EU27 imports**

(annualized index, 2000=100)




Source: Eurostat
Countries are sorted in descending order according to latest value