REPUBLIC OF BULGARIA
Ministry of Finance

CONVERGENCE PROGRAMME

(2018–2021)

2018
Sofia, Bulgaria

CONVERGENCE PROGRAMME

OF THE REPUBLIC OF BULGARIA 2018–2021

Sofia, 2018
Ministry of Finance

Table of Contents

List of Abbreviations

AF	Armed Forces
ATR	Annual tax return
AQR	Asset Quality Review
BNB	Bulgarian National Bank
CEB	Council of Europe Development Bank
CITA	Corporate Income Tax Act
CP	Convergence Programme
EC	European Commission
ECB	European Central Bank
EDTWA	Excise Duties and Tax Warehouses Act
EIB	European Investment Bank
ESA 2010	European System of Accounts 2010
EU	European Union
EUR	euro
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GS	Government securities
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
HIA	Health Insurance Act
IMF	International Monetary Fund
ITC	International Trade Centre
LFS	Labour Force Survey
LIBOR	London Inter-Bank Offered Rate
MF	Ministry of Finance
MoI	Ministry of Interior
MRR	Minimum reserve requirements
MTO	Medium-term budgetary objective
NCA	National Customs Agency
NHIF	National Health Insurance Fund
NRA	National Revenue Agency
NRIC	National Railway Infrastructure Company
NSI	National Statistical Institute
NSSI	National Social Security Institute
OPAC	Operational Programme Administrative Capacity
O-SIIs	Other Systematically Important Institutions
PFA	Public FinanceAct
PIC	Personal Identification Code
PITA	Personal Income Tax Act
p.p.	Percentage points
PSS	Public Social Security scheme
R&D	Research and Development
RA	Registry agency
REER	Real effective exchange rate
RRCIIFA	Recovery and Resolution of Credit Institutions and Investment Firms Act
SBA	Republic of Bulgaria's State Budget Act
SGP	Stability and Growth Pact
SSC	Social Security Code
ULC	Unit Labour Costs
USD	U.S. dollar
VAT	Value Added Tax
VATA	Value Added Tax Act
WB	World Bank
WTO	World Trade Organisation

1. Overall policy framework and objectives

Bulgaria's Convergence Programme (2018–2021) outlines the key policies for maintaining the macroeconomic and fiscal stability of the country in order to create conditions for economic growth.

Key objectives in public finance management are maintaining fiscal sustainability, overcoming macroeconomic imbalances and the pursuit of a coherent, transparent and predictable fiscal policy to improve the business environment, promote investment and stimulate labour market developments.

Policies aimed at increasing productivity and competitiveness of the economy will have a positive impact on economic growth by ensuring better match between supply and demand on the labour market, improving the quality of public goods and services provided, and increasing funding in areas such as education, healthcare, R&D and investment in infrastructure. To achieve balanced growth, sustainable convergence and higher living standards, the Bulgarian authorities will persist in their efforts to improve the efficiency and effectiveness of the administration, transparent absorption of EU funds, to eliminate barriers to private sector investment, including as part of the efforts under the third pillar of the Investment Plan for Europe (the so-called Juncker Plan).

In the medium-term fiscal policy is fully geared towards maintaining the sustainability of the budgetary framework in the context of Bulgaria's commitments both under the Stability and Growth Pact and its status of a Contracting Party under Title III of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. In this respect, fiscal policy clearly sets strict adherence to budget discipline as the main commitment of the government. The fiscal parameters are based on realistic projections for the key macroeconomic indicators, conservative revenue estimates and more austere planning of budget expenditure.

The medium and long-term sustainability of public finances remains a priority of policy, including in terms of strengthening credibility and creating predictable investment and business environment. In this update of the Convergence Programme, Bulgaria maintains its medium-term budgetary objective of -1% of GDP for the structural balance on an annual basis.

The tax policy of the Republic of Bulgaria remains predictable while at the same time oriented towards promoting business development and investment activity. The government will continue its policies to improve the tax collection and the fight against shadow economy and undeclared work.

In the context of preserving its macroeconomic stability, Bulgaria guarantees that it will maintain the currency board arrangement at the current fixed exchange rate level of 1.95583 BGN per 1 EUR until the country joins the euro area.

This Convergence Programme covers the period 2018–2021 and comprises seven chapters.

The first chapter contains the overall framework of the government's economic policies and objectives.

The second chapter analyses the economic development of the country in terms of the key macroeconomic indicators, as well as a forecast for their development in the medium-term.

The third chapter makes an overview of the strategic fiscal policy objectives in terms of budget balance and government debt. It details the current budgetary position and the expected developments over the reference period, with an emphasis on the structural balance. The main directions for the development of the debt position during the programming period are outlined. The main policy focuses and concrete measures for their implementation, as well as an assessment of the quantitative effect of their implementation, are also presented.

Chapter four analyses the sensitivity of the forecast parameters by developing an alternative scenario for the country's economic development in the medium-term. It also assesses the effect of implementing alternative scenarios on the budgetary parameters. It presents also the effects on government debt from changes in assumptions under the main macroeconomic scenario.

Chapter five is dedicated to the sustainability of public finances. The main focus is on the long-term budgetary outlook in view of the effects of ageing population.

The sixth chapter examines the quality of public finances. It presents the strategy of government policy in this area, the composition of expenditure, as well as the structure and efficiency of the revenue systems.

Chapter seven reviews the institutional features of public finances in Bulgaria – budgetary procedures and national fiscal rules. This part of the Programme also focuses on key legislative amendments relevant to public finances.

This Convergence Programme takes into account measures and developments under the first of the four Council Recommendations of 11 July 2017 on the National Reform Programme of Bulgaria for 2017 containing the Council Assessment of Bulgaria's 2017 Convergence Programme[1], namely:

> *"Further improve tax collection and tax compliance, including through a comprehensive set of measures beyond 2017. Step up enforcement of measures to reduce the extent of the informal economy, in particular undeclared work."* ▼

[1] OJ C 261/7, 09.08.2017.

2. Economic Outlook

2.1 Assumptions concerning the development of the world economy

This Convergence Programme is based on the macroeconomic framework for the period 2018–2021, developed using the medium-term macroeconomic model of the Ministry of Finance with the assumptions about key indicators of the external environment provided by the International Monetary Fund, the World Bank, the European Commission and the Ministry of Finance of the Republic of Bulgaria, as of mid-March 2018.

Table 2-1: Assumptions on key macroeconomic indicators

	2018	2019	2020	2021
Global economy (real growth,%)	3.9	3.9	3.8	3.7
EU GDP (real growth,%)	2.3	2.1	1.9	1.8
Exchange rate USD/EUR, annual average	1.23	1.23	1.23	1.23
International commodity prices (in USD,%)				
Crude oil Brent (per barrel)	17.6	-6.5	-4.6	-2.7
Non-energy goods	5.5	1.1	-0.6	-0.3
Food	2.6	1.8	-2.0	-1.3
Beverages	-3.5	4.9	2.1	0.0
Agricultural raw materials	3.6	-0.9	-0.4	0.0
Metals	13.0	1.0	1.0	1.0
6-month LIBOR on USD denominated deposits	2.42	3.41	3.86	3.48
6-month LIBOR on EUR denominated deposits	-0.30	-0.01	0.46	0.91

Source: EC, IMF, WB, MF

The global economic growth is expected to reach 3.9% in 2018 compared to growth of 3.7% in 2017 as a result of increased economic activity in developing countries and the U.S. At the same time, the growth of the European economy will start to slow down due to the suspension of temporary fiscal incentives in some countries and the shortage of skilled workforce in others, which will curb employment growth. The uncertainty arising from the consequences of the UK's exit from the EU (Brexit) will also undermine the economic activity in the region. The growth of the European and U.S. economies will slow down in 2019 and will further follow a downward trend until the end of the forecast horizon, gradually approaching its potential level.

2.2 Economic Outlook and Cyclical Developments

2.2.1 Economic Growth

In 2017 Bulgaria's gross domestic product grew by 3.6% in real terms. Domestic demand (5.3 p.p.) contributed positively to growth, while the net export contribution was negative (-1.7 p.p.). The slower growth of the economy compared to the 3.9% growth registered in 2016 was entirely due to the dynamics of imports and exports.

Final consumption increased by 4.5%, versus 3.3% in 2016. The increase in personnel and maintenance costs led to a government consumption increase of 3.2%. Household consumption increased by 4.8%, supported by continued income growth, increased employment and higher consumer confidence.

Total investment rose by 9.5%, driven both by an increase in change in inventories and a higher gross fixed capital formation. Fixed capital investments rose by 3.8% and their dynamics was determined by private investment activity. The increase in private investment[2] in the economy is related to the improvement of the business climate in the country and the increase of credit to non-financial enterprises. During the year growth was registered in investments in construction and machinery and equipment. According to the survey of investment activity in manufacturing, entrepreneurs have increased the share of investment for extension of production capacity.

In 2017, the increase in exports of goods and services was 4%, compared to 8.1% in 2016. The weaker growth was recorded in respect of both goods and services. At the same time, higher domestic demand led to an increase in imports of goods and services by 7.2%.

Gross value added in 2017 rose by 3.7%, compared to 3.4% in 2016. The increase in value added in services reached 4.2% and in manufacturing – 3%. The growth recorded in construction was 5.9%, with the dynamics in the sector being determined by building works.

2.2.2 Cyclical Developments[3]

According to Ministry of Finance estimates, the potential GDP growth in 2017 reached 3.3%. This represents an acceleration compared to 2016, due to a higher contribution from total factor productivity (TFP) and capital. For the period 2018–2020 a potential growth of 3.5% is expected, and in 2021 a slight deceleration of 3.4% is expected. TFP will continue to be a growth driver with a contribution of 2-2.1 p.p. The increase in investment in the economy will contribute to a gradual increase in the contribution of capital stocks to potential growth – from 1.1 p.p. in 2018 to 1.4 p.p. in 2021. The positive contribution of labour as a factor for potential growth will gradually decrease. The increase in the participation rate will compensate for the decline in the working age population, but by the end of the forecast period the negative contribution of the population will prevail.

The output gap reached -0.4% in 2017 and is expected to close in 2018. Within the projection period until 2021 the gap will be positive but will remain below 1%.

2.3 Medium-term Scenario

The Bulgarian economy is expected to grow by 3.9% in 2018, driven by domestic demand. The expected increase in public consumption and investment will have a major contribution to rising domestic demand. Final consumption will increase by 5% and the growth of fixed capital investment is expected to reach 10.1%. Private consumption will also go up slightly to 4.9%, supported by improved consumer confidence, continued employment growth and a real increase in households' dis-

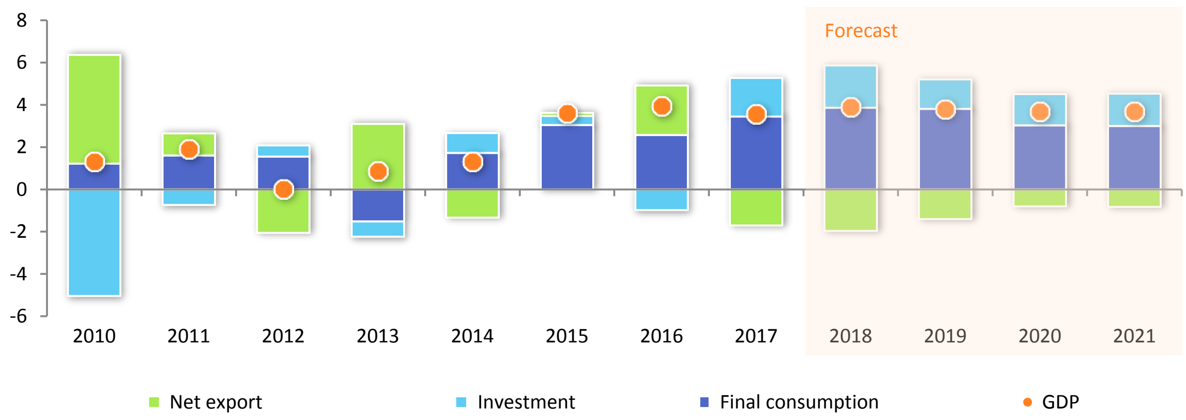
---

[2] Private investment is measured as the difference between fixed capital investment for the overall economy and investment in the General Government sector.

[3] Cyclical development of the economy is measured by the output gap indicator. It is calculated as a difference between the actual and the potential output and is expressed as a ratio to the actual GDP. The potential GDP of the Bulgarian economy is calculated using a production function on a methodology developed by the EC: Havik, K., & Kieran Mc Morrow, K., & Fabrice Orlandi, F., Christophe Planas, C., Rafal Raciborski, R., Werner Roeger, W., Alessandro Rossi, A., Anna Thum-Thysen, A. & Valerie Vandermeulen, V.,"The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps," European Economy – Economic Papers 535, 2014.

posable income. The forecasts of the leading international institutions are for a negligible slowdown in economic activity in the EU and acceleration of global growth. This will affect the sustainability of external demand and the growth in exports of goods will remain close to that of the previous year. Meanwhile, due to the low base of 2017 and the expected favourable dynamics in the current year, growth in exports of services is expected, which will lead to an acceleration of total exports. Increased growth in domestic demand and exports will support the growth of imports. As a result the negative contribution of net exports to GDP is expected to increase in 2018 and to reach 2 p.p.

Figure 2-1: Contributions to GDP growth, by components (in p.p.)



Source: NSI, MF

GDP growth will slow down slightly to 3.8% in 2019 due to the downward dynamics of domestic demand driven by weaker growth in public investment. The increase in fixed capital investment is expected to slow to 6.6%. Private consumption will continue to grow, supported by higher incomes and household loans. However, the growth will be lower compared to 2018 due to a more modest increase in real household disposable income stemming from nominal earnings and rising consumer prices. The expected lower domestic demand growth will be reflected in a slowdown in import growth and, respectively, a negative contribution of net exports to 1.4 p.p.

Economic growth will continue to slow down gradually to 3.7% over the period 2020–2021. Domestic demand (both consumption and investment) will remain the driving force behind GDP growth. While investment activity is expected to rise moderately, a slower increase in employment and real income will result in a slight slowdown in private consumption growth. The negative effect on GDP in respect of net exports is expected to remain around 0.8 p.p. in 2020 and 2021.

2.4 Sector Balances

2.4.1 Labour Market, Incomes and Productivity

In 2017 the positive labour market developments were manifested by an increase in labour supply, in the context of negative demographic developments. This evidenced for an activated labour force participation and together with the decrease in the number of unemployed contributed to a significant increase in employment.

As a result of the increased labour demand and rising incomes, the participation rate of the working-age population reached a level of 71.3% in 2017, which was historically the highest value for the entire period of the labour force surveys. The favourable development was supported by all age groups, but the reported increase of the participation rate of youths (15-24 year-olds) has to be stressed, as it happened for the first time in the last five years. This reflected the increase in the youth employment rate to 22.9%, after a long period of decline between 2009 and 2016, while youth unemployment rate of 12.9% remained 3.9 p.p. below the EU average. Along with the enlarged employment opportunities, the positive developments were also related to the government's policy in support of the targeted groups in the labour market. The number of discouraged (15-64 year-olds) declined by 51.2 thousand compared to 2016, but the labour force increased by 77.9 thousand, which showed the activation of other groups of persons who were inactive in the previous periods.

In 2017, the unemployment rate kept the downward trend and reached 6.2%[4], which was the lowest value since 2009. Along with the cyclical decline, structural improvement was also observed, as evidenced by the rapid decline in the long-term unemployment rate. In 2017 it reached 3.4%, which was 4 p.p. lower than the post-crisis peak in 2013. The lower number of unemployed compared to 2016 explained about 35% of the growth of employed (15-64 year-olds), with a higher contribution to the employment increase from the inflow from inactivity.

The number of people employed (ESA 2010) recorded the highest growth rate of 1.8% in the post-crisis recovery period compared to an average increase of 0.4% in 2014–2016. The favourable development was broadly supported by all economic sectors, with the strongest impact of agriculture. Manufacturing activities reported a sustained growth in demand for labour, and the number of employed increased by 1.1%. The construction sector also contributed to the positive dynamics in the industry, with a gradual stabilization of employment during the year and the increase registered in the last three months on an annual basis. This was related to the recovered value-added growth in the sector, supported to a considerable extent by the revival of the housing market and building construction. While economic activity in the service sector accelerated in 2017, the pace of job creation slowed down and the employment number increased by 0.7%, with a growth of 2.2% in 2016.

The positive labour market developments continued in the first months of 2018 and expectations remained favourable. The registered unemployment rate declined in January and February on an annual basis and consumer assessments showed expectations for a further decline in unemployment. At the beginning of 2018 the business also improved its expectations on the employees' dynamics, which was in place for both manufacturing and construction, as well as for services. At the same time, labour shortages as a barrier to business development in all three monitored economic sectors have consistently exceeded their 2008 levels in 2017. Thus, the high level of labour demand and supply-side constraints have led to expectations for a deceleration in the employment dynamics in the medium-term horizon.

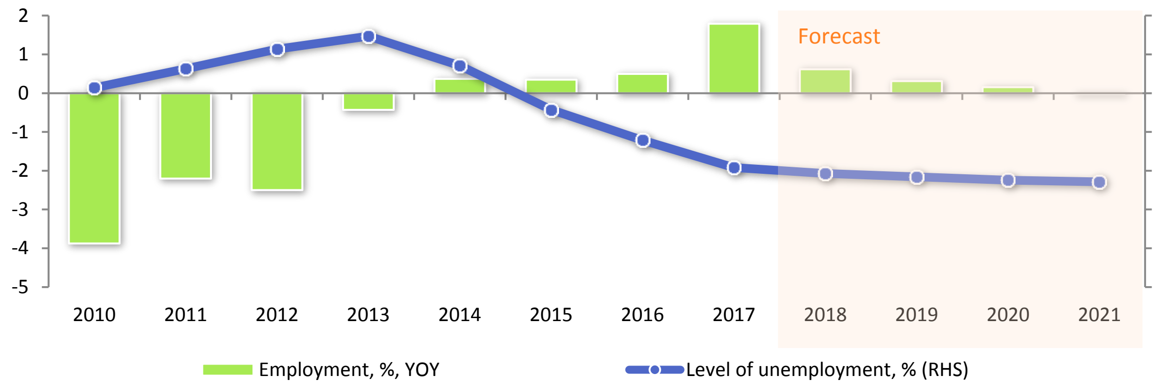
In 2018 employment growth is expected to be 0.6%[5] with the slowdown versus the previous year being linked to agriculture. The high share of the agricultural employment and the restructuring in the sector give reasons to expect a reduction in the self-employed. Thus, a positive impact on employment in 2018 will make the demand for labour in industry and services. The stable growth in exports will support job creation in industry, while the stabilized level of construction employment at the end of 2017 and the acceleration of economic activity in the sector in 2018 suggest that it might report one of the highest employment growth rates by economic activities. In line with the expected positive developments in domestic demand, the dynamics of service sector employment will improve, which will be further supported by the weaker employed dynamics in the sector in 2017. The unemployment rate is expected to drop to 5.9% in 2018 and the labour force participation rate will

[4] NSI data.

[5] According to the ESA 2010 definition of employment.

increase at a slower pace than a year earlier due to the gradual decrease of the potential of the available labour resource to meet the demand for labour.

Figure 2-2: Employment dynamics and unemployment rate, %



Source: NSI, MF

The negative demographic developments and their impact on labour supply will reduce employment growth to 0.3 and 0.2% in 2019 and 2020, and at the end of the forecast horizon, their numbers are expected to stabilise, tending to decrease. The latter also reflects the decline in the labour force after its stabilisation in 2020, and the reduction in the unemployment rate to 5.4% in 2021.

The favourable developments in the labour market were accompanied with accelerated labour income growth. The latter was conditioned by the increase in value added, the positive change in consumer prices in the country, and the demand for a more skilled workforce. Changes related to the increases in the social security burden (with 1 p.p. for Pension funds and 20 p.p. for the employees in the security sector), the salaries in the priority sectors of the public administration and the minimum wage (9.5%) also had an impact. In 2017 the nominal growth of compensation per employee accelerated to 7.5%, with leading contribution from the industry (14.6%). The dynamics of the service indicator continued to decelerate on an annual basis to 4.7%, while some activities even recorded a decrease, including creation and dissemination of information and real estate operations.

With the increase in employment in 2017 the real growth in labour productivity[6] slowed down to 1.7%, mainly due to the drop in the agriculture sector. The main positive contribution was observed in services, while productivity in the industry continued to grow, but at a slower pace on an annual basis. From the point of view of assessing cost competitiveness, the current change in income and labour productivity determined the upward trend in unit labour costs (ULC)[7] to 5.7% in nominal terms. The economic activity comparison by economic activity showed that the increase in service productivity managed to almost compensate for the income and the nominal ULC slowed to barely 1.2%, which is the lowest value of the indicator since 2010. Unlike services, the nominal ULC in industry reported a double-digit growth of 11.8%, largely influenced by construction. The ULC dynamics in manufacturing was also high (9.3%), but in the export-oriented activities the labour income and industrial production growth rates were close and accompanied with a steady increase in foreign market turnover.

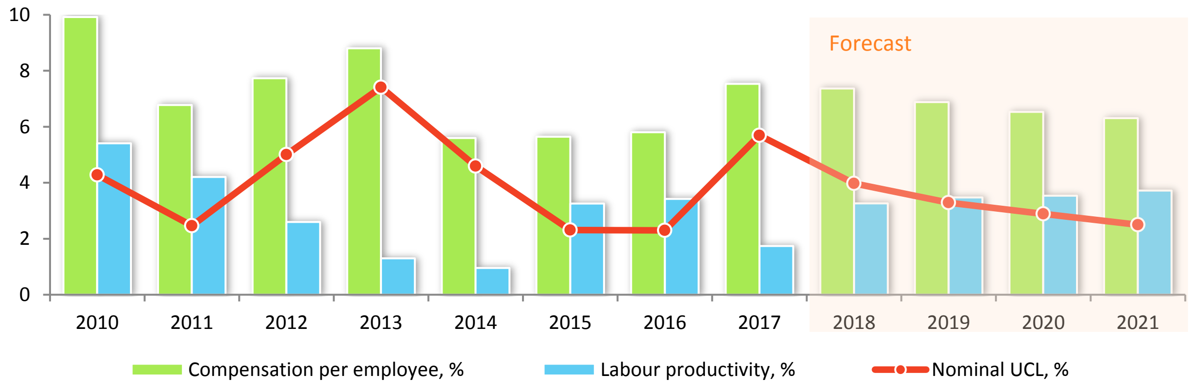
---

6 Calculated as a ratio between GDP in 2010 prices and the number of employees in accordance with ESA 2010.

7 The indicator is calculated as the ratio between compensation per employee (at current prices) and GDP per employee (at constant prices) according to SEN data.

With the higher base effect, the compensation per employee growth in 2018 is expected to remain close to that of the previous year. The nominal increase of the indicator under review is estimated at 7.4%, in line with the upward trend in labour productivity, employees and prices in the country. A further contribution will be observed in terms of the higher minimum wage (10.9%), the increase in the social security contribution to pension funds by 1 p.p. and the projected higher labour costs in priority areas of the public sector. The rate of increase in compensation per employee will decelerate to 6.6% on average per year in 2019–2021, following the expected slower growth in employment and smaller effects of social security contributions.

Figure 2-3: Nominal ULC and breakdown by components

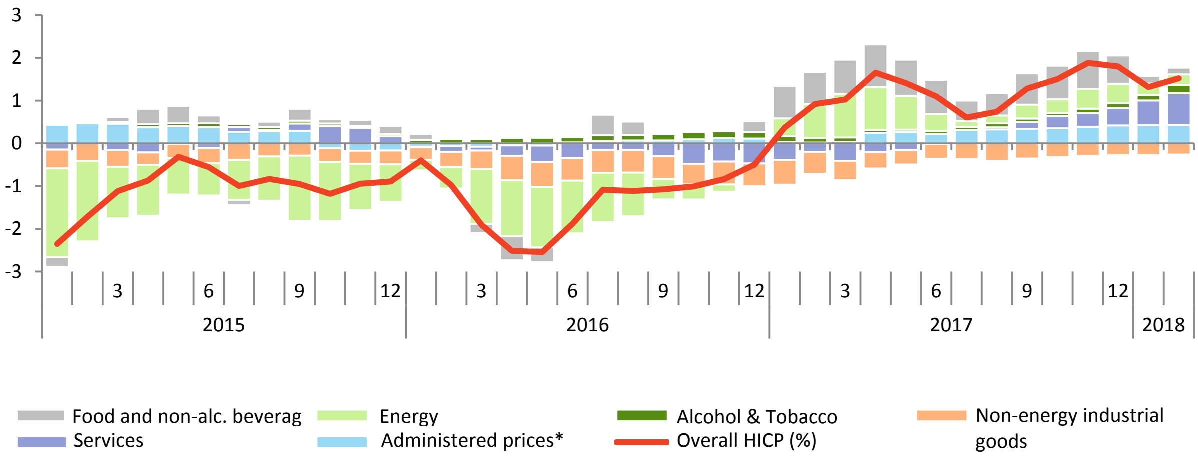


Source: NSI, MF

In the period 2018–2021 the real growth of labour productivity is estimated at 3.5% on average per year. The reported slowdown in the dynamics of the indicator in 2017 was driven by a significant decline in the agriculture sector and should not have a restrictive effect on the growth potential of the economy over the medium-term. The expectated income and labour productivity developments will result in a gradual increase in the share of compensation of employees in gross value added. At the end of the projection horizon, the two indicators will increase at similar rates, and nominal ULC will grow moderately, with an annual average of 3.2%.

2.4.2 Inflation

Figure 2-4: Inflation rate (%) and contributions by main HICP components (p.p.), compared to the corresponding month of the previous year



*The index of administered prices is calculated as a weighted average of the relevant elementary aggregates in the consumer basket.

Source: Eurostat, MF

The average annual HICP inflation in 2017 was 1.2% after being negative in the 2014–2016 period, and the end-of-period inflation rate was 1.8%. Prices of all major components of the total index, excluding non-energy industrial goods, posted an increase as compared to December 2016. Food and non-alcoholic beverages had the largest positive contribution, followed by energy and market services.

The dynamics of domestic consumer prices during the year was largely influenced by the prices of imported goods in the country (figure 2-5). Prices of food and non-alcoholic beverages, which had the largest positive contribution to the inflation rate at the end of the year, rose by an average of 3.1% yoy in December. This was largely due to the increase in processed food prices, especially prices of milk and dairy products, due to rising international dairy prices as well as increased raw milk prices. As for unprocessed food, the higher prices of meat had the most significant contribution, the acceleration of which was also due to an increase in import prices. According to data from the Food and Agriculture Organisation (FAO) of the United Nations, international dairy prices rose by an average of 31.5% during the year, while those of meat – by 8.9%. Energy prices also posted a substantial increase at the end of the year and those of transport fuels in particular (up 6.7% yoy), which also followed the dynamics of international prices of crude oil.

Figure 2-5: HICP inflation and deflator of import of goods, change in % compared to the corresponding quarter of the previous year

Source: Eurostat, MF

Core inflation[8] was 1.0% yoy at the end of 2017. This was also influenced by the increase in services prices (excluding administered prices), which accelerated more markedly between September and December and at the end of the year stood at 1.6% yoy. This also contributed to the acceleration in the overall HICP in the last quarter. Catering prices followed a steady upward trend, which may also be attributed to the observed rise in food prices in the country. There was also a significant slowdown in the decline in airfares, observed over the past two and a half years due to the increased competition among low-cost airlines. The decline in prices for telecommunication services also decelerated.

Only prices of non-energy industrial goods (excluding items with administered prices) continued on the decline, albeit at a slower pace, which stood at -1.3% in December and was mainly driven by the continuing decline in prices of consumer durables.

[8] The price changes of energy and unprocessed food have been excluded from the headline HICP.

Changes in excise rates for tobacco products since the beginning of the year have led to an increase in their prices, which was 2.7% yoy in December, and their contribution to the change in the headline rate was estimated at 0.1 p.p.

Administered prices rose by 2.6%[9] yoy on average at the end of the year, after a more pronounced increase in prices for heating (23.1%), central gas supply (19.2%), sewerage services (8.9%) and water supply (5.8%).

In the first two months of 2018, the annual inflation rate in the country recorded some deceleration to 1.5%, which was mainly due to the lower contribution of food and energy products. At the same time, services inflation continued to accelerate, resulting in core inflation rising to 1.4% yoy in February.

The average annual inflation in 2018 is expected to be 1.8%, with the end-of-period inflation expected to reach 1.9%. The increase in prices of services is expected to accelerate to 2.5% at the end of the year, backed by strong domestic demand. On the other hand, the expected higher food prices in the country will result in higher prices of services in restaurants, hotels and other catering establishments. The projected increase in international oil prices will lead to higher domestic energy prices, with prices of transport fuels expected to rise by 5.1% by the end of 2018. Prices of non-energy industrial goods will continue to report declines, but at a slower pace, and given the appreciation in services, the contribution of core inflation[10] to the headline rate at the end of the period is expected to increase.

The contribution of the planned increase in excise duty rates on cigarettes to the increase in the total HICP index is estimated at 0.1 p.p. at the end of the year.

Table 2-2: HICP forecast for the 2018–2021 period

	2018	2019	2020	2021
Average annual inflation (%)	1.8	2.0	2.1	2.1
End-of-period inflation (%)	1.9	2.0	2.1	2.1

The average annual HICP increase in 2019 is projected at 2.0%, with end-of-period inflation expected to report the same increase. The expected acceleration will be due to the rise in core inflation under the influence of higher domestic demand. The average annual price increase is expected to accelerate to 2.1% in 2020 and 2021, with core inflation continuing to rise, while transport fuels price increases are expected to slow down by the end of the projection horizon, given the expected dynamics of international crude oil prices.

The main risks to the inflation forecast are mainly related to the assumptions about the dynamics of international prices. Considering the current conditions on the global market for crude oil, the existing upward risks that the expectations would fail to materialise are mainly related to unexpected disruptions in supply due to geopolitical tension in some of the producer countries and a more rapid increase in world consumption. Downward impact on prices could result from an increase in US stocks and a possible non-compliance to the agreement among the major oil producers to limit output.

[9] The administrative cost index is calculated by weighing the relevant elementary aggregates in the consumer basket.

[10] The change in the prices of energy commodities and non-processed foods is excluded from the headline HICP.

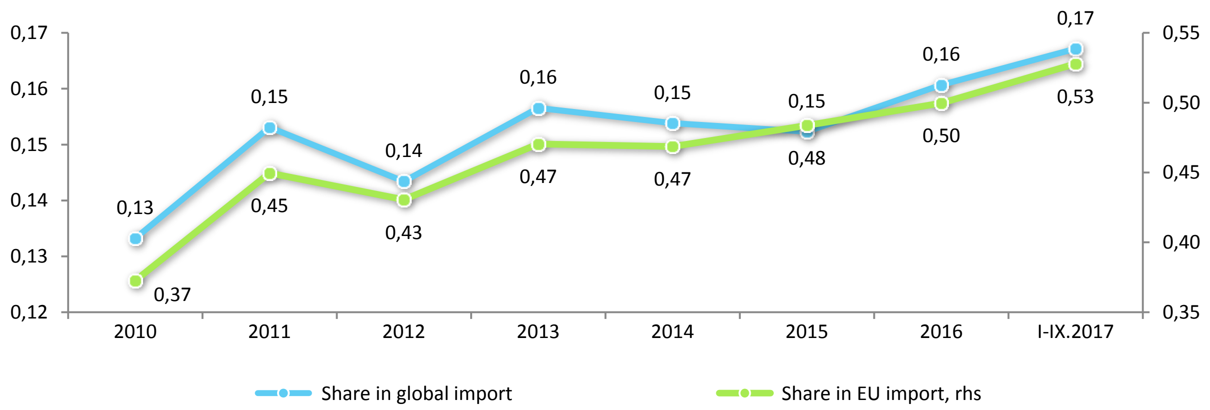
2.4.3 External Sector[11]

In 2017, a surplus of EUR 2.5 billion (5% of GDP) was reported in the current and capital account versus EUR 3.6 billion (7.5% of GDP) in 2016.

The lower positive balance resulted from the reduction in the surplus in trade in goods and services. Balance on services fell to 5.9% of GDP in 2017 as the main reason was the high increase of imports of transport services and payments related to visits of Bulgarians abroad. At the same time, exports of insurance and pension services declined. The 2 p.p. deterioration of the trade balance to a deficit of 4% of GDP reflected both negative terms of trade and the higher real growth in imports of goods compared with exports. The rise in international prices in 2017 and especially the prices of energy raw materials predetermined the higher import deflator against exports. The increase in imports in terms of quantity was driven by the need for raw materials for the export-oriented sectors and the substantial increase in domestic demand, while the growth of exports reflected the favourable external demand.

Export dynamics led to an upward movement in the country's market positions. On average, for the period January-September 2017, the share of Bulgaria's exports in world imports and in imports within the EU continued to increase.

Figure 2-6: Bulgaria's share in international trade (%)



Source: MF estimates based on WTO and Eurostat data

The trend in real effective exchange rate (REER) developments with different deflators shows that the indicator has significantly slowed its growth rates in the post-crisis years. In connection with the deflation observed in the country from mid-2013 to end-2016, the REER based on HICP is below the 2010 average until the end of 2017. Only the REER based on nominal labour costs in total economy reported a more accelerated increase in relation to the observed acceleration of labour costs. It was driven by the observed acceleration in the labour costs' dynamics as compared to our trade partners, but the indicators for the assessment of the competitiveness of the economy did not show any deterioration. On one hand, the accumulated comparative advantage in the sector in terms of the lower share of labour costs compared to the EU-28 average[12] creates potential for income growth without necessarily leading to loss of competitive positions. On the other hand, the current dynamics of wages remained below or close to the real volumes of industrial output in the leading export-oriented

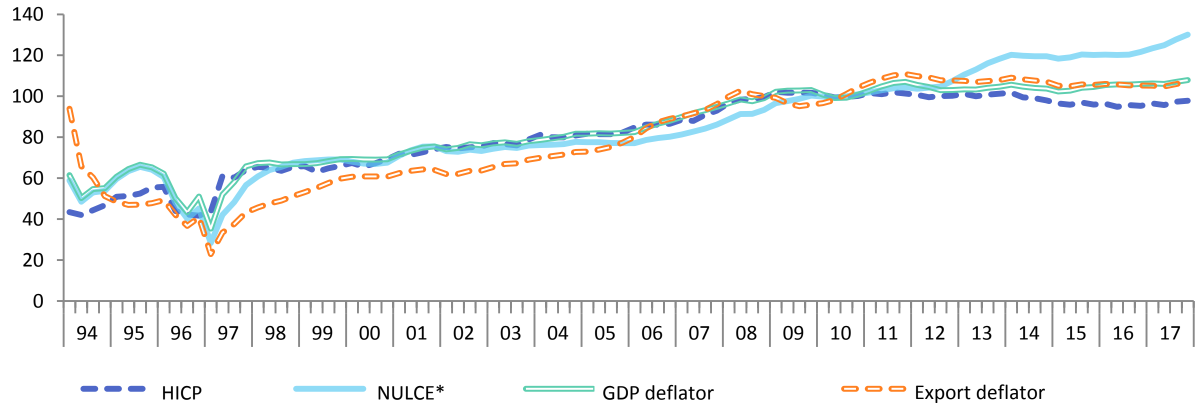
[11] The analysis and projections of the external sector were prepared with statistical data available as of 14 March 2018.

[12] Data from ESA 2010, Eurostat.

activities, including production of basic metals, chemical products, machinery and equipment and computer equipment.

Figure 2-7: REER, Bulgaria vis-à-vis 36 industrial countries, 2010=100

(Quarterly data, until Q4 2017 incl.)

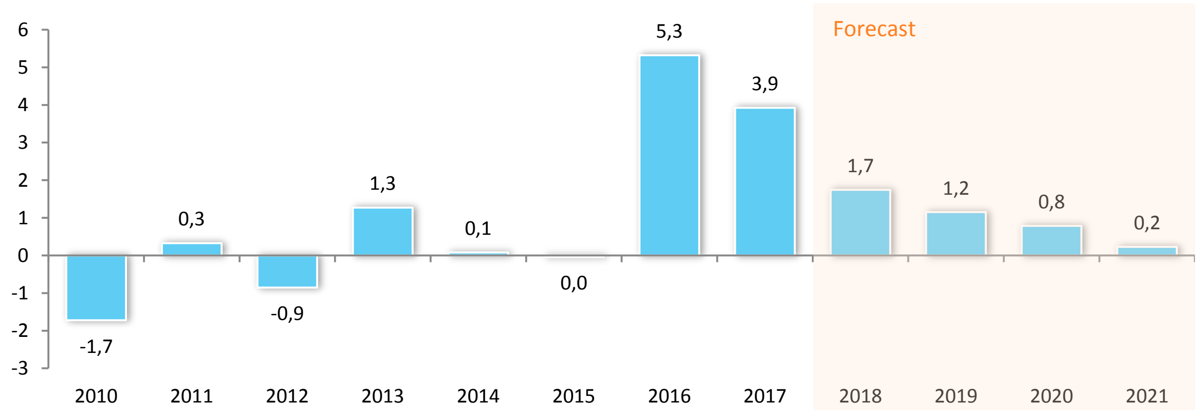


* Nominal unit labour costs, total economy

Source: DG ECFIN, EC

Given the assumptions about the international price dynamics in this forecast, the deflator of exports is expected to be higher than that of imports in 2018, but both decrease compared to 2017. Regarding real growth, the increase in exports is projected to continue at a slightly accelerated pace, driven by the expected positive growth in exports of services. The improvement in domestic demand and the need for raw materials for export-oriented industries will support the increase in imports. As a result, the nominal growth rates of imports and exports will come closer, but imports will continue to prevail. The balance of trade in goods and services will be almost neutral. The expected acceleration of the gross operating surplus, along with the gradual increase in FDI, will result in an increase in the investment income paid to non-residents, an increase in the primary income deficit and a deterioration in the overall balance on Incomes. Taking into account the dynamics of the individual articles, the current account balance to GDP ratio will decrease to 1.7% in 2018.

Figure 2-8: Current account (% of GDP)



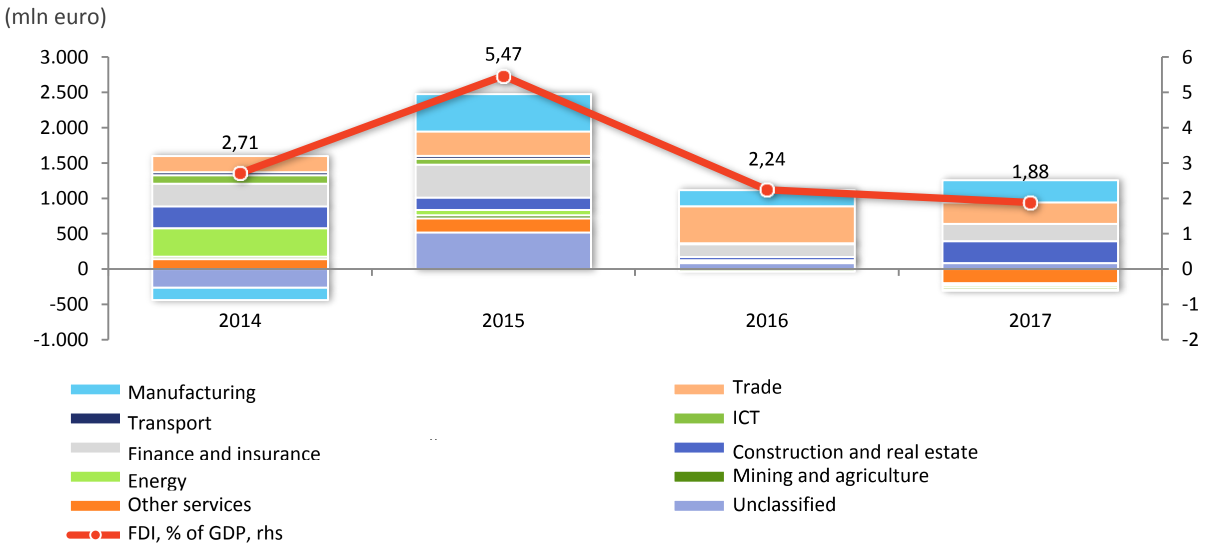
Source: BNB, NSI, MF

In the period 2019–2021, despite the positive terms of trade due to negative net exports, the trade deficit will increase and is projected to reach 6.8% of GDP in 2021. The surplus on Services will grow in nominal terms, but at a lower rate than the GDP growth, which will result in a gradual decline in the balance to 5.4% at the end of the projection horizon. Thus, the overall balance of trade in goods and services will be a major factor in the downward dynamics of the current account. There will be a gradual increase in the surplus on Secondary Income – mainly EU transfers, which will be offset by the change in the Primary income balance. The current account balance will remain positive, but is expected to decline to 0.2% of GDP in 2021.

In 2017 the financial account[13] recorded a higher increase in assets held abroad compared to financial inflows. The dynamics of assets was more pronounced in the last quarter when the increase in the negative excess interest rate on banks held at the BNB led to an increase in the assets of financial institutions in foreign currency, deposits abroad and foreign long-term debt securities.

The annual inflows of foreign direct investment reached 2.7% of GDP or EUR 1.4 billion and were mainly in the form of debt instruments.

Figure 2-9: FDI inflows by sector[14]



Source: BNB

FDI in the country is expected to increase nominally in the period 2018–2021, with the ratio to GDP remaining in the range 2.7-2.8%.

2.4.4 Monetary Sector and Financial Sector

The main objective of monetary policy in Bulgaria is to maintain price stability by ensuring the stability of the national currency. This objective is achieved by means of the Currency Board and a fixed exchange rate of the national currency to the euro.

As of December 2017, the market value of Bulgaria's international foreign exchange reserves – the assets on the balance sheet of the Issue Department[15] of the Bulgarian National Bank (BNB) amounted to EUR 23.7 billion, down by EUR 0.2 billion on an annual basis. Foreign exchange reserves provided coverage of 8.7 months of imports of goods and non-factor services and their ratio to the country's short-term foreign debt was 314.1%.

[13] Analytical presentation of the balance of payments.

[14] FDI data are based on the principle of the initial direction of the investment.

[15] The market value of international foreign exchange reserves includes adjustments from transactions, exchange rate differences and price revaluations.

As of February 2018, international foreign exchange reserves amounted to EUR 22.2 billion, down EUR 1.6 billion from the same period of the previous year. Under the currency board operating principles, the decline in international foreign exchange reserves corresponded to the contraction in the liabilities of the Issue Department balance sheet. The main contribution to the dynamics of liabilities was the decrease in liabilities to banks due to the lower excess reserves of banks. Substantial influence on the decrease of the BNB Issue Department liabilities also came from the decrease in the liabilities to the government and government budget organisations, mainly as a result of the excess of payments on maturing bonds issued on domestic and foreign capital markets over the volume of newly issued government securities on the domestic market and the accumulated budget surplus for the period March 2017 – February 2018.[16] Money in circulation and liabilities to other depositors continued to make a positive contribution to the change in the liabilities of the Issue Department.

In 2017, the inflow of attracted funds from residents in the banking system remained high, reflecting the persistence of a high savings rate in the economy. Broad money continued to grow at relatively high rates, and as of December 2017 their annual rate of change was 7.7%. The main positive contribution to broad money developments came from overnight deposits, while the contribution of money outside MFIs declined slightly compared to the end of 2016, and that of quasi-money was negative. In an environment where interest rates on time deposits are close to zero, the broad money structure was determined by the preferences of economic agents to have quicker and easier access to their funds in banks, which is ensured by overnight deposits. Both households and companies preferred to save mainly in BGN deposits. At the end of 2017 the total growth of deposits of the non-government sector amounted to 6.2% on an annual basis. Household deposits reached BGN 47.8 billion at the end of the year, with a slowdown in annual growth (5.4% at the end of the year, against 6.6% in December 2016), reflecting an increase in consumption and a gradual decrease in the household savings rate. Deposits of non-financial corporations showed a tendency to accelerating growth (13.8% as of December 2017 from 6.3% at the end of the previous year). Deposits of financial corporations declined by 26.9% (versus an 18.1% rise in December 2016) and had a significant negative contribution to the overall growth of non-government sector deposits at the end of 2017. In February 2018 broad money posted an year-on-year increase of 8.1%. The annual growth rate of non-government sector deposits slowed down to 5.6%, mainly as a result of an increase in the negative contribution of deposits by financial corporations.

Loans to non-financial corporations and households saw a gradual acceleration of growth in 2017, reaching 3% in December (1.0% at the end of 2016). The annual growth rate of loans to non-financial corporations totalled 1.6% (0.3% at the end of 2016). Household loans recorded a more substantial acceleration in year-on-year growth, reaching 6.0% in December (2.0% at the end of 2016) with the main contribution of housing and consumer loans and, to a lesser extent, of "other loans" to households. The key drivers for the upward dynamics of loans to the non-government sector in 2017 were the favourable economic environment and the sustained decrease in interest rates on loans. Impacting on the growth of "other loans" to households were loans issued under the National Programme for Energy Efficiency in Multifamily Residential Buildings. The government's repayment of loans under this Programme which started in July 2017 has led to a decline in the contribution of "other loans" to total household loan growth by the end of the year. Non-performing loan (NPL) write-offs and loan sales by banks restricted credit growth for the non-government sector. By February 2018, the annual increase of loans to non-financial corporations and households rose to 3.6%.

[16] Based on MF preliminary data and estimates.

In the first nine months of 2017, banks continued to maintain high levels of excess reserves on accounts with the BNB. Over that period excess funds on banks’ minimum reserve accounts with the BNB over the required minimum under Ordinance No 21[17] of the BNB amounted to 112.3% of the minimum required reserves (MRR) on average. A decision of the BNB Governing Council came into effect on 4 October 2017, which amended the methodology for setting interest rates on accounts with the BNB. According to the decision the BNB applies on banks' excess reserves whichever is lower between 0% and ECB deposit facility rate minus 20 basis points. This change led to a decrease in the BNB excess reserve interest rate to -0.60%[18]. On average for the fourth quarter of 2017 banks' excess reserves decreased by BGN 4.6 billion compared to the levels at the end of September, and the excess of banks’ funds at the BNB over the required minimum reserve assets dropped to 47.4% of the MRR. At the end of 2017, reserves maintained by banks recorded an annual decline of 3.8% (down 2.2% in December 2016).On a daily average basis for 2017 funds in banks' accounts with BNB, which met the requirements of Ordinance No 21, exceeded by 96.1% the minimum required reserves compared with an excess of 92.0% in 2016. As of February 2018, the amount of bank funds held with the BNB in excess of the required minimum reserve assets dropped to 39.6% of the MRR.

The decrease in the interest rate on banks' excess reserves with the BNB in October 2017 was influential in the reduction of interest rates and quotations on the interbank money market in BGN and in the increase in traded volumes in the fourth quarter of 2017, with these trends sustained in the first two months of 2018.

After a decline in the first quarter of 2017, interest rates on time deposits tended to stabilise at the low levels achieved. The persistent strong inflow of attracted funds from residents and high liquidity in the banking system remained the main factors behind the dynamics of interest rates on deposits in the country. By January 2018 the weighted average interest rate on the new[19] time deposits[20], presented as a weighted average on a 12-month basis, amounted to 0.3%, down 0.3 p.p. on a year earlier. The decline in interest rates on new times deposits was more substantial for households and weaker for firms. Interest rates on newly issued loans held their downward trend. By January 2018 the weighted average interest rate on new loans[21] for households and non-financial corporations, presented as a weighted average on a 12-month basis, decreased by 0.9 p.p. compared to the same month of the previous year and amounted to 4.5%. For the same period, the average interest rate on new bank loans to households decreased by 1.0 p.p. to 5.7% and that to non-financial corporations – by 1.1 p.p. to 3.7%.

In 2017 the Bulgarian banking sector continued to report sound financial indicators[22]. The total capital adequacy of the banking system remained high at 22.08% as of December 2017 (22.15% at the end of 2016), including Tier 1 capital adequacy ratio which was 20.86% (20.88% at the end of 2016). The amount of capital exceeding the minimum capital adequacy requirement of 8% also increased at

---

[17] BNB Ordinance No 21 on Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks (effective from 4 January 2016).Pursuant to Ordinance No 21, the rate of the minimum required reserves for deposits of residents is 10% of the deposit base, for non-residents - 5%, and for state and local budgets - 0%.

[18] Since 16 March 2016, the interest rate on the ECB deposit facility has been -0.40%.

[19] The terms “new” deposits and “new” loans refer to the statistical category of “new business”.

[20] The weighted average interest rates on time deposits of the sectors of households and non-financial corporations, weighted in terms of currency and term.

[21] The weighted average interest rates on loans for the sectors of households and non-financial corporations, weighted in terms of currency and term.

[22] The assessment of the state of the banking system is made on the basis of data from the supervision reports by individual bank as of the end of December 2017 received by 26 February 2018, and as of the end of December 2016, received by 24 February 2017.

the end of 2017 to BGN 7.3 billion. The profit of the banking sector for 2017 was BGN 1150 million. The ROA and ROE ratios at the end of the year were 1.18% (1.37% in December 2016) and 9.15% (10.41% in December 2016) respectively.

As a result of banks' actions to improve asset quality[23] the downward trend in credit risk was sustained. At the end of December 2017, the gross amount of all non-performing exposures was BGN 8.3 billion, comprising mainly loans and advances. The non-performing exposures ratio, calculated according to the broadest EBA methodology[24], declined to 8.9% at the end of the year. On an annual basis, the amount of non-performing loans and advances decreased by almost BGN 1.7 billion (by 16.7%) and the total gross stock of loans and advances increased by BGN 4.0 billion (by 5.2%). As a result, the share of gross non-performing loans and advances in total gross loans and advances decreased by 2.7 p.p. compared to the end of 2016 and the non-performing loans and advances ratio dropped to 10.2%. The coverage ratio of gross non-performing loans and advances with inherent impairment at the end of 2017 was 49.4%. The net value of non-performing loans and advances representing potential credit risk in bank balance sheets[25] fell to BGN 4.2 billion and remained fully covered by the excess of BGN 7.3 billion of capital above the minimum regulatory requirement of 8%.

The liquidity position of the banking system continued to ensure a high level of liabilities coverage, and as of December 2017 the liquid assets ratio of the banking system, calculated according to Ordinance No 11[26] of the BNB reached 38.97% (38.24% at the end of 2016)[27].

In line with its mandate, the BNB supervises banks in order to maintain the stability of the banking system. With the introduction of the Basel III Global Regulatory Framework into European legislation through Directive 2013/36/EU (CRD IV) and the alignment of Bulgarian legislation with the EU legal framework on credit institutions, the BNB introduced in 2014 a capital conservation buffer in the amount of 2.5% and a systemic risk capital buffer of 3%. At the beginning of 2016, the BNB introduced a countercyclical capital buffer for banks in the country at 0%, while at the end of 2016 the buffer for other systemically important institutions (O-SIIs buffer), which applies to ten banks, was also introduced[28].

In 2017, a review of the system risk buffer and the capital buffer for O-SIIs was performed. The level of the systemic risk buffer was maintained unchanged at 3% of the risk exposures of banks formed on the territory of the Republic of Bulgaria.

As a result of the annual review of the O-SII buffer in 2017 the BNB identified eleven banks as other systemically important institutions. The banks are divided into three groups and have a specific level of the O-SIIs buffer imposed on an individual and consolidated basis applicable to the total value of the risk exposures in the following amounts by year[29]:

---

[23] Bank credit risk mitigation instruments included write-off of uncollectible receivables at the expense of provisions, loan sales, and acquisition of collateral by the acquisition of ownership.

[24] This ratio represents the share of gross non-performing loans and advances and debt securities in the total gross amount of all exposures in the banking system.

[25] Net non-performing loans and advances are calculated by reducing the gross amount of non-performing loans and advances by their inherent accumulated impairment.

[26] BNB Ordinance No 11 on Bank Liquidity Management and Supervision.

[27] New liquidity reporting requirements under Regulation (EU) No 575/2013 and Commission Delegation Regulation (EU) 2015/61 have been in force since 2018. This harmonises the requirements for liquid assets, incoming and outgoing cash flows for all EU credit institutions.

[28] More information on capital buffers is available on the BNB website: http://www.bnb.bg/BankSupervision/BSCapitalBuffers/index.htm

[29] For more information, http://www.bnb.bg/PressOffice/POPressReleases/POPRDate/PR_20171201_EN

	Level of the capital buffer for O-SIIs		
	As of 1 January 2018	As of 1 January 2019	As of 1 January 2020
Group 1	0.50%	0.75%	1.00%
Group 2	0.25%	0.50%	0.75%
Group 3	0.125%	0.25%	0.50%

For each quarter an analysis is conducted and the level of the countercyclical capital buffer is determined. No accumulation of cyclical systemic risk in the economy was reported in 2017, so the level of the countercyclical buffer applicable to credit risk exposures in Bulgaria was kept at 0%.

In 2017, the BNB was involved in drafting legislative changes in order to improve the regime for regulating the risk arising from the exposures that banks form to related parties – administrators of the bank, its shareholders with a qualified or higher share, persons controlling the bank, subsidiaries of the bank and other parties identified as related to the bank (internal exposures)[30].

In December 2017 the National Assembly adopted legislative amendments in respect of which the individual administrative acts related to the BNB's supervisory functions are issued by the BNB Governing Council.

In compliance with the Plan on Reforms and Development of Banking Supervision exercised by the BNB, a "Manual for Banking Supervision Process" was drawn up, which was approved by Decision No 17 of 9 February 2017 of the BNB Governing Council. The manual defines the rights and obligations of individual entities in the performance of their supervisory duties, as well as the interaction between them.

According to the MoF's forecast, money supply growth will accelerate slightly over the projected period. By the end of 2018, its growth rate is expected to be around 7.9% on an annual basis, against 7.7% yoy at the end of 2017. This is on the account of the current dynamics and expectations for a continuing increase in the country's foreign reserves as well as deposits in the banking system. Broad money growth rate will accelerate to 8% yoy and 8.1% yoy, by the end of 2019 and 2020, respectively. During the forecast period, the growth rate of overnight deposits will slow down on the account of a slight acceleration in the growth of deposits in national currency and a slowdown in the decline in foreign currency denominated deposits. This trend will reflect a gradual decline in economic agents' preferences for higher liquidity.

For the period 2018–2021, credit to private sector will gradually accelerate in line with projections for relatively sustainable growth of private consumption and investments , as well as expectations for sustained, albeit decelerating, growth in employment and income. By end-2018 the annual growth rate of the claims on the private sector is expected to be 4.9% and it will increase to 5.5% yoy in 2019, at the same time its gradual acceleration will continue until the end of the forecast period. Some limitations on the growth rate of private sector credit over the forecast period could come from the downward trend in bad and restructured loans, but the impact of this effect is expected gradually to decrease. Claims on non-financial corporations will have a higher contribution in 2018, reaching annual growth of 5%, The acceleration over the previous year will be in line with the projected higher investments growth. In the following years, their growth rate will gradually increase and will reach 5.7% yoy and 6.2% yoy respectively in 2019 and 2020. Claims on households growth will slow down in 2018 to 4.8% yoy. In 2019, it will be 5% yoy and by the end of the forecast period the growth will further accelerate to 6.2% yoy in 2021. ▼

[30] Law amending the Law on Credit Institutions (promulgated in State Gazette No 97 of 2017).

3. Government Balance and Debt

3.1 Policy Strategy

The main priority of fiscal policy in the current year and in the coming ones is to maintain the sustainability of public finances, while providing for the relevant measures to stimulate economic activity in Bulgaria. This means, in practice, that the preparation of the budgetary framework requires a realistic assessment of its parameters that are in line with the fiscal targets.

The consistent and sustainable fiscal policy is based on the unchanged goal in recent years to achieve and maintain nearly balanced budget position. The gradual reduction of the deficit and the realisation of a positive balance of the General Government sector is a positive trend. The budget framework parameters follow the outlined fiscal policy objectives and take into account the effects of policies implemented in both the revenue and expenditure side of the budget, taking into account the priorities and targets set in the government's programme for the period 2017–2021. As long as the forecast covers the period until the end of the government's mandate, it takes into account the dynamics in the development of the sectoral policies and the need for their financial provision.

The General Government revenue forecast takes note of the continuing positive trends in the development of the national economy. An additional positive fiscal effect is also expected from the implementation of discretionary revenue measures, with changes in discretionary measures for the period 2019–2021 compared to the previous projection being mainly due to a reassessment of the expected magnitude of the effects and, to a lesser extent, to the introduction of new measures.

In terms of spending, the main objective is to limit their annual growth to potential GDP growth, thus ensuring compliance with the SGP requirements in terms of the structural budget balance and expenditure benchmark. Efforts to implement measures to optimise and increase the cost efficiency of budget organisations and improve the delivery of public sector products and services across sectors continue to be pursued, while ensuring the implementation of priority policies and programmes.

In the period 2018–2021, the Central Government sub-sector will continue to be the major contributor to the General Government debt change rate due to its dominance in the total debt of the sector (with a share of about 98% at 31.12.2017). This factor also determines the dominant importance of government debt management policy in defining the current situation and prospects for the development of consolidated liabilities.

The management of sovereign liabilities in the medium-term corresponds to the main fiscal policy objectives aimed at a close-to-the-balanced position of the budget balance. The strategic objective of debt management is to provide the necessary resources for refinancing the debt outstanding, whenever necessary to finance the budget and to ensure the stability of the fiscal reserve at an optimal possible price and acceptable level of risk.

The accumulation of a larger amount of fiscal reserve reported at the end of 2017 and the pursuit of gradual fiscal consolidation in the upcoming three-year period provide an opportunity for a flexible debt policy tailored to both the specific market conditions and the decreasing need to debt financing while preserving the sustainability of key debt indicators. It is envisaged that assuming new government debt will be mainly provided from the domestic market by government securities issues, subject to the statutory annual debt ceilings. Determining the specific characteristics of the new debt will be in line with the current domestic government bond market conjuncture and the amortization profile of debt outstanding, taking into account the possibilities for reducing the refinancing risk and smoothing the maturity debt structure. The goal of the issuance policy on the domestic market over the period will be to secure the refinancing of the maturing debt.

3.2 Medium-Term Objectives

Following consecutive steps in fiscal policy, the medium-term objectives for the General Government deficit are expected to improve the budgetary position compared to the parameters set in the previous Convergence Programme. In 2018, a balanced budget is expected, and for the period 2019–2021 the budget surplus is foreseen between 0.2-0.5% of GDP.

Positive expectations are mainly due to the higher earnings forecast as a result of the improvement in the macroeconomic environment and the fiscal effects of government discretionary measures.

For the period 2019–2021, the General Government balance projection (according to ESA 2010) is a budget surplus of 0.3% of GDP in 2019, 0.5% of GDP in 2020 and 0.2% of GDP respectively in 2021.

In the medium-term, General Government revenue and expenditure as a share of GDP is expected to remain at sustainable levels close to the current ones. Achieving the expected improvement in the budget balance over the projection horizon is achieved with a slight downward trend in both revenue and expenditure. Expenditure as a share of GDP for 2019 is 36.3%, and in 2020 and 2021 it is down to 35.6%, while the revenue ratio ranges from 36.6% in 2019 to 35.8% in 2021.

Nominal revenue growth in individual years is due to an increase in revenues from all major types of taxes – VAT, excise duties, personal income tax and corporate tax. Growth is also expected in social security contributions, which is most significant in 2019.

For General Government expenditure, the highest nominal growth in the medium-term is seen in social security payments and capital expenditures. At the same time, as a percentage of GDP, social security payments are maintained at about 13.7% of GDP. Capital expenditure increases as a share of GDP from 4.3% in 2018 to 4.7% in 2021.

In addition to the positive macroeconomic projections and the effects of discretionary measures, a better implementation of the 2017 budget is a contribution to the adjustment of the budget balance targets to the previous update of the Convergence Programme, which is the basis for determining the forecast parameters of the budgetary framework for the period 2018–2021 where deficit targets were set at -0.6% of GDP for 2017, -0.5% of GDP by 2018 and respectively a surplus of 0.1% of GDP in 2019 and 0.1% of GDP for 2020.

3.3 Actual Balances and Updated Budgetary Plans for the Current Year

After the budget balance of the General Government moved to positive territory in 2016, in 2017 this trend was reaffirmed and the annual budget balance was positive again. The target set in the previous Convergence Programme was for a small deficit (0.6% of GDP). Based on the data of the April EDP Notification tables, Bulgaria's budget balance of the General Government sector is surplus of 0.9% of GDP, an improvement of 1.5 p.p. compared to the forecast in the previous Convergence Programme.

Both the revenue and the expenditure side of the budget had a contribution to the improvement in the budget balance compared to the forecast. The positive trend in recent years' revenue has been strengthened, with a significant increase in tax and social security revenues, while the expenditure have remained lower than preliminary estimates. Increased tax and social contribution proceeds are mainly the result of the positive development of the macroeconomic indicators in the upward phase of the economic cycle and, at the same time, the positive results from the implementation of the Single National Strategy for increasing revenue collection, tackling the informal economy and other steps in this regard.

On the expenditure side, the actual outcome is lower than the projected for 2017 due to the lower capital expenditure incurred, mainly because of the already mentioned delay in the absorption of funds under some of the EU Structural and Cohesion Funds projects, the Rural Development Programme and others. Compared with the forecast in the previous Convergence Programme, the General Government expenditure, represented as a relative share of GDP, is lower by 0.8 p.p. Expectations are that as projects enter into a more advanced phase, the spending under the accounts of EU funds will increase significantly and the delays will be overcome. Another reason for lower absorption of the capital expenditures was that some of the planned investment projects related to the purchase and repair of military equipment for the Bulgarian army were also not implemented, as they were postponed for the following years due to objective reasons.

3.3.1 Budgetary Development in 2017

In 2017 Bulgaria reports a positive General Government balance up to 0.9% of GDP.

The total General Government revenue for 2017 reached 36.2% of GDP, an increase of 1.0 p.p. compared to 2016. Compared to the forecast in the previous Convergence Programme, General Government revenues are higher by 0.7 p.p.

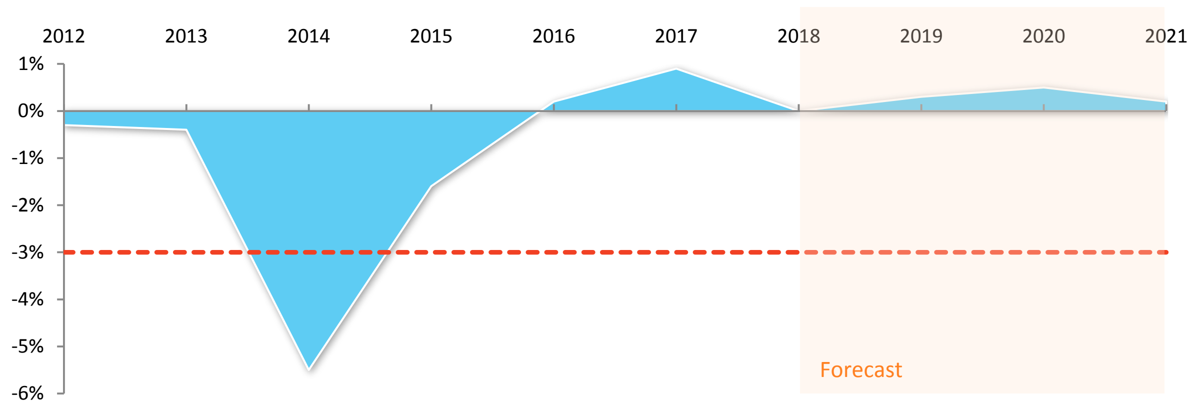
Revenues from production and import tax, current taxes on income, wealth, etc. and taxes on capital increase in nominal terms by approximately BGN 1 billion, as their relative share in GDP remains unchanged vis-à-vis 2016. Revenues from current taxes on income, wealth, etc. increase by 0.3 p.p., which in nominal terms is over BGN 0.5 billion. The two major factors for the increase of the income taxes are the trend of employment growth continuing in 2017, and the registered visible growth in compensation both in the public and private sector. Capital tax revenue retains its share of GDP: 0.3%, unchanged vis-à-vis 2016, while nominally increases by BGN 13 million.

Production and import taxes grow nominally by over BGN 450 million, although they register a reduction of 0.2 p.p. as a share of GDP. VAT revenues are fairly good, as growth is due to an increase in domestic demand and import, stronger activity of the economic agents and the positive effect of the efforts by the revenue administration for improving revenue collection, combating the informal economy and tax evasion. Growth in revenues from excise duties is weaker.

Revenues from social security and health-insurance contributions as a share of GDP grow by 0.7 p.p. vis-à-vis 2016, approximately BGN 1.1 billion. This is due to the benign macroeconomic developments, affecting the income taxes, as well as some administrative measures such as the increase of minimal social security thresholds, the increase of social security contribution for pensions by 1 p.p. and the increase by 20 p.p. of the social security contribution for the employees of sector "Public order and safety".

The capital transfers grow by 0.3 p.p. of GDP, which nominally sums up to almost BGN 0.3 billion.

Figure 3-1: Budget balance (ESA 2010,% of GDP)



Source: Eurostat, MF

The total expenditure of the General Government for 2017 was 35.3% of GDP, which is 0.3 p.p. more than the reported for 2016. At the same time it is 0.8 p.p. lower than the forecast in the previous Convergence Programme. The increase vis-à-vis 2016 is mainly due to growth in current expenditure. The elements of capital spending register a decrease, caused mostly by lower than planned implementation of projects financed by European funds and smaller national co-financing. The drop is most significant for gross fixed capital formation – 0.5 p.p. and capital transfers paid – 0.2 p.p.

Spending on compensation of employees grew by 0.3 p.p. as a share of GDP compared to 2016. The highest contribution originates from the increase in compensation of educational workers since 1 September 2017, which was the first step in making education a major policy priority and a future engine for development. Moreover, budget spending on social security contributions grew due to the increase in contributions for pension fund since 1 January 2017 by 1 p.p. for all employees and by 20 p.p. for employees in the "Public order and safety" sector. Maintenance expenditure grew slightly by 0.03 p.p.

The amount of social transfers as a share of GDP shrank by 0.2 p.p. but in nominal terms they grew by more than BGN 450 million. The largest increase is for social transfers, excluding those in kind, and including pension expenditures, where not only all the pensions were updated by 2.4% since 1 July 2017, but also the minimum pension was increased in two steps – on 1 July and 1 October 2017.

Subsidies spending registered a decrease as a share of GDP compared to the previous year – by 0.3 p.p. and interest expenditure by 0.1 p.p.

3.3.2 2018 Budget Highlights

According to the updated three-year budget forecast, the budgetary target for the General Government balance is stay close to zero, which is expected to remain in the next three years. This objective is in line with current economic conditions and with national fiscal rules.

Revenue policy has retained trends and guidelines in recent years and is geared towards sustaining economic growth, improving the business environment, limiting tax fraud and maintaining macroeconomic and fiscal sustainability in the long run. The Programme for 2018 provides for retaining the tax burden on the main taxes, except for excise duties on tobacco products. A more significant increase is foreseen for the revenue from social security contributions resulting from the changes in the insurance policy in 2018 and the continuing increase in employment and incomes of the employed. A significant increase is also expected from taxes on production and imports (mainly VAT), mainly related to the growth of the tax base, domestic demand and import.

—Priorities on the Revenue Side:

The main focus in the work of revenue administrations will continue to be the implementation of the Single national strategy for increasing revenue collection, tackling the shadow economy and reducing compliance costs, whose enforcement was continued by a decision of the Council of Ministers in 2018. The main regulatory features and amendments in tax legislation are as follows:

- retaining low rates for corporate tax, personal income tax and VAT as an important incentive for investment, economic growth and employment.
- increase in excise duty on tobacco products. This step is part of the planned timetable for a phased increase in excise duty rates to the EU's minimum levels of taxation. The expected positive effect on excise revenue is BGN 90.0 million (0.086% of the projected GDP). In addition to excise revenues, the increase in excise duties on tobacco products will have a positive effect of BGN 18.0 million (0.017% of the projected GDP) on VAT revenue as well.
- the increase of the minimum monthly wage by BGN 50 as of 1 January 2018 is expected to lead to an increase in the revenues from the personal income tax in the amount of BGN 1.4 million (0.001% of the projected GDP).
- the increase of the minimum social security thresholds by the main economic activities and occupational groups and the minimum thresholds for the self-employed as a result of the increase in the minimum wage will generate additional revenues from the personal income tax in the amount of BGN 13.4 million (0.013% of the projected GDP).
- the increase in the remuneration of educational staff in 2017 and 2018 will have a positive effect on the revenues from the personal income tax in the amount of BGN 23.1 million (0.022% of the projected GDP).
- the increase by 1 p.p. of contribution to the pensions fund of the public social security from the beginning of 2018 is expected to have a negative effect on revenues from the personal income tax in the amount of BGN 8.3 million (0.008% of projected GDP).

Social security policy has the following parameters on the revenue side:

- in order to reduce the shortfall in funds from the public social security budget as of 1 January 2018, the amount of the social security contribution for the pensions fund of the PSS is increased by 1 p.p. The aim is to reduce the shortage of funds in the budget of PSS and subsidy received from the state budget. The expected positive effect on revenue is BGN 244.2 million (0.23% of the projected GDP). The amounts of the social security contributions for the other public social security funds and the health insurance contribution remain unchanged in 2018.
- in 2018 the minimum social security thresholds for the main economic activities and professional groups are increased on average by 6.8% vis-à-vis 2017. The minimum social security threshold for self-employed persons increased to BGN 510, eliminating the differentiated minimum thresholds based on taxable income. The minimum thresholds for farmers and tobacco growers also increased from BGN 300 to BGN 350. These changes were due to the administrative increase of minimum social security thresholds by 3.9% and the increase in minimum wage. The expected positive effect on revenue is BGN 84.4 million (0.081% of expected GDP).
- the maximum social security ceiling for 2018 is kept at BGN 2600.

- increase of the revenue from social security contributions as a result of a change in the choice of insurance from a private fund to the NSSI – BGN 12 million (0.011% of the projected GDP).

- the increase in personnel costs in the Ministry of Defence, the Ministry of Interior, the Ministry of Justice, the Ministry of Education and Science, the Ministry of Health, the Ministry of Labour and Social Policy and the National Revenue Agency will have a positive effect on the revenues from the personal income tax amounting to BGN 193.4 million (0.18% of the projected GDP).

Policy of **public spending** is aimed at ensuring the proper functioning of the budgetary systems, providing for the priority policies of the government in education, social work and healthcare, and increasing the efficiency of investment in different sectors in order to enhance their contribution to economic growth.

—Priorities on the Expenditure Side:

Expenditure policies are an instrument to implement government priorities, and their successful implementation is directly dependent on sectoral reforms. Measures are envisaged in the different spheres to improve the efficiency of public spending, including by strengthening the role of market mechanisms and compliance with budgetary ceilings and constraints.

⊙ Measures in the Area of Education

In 2017 started the implementation of the measures to improve the social status of pedagogical specialists in the education sector. Additional funds were provided for that purpose in the amount of BGN 80.0 million for an increase of staff remuneration by 15% on average. For 2018, the additional funds foreseen amounted to BGN 330.0 million (0.32% of projected GDP). This amount provides a full-year increase in the remuneration of the educational staff and introduces an additional funding mechanism for working with children from vulnerable groups and priority areas and protected specialties in vocational schools. For the period 2018–2021, there is a plan to provide additional funding in order to double the funds for remuneration of educational specialists in 2021 compared to 2017. To ensure the match between funding and the quality of education, a change will be introduced in 2018 in the system of delegated budgets, with funding not only dependent on the number of children and pupils, but also on the number of classes, the specificity of the region, where the school is located, and in the longer term also the quality of the educational process. Additional funding is envisaged for schools with a concentration of pupils from vulnerable groups as well as for vocational schools where pupils are trained in professional fields with a future shortage in the labour market. Improving the mechanism of allocating funds from the state budget to pre-school and school education will ensure a fair and efficient allocation of financial resources in line with the needs of kindergartens and schools.

In 2018 funding is provided for the following priority measures and activities in the field of primary and secondary education:

- activities related to enrollment of children and pupils, prevention of dropping out of the education system and reintegration of early school leavers. For the implementation of these measures, additional funds amounting to BGN 35.0 million were provided.

- financing of the protected schools and kindergartens – the additional funds estimated amount to BGN 7.4 million.

- financing of vocational schools, training students in professional fields with a future shortage in the labour market – additional BGN 3.0 million.
- for scholarships for 8th graders in implementation of the policies under the Preschool and School Education Act, an additional BGN 6.6 million was provided.
- for financing of private schools and kindergartens, which have declared willingness to participate in the system of state funding – BGN 7.0 million was provided.

Policies in field of higher education will be put in place by providing funding targeted at learning outcomes; by strengthening the interaction between higher education institutions and businesses; by improving the model of accreditation and quality assessment in higher education; by stimulating the scientific development and career advancement of teachers from higher education institutions; by supporting the mobility of students and teachers. For 2018, an additional BGN 8.6 million was provided for student training allowances on the basis of learning outcomes and BGN 9.0 million for scholarships for students trained in priority professional fields.

⊙ Measures in the Area of Healthcare

The main policy focus on public health and health insurance in 2018 is to achieve the priorities of the 2020 National Health Strategy through the implementation of the National Health Strategy Action Plan to improve effectiveness and citizens' satisfaction with the functioning of the sector. The NHIF budget for 2018 provides for an additional BGN 400 million in expenditure (0.38% of projected GDP). There will be preconditions to improve the control and cost effectiveness of the health insurance system and to ensure quality of treatment and equal access to medical care. It is foressen to introduce information technologies that provide information, traceability, fairness, equal treatment and objective control of the processes in the health system. Priorities in the sector remain emergency medical assistance, electronic healthcare, maternal and child healthcare, assisted reproduction, facilities for medical care and pharmaceutical policy.

The provisions of the HIA, setting out a gradual increase of the proportion of the minimum insurable income which serves as the basis for the health insurance contributions for persons insured by the state budget – from 55% in 2016 to 65% of the minimum insurable income for self-employed persons as of 1 January 2018, with a 5 p.p. rise in the ratio every year until the minimum insurable income for self-employed persons is reached. Meanwhile, the increase in the minimum wage raises the minimum insurable income, on which the state pays contributions. The total amount transferred as a result of the changes will increase by BGN 77.9 million. The impact on the balance on a consolidated basis is neutral as revenue and expenditure will increase by the same amount.

⊙ Policy in the Area of Defence

Defence policy is associated with maintaining modern and combat-ready armed forces (AF). In the medium-term Bulgaria shall fulfill the commitment made at the NATO summit in Wales in 2014 to implement the “National plan to increase defence spending up to 2% ot GDP by 2024”. In 2018, the additional expenditure are foreseen for maintaining existing and gradual development of new defence capabilities for: ensuring operational ability of MiG-29 aircrafts and investment projects to develop the defence capabilities of the armed forces of the Republic of Bulgaria of total amount BGN 397 million (0.38% of projected GDP).

⊙ Measures Concerning Pensions and Social Assistance:

Concerning Pensions

- Since 1 January 2018, the increase in the mandatory retirement age and length of service continues for all categories of employees in accordance with the schedule adopted in the SSC in 2015. In 2018 the gradual increase of the weighting of one year of pensionable work experience in the pension formula continues with a percentage equal to or higher than the percentage determined by the rule of Article 100 of SSC. According to Article 70(1) of the SSC, the percentage for each year of covered service is to be set annually in the act on the PSS budget for the respective year. For the year 2018, this figure is 1.169, an increase of 3.8% compared to 1.126, which was used in the calculation of the new pensions and the recalculation of existing pensions in 2017. Retirement pensions granted by 31 December 2017 will be recalculated from 1 July 2018, in view of the increased percentage per year of retirement. The change in the retirement conditions for all categories of work, the increase in the percentage for each year of pensionable work experience in the pension formula, the yearly payment of the pensions recalculated from 1 July 2017, the increase in the minimum pension and retirement age in 2017 and the recalculation of pensions from 1 July 2018 will be reflected in an increase in pension expenditure by BGN 519.4 million (0.496% of projected GDP), including BGN 282.0 million full-year effect of the increase in the minimum pension in two steps in 2017.
- The maximum amount of one or more pensions received is kept at BGN 910.
- To support pensioners receiving the lowest pensions, in April 2018, a one-off benefit will be added to all pensions below the poverty line – BGN 321.The total amount of this aid – BGN 49.1 million will increase expenditure by 0.047% of the projected GDP.

In the field of social benefits paid by the public social security, changes in some types of cash benefits are in force since 2018:

- the amount of the allowance for raising a child from one to two years of age increased from BGN 340 to BGN 380. The change leads to an increase in expenditure by BGN 18.6 million (0.018% of projected GDP).
- the minimum daily amount of the unemployment benefit increased from BGN 7.20 to BGN 9 and a maximum daily amount of BGN 74.29 was set. The cost effect is an increase of BGN 7.4 million (0.007% of projected GDP).
- the required insurance period to ensure entitlement to cash unemployment benefit (at least 12 months' length of service for the past 18 months) was increased and the period during which the unemployment benefit is paid is more closely linked to the social security contributions of the individuals. The cumulative effect of the changes is a reduction in expenditure of BGN 79.0 million (0.075% of projected GDP).
- the maximum amount of guaranteed employees' claims (from the Guaranteed Claims and Employee Benefits Fund) in case of employer insolvency increased from BGN 1200 to BGN 1300.
- for the other types of cash benefits, the parameters of the current legislation remained unchanged in 2018: the period of payment of the cash benefit for pregnancy and childbirth is retained; the regime for granting the temporary disability allowance is retained; the period used for the calculation of short-term benefits for temporary incapacity to work and pregnancy and childbirth is retained; the amount of one-off assistance in the event of death is preserved.

Social assistance policy

One of the priorities for 2018 remains the guarantee of social protection for the most vulnerable groups by better targeting of social benefits, increasing programme efficiency, implementing a differentiated approach, improving the legal framework in the field of social assistance and optimising the institutional structure related to social protection of those of the lowest income and risky groups of the population. The policy objective is to continue to address as much as possible the problems of the risk groups within the state's financial capabilities, and in terms of poverty, but not by establishing and maintaining a lasting dependency on the social assistance system.

With a view to providing an appropriate level of support to the most deprived groups of the population at the beginning of 2018, the guaranteed minimum income (GMI) increased from BGN 65 to BGN 75. The guaranteed minimum income is the basis for determining the access limit and the amount of social benefits under the Social Assistance Act. In addition, it determines the sizes of different types of social payments, such as: the amount of integration allowances under the Integration of People with Disabilities Act, the amount of financial aid for prevention and reintegration, the child benefits for relatives and foster families under the Child Protection Act, etc. The increase in GMI, ceteris paribus, results in both an increase in the number of persons and families supported and a higher rate of the allowance. The impact on the expenditure of the higher GMI is BGN 27.6 million (0.026% of projected GDP).

Amendments to the Family Allowances For Children Act in 2018 introduced a different income-based criterion for granting the four types of family allowances for which there is an income test. Lump-sum benefits for pregnancy, one-off allowance for pupils enrolled in the first grade and monthly child-care allowances for children up to one year of age will be provided based on a common earnings criterion. This criterion for 2018 amounts to BGN 450. In order to achieve better targeting and at the same time to provide support for more families, a different procedure is introduced to determine the income-based criterion for monthly child benefits up to the completion of secondary education, but not more than 20 years of age, and to link the amount of benefits with this income-based criterion. The expected outcome of the amendments is an increase in supported families by about 20,000. For 2018, a family member's income-based criterion to entitle them to the full amount of this kind of monthly child allowance was set at BGN 400. Under the new approach, families where the income ranges between BGN 400.1 and BGN 500 inclusive, will be entitled to 80% of the full amount of the assistance. Hence, more families outside the groupof the lowest income families could benefit from financial support from the state for raising children, albeit at a lower rate. Besides raising the income entitling parents to monthly childcare allowances, the amount of these benefits has also increased in 2018, with the full amount of benefits being as follows: for one child – BGN 40, for two children – BGN 90, for three children – BGN 135, for four children – BGN 145 and for each subsequent child the aid grows by BGN 20. The cumulative effect on the expenditure of changing the average monthly income per family member entitling them to monthly childcare allowances and changing the amount of benefits is BGN 25 million (0.024% of projected GDP).

—Income Policy

As of 1 January 2018 the minimum wage for the country increased from BGN 460 to BGN 510. The effect of the measure on expenditure in the budget sector is an increase in staff expenditure of BGN 85.3 million (0.081% of the projected GDP). The increase in the minimum wage is aimed at a nominal increase in the income of the lowest income groups in the labour market. The current income policy facilitates the achievement of social cohesion and provides equal opportunities for a full-fledged social and work life for all social groups in the population, which is in line with the established practices in EU Member States for protecting the income and living standard of the low-paid workers and the “working poor”, and for implementing the minimum standards to ensure a decent standard of living. The increased contribution to the pensions fund by 1 p.p. in 2018 leads to growth in social security expenditures in the budget by BGN 22.7 million (0.022% of projected GDP).

For 2018, the income policy provides for an increase in staff resources for the sectors: Defence and Security; Education; Health; Social Security, Assistance and Care and others, as follows:

- BGN 100.0 million to increase staff resources at the Ministry of Defence as a prerequisite for motivation and professional selection of staff needed to implement defence policy;
- BGN 155.0 million earmarked to increase staff resources at the Ministry of Interior (MoI) to improve the efficiency in the implementation policies in the area of public order and safety.
- BGN 6.6 million to increase staff costs for employees under the MoI Act, the Directorate General of Execution of Penalties and the Directorate General for Security Guards at the Ministry of Justice to strengthen the penitentiary system and security infrastructure in prisons and detention facilities and providing a higher level of security and protection of public order in court buildings and the protection of the health and life of magistrates and witnesses.
- in the Education sector in 2018 additional funds amounting to BGN 330 million are provided, which provide for a full-year increase in the costs of educational staff, as well as the introduction of an additional funding mechanism for working with children from vulnerable groups and priority fields and protected specialties in vocational schools. The amount is also indicated in the part of the publication which describes the measures in education.
- in the healthcare system for 2018 in support of the Council of Ministers Concept for development of the emergency care system in the Republic of Bulgaria 2014-2020, additional remuneration funds amounting to BGN 19.7 million are envisaged to ensure sustainable human resources development and equal access for citizens to emergency care in line with the best European practices and requirements for timeliness, sufficiency, quality and safety. Within the total expenditure of the Ministry of Health budget for 2018 an increase of the staff resources for budgetary structures to the Minister of Health is envisaged for BGN 8.1 million.
- to link the work done with the results achieved and to preserve the administrative capacity and the normal functioning of the structures at the Minister of Labour and Social Policy, the Agency for Social Assistance, the Employment Agency, the Executive Labour Inspection Agency, the Agency for People with Disabilities, etc., there is an additional increase of the staff resources amounting to BGN 9.4 million.
- in order to ensure the subsequent increase in the efficiency and fiscal effect of the National Revenue Agency's control activity for 2018, funds are foreseen to increase the number of staff by two hundred permanent positions. The additional financial and human resources ensure the implementation of the extended scope of activity assigned to the NRA under the amendments to the Excise Duties and Tax Warehouses Act related to the treatment of certain types of fuels as goods with high fiscal risk. The envisaged increase of the staff resources amounts to BGN 12.1 million, providing for the increase in employee compensation by 5% and the increase in the number of staff by 200 permanent positions.

The overall effect of these increases in personnel expenditure in the budget-funded sector (including in education) represents an increase in expenditure by BGN 640.9 million (0.61% of projected GDP).

3.4 Medium-Term Perspectives, Including Description and Quantification of the Strategic Policy Impact

The government's medium-term strategy is detailed in the Medium-Term Budgetary Forecast, the National Reform Programme and the three-year Action Plan for the implementation of the National Development Programme: Bulgaria 2020 for the period 2018–2020. The latter provides for the implementation of a wide range of measures grouped into several key priority areas, which are expected to lead to a more balanced regional development, enhanced quality of human capital, promotion of innovation, improved infrastructure quality and an increase in the competitiveness of the economy, as well as employment and income levels. The relevant funding will be secured primarily from the EU funds which complement the expenditure from the national budget.

3.4.1 Improved access to and quality of education and training and qualitative features of the labour force: allocations in the amount of BGN 3.7 billion

The policy is focused on the formation of human capital and enhancing its quality in all dimensions. It is primarily aimed at modernisation, improving access to the educational system and introducing mechanisms for better quality management. Activities in that area include measures to improve access to education, as well as gearing education towards creativity and innovation which lead to personal development, and reducing the rate of early school leavers. In order to improve the quality of education, a more efficient model and funding will be developed, introducing a credit system, raising the qualification of the educational staff and improving the link with the business sector. The enhanced qualitative features of the labour force will be ensured via measures aimed at adapting policies in the area of lifelong learning to the needs of the labour market. These measures include: improving mobility, introduction of a system of course credits, strengthening links with the business sector and promoting the adoption of up-to-date forms of work organisation in enterprises.

In addition, increasing the social role and relevance of research, improved career development and working conditions for researchers, developing scientific potential through integration into the European Research Area, as well as bolstering research and development through programme financing via competitive procedures, are envisaged. Measures to ensure national access to European and global infrastructure, e-infrastructures and databases of key importance for the development of science in the country will be funded. In terms of improving the quality of healthcare, innovations are envisaged for a sustainable and efficient health system as well as improving the quality of healthcare and ensuring access for all citizens to healthcare and services. Measures are also envisaged to improve the physical activity and health of students, pupils and other population groups by improving the conditions for practicing sport.

3.4.2 Poverty reduction and promoting social inclusion: allocations in the amount of BGN 3.5 billion

Emphasis is placed on guaranteeing the adequate participation of vulnerable groups in all areas of public life through a set of comprehensive measures, covering areas such as the provision of opportunities for training and employment, and for starting one’s own business, improving the quality of social services, deinstitutionalisation of care for children, the elderly and people with disabilities, as well as a number of legislative changes. Planned activities include improving the qualifications of the unemployed, enhancing the quality of intermediary services in the area of employment to ensure that they better match the needs of the labour force, as well as measures to ensure more flexible employment, so as to improve the possibilities for reconciling private and work life. Measures are also envisaged to reduce the shadow economy in the labour market by better protecting labour rights and reducing undeclared work.

3.4.3 Achieving sustainable integrated regional development and utilisation of local potential: allocations in the amount of BGN 6.2 billion

Regional development in Bulgaria is geared towards developing the potential of the Bulgarian regions, reducing interregional disparities and improving the attractiveness of all regions as places for living and doing business. The key areas of government intervention are: strategic planning and regional governance through enhanced capacity of the local authorities; promoting the development of towns and improving the integration of Bulgarian regions through integrated sustainable urban development and strengthening of the functions of the polycentric network of cities; improving urban labour mobility; developing and improving access to cultural services and sports in the regions and the building of broadband infrastructure; support for effective and sustainable utilisation of tourism potential in the regions through development of the infrastructure for specialised forms of tourism and through marketing of the tourism regions and development of regional tourism products; support for the development of underdeveloped regions and improving the quality of life in rural areas; creating conditions for environmental protection in the regions by improving the quality and efficiency of water supply services for businesses and citizens and building and upgrading sewage and waste water treatment systems for sustainable water resource management; as well as enhancing territorial cohesion through the development of cross-border, interregional and transnational cooperation.

3.4.4 Support for innovation and investment activities to enhance the competitiveness of the economy: allocations in the amount of BGN 0.4 billion

The key priority areas in the three-year period will be the building of innovation and scientific infrastructure to improve the connections between business, science and education, and the implementation of measures under the Investment Promotion Act. There will be comprehensive measures for promoting investments in manufacturing and in high-tech industries and services, such as support for infrastructural projects, education, job creation and financing innovation projects. Concrete steps will also be taken to improve the quality of services in the tourism sector. Pro-active marketing will help support the attraction of targeted investment to the economy and the promotion of the country as a tourist destination. The sector of small and medium-sized enterprises will be supported by measures aimed at improving the conditions for starting up business and implementing good practices, including wider use of ICT and support for R&D projects. EU funds will be used to finance the building and completion of innovation and scientific infrastructure in Bulgaria, while national financing will be used to support the participation of Bulgarian enterprises in EU programmes such as Horizon 2020 and Eureka.

3.4.5 Strengthening the institutional environment for greater efficiency of public services for citizens and businesses: allocations in the amount of BGN 0.2 billion

In the period until 2020, the government will focus, inter alia, on the introduction and mainstreaming of integrated administrative services and the review of all regulatory regimes set up by means of special legislative act, with the aim of reducing the regulatory burden and preventing its subsequent increase, as well as ensuring better coordination among the territorial units of the central government administration which provide services. The government policy will emphasize, among others, on developing e-government and ensuring the interconnectivity and interoperability of the information systems in the public administration. Insolvency procedures will be streamlined and the use of the tacit agreement principle will be expanded. Improved cooperation among the various units within the structures of the judicial system and the wider implementation of ICT are expected to improve its effectiveness. Measures to enhance law enforcement and unregulated and corrupt practices will be implemented. To make the administration more effective, the system for assessing and planning the need for experts will be improved and a wider choice of up-skilling options will be offered. Measures to modernise selection methods and improve mobility options are also envisaged. Work to improve the dialogue with the public on policy-making and monitoring government policies will continue by developing the capacity of the private sector in that field and improving access to information.

3.4.6 Energy security and improving resources efficiency: allocations in the amount of BGN 0.2 billion

Government efforts will be geared towards enhancing energy security, independence and efficiency in the economy, as well as towards improving the environment. To ensure Bulgaria's energy security, conditions will be provided enabling diversification of sources and routes for the supply of natural gas by building gas interconnections with the neighbouring countries and supporting the construction of gas pipelines along the main European gas corridors, as well as by promoting the maintenance of a reasonable balance between the energy resources available in Bulgaria and the EU clean energy targets. Reducing the use of electricity in households by replacing it with natural gas will result in a more efficient use of resources, lower costs and a higher quality, healthier environment. In terms of resource efficiency, actions will be undertaken to promote the introduction of low-carbon, energy-efficient and clean technologies, and the increase the proportion of waste recycling and reuse. As regards the provision of an integrated internal energy market, the efforts will be geared towards full transposition of the Third Energy Liberalisation Package of the EU with the aim of achieving full liberalisation of the market for electricity.

3.4.7 Improving transport connectivity and access to markets: allocations in the amount of BGN 7.8 billion

During the period until 2020, the key focus of the policies aimed at creating optimal conditions for the development of the economy, improving access to markets and limiting environmental pollution will be on efficient maintenance, upgrading and developing transport infrastructure, sustainable development of public transport and reforming the railway transport system. A number of projects along the trans-European corridors which cross national territory are planned. The largest projects include the completion of the Struma motorway, upgrading the Sofia-Plovdiv railway line, rehabilitation of the Plovdiv – Burgas railway line, development of the Sofia railway junction and completion of the Plovdiv – Svilengrad railway line. With a view to ensuring sustainable development of mass public transport, efforts are focused primarily on the construction and development of smart networks and services. The extension of the subway in Sofia is of paramount importance in this respect. As regards the reform in the railway transport system, the main efforts will focus on improving the management of the railway sector, as well as on restructuring BDZ Holding EAD and the National Railway Infrastructure Company (NKZI).

3.4.8 Ex-ante impact assessment

The table below presents the expected effects from the implementation of the measures planned. The SIBILA (Simulation model of Bulgaria's Investment in Long-term Advance) model has been used for this purpose. The assessment covers the effects[31], defined as changes in the levels of key macroeconomic indicators.

[31] The overall effects for the economy from the implementation of measures are calculated as the difference between two scenarios: a baseline scenario (scenario 0), which simulates the development of the economy without the Action

The interventions planned are expected to result in a positive change in employment (an increase of 5.4% against the baseline scenario) and in the unemployment rate (a decrease of 2.2 p.p.) at the end of 2020. This is due both to direct effects from the inflow of the funds into the economy (job creation) and to indirect effects (expressed in improved quality of employees and the labour force as a whole).

Table 3-1: Effects from the implementation of the measures planned

Macroeconomic indicator	Effect as of 2020
GDP	10.3%
Export of goods and services	2.7%
Current account balance,% of GDP	-5.4 p.p.
Employment rate (aged 15-64), in thousands	5.4%
Unemployment rate (aged 15-64)	-2.2 p.p.
HICP inflation	3.6 p.p.
Budget balance,% of GDP	-2.3 p.p.

Source: MF, SIBILA.

According to the analysis, the net effect of the planned measures on the budget balance will reach -2.3 p.p. of GDP by the end of 2020. As a whole, the overall effect is a combination of several effects acting in opposite directions – increasing government spending, and higher income levels and a favourable economic situation, which leads to increasing budget revenue. In the medium-term, the interventions will contribute positively to the budget balance as a result of the improved economic situation, the increase in output and increased consumption.

Over the period under review, the country's output and GDP will grow smoothly, allowing a gradual real convergence with the EU. The implementation of the planned measures would play a significant role in this respect, with simulations showing that their impact on GDP by 2020 would be 10.3% above the baseline scenario without realizing the planned funds in the Action Plan. Inflation will accelerate by 3.6 p.p. against the baseline scenario. Exports of goods and non-factor services will also grow faster than the baseline scenario (2.7%) as a result of planned interventions.

3.5 Structural balance (cyclical components of the balance, one-off and temporary measures) and fiscal stance, including in terms of the government expenditure benchmark

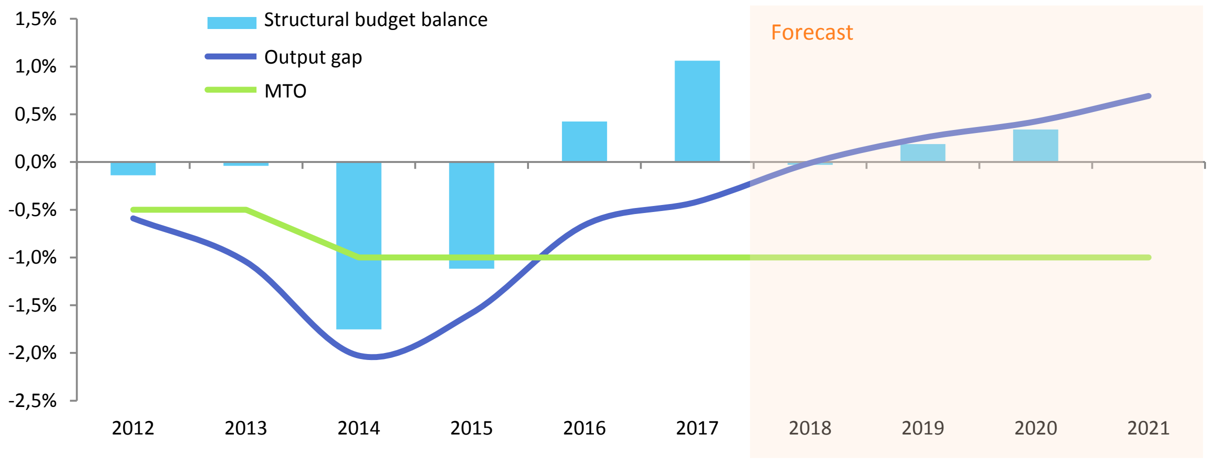
The structural budget balance in 2017 is estimated as a surplus of 1.1% of GDP. The budget position improvement in structural terms compared to 2016 was 0.6 p.p. The fiscal policy aim in 2018 is achieving a balanced budget of the General Government sector. In structural terms the balance is also estimated at 0% of GDP, in the forecast of reaching the potential output of the economy. In 2019 the positive output gap is expected to reach 0.3%, and the cyclically-adjusted budget balance to have an improvement of 0.2 p.p. reaching a surplus of 0.2% of GDP. In 2020 the structural balance will be further improved to a surplus of 0.3%, and in 2021 it decreases to 0% of GDP.

Over the projection horizon, the assessment of the structural budget balance remains far more conservative than the MTO of 1% of GDP. Thus, the sustainability of public finances is ensured in the

Plan interventions, and a hypothetical alternative scenario (scenario 1), which takes account of the implementation of the measures within the deadlines set in the Action Plan and with the resources planned for this purpose.

medium-term, as well as the required short-term buffer in the event of an unplanned deterioration in the actual budget balance.

Figure 3-2: Fiscal position



Source: MF

The assessment of compliance with Stability and Growth Pact and Public Finance Act requirements in terms of budget expenditure growth is based on the common methodology for the expenditure benchmark, taking into account the division between public investments funded by the national budget and the EU. In 2018, as well as in the projection period 2019–2021, Bulgaria is expected to exceed its medium-term budgetary objective and therefore, according to the EU fiscal governance rules, it is allowed to temporarily exceed the reference rate of potential GDP growth. According to the EC, this reference rate is 2.2% for 2018. Due to the over-fulfilment of the medium-term budgetary objective (MTO), the EC estimates that the maximum eligible increase in the expenditure indicator is 3.9% in real terms. However, adjusted budget expenditures, net of the effect of revenue discretionary measures, are projected to fall in 2018, i.e. to be well below the maximum growth rate calculated by the EC.

The real net public expenditure annual growth is estimated at -3.0% for 2018, 4.5% for 2019, 1.9% for 2020 and 0.6% for 2021. In 2019, the expenditure indicator growth exceeds the medium-term rate of potential GDP growth but when the medium-term budgetary objective (MTO) is overachieved.

3.6 Debt levels and developments, below-the-line operations

In the context of the favourable internal and external macroeconomic environment, as a result of a strict fiscal policy and a consistent approach to government debt management, by the end of 2017 it is envisaged that the size of the consolidated general government debt will decrease compared to the level, registered at the end of the previous year both in nominal terms and as a share of GDP. According to preliminary data, in nominal terms the debt level is reduced to about BGN 25.1 billion, while the value of the „General government debt/GDP“ ratio to 25.4%, significantly below the 60% reference value. The reported debt level outlines the expectations in 2017 for the Republic of Bulgaria to maintain its leading position among the 28 EU Member States with the lowest government indebtedness. Compared to 2016, the values of these parameters were respectively: BGN 27.3 billion and 29% as a share of GDP.

The already established lasting trend of structural allocation of consolidated liabilities remains in 2017 as a major share and component with the most significant impact on the sector's debt continues to occupy the Central Government sub-sector. Based on reporting data for 2017, this component represents about 98.0%, keeping its dominance in each of the following years. The other two components – the Local Government sub-sector and the Social Security Funds sub-sector – have almost a neutral impact on the total debt of the sector.

In nominal terms, the decrease in the general government debt in 2017 is the result of the regular debt repayments, including BGN 1 842.8 million on government securities issued on the international capital markets, BGN 785.1 million on domestic government securities and BGN 452.9 million on government loans.

To ensure financing from debt sources in 2017, the opportunities provided by market-oriented financing in the domestic market through the use of the most favourable structure of debt instruments were used. The main source of debt financing remains the issue of government securities with a share of about 70% of the total amount of the funding received for the Central Government sub-sector. The nominal value of government securities issued on the domestic debt market during the reporting period amounted to BGN 789.5 million, including: a 10.5-year issue with a nominal value of BGN 339.5 million, a 7.5-year issue with a nominal value of BGN 250 million, and a 4-year issue with a nominal value of BGN 200 million.

For the first time in the history of the domestic sovereign debt market, a negative yield (-0.19%) was realized on the auction held on 13.11.2017 for the 4 years bond. At the same time, yield on the issue of 10.5-year government securities, based on real deals concluded on the secondary market, showed a downward trend (compared to the end of 2016) and from 1.80% reached 1.02% in December 2017, which is the lowest value of the long-term interest rate to assess the level of convergence from 2003 to the present (the time from which it is calculated for Bulgaria).

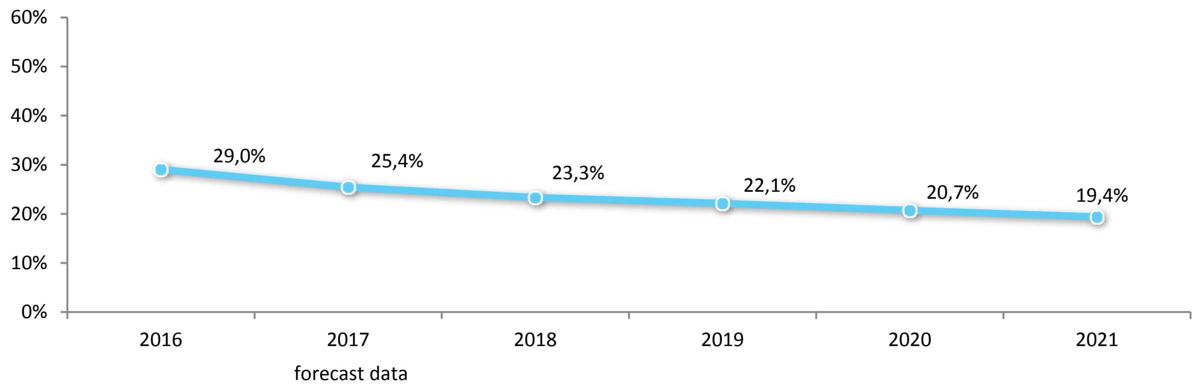
The remaining 30% represent loan disbursment (internal and external) of entities classified in the subsector, including ministries, state hospitals, FLAG EAD, BDIF and others.

In structural terms, the share of domestic financing in 2017 reached about 93% of the total amount of the new borrowing, and of the external – about 7%.

Based on the debt level forecast for the period 2018–2021 (BGN 24.4–24.2 billion), the debt to GDP ratio is expected to fluctuate between 23.3% and 19.4%, decreasing in each of the years under review. Compared to the assumptions set out in the previous Convergence Programme for the period 2017–2020, lower debt/GDP ratios are projected. The reasons for this adjustment stem from the positive macroeconomic developments, the improvement in the budgetary position and the decreasing need to provide financial resources from debt sources to finance the budget. There is also an increase in the estimated amount of the consolidation elements of the General Government sector of about BGN 650 million per year (assets of the Social Security Funds sub-sector in the form of government securities issued by the Central Government sub-sector as of 31.12.2017 – about BGN 730 million).

Preliminary estimates of parameter dynamics over the current and next three years remain well below the Maastricht convergence criterion of 60%, and ensure that the level of government indebtedness remains within sustainable limits.

Figure 3-3: Consolidated Government Debt-to-GDP Ratio



Source: MF

The Central Government sub-sector is the main contributor to the change in the General Government debt. The debt obligations of the entities included in the subsector, whose service is their responsibility, are of relatively low share and have a minimal impact on the total debt of the sector. Thus, the government debt management policy will remain a leading factor influencing the debt dynamics of the General Government sector during the projection period. Efforts to control the level of government debt and keep it at low risk are reflected in the debt restrictions provided for in the State Budget Act of the Republic of Bulgaria for 2018:

- The maximum amount of government debt at the end of 2018 cannot exceed BGN 23.5 billion;
- The maximum amount of the new government debt, which can be assumed under the Government Debt Act, is BGN 1.0 billion.

Under circumstances that would lead to a negative development or a risk of breaching the 60% threshold of the General Government debt-to-GDP ratio, a legislative option is foreseen in the annual state budget act to pledge additional restrictions on the assumption of debt by municipalities and social security funds.

In the period 2018–2021 debt financing in the form of government securities is planned to be in the range of about BGN 0.8-1.25 billion per year, based on the amount of maturing debt outstanding (BGN 1.8–1.1 billion). There are also plans for disbursments of negotiated government loans in the amount of about BGN 200 million per year by international financial institutions (EIB and Council of Europe Development Bank), intended for co-financing of projects implemented with EU funds. Taking of new governmental obligations it is envisaged to continue the assumption of fixed-rate debt denominated in BGN and EUR in order to minimize the effects of interest rate and currency risk in the future servicing of the debt.

During the period under review, it is not planned to issue Government Securities on the international capital markets and use the remaining limit on the Global Medium-Term Programme of the Republic of Bulgaria for issuing bonds on the ICM.

Within the projection horizon, the debt level of the Local Government sub-sector is not expected to change notably from the level reported at the end of 2017 (preliminary data about BGN 1.5 billion), stabilizing within the range BGN 1.2 billion and BGN 1.0 billion. The main factors behind this are the restrictions laid down in the Public Finance Act and the Municipal Debt Act. They stipulate that the annual sum of municipal debt payments for any municipality in any given year may not exceed 15% of the annual average amount of its own revenue and general balancing subsidy for the past three years calculated on the basis of data from the annual reports on the implementation of the budget of that municipality, and that, within the current budget year, municipalities may assume new debt to finance long-term energy performance contracts (ESCO contracting) in an amount up to 15% of the annual average amount of their reported capital expenditure in the past four years in the respective municipal budget. Estimates for 2017 show that the statutory restrictions as well as the expected flexible municipal financing schemes in the new programming period will retain its share within about 1% of GDP, respectively a share of about 2% of the total amount of consolidated obligations for the entire period from 2018 to 2021.

The Social Security Funds sub-sector does not have any debt obligations and it is not expected to take any new ones in the coming years. The sub-sector will continue to exert its influence in the direction of a reduction in the General Government's consolidated debt through the accumulation of financial assets in the form of Government Securities issued by the Central Government sub-sector. For 2017, they amount to about BGN 730 million.

The assumptions about the debt size of the Local Government and Social Security sub-sectors in the period 2018–2021 show the level of influence of these sub-sectors in measuring the debt burden of the General Government sector.

Table 3-2: Revenues from privatisation and post-privatisation control in the central budget, (BGN million)

Reported 2017.	SBA 2018.	Forecast 2019	Forecast 2020.	Forecast 2021
3.3	6.98	4.69	4.19	35

Source: MF

The values in the table are based on a forecast of revenues from privatisation sales and post-privatisation control for the period 2019–2021, prepared in February 2018 by the Privatisation and Post-Privatisation Agency.

The sale of the following companies is expected to generate the main revenue in the respective year:

- 2018 – proceeds from the sale of state-owned real estate held in the private law domain;
- 2019 – Plod – Zelenchuk EOOD (Fruit and Vegetables), Rousalka EOOD, Pazar za plodove i zelenchutsi AD (Fruit and Vegetables Market);
- 2020 – Sortovi Semena Elit EAD (seed bank), SAPI EOOD (Agri-Market Information System);
- 2021 – Slanchev Bryag AD (Sunny Beach), GUSV EAD, Sofia, BSE AD, Central Depository AD.

Proceeds are also expected from the sale of state-owned real estate held in the private law domain and minority stockholdings, and from post-privatisation control.

3.7 Budgetary Implications of Major Structural Reforms

3.7.1 Implications for the Expenditure Side of the Budget

—Changes in the Pension System

The pension reform undertaken over the recent years aims to ensure revenue stability in the pension and social security system, and improve the adequacy of pensions in view to the demographic challenges the country is facing. The further increase in the retirement age will be geared towards increased stability in the pension system in the long term, maintaining solidarity among generations and reducing poverty risk for elderly pensioners.

The pension expenditure forecast for the period 2019–2021 takes into account the provisions laid down in the SSC and the assumptions in the medium-term fiscal framework of the government, including:

- The retirement age for category 3 workers has further increased, rising by 2 months for women and by 1 month for men. The required length of service for both sexes continues to increase by 2 months to reach 36 years for women and 39 years for men in 2021. The eligibility requirements for retirement in the period 2018–2021 are shown in the table below:

Table 3-3: Conditions for retirement under Article 68(1)-(2) of the SSC, 2018–2021

year	WOMEN		MEN	
	age	length of service	age	length of service
2018	61 years and 2 months	35 years and 6 months	64 years and 1 month	38 years and 6 months
2019	61 years and 4 months	35 years and 8 months	64 years and 2 months	38 years and 8 months
2020	61 years and 6 months	35 years and 10 months	64 years and 3 months	38 years and 10 months
2021	61 years and 8 months	36 years	64 years and 4 months	39 years

- The minimum retirement age for persons employed in the Security sector continues to rise by 2 months until it reaches 53 years and 8 months in 2021.
- The minimum retirement age for persons who have been employed under Labour Categories 1 and 2 and do not meet the retirement requirements for an occupational pension fund laid down in Article 168 of the SSC or have opted for a switch in their social security scheme under Article 4c of the SSC continues to rise by 4 months for women and 2 months for men until it reaches 49 years and 8 months for women and 53 years and 8 months for men for Category 1, and 54 years and 8 months for women and 58 years and 8 months for men for Labour Category 2.

The expected financial effect from the above mentioned changes is a reduction of pension expenditure accordingly by BGN 14.0 million in 2019, BGN 16.0 million in 2020, and BGN 15.0 million in 2021.

- Over the 2019–2021 period, the percentage for each year of covered service (accrual rate) in the pension formula continues to rise by percentage equal to or higher than the percentage specified in Article 100 of the SSC. Over the 2019–2021 period, the employment related pensions, granted up to 31 December of the previous year will be recalculated as from 1 July of the respective year using the new accrual rate as specified for the respective calendar year. These recalculations will replace the indexation under Article 100 of the SSC.

The expected effect on the expenditure for pensions is as follows:

- for 2019 – the necessary funds for accrual rate increase from 1.169 to 1.223 (4.6% increase) amounted to BGN 246.2 million, incl. for newly granted and already granted pensions;
- for 2020 – the necessary funds for accrual rate increase to 1.277 (4.4% increase) were BGN 246.7 million, incl. for newly granted and already granted pensions;
- for 2021 – the necessary funds for accraul rate increase to 1.332 (4.3% increase) were BGN 257.0 million, incl. for newly granted and already granted pensions.

- The maximum amount of one or more pensions granted by 31 December 2018 increases – from 35 to 40% of the maximum insurable income, as of 1 July 2019. The maximum sum per person of one or more pensions he/she can receive will not apply for pensions granted after 31 December 2018.

The expected increase in pension expenditure is about BGN 45 million in 2019.

In the reference medium-term programme, the expenditure for pensions and supplementing allowances remains in the range of 9.0% to 8.8% of GDP.

Table 3-4: Pension and allowances expenditure estimates, 2018–2021[32]

year	Pension expenditure	
	BGN million	% of GDP
2018	9 454.4	9.0
2019	9 938.8	8.9
2020	10 452.0	8.8
2021	10 950.4	8.8

Source: NSSI, MF

- Effects on the expenditure side of the introduction of a mixed system: electronic toll for cars and toll fee for trucks:

On the basis of the planned revenues from the introduction of a mixed charging system for the use of the national road network in the SBS for the period 2019–2021, the respective costs were also calculated. These include the cost of introducing the toll system in 2019, operating costs and maintenance of the system over the medium-term as well as the costs of building road infrastructure, ongoing repairs, rehabilitation and maintenance of the national road network for the period 2019–2021.

The budget effect in the part of the expenditure for the first year (2019) from the introduction of the toll and the electronic vignette is BGN 215.3 million. In 2020 and 2021, the cost effect is tied to the expected higher revenue from toll fees, respectively BGN 263 million in 2020 and BGN 294 million in 2021.

—Policy in the field of education and science

⊙ In the field of pre-school and school education

The key policies in the education sector over the period 2019–2021 will aim at fully covering all children and pupils to be educated, preventing the dropout from the education system and reintegration of early school leavers; enhancing the educational results of all students; providing support to educational specialists and attracting young people into the profession; support for Bulgarian schools abroad to preserve the Bulgarian communities and the Bulgarian national identity abroad; expanding the opportunities for lifelong learning and promoting it across all sections of the population.

⊙ In the field of higher education

Higher education policy is geared towards sustainable development and quality of education through financial promotion and orientation to the practical needs of the labour market. And in the period 2019–2021 the reforms aimed at the specialization of state-run higher education institutions and their profiling optimization will continue to be implemented; restructuring of admissions to profes-

[32] The data up to 2021 are based on the revenue and expenditure forecast of the consolidated budget of the PSS for 2019-2021 of March 2018.

sional fields with expected higher future demand on the labour market; improving the rating system of higher education institutions; provision of public guarantees for student credits; abolition of restrictions on the admission of students from Bulgarian communities abroad.

⊙ In the field of science

The science policy is aimed at implementing the National Strategy for the Development of Scientific Research in the Republic of Bulgaria 2017-2030, the National Roadmap for Scientific Infrastructure and the Strategy for the Promotion of Scientific Research.

⊙ Reform of the institutional framework in the field of prevention and counteraction of corruption

At the beginning of 2018, the adoption of the Anti-Corruption and Forfeiture of Unlawfully Acquired Assets Act (effective from 21 January 2018) set up a new single independent anti-corruption body – the Commission for Anti-Corruption and Forfeiture of Unlawfully Acquired Assets. The new anti-corruption body brings together the functions of existing public authorities and bodies whose competence includes the prevention of corruption: checks on the declarations of property and interests; activities related to corruption incidents of senior public officials; identifying conflicts of interest; detecting and forfeiture of illegally acquired assets. The highlight in the adopted act is the reform of the institutional framework in the field of prevention and counteraction of corruption, aiming at greater efficiency and better coordination between the existing bodies and entities in the public administration.

3.7.2 Implications for the Revenue Side of the Budget

—I. Legislative Changes in the Tax Policy Area

Table 3-5: Estimated budgetary effect from discretionary revenue measures

Discretionary measures in MBGN	2018	2019
Change in the social security contribution to the PSS Pensions fund	235.9	
Step-by-step change in the excise duty rate levied on cigarettes until it reaches the minimum excise duty rate of BGN 177 per 1000 pieces as of 1 Jan 2018	90.0	
Positive effect on VAT revenue from increased excise duty rates for cigarettes	18.0	
Revenue from personal income tax and social contributions from the increase in the salaries in the budgetary area	216.5	109.1
Revenue from personal income tax and social contributions from the change in the MW, minimum social security and health insurance thresholds and the minimum insurance income	99.2	103.0
Revenue from social security choice	12.0	11.5
Revenue from raising the retirement requirement for length of covered service by 2 months	0.5	0.5
Introduction of a toll fee and electronic vignette		215.3
Total:	672.1	439.4

Source: MF

⊙ Corporate taxes

The forecast for corporate tax revenue is based on retaining the basic tax rate of 10%.

In 2017 a provision in the Corporate Income Tax Act (CITA) was supplemented, whereby in addition to the Annual Activity Report, taxable entities who have not performed an activity within the meaning of the Accounting Act are no longer bound to submit an Annual Tax Return. At the same time, a measure is adopted in the Accounting Act, according to which enterprises that have not performed activity in the reporting period may not publish financial statements in the Commercial Register. They are only bound to submit a declaration in free text that they have not performed any activity. The adopted changes further provide for that no fee is due for submission of the declaration.

An amendment to the CITA is adopted, whereby an obligation is created to mandatorily submit electronically, with an electronic signature, the tax return forms under the CITA, in respect of which the obligation for submission arises after 31 December 2017 (Act Amending the EDTWA, promulgated in the State Gazette, №97 of 06 December 2016).

⊙ Personal Income Taxation

The forecast concerning revenue under the PITA for the period 2018–2021 has been made while preserving the flat tax rate of 10% (with no tax-exempt minimum amount) for all taxpayer incomes, with the exception of income from economic activities of sole traders, for which the tax rate is 15%. Personal income tax revenues also include patent tax proceeds in the municipal budgets.

The higher collection rate of the PITA revenue is also supported by the measures undertaken for decreasing the undeclared labour, the measures for increasing the collection rate of obligations for past periods and the information campaigns conducted by the National Revenue Agency, as well as the adopted legislative changes.

It has been set fort that the tax return referred to in Article 55, paragraph 1 that is to be prepared and submitted by the enterprises – income payers that are bound to deduct and pay taxes shall from 2018 be submitted electronically only (Act Amending the VATA, promulgated in the State Gazette, №97 of 05 December 2017).

As a result from the changes made, the local natural persons may declare in their annual tax return the tax exempt incomes earned during the year, pursuant to Article 13 of the PITA, the property received by inheritance, last will and testament and donation, as well as the property received with a restored ownership right under the procedure of a legal instrument.

An amendment to the PITA changes the 5% tax deduction used from the final tax instalment payable under the annual tax return for 2017 (payable in 2018), limiting the amount of the tax deduction to 500 BGN.

⊙ Value Added Tax

The forecast of VAT revenues includes the assumption that the current proportion of VAT proceeds to consumption will be maintained.

According to the amendment adopted to the VATA (Act Amending the VATA, promulgated in the State Gazette, №97 of 05 December 2017, effective from 01 January 2018) in connection with the further harmonisation with the rules in Directive 2006/112/EC on the common system of value added tax, a zero-rated taxable supply is the transportation of passengers, as this is considered to include also the transportation of goods and motor vehicles when they are a part of the passenger's baggage. Motor vehicles are not a part of a passenger's baggage when used to perform cargo transportation contracts, with respect to their drivers.

The amendments adopted to the Act Amending the Tax and Social Insurance Procedure Code (promulgated in the State Gazette, №92 of 2017, effective from 1 January 2018) are developed in furtherance of Resolution №338 of the Council of Ministers of 2017 for the adoption of measures for decreasing the administrative burden on the citizens and businesses through the elimination of the requirement for provision of certain official certification documents on a paper. The amendments to the VATA made by the transitional and final provisions of the act enable filing an application for regulation under the VATA (under Article 100, paragraphs 1 and 2) to the Registry Agency simultaneously with the application for making initial registration in accordance with chapter two of the Commercial Register and Register of Non-Profit Legal Entities Act (effective from 01 January 2019). There is no longer an obligation for the persons to draw up and submit a list of the available assets upon initial and repeated VATA registration.

The Act Amending the VATA (promulgated in the State Gazette in №97 of 05 December 2017, effective from 01 January 2018) provides for that the VATA return, the VIES return and the reporting registers must only be submitted electronically under the conditions and procedure of the Tax and Social Insurance Procedure Code, except for the cases provided for in the law.

The provision of Article 176c, paragraph 1 of the VATA is supplemented, as a result from which when liquid fuels are for own consumption the following persons are exempted from the obligation to submit a security in the cases referred to in Article 176c, paragraph 1, subparagraph 2 and subparagraph 3 of the VATA: registered agricultural producers; budgetary organizations; a person other than the specified ones when the fuels acquired or released for consumption are intended for own consumption and the person is registered in a public electronic register created and maintained by the NRA.

The conditions and procedure for the issue and cancellation of permits to and of the persons performing technical servicing of fiscal devices/integrated automated commercial activity management systems are made more precise, as administrative punishments are provided for in case of service maintenance, putting into operation, registration of fiscal devices/integrated automated commercial activity management systems or dismantling of fiscal memory otherwise than under the established procedure.

Estimates for the 2018 VAT proceeds take into account the expected positive budgetary effect of BGN 18.0 million as a result of the scheduled increase, pursuant to the Excise Duties and Tax Warehouses Act (EDTWA), of the excise duty rates for cigarettes.

⊙ Excise Duties

The forecast of excise duty revenues takes into account, in addition to the macroeconomic indicators, also the positive effect from the measures for improving the control of the trade in excisable goods, as well as the legislative changes.

For the purpose of reaching the minimum levels of excise duty rates in the EU of EUR 90 per 1000 pieces (BGN 177 per 1000 pieces) as at 01 January 2018, in accordance with the provisions of Council Directive 2011/64/EU and in accordance with the time schedule established in the EDTWA for step-by-step ***increase of the excise duty rate of cigarettes***, effective from 1 January 2018 the specific excise duty is BGN 109 per 1000 pieces, and the proportional excise duty is 25% of the sale price. The total amount of the excise duty must not be less than BGN 177 per 1000 pieces from 1 January 2018. The positive effect on the budgetary revenues from the increase of the excise duty for cigarettes is estimated to be BGN 90.0 million more excise duty proceeds for 2018. ▼

4. Sensitivity Analysis and Comparison with the Previous Update

4.1 Alternative Scenario: Deterioration of the External Environment

According to the winter forecast of the European Commission, the growth of the European economy will decelerate in the medium-term. The slowdown of GDP growth will start in 2018 as a result of factors, such as the limited increase in employment and the negative effect from the uncertainty, related to the outcome of Brexit. At the same time, the negative effects from Brexit may be even greater than expected. The risks that may additionally limit growth not only of the European economy but also of the global economy, include tighter financial conditions on a global scale, intensified protectionist policies in certain countries, especially in the USA, increased geopolitical tension and higher than expected slowdown of the Chinese economy.

The presented alternative scenario has been developed on the assumption of a lower growth of the European and global economy during the entire forecast period compared to the baseline scenario as a result of the specified risks

Table 4-1: Comparison between baseline and alternative scenario assumptions

	Alternative scenario				Difference from the baseline scenario (p.p.)			
	2018	2019	2020	2021	2018	2019	2020	2021
European economy – EU28 (real growth, %)	2.0	1.6	1.6	1.6	-0.3	-0.5	-0.3	-0.2
Global economy (real growth , %)	3.7	3.5	3.5	3.5	-0.2	-0.4	-0.3	-0.2

Source: MF

Given the envisaged faster slowdown of the global economic activity, a more adverse foreign demand for Bulgarian exports is expected, compared to the baseline scenario. The effect will be observed during the entire forecast period but the deviation will be most significant in 2019. The changes in the foreign demand are expected to be reflected in a smoother acceleration of real exports in 2018 followed by a sharper slowdown in the next years. The total growth of exports will reach 4.4% in real terms (6.6% in nominal terms) in 2018 and 3.8% (respectively 4.5%) in 2019. The increase will be more moderate in 2020–2021 too, but the deviation of the growth rates compared with the baseline scenario, will be limited near the end of the forecast period as the alternative and baseline forecasts for the economic activity in our trade partners will come closer. The more unfavourable external environment and the weaker increase of export revenues will have a restraining effect on domestic demand – both through limitation of the growth of consumption and through a weaker investment activity. The growth of the Bulgarian economy is expected to slow down within 0.1–0.3 p.p. compared to the baseline scenario in the period 2018–2021.

Weaker domestic demand will in turn result in lower increase of consumer prices in the country as this effect will be particularly notable in 2019.

Lower demand of raw materials for the export-oriented industries, along with the slowdown of domestic demand, will result in a lower increase of imports compared to the baseline scenario. This will fully compensate for the export dynamics and will restrict the adverse effect of net exports on GDP and of the balance of goods and services on the current account. The more adverse dynamics in the external environment will have an insignificant effect on the primary and secondary income balances and will have an impact mostly on the trade in goods and services. The current account is expected to improve, as the surplus (expressed as a ratio to GDP) will increase by 0.1 p.p. against the baseline scenario in the period 2018–2020 and will remain unchanged in the last year of the forecast period.

The lower growth of real household expenditures in the alternative scenario will be also due to expectations for a slower increase in real disposable income, as a result of lower revenues from export production and limited domestic activity. The slowdown in the compensation of employees growth will be most notable in 2019 (-0.5 p.p.), whereafter this negative effect will gradually be limited to -0.3 p.p. in the end of the forecast period. The descending dynamics will affect both the compensation per employee and the employed number, but the negative contribution of the latter is expected to remain more limited.

The highest effect on the employment growth rate of a little more than -0.1 p.p. is forecast to take place in 2019. The deviation in the dynamics of the employed from the baseline scenario falls to -0.07 p.p. in 2020–2021, as in the end of the forecast period the employment goes down more significantly on an annual basis. In the period 2019–2020 the unemployment rate will be on the average 0.1 p.p. higher and the reduction of employment in 2021 and the higher decrease of the workforce determine the faster decrease of the unemployment to its level from the baseline scenario.

Table 4-2: Effects on the key macroeconomic indicators

Indicator	Alternative scenario (%)				Difference from baseline scenario (p.p.)			
	2018	2019	2020	2021	2018	2019	2020	2021
Growth rates in real terms, %								
GDP	3.8	3.5	3.5	3.5	-0.1	-0.3	-0.2	-0.2
Final consumption	4.8	4.5	3.8	3.7	-0.2	-0.4	-0.1	-0.1
Investments	9.4	5.9	6.5	6.7	-0.2	-0.5	-0.2	-0.1
Export of goods and services	4.4	3.8	4.0	3.9	-0.5	-1.0	-0.7	-0.7
Import of goods and services	7.4	5.8	5.3	5.3	-0.7	-1.2	-0.6	-0.5
Growth rates in nominal terms, %								
GDP	5.9	5.7	5.8	5.7	-0.2	-0.5	-0.3	-0.2
Final consumption	6.5	6.3	5.7	5.8	-0.3	-0.6	-0.1	-0.1
Investments	10.5	6.9	7.8	8.1	-0.2	-0.6	-0.2	-0.1
Export of goods and services	6.6	4.5	4.7	4.9	-0.5	-1.1	-0.7	-0.7
Import of goods and services	8.8	5.6	5.3	5.9	-0.7	-1.2	-0.6	-0.5
GDP Deflator	2.1	2.1	2.2	2.1	-0.1	-0.2	-0.1	0.0
Average annual inflation (HICP)	1.8	1.9	2.0	2.1	-0.1	-0.2	0.0	0.0
Employment (ESA 2010)	0.6	0.2	0.1	-0.1	0.0	-0.1	-0.1	-0.1
Unemployment rate	5.9	5.8	5.6	5.4	0.0	0.1	0.1	0.0
Compensation of employees	8.3	6.8	6.4	6.0	-0.2	-0.5	-0.3	-0.3

Indicator	Alternative scenario (%)				Difference from baseline scenario (p.p.)			
	2018	2019	2020	2021	2018	2019	2020	2021
Nominal value, MBGN mn								
GDP	104 491	110 436	116 854	123 534	-184	-710	-1 036	-1 385
Final consumption	81 530	86 652	91 633	96 974	-233	-715	-880	-1 042
Investments	22 760	24 335	26 243	28 357	-42	-178	-244	-298
Export of goods and services	69 724	72 885	76 275	80 037	-346	-1 117	-1 697	-2 339
Import of goods and services	69 523	73 435	77 296	81 834	-438	-1 301	-1 785	-2 293
Compensation of employees	46 018	49 149	52 315	55 462	-73	-301	-456	-624

Source: MF

4.2 Sensitivity of Budgetary Projections to Various Scenarios

4.2.1 Sensitivity of Budgetary Projections to the Alternative Scenario

The sensitivity analysis of the budgetary projections is built on the assumption of unchanged policies with respect to the baseline scenario. As a result from the lower levels of the approximated bases in the main revenue groups, the change in the budgetary proceeds in the alternative scenario follows the same direction. The dynamics of the domestic demand and in particular of the final consumption and the import of goods and services has a considerable impact on the revenue side of the budget through the indirect tax proceeds. According to the alternative scenario, the effect of the lower (compared to the baseline scenario) nominal increase of the final consumption and the import of goods and services (respectively by 0.3 p.p. and 0.7 p.p. on an annual basis) on the indirect tax proceeds in 2018, is estimated to be in the amount of around BGN 44.5 million in the form of unrealized revenue. As regards direct taxes, the effect from the lower forecast values for a net operating surplus and compensation of employees in the same year is established to be around BGN 23.4 million. The aggregate effect on the budget balance for 2018 from the lower revenues, with unchanged level of costs compared to the baseline scenario, is in the amount of 0.1 p.p. of GDP worsening of the negative budget balance.

In 2019 the negative impact of the consumption and income indicators becomes stronger: in indirect taxes the proceeds are expected to decrease by BGN 134.8 million, and in direct – BGN 95.3 million. The aggregate effect on the budget balance is estimated as a higher deficit in the amount of 0.3 p.p. of GDP.

In 2020–2021, as a result from the accumulated slowdown of the theoretical macroeconomic bases, the overall effect on the revenue will be most significant (proceeds decrease by BGN 368.6 million and BGN 459.7 million, respectively). The budget result in the implementation of the scheduled costs would be changed from balanced to negative, in the amount of 0.3% of GDP and 0.4% of GDP for 2020 and 2021, respectively.

4.2.2 Debt Sensitivity to Changes in Exchange and Interest Rates on International Markets

The extent of the impact from a possible change in exchange and interest rates on the nominal value of the debt, as well as on the amount of the forthcoming payments for the servicing thereof was established by the performance sensitivity analysis. In a scenario of a drastic change in the values of basic market indicators against the baseline levels of these variables, the expected slight fluctuation of the debt obligations was confirmed.

The results from the conducted analysis show that 20% increase in the BGN/USD and BGN/JPY ratios will cause a minimum deviation in the nominal level of the General Government sector debt for the period 2019–2021 with a growth of about 0.1%. Respectively, the scheduled amortization payments under the debt of the Central Government subsector (with a dominant share of about 98% in the structure of the consolidated obligations of the sector), respond by an average change for the period in the amount of about 0.3% or about BGN 3.4 million.

The parallel increase of the levels of 6M LIBOR-EUR, 6M LIBOR-USD, 6M EURIBOR and the basic rate of interest under analogical assumptions – by 20%, results in an insignificant increase (at a rate of about 0.2% or BGN 1.5 million on the average, per year) of the interest costs scheduled for the period 2019–2021 under the debt of the subsector.

The registered low sensitivity of the sector debt and of the funds for its servicing in case of a change in the basic levels of the main market variables, such as interest and exchange rates, is due to the presently low-risk currency and interest structure of the General Government sector debt with a prevailing share of obligations in BGN and EUR – about 99% and fixed interest coupons – 91%, which in practice does not indicate any serious dependence of the debt portfolio on the market risk impact.

4.3 Comparison with the Previous Programme

In 2017 the Bulgarian economy grew at 3.6% compaired to an expected growth of 3% envisaged in the previous Convergence Programme. The higher growth was due to a higher than expected contribution of domestic demand, most of all private consumption. Despite the higher than expected performance of the European and global economy, net exports had a negative contribution to GDP growth, compared to expected low positive contribution in the previous programme. The main reason for the difference in the two forecasts is due to the revision of the data for GDP and its components for 2016 made in October 2017, which resulted in a change in the base for 2017.

Revised data for the Bulgarian economy and revised projections of international institutions for GDP growth in the EU, the U.S. and globally, and the changed assumptions for the developments in international prices and exchange rates required an adjustment to the medium-term macroeconomic forecast of the Ministry of Finance.

In the current Convergence Programme, a higher economic growth is expected over the whole forecast period. As in the previous Programme, GDP growth will be driven by domestic demand. A more significant increase is projected in 2018 for investment, mainly as a result of the planned increase in public capital expenditure. The higher domestic demand results also in an increase in imports. At the same time, exports growth has decreased given the outturn data for 2017. As a result, net exports is expected to have a negative contribution to GDP growth over the entire forecast period compared to a forecasted low positive contribution in the previous programme.

As regards inflation, the annual average increase in HICP in 2017 completely corresponds to the forecast in the previous CP update. Nevertheless, the inflation reported in the end of the year was 0.5 p.p. higher. The difference was mostly due to the higher than expected increase in prices of food and services, as well as to the faster than expected slowdown in the deflation rate of non-energy industrial goods. Considering the current dynamics and the updated assumptions for international prices, the forecast for the increase of the overall level of consumer prices was adjusted more significantly for 2018, as it was increased by 0.6 p.p. compared to the previous programme, mostly due to a more accelerated increase in prices of energy and services.

The comparison of the present scenario for the labour market development and the one in the previous CP shows that the main differences come from the higher reported growth of employed persons in 2017 compared to the expectations, accompanied by a faster decrease of the unemployment and increase of the workforce. The mentioned increase in the workforce, considering the forecasted decrease in the CP 2016 brought about a revision of the expectations for its dynamics in a medium-term perspective from a decrease to a gradual stabilization and decline in the end of the forecast period. The employment growth of 1.8% for 2017 exceeded the expected 0.5% and this, in combination with the increased supply of labour, resulted in a faster shrinking of the potential for employment growth in a medium-term horizon. Because of this reason the dynamics of the employed persons is reduced after 2018 until a slight decrease is reached in 2021. The lower base of the unemployment rate from 2017 also led to a lower value of the indicator of 0.6 p.p. per year for the entire forecast horizon. Differences were also observed with respect to the compensation of employees. The revisions of GDP data by the income approach in October 2017 brought about an increase of the growth rate of the compensation per employee up to 5.8% in 2016, with a preliminary growth of 3.1%. In 2017 the pace of increase of the indicator accelerated to 7.5% and with the higher base reported in the last two years and the expectations for an increase in the economic growth, the dynamics of incomes was revised upwards in the medium-term perspective. Still, the estimates for the labour productivity will compensate to a large extent the changes in the compensation per employee, and the dynamics of the nominal ULC will exceed the values set in the previous programme by less than 1 p.p. on the average per year for the 2018–2020 period.

Table 4-3: Key macroeconomic indicators

Real growth rates	2017			2018			2019			2020		
	2018 CP	2017 CP	Difference, p.p.	2018 CP	2017 CP	Difference, p.p.	2018 CP	2017 CP	Difference, p.p.	2018 CP	2017 CP	Difference, p.p.
GDP	3.6%	3.0%	0.6	3.9%	3.1%	0.8	3.8%	3.2%	0.6	3.7%	3.2%	0.5
Final consumption	4.5%	2.6%	1.9	5.0%	2.8%	2.2	4.9%	2.9%	2.0	3.9%	2.9%	1.0
Investments	9.5%	2.6%	6.9	9.6%	3.8%	5.8	6.4%	4.5%	1.9	6.7%	4.8%	1.9
Export of goods and services	4.0%	5.2%	-1.2	4.9%	5.4%	-0.5	4.9%	5.4%	-0.5	4.7%	5.6%	-0.9
Import of goods and services	7.2%	4.8%	2.4	8.1%	5.3%	2.7	7.0%	5.6%	1.4	5.9%	5.9%	0.0
Average annual inflation (HICP)	1.2%	1.2%	0.0	1.8%	1.3%	0.6	2.0%	1.7%	0.3	2.1%	1.8%	0.2
Employment	1.8%	0.5%	1.3	0.6%	0.6%	0.1	0.3%	0.5%	-0.2	0.2%	0.4%	-0.2
Unemployment	6.2%	6.9%	-0.7	5.9%	6.5%	-0.6	5.7%	6.3%	-0.6	5.5%	6.2%	-0.7

Source: Ministry of Finance

5. Sustainability of Public Finance

5.1 Policy Strategy

This chapter analyses the sustainability of the fiscal position by evaluating the current status of public finance in view of the future increase in age-related public expenditures. For this purpose, the sustainability indicators S1 and S2 are used, calculated under the methodology elaborated by the Commission[33]. The medium-term fiscal sustainability indicator (S1) shows the necessary adjustment to the primary structural budget balance, which is needed to sustain the level of government debt of up to 60% of GDP in 2030. The long-term fiscal sustainability indicator (S2) shows the adjustment to the current primary balance required to fulfil the inter-temporal budget constraint (the discounted value of the future primary structural balances should cover the current debt level) over infinite horizon including additional age-related costs. The positive value of the indicators means a need for fiscal consolidation or structural reforms to reduce the burden of the ageing population on public finance.

Table 5-1: Comparison between sustainability indicators under the old and the new Programme scenario

	Programme scenario 2017		Programme scenario 2018[34]	
	S1	S2	S1	S2
Value, of which:	-4.5%	1.1%	-5. 3%	0.4%
Initial budgetary position	-1.2%	0.3%	-1.7%	-0.1%
Debt requirement	-2.6%		-3.2%	
Future changes in the budgetary position[35]	-0.7%	0.8%	-0.4%	0.5%

Source: MF

The estimates of the Ministry of Finance show that the value of the S1 indicator for 2018 is negative, which according to the Commission's reference values[36] means low fiscal sustainability risk in the medium-term and presupposes maintenance of the debt level below 60% of the GDP. The S2 value of

33 Annex 2 of Fiscal Sustainability Report 2015.

34 The assessment of fiscal sustainability is strongly dependent on the prospects for long-term development of the economy. The basic parameters used in this scenario are shown on Table 7 of Annex A. They have been developed by the Ministry of Finance on the basis of the long-term assumptions and methodology set in the 2018 Ageing Report (The 2018 Ageing Report: Underlying Assumptions and Projection Methodologies). The forecast used for the population is Eurostat population projection 2015. The differences between the long-term macroeconomic scenario released in the Report and in the present Convergence Programme is justified by the different medium-term forecasts used to start calculations. The MF scenario is based on the forecast in this Convergence Programme (2018-2021), while the one in the Report is based on the Commission's 2017 Spring Forecast.

35 Future changes in the budgetary position are related mostly to the pension, healthcare and education costs. The calculation of this position in the resent Convergence Programme uses a forecast for costs for pensions submitted by the National Social Security Institute and forecasts for the healthcare and education costs obtained from the long-term model of the MF on the basis of the methodology described in http://www.minfin.bg/upload/9114/D.E.2008.pdf .

36 S1<0 – low risk; 0<S1<2.5 – moderate risk; S1>2.5 – high risk;

S2<2 – low risk; 2<S2<6 – moderate risk; S2>6 – high risk.

0.4% also corresponds to a low fiscal sustainability risk but shows that an adjustment to the ageing expenditure component (0.5 p.p.) is required. Chapter 5.2 addresses in detail the increase in the expenditure caused by the demographic changes.

The conclusions of the European Commission from the Monitoring[37] report on the debt sustainability of EU member states published in January 2018 coincide with the stated analysis. According to the European Commission there are no forecasted risks for the fiscal sustainability of Bulgaria in a medium-term plan due to the advantageous initial budgetary position and the low initial level of debt to GDP. In the long term, the risks facing the fiscal sustainability of Bulgaria are also low.

5.2 Long-term budgetary prospects, including the implications of ageing populations

5.2.1 Social security

The long-term budgetary forecast for the development of the pension system is based on the current (2018) pension legislation and on the provisions of the Social Security Code. For the preparation of the pension expenditure forecast in the period 2018–2070, the most recent Eurostat demographic projections and a macroeconomic forecast prepared by the ageing working group (AWG) at the EU's Economic Policy Committee in relation to the Ageing Report (The 2018 Ageing Report)[38] were used.

In the long term it is possible to distinguish three stages in the dynamics of the pension expenditures as a share of GDP. Within the first stage covering the period between 2018 and 2027 the share of the pension expenditures in GDP is expected to decrease due to the gradual increase of the retirement age and of the required insurance length of service. The second stage covers the period from 2028 to 2060 when as a result from the process of ageing of the population and the expected higher average life expectancy, the fiscal pressure on the state pension system will increase and the pension expenditures as a percentage of GDP will start growing. The third stage covers the last decade of the forecast period, when certain decrease in the share of the pension expenditures in GDP is expected due to the higher fertility rates and gradual increase of the share of the working age population in the end of the period forecasted by Eurostat.

In addition to the demographic factors, the dynamics of the pension expenditures will be influenced in the long run also by the opportunity given to the insured persons born after 1959, who were mandatorily insured until August 2015 in the public social security (pillar I) and in an universal pension fund (pillar II), to change their insurance and to shift to insurance in the first pillar only with an increased social security contribution[39].

The share of the pension expenditures in GDP varies depending on different assumptions about the percentage of the insured persons who will choose insurance in the public social security (the so called "first pillar")[40] only. It is lowest (10.9% in 2070) in the case, in which the insured persons born

---

[37] Debt Sustainability Monitor 2017, EC, January 2018, https://ec.europa.eu/info/sites/info/files/economy-finance/ip071_en.pdf

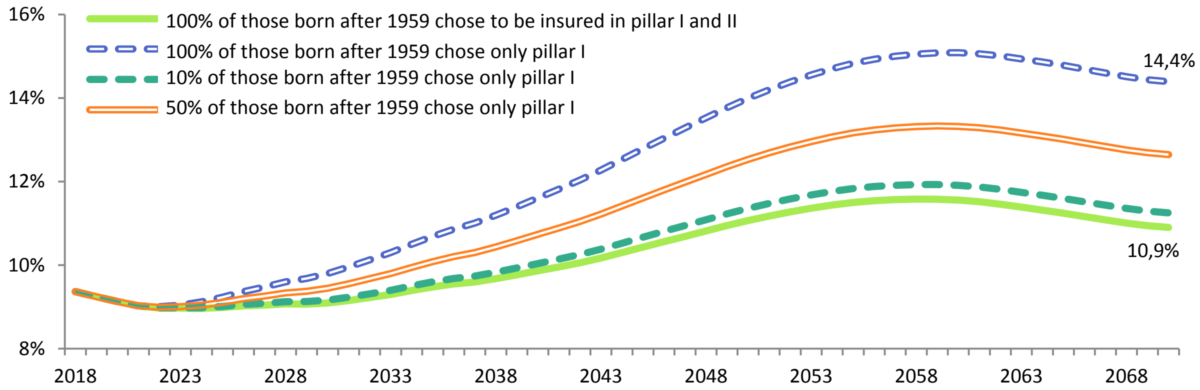
[38] The projection does not take into account the linking of the retirement age with the changes in the average life span after 2037, as the exact mechanism of this commitment is not defined in the legislation.

[39] By the end of January 2018, 14 589 insured persons applied to the NRA to transfer their insurance from a universal pension fund to the State Social Security, which is 0.6% of the insured persons born after 1959.

[40] The currently available data do not allow a specific assumption of the percentage of persons born after 1959 that would only be covered by PSS to be made. With this respect a baseline scenario was developed on the assumption that 100% of insured persons born after 1959 will continue to be insured in both pillars., as well as regarding three additional

after 1959 continue being insured in both pillars as the pensions from the public social security of all persons born after 1959 will be reduced pro-rata to the social security contribution that is transferred to pillar II. The share of the pension expenditures of GDP is highest in the case, in which 100% of those born after 1959 chose insurance in the first pillar only due to the fact that all persons will receive pensions in full amount. In this case the pension expenditures reach 14.4% of GDP in 2070. Thus, in the end of the period, there will be an increase in the pension expenditures amounting to about 0.35% of GDP per every 10% of insured persons who transferred to the first pillar.

Figure 5-1: Pension expenditures as % of GDP, 2018–2070 г.



Source: National Social Security Institute

The possibility of fully transferring the social security to the first pillar will also bring about an increase in the revenues in the public social security because the social security contribution for the Pensions fund, respectively the Pensions for Persons under Article 69 fund, for the persons who have chosen social security in the first pillar only will be 5 p.p. higher. Upon retirement the funds from the individual accounts of these persons will also be received as an income to the public social security budget. The results show in the end of the period an increase of the public social security revenue of around 0.13% of GDP for every 10% of persons transferring to insurance in the first pillar only.

The key indicators of the financial condition of the pay-as-you-go systems are the dependency ratio[41] and the income replacement rate[42].

As regards the dependency ratio, the data shows that in 2017 a hundred social insured individuals corresponded to 76 pensioners with pensions for labour activity. According to the forecast results, In the period until 2037, when the retirement age for women and men will become equal at the level of 65 years of age, the dependency ratio will remain at levels below 80% due to the increase in the retirement age and in the required insurance length of service, the limitation of early retirement, as well as due to the existence of incentives for longer presence of older workers on the labour market. In the period 2037 – 2060 the values of this indicator are expected to grow considerably due to the ageing of the population and the increasing life expectancy, as in 2060 a hundred social insured individuals are expected to correspond to more than 90 pensioners with pensions for labour activity. Between 2060 and 2070 there is a certain improvement in the dependency ratio as a result from the forecast of Eurostat for a gradual increase of the total fertility rate from 1.5 to 1.8, which brings

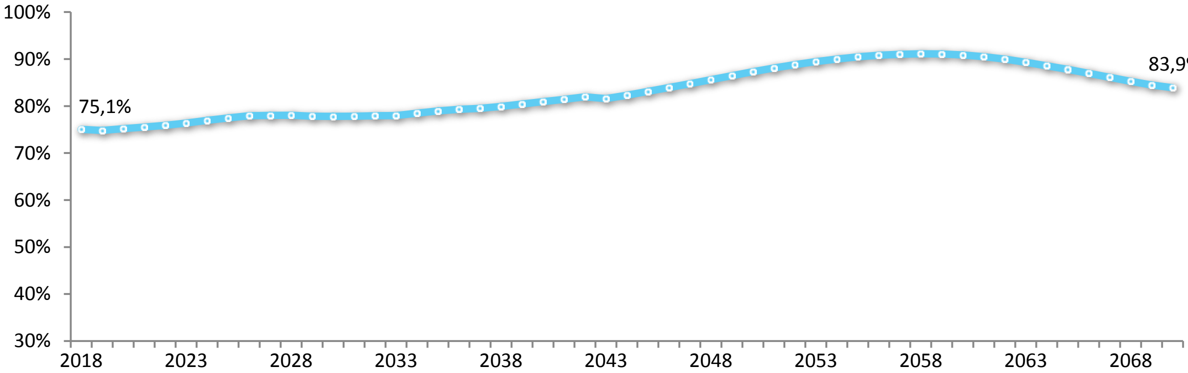
scenarios with different assumptions about the percentage of persons born after 1959 who will choose to be insured in the first pillar only .

41 The ratio between the number of pensioners for labor activity and the number of insured persons.

42 The ratio between the average pension for labor activity and the average insurable income for the country.

about an increase in the share of the working age population as at the end of the period, when a hundred social insured individuals are expected to correspond to about 84 pensioners with pensions for labour activity.

Figure 5-2: Number of pensioners to number of socially insured individuals (dependency ratio), 2018–2070 г.



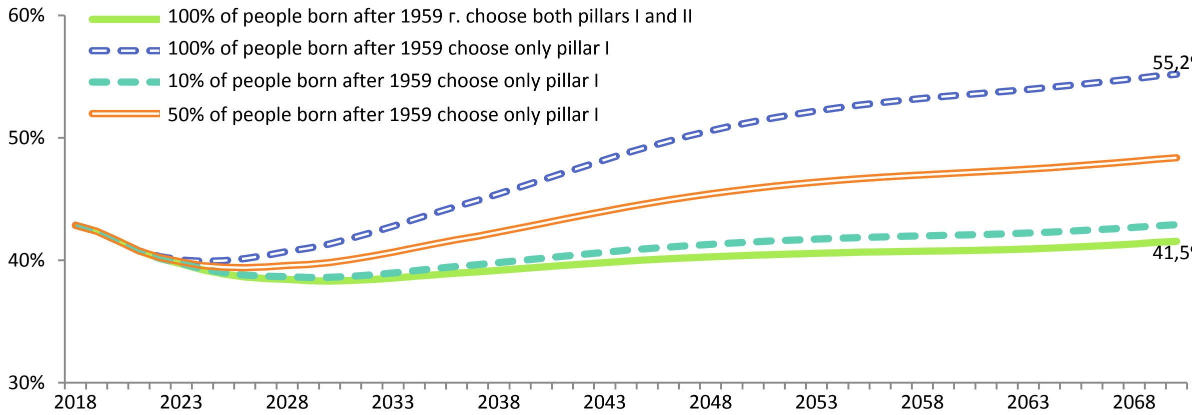
Source: NSSI

The first pillar replacement rate is considerably influenced by the gradual increase in the percentage for each year of insured length of service (accrual rate) in the pension formula from 1.1 to 1.5 in the period between 2017 and 2026. The pension legislation stipulates that from 2017 the accrual rate will increase by a percentage larger than or equal to the one calculated from the sum of 50% of the increase of the insurance income and 50% of the consumer price index in the preceding year. For new pensioners the accrual rate will apply upon determination of the amount of their pensions, and as regards already granted pensions there will be a recalculation of the amounts performed from 1 July of the respective year, which will replace the annual indexation in the period of achievement of an accrual rate of 1.5%[43]. Due to the fact that the increase in the accrual rate is carried out by a percentage that is lower than the increase of the insurance income, the replacement rate is expected to decrease to a certain extent in the period by 2026. After 2026, when the accrual rate for all pensions reaches 1.5 and the annual indexation is recovered, the replacement rate will gradually start growing.

Considerable impact on the replacement rate from the first pillar will also be caused by the possibility, provided in the legislature, to transfer social security rights from the first and second pillars to the first pillar only. The next figure shows the values of the average gross replacement ratio from the first pillar of the pension system depending on the percentage of insured persons born after 1959 who will choose to be insured in the public social security only. The possibility to transfer social security rights entirely to the public social security has a favourable influence on the replacement rate from the first pillar in the long run, as in the case when 100% of the insured persons born after 1959 choose to pay contributions in pillar I only, the average gross replacement ratio exceeds 55% in 2070, compared to values of about 41.5% in case when 100% of the persons born after 1959 are insured in both pillars.

[43] As of 01.07.2017 the rate per year of service was increased from 1.1 to 1.126 or by 2.36%..

Figure 5-3: Average labour activity pension to average social insurance income (replacement rate), 2018–2070 r.



Source: NSSI

5.2.2 Healthcare

In the long term population aging would have a considerable impact on the budgetary expenditure and revenue for several reasons. On the one hand, the expenditures for old age pensions and those for health and long-term care will, in the context of increasing life expectancy and decreasing growth rate, increase. Although healthcare is directed to various age groups of the society, the expenditures per capita, expressed as a percentage of GDP, are expected to increase as the age increases and in particular from 55 for men and from 60+ for women. The combination between sharp decrease of the working age population and the expected increase of the demand for health care by the aged population predetermine the increasing financial burden for those who work as well as an increase in the total amount of the healthcare expenditure. This determines also the trend that the goods and services offered in the sector are mostly addressed to aged people. In many EU member states public healthcare is largely financed out of the social insurance contributions of the working age population. Ageing results in an increase of the age dependency ratio, i.e. less participants in the social security system. The age dependency ratio in Bulgaria is expected to increase from 31.5% in 2016 to 56.2% in 2070.[44]

The forecast for the dynamics of long-term healthcare expenditures is only based on the population dynamics. Such a scenario is very restrictive. It does not presuppose a change in the policy of public expenditure on healthcare in the context of expansion of the healthcare services funded out of the budget. Likewise, according to a number of econometric surveys, the technological progress and other non-demographic factors are among the main reasons for the increase in the expenditure on healthcare in developed countries.

The newly developed methods for early diagnosis and treatment greatly contribute to the increase of the expenses but certain medical innovations may also bring about a decrease of the expenses in the long term. Investments in prevention and in healthcare technologies allow the population to remain in good health and to be productive for a longer period of time. Besides, the development of treatments for less known pathologies provides opportunities for employment and growth. These possibilities are not included in the present forecast.

[44] Population 65+/population 15-64 (Eurostat population projection 2015).

Table 5-2: Healthcare expenditure

	2030	2040	2050	2060	2070
Share of the healthcare expenditure, % of GDP	5.4%	5.6%	5.7%	5.5%	5.4%
Share of the healthcare expenditure of the total expenditure, 65+	46.5%	49.6%	54.7%	57.6%	53.1%
Share of the population 65+	24.7%	27.9%	31.5%	33.3%	30.9%

Source: MF

As shown in Table 5-2 the increase of the healthcare expenditure is due to an aggravation of the demographic structure of the population. The share of people aged more than 65 increases considerably, by about 9 p.p. until 2060. Bearing in mind that in most of the cases the main healthcare expenditure of an individual are made in the years immediately before his death, the ageing of population logically results in an increase of the healthcare expenditure for the aged population compared to the total expenditure. In the end of the period under review they are expected to exceed 50% of the total expenditure. The total healthcare expenditure is expected to increase from 5%[45] of GDP in 2016 to 5.7% in 2050 and then to slightly decrease to 5.4%.

5.2.3 Education

The forecast for the educational public expenditure is based on the long-term demographic forecast and on the assumption that the expenses will be indexed by the increase of the nominal labour productivity. In the period after 2040 the stabilization of the demographic dynamics of the population aged up to 18 is expected to bring about a gradual increase of the total educational expenditure, which will cause certain pressure on the budget.

The impact of ageing on public expenditure for education remains indefinite and in contrast to other main expenditure items, such as pensions and health, where the effect is expected to be negative. On the one hand the expected decrease in the number of young people is likely to bring about budgetary economies, but on the other hand the trends of higher and higher levels of enrolment, the longer periods spent in education and the constantly increasing higher education expenditure may cause pressure on the total education expenditure.

5.3 Contingent Liabilities

The general government guaranteed debt as of end-2016 was 0.5% of GDP, while the average level for the EU is around 8%. As of end-2017 it amounted to BGN 732.0 million or 0.7% of GDP, as it increases compared to end-2016 by BGN 287 million. Most of it is formed by obligations to foreign creditors.

With the assumptions for the issuance of new guarantees for 2018 (according to the opportunities, envisaged in the SBA for 2018), respectively disbursement from loans and the repayment of agreed guaranteed loans, at the end of the 2018–2021 period, the nominal amount of the debt of the general government guaranteed sector is expected to decrease to about BGN 300 million, and its' proportion to GDP to 0.2%.

The predominant share of 69% in the sectoral structure of guarantees in 2017 is for the Financial Sector while in 2016 the predominant sector was "Energy" (56%). The change is due most of all to

[45] Data from General government expenditure by function (COFOG)

disbursments by the Bulgarian Development Bank of state guarantees issued in relation to the National Multifamily Residential Building Energy Efficiency Programme (created by Decree №18 of the Council of Ministers of 02 February 2015). The disbursments in 2017 under this Programme in the amount of EUR 205 million brought about an increase of the share of loans in BGN and EUR to 90% in the currency composition of the guaranteed debt of the General Government sector, compared to 72% as of end-2016. In the meantime, the regular repayments made over the year with respect to effective loan agreements decreased the obligations in Japanese yens to 10% (27% in 2016), the USD ones to about 0.3% (0.9% in 2016). In 2017 new foreign guarantee agreements were not ratified.

Pursuant to item 1.12 of Resolution №51 of the Council of Ministers of 31 January 2018 on the Budgetary Procedure for 2019 and in conjunction with Article 73, subparagraph 8 of the Public Finance Act, all state and municipal enterprises having a total amount of their obligations as at 31 December 2016 in excess of 0.1% of the GDP of the country, which are not a part of the consolidated fiscal programme and do not fall within the scope of the General Government sector, are subject to monitoring. They are supposed to present information and evaluation of the forecasts for revenues and expenses and for the assets and liabilities with reported data for 2016 and 2017, an estimate for 2018 and a forecast for the period 2019–2021.

The companies falling within the scope of the specified criterion are 14, according to a submitted list from the NSI, as BU №1/12 February 2018 includes 13 of them.

On the basis of the received information, a decrease by 15.6% of the obligations of the state companies from non-financial sector, subject of monitoring, is forecasted for the four-year period 2018–2021. The amount of the long-term and short-term obligations of these companies reported as of 31 December 2017 is in total BGN 7.96 billion, and the forecasts say that as of 31 December 2021 they will amount to BGN 6.73 billion.

The aggregate leverage ratio decreases from 0.86 as of 31 December 2017 to 0.70 in the end of the period. The aggregate ratio of the debt of these companies to their assets decreases by 16% over the forecast period to 0.41. The liquidity ratio remains stable at a level of more than 1.30 over the entire period 2017–2021.

As regards the two monitored municipal companies, the forecast is that the amount of the obligations – both long-term and short-term – will decrease, in case the amount of the assets increases. In the end of the period both municipal companies are expected to generate profit. ▼

6. Quality of Public Finances

6.1 Policy Strategy

The policy strategy in the area of the quality of public finances follows the consistent acts for institutional, legal and methodological changes towards improvement of the public finance management.

Regardless of the established permanent regulation of the budgetary framework by the adoption of the Public Finance Act in 2013, the efforts for improving the budgetary legal framework continue as they are accompanied by monitoring and analysis of the application of the budgetary legislation and of the budgetary practices as well as of the compliance with the fiscal rules.

An appraisal of the efforts of the Ministry of Finance towards the improvement of the quality of the budgetary process and of the public finance as a whole is the conclusion of the European Commission set out in the report on Bulgaria, which includes a thorough review concerning the prevention and adjustment of the macroeconomic imbalances of 7 March 2018, and which highlights the additional steps already taken by Bulgaria for improving the fiscal framework through the most recent amendment to the Public Finance Act and the setting thereof in full conformity with the requirements of the EU budgetary frameworks (Council Directive 2011/85).

The adopted Amending and Supplementing Act to the Public Finance Act (promulgated in the State Gazette, №91 of 2017) addressed the inaccuracies found by the European Commission as a result from the European Commission review, which started in 2016, of the extent of transposition of Council Directive 2011/85/EU in the national legislations of the member states and also there was given an additional regulationof the relations of the municipal budget with the state budget and the implementation of the municipal budget. For the purpose of improving the process of budgetary planning a requirement was set in the medium-term budgetary forecast to include information concerning:

- the forecast for all major expenditure and revenue indicators for the next three years of the General Government sector, including more information about the “Central Government” and “Social Security Funds” subsectors, on the basis of unchanged policies, as well as, a description of the envisaged policies with financial impact on the General Government sector. Such information was already included upon the preparation of the national budget documents as early as within budgetary procedure for 2018 (for the 2018–2020 forecast).
- the general impact of the activity of legal entities controlled by the state and/or by the municipalities, which are not a part of the consolidated fiscal programme but fall within the scope of the General Government sector, on the balance and the consolidated debt of the General Government sector.
- the contingent liabilities with potentially considerable impact on the General Government sector, including on the level of subsectors.
- a comparison by the Ministry of Finance, not only of its current macroeconomic forecast but also of its forecast for main budgetary indicators to the ones of the European Commission, as

well as to provide arguments in case of presence of considerable differences. The forecasts for the main budgetary indicators may also be compared to the ones of other independent organizations.

- the main macroeconomic and budgetary indicators under different assumptions, taking into account to the maximum extent possible the respective risk scenarios.
- analysis of the reasons for the establishment of a considerable deviation of the macroeconomic forecasts from the reporting data for a period of at least four years in a row, including measures for overcoming the established omissions.

Additional regulation was also set forth with respect to the relations of the municipal budget with the state budget and the implementation of the budget of the municipalities, thus, establishing a clear framework of the budgetary relations between the municipal budgets and the central budget, improvement of the procedure for financial rehabilitation of municipalities and encouraging the endorsement of measures by the municipal authorities for achieving financial sustainability and stability of the local finance, increase of the responsability of the local authorities upon the provision of services to the local community and decrease of the number of municipalities facing financial difficulties.

An important element for the improvement of the quality of public finances is the process of application of programme and result-oriented budgeting on the part of the budgetary organizations in charge of the pursuit and implementation of public-sphere policies. The legislative regulation of the classification of the policy areas/functional areas and the budgetary programmes created a sustainable framework of the policies and budgetary programmes being implemented and their closer linking to the functions and activities of the budgetary organizations. With the latest amendments, higher liability is introduced for the first-level spending units applying a programme budget, in the process of submitting and presenting the programme budgets to the Council of Ministers and to the National Assembly in accordance with the approved parameters of the draft State Budget Act and of the updated Medium-Term Budgetary Forecast.

In relation to the continuing improvement of the programme budgeting approach, the Ministry of Finance started an initiative for review and prioritization of performance indicators under the programme budgets of the first-level spending units from key sectors, the aim of which is the identification of indicators reflecting the degree of achievement of the strategic objectives in the specific sectors and measuring the success of the policies being pursued and the conducting of constant monitoring and evaluation of their dynamics. The expectations are related to the improvement of the quality of the budget documents and of the efficiency of the policies implemented by the budgetary organizations.

New opportunities and mechanisms are sought for closer interaction between the institutions engaged in the implementation of the budgetary process, the development and implementation of the fiscal policy, the monitoring of the observance of the fiscal rules, etc. The efficient interaction with the Fiscal Council appears to be an essential factor for the improvement of the quality of the budget documents and for orientation concerning the fiscal policy conducted by the government, for the adherence to the numerical fiscal rules and for the potential risks for the budget. The opinions and the recommendations of the Council are an element of the conciliation procedure in the preparation of the basic budget documents.

As regards the budget transparency it should be noted that Bulgaria makes constant progress over the years, reported by the international initiative – International Budget Partnership (IBP) whose surveys concerning an open budget for Bulgaria date since 2006, as according to the most recent

Open Budget Index 2017 survey our country ranks 21st out of a total of 115 countries in terms of budget transparency, which ranks it among the countries with a considerable level of transparency, and the evaluation according to the open budget index reaches 66 of 100%.

6.2 Composition, efficiency and effectiveness of expenditure – COFOG

Table 6-1: Budget expenditure by function

	% of GDP		% of the total budget expenditure	
	2016	2021	2016	2021
1. General public services	2.7	2.9	7.8	8.2
2. Defence	1.1	1.8	3.1	5.1
3. Public order and safety	2.4	2.3	6.7	6.6
4. Economic affairs	4.1	5.2	11.8	14.5
5. Environmental protection	0.6	0.8	1.8	2.3
6. Housing and community amenities	1.9	1.1	5.5	3.1
7. Healthcare	5.0	4.9	14.3	13.7
8. Recreation, culture and religion	1.0	0.6	2.8	1.7
9. Education	3.4	4.0	9.8	11.3
10. Social protection	12.7	11.9	36.4	33.4
11. Total expenditure	35.0	35.6	100.0	100.0

The expenditures under the **"General public services"** function increase their share of 2.7% of GDP in 2016 to 2.9% in 2021. The increase of their share is contributed to by the increase of the expenditure for science and for executive and legislative authorities.

The expenditures for the **"Defence"** function increase as a share of GDP from 1.1% to 1.8% and as a share of the total expenditures from 3.1% to 5.1% due to the action taken for modernization of the equipment of the Bulgarian Army. It is intended to acquire aviation equipment and a multifunctional modular patrol ship for the Navy Forces.

The expenditures for the **"Economic affairs"** function decrease from 4.1% of GDP in 2016 to 5.2% of GDP in 2021. The function includes the state-owned enterprises which form part of the General Government sector and excludes the expenditures covered by EU funds which, according to ESA 2010 methodology, do not have any impact on revenues and expenditures in the General Government sector. The largest contribution for the expenditure increase in this function have the expenditures in the "Transport and communication" and "Agriculture", where a significant increase in capital expenditures is expected.

The expenditures for the **"Environmental Protection"** function increase from 0.6% of GDP in 2016 to 0.8% of GDP in 2021. The expenditures for the function include measures for continuing the accelerated construction of an ecological infrastructure in the country and the Natura 2000 ecological network, which will support the improvement of the life quality of the population and the protection of the ecosystems, as well as the meeting of the country's commitments to the EU.

The expenditures for the **"Healthcare"** function decrease from 5.0% of GDP in 2015 to 4.9% of GDP in 2020 and from 14.3% to 13.7% of the common expenditures. This is the result of the measures for optimizing the activities and improving the control over the expenditures in the healthcare system, which aims at stabilizing the health insurance model and increasing the financial independence of the health sector as a whole.

The expenditures for the **"Education"** function increase from 3.4% of GDP in 2016 to 4.0% of GDP in 2021 as a result of the envisaged salary increase of pedagogical staff. This function includes measures directed towards the achievement of higher transparency and efficiency of the spending of public funds in the educational system, optimization of the structures in the school network system and more comprehensive coverage of students within the system.

The reduction of the expenditures for the **"Social protection" function** from 12.7% of GDP in 2016 to 11.9% of GDP in 2021 reflects the decrease of the pension expenditures as a share of GDP as of the end of the period. The pension reform continues in the medium-term, as an increase is envisaged both of the insurance contributions and of the age and length of insurance service required to obtain an entitlement to pension.

6.3 Structure and Efficiency of Revenue Systems

Institutional Changes and Legislative Amendments Related to Public Finances and Improving the Collection Rate of Tax Revenues, Tackling the Shadow Economy, Reducing the Compliance Costs, which Address Specific Recommendation 1 in the Part Concerning Tax Revenues

—Tax Policy and Legislation

The tax and social security policy in the Republic of Bulgaria is oriented towards supporting the economic growth, improving the business environment, combating tax offenses and increasing the fiscal sustainability in the long run. The low tax rates are preserved for corporate taxes as well as the personal income tax as an important prerequisite for investments, economic growth and employment. In an international aspect, the tax policy in the period 2018–2021 will be oriented to support the functioning of the Single Market of the European Union and to meet the challenges of globalization and digitalization of economy.

The main objective in the period is implementing a policy aimed at increasing the collection rate of the revenues and achievement of the set budget targets.

The implementation of the measures from the Action Plan to the Single national strategy for improving the tax collection, tackling the shadow economy and reducing the compliance costs 2015-2017 (SNS), adopted by Resolution №806 of 2015 of the Council of Ministers, in response to Council Specific Recommendation 1 of 2014, continues. The first two reports with an evaluation of the application of SNS for 2015 and 2016 were drawn up and approved by the Council of Ministers respectively, with Protocol Decision №.17/27.04.2016 and with Protocol Decision №.13/22.03. 2017. They are published on the webpage of the Ministry of Finance (MF) in Bulgarian and English in the column "Tax Policy in Figures". For the purpose of providing a comprehensive package of measures for the post-2017 period, the term of validity of SNS was extended also in 2018 by Resolution №.95 of 16.02.2018 of the Council of Ministers.

Abiding to the principles of justice and effectiveness, the tax system must develop in a way that favours growth and ensures an increase of the budget revenues. Considering this, the main objective during the period is the implementation of a policy oriented towards an increase of the collection rate of revenues upon preservation of the burden of taxation and an expected positive effect from the strengthened acts upon revenue administration. This objective corresponds to the specific recommendations issued by the Council to Bulgaria in the last four years (2014-2017). In this respect an important factor are the measures taken for restricting the tax frauds, for preventing tax evasion and for tackling with the shadow economy. The main tools for minimizing the losses from uncollected tax revenues in the budget include, inter alia, the strengthening of the interaction of the institutions and the exchange of information both on national and international scales, as well as the decrease of the administrative burden and the compliance costs for business and for the citizens.

The measures implemented for improving the tax collection rate can be presented in the following two main groups:

⊙ Permanent Measures in the Field of Tax Policy.

- Implementation of the Single national strategy for improving the tax collection, tackling the shadow economy and reducing the compliance costs 2015-2017 (SNS). The reporting of the progress in the implementation of the measures in the strategy is carried out in annual reports containing an evaluation on the SNS implementation drawn up in furtherance of Resolution №806 of the Council of Ministers of 15.10.2015. The reports are approved by the Council of Ministers;

- Application of the VAT reverse charge mechanism upon supplies of cereal and technical cops as an effective tool for prevention of VAT frauds and for increasing budgetary revenues. The mechanism is put in place since 1 January 2014 and is among the most effective tools for prevention of and fight against VAT tax frauds, since the tax is charged by the recipient, which rules out any possibility of unlawful recovery of VAT from the budget and commitment of VAT frauds. The term of validity of the measure was extended until 31.12.2018;

- Exerting of fiscal control over the movement of high fiscal risk goods (HFRG). The measure is put in place in 2014. The list of high fiscal risk goods is determined by an Ordinance of the Minister of Finance, which is published on the websites of the MF and the NRA.

- Implementation of a mechanism directed towards preventing the possibilities of tax offenses and frauds involving VAT in the trade in liquid fuels. In the period after 2011 comprehensive control was put in place of the process related to the supplies and movement of liquid fuels from the producer and importer to the end consumer and exchange of data between the information systems of the two revenue agencies. In 2016 amendments to the Value Added Tax Act put in place a mechanism, by virtue of which when carrying out trade in liquid fuels having a tax base in excess of BGN 25 thousand, the persons are bound to mandatorily present a security for a term of one year before the competent territorial directorate of the NRA;

- Application of a mechanism for repayment of public obligations of persons with receivables against municipalities, other departments or state-owned enterprises under public procurement contracts and contract awarded in pursuance of EU operational programmes. The measure was introduced in 2014 for the purpose of increasing the collection rate of the budget revenues (Resolution №788/2014 of the Council of Ministers).

- Performance of constant monitoring of debtors with overdue obligations exceeding BGN 100 thousand (BGN 200 thousand for the Sofia City Territorial Directorate of the NRA) for taxes and mandatory health and social security contributions and an approved plan for conducting telephone campaigns under a timetable.

⊙ Legislative changes in 2017

The changes introduced to the tax legislation in 2017 are related to the implementation of measures under the tax policy priorities, and namely:

- measures for increasing the collection rate of budget revenue through prevention of the possibilities to evade and not to pay taxes and deviation from taxation;
- measures for reducing the administrative burden and compliance costs for business and for the citizens;
- introduction in the national legislation of European Directives in the field of taxes, as well as for setting of the national legal framework in conformity with the case-law of the EU Court of Justice.

⊙ Measures for increasing the collection rate of budget revenue through prevention of the possibilities to evade and not to pay taxes and deviation from taxation

—Improvement of the control of the supplies and movement of liquid fuels

In 2017 the provision (Article 176c of the Value Added Tax Act (VATA), the State Gazette, №97 of 2017, effective from 01.01.2018) about the security upon supplies of liquid fuels was rendered more precise, as under certain circumstances there is no longer an obligation to submit securities for end consumers – persons who do not trade but only directly consume liquid fuels. The objective of the mechanism (fight against VAT frauds in the trade in liquid fuels) is preserved while at the same time legal certainty is ensured for loyal and good-faith tax-payers.

For the purpose of improving the reporting of the sales and enhancing the control, amendment and supplementations were made in the period to Ordinance №H-18/2006 on the Registration and Reporting of Sales in Trade Outlets though Fiscal Devices (Ordinance Amendment and Supplementing Ordinance №H-18, issued on 13.09.2017 by the Minister of Finance and promulgated in the State Gazette , №76 of 19.09.2017). The main amendments include:

- Development of a scheme approved in advance by the NRA and the Bulgarian Institute of Metrology (BIM) for each particular liquid fuel sales outlet, which reflects all components of the electronic liquid fuel sale system and the connection between them;
- Performance of service maintenance activity of Electronic Fiscal Memory Systems by service technicians who have a unique service key issued by a manufacturer/importer;
- Putting in place of specific requirements to the work of Electronic Fiscal Memory Systems, according to which in case of an interruption of the connection/communication between its individual components, the system operation may be blocked;
- Putting in place of an obligation to the persons to submit data to the NRA for each printed receipt.

—Optimization of the control activity and improvement of the collection rate of excise duties

The provisions in the EDTWA about the application of the technical devices and technical means of control were further developed. The new Article 102a (State Gazette, №97 of 2016, effective from 01.01.2017) outlined the field of application of the technical means used for the purposes of the excise duty control, and namely: tracking, positioning and stopping of transport vehicles; monitoring and/or photographing of transport vehicles and places where activities are performed or excisable goods are kept; receipt of data and/or determination of indicators relevant to the levying of an excise duty; prevention of violations. The new Article 102b (State Gazette, №97 of 2017, effective from 01.01.2018) created rules for control over the excisable goods during their transportation on the territory of the country, related to the use of technical means and technical control devices. The rules are more precise and further developed rules of fiscal control implemented by the specialized units of the NRA. The provisions of the new Article 102c (effective from 01.01.2018) provide the customs authorities with the possibility to use information from the competent administrations for detecting the location and route of transport vehicles, as well as to request assistance for their stopping.

The Amending and Supplementing Act of the Tax and Social Insurance Procedure Code, whereby amendments and supplementations were made to the EDTWA (Article 103c of the EDTWA, promulgated in the State Gazette, №63 of 04.08.2017) lays down a requirement for all persons, whether or not they are taxable persons under the EDTWA, who receive, unload, keep or remove energy products from ports and customs warehouses, to use means of measuring and control under Article 103a of the EDTWA at the places for entry and removal of energy products in the respective facility, as well as at the places for storage of the energy products in the facility. The respective amendments are also made to Regulation № Н-1 of 2014 on the Specific Requirements and the Control Implemented by the Customs Authorities over the Excisable Goods Measurement and Control Devices.

Effective as of 01.01.2018 (by the Act Amending the VATA, promulgated in the State Gazette, №97 of 05.12.2017), prohibitions are introduced in relation to increasingly frequent cases of fictitious cross-border transactions with excisable goods and participation of Bulgarian licensed warehouse holders and Bulgarian business companies, owned by European country nationals, in international fraud schemes. The change (Article 91b of the EDTWA) prohibits the issue/ conclusion of documents for excisable goods, which have not been produced or physically received in the tax warehouse/facility, as the burden of proof for this circumstance lies with the customs authorities. An administrative-and-penal l provision is set forth for the transportation of excisable goods without a simplified accompanying document, as well as their forfeiture for the benefit of the state when a violation is found (Article 112a of the EDTWA).

For the purpose of voluntary compliance, an amendment is adopted to the EDTWA (Article 110), to regulate a lower pecuniary sanction in case of voluntarily charged and paid excise duty, for which the full or partial security of the one owed under the EDTWA has been avoided.

Prohibitions are established for the publication of electronic announcements or communications whereby excisable goods are offered on sale without an excise duty label or without excise duty paid. The primary objective is to prevent non-compliant sales of excisable goods. A new provision is also set up (Article 99a of the EDTWA), to relate to the cases of distribution of excisable goods by the use of courier (postal) services. The amendment has a preventive objective and will contribute to the enhancement of the operative interaction between the business and the administration with respect to the control of excisable goods and the countering of their illicit distribution.

A prohibition is put in place (Article 99, paragraph 4 of the EDTWA) with respect to the placement, keeping, carrying or transportation, of used excise duty labels, including on excisable goods.

A new provision is set up in the EDTWA, which introduces an obligation for the persons to present an ID document upon request by the customs authorities for the purposes of the control over excisable goods being implemented by the authorities.

Amendments are adopted to the EDTWA in relation to the installation of the technical devices for the exercising of control over the movement of tobacco waste (Article 102, paragraph 3 of the EDTWA).

—Administrative-and-penal provisions are aimed at the prevention and rendering sanctions more precise, depending on the gravity of the violation

An administrative-and-penal provision is adopted, which provides for a sanction for the persons in case of establishment of shortages or in case of excesses in taxable persons by the customs authorities for the purpose of implementing an effective control and tracking of the entered, produced or removed excisable goods, including the interim products. Likewise, a provision is introduced about the obligation of postal operators to require senders to declare that the excisable goods or tobacco waste being sent are with paid, charged or secured excise duty, as well as that they are with an excise duty label when such label is mandatory.

—Restriction of the possibilities to evade taxation in relation to registration / deregistration for VAT purposes

Mandatory VATA registration is introduced for an unincorporated company, to which goods or services are contributed by a partner that is a person registered under the law, for the cases when the partner is registered under the law after the date of creation of the unincorporated company. The purpose of the change is to prevent any possibility that the company may remain VATA unregistered in the presence of partners who are registered under the law, which could favour VAT avoidance.

An amendment is adopted in relation to ex-officio deregistration under the VATA of taxable persons upon dissolution of a legal entity without winding-up or of an unincorporated company or of an insurance fund.

Improvement of the efficiency of the provisions for engaging third parties' liability for undischarged tax and social- and health insurance contributions of obligated legal entities (Article 19 of the Tax and Social Insurance Procedure Code).

The purpose of the amendments is discontinuation of the practice of transferring companies with obligations soon after the commencement of an inspection or audit.

A coercive administrative measure of "sealing off a facility for a period of up to one month" is introduced, which may also be applied to a third party.

—Amendments related to notification upon dissolution, transfer and transformation of an enterprise

According to the amendments made to the Tax and Social Insurance Procedure Code (Article 77), in case of dissolution of a legal entity – merchant, transfer of an enterprise, transformation and liquidation, the merchant or the applicant is supposed to notify the territorial directorate of the NRA, whose jurisdiction covers the merchant's seat, before the submission of the respective application for a change in the circumstances. The certificate of notification made to the territorial directorate is to be enclosed to the application or registration filed to the Registry Agency and is a condition for the consideration thereof.

- **Measures for reducing the administrative burden and compliance costs for business and for the citizens**

  – ***Ex-officio establishment of the circumstance about the criminal conviction status for Bulgarian citizens and of information for the presence or absence of obligations of the persons***

The amendments to the Supplementing Act of the Limitation of Administrative Regulation and Administrative Control of Economic Activity Act introduce the requirement to provide a certificate of criminal conviction status ex-officio in: the Tax and Social Insurance Procedure Code, the Insurance Code, the Social Security Code, the EDTWA, the Corporate Income Tax Act (CITA), etc.

Pursuant to the amendments to Article 87, paragraph 11 of the Tax and Social Insurance Procedure Code, for the purposes of complex administrative servicing the competent authorities and other entitled persons require and receive ex-officio electronically from the NRA, the NCA and the municipalities information about the presence or absence or obligations of the persons, except for obligations under acts that still have not entered into force, as well as deferred, postponed or secured obligations.

– ***Electronic submission of returns under the Personal Income Tax Act (PITA)***

It is adopted that the return under Article 55, paragraph 1, which is drawn up and submitted by the enterprises – payers of incomes, which are bound to deduct and pay taxes, will from 2018 be submitted electronically only.

– ***Facilitating the persons declaring incomes from a source abroad by expanding the definition of evidence submitted for the amount of the taxes paid abroad***

An amendment is adopted, according to which the requirement of the PITA for enclosing to the annual tax return "certificates" of the tax paid abroad and mandatory social and health insurance contributions issued by the competent authorities of the other country, in the cases of incomes of local natural persons from sources abroad is replaced by the requirement to enclose "evidence".

– **Optimization of the processes related to inspections and audits of individuals for the purpose of making a comparison between the property acquired throughout the year and the incomes declared by the persons**

The local individuals are intended to be able to declare in their annual tax return the non-taxable incomes acquired in the year under Article 13 of the PITA, the property received by inheritance, last will and donation, as well as the property received as a result from a restored ownership right under the procedure of a legal instrument. The aim of the change is to optimize the processes related to inspections and audits of the natural persons in relation to the comparison between the property acquired in the year and the incomes declared by them.

– ***Restriction of the tax discount under the Personal Income Tax Act for those who file the annual tax return for 2017 by 31 January 2018 electronically***

The deadline is cut – by 31 January of the next year – and the discount used is 5% of the tax subject to final payment under the annual tax return but no more than BGN 500, provided that the taxable persons do not have public obligations subject to enforcement as at the time of filing of the return and the tax subject to final payment is paid by 31 January.

– ***Ensuring effective control by the tax administration upon the declaring of tax liabilities under the PITA***

A change is adopted in the deadline for filing the statement that must be filed by enterprises and self-employed persons – payers of incomes for incomes of natural persons paid in the year (the statement referred to in Article 73, paragraph 1 of the PITA), which is changed from by 30 April to by 15 March of the next year.

– ***Decrease of the administrative burden and costs for compliance with the Corporate Income Tax Act***

An amendment is adopted, which introduces mandatory electronic filing of the declarations under a form in accordance with the CITA. In this relation, the discount from the tax provided for in the act for electronic filing of the declaration will no longer apply.

A provision in the CITA (Article 92, paragraph 4) is supplemented, whereby in addition to the Annual Activity Report, taxable entities who have not performed an activity within the meaning of the Accounting Act are no longer bound to submit an Annual Tax Return.

- **Introduction in the national legislation of European Directives in the field of taxes, as well as for setting the national legal framework in conformity with the case-law of the EU Court of Justice.**

  – ***Participation of the Republic of Bulgaria in initiatives of the Organization for Economic Cooperation and Development (OECD) in the field of taxes and administrative cooperation***

In 2016 the Republic of Bulgaria joined the Inclusive Framework for introduction of tax measures against base erosion and profit shifting (Base Erosion and Profit Shifting – BEPS) based on official Resolution of the Council of Ministers №23 of 8 June 2016 whereby the country was given the opportunity to take part in the activities related to the establishment of standards in the field of tax treaties and transfer pricing, as well as to the process of development of monitoring in relation to the introduction of the four minimum standards already agreed with OECD and other elements of the BEPS package of measures. The introduction of the minimum standards is related also to the fulfilment of the obligations of Bulgaria as a member state of the EU, which is a member of G20 and is also engaged in the introduction of the standards in the European legislation. In this relation, an Act Amending and Supplementing the Tax and Social Insurance Procedure Code (promulgated in the State Gazette, №63 of 04.08.2017) the following was introduced in 2017:

- rules governing the exchange of information about preliminary cross-border rulings and advance spricing arrangements (Council Directive (EU) 2015/2376 of 8 December 2015).
- rules governing the exchange of country by country reporting of the multinational groups of enterprises (Council Directive (EU) 2016/881 of 25 May 2016).
- changes related to Directive 2006/112/EC on the common system of value added tax and as a result from established discrepancies with the EU law and harmonization of the national legislation with the European legislation for the purpose of uniform application due consideration being given to the case-law of the EU Court of Justice.

In order to prevent tax treatment not conformed to the rules of Directive 2006/112/EC on the common system of value added tax in relation to the international transport of passengers from a place on the territory of the country to a place outside the territory of the country, it is specifically set out that the application of a zero rate in the cases of transportation of passengers is only applicable to their baggage. The amendment provides for that upon performance of cargo transportation contracts the motor vehicles, the goods and the motor vehicles are not a part of a passenger's baggage, with respect to their drivers.

An editorial change is made to the term “Accommodation” in § 1, subparagraph 45 of the additional provisions of the VATL, as the “from a tour operator to a travelling person” is deleted in the definition.

In accordance with the rules of Articles 344 and 345 of Directive 2006/112/EC on the common system of VAT a supplementation is made to the provisions regulating the qualification of gold coins as investment gold in view of the application of the special investment gold scheme.

– ***Changes in the field of excise duty taxation***

For the purpose of reaching the minimum excise duty of 90 EUR per 1000 pieces as at 01.01.2018, the excise duty increased gradually, in accordance with the approved timetable for an increase in the excise duty for cigarettes for reaching the minimum levels of taxation determined by the directive. Effective as of 1 January 2018 the specific excise duty is BGN 109 per 1000 pieces, and the proportional excise duty is 25% of the sale price. The total amount of the excise duty shall not be less than BGN 177 per 1000 pieces as of 1 January 2018.

Rules are introduced that are related to harmonizing the effective legislation in the field of trade in natural gas and the liberalization of the market in electricity that explicitly determine the status of the traders within the meaning of the legislation of another member state or a state, which is a party to the Agreement on the European Economic Area, that can perform an activity as persons registered under the Excise Duties and Tax Warehouses Act. A possibility is given to the persons to perform an activity on the territory of the country through a branch in the Republic of Bulgaria or through a local legal entity – an accredited representative in accordance with Art.133 – 135 of the Value Added Tax Act.

A legal possibility is created for excise duty exemption also through its recovery for excisable goods when this is provided for in an international treaty, which is ratified, promulgated and has duly entered into force. The procedure is determined by the EDTWA implementing regulations.

A provision for the avoidance of double taxation in the cases of production of electricity for own needs is supplemented, as excise duty is only imposed on raw materials for the production of electricity, in accordance with Article 21 (5) of Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity.

A provision is added (Article 75b of the EDTWA), which is aimed at regulating cases when shortages are found on the territory of the country upon the completion of the movement of excisable goods under a duty suspension arrangement. The change is related to a Judgment of the EU Court of Justice of 28 January 2016 (Case C-64/15) under a request for preliminary ruling about the interpretation of Council Directive 2008/118/EC of 16 December 2008 concerning the general arrangements for excise duty.

—National Customs Agency

The amendments to the EDTWA adopted in 2017 are aimed at improving the tax legislation and rendering more precise the provisions of the law for the purpose of eliminating any vagueness and facilitating its practical application, as well as ensuring compliance with EU Court of Justice case-law.

The adopted amendments to the regulatory framework follow to a large extent the adopted amendments and supplementations to the EDTWA.

A provision was created in Chapter seven "Limitations and Prohibitions" of the EDTWA, which prohibits the registration and issue of documents related to the excise duty taxation, for excisable goods that have not been produced or received physically in the respective tax warehouse or facility (Article 91b, paragraphs 2-4). The change comes as a result of the increasingly frequent cases of fictitious cross-border transactions with excisable goods (mainly beer, wine and high-alcohol beverages). Furthermore, specific prohibitions were introduced with respect to the publication of announcements or communications, including in an electronic form, whereby excisable goods subject to excise duty labels and tobacco waste are offered on sale (Article 99, paragraphs 6-8), as well as the performance of postal services related to the acceptance, carriage and delivery through the postal network of excisable goods and tobacco waste prohibited by the EDTWA (Article 99a).

The changes are necessitated by the numerous publications of announcements on different internet platforms, through which excisable goods without an excise duty label and paid excise duty are offered for sale, as well as the large number of cases when the customs authorities find illicit distribution of excisable goods through courier or postal packages.

In chapter eight "Control", the provisions of Article 102b and 102c in the EDTWA create a clear procedure with respect to the application of Article 102a, paragraph 1, subparagraph 1 of the law and regulation of the obligations for the persons operating vehicles used to transport excisable goods and the recipients of these goods on the territory of the country. The texts of Article 102b are drawn on the special provisions for the control of high fiscal risk goods laid down in the Tax and Social Insurance Procedure Code and Ordinance №H-2 of 30 January 2014 of the Minister of Finance. Article 102c introduces obligations equalizing the control approach during the movement of excisable goods; a legal possibility is given to the customs authorities to request assistance from other competent authorities for the identification and stopping of transport vehicles that for objective reasons could not have been stopped by them; different variants for establishing the route of movement of the transport vehicles subject to control are regulated. An amendment to Article 103, paragraph 7 of the act provides for a legal possibility for the director of the NCA to approve a budget for the control purchases made in accordance with Article 103, paragraph 5 of the act. The amendment is in conformity with the implementation of a measure laid down in the Single national strategy for improving the revenue collection, tackling the shadow economy and reducing the compliance costs 2015–2017, as such an approach is also adopted with respect to the control purchases made by the NRA under the procedure set out in Regulation № H-18/2006 of the Minister of Finance.

Restrictions are imposed, including explicit prohibitions of registration of an electronic excise duty document, submission of a notice of receipt and issue of tax documents, when the excisable goods are not produced or have not been physically received in the tax warehouse (see Article 91b, paragraphs 2 – 4 of the EDTWA); prohibitions of the publication of announcements and communications, including in an electronic form, on bottled alcoholic beverages and tobacco products without an excise duty label or with a DUTY FREE excise duty label and on tobacco waste, as well as their sending by the postal network. (see Article 99, paragraphs 6-8 of the EDTWA and Article 99a of the EDTWA). If shortages or excesses of excisable goods are found, and these circumstances have not been accounted for in the material accounts of the person, according to Article 112b, this violation is punishable by a pecuniary sanction – if shortages are found the pecuniary sanction is in the amount of the excise duty owed for the missing excisable goods but no less than BGN 500; if excesses of excisable goods are found, the property sanction is in the amount of BGN 3000 to BGN 20 000. Increased sanctions are provided for in case of a repeated violation.

A possibility for to impose a sanction on a supplier or recipient is provided for, when the person knew or was bound to know that certain excisable goods have unidentified (unknown) origin and this is proven by the customs authorities or by the revenue authorities. It includes also specific hypotheses, in which it is assumed that the person was bound to be aware of the unidentified origin of the goods: supplies between related parties, fictitious or law-evading transaction, sale at a price other than the market price or for which there are no quality or conformity documents (Article 126, paragraphs 2–4 of the EDTWA).

The more significant amendments to the RIEDTWA are, as follows:

- A requirement for information to be submitted for an additional (product) code of the excisable goods before the commencement of their movement under a duty suspension arrangement.

- The cases, in which a permission is issued for the establishment of public excise duty obligations when shortages are found upon the completion of the movement of excisable goods under a duty suspension arrangement, are regulated on the territory of the country.
- Changes are made for the purpose of relieving the procedure related to the unused excise duty labels, when a licensed warehouse keeper has several tax warehouses and terminates the activity of one of them, and the possibility of transferring the unused excise duty labels to another tax warehouse of the same warehouse keeper.
- The provisions for the purpose of simplifying the scrap procedure are rendered more precise, as there is no longer an obligation to remove the excise duty labels from the consumer packages and apply them on sheets that are to be handed over to the competent customs office.
- A new provision is created with respect to the cases, where waste is not reported and entered for each tax period, according to which the licensed warehouse keepers are bound to establish the losses from the natural waste in the end of each calendar year, as they must document them by a template document.
- An amendment is made for the purpose of improving the control and introduction of an obligation of the economic operators to provide access to the customs officers to production and warehouse premises and to the raw materials and ready products located therein. An administrative procedure is also regulated in relation to the termination of the validity of the certificate of an approved vessel for transportation of energy products.
- A provision is created about the submission of necessary information for own vehicles or those used on other grounds by the persons who received a permit for trade in tobacco products.
- The provision about the denaturing of ethyl alcohol is amended in accordance with the annex to Commission Implementing Regulation (EU) 2016/1867 of 20 October 2016 amending the Annex to Regulation (EC) No 3199/93 on the mutual recognition of procedures for the complete denaturing of alcohol for the purposes of exemption from excise duty.

Amendments to Regulations and Instructions, made in 2017:

- In 2017 the following Regulations were drawn up and promulgated - Regulation Amending and Supplementing Ordinance № H-1 of 22 January 2014 on the Specific Requirements and the Control Implemented by the Customs Authorities over the Excisable Goods Measurement and Control Devices and the Regulation Amending and Supplementing Regulation №H-7 of 19 September 2016 on the Determination of a Procedure, Manner and Format for Sending Measurement and Control Device Data under Article 103a, paragraph 1 of the EDTWA, in relation to ensuring the compliance with the requirements of the persons referred to in Article 103c, paragraph 1 of the EDTWA.
- Regulation Amending and Supplementing Regulation № H-18 of 13 December 2006 on the Registration and Reporting of Sales in Trade Outlets though Fiscal Devices was drawn up and promulgated in 2017 in relation to the setting into conformity with the requirements to the persons referred to in Article 103c of the EDTWA. A change was implemented in the communication module between the NCA and the NRA, related to the provision of information for the licenses from BACIS.

- In 2017 Instruction №И-2/13 July 2017 (Ministry of Finance) and №8121з-878/06 July 2017 (Ministry of Interior) was signed. It sets out the conditions and procedures for the interaction between customs and Ministry of Interior authorities in relation to the performance of their functions, determined by law.

—National Revenue Agency (NRA)

In order to decrease the shadow economy, to improve the collection of tax and social security liabilities and to reduce the administrative burden the National Revenue Agency continues implementing the following measures:

⊙ Provision of the quality service and reducing compliance costs of the customers:

- Implementation of constant and purposeful communication and conduction of explanatory campaigns to specific customer groups.
- Optimization of the process of registration/deregistration under the VAT Act and relieving of the customers of the NRA.
- Application of specific measures for improving the voluntary fulfilment of the obligations on the part of customers, in respect of which an analysis of the declared data has shown that they have made mistakes in the fulfilment of tax,social security and other liabilities.
- Provision of the opportunity of payment for public liabilities, administrated by the NRA, through point-of-sale (POS) terminals, including virtually.
- Maintenance and improvement of the existing e-services and in line with the new technologies. Facilitating the clients of the NRA when using said services. Examining the opinions of the clients using the e-services and developing them according to the customers expectations.

⊙ Development of control activity and counteraction of tax and insurance fraud

- Constant monitoring and communication with obligated persons forming a significant share of the economy in the country.
- Development of specific approaches for branch-based control, which are distinguished for a high frequency of tax frauds with a considerable fiscal effect.
- Active interinstitutional interaction within interdepartmental coordination centres that have been set up.
- Improving the NRA capacity for control over e-commerce.
- Strengthening the control over persons, hiding income/revenues from trade activity on the internet, by analyzing information from third parties and mandating control actions.
- Preparation of proposals for legislative amendments, aiming to regulate the trade activity done on the internet.
- Strengthening control over tracking the movement of high fiscal risk goods, introducing electronic verification of the movement data.

⊙ Effective and efficient collection of overdue obligations

- Making available a clear, unified and easily accessible information for the current liabilities of individuals.

- Early implementation of instruments, stimulating the voluntary payment of overdue liabilities, thus evading the necessity of implementing enforcement actions.
- Improvement of communication, incl. electronic communication, with debtors, public execution creditors and interested parties.
- Developing unified rules concerning the ways of collecting overdue public obligations, depending on the debtors' profile.
- Constant monitoring and communication with individuals that have liabilities with a high fiscal effect.
- Improving efficiency when using mutual assistance when collecting public obligations from debtors with overdue obligations, who have submitted requests for VAT refunds in another Member state of the EU.

Development of the system for management of the risk of failure to comply with the tax and social security legislation

- Execution of the measures in the "Programme for compliance with the legislation and decrease of the risk levels – 2018-2019".
- Implementation of activities in accordance with the signed agreement with the research team from Europe, including the"Undeclared labour" risk.
- Implementation of the project "Segmentation and behavioral profiling of debtors within the country".

Development and maintaining partnerships

- Implementing a structured approach for review, prioritization, expansion and updating the National Revenue Agencies' partnerships with other entities and organizations.
- Rising the share of electronic interaction and exchange of information with other administrations, also including a connection for implementing complex administrative servicing, as well as participation in connected national projects. Participation in the building and supporting the functioning of the electronic governance of the country.
- Promoting and effective utilization of the instrument "Presence in the administrative services and participation in administrative proceedings" by the NRA as a means of faster information exchange and prevention of tax fraud.
- Implementing new and effective behavioral models from the revenue authorities when working with clients in support, cooperation and involvement for timely and quality service.

7. Institutional Features Of Public Finances

7.1 National budgetary rules

With the adoption of the Public Finance Act (PFA) and Fiscal Council and Automatic Corrective Mechanisms Act, Bulgaria has introduced the European requirements for enhancing and strengthening economic governance in the European Union. The presence of a legal framework that determines budgetary rules, restrictions and procedures for action upon any deviations from the targets set for a certain indicator, is a precondition for increasing the predictability of the fiscal policy, compliance with the budgetary and financial discipline, and ensuring public finance sustainability.

The fiscal rules set in the Public Finance Act aim at defining clear and transparent restrictions on the fiscal policy in the long run, expressed in the imposition of numerical restrictions on main budgetary aggregates. The rules were developed in accordance with the internationally adopted definitions and criteria, as well as with the requirements for coordination of the national fiscal planning with the preventive and corrective arm of the Stability and Growth Pact.

The concentration of fiscal rules and their permanent regulation within the Public Finance Act have a positive effect as they guarantee long-term sustainability, link the elaboration of the fiscal policy to the making of a complex evaluation for their application and create preconditions for preserving budgetary discipline at all levels of governance of public finance.

The fiscal rules and restrictions comprise indicators under the national methodology – for the budget balance and the expenditures under the consolidated fiscal programme (on a cash basis) and for the state debt, as well as indicators of the General Government sector (for some rules as well as for its relevant subsectors) – for the medium-term budgetary objective for the structural deficit, the budget balance and the consolidated debt of the General Government sector. The construction of three groups of fiscal rules – balance, debt and expenditure ones helps to reflect the impact of the policies on the parameters of key budget indicators relevant to the General Government sector and to its relevant subsectors, as well as to the consolidated fiscal programme, incl. on a local level (municipalities/municipal budgets). The rules are further developed with the inclusion of specific provisions for cases of deviation from the target/restriction and the respective correction mechanisms and measures for returning to the target or the limit determined by the rule.

Regardless of the extended scope of the rules governing the budgetary framework, the application of the PFA revealed certain discrepancies and gaps with respect to the transposition of the European legislation in this field, as well as non-regulated public relations in the management of public finances, which give rise to risks for the budget and observance of the fiscal rules both on a consolidated level and on the level of individual independent budgets.

The Amending and Supplementing Act of the Public Finance Act (promulgated in the State Gazette, №91 of 2017) adopted by the National Assembly, introduced the necessary correction mechanisms with respect to both expenditure fiscal rules. These mechanisms guarantee the effective implementation of these rules and that the rules contain all the necessary requisites for their classification as such.

As regards the rule limiting the annual growth of the budgetary expenditure, specific consequences and action in case of non-compliance with it were regulated, as a requirement was laid down that in the update of the medium-term budgetary forecast additional measures should be determined for achieving the admissible ratio in the next year in case of an expected deviation from the rule. An exception from the rule for the annual growth of the expenditures is also permited when the medium-term budgetary objective is overachieved, which is admissible according to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies.

The provisions concerning the admissible amount of the costs under the consolidated fiscal programme in case of an expected excess of the maximum amount of the costs set under the Consolidated Fiscal Programme, presented as a percentage of GDP were supplemented similarly to this change.

As early as with the adoption in 2016 of the Amending and Supplementing Act of the Public Finance Act a number of issues were resolved related to the need of taking action to set the budget position of municipalities in accordance to the requirements of the national fiscal rules, applicable to municipalities pursuant to the PFA. Issues concerning the identification of municipalities in financial difficulty, the introduction of procedures for their recovery and the implementation of a financial recovery plan were provided for.

The financial recovery plans include measures in an annual and medium-term perspective for prioritization and optimization of the expenditures, for increasing the revenue collection rate, for decreasing the liquidation of obligations overdue, for decreasing the municipal budget deficit, as well as management and organizational acts towards the implementation of the plan for the purpose of achieving financial sustainability and stability of the municipal finances.

In line with the implementation of the amendments to the PFA of 2016, methodical guidelines were drawn up and criteria were approved for determination of municipalities with financial difficulties. Quarterly analyses are performed and the data for the financial condition of municipalities and for municipalities in a financial recovery procedure is published, while an evaluation of different financial indicators for financial independence is made and the observance of fiscal rules is monitored.

For the relatively short period of application of the amendments to the PFA with respect to the created mechanism for financial recovery of municipalities, the number of municipalities defined as municipalities in financial difficulty decreases.

In the beginning of March 2018 it was established that the municipalities, which meet three and more criteria for being classified as municipalities in financial difficulty, are 13 municipalities, against 32 municipalities classified as municipalities in financial difficulty in 2017 and 36 municipalities defined as municipalities in financial difficulty in 2016 .

As a result from the improvement of the financial indicators with respect to the obligations overdue, the obligations for expenditures, the engagements for expenditures, the collection rate of tax revenues and the debt rule under the PFA, as well as the implementation of the measures and activities provided for in the coordinated recovery plans, seven of the ten municipalities with coordinated financial recovery plans are removed from the list of municipalities in financial difficulty in 2018.

7.2 Budgetary procedures

One of the elements of sound public finance governance is the successful first step and the start of the process of planning and drawing up of budget documents. The first document in this process is a well-structured budget procedure conformed to the Public Finance Act, synchronized with the European requirements and engaging all responsible institutions – both budget organizations and legal entities that though not being a part of the consolidated fiscal programme are within the scope of the General Government sector.

The budgetary procedure for 2019 is approved by Resolution №51 of the Council of Ministers of 31 January 2018 and is conformed to the deadlines for the application of the mechanisms and measures laid down in the main stages of the European Semester for Economic Policies Coordination in 2018.

The budgetary procedure was drawn up in accordance with the rule and requirements of the Public Finance Act, as its preparation reflected the requirements set for the structure and contents of the key budget documents and the deadlines for their adoption. These requirements are also in harmony with the most recent amendments to the Public Finance Act of 2017 about the structure and contents of the main national budget documents.

The first stage of the budgetary procedure for 2019 was launched by guidelines of the Minister of Finance for the drawing-up and submission of the budget forecasts of the first-level spending units for the period 2019–2021 and it is supposed to end by the adoption of a resolution of the Council of Ministers for the approval of the medium-term budgetary forecast for the period 2019–2021.

The second stage of the procedure covers the preparation, consideration and approval by the Council of Ministers of the 2019 Budget and of the updated Medium-Term Budgetary Forecast as motives to the Budget and the subsequent steps for reflection of the final budget parameters approved by the National Assembly. The successful implementation of the second stage implies achievement of coordination of the fiscal policy parameters in the medium-term with the sectorial policies of the government being conducted and the possibilities for their financing in the period 2019–2021, subject both to the fiscal rules and restrictions of the Public Finance Act and to the latest values of macroeconomic parameters and the expectations for the development of the national and world economy.

Within his powers and in accordance with the deadlines defined in the procedure the Minister of Finance must issue instructions and guidelines also for the second stage of the budgetary procedure for 2019 in order to support the processes of planning and preparation of the draft budgets of the budget organizations, including those that apply programme budgeting. The guidelines to the spending units concern not only the determination of the budgetary parameters of their forecast but also the increase of the quality of the information contained in the budget documents drawn up by them. Particularly attention, with respect to the first-level spending units applying programme budgeting, is drawn to the achievement of a closer link between the policies being conducted and the results achieved from the implementation of the respective policies, measured through objectively defined and reliable performance indicators. This should contribute to the creation of a sustainable link between the strategic objectives of the budgetary organization and the policy areas/budgetary programmes implemented by it.

The procedure creates good organization and coordination upon the drawing-up of the medium-term budgetary forecast, its update and development of the draft state budget act, as the effective inclusion of the main participants in the budgetary process is ensured subject to adherence to the stages, deadlines and requirements for preparation of the budgetary documents.

7.3 Other institutional developments in relation to public finances

—Spending review of the public expenditures in Bulgaria

In 2016 a Spending review of the public expenditures in Bulgaria was initiated. The review is carried out by the World Bank and is a result from a request made by the Ministry of Finance for the performance of an analysis of the effectiveness and efficiency of the public expenditures, for the purpose of identification of options for savings and redistribution of funds to more efficient activities in the public sector.

The first phase of the review, which was successfully completed, includes an analysis of the expenditures for remunerations, operational activity and maintenance of seven ministries and 21 municipalities. The second phase, for which this concept is drawn up is aimed to elaborate and develop two pilot projects focused on a specific area. They are, in turn, intended to serve as examples for future spending reviews, which are to be developed by Bulgaria.

On the basis of the analysis made in the first phase, the government chose in July 2017 two programme areas for similar reviews of the expenditures in the second phase: 1) public order and safety and 2) waste management.

The political body that directs the review of the public expenditures in Bulgaria is a Steering Committee including deputy ministers and chaired by a deputy Minister of Finance. Such representation is supposed to ensure the strong political commitment to the recommendations made in the course of the Spending review, and their addressing in a subsequent budgetary procedure.

The review of the public finances is intended to be finally completed in the middle of 2018. In addition to a report on the results from the analysis and recommendations for further action, a manual will also be drawn up for the conduction of future spending reviews by the Bulgarian administration.

8. Annex A

Table 1a: Macroeconomic prospects

	ESA 2010 code	2017	2017	2018	2019	2020	2021
		Level (MBGN)	**Rate of change**	**Rate of change**	**Rate of change**	**Rate of change**	**Rate of change**
Real GDP (at previous year prices)	B1*g	97 482	3.6	3.9	3.8	3.7	3.7
Nominal GDP	B1*g	98 631	4.8	6.1	6.2	6.1	6.0
Components of real GDP							
Private consumption expenditure	P.3	60 083	4.8	4.9	4.8	4.6	4.4
Government consumption expenditure	P.3	15 210	3.2	5.4	5.3	1.0	1.8
Gross fixed capital formation	P.51	18 149	3.8	10.1	6.6	6.9	7.0
Change in inventories and net acquisition of valuables (% of GDP)	P.52+ P.53	1 589	1.7	1.7	1.7	1.7	1.7
Export of goods and services	P.6	62 658	4.0	4.9	4.9	4.7	4.6
Import of goods and services	P.7	60 206	7.2	8.1	7.0	5.9	5.8
Contributions to real GDP growth (In percentage points)							
Final domestic demand		-	4.2	5.8	5.1	4.4	4.5
Change in inventories and net acquisition of valuables	P.52+P.5 3	-	1.1	0.1	0.1	0.1	0.1
External balance of goods and services	B.11	-	-1.7	-2.0	-1.4	-0.8	-0.8

Table 1b: Price developments

	ESA 2010 code	2017	2017	2018	2019	2020	2021
		Level	**Rate of Change**[46]	**Rate of Change**	**Rate of Change**	**Rate of Change**	**Rate of Change**
GDP deflator		100	1.2	2.1	2.3	2.3	2.2
Private consumption deflator		100	1.1	1.5	1.6	1.7	1.8
HICP[47]		100	1.2	1.8	2.0	2.1	2.1
Public consumption deflator		100	3.9	2.9	2.9	2.8	2.9
Investments deflator		100	4.3	1.0	1.0	1.3	1.3
Export price deflator (goods and services)		100	4.4	2.1	0.7	0.6	1.0
Import price deflator (goods and services)		100	6.2	1.3	-0.2	0.0	0.6

[46] Percentage change as compared to the previous year.

[47] Optional for Stability Programmes.

Table 1c: Labour market developments

	ESA 2010 code	2017 Level	2017 Rate of Change	2018 Rate of Change	2019 Rate of Change	2020 Rate of Change	2021 Rate of Change
Employment (thousand persons)[48]		3 525	1.8	0.6	0.3	0.2	0.0
Employment (millions of hours worked)[49]		5 793	1.8	0.6	0.3	0.1	-0.1
Unemployment[50]		6.3	6.3	5.9	5.7	5.5	5.4
Labour productivity (BGN per person employed)[51]		27 652	1.7	3.3	3.5	3.5	3.7
Labour Productivity (BGN per hour worked)[52]		16.8	1.8	3.3	3.5	3.6	3.8
Compensation of employees (MBGN)[53]	D.1	42 491	7.9	8.5	7.3	6.7	6.3
Compensation per employee		16 441	7.5	7.4	6.9	6.5	6.3

Table 1d: Sectorial balances

% of GDP	ESA 2010 code	2017	2018	2019	2020	2021
Net lending/borrowing vis-à-vis the rest of the world	B.9	5.0	3.1	2.6	2.3	1.7
of which: –balance of goods and services		1.9	0.1	-0.7	-1.0	-1.4
–balance of primary incomes and transfers		2.1	1.7	1.8	1.8	1.7
–capital account		1.0	1.4	1.5	1.5	1.4
Net lending/borrowing of the private sector	B.9	4.0	3.1	2.3	1.8	1.5
Net lending/borrowing of the general government	EDP B.9	0.9	0.0	0.3	0.5	0.2
Statistical discrepancy						

48 Occupied population, national accounts definition.

49 National accounts definition.

50 Harmonised definition, Eurostat; levels.

51 Real GDP per one person employed.

52 Real GDP per one hour worked.

53 In MBGN.

Table 2a: General government budgetary prospects

	ECC 2010	2017 Level	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP	2021 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	920.4	0.9	0.0	0.3	0.5	0.2
2. Central government	S.1311	727.5	0.7	-0.1	0.2	0.4	0.1
3. State government	S.1312		0.0	0.0	0.0	0.0	0.0
4. Local government	S.1313	256.0	0.3	0.1	0.1	0.1	0.1
5. Social security funds	S.1314	-63.2	-0.1	0.0	0.0	0.0	0.0
6. Total revenue	TR	35 702.0	36.2	36.3	36.6	36.1	35.8
7. Total expenditure	TE	34 781.7	35.3	36.3	36.3	35.6	35.6
8. Net lending / borrowing	EDP B.9	920.3	0.9	0.0	0.3	0.5	0.2
9. Interest expenditure	EDP D.41	784.9	0.8	0.7	0.6	0.6	0.6
10. Primary balance		1 705.2	1.7	0.7	0.9	1.1	0.8
11. One-off and other temporary measures		0.0					
12. Total taxes (12=12a+12b+12c)		20 982.3	21.3	21.4	21.6	21.5	21.4
12a. Taxes on production and import	D.2	14 903.2	15.1	15.3	15.3	15.2	15.1
12b. Current taxes on income, wealth, etc.	D.5	5 812.1	5.9	5.8	6.0	6.1	6.1
12c. Capital taxes	D.91	267.0	0.3	0.2	0.3	0.2	0.2
13. Social contributions	D.61	8 456.5	8.6	8.8	8.9	8.9	8.8
14. Property income	D.4	784.9	0.8	0.7	0.5	0.5	0.5
15. Other		5 478.4	5.6	5.4	5.6	5.2	5.1
16=6. Total revenue	TR	35 702.0	36.2	36.3	36.6	36.1	35.8
Tax burden (D.2+D.5+D.61+D.91-D.995)		29 438.7	29.8	30.1	30.5	30.4	30.2
17. Compensation of employees + intermediate consumption	D.1+P.2	13 932.3	14.1	14.5	14.4	14.2	13.9
17a. Compensation of employees	D.1	9 148.3	9.3	9.5	9.6	9.6	9.4
17b. Intermediate consumption	P.2	4 784.0	4.9	5.0	4.8	4.6	4.5
18. Total social transfers (18=18a+18b)		13 462.7	13.6	13.7	13.8	13.7	13.5
of which Unemployment benefits	D.621, D.624	394.1	0.4	0.4	0.4	0.4	0.3
18a. Social transfers in kind	D.6311. D.63121. D.63131	2 084.6	2.1	2.2	2.5	2.6	2.6
18b. Social transfers other than in kind	D.62	11 378.1	11.5	11.5	11.3	11.1	10.9
19=9. Interest expenditure	EDP D.41	784.9	0.8	0.7	0.6	0.6	0.6
20. Subsidies	D.3	1 085.0	1.1	1.0	1.2	1.1	1.0
21. Gross fixed capital formation	P.51	2 070.9	2.1	4.3	4.6	4.4	4.7
22. Capital transfers	D.9	1 232.2	1.2	0.8	0.5	0.5	0.5
23. Other		2 213.6	2.2	1.3	1.1	1.1	1.3
24=7. Total expenditure	TE1	34 781.7	35.3	36.3	36.3	35.6	35.6
Government consumption (nominal))	P.3	15 806.2	16.0	16.4	16.7	16.3	16.1

Table 2b: No-policy change projections

	2017	2017	2018	2019	2020	2021
	Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Total revenue at unchanged policies	35 702.0	36.2	35.6	36.2	35.6	35.3
2. Total expenditure at unchanged policies	34 781.7	35.3	35.2	35.5	34.7	34.4

Table 2c: Amounts to be excluded from the expenditure benchmark

	2017	2017	2018	2019	2020	2021
	Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	1 034.2	1.0	1.7	1.9	1.4	1.3
1a. Investments fully matched by EU funds revenue	550.1	0.6	1.1	1.4	1.0	0.8
2. Cyclical unemployment benefit expenditure	394.1	0.4	0.4	0.4	0.4	0.3
3. Effect of discretionary revenue measures	115.1	0.1	0.6	0.4	0.4	0.5
4. Revenue increases mandated by law	0.0	0.0	0.0	0.0	0.0	0.0

Table 3: General government expenditure by function

% of GDP	ESA 2010 code	2016	2021
1. General public services	1	2.7	2.9
2. Defence	2	1.1	1.8
3. Public order and safety	3	2.4	2.3
4. Economic affairs	4	4.1	5.2
5. Environmental protection	5	0.6	0.8
6. Housing and community amenities	6	1.9	1.1
7. Healthcare	7	5.0	4.9
8. Recreation, culture and religion	8	1.0	0.6
9. Education	9	3.4	4.0
10. Social protection	10	12.7	11.9
11. Total expenditure (= item 7 = 24 of Table 2)	TE1	35.0	35.6

Table 4: General government debt developments

% of GDP	ESA code	2017	2018	2019	2020	2021
1. Gross debt[54]		25.4	23.3	22.1	20.7	19.4
2. Change in gross debt level		- 3.6	-2.1	-1.2	-1.4	-1.3
Contributions to changes in the gross debt to GDP ratio						
3. Primary balance[55]						
4. Interest expenditure[56]	EDP D.41	0.8	0.7	0.6	0.6	0.6
5. Stock-flow adjustment						
of which:						
Differences between cash and accruals[57]						
Net accumulation of financial assets[58]						
of which: privatisation proceeds						
Valuation effects and other[59]						
Implicit interest rate on debt[60]		2.8	2.7	2.7	2.8	2.8
Other relevant variables						
6. Liquid financial assets[61]						
7. Net financial debt (7=1-6)						
8. Debt amortization since the end of the previous year		11.9	6.6	5.1	5.6	4.4
9. Percentage of debt denominated in foreign currency		78.9	80.2	78.1	76.7	75.5
10. Average maturity		7.7	7.5	7.0	6.5	5.9

54 As defined in Regulation 479/2009 (not an ESA concept).

55 Cf. item 10 in Table 2.

56 Cf. item 9 in Table.

57 The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

58 Including liquid assets, government securities, assets in third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

59 Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

60 Approximately calculated as interest expenditure divided by the debt level of the previous year.

61 AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5: Cyclical developments

% of GDP	ESA 2010 code	2017	2018	2019	2020	2021
1. GDP growth (%)		3.6	3.9	3.8	3.7	3.7
2. Net lending of general government	EDP B.9	0.9	0.0	0.3	0.5	0.2
3. Interest expenditure	EDP D.41	0.8	0.7	0.6	0.6	0.6
4. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		3.3	3.5	3.5	3.5	3.4
Contributions:						
labour		0.5	0.3	0.3	0.1	-0.1
capital		0.9	1.1	1.2	1.3	1.4
total factor productivity		1.9	2.0	2.1	2.1	2.1
6. Output gap		-0.4	0.0	0.3	0.4	0.7
7. Cyclical budgetary component		-0.1	0.0	0.1	0.1	0.2
8. Cyclically-adjusted balance (2-7)		1.1	0.0	0.2	0.3	0.0
9. Cyclically-adjusted primary balance (8+3)		1.9	0.7	0.8	1.0	0.6
10. Structural balance (8-4)		1.1	0.0	0.2	0.3	0.0

Table 6: Divergence from previous update

	ESA 2010 code	2017	2018	2019	2020	2021
Real GDP growth (%)						
Previous update		3.0	3.1	3.2	3.2	
Current update		3.6	3.9	3.8	3.7	3.7
Difference (p.p.)		0.6	0.8	0.6	0.5	
General government net lending (% of GDP)	EDP B.9					
Previous update		-0.6	-0.5	0.1	0.1	
Current update		0.9	0.0	0.3	0.5	0.2
Difference (p.p.)		1.5	0.5	0.2	0.4	
General government gross debt (% of GDP)						
Previous update		26.4	25.6	25.1	23.8	
Current update		25.4	23.3	22.1	20.7	19.4
Difference (p.p.)		-1.0	-2.3	-3.0	-3.1	

Table 7: Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060	2070
Total expenditure	37.6	35.9	35.6	35.7	36.7	38.2	38.8	38.0
Of which: age-related expenditures	15.1	17.8	17.0	17.1	18.1	19.6	20.2	19.4
Pension expenditures	7.4	9.3	8.4	7.9	8.6	9.8	10.2	9.7
Social security pension	7.1	9.1	8.2	7.8	8.5	9.5	10.0	9.4
Old-age and early pensions	5.6	7.5	6.5	5.8	6.1	7.1	7.9	7.7
Other pensions (disability, survivors)	1.5	1.6	1.7	2.0	2.4	2.4	2.2	1.8
Occupational pensions (if in general government)								
Healthcare	4.0	4.4	5.1	5.4	5.6	5.7	5.5	5.4
Long-term care								
Education expenditure	3.6	3.6	3.2	3.5	3.6	3.9	4.2	4.1
Other age-related expenditures	0.1	0.4	0.2	0.3	0.3	0.3	0.3	0.3
Interest expenditure	1.1	0.7	0.6	0.6	0.7	1.3	2.3	2.9
Total revenue	38.7	32.8	36.1					
Of which: property income	1.3	1.2						
Of which: from pensions contributions (or social contributions if appropriate)	5.7	7.0						
Pension reserve fund assets								
Of which: consolidated public pension fund assets (assets other than government bonds)								
Social contributions diverted to mandatory additional pension scheme[62]	0.7	1.0						
Pension expenditure paid by mandatory additional pension scheme[63]	0.0	0.0						
Labour productivity growth	2.6	8.0	3.5	3.4	2.5	2.2	1.8	1.5
Real GDP growth	7.3	1.3	3.7	1.3	1.1	0.8	1.2	1.1
Participation rate males (aged 20-64)	78.3	76.8	78.5	77.9	76.8	77.1	78.3	77.5
Participation rate females (aged 20-64)	68.4	67.0	69.1	68.3	66.9	66.6	68.0	67.2
Participation rate total (aged 20-64)	73.3	71.9	73.8	73.1	71.9	71.9	73.2	72.5
Unemployment (%. 15-64)	6.9	10.3	5.5	6.5	6.5	6.5	6.5	6.5
Population aged 65+ over total population	17.3	17.5	21.7	24.7	27.9	31.5	33.3	30.9

62 Revenue from social security contributions or other revenue for the mandatory additional pension insurance, with which the accounts payable can be covered.

63 Pension expenditure or other social benefits paid by the mandatory additional pension insurance.

Table 7a: Contingent Liabilities

% of GDP[1]	2017	2018
General Government sector guaranteed debt	0.7	0.6
Of which: linked to the financial sector	0.5	0.4

Table 8: Basic assumptions

	2017	2018	2019	2020	2021
Short-term interest rate (annual average) 6-month LIBOR in EUR, %	-0.33	-0.30	-0.01	0.46	0.91
Short-term interest rate (annual average) 6-month LIBOR in USD, %	1.48	2.42	3.41	3.86	3.48
Long-term interest rate (annual average), %	1.60	2.04	2.16	2.37	2.55
USD/EUR exchange rate (annual average)	1.13	1.23	1.23	1.23	1.23
Nominal effective exchange rate. percentage change. previous year = 100[64]					
EUR/BGN exchange rate (annual average)	1.95583	1.95583	1.95583	1.95583	1.95583
World economy (excluding EU). GDP growth, %	3.7	3.9	3.9	3.8	3.7
EU GDP growth, %	2.4	2.3	2.1	1.9	1.8
Growth of relevant foreign markets. %					
World import volumes, excluding EU, %					
Oil Brent (USD/barrel)	54.4	64.0	59.8	57.0	55.5
International prices of non-energy goods, %	4.9	5.5	1.1	-0.6	-0.3
International prices of food products, %	-0.1	2.6	1.8	-2.0	-1.3
International prices of agricultural raw materials, %	2.4	3.6	-0.9	-0.4	0.0
International prices of metals, %	22.4	13.0	1.0	1.0	1.0

64 The positive values reflect appreciation, the negative – depreciation.