



EUROPEAN COMMISSION
Directorate-General
Economic and Financial Affairs

Brussels, 27 May 2015

**Assessment of the 2015 Convergence Programme for
BULGARIA**

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION.....	3
2. MACROECONOMIC OUTLOOK.....	3
3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS.....	5
3.1 Deficit developments in 2014	5
3.2 Target for 2015 and medium-term strategy.....	5
3.3 Debt developments	8
3.4 Risk assessment.....	10
4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT	12
5. LONG-TERM SUSTAINABILITY	14
6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES.....	17
6.1. Fiscal framework.....	17
6.2. Quality of public finances	17
7. CONCLUSIONS	18
ANNEX.....	19

1. INTRODUCTION

This document assesses Bulgaria's April 2015 Convergence Programme (hereafter called Convergence Programme), which was submitted to the Commission on 30 April 2015 and covers the period 2014-2018. It was approved by the government and presented to the national parliament for information. The budgetary plans of the programme are based on the 2015 budget law approved and the update of the medium-term budgetary framework for the period 2015-2017 which were adopted by the parliament in December 2014.

Bulgaria is currently subject to the preventive arm of the the Stability and Growth Pact and should ensure sufficient progress towards its MTO.

This document complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence Programme. Section 2 presents the macroeconomic outlook underlying the Convergence Programme and provides an assessment based on the Commission 2015 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Stability Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the Stability and Growth Pact, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 summarises the main conclusions.

2. MACROECONOMIC OUTLOOK

After expanding by 1.7% in 2014, real GDP growth is expected to slow down to 1.4% in 2015 according to the Convergence Programme. The authorities thereafter assume a gradual strengthening of GDP growth to 1.7% in 2016 and above 2% over the years 2017 and 2018. Domestic demand is projected to be the key driver of growth, whereas net external trade contributes negatively throughout the forecast horizon.

The macroeconomic outlook in the Convergence Programme is markedly weaker than the one presented in last year's programme. In the previous programme, growth was forecast to amount to 2.1% in 2014, 2.6% in 2015 and to 3.4% in 2016. For both 2015 and 2016, the update has largely been driven by downward revisions to domestic demand, in particular private consumption and investment. Growth in public consumption and investment is also projected to be slightly weaker than in the previous programme.

Compared to the Commission's spring 2015 forecast, the programme¹ foresees a slightly higher rate of real GDP growth in both 2015 and 2016 by about 0.4 pp in each year. There are several factors explaining these differences. The programme forecasts stronger growth of private consumption than the Commission forecast, mainly driven by somewhat higher wage dynamics and productivity growth. The programme also projects a positive contribution of gross fixed capital formation to real GDP growth in 2015-16, implying high growth in

¹ The external assumptions underlying the Convergence Programme are based on the Commission's winter 2015 forecast, which was available at the time of preparation.

private-sector investment which may not materialise. Therefore, there are also notable differences in the composition of growth for both years, as the Commission's forecast projects only a modest positive contribution from domestic demand. Finally, the Commission forecast projects a positive contribution of net exports in both 2015 and 2016 while the programme forecasts the contribution to remain negative despite similar assumptions on the world and the EU economic outlook. Overall, the 2015 Convergence Programme is based on plausible macroeconomic assumptions, as the differences compared to the Commission forecast are within a reasonable margin considering the inherent uncertainty underlying medium-term economic projections.

The output gaps as recalculated by the Commission² based on the information in the programme, following the commonly-agreed methodology indicate a further deterioration of the economic cycle in 2015 and 2016 and a closure of the output gap by 2018. Over 2014 to 2016, this profile is broadly consistent with the Commission's spring 2015 forecast.

Table 1: Comparison of macroeconomic developments and forecasts

	2014		2015		2016		2017	2018
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	1.7	1.7	1.0	1.4	1.3	1.7	2.3	2.1
Private consumption (% change)	2.0	2.0	1.0	2.4	1.5	2.9	3.2	2.7
Gross fixed capital formation (% change)	2.8	2.8	-1.7	1.8	-2.9	1.5	2.9	3.2
Exports of goods and services (% change)	2.2	2.2	3.1	2.8	4.0	3.1	3.4	3.6
Imports of goods and services (% change)	3.8	3.8	2.0	3.6	3.0	4.0	4.4	4.4
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	2.5	2.5	0.3	2.0	0.5	2.4	3.0	2.8
- Change in inventories	0.3	0.3	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-1.1	-1.1	0.7	-0.6	0.7	-0.7	-0.7	-0.7
Output gap ¹	0.0	-0.2	-0.8	-0.7	-1.4	-1.0	-0.6	-0.1
Employment (% change)	0.4	0.4	0.2	0.3	0.3	0.5	0.9	0.5
Unemployment rate (%)	11.4	11.4	10.4	10.8	9.8	10.2	9.4	9.0
Labour productivity (% change)	1.3	1.3	0.8	1.1	1.0	1.2	1.4	1.6
HICP inflation (%)	-1.6	-1.6	-0.5	-0.6	1.0	1.8	1.9	2.0
GDP deflator (% change)	0.6	0.6	0.4	0.3	0.6	1.2	1.4	1.5
Comp. of employees (per head, %)	1.5	1.5	1.8	1.8	2.5	2.8	3.5	3.3
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.3	1.6	2.6	0.8	2.5	0.2	-0.3	n.a.
Note:								
¹ In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
Source:								
Commission 2015 spring forecast (COM); Convergence Programme (CP).								

² Over 2014-16, the recalculated output gaps are 0.2 percentage points of potential GDP lower than the output gaps presented in the programme.

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1 Deficit developments in 2014

The general government deficit worsened significantly in 2014, reaching 2.8% of GDP³ and marking an increase of 1.9 pps. over the previous year. This outcome proved to be above the target set in the 2014 Convergence Programme which expected the headline deficit to reach 1.8% of GDP. The expansionary fiscal stance in 2014 also breached the national fiscal rule, i.e. a cash-deficit ceiling of 2% of GDP. In 2014, the general government expenditure increased by 0.9 pp. to 39.2% of GDP. General government revenue stood at 36.5% of GDP, i.e. 1.0 pp. lower than in the previous year.

The deficit increase in 2014 was largely driven by a significant decline in taxes on production and imports on the revenue side, and by current expenditure, in particular social spending and wage increases in some public institutions. Also, capital investments increased substantially in 2014, related to the peak in the EU funds absorption cycle of 7-years. However, since a large part of this investment increase is EU funded, its impact on the government deficit is much smaller, and is mostly related to national co-financing. The tax burden remained constant, at 28.2% of GDP in both 2013 and 2014.

Still, the headline deficit in 2014 proved much lower than the revised target of 3.5% of GDP included in the 2015 budget approved in late 2014. This outcome is mainly explained by two factors: i) the improved budget balance of local governments reported in 2014, linked to the un-freezing of EU funds under some operational programmes in early 2015; and ii) better tax collection at the beginning of 2015 which count for 2014 budget revenue in accrual terms.

3.2 Target for 2015 and medium-term strategy

The target for 2015

The Convergence Programme foresees a general government deficit of 2.8% of GDP in 2015, significantly higher than the 1.3% of GDP set in the 2014 programme. This is mainly due to the weaker-than-expected macroeconomic outlook as well as the negative carry-over from the 2014 fiscal outcome. Compared to 2014, the expenditure ratio is expected to decline by 0.4 pp to 38.8% of GDP in 2015. The 2015 budget foresees fiscal consolidation measures, most notably a 10% cut in government personnel spending and savings in goods and services. The revenue ratio is forecast to slightly decline to 35.9% of GDP, largely driven by the foreseen drop in EU transfers.

The Convergence Programme's deficit target is broadly in line with the Commission's 2015 spring forecast of a headline deficit of 2.9% of GDP in 2015.

³ Eurostat expressed a reservation on the quality of the data reported by Bulgaria for 2014 in relation to the sector classification of the Deposit Insurance Fund and the impact on the government deficit of the fund's repayment of the guaranteed deposits (3.7 bn BGN) in the Corporate Commercial Bank. The impact of the transaction will be assessed by Eurostat in cooperation with the Bulgarian statistical authorities during the coming months.

The structural balance, as implied by the programme,⁴ is expected to be -2.5% of GDP. According to the Commission forecast the structural balance remains at -2.6% of GDP in 2015. Hence, the programme is in line with the Commission forecast.

The medium-term strategy

The budgetary strategy underlying the 2015 Convergence Programme aims at bringing down the headline deficit from 2.8% of GDP in 2015 to 2.4% of GDP in 2016 and further to 1.3% of GDP by the end of the programme period, which according to the authorities, would bring the structural deficit to the MTO. Bulgaria has chosen a MTO of -1.0% of GDP, reflecting the objectives of the Pact. The MTO is also unchanged compared to last year.

Based on the structural balances from the programme recalculated by the Commission, the MTO would be met with a margin in 2018. However, while the government estimates that the structural balance would improve by 0.5% of GDP every year over 2016-18, the recalculated improvement in the structural balance would amount to 0.4% of GDP in 2016, which is lower than the required 0.5% of GDP, and remain at around 0.4% in 2017 and 2018. The planned headline deficits included in the programme are significantly higher than those of the 2014 Convergence Programme, mainly due to the sizeable deterioration of the deficit in 2014..

The adjustment is expected to be primarily driven by lower spending, which declines by 1.7pps. over 2014-18. Wage expenditure, goods and services and social spending are expected to gradually decline as a share of GDP by 2018, while gross fixed capital formation would remain broadly constant.

Whereas the revenue share of GDP is projected to remain constant at around 36% of GDP, the ratio of tax revenues to GDP are projected to increase over the period given the expected tax-rich composition of economic growth based on consumption and the government plans for reducing tax evasion for which measures are however not yet sufficiently specified. The envisaged consolidation strategy is supported by detailed measures fully for 2015 and only partly for 2016. For the period 2017-18, the budgetary adjustment represents projections under a no-policy-change assumption. There are no significant one-off or other temporary measures planned in the programme.

⁴ The structural balance was recalculated by the Commission based on the information in the programme following the commonly-agreed methodology.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2014	2015		2016		2017	2018	Change: 2014-2018
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	36.4	36.4	35.9	36.2	36.0	36.1	36.1	-0.3
<i>of which:</i>								
- Taxes on production and imports	14.8	14.8	14.8	14.9	15.5	15.5	15.5	0.7
- Current taxes on income, wealth, etc.	5.3	5.4	5.5	5.4	5.5	5.5	5.4	0.1
- Social contributions	7.8	7.9	8.0	7.9	7.8	7.7	7.5	-0.3
- Other (residual)	8.4	8.3	7.6	8.0	7.2	7.4	7.7	-0.7
Expenditure	39.2	39.3	38.8	39.1	38.4	37.9	37.5	-1.7
<i>of which:</i>								
- Primary expenditure	38.5	38.4	37.8	38.1	37.4	36.7	36.4	-2.1
<i>of which:</i>								
Compensation of employees	9.7	9.5	9.1	9.6	9.1	8.9	8.7	-1.0
Intermediate consumption	5.6	5.6	5.5	5.6	5.3	5.0	4.9	-0.7
Social payments	14.9	15.1	15.0	15.2	14.9	14.7	14.5	-0.4
Subsidies	1.2	1.0	1.0	1.0	1.0	1.0	1.0	-0.2
Gross fixed capital formation	5.0	4.8	5.0	4.0	4.6	4.8	4.9	-0.1
Other (residual)	2.1	2.4	2.2	2.7	2.5	2.4	2.3	0.2
- Interest expenditure	0.7	1.0	1.0	1.0	1.0	1.2	1.1	0.4
General government balance (GGB)	-2.8	-2.9	-2.8	-2.9	-2.4	-1.8	-1.3	1.5
Primary balance	-2.1	-2.0	-1.8	-1.9	-1.4	-0.7	-0.2	1.9
One-off and other temporary	-0.2	-0.1	-0.1	0.0	0.0	0.0	0.0	0.2
GGB excl. one-offs	-2.6	-2.9	-2.7	-2.9	-2.4	-1.8	-1.3	1.3
Output gap ¹	0.0	-0.8	-0.7	-1.4	-1.0	-0.6	-0.1	-0.1
Cyclically-adjusted balance ¹	-2.8	-2.7	-2.6	-2.5	-2.1	-1.6	-1.3	1.6
Structural balance (SB)²	-2.6	-2.6	-2.5	-2.5	-2.1	-1.6	-1.3	1.4
Structural primary balance ²	-1.9	-1.7	-1.5	-1.5	-1.1	-0.4	-0.2	1.7
Notes:								
¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.								
² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
Source:								
Convergence Programme (CP); Commission 2015 spring forecasts (COM); Commission calculations.								

Measures underpinning the programme

The 2015 Convergence Programme incorporates all measures proposed and announced by the government in the 2015 budget. While the main tax rates remain unchanged, some specific legislative changes are expected to have an overall small revenue impact in 2015. In addition, the programme plans to significantly boost VAT revenue over 2015-16 through various measures to fight tax evasion (tighter control for goods with a high fiscal risk, improvements to excise duty legislation/collection). The Commission's spring 2015 forecast does not assume additional revenue from these measures. While these measures might be effective and necessary, significant additional revenue seems rather optimistic in the short-term and the Commission forecast takes a more cautious approach in its revenue projections. Furthermore,

the Commission does not explicitly factor in its forecast any revenue from second-round effects. The impact of reforms on macroeconomic variables is highly difficult to predict. Therefore, the materialisation of additional resources should be treated as an upside risk. On the expenditure side, the programme envisages significant cuts in government spending on wages (by 10% in central administration and agencies) as well as savings in the healthcare sector on goods and services. However, the programme does not specify how these measures would be operationalized in practice.

Main budgetary measures

Revenue	Expenditure
2015	
<ul style="list-style-type: none"> • Measures improving revenue collection⁵ (0.4% of GDP) 	<ul style="list-style-type: none"> • Cutting government wage spending (-0.4% of GDP) • Measures to limit goods and services in healthcare (-0.1% of GDP)
2016	
<ul style="list-style-type: none"> • Measures improving revenue collection (0.3% of GDP). 	<ul style="list-style-type: none"> • No concrete expenditure measures announced
<p><u>Note:</u> The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

3.3 Debt developments

General government gross debt increased rapidly from 18.3% at end 2013 to 27.6% of GDP at end 2014, reflecting the support to the financial sector (about 4% of GDP), the deterioration in the budget deficit as well as the planned repayment and refinancing operations of some larger bonds maturing in early 2015 (2.1% of GDP). The stock-flow adjustment had a sizeable impact on the debt level in 2014, also due to the building up of cash buffers in view of the volume of the short-term debt maturing in 2015.

The programme projects government debt to continue increasing, albeit at a slower pace, and reach about 31% of GDP in 2018. The underlying debt dynamics reflect the positive impact of a gradual improvement in the primary balance and the nominal GDP growth dynamics as well as the increased use of cash buffers which would need to be replenished by 2018. The projections of the debt-to-GDP ratio in the programme appear plausible taking into account the Commission's spring 2015 forecast and latest available information. According to the Commission 2015 spring forecast, public debt is expected to reach 31.2% of GDP by 2016, mainly due to the higher headline deficit in the Commission's projections.

However, this profile is different from the one included in the previous Convergence Programme as estimates of the governmental debt level were well below the threshold of 30%

⁵ The Commission's spring 2015 forecast does not assume additional revenue from measures aiming to fight tax evasion. While the measures might be effective, the Commission forecast takes a cautious approach in its revenue forecast.

of GDP over 2016-17 period (see Figure 1). Since the debt-to-GDP ratio is significantly below the 60% Treaty reference value, the debt reduction benchmark is not applicable.

Table 3: Debt developments

(% of GDP)	Average 2009-2013	2014	2015		2016		2017	2018
			COM	CP	COM	CP	CP	CP
Gross debt ratio¹	16.4	27.6	29.8	29.8	31.2	30.1	30.4	30.9
Change in the ratio	1.0	9.3	2.2	2.2	1.4	0.3	0.3	0.5
<i>Contributions²:</i>								
1. Primary balance	1.4	2.1	2.0	1.8	1.9	1.4	0.7	0.2
2. “Snow-ball” effect	0.4	0.3	0.6	0.5	0.4	0.2	0.0	0.1
<i>Of which:</i>								
Interest expenditure	0.8	0.7	1.0	1.0	1.0	1.0	1.1	1.1
Growth effect	0.0	-0.3	-0.3	-0.4	-0.4	-0.5	-0.7	-0.6
Inflation effect	-0.4	-0.1	-0.1	-0.1	-0.2	-0.3	-0.4	-0.4
3. Stock-flow adjustment	-0.8	6.8	-0.4	-0.2	-1.0	-1.3	-0.4	0.3
<i>Of which:</i>								
Cash/accruals diff.								
Acc. financial assets								
<i>Privatisation</i>				0.1		0.0	0.0	0.0
Val. effect & residual				0.1		0.1	0.1	0.1

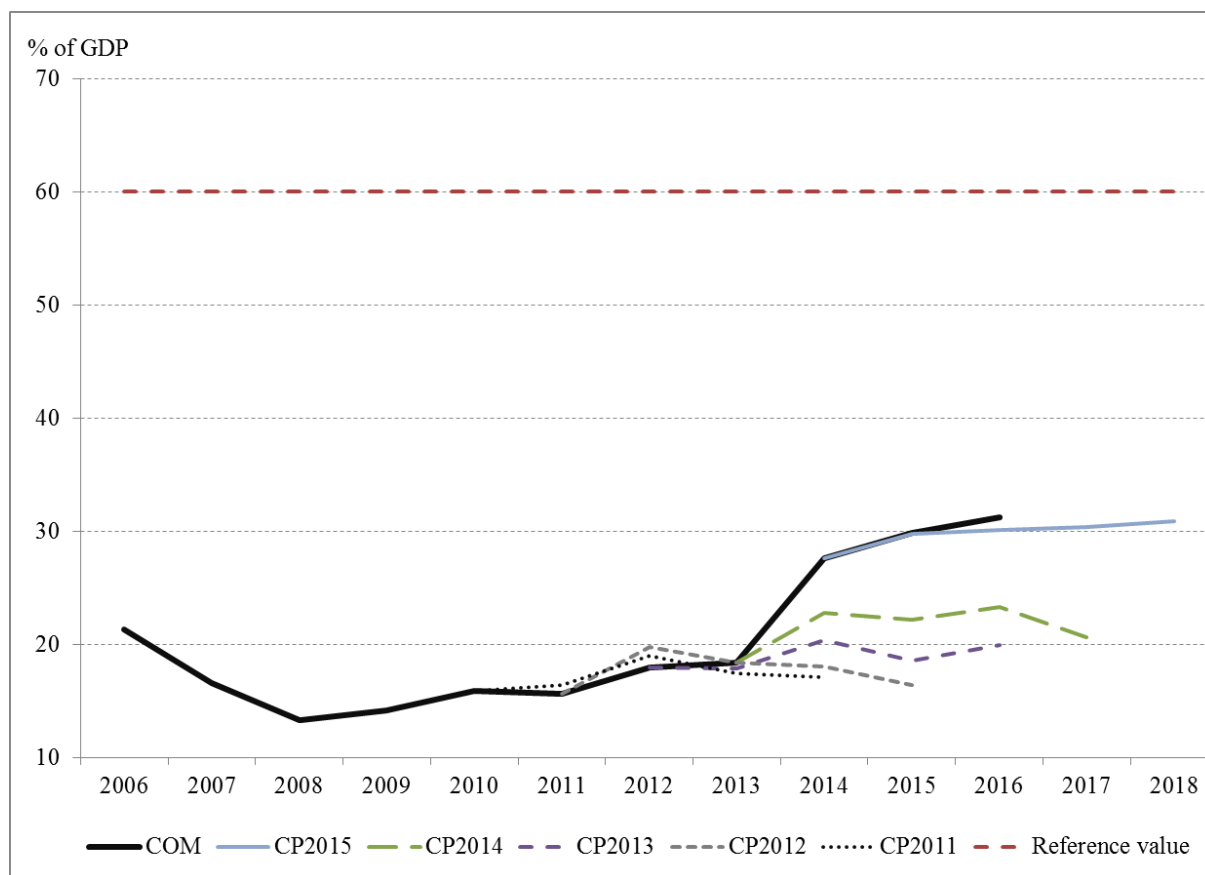
Notes:

¹ End of period.

² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:
Commission 2015 spring forecast (COM); Convergence Programme (CP), Commission calculations.

Figure 1: Government debt projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast; Convergence Programmes

3.4 Risk assessment

Deficit and debt developments

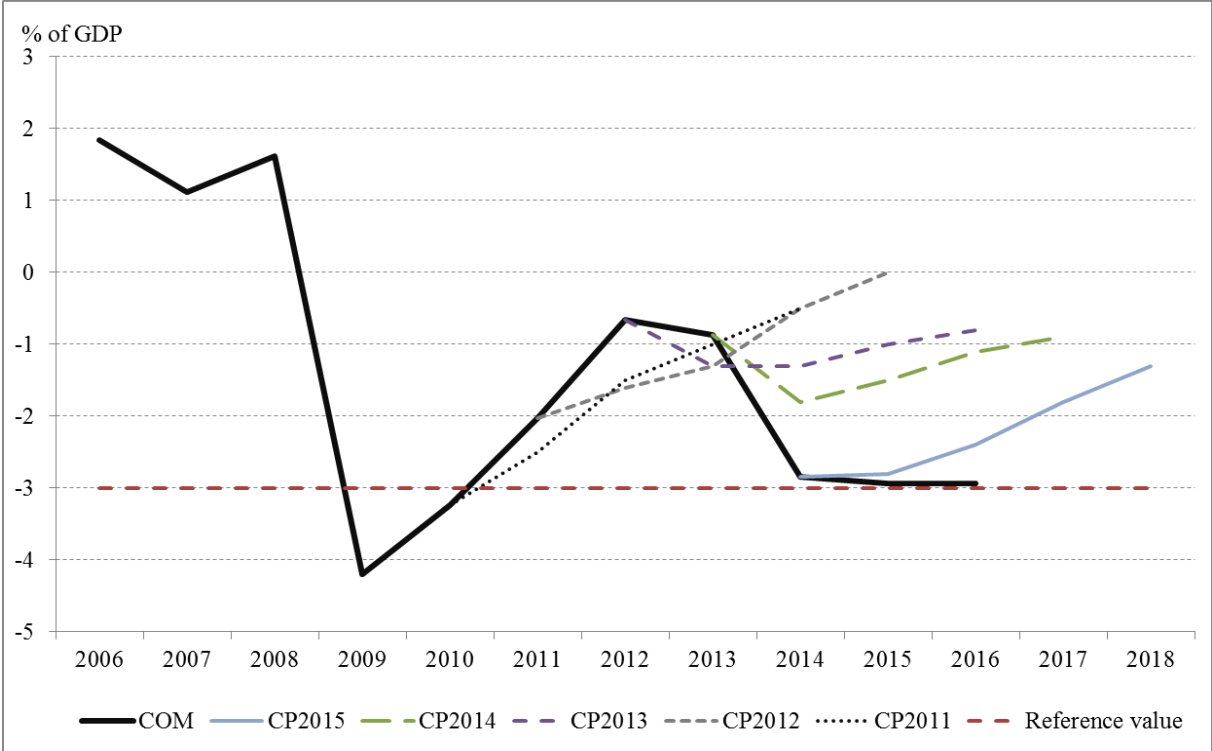
The scenario reported in the Convergence Programme is characterised by two main sources of risks. On the one hand, the programme assumes that real output would continue to be driven by tax-rich growth components. Specifically, private consumption and investment and tax collection are expected to improve markedly in the programme. On the other hand, the ambitious budgetary strategy pursued by the authorities is not yet sufficiently specified.

The macroeconomic forecast of the government is overall plausible, but the programme expects somewhat faster GDP growth over 2015-16 and significantly higher inflation in 2016 than the Commission assumes in its forecast. More importantly, the macroeconomic scenario assumes rather optimistic projections of consumption and investment. Given the slow recovery in employment, there is a significant risk of weaker-than-expected recovery in private consumption compared to the programme's macroeconomic scenario. Also consumer and business sector confidence remain fragile and could deteriorate in case of further signs of instability in the financial sector. On the positive side, exports could turn out higher than expected given that a sizeable portion of Bulgarian exports goes to non-euro area countries and exporting industries are also expected to benefit from the depreciation of the euro, to which the lev is pegged. The programme assumes very high tax elasticities for personal

income and VAT revenue, in relation to their respective tax-bases. Unlike the Commission forecast, the programme scenario assumes that measures to improve tax collection would boost revenues; in particular substantially higher income tax in 2015 and VAT in 2016 are projected in the programme. As tax elasticities are usually linked to the cyclical position, the programme plans only a limited reduction in the output gap. Therefore, the return to a unitary or even an above-unitary elasticity of tax revenue may take longer than expected by the government.

Apart from the macroeconomic scenario and its impact on tax revenue, some risks also arise on the expenditure side. The uncertainties mainly stem from the budgetary execution and the ability of the authorities to effectively comply with the expenditure targets set in the Convergence Programme. For 2015, the approved budget foresees some consolidation measures regarding government sector wages and goods and services, which have been partially taken on board in Commission's spring forecast. While ambitious saving targets have also been set for 2016 in the area of goods and services and social spending, the measures underpinning the reduction in expenditure growth have not been specified at this stage. There are risks that the targeted efficiency gains are insufficient to ensure the planned reduction in public spending, making it more difficult for the government to comply with the deficit targets. Other sources of uncertainties stem from the fragile financial situation of some large state-owned enterprises in the energy and transport sectors which may lead to the accumulation of significant contingent liabilities for the government. Somewhat reducing the risks above, the authorities have a proven track record of meeting and even over-performing their fiscal targets in the past, excepting the 2014 outcome (see Figure 2).

Figure 2: Government balance projections in successive programmes (% of GDP)



Source: Commission 2015 spring forecast; Convergence Programmes

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 1. Council recommendations addressed to Bulgaria

On 8 July 2014, the Council addressed recommendations to the Bulgaria in the context of the European Semester. In particular, in the area of public finances the Council recommended Bulgaria to reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements. Bulgaria was also recommended to: (a) strengthen the budgetary strategy in 2015 to ensure reaching the medium-term objective and remain at it thereafter; (b) ensure the capacity of the new fiscal council to fulfil its mandate; and (c) implement a comprehensive tax strategy to strengthen tax collection, tackle the shadow economy and reduce compliance costs.

Bulgaria started the year 2014 at its MTO - a structural deficit of 1% of GDP. However, the significant weakening in the headline deficit has led the structural deficit to deteriorate to 2.6% in 2014, which points to a significant deviation of 1.5% of GDP from the MTO. The expenditure benchmark, on the other hand, is met with a margin of 1.0% of GDP. The average deviation over 2013-2014 from the required adjustment under the structural balance pillar is 0.5% of GDP, while the expenditure benchmark over two-years is met with a margin of 0.8% of GDP. This warrants an overall assessment. The structural effort is negatively affected by a sizable revenue shortfall in 2014 due to a negative shock in inflation (deflation). In addition, the large increase in public investment in 2014 also contributes to a deterioration of the structural balance whereas investment is smoothed in the calculation of the expenditure benchmark. In this case, the expenditure benchmark provides a more relevant assessment of progress made towards the MTO. Therefore, following an overall assessment, the ex-post analysis concludes that there is some deviation from the requirements in 2014.

In 2015, the structural deficit based on the recalculated programme data is projected at 2.5% of GDP. According to the Commission's spring 2015 forecast, Bulgaria appears to be in line with the requirements in 2015 as both the structural balance and the expenditure benchmark are met over one year. However, given the deterioration of the structural balance in 2014, the structural balance pillar over 2014 and 2015 taken together indicates an average annual deviation of 0.7% of GDP, above the threshold for a significant deviation, while the expenditure benchmark points to compliance. As the deviation over two years is stemming from the previously mentioned revenue shortfall and the increase in public investment in 2014, following an overall assessment there is a risk of some deviation from the adjustment path towards the MTO in 2015. A similar conclusion can be drawn based on the recalculated figures from the programme.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2014	2015		2016	
Initial position¹					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance ² (COM)	-2.6	-2.6		-2.5	
Structural balance based on freezing (COM)	-1.5	-2.6		-	
Position vis-a-vis the MTO³	At or above the MTO	Not at MTO		Not at MTO	
(% of GDP)	2014	2015		2016	
	COM	CP	COM	CP	COM
Structural balance pillar					
Required adjustment ⁴	0.0	0.0		0.5	
Required adjustment corrected ⁵	-0.3	0.0		0.5	
Change in structural balance ⁶	-1.7	0.1	0.0	0.4	0.1
<i>One-year deviation from the required adjustment⁷</i>	-1.5	0.1	0.0	-0.1	-0.4
<i>Two-year average deviation from the required adjustment⁷</i>	-0.8	-0.7	-0.7	0.0	-0.2
Expenditure benchmark pillar					
Applicable reference rate ⁸	2.9	2.1		0.7	
<i>One-year deviation⁹</i>	1.0	0.3	0.5	-1.6	-0.9
<i>Two-year average deviation⁹</i>	0.8	0.7	0.8	-0.6	-0.2
Conclusion					
Conclusion over one year	Overall assessment	Compliance	Compliance	Overall assessment	Overall assessment
Conclusion over two years	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Notes					
¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points is allowed in order to be evaluated as having reached the MTO.					
² Structural balance = cyclically-adjusted government balance excluding one-off measures.					
³ Based on the relevant structural balance at year t-1.					
⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 28.).					
⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
⁶ Change in the structural balance compared to year t-1.					
⁷ The difference of the change in the structural balance and the required adjustment corrected.					
⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is not at its MTO.					
⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<i>Source:</i>					
<i>Convergence Programme (CP); Commission 2015 spring forecasts (COM); Commission calculations.</i>					

In 2016, the recalculated programme data points to a deviation from the required adjustment by 0.1% of GDP based on the structural balance pillar. The growth rate of expenditure net of discretionary measures exceeds the applicable expenditure benchmark rate, leading to a significant deviation from the adjustment path by almost 1.6% of GDP. The expenditure

benchmark over 2015 and 2016 taken together indicates an average annual deviation of 0.6% of GDP, also above the threshold for a significant deviation. In turn, the structural balance pillar points to compliance over 2015 and 2016 together. Based on the commission forecast, the net expenditure growth also exceeds the benchmark by 0.9% of GDP in 2016, pointing to a significant deviation, while the structural balance pillar shows a gap of 0.4% of GDP, slightly below the threshold for a significant deviation. As the structural balance is negatively affected by revenue shortfalls and volatility of investment, the expenditure benchmark is considered a more relevant indicator of the fiscal stance. The overall assessment therefore concludes that there is a risk of a significant deviation in 2016.

To summarise, following an overall assessment, some deviation is to be expected in 2014 and 2015 together according to both the programme and the Commission's spring 2015 forecast. In 2016, the programme points to a risk of significant deviation on the basis of the net expenditure growth pillar. The Commission spring forecast also indicates that a significant deviation could materialise in 2016 on the basis of the assessment over one year, putting under risk the compliance with the requirements of the preventive arm of the Pact.

5. LONG-TERM SUSTAINABILITY

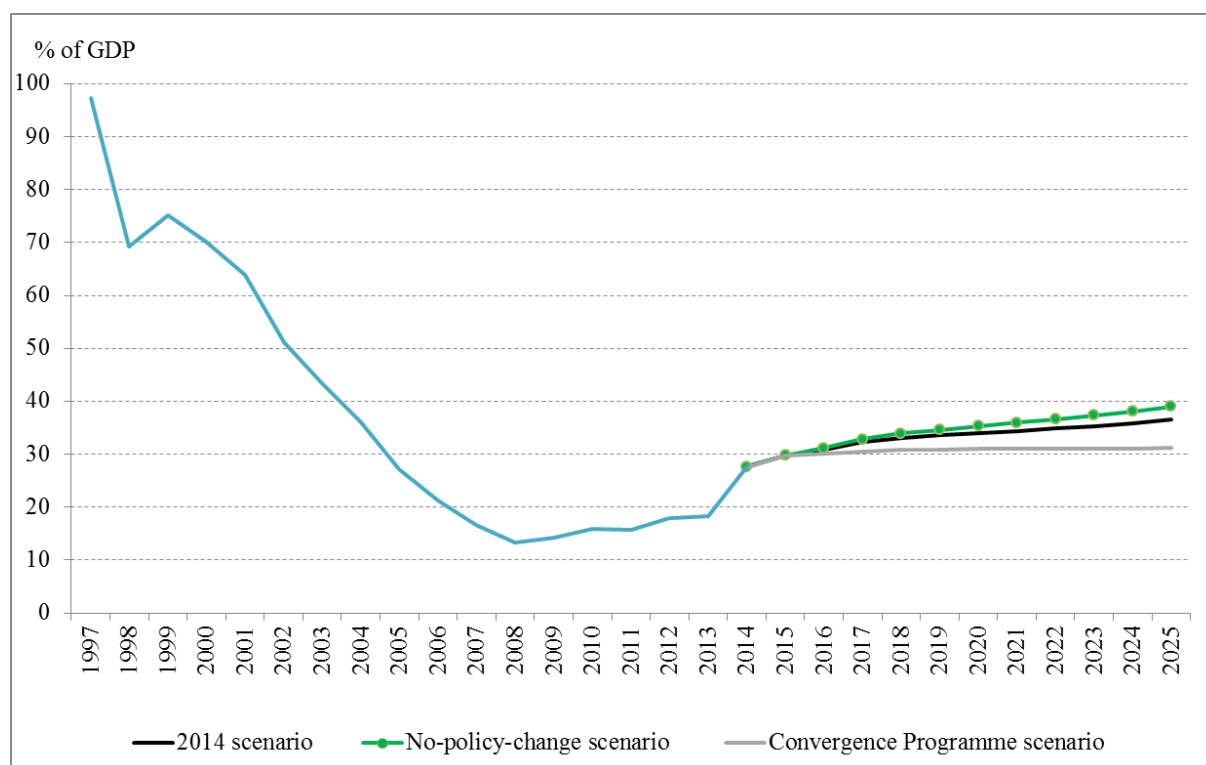
The analysis in this section includes the new long-term budgetary projections of age-related expenditure (pension, health care, long-term care, education and unemployment benefits) from the 2015 Ageing Report⁶ published on 12 May. It therefore updates the assessment made in the Country Reports⁷ published on 26 February.

Government debt stood at 27.6% of GDP in 2014, well below the 60% of GDP Treaty threshold. It is expected to rise to 39% in 2025, remaining well below the 60% of GDP Treaty threshold, driven by the level of the structural primary balance in 2016 (at -1.5% of GDP), which is assumed constant under the no-policy change baseline scenario, as well as the projected costs of ageing. However, the full implementation of the programme would level off debt at about 31% of GDP by 2025.

⁶ See http://ec.europa.eu/economy_finance/publications/european_economy/2015/ee3_en.htm

⁷ See http://ec.europa.eu/europe2020/making-it-happen/country-specific-recommendations/index_en.htm

Figure 3: Gross debt projections (% of GDP)



Source: Commission 2015 spring forecast; Convergence Programme; Commission calculations

Based on the sustainability indicators developed by the Commission, Bulgaria appears to face low fiscal sustainability risks in the medium term and medium fiscal sustainability risks in the long term. Bulgaria appears to also face some risk of fiscal stress in the short run, as there are indications that fiscal policies pose potential challenges.

The medium-term sustainability gap, standing at -1.3% of GDP, indicates low risks for the country and is primarily related to the low level of government debt of 29.8% of GDP in 2015. The initial budgetary position is putting pressure in the medium term (1.5% of GDP), however it is more than compensated by the reduction in the debt requirement and in the cost of ageing (-2.0% of GDP and -0.8% of GDP respectively). In the long-term, Bulgaria appears to face medium fiscal sustainability risks, primarily related to the initial budgetary position, contributing with 2.1 pp. of GDP over the very long run. The long-term sustainability gap, which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path, amounts to 2.3% of GDP.

Risks would be lower in the event of the structural primary balance reverting to higher values observed in the past, such as the average for the period 2004-2013. It is therefore appropriate for Bulgaria to continue to implement measures that reduce risks to fiscal sustainability in the short term. Further containing age-related expenditure growth appears necessary to contribute to the sustainability of public finances in the long run.

Table 5: Sustainability indicators

	Bulgaria			European Union		
	2014 scenario	No-policy-change scenario	Convergence Programme scenario	2014 scenario	No-policy-change scenario	Stability/Convergence Programme scenario
S2*	2.0	2.3	1.0	1.4	1.7	0.4
<i>of which:</i>						
Initial budgetary position (IBP)	2.4	2.1	0.3	0.4	0.5	-0.7
Long-term cost of ageing (CoA)	-0.4	0.2	0.7	1.0	1.1	1.1
<i>of which:</i>						
pensions	-0.9	-0.3	0.3	0.0	0.1	0.1
healthcare	0.3	0.3	0.2	0.8	0.7	0.6
long-term care	0.1	0.1	0.1	0.7	0.7	0.6
others	0.1	0.1	0.1	-0.4	-0.3	-0.2
S1**	-1.5	-1.3	-2.7	1.4	1.8	0.5
<i>of which:</i>						
Initial budgetary position (IBP)	1.8	1.5	0.0	-0.4	-0.3	-1.6
Debt requirement (DR)	-1.9	-2.0	-2.3	1.7	1.9	1.8
Long-term cost of ageing (CoA)	-1.3	-0.8	-0.4	0.1	0.3	0.4
S0 (risk for fiscal stress)***	0.26	:		:		
<i>Fiscal subindex</i>	0.17	:		:		
<i>Financial-competitiveness subindex</i>	0.29	:		:		
Debt as % of GDP (2014)	27.6			88.6		
Age-related expenditure as % of GDP (2014)	17.8			25.6		

Source: Commission, 2015 Convergence Programme

Note: the '2014' scenario depicts the sustainability gap under the assumption that the structural primary balance position remains at the 2014 position according to the Commission 2015 spring forecast; the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commission 2015 spring forecast until 2016. The 'stability programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

* The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

** The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2016) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

*** The S0 indicator reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

6. FISCAL FRAMEWORK AND QUALITY OF PUBLIC FINANCES

6.1. Fiscal framework⁸

As discussed in the 2015 Country Report on Bulgaria, the current fiscal framework is incomplete. The scope of the medium-term budgetary planning and of the numerical fiscal rules is limited and was not effective in avoiding fiscal slippages in 2014. The new public finance law which came into force in January 2014 as planned and limited the cash deficits to 2% of GDP has been already breached last year.

The macroeconomic forecasts underpinning the medium-term budgetary plans are currently produced by the Ministry of Finance and they are not reviewed by an independent body. A reform of the fiscal framework is currently underway and is meant to transpose into national legislation key elements of the Council Directive 2011/85/EU on budgetary frameworks and of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. The reform has been approved by the parliament in April 2015 and the key elements include establishing an independent fiscal institution and defining a correction mechanism for the structural balanced-budget rule. Under the new law, once a significant deviation from the MTO is detected, it should be addressed through a corrective plan prepared of by the Minister of Finance. The Convergence Programme provides an overview of the main elements of the reform aimed at strengthening transparency and efficiency of public finances. It remains to be seen to what extent the fiscal council will, in practice, be given functional autonomy and adequate resources to effectively carry out its mandate.

6.2. Quality of public finances

The Convergence Programme outlines several measures aimed at improving the quality of public finances both on the revenue and the expenditure side. On improving the efficiency of public expenditure, the programme mentions the requirement for the line ministries and spending agencies to report on a system of performance indicators the achievement of the planned objectives. However no details on the concrete scope and the impact of this measure are provided at this stage.

The programme also reiterates that a key priority for Bulgaria is improving tax collection and reducing tax evasion. One important element refers to the government's commitment to elaborate a comprehensive tax compliance strategy which includes strengthening the inter-institutional cooperation and coordination and the impact assessment of the planned measures. This reform would go in the direction indicated by the country specific recommendation addressed to Bulgaria in the framework of the 2014 European Semester. As mentioned in the 2015 Country Report, it is necessary that the envisaged measures are adopted without further delays and that appropriate implementation at all levels is ensured.

⁸ This section complements the Country Report published on 26 February 2015 and updates it with the information included in the Convergence programme.

7. CONCLUSIONS

In 2014, the structural balance of Bulgaria deteriorated to 2.6% of GDP, pointing to a significant deviation of 1.5% of GDP from the MTO. On the other hand, the growth rate of government expenditure, net of discretionary revenue measures, is met with a margin of 1.0pp. of GDP. Following an overall assessment, there is some deviation from the requirements in 2014.

Based on data in the Convergence Programme, the recalculated structural deficit is projected at 2.5% of GDP in 2015. Bulgaria plans an improvement of the structural balance of 0.4% of GDP in 2016 and a further adjustment of 0.4% of GDP on average by 2018, when it plans to reach the MTO but only with a margin.

According to both the Commission's spring 2015 forecast and the recalculated programme data, Bulgaria appears to be in line with the requirements in 2015 as both the structural balance and the expenditure benchmark are met. However, given the deterioration of the structural balance in 2014, the structural-balance pillar over 2014 and 2015 together points to an average annual significant deviation of 0.7% of GDP. The expenditure benchmark still points to compliance in 2014 and 2015 together. Hence, following an overall assessment, there is a risk of some deviation from the requirements in 2015.

In 2016, based on the recalculated programme data, net expenditure growth exceeds the benchmark by 1.6% of GDP and the structural balance pillar shows a gap of 0.1% of GDP. According to the Commission spring forecast, net expenditure growth also exceeds the benchmark by 0.9% of GDP while the structural balance pillar indicates a gap of 0.4% of GDP. Following an overall assessment there is a risk of significant deviation from the required adjustment of 0.5pp of GDP in 2016.

ANNEX

Table I. Macroeconomic indicators

	1997-2001	2002-2006	2007-2011	2012	2013	2014	2015	2016
Core indicators								
GDP growth rate	1.3	5.8	2.1	0.5	1.1	1.7	1.0	1.3
Output gap ¹	0.6	0.8	0.6	-0.2	0.1	0.0	-0.8	-1.4
HICP (annual % change)	9.7	5.6	5.7	2.4	0.4	-1.6	-0.5	1.0
Domestic demand (annual % change) ²	6.3	8.2	0.2	3.3	-1.5	2.8	0.3	0.5
Unemployment rate (% of labour force) ³	15.7	12.6	8.2	12.3	13.0	11.4	10.4	9.8
Gross fixed capital formation (% of GDP)	15.2	22.7	26.9	21.5	21.3	21.0	20.3	19.4
Gross national saving (% of GDP)	18.0	16.7	17.7	21.0	23.1	22.4	22.2	21.2
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	0.5	0.6	-1.3	-0.7	-0.9	-2.8	-2.9	-2.9
Gross debt	75.2	35.8	15.1	18.0	18.3	27.6	29.8	31.2
Net financial assets	10.5	5.2	5.4	0.4	n.a	n.a	n.a	n.a
Total revenue	37.4	38.0	36.4	34.5	37.4	36.4	36.4	36.2
Total expenditure	36.9	37.4	37.7	35.2	38.3	39.2	39.3	39.1
<i>of which: Interest</i>	4.4	1.8	0.8	0.8	0.8	0.7	1.0	1.0
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	6.3	-1.0	-3.0	5.4	n.a	n.a	n.a	n.a
Net financial assets; non-financial corporations	-62.3	-90.9	-177.7	-157.0	n.a	n.a	n.a	n.a
Net financial assets; financial corporations	1.2	-11.4	-3.5	-0.2	n.a	n.a	n.a	n.a
Gross capital formation	11.2	19.8	22.0	18.3	n.a	n.a	n.a	n.a
Gross operating surplus	23.8	26.8	28.7	29.4	n.a	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	-10.2	-7.3	-6.3	-4.8	n.a	n.a	n.a	n.a
Net financial assets	46.9	51.6	65.7	77.5	n.a	n.a	n.a	n.a
Gross wages and salaries	24.4	31.6	31.1	31.4	n.a	n.a	n.a	n.a
Net property income	0.4	0.5	0.3	0.1	n.a	n.a	n.a	n.a
Current transfers received	13.0	14.8	13.7	15.0	n.a	n.a	n.a	n.a
Gross saving	-8.8	-6.5	-4.4	-3.4	n.a	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-4.8	-8.1	-11.0	0.1	2.9	2.3	2.6	2.5
Net financial assets	6.5	47.9	114.2	85.1	n.a	n.a	n.a	n.a
Net exports of goods and services	0.2	-12.4	-9.9	-2.8	-0.6	-0.7	0.1	0.6
Net primary income from the rest of the world	-1.7	0.5	-4.1	-2.2	-1.9	-2.5	-2.6	-2.9
Net capital transactions	-0.1	0.5	0.4	1.3	1.3	1.4	1.3	1.2
Tradable sector	51.5	50.1	46.0	47.3	47.9	47.9	n.a	n.a
Non tradable sector	37.6	36.0	39.7	38.7	38.2	38.1	n.a	n.a
<i>of which: Building and construction sector</i>	4.0	4.7	6.7	5.1	4.1	4.1	n.a	n.a
Real effective exchange rate (index, 2000=100)	60.8	72.8	94.3	105.0	113.7	114.1	110.6	110.3
Terms of trade goods and services (index, 2000=100)	77.2	87.5	99.0	101.5	101.0	102.3	102.5	102.1
Market performance of exports (index, 2000=100)	96.2	76.9	96.3	110.3	117.9	115.8	114.4	112.8
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source:								
AMECO, Commission 2015 spring forecast								