COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.3.2007
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Recommendation for a

COUNCIL OPINION

in accordance with the first paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

on the convergence programme of Bulgaria, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes).

Bulgaria joined the EU on 1 January 2007 and submitted its first convergence programme on 5 January. In accordance with the Regulation, the Council is to deliver an opinion on it on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee (see box for the main points covered by the assessment).

2. BACKGROUND FOR THE ASSESSMENT OF THE PROGRAMME

In order to set the scene against which the budgetary strategy in the convergence programme is assessed, this section summarises the economic and budgetary performance over the last ten years.

Bulgaria has achieved a high degree of macroeconomic stability supported by sound public finances. Economic growth has been strong and stable, increasing to around 5½% in recent years, but the GDP per capita (in PPS) remains low at 32.9% of the EU-25 average in 2005. Therefore, the scope for catching up remains ample and represents Bulgaria's overriding challenge for the medium- and long-term. Employment has risen steadily, but while unemployment rates have been reduced considerably, employment rates remain below the EU average. Skills and geographical mismatches hamper labour market flexibility and there are increasing shortages especially in high-skilled segments of the labour market. Emigration and a drop in fertility rates have contributed to a rapid shrinking and ageing of the population. Average growth of labour productivity was fairly low over the period 1996-2005, but increased to close to 4% recently on the back of growing foreign and domestic investment. After the introduction of the currency board in 1997, inflation was reduced to single-digit figures by 1999, but the disinflation process has stalled in recent years. Very high credit growth and increasing external deficits – although related to very high inflows of FDI – have been a cause of concern for macroeconomic stability. A considerable degree of fiscal

[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

consolidation has been accomplished by running a general government budget close to balance or in surplus since 1998. The debt-to-GDP ratio has been reduced from over 100% to below 30%. Moreover, some steps have been taken to meet the challenges of demographic change for the pension system.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[2];
- compliance with the code of conduct[3], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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[2] Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

[3] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

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in accordance with the first paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

on the convergence programme of Bulgaria, 2006-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard 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[4], and in particular Article 9(1) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [27 March 2007] the Council examined the convergence programme of Bulgaria, which covers the period 2006 to 2009.

(2) Bulgaria has achieved a high degree of macroeconomic stability supported by sound public finances. Economic growth has been strong and stable, increasing to around 5½% in recent years, but the GDP per capita (in PPS) remains low at 32.9% of the EU-25 average in 2005. Therefore, the scope for catching up remains ample and represents Bulgaria's overriding challenge for the medium- and long-term. After the introduction of the currency board in 1997, inflation was reduced to single-digit figures by 1999, but the disinflation process has stalled in recent years, and CPI inflation reached 7.3% in 2006.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will remain at a high level, slightly increasing from 5.9% in 2006 to 6.1% on average over the rest of the programme period. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. However, high external imbalances continue to be a risk factor in the medium term, in particular as the external deficit in 2006 turned out higher than projected at 16% of GDP instead of 14.1% of GDP, although the financing of the deficit has been fully

4 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

ensured through FDI inflows. The programme's projections for inflation appear realistic.

(4) For 2006, the general government surplus is estimated at 3.3% of GDP in the Commission services' autumn 2006 forecast, against a target of a balanced budget set in the December 2005 pre-accession economic programme (PEP) and a projected surplus of 3.2% of GDP in the Convergence Programme. The substantially better budgetary outcome is mainly the result of higher than projected revenues due to conservative revenue forecasts in the PEP, higher output growth, and improved revenue collection. Compared to the PEP projections, expenditures are also lower by 1% of GDP, reflecting mainly lower current expenditures.

(5) The medium-term budgetary strategy laid down in the convergence programme aims at maintaining a general government surplus in the range of 0.8-1.5% of GDP in order to safeguard macroeconomic stability and sustainability of public finances. A strong fiscal loosening is projected in 2007, with the budgetary surplus attaining 0.8% of GDP, down from 3.2% of GDP in 2006. In 2008 and 2009, the general government surplus would rise again and stabilise at 1.5% of GDP. With interest expenditures declining by around ¼% of GDP over the programme period, the primary surplus is projected to decline from 4½% of GDP in 2006 to 2¼% of GDP in 2007 before reverting to around 2¾% of GDP in 2008 and 2009. The fiscal loosening in 2007 would be almost exclusively expenditure-driven. Expenditures are projected to increase by 2¾% of GDP, with only part of this increase, about ¾% of GDP, being reversed in 2008. The projected increase in expenditures in 2007 would come mainly from 'other expenditures' (+2½% of GDP) and subsidies (+½% of GDP). The increase in 'other expenditures' reflects Bulgaria's contribution to the EU (1¼% of GDP), an increase in expenditures on EU Structural Fund projects (¼ % of GDP), which would be fully covered by higher revenues from EU grants, and an increase in 'other current expenditure' (1% of GDP). Planned reductions in corporate and personal income taxes in 2007 are projected to be almost fully compensated by improved compliance and tax collection rates. Consequently, total revenues would remain almost constant (as a percent of GDP) over the programme period. The programme also indicates that although the budget for 2007 envisages a general government surplus of 0.8% of GDP, a higher surplus of 2% of GDP would actually be targeted during budget execution. This would be done on the basis of provisions in the Budget Law, which allow the spending of 10% of the budgeted current primary expenditures only in case that the external deficit does not widen further. Budgetary targets have been revised considerably upwards compared to the 2005 pre-accession economic programme, reflecting substantial revenue over-performance in 2006 with carry-over effects in subsequent years and a slightly more favourable outlook for output growth.

(6) The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to decrease from around 3¼% of GDP in 2006 to 1% in 2007 and then to increase again to around 2% of GDP in 2008 and 2009. If a higher nominal surplus of 2% of GDP is achieved in 2007 during the budget execution, as outlined as a target in the programme, the adjustment path would be smoother. The medium-term objective (MTO) for the budgetary position presented in the programme is a balanced budget in structural terms, which it plans to maintain by a large margin throughout the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1¼% of GDP), achieving it should fulfil the aim of

providing a safety margin against the occurrence of an excessive deficit. The MTO is more demanding than implied by the debt ratio and average potential output growth in the long term.

(7) The budgetary outcome in 2007 could be better than projected in the programme, while in 2008 and 2009 the risks to the budgetary projections appear broadly balanced. In view of the good track record with respect to the achievement of budgetary targets and provisions in the 2007 Budget Law for limiting expenditures during budget execution, a higher surplus for 2007 appears to be realistic even though revenue projections for 2007 could entail certain downside risks as revenue shortfalls from tax reductions may not be fully compensated by improved compliance and collection rates. Although no details are given on the adjustment strategy from 2008 onwards, the budgetary targets until the end of the programme period appear to be broadly plausible, provided that a better than currently projected budgetary outcome in 2007 is realised.

(8) In view of this risk assessment, the budgetary stance in the programme implies that the MTO is maintained by a large margin throughout the programme period. In addition, it provides a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. The fiscal policy stance implied by the programme could turn out to be pro-cyclical in good times in 2007. This would not be fully in line with the Stability and Growth Pact. In particular, good times are expected to occur in 2007, when the structural balance is planned to decline by around 2¼% of GDP according to the programme and by 1½% according to the Commission services' autumn 2006 forecast.

(9) Government gross debt is estimated to have reached 25¼% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by 4 percentage points over the programme period.

(10) In the absence of the long-term projections of age-related expenditures, based on the common macroeconomic assumptions as carried out by the EPC/Commission, it is not possible to assess the impact of population ageing in Bulgaria on a comparable and robust basis as it is currently done for the other Member States, for which the projections on this basis are available. However, a significant impact of ageing on expenditures cannot be excluded given the current demographic structure. The initial budgetary position, with a large structural surplus, contributes significantly to stabilise debt before considering the long-term budgetary impact of ageing. Maintaining high primary surpluses over the medium-term would contribute to containing risks to the sustainability of public finances.

(11) The budgetary strategy in the programme is partly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the fiscal policy stance in 2007 is programmed to be pro-cyclical in good times and risks aggravating the already high external deficit. In addition, while steps to improve the long-term sustainability of the pension system have been taken, very few concrete measures to improve the efficiency of public spending, in particular as regards healthcare expenditures, where there are recurrent problems with the monitoring and control of expenditures and the quality of the services provided, are presented.

(12) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data[5].

The overall conclusion is that the medium-term budgetary position is sound and the budgetary strategy provides an example of fiscal policies conducted in compliance with the Stability and Growth Pact. However, the planned reduction in the budget surplus during economic good times in 2007 could turn out to imply a pro-cyclical fiscal stance and could add to existing external imbalances.

In view of the above assessment, Bulgaria is invited to:

(i) achieve a higher budgetary surplus in 2007 than currently planned and to maintain a strong position thereafter in order to foster macroeconomic stability and to contain the high external deficit;

(ii) to further strengthen the efficiency of public spending, in particular through a reform of the healthcare system.

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5 In particular, the labour market data on hours worked and some information on long-term sustainability are not provided.

Comparison of key macroeconomic and budgetary projections[1]

		2005	2006	2007	2008	2009
Real GDP (% change)	**CP Jan 2007**	**5.5**	**5.9**	**5.9**	**6.2**	**6.1**
	COM Nov 2006	5.5	6.0	6.0	6.2	n.a.
	PEP Dec 2005	*5.7*	*5.7*	*5.9*	*5.9*	*n.a.*
HICP inflation (%)	**CP Jan 2007**	**5.0**	**7.4**	**4.0**	**3.0**	**3.0**
	COM Nov 2006	5.0	7.0	3.5	3.8	n.a.
	PEP Dec 2005	*4.9*	*6.7*	*3.1*	*2.8*	*n.a.*
Output gap (% of potential GDP)	**CP Jan 2007[2]**	**0.5**	**0.1**	**-0.4**	**-0.8**	**-1.0**
	COM Nov 2006[6]	0.5	0.3	-0.1	-0.5	n.a.
	PEP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
General government balance (% of GDP)	**CP Jan 2007**	**2.4**	**3.2**	**0.8**	**1.5**	**1.5**
	COM Nov 2006	2.4	3.3	1.8	1.7	n.a.
	PEP Dec 2005	*1.8*	*0.0*	*-0.2*	*-0.7*	*n.a.*
Primary balance (% of GDP)	**CP Jan 2007**	**3.9**	**4.6**	**2.2**	**2.8**	**2.7**
	COM Nov 2006	3.9	4.7	2.9	2.7	n.a.
	PEP Dec 2005	*3.4*	*1.5*	*1.2*	*0.5*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**CP Jan 2007[2]**	**2.1**	**3.2**	**1.0**	**1.9**	**2.0**
	COM Nov 2006	2.1	3.2	1.8	1.9	n.a.
	PEP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Structural balance[3] (% of GDP)	**CP Jan 2007[4]**	**2.1**	**3.2**	**1.0**	**1.9**	**2.0**
	COM Nov 2006[5]	2.1	3.2	1.8	1.9	n.a.
	PEP Dec 2005	*n.a.*	*n.a.*	*n.a.*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**CP Jan 2007**	**29.8**	**25.3**	**22.7**	**22.3**	**21.1**
	COM Nov 2006	29.8	25.8	21.8	17.9	n.a.
	PEP Dec 2005	*31.3*	*26.3*	*23.9*	*22.7*	*n.a.*

Notes:
[1] The government accounts of Bulgaria have not yet been officially subject to a complete quality assessment by Eurostat. Eurostat will publish and validate government balance and debt figures shortly after the data notification of 1 April 2007.

[2] Commission services calculations on the basis of the information in the programme.

[3] Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

[4] There are no one-off and other temporary measures in the programme.

[5] There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.

[6] Based on estimated potential growth of 5.8%, 6.3%, 6.4% and 6.7% respectively in the period 2005-2008.

Source:
Convergence programme (CP); Pre-accession economic programme (PEP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations