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BULGARIA: MACRO FISCAL ASSESSMENT

AN ANALYSIS OF THE DECEMBER 2007 UPDATE OF THE CONVERGENCE PROGRAMME

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not. The most recent update of Bulgaria’s convergence programme was submitted on 7 December 2007.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 1 February 2008. Comments should be sent to Bozhil Kostov and Norbert Wunner (Bozhil.Kostov@ec.europa.eu, Norbert.Wunner@ec.europa.eu). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services’ autumn 2007 forecast, (ii) the code of conduct (“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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying “methodological paper” prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 13 February 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 4 March 2008.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that does not use the single currency, such as Bulgaria, has to submit a convergence programme and annual updates thereof. The most recent programme, covering the period 2007-2010, was submitted on 7 December 2007.

Real GDP growth in Bulgaria has been high at over 6% per year since 2003, while the growth pattern has become increasingly unbalanced with accumulation of large external deficits. Accordingly, the general government balance has been raised from a position close to zero to a surplus of over 3% of GDP in 2006, with the fiscal stance being counter-cyclical or broadly neutral since 2003. At the same time, monetary conditions have been accommodative within the context of the currency board framework. Strong economic growth has been accompanied with signs of overheating and increasing macroeconomic imbalances reflected in a widening external deficit, re-acceleration of bank credit growth, and rising inflation. In addition, with unemployment falling sharply, the labour market has tightened and in 2007 wage growth accelerated considerably, clearly outpacing productivity growth for the first time in several years. If this trend were to continue, it could lead to an erosion of competitiveness and call into question the sustainability of high growth. Looking ahead, Bulgaria is confronted with the challenges of tackling these imbalances while strengthening the conditions for sustained catching-up through maintaining prudent fiscal policy and wage moderation, improving the quality of public finance, ensuring financial sector stability, and stepping up structural reforms.

The programme projects real GDP growth to remain high at 6.4% in 2007 and 2008, and to accelerate to close to 7% in 2009 and 2010. This scenario appears to be based on broadly plausible growth assumptions, although slightly favourable especially towards the end of the programme period when growth in domestic demand, in particular investments, appears to be on the high side. The Commission services' autumn 2007 forecast projects a stronger rebalancing of the economy due to domestic and foreign investment returning to more sustainable levels. Against the background of high real GDP growth, the programme envisages limited progress towards nominal convergence with inflation remaining relatively high. The inflation outlook appears optimistic in 2009 and 2010 given the projected sustained wage pressures and planned increases in excise duties on tobacco. Although the composition of growth is expected to become slightly more balanced on the back of higher export growth, the external deficit would widen further and is projected to peak at 20¾% of GDP in 2008, which appears broadly plausible in light of recent developments. Overall, the economy seems to be in economic good times in the near term, even though the output gap is projected to turn slightly negative.

For 2007, the general government surplus is estimated at 3.1% of GDP in the most recent update of the programme, against a target of 0.8% of GDP set in the January 2007 convergence programme. This budget over-performance is entirely due to higher than expected revenues, while expenditure control was not fully maintained. Initially envisaged savings of 10% of budgeted non-interest current expenditures were not implemented and an additional expenditure programme, mostly on infrastructure, of around 2¼% of GDP was adopted in December 2007. Moreover, pensions were increased twice by 10% in 2007 and thus by more than the 8½% implied by the indexation formula in place. Finally, wage pressures have also started to spill over into the public sector, with a clear acceleration of public sector wage growth in the second half of the year. In view of the continued strong revenue growth, the 2007 budgetary outturn could even be better than envisaged in the programme.

The programme's medium-term budgetary strategy aims at maintaining a neutral fiscal stance over the entire programme period. The medium-term objective (MTO) presented in the programme has been revised from a balanced position in structural terms (i.e. cyclically adjusted net of one-off and other temporary measures) to a surplus of 1½% of GDP, which would be respected throughout the programme period. Although the MTO endorsed by the Council in its opinion on the original programme was already more demanding than required by the Pact, the upward revision is justified in the programme by the rising external imbalances, accelerating inflation and the projected population ageing impact. Both the general government balance and the primary balance are projected to remain stable over the programme period at a surplus of around 3% and 4% of GDP, respectively. According to the programme, revenue- and expenditure-to-GDP ratios will increase by around 1¾ pp. each over the programme period, with the adjustment occurring mainly in 2008. On the revenue side, the programme projects an increase of ‘other revenue’ by 2¼% of GDP, mainly reflecting an increase in EU transfers over the programme period. In 2008, tax revenues are expected to increase by 1¼% of GDP due to rate hikes on certain excises, improvements in tax compliance, and a favourable composition of growth. The introduction of a 10% flat rate personal income tax is expected to be fully financed by a further de-shadowing of the informal economy and suppression of certain tax breaks. Also in 2008, social contributions are projected to decrease by 1% of GDP due to a reduction in contribution rates, which should, however, be largely off-set by an increase in the contribution base. In 2009 and 2010, tax revenues and social contributions are expected to drop slightly. On the expenditure side, the programme projects a considerable restructuring, with capital expenditures increasing by around 2% of GDP, increasingly financed by EU transfers, and ‘other expenditures’ by around 1½% of GDP over the programme period. This increase would be partly compensated by lower interest expenditures, lower social transfers and a reduction in the government wage bill thanks to planned reductions in public sector employment. Building on the better-than-expected 2007 outturn, the current budgetary targets are significantly more ambitious than in the January 2007 programme, also against the background of a somewhat stronger economic outlook. High primary surpluses and robust nominal GDP growth will remain the main factors behind a projected further reduction in general government debt, while privatisation revenues are expected to become less and less important.

The risks to the budgetary projections in the programme appear broadly balanced. On the one hand, the macroeconomic scenario could be subject to certain risks especially in view of the growing external and internal imbalances. Also in 2008, revenue projections are subject to some uncertainty linked to the introduction of the flat-rate personal income tax. On the other hand, those risks would be balanced by a very strong track record in meeting budgetary targets and buffers on the expenditure side thanks to the budgeting of a contingency reserve. Moreover, for 2009 and 2010, the expected drop in tax revenue is not fully consistent with the underlying growth scenario and tax revenue could therefore turn out stronger than planned.

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. The fiscal policy stance implied by the programme is in line with the Stability and Growth Pact throughout the period. The envisaged neutral fiscal stance would avoid adding to the existing domestic and external macroeconomic imbalances. Given the limited set of policy instruments available within the framework of the currency board, fully saving any revenue over-performance and maintaining expenditure control could help reduce imbalances.

In the absence of 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 25 Member States, for which the projections on this basis are available. While a significant impact of ageing on expenditure cannot be excluded given the current demographic structure, the budgetary position in 2007, with a large structural surplus, contributes significantly to reducing the already low level of debt. Maintaining high primary surpluses over the medium-term would contribute to limiting risks to the sustainability of public finances.

Bulgaria's March 2007 national reform programme identifies as key priorities maintaining macro-economic stability; infrastructure; improving the business environment; improving the quality of human capital; activating labour supply and improving administrative capacity. Against the background of strengths and weaknesses identified, the Commission recommended in its December 2007 Strategic Report on the renewed Lisbon strategy for growth and jobs that Bulgaria is recommended to give highest priority to the challenges in the areas of: administrative capacity; macroeconomic stability; cutting red tape and improving the business environment; and active labour market policies and education reform. In addition, Bulgaria should also focus on the areas of: long-term sustainability of public finances; competition in network industries; R&D and innovation; undeclared work; and lifelong learning. The convergence programme seems to be broadly consistent with the national reform programme and the October 2007 implementation report. In particular, the budgetary strategy and the measures envisaged to promote the quality of public expenditures, including through further implementation of programme budgeting, are fully in line with the priorities identified in the national reform programme. The update seems to reflect public finance implications of the reforms envisaged in the national reform programme. However, the update provides relatively little information on the direct budgetary costs of key measures, such as those linked to strengthening administrative capacity or active labour market policy. On the whole, the programme envisages a series of measures directed at improving the quality and efficiency of public finances, which, in most cases and if fully implemented, can be considered as useful steps in addressing the macroeconomic challenges that Bulgaria is currently facing. Among others these measures include further implementation of programme budgeting, carrying out public expenditure reviews, furthering the education reform, however, few concrete steps are envisaged in improving the efficiency of public spending on healthcare.

The overall conclusion is that the programme aims at maintaining a sound budgetary position throughout the period, planning the continuation of high general government surpluses. The budgetary targets seem plausible. The programme proposes an upward revision of the MTO from a balanced structural position to a surplus of 1½% of GDP, which will be comfortably met throughout the programme period. Safeguarding macroeconomic stability and sustaining catching-up in a context of rising external imbalances and high inflation requires the continuation of tight fiscal policies, further improvements in the quality of public spending, including in healthcare, and fiscal institutions and a public sector wage policy that contributes to overall wage moderation in line with productivity gains.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Dec 2007**	**6.1**	**6.4**	**6.4**	**6.8**	**6.9**
	COM Nov 2007	6.1	6.3	6.0	6.2	n.a.
	CP Jan 2007	*5.9*	*5.9*	*6.2*	*6.1*	*n.a.*
HICP inflation (%)	**CP Dec 2007**	**7.4**	**7.2**	**6.9**	**4.4**	**3.7**
	COM Nov 2007	7.4	7.1	7.3	5.8	n.a.
	CP Jan 2007	*7.4*	*4.0*	*3.0*	*3.0*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Dec 2007**	**0.8**	**0.6**	**0.0**	**-0.4**	**-0.2**
	COM Nov 2007[2]	1.1	0.7	-0.1	-0.6	n.a.
	CP Jan 2007	*0.1*	*-0.4*	*-0.8*	*-1.0*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Dec 2007**	**-15.0**	**-19.9**	**-20.7**	**-19.5**	**-18.6**
	COM Nov 2007	-15.0	-17.0	-16.0	-15.8	n.a.
	CP Jan 2007	*-14.1*	*-13.6*	*-12.8*	*-12.4*	*n.a.*
General government balance (% of GDP)	**CP Dec 2007**	**3.2**	**3.1**	**3.0**	**3.0**	**3.0**
	COM Nov 2007	3.2	3.0	3.1	3.1	n.a.
	CP Jan 2007	*3.2*	*0.8*	*1.5*	*1.5*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2007**	**4.6**	**4.3**	**4.0**	**4.0**	**4.0**
	COM Nov 2007	4.6	4.1	4.1	4.0	n.a.
	CP Jan 2007	*4.6*	*2.2*	*2.8*	*2.7*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Dec 2007**	**2.9**	**2.9**	**3.0**	**3.1**	**3.1**
	COM Nov 2007	2.9	2.8	3.1	3.3	n.a.
	CP Jan 2007	*3.2*	*1.0*	*1.9*	*2.0*	*n.a.*
Structural balance[3] (% of GDP)	**CP Dec 2007**	**2.9**	**2.9**	**3.0**	**3.1**	**3.1**
	COM Nov 2007	2.9	2.9	3.1	3.3	n.a.
	CP Jan 2007	*3.2*	*1.0*	*1.9*	*2.0*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2007**	**22.8**	**19.8**	**18.3**	**17.4**	**16.9**
	COM Nov 2007	22.8	19.3	15.9	12.9	n.a.
	CP Jan 2007	*25.3*	*22.7*	*22.3*	*21.1*	*n.a.*

Notes:

[1]Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes. The cyclically-adjusted balance in the Commission services' autumn forecast has been recalculated following a revision of the budgetary sensitivity for Bulgaria.

[2]Based on estimated potential growth of 6.2%, 6.7%, 6.8% and 6.8% respectively in the period 2006-2009.

[3]Cyclically-adjusted balance excluding one-off and other temporary measures. The most recent programme provides no information on one-off and other temporary measures; according to the Commission services' autumn forecast, they are 0.1% of GDP (surplus-reducing) in 2007. The structural balance in the Commission services' autumn forecast has been recalculated following a revision of the budgetary sensitivity for Bulgaria.

Source:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The December 2007 update of Bulgaria's convergence programme was submitted to the European Commission and the Council on 7 December 2007, covering the years 2007-2010. The programme was adopted by the Council of Ministers on 29 November 2007 and is in line with the 2008 Budget Law, which was adopted by Parliament on 20 December 2007.

This assessment is further structured as follows. Section 2 discusses the key challenges for public finances in Bulgaria, with a particular focus on external imbalances and convergence. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the convergence programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key economic indicators of past economic performance (Annex 2).

2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON EXTERNAL IMBALANCES AND CONVERGENCE

2.1. Introduction: economic convergence with growing imbalances

Following the introduction of a currency board arrangement in 1997, Bulgaria has experienced a period of strong economic activity, with real GDP growth averaging around 5½% per year in the years 2001-06. This was approximately 1 percentage point higher than in the other new Member States from Central and Eastern Europe (EU-8) and more than 3 percentage points above the average for EU-27. Economic convergence has thus started in Bulgaria since the early 2000s, with real GDP per capita (in purchasing power standards) increasing from around 25% of the EU average in 1997 to over 35% in 2006.

Bulgaria's catching-up process was, however, characterised by a very unbalanced growth pattern with an accumulation of high external deficits and, mainly since 2006, growing signs of overheating. Economic growth was heavily skewed towards domestic demand with private consumption and investment being the main drivers of growth. In contrast, the contribution from net exports became increasingly negative since 2000. Consequently, the external deficit widened from around 6% of GDP in 2004 to 11% in 2005 and to over 15% in 2006. These deficits were fully financed (usually by a wide margin) by net FDI inflows alone, implying that foreign reserves actually kept increasing strongly. While growing external deficits have thus not implied any solvency or liquidity problems, they have reached a level which is hardly sustainable in the long run. Moreover, growing signs of overheating, with an increasingly tight labour market, accelerating wage growth and mounting inflationary pressures, further accentuate the unbalanced nature of economic growth and could call into question the sustainability of the convergence process.

Given the limited range of policy instruments available within the currency board arrangement, public finances have a crucial role to play in safeguarding macroeconomic stability. So far, fiscal policy in Bulgaria has helped contain domestic demand pressures, with rising public savings counterbalancing at least to some extent the steady decline in private savings. However, the persistent widening of external deficits puts strain on fiscal policy, calling for the continuation of tight fiscal policy in order not to aggravate imbalances at a time when considerable infrastructure investments are needed to underpin convergence. Moreover, the overheating of the economy also underscores the importance of targeting public finances to promote productivity growth and to ease labour market tensions in order to reduce inflationary pressures.

The assessment of Bulgaria's January 2007 Convergence Programme already concluded that maintaining macroeconomic stability and promoting economic convergence were among the biggest fiscal policy challenges for Bulgaria.[1] This section analyses in more detail the factors behind the growing external imbalances in Bulgaria and the potential role, but also the limitations, of public finances in addressing the associated challenges. Section 2.2 discusses the main structural forces behind the rising external deficit, largely from a savings-investment perspective, and the role of public finances in this context. Section 2.3 highlights the growing importance of cyclical factors in explaining the widening external deficit, arguing that these imbalances increasingly reflect a more general phenomenon of overheating. Section 2.4 finally analyses to what extent competitiveness losses – or rather insufficient competitiveness gains – may exacerbate these imbalances. Section 2.5 concludes by identifying the main implications with respect to fiscal policy.

2.2. Savings-investment gap and the role of public finances

As shown in Figure 1, Bulgaria's external deficit has persistently widened over the last ten years from a situation close to balance in 1998 to a deficit of over 15% of GDP in 2006. The main source behind this growing external deficit has been a widening trade gap, which increased to over 20% of GDP in 2006.[2] Large external deficits are not an unusual phenomenon in catching-up economies, reflecting a gap between low savings rates on the one hand and large investment opportunities (and needs) on the other. With free capital movements and a high expected real rate of return, FDI inflows naturally close this gap. Relatively low household savings rates are linked to both low income levels and to consumption-smoothing behaviour in view of expected future income gains, as they might be anticipated in particular in an accession context. At the same time, low

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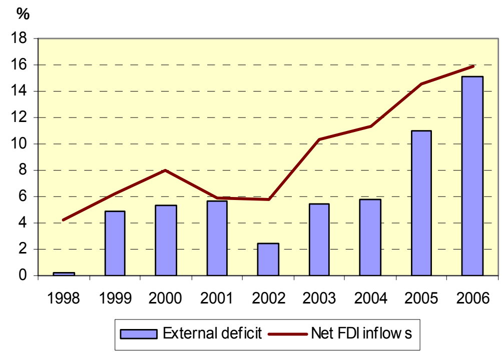
[1] European Commission (2007): Economic Assessment of the Convergence Programme of Bulgaria (January 2007). ECFIN/50976/07-EN. Available at: http://ec.europa.eu/economy_finance/about/activities/sgp/country/commwd/bg/com_bg20062007_.pdf

[2] All other items in the balance of payments have been in surplus or close to balance. Thanks to robust growth of tourism and relatively high remittances, both the services balance and net current transfers have usually posted surpluses of around 3% of GDP in recent years. In contrast, the surplus in the income balance has been declining steadily since 2002 as outflows of (repatriated and reinvested) earnings on FDI have been increasing.

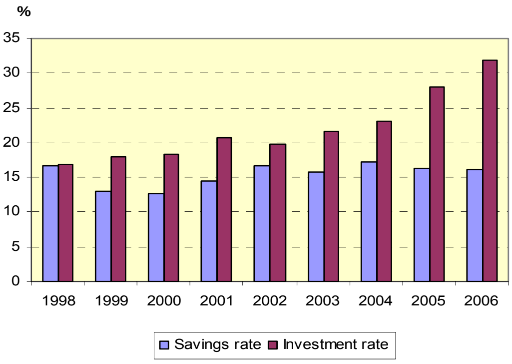
and sometimes obsolete capital stocks, low wage rates, and favourable growth prospects imply relatively high returns on investments and provide ample investment opportunities.

Figure 1. External deficit and net FDI inflows (% of GDP)



<u>Source</u>: Bulgarian National Bank, Commission services.

Figure 2. Savings and investments (% of GDP)



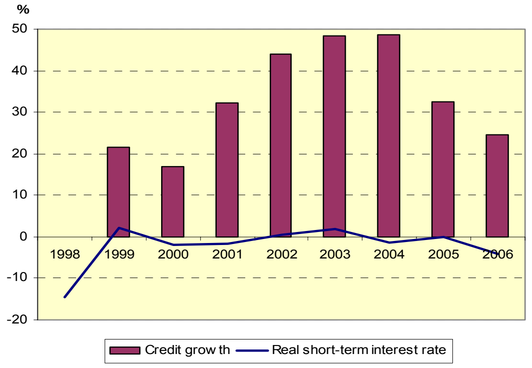
<u>Source</u>: Ameco

From this perspective, the growing external deficits in Bulgaria can be interpreted as a reflection of the savings-investment gap typical for a catching-up economy. As highlighted in Figure 2, the growing external imbalances in Bulgaria have indeed been linked to a very rapid and considerable increase in the investment rate, doubling to over 30% of GDP between 1998 and 2006, and an associated widening of the savings-investment gap. While no sectoral break-down of savings is available for Bulgaria, the national savings rate has clearly not kept pace with this investment boom and remained relatively stable.

The increase in the savings-investment gap has been mirrored by equally rapid growth of imports of investment goods, by around 20-30% per year between 2004 and 2006. In these years about one quarter of the growth in total imports was due to investment goods alone. Investment goods have made up approximately one quarter of all imports since 1998, with the share growing persistently. In contrast, the share of consumer goods remained almost unchanged at around 15% of total imports since 1998. This clearly underscores the importance of convergence-related investment growth in explaining the persistent widening of the trade deficit.

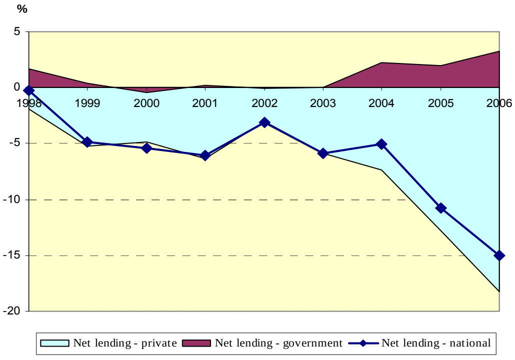
Soaring imports of investment goods have also been the flip side of increasing FDI inflows. Attracted by high rates of return and a stable macroeconomic environment, considerable inflows of FDI of over 10% of GDP per year since 2003 have on the one hand facilitated the financing of this savings-investment gap, but have on the other hand also contributed to its widening by boosting investment growth (see Figure 1).

Figure 3. Credit growth and real interest rates



Source: Ameco, Bulgarian National Bank.

Figure 4. Net lending (+)/borrowing (-) by sector (% of GDP)



Source: Ameco

Low real interest rates and buoyant credit growth have further contributed to the widening savings-investment gap (see Figure 3). The high credibility of the currency board has led to a close convergence of nominal interest rates to euro area levels. However, since inflation remains noticeably higher in Bulgaria than in the euro area, real interest rates have been close to zero or even negative for most years since 1998. Low real interest rates have thus helped financing the ongoing investment boom, but have provided little incentives for households to increase savings, raising also the issue of efficient resource allocation within the private sector. As a result, credit has expanded rapidly with annual growth rates close to 50% between 2002 and 2004. After the introduction of administrative measures in 2005 to control credit growth, bank credit growth slowed down temporarily.[3] However, after the expiry of these measures at the end of 2006, credit growth has re-accelerated to rates of well above 50% in 2007. Starting at very low levels in Bulgaria, the credit-to-GDP ratio has only recently exceeded 60%. The high credit growth rates witnessed since the early 2000s are thus mainly a reflection of financial deepening accompanying economic convergence. Nevertheless, together with low real interest rates, they have fuelled domestic demand growth and added to the savings-investment gap.

Box 1. The macroeconomic effects of rapid financial convergence

EU membership and strong presence of foreign banks accelerated financial convergence in most RAMS. This has improved availability of credit to domestic borrowers, including households. As a result, many RAMS are going through periods of rapid private credit growth, in many cases financed through external borrowing by their commercial banks. Private credit growth has been particularly strong in the Baltic countries and Bulgaria in recent years, ranging from 37.4 to 61.3 percent in the twelve months to November 2007. Financial convergence offers major benefits, most importantly it tends to improve the efficiency of capital allocation and, thus, enhance the growth potential.

Recent research in the European Commission points to a mechanism through which financial convergence may also influence real exchange rate and current account trends in

[3] See the Commission's assessment of Bulgaria's January 2007 Convergence programme for a more detailed discussion.

RAMS. Results of stochastic dynamic general equilibrium model-based simulations show that improved access to credit, while leaving TFP growth unchanged, leads to a persistent real appreciation and a widening of the current account deficit in the short to medium run —just like in the case of the Balassa-Samuelson (B-S) effect.[4] The longer-run implications are, however, markedly different from those of the B-S effect, where the real appreciation is due to a productivity shock in the tradable sector. The appreciation of the real exchange rate is not permanent. In the longer run, when the impact of the improved access to credit is over, the real exchange rate returns to a level that is slightly more depreciated than in the baseline. The current account balance also starts to improve and in the long run returns to the same level as in the baseline. The faster the financial convergence the larger the swings in the real exchange rate and the current account balance are likely to be.

These results also indicate the vulnerabilities rapid financial development and integration can create in RAMS. When prices are sticky the exchange rate regime matters in the short run: a fixed exchange rate regime generates a larger current account deficit than a flexible exchange rate regime. That is, the dynamics will depend on several factors, and trade-offs between these. These factors include the stickiness of prices, the extent of unhedged balance sheet exposures, and the degree of nominal flexibility afforded by the exchange rate regime.

Although the national savings rate has remained relatively stable, there has been a considerable shift in the composition of savings from the private to the public sector (see Figure 4). Public sector net lending remained close to zero between 1998 and 2003 and increased markedly to around 2% of GDP in 2004 and 2005 and to over 3% of GDP in 2006, thus helping at least to some extent contain the widening external deficit and preventing an even stronger increase in the savings-investment gap.

The fiscal tightening between 2003 and 2006 was the result of both expenditure restraint and buoyant revenue growth. The expenditure-to-GDP ratio decreased by over 3 percentage points between 2003 and 2006, thanks to lower interest payments, but also as a result of a reduction in the government wage bill and social transfers relative to GDP. In addition, the composition of expenditures was also improved, with capital expenditures increasing by more than 1 percentage point to 4% of GDP over the same period. The increase in public sector net lending was also aided by buoyant revenue growth, especially as regards indirect tax revenue thanks to rapidly expanding domestic demand. Revenue growth might have been even stronger, if revenue windfalls had not been used to lower personal and corporate income tax rates as well as social contribution rates since 2004. Although these tax cuts have improved supply-side conditions and have helped reduce the informal sector, they are not unproblematic from a longer-term perspective since they have largely been financed by what are arguably composition effects, i.e. reflecting extraordinarily strong domestic demand growth and one-off improvements in tax compliance and tax collection.

2.3. Cyclical conditions, overheating and the fiscal stance

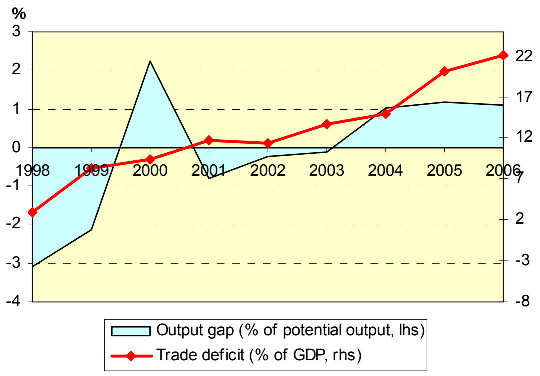
As highlighted in the previous section, the growing external deficits in Bulgaria essentially reflect an investment boom driven by considerable FDI inflows and high credit growth. In contrast, private consumption growth has played only a limited role and thanks to rising public sector savings the national savings rate has remained more or less stable. To the extent that the substantial increase in investment can boost potential growth in the future, this should mitigate concerns about the sustainability of the external

[4] Székely, István P. and Maxwell Watson (2007), Growth and Economic Policy: Are There Speed Limits to Real Convergence?, Economic Papers, European Commission DGECFIN, forthcoming

deficit. However, the rates at which domestic demand in general and investment in particular have been growing in Bulgaria in recent years also seem to highlight increasing risks of overheating and thus a more important role of cyclical factors in explaining the widening external deficit.

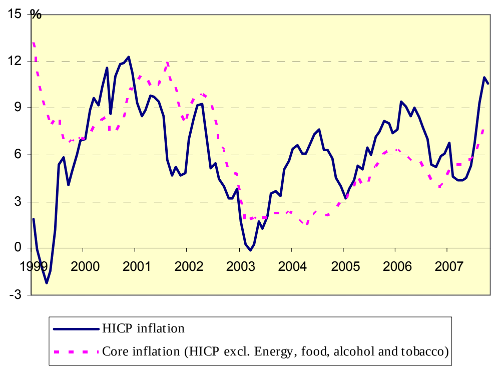
Cyclical conditions have steadily improved in Bulgaria over the last ten years (see Figure 5). Following the economic crisis in 1996-97, strong real GDP growth implied that the negative output gap was quickly closed, turning positive and increasing to around 1% since 2004.[5] Although this steady improvement in cyclical conditions coincided with a widening of the trade deficit, it seems, however, that at least until recently cyclical factors did not play a major role in explaining the worsening of the external position of the country.

Figure 5. Cyclical conditions and trade deficit



Source:Ameco, Bulgarian National Bank.

Figure 6. HICP and core inflation (y-o-y % change)



Source: Ameco

Starting from 2005 there has been an acceleration of core inflation (excluding energy, food, alcohol and tobacco) to around 5-6%, indicating that risks of overheating have become more acute (see Figure 6). However, before 2005, the development of inflation does not reveal any obvious signs of overheating in the Bulgarian economy. Following the introduction of the currency board and thanks to stability-oriented fiscal and wage policies, both headline and core inflation were reduced to below 3% in 2003. Subsequent increases in headline inflation were primarily linked to volatile food prices, oil price increases and increases in excises on alcohol and tobacco, whereas core inflation remained relatively contained at below 3% in 2003 and 2004.

At least until 2005, it therefore seems that the increase in the trade deficit and the gradual closure of the negative output gap jointly reflected Bulgaria's economic recovery after the economic crisis in 1996/97 and the start of an investment-led convergence process. However, fuelled by massive FDI inflows and easy access to credit, signs of overheating

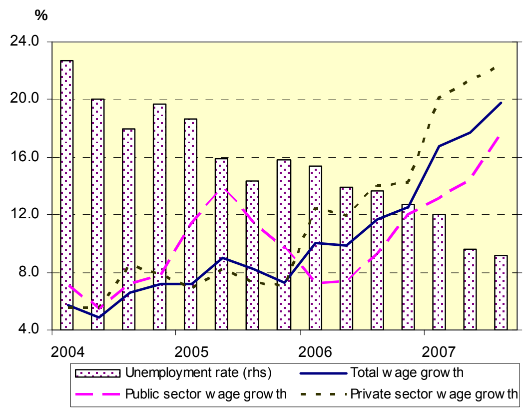
[5] Given the substantial uncertainty surrounding output gap calculations especially in transition economies, these results have to be interpreted with a considerable degree of caution. However, strong domestic demand growth, high credit growth and rapidly falling unemployment in the 2000s corroborate the steady improvement in cyclical conditions in Bulgaria.

have become increasingly evident indicating that cyclical factors are becoming a more important determinant of the external deficit.

Moreover, as buoyant domestic demand growth has started to spill over into labour market and wage developments, a gradual shift in the quality and nature of the convergence process also seems to emerge. Between the beginning of 2004 and the third quarter of 2007, the unemployment rate in Bulgaria was more than halved, from around 13½% of the civilian workforce to around 6½% (see Figure 7). This rapid decrease in unemployment was largely due to dynamic job creation in the private sector, reflecting strong economic growth and high investments. Although participation and employment rates increased considerably over the last two years, they did not keep pace with the speed of employment growth. As a result, the labour market has become increasingly tight, especially since the second half of 2006, with growing shortages emerging especially for high-skilled labour. This has triggered an unprecedented acceleration of wage growth since the second half of 2006. As highlighted in Figure 7, private sector wage growth has accelerated to well over 20% in 2007, with public sector wage dynamics still lagging behind but also showing clear signs of acceleration. As a result, private consumption growth has picked up noticeably since the second half of 2006; which has also affected the dynamics of import growth. Between the end of 2004 and early 2006 import growth had been dominated by particularly buoyant growth of investment goods imports. In contrast, since early 2007 imports of consumer goods have accelerated considerably and their growth has clearly outpaced imports of investment goods.

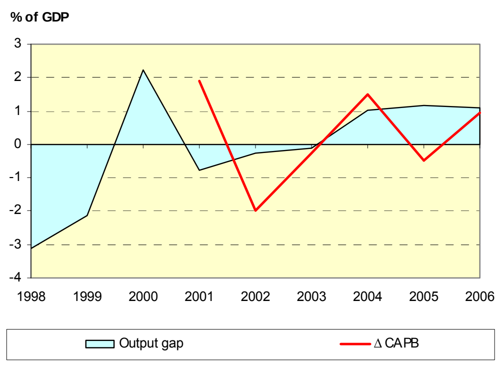
The Commission services autumn 2007 forecast projects wage pressures remaining strong in the coming years. A certain re-balancing of the economy may be expected as tighter international liquidity conditions and lower profit margins for companies would lead to a deceleration of investment growth. This correction will, however, probably be insufficient to bring about a noticeable reduction of the external deficit or a significant easing of inflationary pressures.

Figure 7. Nominal average quarterly wage increase (yoy) and unemployment rates



Source: Bulgarian National Statistical Institute.

Figure 8. Cyclical conditions and fiscal stance



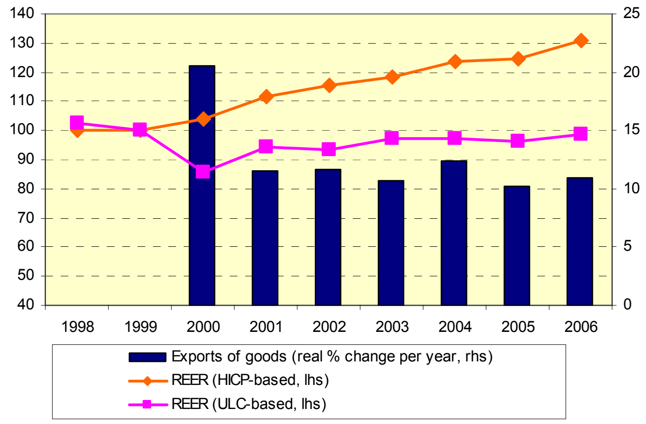
Source: Ameco

Fiscal policy has so far not been adding to these overheating pressures. In the years for which data are available and especially in 2004-2006, the fiscal stance has been either counter-cyclical or broadly neutral (see Figure 8). The tightening of the fiscal stance, especially in 2004 and 2006, helped contain demand-side pressures and limit the risks of overheating at least to some degree, especially as public consumption increased at a relatively moderate pace of less than 3% per year in real terms. However, to the extent that the current overheating of the economy is largely linked to growing labour market tightness, public finances may play an important role in alleviating these labour market tensions, both through sustained wage moderation in the public sector and through measures aimed at raising participation and employment rates (see Section 2.5 below).

2.4. Competitiveness

As a result of the persistent inflation differential with the euro area, Bulgaria's real effective exchange rate in terms of consumer prices and compared to a group of 36 industrialised countries has appreciated by almost one third between 1998 and 2006 (see Figure 9). This raises the question, whether the widening external deficit could also reflect a loss of competitiveness. However, so far, there seems to be little evidence for this. Thanks to moderate real wage increases since 1998, the real effective exchange rate based on unit labour costs has actually remained broadly stable. Cost competitiveness has thus been largely preserved since the introduction of the currency board despite above-average price inflation. This is also reflected in rather robust export growth (in real terms) of around 10% per year and associated increases in market shares. However, if the acceleration of nominal wage growth to rates above productivity gains observed since the end of 2006 persists, this picture could clearly change with a further real appreciation potentially eroding competitiveness. To the extent that high wage growth is not matched by a substantial acceleration of productivity growth, preserving competitiveness will inevitably entail adjustments in wages and require a high degree of wage flexibility.

Figure 9: Real effective exchange rate (relative to group of 36 industrialised countries, 1999=100) and export of goods (annual % change, volumes)

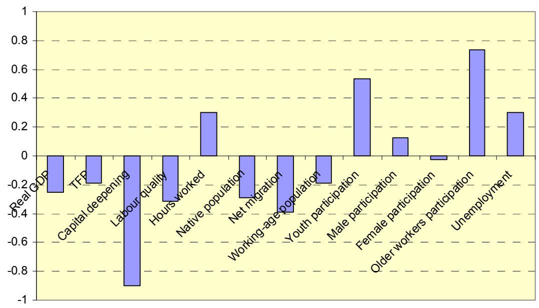


Source: Commission services

Improvements in competitiveness in Bulgaria have in the past been hampered by relatively low overall productivity growth. Given that high external deficits have been driven by large capital inflows and an associated increase in investment, corresponding improvements in competitiveness and productivity could be expected to boost Bulgaria's growth and export potential thus helping to correct the external deficit in the medium term. Moreover, in view of negative demographic trends, sustaining economic convergence in the future will have to increasingly rely on higher productivity. However, Bulgaria's growth pattern so far gives only limited indication that this is actually happening. Despite relatively strong real GDP growth since 1998, labour productivity growth has lagged behind the EU-8 average. Labour productivity growth largely remained at around 3-4% per year between 1998 and 2006 in Bulgaria and was thus around 1-2 percentage points lower than in EU-8.

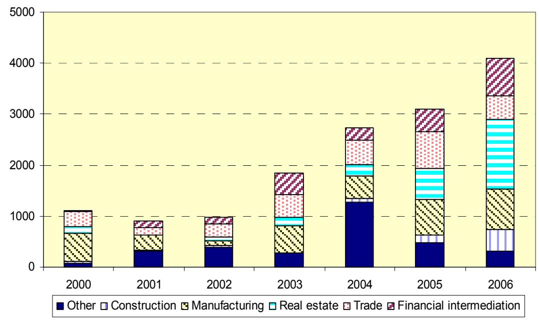
This is also corroborated by an analysis of the composition of real GDP growth from a growth accounting perspective.[6] Figure 10 shows that compared to the EU-8 average, real GDP growth in Bulgaria in the period 2000-2005 was driven less by labour productivity growth (reflected in a below-average growth of total factor productivity, capital deepening and labour quality, measured as the ratio between average productivity per employee and productivity of low-skilled workers) and to a much larger extent by an increased labour input (through a stronger reduction in unemployment and stronger increases in participation rates in particular of older workers).

Figure 10. Real GDP growth and its components (2000-2005): Difference between BG and the EU-8 average



Source: Mourre (2007)

Figure 11. FDI inflows by industry (mio. EUR)



Source: Bulgarian National Bank.

There are a number of reasons why despite the ongoing investment boom labour productivity growth in Bulgaria has been less buoyant than in other countries. Firstly, the pick-up in investment growth in Bulgaria is a rather recent phenomenon. Investment rates have been extraordinarily low in the 1990s and have exceeded 25% only since 2005. It may thus take some time before a more noticeable effect on productivity growth can be observed. Secondly, the structure of investments and FDI inflows has been tilted towards the real estate, construction and services sectors where the potential for productivity growth may be more limited than for example in the manufacturing sector (see Figure 11). The share of manufacturing in total annual FDI inflows has been declining from over 50% still in 2000 to around 20% in 2005 and 2006. The boom in FDI inflows in recent years was thus driven to a large extent by the real estate and construction sectors where FDI more than doubled on average in both years. Thirdly, as highlighted in Figure 10, labour productivity growth is also held back by the relatively

[6] See Mourre, G. (2007): What are the main sources of income differentials and what are the key components of economic growth in Europe? A detailed GDP accounting exercise. European Economy Economic Papers, forthcoming.

low quality of human capital which reflects inter alia a large share of early school leavers, low tertiary education participation rates and relatively low educational outcomes. Finally, various studies and surveys also highlight gaps in Bulgaria in the quality of institutional governance in key areas such as business environment, judicial system, and administrative capacity which are likely to negatively affect productivity growth and supply-side conditions.[7]

2.5. Correcting the external deficit: the role of public finances

In summary, Bulgaria's widening external deficit reflects primarily a widening savings-investment gap driven by an investment boom which has been fuelled by strong FDI inflows and high credit growth. This situation has been aggravated by increasing risks of overheating, linked mainly to an increasingly tight labour market and mounting wage pressures, and a mitigated supply-side response with relatively low productivity growth. Public finances have played an important role so far in containing the widening savings-investment gap by raising public sector net lending since 2003. Moreover, the broadly neutral or even countercyclical fiscal stance since 2004 alleviated at least to some extent pressures of overheating. Tight fiscal policy in good times has, however, not been sufficient to prevent the substantial widening of the external deficit and the overheating of the economy. This section therefore explores in more detail what additional role public finances could play in correcting external imbalances in Bulgaria.

2.5.1. Closing the savings-investment gap and alleviating overheating

Fiscal policy has been tightened considerably in Bulgaria in recent years. Public finances have thus helped contain the widening savings-investment gap. Even though a further tightening of fiscal policy might be difficult to achieve, avoiding a pro-cyclical fiscal easing is critical in order not to exacerbate existing imbalances which could eventually undermine the sustainability of the catching-up process. In particular, resisting pressures to use temporary revenue windfalls from buoyant domestic demand growth to finance higher expenditures and / or tax cuts will therefore be essential.

While the scope for increasing public sector savings may be limited, another, more indirect way in which public finances could potentially contribute to a closing of the savings-investment gap would be through stimulating private sector savings. This could in particular be the case with regard to private pension insurance, where further incentives might be considered to develop second- and third-pillar pension schemes, which would at the same time help address the challenges of fiscal sustainability in a rapidly ageing society.

As regards the risks of overheating, public sector wage moderation will play a crucial role in dampening overall wage pressures in the economy. The recent acceleration of wage growth was mainly driven by private sector developments, with private sector wage increases clearly outpacing those in the public sector. So far, there are no indications that public sector wage growth has played any significant role in fuelling overall wage pressures. However, preventing private-sector wage pressures from spilling over into the public sector and keeping public sector wage increases under control will be important to avoid the emergence of a potentially hazardous wage-price spiral in the future.

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[7] See for instance World Bank (2007) : Accelerating Bulgaria's Convergence : The challenge of raising productivity. Report No. 3857.

2.5.2. *Improving the quality of public finances: boosting productivity and raising employment*

Given the limited range of policy instruments to curb domestic demand, improving supply-side conditions will be central to achieve high and sustained economic growth while at the same time reducing economic imbalances. This obviously requires a whole array of economic reforms that go far beyond the area of public finances. However, public finances can play an important role in this, for example by re-directing public spending to growth-enhancing areas, including in particular investments in physical and human capital, or by improving the efficiency of public spending in key sectors.

As mentioned above, the restructuring of public expenditures has already started in recent years (see Figure 12). Investment expenditures have increased both as a share of GDP (reaching around 4% in 2006) and as a share in total expenditures. At the same time, social expenditures and the government wage bill have been gradually reduced. A certain re-orientation of public spending towards growth-enhancing areas has thus begun, although public expenditures for example in the field of innovation and R&D remain low. Further improving the composition of expenditures could therefore help, especially in view of the large investment needs in the areas of public infrastructure as well as human capital. In this context, improving the efficiency of public spending and ensuring that the right infrastructure projects are targeted will also be critical.

Figure 12: The evolution of general government expenditure (economic classification) (% of GDP)

Source: Eurostat

The current overheating in the economy seems to be linked to a large extent to the growing tightness in the labour market and associated wage pressures despite the fact that participation and employment rates in Bulgaria are still relatively low compared to the EU average. This suggests that there exists still a so-far untapped labour reserve which, if activated, could help ease labour market pressures. Public finances could play a role in this context: firstly, by further removing disincentives in the tax-benefit system; secondly, by improving the efficiency of public spending on active labour market policies and education with a view to ensuring more effective labour market activation and closing skills gaps; and thirdly, by further reducing public sector employment to free resources for the private sector.

Although the share of public expenditures on education in Bulgaria is largely comparable to other countries, a number of indicators suggest that educational outcomes are significantly lower (see e.g. World Bank, 2007). While education reform has started in the primary and secondary sector with a reform of the financing mechanism in 2007, improving the quality and efficiency of public spending in education will be critical to raise the potential for higher productivity growth in the future, for tackling shortages in the labour market and for laying the foundations for a stronger supply side response needed to reduce external imbalances.

On the revenue side of the budget, there has been a clear shift in recent years from direct to indirect taxes, following a number of reductions in direct taxes and social contributions. This has clearly helped reduce payroll taxes from very high levels, giving greater incentives for investment, job creation and participation in the labour market, while at the same time effectively reducing the size of the informal economy. This is most clearly reflected in the rapid reduction of unemployment and a considerable increase in the total employment rate by 8 percentage points between 2002 and 2006. Despite this progress, labour market participation and employment rates are, however, still below the EU average. At least partly, this still seems to reflect certain disincentives in the tax-benefit system especially for the transition from unemployment to employment (see calculations in World Bank, 2007). Further reform of the tax-benefit system to reduce disincentives for labour market participation could help raise participation rates and alleviate shortages in the labour market.

3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes how the macroeconomic vulnerabilities identified in the preceding section are expected to develop according to the programme.

3.1. Economic activity

The programme projects real GDP growth to remain high at 6.4% in 2007 and 2008, and to accelerate to close to 7% in 2009 and 2010[8]. For most of the programme period real GDP would continue to grow slightly below potential, which would increase to around 7% by 2009 driven mainly by strong capital accumulation in recent years. The macroeconomic outlook assumes a certain acceleration vis-à-vis the average growth performance of the past five years.

As in previous years, economic growth is expected to be mainly driven by domestic demand. Private consumption would continue to grow at around 6½% on average during the programme period due to expected sustained increases of incomes resulting from rising labour productivity. There is some volatility in the profile though, which is not fully explained. Gross fixed capital formation would remain strong, but gradually decelerate from the current high growth rate of around 26% in 2007 to around 13% in

[8] The external outlook behind the programme's macroeconomic scenario is broadly in line with that in the Commission services' autumn 2007 forecast, except for the oil price that is assumed to be lower.

2009-2010. A certain rebalancing of economic growth is projected to come in 2009 and 2010 from a pick-up in export growth which is expected to increase on the back of a gradual improvement in the country's relative competitiveness and productivity linked to past investments and ongoing restructuring. With domestic demand growth slowing down slightly over the programme period, import growth would also decelerate from around 13½% in 2007 to 11% in 2010. Consequently, the negative contribution of net exports to growth would decline by around 2 pps. over the programme period.

Table 1: Comparison of macroeconomic developments and forecasts

	2007		2008		2009		2010
	COM	**CP**	**COM**	**CP**	**COM**	**CP**	**CP**
Real GDP (% change)	6.3	6.4	6.0	6.4	6.2	6.8	6.9
Private consumption (% change)	7.3	7.1	7.0	6.0	6.5	6.9	6.4
Gross fixed capital formation (% change)	25.0	26.1	14.0	18.3	12.0	13.5	12.7
Exports of goods and services (% change)	7.4	8.7	8.4	9.0	8.2	11.2	11.6
Imports of goods and services (% change)	12.6	13.6	10.6	11.7	9.5	11.1	11.1
Contributions to real GDP growth:							
- Final domestic demand	11.9	11.9	9.4	10.8	8.6	9.6	9.3
- Change in inventories	0.1	0.7	0.1	0.2	0.2	0.0	-0.1
- Net exports	-5.7	-5.7	-3.4	-4.5	-2.5	-2.8	-2.3
Output gap[1]	0.7	0.6	-0.1	0.0	-0.6	-0.4	-0.2
Employment (% change)	2.2	1.6	1.2	1.1	1.0	0.6	0.2
Unemployment rate (%)	7.5	7.2	6.8	6.8	6.0	6.5	6.4
Labour productivity (% change)	4.0	4.7	4.7	5.3	5.2	6.1	6.6
HICP inflation (%)	7.1	7.2	7.3	6.9	5.8	4.4	3.7
GDP deflator (% change)	7.6	5.0	7.4	5.7	5.3	3.8	3.2
Comp. of employees (per head, % change)	14.9	16.0	12.6	14.5	10.7	11.5	10.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-17.0	-19.9	-16.0	-20.7	-15.8	-19.5	-18.6

Note:

[1]In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.

Source :

Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP)

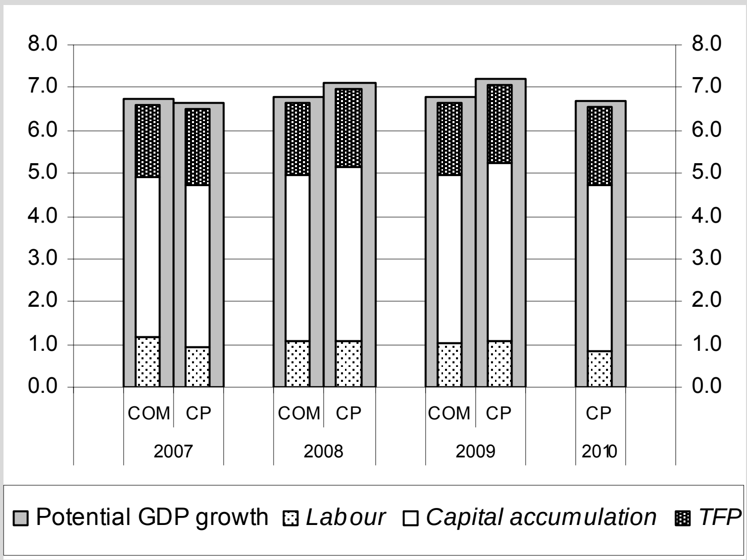
The macroeconomic scenario of the programme is based on broadly plausible growth assumptions, although slightly favourable especially towards the end of the programme period. The Commission services' autumn forecast projects a stronger rebalancing of the economy due to domestic and foreign investment returning to more sustainable levels. This is reflected in a temporary slowdown of growth to 6% in 2008, and only some re-acceleration to 6¼% in 2009. Beyond 2009, the projected real GDP growth in the programme is broadly in line with the Commission services' estimate of average potential GDP growth for the period 2007-09, as calculated according to the commonly agreed methodology in the 2007 autumn forecast. However, to the extent that a correction of current macroeconomic imbalances is likely to be accompanied by a moderation of economic activity, real GDP growth might actually remain below potential. Recent data for 2007 also suggest that due to a negative supply-side shock in the agricultural sector because of bad weather conditions, economic activity could turn out lower than expected in 2007.

With respect to the GDP components, growth of investment is projected to be stronger over the whole programme period (especially in 2008) than in the Commission services' autumn forecast, which foresees a stronger negative impact on FDI inflows due to tighter international liquidity constraints and higher wage costs reducing profit margins. Private consumption growth in the programme is somewhat weaker in 2008 despite the projected significant real wage increases and stronger employment growth. However, in 2009 it is stronger, given the expected higher real wage growth. The weaker private consumption growth in 2008 would, however, be compensated by a significant acceleration in government consumption due to a one-off adjustment linked to increased EU-related expenditures. The stronger domestic demand growth in the programme is also reflected in higher import growth during the entire programme period. Overall, the GDP growth outlook is thus less balanced in the programme than in the Commission services' autumn forecast due to assumptions for a more buoyant domestic demand growth and therefore a smaller decrease in import growth. This would only partly be offset by a stronger expected pick-up in export growth.

Box 2: Potential growth and its determinants

Potential GDP growth according to the Commission services' recalculations using the commonly agreed methodology based on the information provided in the programme, is projected to increase by slightly over ½ pp. between 2007 and 2009 while in the Commission services' 2007 autumn forecast it would remain almost unchanged. Potential growth during the programme period is clearly above the average GDP growth and also average potential growth in recent years.

Potential growth and its determinants



The projected increase in potential output growth is driven primarily by a higher contribution from capital accumulation, which would rise by around ½ pp. between 2007 and 2009. This is consistent with the assumed stronger investment growth in the programme and continues the trend of strong investment growth observed for some time. The contribution from labour input would also increase, although to a lesser extent. The contribution of TFP would remain constant throughout the programme period.

Cyclical conditions as measured by the output gap recalculated by the Commission services based on the data provided in the programme using the commonly agreed methodology show a steady decline in the output gap, which would become zero in 2008 and turn slightly negative in 2009 and 2010. This is close to the output gaps implied by the Commission services' forecast, which projects the output gap to turn negative already in 2008 due to lower projected GDP growth. The decline in the output gap throughout the programme period is a result of the strong increase of potential growth following a very strong build-up in investments in recent years.

3.2. Labour market and cost and price developments

Employment growth is projected to be below 1% on average over the programme period, slowing down considerably to just ¼% in 2010. Projections are in line with the Commission services' autumn forecast, although the growth rate is decelerating somewhat quicker in the period 2009-10. The expected deceleration in the programme follows a relatively buoyant employment growth and sharp drop in unemployment in recent years. It reflects the projected steady decline in the labour force due to demographic developments which is only partly compensated by an increase in participation rates and a further reduction in unemployment.

The labour content of GDP growth is projected to decline considerably over the programme period, while labour productivity growth would increase to 6½% in 2010, in line with the ongoing capital accumulation and economic restructuring. The decreasing output gap implied by the Commission services' calculations, applying the commonly agreed methodology, is not expected to be accompanied by an increase in the unemployment rate. The programme projects unemployment to continue to fall, although at a decelerating rate. The labour market developments are thus largely in line with the Commission services' autumn forecast despite the more optimistic growth scenario and somewhat stronger increases in productivity growth in the programme.

Annual average HICP inflation has accelerated sharply in 2007 on the back of increasing demand-side pressures and rising food, energy and administrative prices. It is projected to remain high in the programme at around 7% in 2007 and 2008, before decelerating sharply to under 4% by 2010. The inflation outlook in the programme appears to be on the low side in 2009 and 2010. This is partly explained by the assumed lower external oil prices; however, the inflationary impact from the projected further increases in tobacco excises seems to not have been fully reflected. In the Commission services' 2007 autumn forecast inflation is expected to decelerate less in view also of persistent wage pressures.

Wage growth is expected to increase considerably in the programme to 16% in nominal terms and close to 9% in real terms in 2007 due to the sharp fall in unemployment and tightened labour market conditions. The high nominal wage growth partly reflects a de-shadowing of the grey economy as a result of the reduction in the social security burden since the beginning of 2006 and a more accurate reporting of wage incomes. At the same time, although productivity growth is projected to surge to over 4½% in 2007 it would lag behind real wage growth, leading to a jump in the real unit labour costs of around 4% for the first time in several years. For the period 2008-10, the programme projects nominal wage growth to gradually decelerate to 10½%. While this is broadly in line with the trend assumed in the Commission services' autumn forecast, wage pressures are expected to remain somewhat more persistent in the programme. As the programme projects a strong increase in productivity (to over 6½% in 2010), growth of nominal unit labour costs would, however, decrease to around 4% again in 2010, from around 11% in 2007. Apart from 2008, where the programme assumes a stronger increase in nominal unit labour costs, these developments are largely in line with Commission services' projections. However, as the programme anticipates lower inflation, real unit labour costs are expected to grow more strongly than in the Commission services' autumn forecast. Thus the wage and productivity growth dynamics in the programme might lead to a worsening in the relative competitive position of the economy.

3.3. Macroeconomic challenges

Relatively strong economic growth in recent years has been accompanied with signs of overheating and increasing macroeconomic imbalances, reflected in a widening external deficit, re-acceleration of bank credit growth, and rising inflation. In addition, with unemployment falling sharply, the labour market has tightened and in 2007 wage growth has outpaced productivity growth for the first time in several years. As highlighted in Section 2, Bulgaria is confronted with the challenges of tackling these imbalances in the context of the currency board arrangement while strengthening the conditions for sustained catching-up.

On the external side, the deficit has continued to widen and is expected to reach around 20% of GDP in 2007. The external deficit is envisaged to be higher throughout the programme period than in the Commission services' autumn forecast in line with the government's more buoyant domestic demand assumption. It is projected to peak at 20¾% of GDP in 2008 before gradually falling to 18½% in 2010. In the autumn forecast the external deficit is expected to decelerate more quickly. While recent data indicate that the external deficit could indeed be higher in 2007 than projected in the autumn forecast, the difference in the profile for 2008 and 2009 is mainly explained by the programme's assumption of higher domestic demand and import growth and by a less strong projected increase in capital transfers. At the same time the programme projects export growth to gradually recover from the slowdown in 2007 as high capital accumulation in recent years should strengthen the export potential of the economy.

In the banking sector, domestic private credit growth has sharply re-accelerated after the expiry of administrative restrictions at the end of 2006. Underpinned by strong investment activity, high employment and wage growth as well as low real interest rates total claims on the non-government sector have surged. To counteract the potential risks to the stability of the banking sector the Central Bank has decided to raise the minimum reserve requirements (MRR) from 8 to 12 percent from September 2007, announcing that it expects credit to slow down to 45-50% at the end of the year. So far, bank soundness indicators point to a well capitalized and profitable banking sector that is largely foreign-owned. The ratio of non-performing to total gross loans remains low in the order of 2-3%, although it has to be interpreted with caution given that the rapid credit growth could mask underlying deterioration in the loan portfolio quality. The banking supervision legislative framework has been harmonized with the EU requirements and from the beginning of 2007 the Basel II requirements have been implemented following a very conservative and restrictive system-wide risk assessment approach (instead of bank-specific). In addition, the central bank is applying very strict and conservative loan provisioning and loan classification rules. Nevertheless, the high rates of credit growth are a cause of concern given the rising inflationary pressures and the widening external deficit. The programme envisages that if bank credit continues to grow at the current high and unsustainable rates the Central Bank will adopt additional measures to moderate credit growth including through further raising the MRR and measures directed towards increasing capital requirements for those credits that grow at the highest rate and lead to a faster accumulation of credit risk.

The considerable rise in inflation in 2007 was partly linked to exogenous shocks stemming from drought-related food as well as energy price hikes. However, core inflation (net of energy, food, alcohol and tobacco) has also picked up reflecting growing demand-side pressures. There is a risk that continued high wage growth and buoyant domestic demand could further add to inflationary pressures, potentially undermining the sustainability of the current growth path. Therefore, bringing inflation down remains a major challenge to safeguard competitiveness and ensure sustainability of the convergence process.

In summary, the macroeconomic scenario of the programme is broadly realistic, although slightly favourable especially towards the end of the programme period. The programme envisages stronger persistence of an unbalanced growth pattern reflected in more buoyant domestic demand growth, and in particular investment growth, which is only partly compensated by an assumed pick-up in export growth. Mounting domestic and external macroeconomic imbalances entail clear risks to the growth outlook. Thus, less buoyant growth in the medium-term than foreseen in the programme is a distinct possibility.

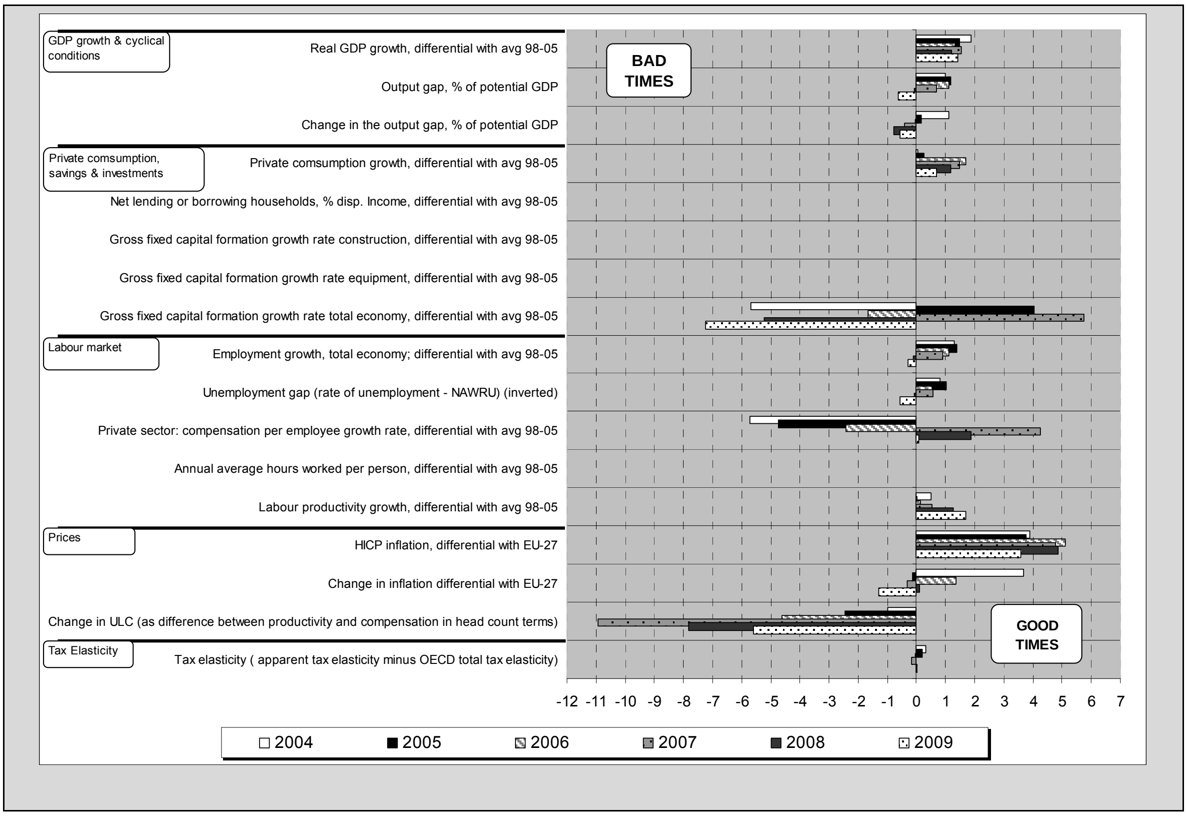
Box 3: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in good economic times taking into account tax elasticities in the period 2007-2009.

The Commission services' calculations show that the economy has been growing above potential over the past several years, implying a positive output gap of around 1% in 2004-06. According to these calculations the output gap is expected to start decreasing from 2007, turning slightly negative in 2008-09. This reflects the substantial increase in potential growth estimates following the strong build-up in investments over recent years. However, real GDP growth has been and is projected to remain above the 1998-05 average in all years since 2004. The current phase of expansion is characterized by a significant increase in gross fixed capital formation, strong private consumption growth, and a tightening labour market with sharply falling unemployment and strong acceleration of wage growth. The labour productivity growth differential is strongly positive. Further, inflation has been above the EU-27 average for some time, with inflationary pressures expected to recede only gradually. Together with the increasing external deficit and the strong re-acceleration in credit growth, this indicates that Bulgaria is witnessing economic good times, albeit somewhat weakening over the programme horizon.

This is confirmed by the assessment of tax elasticities. The apparent tax elasticities have been above the OECD standard values in 2004-2005 in line with the positive output gap dynamics. The difference turns negative or close to zero in 2008-09 when the output gap is projected to turn negative as well. However, the decrease in the apparent tax elasticities reflects consecutive discretionary reductions in corporate and personal income taxes as well as in social security contributions, while the underlying growth composition remains very tax-rich.

Good versus bad times



4. General government balance

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2007

Table 2 compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the January 2007 convergence programme with the current update. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect on the denominator and a revenue / expenditure growth effect[9]:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the original programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the original programme or because GDP turned out to be different from the scenario in the original programme). The base effect therefore also captures the effect of revisions to the GDP series.

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[9] A fourth, residual component is usually small, except if there are very large differences between updated programme and the target (the full mathematical decomposition is in the methodological paper mentioned above).

- The GDP growth effect on the denominator captures the part of the difference that is related to current GDP growth projections for 2007 turning out higher or lower than anticipated in the original programme (therefore reducing / increasing the denominator of the revenue and expenditure ratio).
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the original programme. This would typically be due to GDP developments different from those expected in the previous update of the programme, or as a result of apparent tax elasticities different from the ex ante tax elasticities (or both).

Table 2: Budgetary implementation in 2007[10]

			2006		2007	
			Planned CP Jan 2007	Outcome CP Dec 2007	Planned CP Jan 2007	Outcome CP Dec 2007
Revenue (% of GDP)			41.5	40.3	41.8	42.2
Expenditure (% of GDP)			38.2	37.1	41.0	39.1
Government balance (% of GDP)			3.2	3.2	0.8	3.1
Nominal GDP growth (%)					9.9	11.8
Nominal revenue growth (%)					10.7	17.0
Nominal expenditure growth (%)					18.0	17.8
Revenue surprise compared to target (% of GDP)					**0.4**	
Of which[1]:	1. Base effect				-1.2	
	2. GDP growth effect				-0.6	
	3. Revenue growth effect				2.1	
	Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1[2]				*1.5*	
Expenditure surprise compared to target (% of GDP)					**-1.9**	
Of which[1]:	1. Base effect				-1.2	
	2. GDP growth effect				-0.6	
	3. Expenditure growth effect				-0.1	
Government balance surprise compared to target (% of GDP)					**2.3**	
Of which:	1. Base effect				0.0	
	2. GDP growth effect				0.0	
	3. Revenue / expenditure growth effect				2.1	

Notes:

[1] A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive GDP growth effect (on the denominator) indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small.

[2] Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.

Source:
Commission services

The budgetary outcome for 2007 is estimated at a surplus of slightly above 3% of GDP in the update of the programme. This is approximately 2¼% of GDP higher than the original target and in line with the projections in the Commission services' autumn

[10] Due to considerable methodological changes related to the further alignment of government finance statistics with ESA 95 the data in the December 2007 update and in the original programme are not fully comparable, especially as regards the expenditure and revenue ratios.

forecast. Given the sustained strong revenue growth towards the end of the year, the actual outcome could turn out even higher.

According to the programme, this over-performance is entirely due to higher than expected revenues. Particularly buoyant revenue growth in 2007 reflects composition effects due to strong domestic demand and wage growth and improved revenue compliance as reductions in the corporate income tax rates in 2007 and in social contributions in 2006 appear to have led to a considerable reduction of the grey economy and a more accurate reporting of profits and wages.

While the expenditure-to-GDP ratio in the update of the programme is around 2 pps. lower than in the original programme, this appears to be mainly due to base effects (following in particular an upward revision of historical GDP data), higher-than-planned nominal GDP growth in 2007 implying a higher denominator in the calculation of the expenditure-to-GDP ratio, but also methodological changes which make a direct comparison between the original programme and its update very difficult.

The fact that the budget over-performance in 2007 comes exclusively from a positive revenue surprise is a major difference compared to the indications given in the January 2007 programme which indicated that a potentially better budgetary outcome of a 2% of GDP surplus might be achieved through savings on the expenditure side. This was also reflected in the Commission services' autumn forecast which expected that part of the budget over-performance would come from expenditure restraint. However, in view of the very high revenue over-performance, expenditures were not kept fully under control in 2007. The Bulgarian authorities thus decided to release the 10% of budgeted non-interest current expenditures (around 1% of GDP) which according to provisions in the 2007 budget law were supposed to be released only if the current account deficit had not widened. In addition, they approved additional expenditures in December 2007 of around 2¼% of GDP, aiming mainly at financing infrastructure projects which will partly be implemented only in 2008. Finally, they also decided to raise pensions twice by 10% in July and October, even though the increase should have been limited to 8½% in line with the existing indexation formula. The Commission services' autumn forecast also took into account the cancellation of Libya's debt to Bulgaria as a one-off expenditure, amounting to around 0.1% of GDP. In the programme, this has not yet been taken into consideration.

The Council opinion of 27 March 2007 on Bulgaria's convergence programme invited Bulgaria to achieve a higher budgetary surplus in 2007 than planned in the programme in order to foster macroeconomic stability and to contain the high external deficit. According to the programme update, a higher budget surplus than initially planned will indeed be achieved in 2007 thanks to particularly strong revenue growth. However, even though Bulgaria pursued a policy of expenditure restraint for most of the year, the above-mentioned expenditure increasing measures adopted at the end of the year risk adding to domestic demand pressures.

4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme – and how it compares with the one in the previous update – as well as the composition of the budgetary adjustment, including the broad measures envisaged.

4.2.1. The main goal of the programme's budgetary strategy

The medium-term budgetary strategy aims at maintaining a neutral fiscal stance with the goal to preserve macroeconomic stability and sustain robust economic growth. The budgetary objectives are targeted at generating significant positive budget balances, smoothing the business cycle, decreasing inflationary pressures, and counteracting the increasing external sector imbalances.

The MTO presented in the programme has been revised from a balanced budget in structural terms (i.e. cyclically adjusted net of one-off and other temporary measures) to a surplus of 1½% of GDP. This new MTO is significantly more demanding than implied by the debt ratio and long term potential growth. It satisfies by a wide margin the condition of ensuring a safety margin against breaching the 3% deficit limit. Recent Commission services' estimates put the minimum benchmark at a cyclically-adjusted deficit of 1¾% of GDP. Although the MTO endorsed by the Council in its opinion on the previous programme was already more demanding than required by the Pact, the upward revision is justified in the programme with the rising external imbalances, accelerating inflation and the projected population ageing impact.

Table 3: Evolution of budgetary targets in successive programmes

		2006	2007	2008	2009	2010
General government balance (% of GDP)	**CP Dec 2007**	**3.2**	**3.1**	**3.0**	**3.0**	**3.0**
	CP Jan 2007	*3.2*	*0.8*	*1.5*	*1.5*	*n.a.*
	COM Nov 2007	3.2	3.0	3.1	3.1	n.a.
General government expenditure (% of GDP)	**CP Dec 2007**	**37.1**	**39.1**	**40.7**	**40.9**	**41.0**
	CP Jan 2007	*38.2*	*41.0*	*40.2*	*40.2*	*n.a.*
	COM Nov 2007	37.1	36.7	36.3	36.3	n.a.
General government revenue (% of GDP)	**CP Dec 2007**	**40.3**	**42.2**	**43.7**	**43.9**	**43.9**
	CP Jan 2007	*41.5*	*41.8*	*41.8*	*41.7*	*n.a.*
	COM Nov 2007	40.3	39.7	39.4	39.4	n.a.
Structural balance[1] (% of GDP)	**CP Dec 2007**	**2.9**	**2.9**	**3.0**	**3.1**	**3.1**
	CP Jan 2007	*3.2*	*1.0*	*1.9*	*2.0*	*n.a.*
	COM Nov 2007	2.9	2.9	3.1	3.3	n.a.
Real GDP (% change)	**CP Dec 2007**	**6.1**	**6.4**	**6.4**	**6.8**	**6.9**
	CP Jan 2007	*5.9*	*5.9*	*6.2*	*6.1*	*n.a.*
	COM Nov 2007	6.1	6.3	6.0	6.2	n.a.

Note:

[1]Cyclically-adjusted balance excluding one-off and other temporary measures. The most recent programme provides no information on one-off and other temporary measures; according to the Commission services' autumn forecast, they are 0.1% of GDP (surplus-reducing) in 2007. The structural balance in the Commission services' autumn forecast has been recalculated following a revision of the budgetary sensitivity for Bulgaria.

Source:

Convergence programmes (CP); Commission services' autumn 2007 economic forecasts (COM)

The current update of the programme envisages the general government surplus to remain at 3% of GDP over the entire programme period from an expected outcome of 3.1% in 2007. The government intends to continue to implement the policy of maintaining fiscal buffers to ensure flexibility in meeting the budgetary targets. To this end it will replace the current practice of freezing 10% of discretionary spending allocations until the end of the year with increasing the budgeted contingency reserves by ½% of GDP in 2008, adding a 'fiscal sustainability' component. The contingency funds could be spent only on the condition that both the expected consolidated budget surplus exceeds 3% of GDP and the approved central government budget balance does not worsen. According to the programme, the budgetary targets for 2009 and 2010 represent projections under a no-policy change assumption.

The structural balance, based on the recalculation of the output gap by the Commission services on the basis of the information in the programme according to the commonly agreed methodology, is projected to increase by around ¼% of GDP over the programme period from a surplus of close to 3% of GDP in 2007 to a surplus of slightly above 3% of GDP in 2009-2010. The adjustment path is in line with the projections in the Commission services' autumn forecast which are made under a no-policy change assumption. The underlying fiscal position is thus broadly neutral over the entire programme period.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2006	2007	2008	2009	2010	Change: 2010-2007
Revenue	**40.3**	**42.2**	**43.7**	**43.9**	**43.9**	**1.7**
of which:						
- Taxes on production and imports	19.4	19.6	20.2	19.8	19.8	**0.2**
- Current taxes on income, wealth, etc.	6.5	6.6	7.3	7.1	7.1	**0.5**
- Social contributions	8.8	8.8	7.8	7.6	7.6	**-1.2**
- Other (residual)	5.6	7.2	8.4	9.4	9.4	**2.2**
Expenditure	**37.1**	**39.1**	**40.7**	**40.9**	**41.0**	**1.9**
of which:						
- Primary expenditure	35.8	37.9	39.6	39.9	40.0	**2.1**
of which:						
Compensation of employees	9.0	8.8	8.7	8.4	8.4	**-0.4**
Intermediate consumption	7.9	8.1	8.1	7.8	7.5	**-0.6**
Social payments	12.8	12.1	12.2	11.9	11.5	**-0.6**
Subsidies	0.9	1.4	1.5	1.7	1.8	**0.4**
Gross fixed capital formation	4.0	5.7	6.2	7.0	7.6	**1.9**
Other (residual)	1.1	1.7	3.0	3.1	3.1	**1.4**
- Interest expenditure	1.3	1.2	1.1	1.0	1.0	**-0.2**
General government balance (GGB)	**3.2**	**3.1**	**3.0**	**3.0**	**3.0**	**-0.1**
Primary balance	**4.6**	**4.3**	**4.0**	**4.0**	**4.0**	**-0.3**
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	**0.0**
GGB excl. one-offs	**3.2**	**3.1**	**3.0**	**3.0**	**3.0**	**-0.1**
Output gap[1]	0.8	0.6	0.0	-0.4	-0.2	**-0.8**
Cyclically-adjusted balance[1]	2.9	2.9	3.0	3.1	3.1	**0.2**
Structural balance[2]	**2.9**	**2.9**	**3.0**	**3.1**	**3.1**	**0.2**
Change in structural balance		*0.0*	*0.1*	*0.1*	*-0.1*	
Structural primary balance[2]	4.2	4.1	4.1	4.1	4.1	**0.0**
Change in structural primary balance		*-0.1*	*0.0*	*0.0*	*-0.1*	

Notes:

[1] Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.

[2] Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:
Convergence programme; Commission services' calculations

The current budgetary strategy is more ambitious than in the January 2007 programme. Starting from a 3% of GDP surplus in 2007 (compared to an initial target of 0.8%) the fiscal targets for 2008-09 have been adjusted upwards by 1½ pps. to 3% of GDP. Moreover, the current update envisages a broadly neutral fiscal stance over the whole programme period, whereas the January 2007 programme had envisaged a strong pro-cyclical expansion in 2007.

4.2.2. The composition of the budgetary adjustment

The programme envisages an increase in the revenue- and expenditure-to-GDP ratios by around 1¾ pp. each. The increase is more pronounced in 2008 when total revenue and expenditure are set to grow by around 1½% of GDP each. A small further increase by around ¼% of GDP is projected in 2009, leaving the overall levels unchanged in 2010. Interest expenditure is projected to continue to decline gradually by around ¼% of GDP over the programme period in line with the foreseen debt reduction. The primary balance would thus decrease in 2008 by ¼% of GDP and would remain unchanged at a surplus of 4% of GDP over the programme period.

On the revenue side, the programme projects a gradual increase of 'other revenue' by 1¼% of GDP in 2008 and another 1 pp. in 2009. This is mainly due to an assumed increase in EU transfers. Social contributions are projected to decrease by 1¼% of GDP over the programme period and in particular by 1 pp. in 2008. Although part of the decrease may be due to the negative effect of the 3 pps. cut in social contribution rates from 1 October 2007, the overall drop is not fully explained given that there are a number of compensating measures increasing social security revenue. The latter include raising the mandatory social insured income thresholds (the base for calculating and paying social contributions) in 2008 by over 20% on average and increasing the maximum ceiling and minimum threshold for the category of self-employed. Revenues from both direct and indirect taxes are projected to increase by close to ¾% of GDP each in 2008, but then drop slightly in 2009 and 2010. The increase in direct taxes in 2008 is partly driven by the expected increase of personal income tax revenues despite some uncertainty linked to the introduction of a 10% flat-rate tax from the beginning of the year. The programme projects the counter-financing of the flat-rate income tax to come from the implied tax increase for low-income earners, removing certain existing tax breaks, and potential reduction of the informal economy. Indirect tax revenues would increase in 2008 mainly due to the gradual increase in certain (tobacco and fuel) excise duties following the scheduled harmonization with the EU levels. The slight revenue drop towards the end of the programme period, despite further rate hikes, is expected to come from a decline in the consumption of excise goods.

The programme projects a considerable restructuring on the expenditure side. Primary expenditures are expected to increase by around 2% of GDP during the programme period, partly offset by the drop in interest expenditures. Capital expenditures are planned to gradually increase by around 2 pps. to 7½% of GDP in 2010, increasingly financed by EU transfers. 'Other expenditures' are expected to increase by around 1½% of GDP, almost exclusively in 2008. This increase is, however, only partly explained by the ½% of GDP adjustment to the contingency reserve in 2008. Subsidies would gradually rise by around ½% of GDP for the whole programme period. At the same time, the wage bill, intermediate consumption, and social payments are scheduled to be reduced by around ½% of GDP each by the end of the programme period. Public sector wages are projected to increase by between 5 to 10% in 2008. For 2009-10 the programme projects public sector wage increases which do not exceed overall labour productivity growth.

No one-off and other temporary measures with significant impact on the budget balance are envisaged in the programme. According to the programme, the revenue and expenditure estimates for 2009 and 2010 are made under a no-policy change assumption, implying that no new measures are envisaged on the expenditure or revenue side in those years. This is also reflected in the fact that the structural balance would remain almost unchanged. However, a considerable shift in the composition of revenues is envisaged, with an increase in 'other revenues', apparently linked mainly to higher EU transfers, compensating a drop in tax revenues. This latter decrease in tax revenues is not explained by new measures and is not fully consistent with the projected growth scenario and composition.

Box 4: The budget for 2008

The draft budget for 2008 was approved by the Council of Ministers and submitted to parliament on 31 October 2007. The parliament adopted the budget on 20 December 2007. The target for the general government balance is a surplus of 3% of GDP.

On the revenue side, a 10% flat-rate personal income tax has been introduced from 1 January 2008 abolishing the current system of progressive tax brackets. Existing tax breaks, such as family taxation and minimum non-taxable income, and adjustments to the taxable base for self-employed have been either eliminated or reduced. Certain excise tax rates are being increased in line with the EU harmonization requirements. The budget envisages an increase of the maximum ceiling for social insured income and the minimum threshold for self-employed.

On the expenditure side, wages in the general government sector are projected to increase between 5% and 10% as of 1 July, following a 12% envisaged cut in the public sector staffing levels by mid-year. Pensions will be indexed by 9½% in line with the pension indexation rule set in the law. Both increases would remain below the projected nominal GDP growth. The 90% expenditure rule will be replaced by an increase in the budget contingency reserves by adding a 'fiscal sustainability' component.

Main measures in the budget for 2008

Revenue measures*	Expenditure measures**
o Introduction of 10% flat-rate personal income tax (-¼% of GDP) o Increase in maximum and minimum insured income levels (+¼% of GDP) o Increase in excise rates on certain fuels, cigarettes, electricity and coal and removal of the excises on coffee beans (+½% of GDP)	o Increase of contingency reserves (+½% of GDP) o Indexation of pensions by 9.5% from 1 July 2007 (+½% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.

Sources: Commission services and December 2007 Convergence Programme.

4.3. Risk assessment

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 5 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

Table 5: Comparison of budgetary developments and projections

(% of GDP)	2006	2007		2008		2009		2010
	COM	COM	CP	COM	CP	COM[1]	CP	CP
Revenue	**40.3**	**39.7**	**42.2**	**39.4**	**43.7**	**39.4**	**43.9**	**43.9**
of which:								
- Taxes on production and imports	19.4	18.7	19.6	18.7	20.2	18.7	19.8	19.8
- Current taxes on income, wealth, etc.	6.5	6.6	6.6	6.6	7.3	6.6	7.1	7.1
- Social contributions	8.8	8.7	8.8	8.6	7.8	8.6	7.6	7.6
- Other (residual)	5.6	5.7	7.2	5.6	8.4	5.6	9.4	9.4
Expenditure	**37.1**	**36.7**	**39.1**	**36.3**	**40.7**	**36.3**	**40.9**	**41.0**
of which:								
- Primary expenditure	35.7	35.5	37.9	35.3	39.6	35.5	39.9	40.0
of which:								
Compensation of employees	9.0	8.8	8.8	8.4	8.7	8.2	8.4	8.4
Intermediate consumption	7.9	7.4	8.1	7.1	8.1	6.8	7.8	7.5
Social payments	12.8	12.5	12.1	12.4	12.2	12.4	11.9	11.5
Subsidies	0.9	0.9	1.4	0.9	1.5	0.9	1.7	1.8
Gross fixed capital formation	4.0	4.3	5.7	4.8	6.2	5.5	7.0	7.6
Other (residual)	1.1	1.6	1.7	1.7	3.0	1.7	3.1	3.1
- Interest expenditure	1.3	1.1	1.2	1.0	1.1	0.9	1.0	1.0
General government balance (GGB)	**3.2**	**3.0**	**3.1**	**3.1**	**3.0**	**3.1**	**3.0**	**3.0**
Primary balance	**4.6**	**4.1**	**4.3**	**4.1**	**4.0**	**4.0**	**4.0**	**4.0**
One-off and other temporary measures	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
GGB excl. one-offs	**3.2**	**2.9**	**3.1**	**3.1**	**3.0**	**3.1**	**3.0**	**3.0**
Output gap[2]	1.1	0.7	0.6	-0.1	0.0	-0.6	-0.4	-0.2
Cyclically-adjusted balance[2]	2.9	2.8	2.9	3.1	3.0	3.3	3.1	3.1
Structural balance[3]	**2.9**	**2.9**	**2.9**	**3.1**	**3.0**	**3.3**	**3.1**	**3.1**
Change in structural balance		*0.0*	*0.0*	*0.2*	*0.1*	*0.2*	*0.1*	*-0.1*
Structural primary balance[3]	4.2	4.0	4.1	4.1	4.1	4.2	4.1	4.1
Change in structural primary balance		*-0.2*	*-0.1*	*0.1*	*0.0*	*0.1*	*0.0*	*-0.1*

Notes:

[1]On a no-policy-change basis.

[2]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[3]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

As highlighted in Section 3, the macroeconomic scenario underlying the programme is based on broadly plausible assumptions, although slightly favourable especially towards the end of the programme period. Moreover, domestic and external macroeconomic imbalances entail certain risks to the macroeconomic scenario and thus to the budgetary projections in the programme. The sensitivity analysis carried out in the programme estimates a deterioration in the budgetary balance in 2008 of around ¼% of GDP as a result of a ½ pp. negative growth surprise. Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained ½ pp. deviation from the real GDP growth projections in the programme over the 2007-2010 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that by 2010, the cyclically-adjusted balance would be ¾ pp. of GDP below the central scenario. Hence, in the case of persistently lower real growth, additional measures of around ¾ pp. of GDP would be necessary to keep the public finances on the path targeted in the central scenario.

The programme describes in detail and provides sufficient information on the measures foreseen in 2008. The expected budgetary impact of the measures is clearly spelled out. The drop in social contributions and the increase in 'other expenditures' in 2008 are, however, not fully explained (see Section 4.2). The programme's revenue and expenditure targets for 2009 and 2010 are made under a no-policy change assumption. While the increase in 'other revenues' seems to be linked to higher EU transfers, the drop in tax revenue is not consistent with the underlying macroeconomic scenario and is not explained by any new measures.

Table 6: Assessment of tax projections

	2008			2009			2010
	CP	**COM**	**OECD**[3]	**CP**	**COM**[1]	**OECD**[3]	**CP**
Change in tax-to-GDP ratio (total taxes)	0.3	-0.1	0.0	-0.9	0.0	0.0	0.0
Difference (CP – COM)	0.5		/	-0.9		/	/
of which[2] *:*							
- discretionary and elasticity component	*0.2*		/	*-1.0*		/	/
- composition component	*0.5*		/	*0.1*		/	/
Difference (COM - OECD)	/	-0.1		/	0.0		/
of which[2] *:*							
- discretionary and elasticity component	/	*-0.5*		/	*-0.3*		/
- composition component	/	*0.5*		/	*0.4*		/
p.m.: Elasticity to GDP	1.1	1.0	1.0	0.8	1.0	1.0	1.0

Notes:

[1]On a no-policy change basis.

[2]The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small.

[3]OECD ex-ante elasticity relative to GDP.

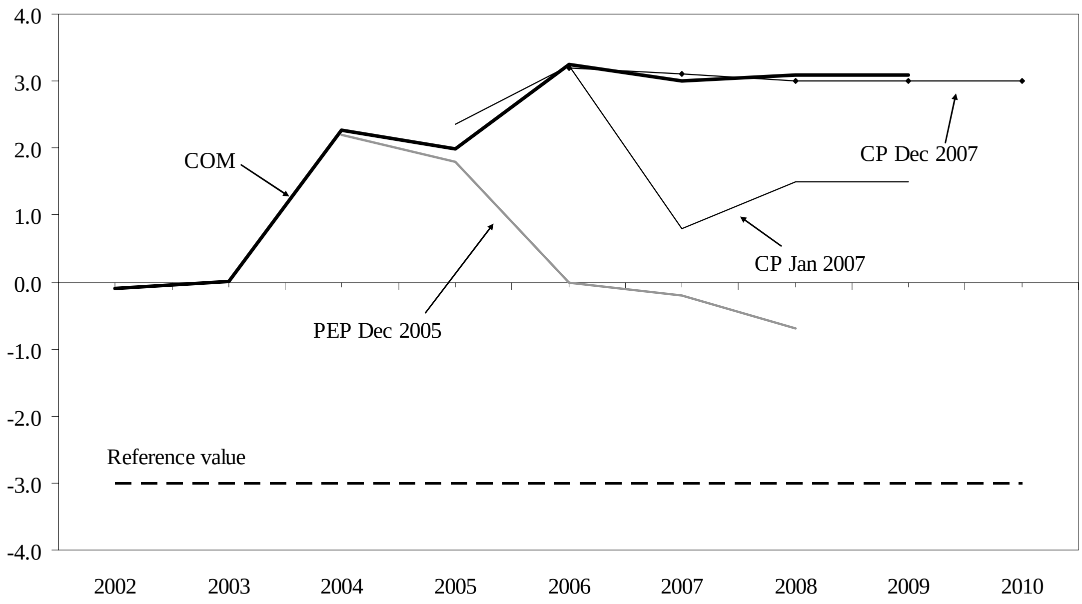
Source:

Commission services' autumn 2007 economic forecasts (COM); Convergence programme (CP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).

The programme does not rely on any one-off or other temporary measures to achieve the budgetary targets. On the revenue side, the projected increase in non-tax revenues throughout the programme period would more than compensate the drop in tax revenues and social contributions. Regarding the tax revenue projections, the programme is more optimistic about the tax intensity of economic activity in 2008 than the Commission services' autumn 2007 forecast, while it is very conservative compared to the Commission services' projections for 2009 (see Table 6). The overall difference in 2008 is due to a more favourable assumption about the composition of growth and to a more optimistic assumption on the impact from discretionary measures. With regards to direct taxes, the programme projects that the introduction of a 10% flat rate personal income tax in 2008 would have hardly any effect on tax revenues and that the tax-to-GDP ratio of this tax would actually increase. In the programme, this is explained by improvement in tax compliance resulting from expected further reduction in the informal economy and from suppression of existing tax breaks. Corporate income tax revenues as a share of

GDP are projected to go up due to discretionary measures, including improvements in the tax legislation and the administration of the tax collection procedure. The tax-to-GDP ratio of taxes on production and imports is anticipated to increase due to rising excise taxes on tobacco and fuel in line with the EU harmonization schedule. Regarding social contributions, the programme projects the tax-to-GDP ratio to drop by 1 pp. reflecting a strong negative impact from discretionary measures and elasticities and despite a more favourable assumption on the composition of growth. This points to a certain underestimation of social contributions in 2008 especially since there are certain revenue compensating measures implemented as well. Overall, the total revenue growth projections in 2008 appear to be more realistic than in previous years. However, while projections for social contributions may be on the cautious side, total revenue projections in 2008 are subject to certain risks stemming from the fact that the expected increase in the tax-to-GDP ratio is only partly explained by the assumed persistence of a very tax-rich growth composition, and in view of uncertainties linked to the introduction of the flat personal income tax rate. For 2009 and 2010 the projected reductions in the tax-to-GDP ratio are not fully consistent with the underlying growth scenario of the programme.

Figure 13: Government balance projections in successive programmes (% of GDP)



Note: PEP = pre-accession economic programme.

<u>Source</u>: Commission services' autumn 2007 forecast (COM) and successive pre-accession and convergence programmes

On the expenditure side, the programme projects an increase in the expenditure-to-GDP ratio compared to a slight drop in the Commission services' 2007 autumn forecast. The difference is primarily due to the assumed increase in 'other expenditures' in the programme. While the growth in 'other expenditures' partly reflects the adjustment to the expenditure contingency reserves the overall increase is not explained with relevant measures. The capital expenditure-to-GDP ratio is projected to grow substantially over the programme period relying on an efficient and smooth absorption of EU funds. The programme envisages continuing implementing the policy of maintaining fiscal buffers in the expenditures to ensure flexibility in meeting the budgetary targets (see Section 4.2.1). The 2008 Budget Law foresees the spending of ½% of GDP to be contingent on both (i) the expected general government surplus exceeding the budgeted target for 2008 and (ii) the approved central government budget balance not worsening. A similar rule (i.e. withholding the release of 10 percent of budgeted non-interest current expenditures) has been applied in the past several years, helping to achieve better budgetary outcomes than initially planned. However, in 2007 due to very buoyant revenue growth the rule has not been observed. On the whole, expenditure projections are broadly plausible and the budgeted contingency reserves provide some buffer for the budgetary targets to be realised.

Bulgaria's overall track record when it comes to respecting its budgetary targets is very good (see Figure 13 and Table 3). Better-than-planned budgetary outcomes have been a recurrent pattern in the past, reflecting traditionally very conservative revenue projections as well as maintaining buffers on the expenditure side providing for certain fiscal flexibility during the execution phase.

In summary, the programme envisages maintaining a broadly neutral fiscal stance throughout the whole programme period. The programme's budgetary projections are broadly plausible. For 2008 the revenue projections could be subject to some downside risks which, however, are neutralised by a very strong track record in meeting budgetary targets over the past several years and the envisaged expenditure buffer in the contingency reserves. For 2009 and 2010 the budgetary targets are in line with the Commission services' 2007 autumn forecast, although the projected reduction in the tax-to-GDP ratio is not fully consistent with the underlying growth scenario and the no-policy change assumption of the programme.

4.4. Assessment of the fiscal stance and budgetary strategy

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

Table 7: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with the targets taken at face value)	**Assessment** (taking into account risks to the targets)
a. Safety margin against breaching 3% of GDP deficit limit[1]	throughout programme period	throughout programme period
b. Achievement of the MTO	throughout programme period	throughout programme period
c. Fiscal stance in line with Pact[2]?	in line	in line

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a deficit of around 1¾% of GDP for Bulgaria). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in "good times".
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

The medium-term objective (MTO) presented in the programme has been revised from a balanced position in structural terms to a surplus of 1½% of GDP. Although the MTO endorsed by the Council in its opinion on the original programme was more demanding than required by the Pact, the upward revision is justified in the programme by the rising external imbalances, accelerating inflation and the projected population ageing impact.

In view of the risk assessment above, the budgetary stance in the programme implies that the new MTO is maintained by a large margin throughout the programme period.

The budgetary strategy thus provides for a wide margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. Taking into account the assessment of risks, the general government budget shows a cyclically-adjusted surplus of close to 3% of GDP over the whole programme period, which is well above the value of the minimum benchmark of a 1¾% of GDP cyclically-adjusted deficit.

The fiscal policy stance implied by the programme is in line with the Stability and Growth Pact throughout the period. The envisaged neutral fiscal stance would avoid adding to the existing domestic and external macroeconomic imbalances. Given the limited set of policy instruments available within the framework of the currency board, fully saving any revenue over-performance and maintaining expenditure control could help reduce imbalances.

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

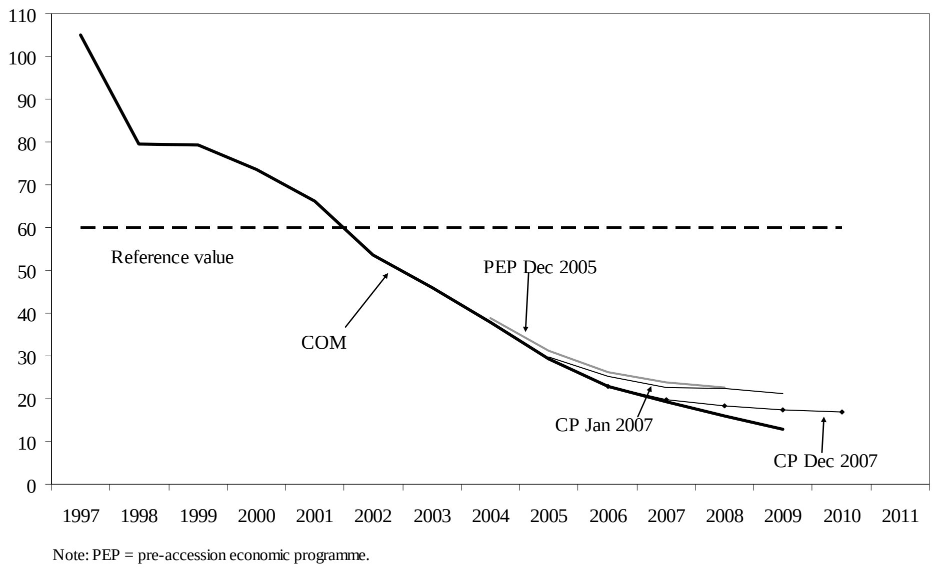
5.1.1. Debt projections in the programme

As a result mainly of high primary surpluses, strong nominal GDP growth and substantial privatisation revenues, the debt-to-GDP ratio decreased from over 100% in 1997 to around 22% in 2006 (see Figure 14). The programme projects a further reduction in general government debt, albeit at a declining rate, to below 17% in 2010 (see Table 8). In 2007, the debt-to-GDP ratio is projected to drop below 20%. This is below the original projections in the January 2007 programme, mainly because of the higher expected budget surplus.

Besides the reduction in the debt-to-GDP ratio, the Bulgarian government has accumulated a large stock of liquid assets, held in the form of a deposit with the central bank. This so-called ‘Fiscal Reserve Account’, which is held to guarantee the service of foreign debt, increased from close to 12% of GDP at the end of 2006 to almost 17% of the projected full-year GDP until the end of November 2007.

High primary surpluses and robust nominal GDP growth will remain the main factors behind the projected further debt reduction, while privatisation revenues are expected to become less and less important. Substantial debt-increasing stock-flow adjustments of around 3½% of GDP on average, reflecting a further accumulation of net financial assets mainly through the Fiscal Reserve Account, will limit the further reduction in gross general government debt.

Figure 14: Debt projections in successive programmes (% of GDP)



<u>Source</u>: Commission services' autumn 2007 forecast (COM) and successive pre-accession and convergence programmes

5.1.2. Assessment

The projections for the debt-to-GDP ratio in the programme appear broadly plausible. Differences to the Commission services' 2007 autumn forecast, especially for the period 2008-2010, reflect almost exclusively higher stock-flow adjustments which were not known at the cut-off date for the forecast. A somewhat stronger-than-projected reduction in the debt-to-GDP ratio in 2007 could be possible because of higher inflation and thus higher nominal GDP growth.

Regarding the structure of debt, the share of fixed-rate debt has increased from around 66% of total debt at the end of 2006 to over 69% at the end of November 2007. The share of debt denominated in Bulgarian lev has increased from around 17¾% of total debt at the end of 2006 to 21½% of total debt at the end of November 2007, while the share of euro-denominated debt remained relatively stable at around 53%. Slightly below 20% of the debt is held in USD, and around 5% in other currencies. The average residual maturity of outstanding domestic debt remained relatively stable since the end of 2006 at around 7 years and 3 months, while the average residual maturity of foreign debt increased from 8 years and 9 months at the end of 2006 to 9 years and four months.

Table 8: Debt dynamics

(% of GDP)	average 2002-05	2006	2007 COM	2007 CP	2008 COM	2008 CP	2009 COM	2009 CP	2010 CP
Gross debt ratio[1]	**41.7**	**22.8**	**19.3**	**19.8**	**15.9**	**18.3**	**12.9**	**17.4**	**16.9**
Change in the ratio	-9.2	-6.4	-3.5	-3.0	-3.4	-1.5	-3.0	-0.9	-0.5
Contributions[2] *:*									
Primary balance	**-3.0**	**-4.6**	**-4.1**	**-4.3**	**-4.1**	**-4.0**	**-4.0**	**-4.0**	**-4.0**
“Snow-ball” effect	**-2.3**	**-2.3**	**-1.6**	**-1.1**	**-1.3**	**-1.1**	**-0.8**	**-0.8**	**-0.6**
Of which:									
Interest expenditure	1.9	1.3	1.1	1.2	1.0	1.0	0.9	1.0	1.0
Growth effect	-2.5	-1.6	-1.3	-1.3	-1.0	-1.1	-0.9	-1.1	-1.1
Inflation effect	-1.7	-2.1	-1.5	-1.0	-1.3	-1.0	-0.8	-0.6	-0.5
Stock-flow adjustment	**-3.8**	**0.6**	**2.3**	**2.5**	**2.0**	**3.7**	**1.8**	**3.9**	**4.1**
Of which:									
Cash/accruals diff.	0.5	-0.3		0.0		0.0		0.0	0.0
Acc. financial assets	-1.9	1.6		2.5		1.3		2.2	2.8
Privatisation	*-3.1*	*-1.4*		*-0.5*		*-0.3*		*-0.1*	*-0.1*
Val. effect & residual	-2.3	-0.8		0.0		0.0		0.0	0.0

Notes:

[1]End of period.

[2]The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Convergence programme (CP); Commission services’ autumn 2007 economic forecasts (COM); Commission services’ calculations

5.2. Long-term debt projections and the sustainability of public finances

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

5.2.1. Sustainability indicators and long-term debt projections

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 25 Member States, for which the projections on this basis are available.

Table 9 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the 2007/08 convergence programme.

Table 9: Long-term age-related expenditure: main projections

(% of GDP)	2005	2010	2020	2030	2050	Change 2010-50
Total age-related spending	17.5	16.8	15.1	15.1	17.0	+0.2

- Pensions	8.6	8.2	6.9	6.7	8.2	0.0
- Healthcare	4.7	4.3	4.2	4.3	4.8	+0.5
- Long-term care	-	-	-	-	-	-
- Education	4.2	4.3	4.0	4.1	4.0	-0.3
- Unemployment benefits	-	-	-	-	-	-
Property income received	1.3	1.4	1.4	1.4	1.4	0.0
Source: 2007/08 convergence programme of Bulgaria						

According to the convergence programme, age-related spending is projected to remain broadly constant as a share of GDP between 2010 and 2050, to be compared with an increase of around 2.5% of GDP between those two dates for the average of the EU.

The increase in expenditure on pensions is projected to be relatively limited up to 2050. Health-care expenditure is projected to increase by around ½% of GDP over the long term between 2010 and 2050, below the average increase for EU10 Member States (+1.0% of GDP) and education expenditure is projected to decrease by 0.3 pp., below the average decrease in EU10 Member States (-0.5% of GDP).

Table 10: Sustainability indicators and the required primary balance

	2007 scenario			Programme scenario		
	S1	**S2**	**RPB**	**S1**	**S2**	**RPB**
Value	-6.0	-4.5	0.1	-6.0	-4.5	0.1
of which:						
Initial budgetary position (IBP)	-4.0	-3.9		-4.0	-3.9	
Debt requirement in 2050 (DR)	-0.8			-0.8		
Long-term change in the primary balance (LTC)	-1.2	-0.7		-1.2	-0.7	
Source: Commission services.						

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 10 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained. In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be -4½% of GDP.[11] The results are close to last year's assessment.[12]

The initial strong budgetary position with a structural primary balance of 4.1% of GDP contributes to the reduction of gross debt and the accumulation of financial assets. According to both sustainability gaps, the long-term budgetary impact of ageing is negative.

The 2007 convergence programme plans to maintain a strong 2007 primary surplus of 4.1% of GDP over the programme period, leaving unchanged the sustainability gap of the 2007 scenario.

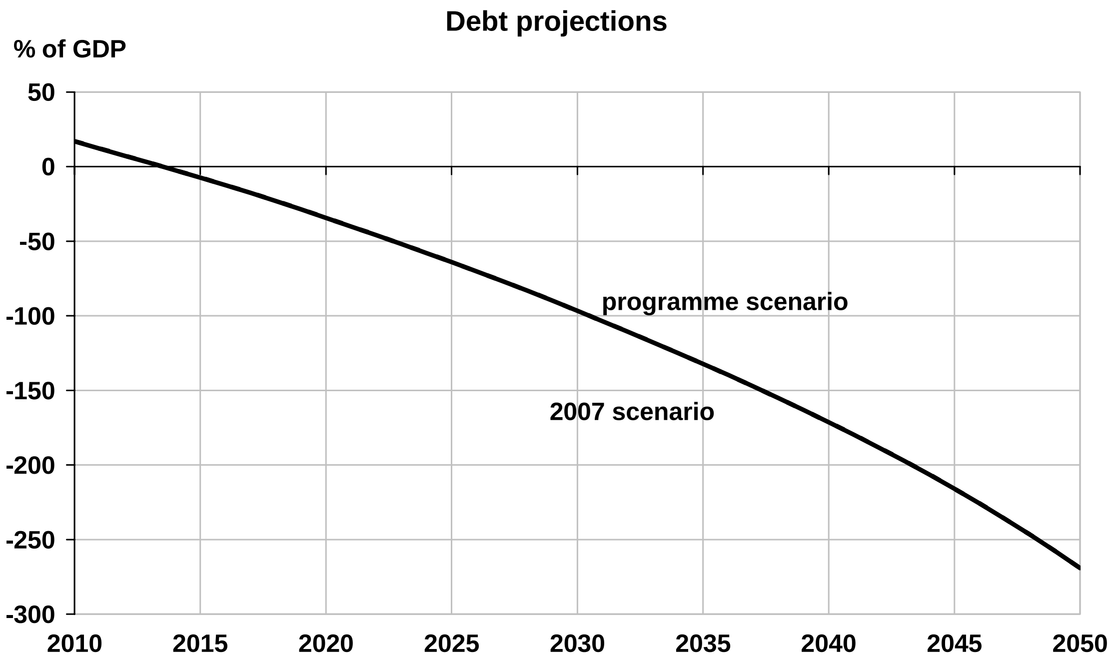
[11] The sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be -6.0% of GDP.

[12] While remaining highly negative, the sustainability gap is 0.7% of GDP higher compared to last year's assessment. The structural primary balance was estimated to be 4.7% of GDP in 2006 in the convergence programme assessment of last year and is estimated to be 4.1% of GDP in 2007 in this year's assessment.

The required primary balance (RPB) is close to balance, reflecting the low ageing cost according to the programme and the low level of debt.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 15. The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at 20% of GDP in 2007. In both the "2007 scenario" and the "programme scenario", the debt ratio is projected to decrease substantially over the projection period.

Figure 15: Long-term projections for the government debt ratio



Source: Commission services

5.2.2. Additional factors

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, the current level of debt is very low in Bulgaria at around 20% of GDP; maintaining a low level of debt, in line with the budgetary plans of the convergence programme, would contribute to containing the risks to the long-term sustainability of public finances.

Second, the programme presents long-term pension projections, on the basis of the current indexation rules as stated in the law. However, pensions have recently benefited from higher indexation than implied by the legislated indexation formula (10% in July 2007 and another 10% in October 2007 as compared to the 8.5% increase). If such hikes were to pertain over the medium and long term, they could imply significantly higher pension expenditure than projected in the programme.

5.2.3. *Assessment*

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 25 Member States, for which the projections on this basis are available.

While a significant impact of ageing on expenditure cannot be excluded given the current demographic structure, the budgetary position in 2007, with a large structural surplus, contributes significantly to reducing the already low level of debt. Maintaining high primary surpluses over the medium-term would contribute to limiting risks to the sustainability of public finances.

6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

Improving the quality of public finances and structural reform was identified in Section 2 as an important element in addressing the macroeconomic challenges Bulgaria is currently facing through i) improving the composition and efficiency of public spending to boost productivity and potential growth, ii) providing better incentives for labour market participation to tackle labour shortages, and iii) education reform to close skills gaps. The programme envisages a number of measures in these areas, which, in most cases and if fully implemented, can be considered as useful steps in the right direction.

On the revenue side, the introduction of the flat rate personal income tax from 1 January 2008 replaces the current system of progressive income tax brackets (with tax rates ranging from 0% for the part of the monthly income below EUR 102 to 24% for the part of the income exceeding EUR 306) with a uniform 10% rate. This 10% rate also applies to the part of income under EUR 102 which so far was tax free. Moreover, a number of tax breaks including for example family taxation are also abolished. This reform continues the efforts of the Bulgarian authorities to simplify the tax system and to reduce rates on direct taxes to improve incentives for job creation, investment and reducing the informal economy. The reduction of the tax rate for higher income groups provides incentives to declare incomes more accurately and may thus help reduce the size of the grey economy. However, the increase in average and marginal tax rates for low- and medium income groups might actually reduce incentives for labour market participation for unskilled and low-skilled workers. In addition, given the negative impact of the introduction of the flat rate personal income tax on lower-income groups a number of compensating measures have been adopted. These include an increase in the minimum wage by over 20% from 1 January 2008 and wage increases for public sector employees and, through collective agreements, private sector employees who are negatively affected by the introduction of the flat rate personal income tax. These compensating measures clearly add to existing wage pressures and risk undermining competitiveness especially in labour-intensive, low value-added sectors.

The further reduction of social contributions from 1 October 2007 (1 pp. on pension contributions, 2 pps. on unemployment contributions) is a welcome step to reduce the still relatively high non-wage labour costs, accompanied by measures to broaden the contribution base and thus to limit the negative fiscal impact.

On the expenditure side, the programme envisages further improvements in the composition of public spending, notably by increasing the share of investment expenditures mainly in the areas of transport and environment. Another spending priority is education, with expenditures envisaged to increase noticeably in nominal terms (and slightly as a share of GDP) despite a projected reduction in the number of students. Efforts to reduce the size of public sector employment will also continue with an announced 12% cut in the number of staff in 2008 which should help contain the government wage bill. While savings are expected to come mainly from lower maintenance expenditures, this may not be fully consistent with the planned increase in infrastructure investment which will have to be properly maintained.

Given the envisaged increase in spending on infrastructure and the aim to contain the overall size of the public sector, increased attention will have to be paid to improving the efficiency and effectiveness of public spending. A number of measures in this direction are mentioned in the programme. In particular, programme budgeting which so far has been introduced only on a pilot basis is to be developed further. With the 2008 Budget Law, budget allocations have been more clearly linked to policy priorities. However, in order to fully implement programme budgeting, further legislative and administrative steps are needed. A new Organic Budget Law defining budgetary procedures and the structure of the state budget is still under preparation. Moreover, the administrative capacity to actually apply programme budgeting at all levels of government still has to be built up. Appropriate structures and information systems also need to be developed to allow for reporting of the budget execution on a programme basis and to improve financial accountability. Expenditure reviews which are scheduled to be carried out over the next three years in key sectors, including healthcare, education and justice and internal affairs, may help identify ways for improving the efficiency of public spending in a systematic way.

Regarding fiscal rules and institutions, the annual budget process is in principle integrated in a multi-annual perspective through the elaboration of a three-year medium-term fiscal framework. The fact that this procedure was not strictly followed in the preparation of the 2008 budget underscores the scope for strengthening and further developing a comprehensive and binding multi-annual budgetary framework. Replacing the so-called ‘90%-rule’, which made the release of part of the budget allocations dependent on the fulfilment of certain budgetary or economic conditions, with a contingency reserve could ensure a more efficient budget execution. In particular, it may help avoid large, discretionary spending sprees at the end of year as they have been a recurrent phenomenon in recent years. However, clearer rules on the conditions for the use of this reserve would have been important to improve predictability and transparency of budget execution. The 2008 Budget Law foresees that up to 50% of any revenue over-performance may be used by the government for additional budget allocations without parliamentary approval. Apart from the fact that fully saving any revenue over-performance would be important to contain domestic demand pressures, this rule is also potentially contradictory to provisions in the Organic Budget Law that limit increases in budget allocations without parliamentary approval to 1½% of projected revenues. It effectively runs against the idea of reducing the leeway for discretionary government spending to improve transparency and accountability of budget execution. Efforts to further improve revenue collection and administration in the National Revenue Agency and the Customs Agency will continue. The process of fiscal decentralisation has progressed with changes in the constitution but is still at an early stage. From 2008, greater powers are given to municipalities to set tax rates and administrative fees. In addition, the patent tax will in the future accrue to municipalities. In line with this increased decentralisation, administrative capacity for budget management at municipal level will have to be strengthened.

Regarding structural reforms, further steps are envisaged in the implementation of the education reform strategy. In 2007, a so-called uniform standard has been introduced, linking the financing of schools directly to the number of pupils. According to the programme, this is to be followed up with the introduction of fully delegated budgets and an optimisation of the school network. Associated efficiency gains and increased budget allocations are supposed to be used to improve the quality of education, for example through better equipment or through better training of teachers, but also to increase the remuneration of teachers. While the reform of primary and secondary education is thus advancing, steps to improve higher education and vocational education and training would be important to address more directly skills gaps in the labour market.

Regarding healthcare, the programme highlights that "the incomplete reforms in the sector as well as the allocation of resources without binding it to the achievement of a certain level of quality of services" is one of the main risks for the budget. It envisages that the annual financing gap of the National Health Insurance Fund will persist over the whole programme period. While expenditures on healthcare in Bulgaria as a share of GDP are comparable to those in other recently acceded member states, there are widespread problems in the quality of the services provided, in the access to healthcare and in ensuring effective monitoring and control of spending. Following repeated delays, a draft health reform strategy has been elaborated in 2007 but has still not been approved by government.

Regarding pensions, contributions to the public pension scheme were reduced by 1 pp. from 1 October 2007. In 2007, a special pension reserve fund has been capitalised through a general government transfer, even though the accompanying legislation still needs to be adopted. According to the programme, the implementation of the 2000 pension reform will continue with a further shift of the social security burden from employers to employees (lowering the employers' share to 60% in 2008, 55% in 2009 and 50% in 2010). No additional reform measures are envisaged in the programme. As outlined in the programme, the pension system continues to run deficits which have to be covered by central government transfers (around 3% of GDP in 2007). The indexation formula in place for adjusting pensions has repeatedly not been applied. As in previous years, additional discretionary pension increases were adopted in 2007. Pensions were thus raised by 10% on 1 July, instead of the 8½% implied by the indexation formula, and by a further 10% on 1 October. If continued, this practice of discretionary pension increases will add to fiscal pressures and weaken the sustainability of public finances.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

In the macroeconomic and fiscal area, the March 2007 National Reform Programme and the October 2007 implementation report focus on maintaining high budgetary surpluses and avoiding pro-cyclical fiscal policy to contain external and internal imbalances, on improving the quality of public expenditure and on strengthening the long-term sustainability of public finances, especially through measures in the areas of pension and health. This is in line with the priorities and measures identified in the December 2007 convergence programme. In particular, the budgetary strategy outlined in the update of the convergence programme and the measures envisaged to promote the quality of public expenditures through programme budgeting and expenditure reviews are fully aligned with the NRP.

The update does not contain a systematic qualitative assessment of the overall impact of the National Reform Programme within the medium term fiscal strategy, even though the expected impact of individual measures especially in the areas of better regulation, education and labour market policy on growth and employment is highlighted.

The budgetary projections in the programme seem to take into account the public finance implications of the reforms envisaged in the NRP and in the implementation report. This concerns in particular the planned increase in infrastructure investments. However, the update does not contain any systematic information on the direct budgetary costs of key reform measures envisaged in the NRP, such as those linked to strengthening administrative capacity or active labour market policy.

Overall, taking into account the analysis provided in the NRP and the October 2007 implementation report as well as the December 2007 convergence programme, the two programmes seem to be broadly consistent.

Box 5: The Commission assessment of the March 2007 national reform programme and the October 2007 implementation report

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Bulgaria's national reform programme[13], and is summarised as follows.

Bulgaria's national reform programme identifies as key priorities maintaining macro-economic stability; infrastructure; improving the business environment; improving the quality of human capital; activating labour supply and improving administrative capacity.

Against the background of strengths and weaknesses identified, the Commission recommends that Bulgaria is recommended to take action in the areas of: administrative capacity; macroeconomic stability; cutting red tape and improving the business environment; and active labour market policies and education reform.

The Commission also recommends that Bulgaria is encouraged to focus on the areas of: long-term sustainability of public finances; competition in network industries; R&D and innovation; undeclared work; and lifelong learning.

The table below provides an overview of whether the strategy and policy measures in the convergence programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs, in particular the integrated guidelines for the period 2005-2008, adopted by the Council in July 2005.

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[13] Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM (2007)803.

Table 11: Consistency with the broad economic policy guidelines (integrated guidelines)

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
1. To secure economic stability				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it[1].	X			
– Member States should avoid pro-cyclical fiscal policies[2].	X			
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits[3].				X
– Member States posting current account deficits that risk being unsustainable should work towards (…), where appropriate, contributing to their correction via fiscal policies.		X		
2. To safeguard economic and fiscal sustainability In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (…)		X		
3. To promote a growth- and employment-orientated and efficient allocation of resources				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X		

Notes:
[1]As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.
[2]As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in "good times".
[3]As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.

Source:
Commission services

* * *

Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

(i) Model structure

The programme closely follows the model structure in Annex 1 of the code of conduct.

(ii) Data requirements

The programme provides almost all compulsory and most of the optional data prescribed by the code of conduct as amended by the September 2007 EFC. Regarding compulsory data, information on one-off measures in 2007 is not included. Regarding optional data, in Table 4 no information on liquid financial assets and net financial debt is provided. In Table 7, data on occupational pensions, long-term care, and pension reserve fund assets is missing.

The tables on the following pages show the data presented in the December 2007 update of the convergence programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

(iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct.

The SCP…	Yes	No	Comments
a. Involvement of parliament			
… mentions status vis-à-vis national parliament.		X	
… indicates whether Council opinion on previous programme has been presented to national parliament.		X	
b. Economic outlook			
… (for euro area and ERM II Member States) uses "common external assumptions" on main extra-EU variables.			Not applicable
… explains significant divergences with Commission services' forecasts[1].	X		
… bears out possible upside/downside risks to economic outlook.	X		
… analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
c. Monetary/exchange rate policy			
… (CP only) presents medium-term monetary policy objectives and their relationship to price and exchange rate stability.	X		
d. Budgetary strategy			
… presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
… (in case new government has taken office) shows continuity with respect to budgetary targets endorsed by Council.			Not applicable
… (when applicable) explains reasons for deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify situation (+ provides information on them).	X		
… backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
… specifies state of implementation of measures.	X		
e. "Major structural reforms"			
… (if MTO not yet reached or temporary deviation is planned from MTO) includes comprehensive information on economic and budgetary effects of possible 'major structural reforms' over time.			Not applicable
… includes quantitative cost-benefit analysis of short-term costs and long-term benefits of reforms.			Not applicable

The SCP…	Yes	No	Comments
f. Sensitivity analysis			
… includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions c) (for CP only) different exchange rate assumptions d) if common external assumptions are not used, changes in assumptions for main extra-EU variables.	X		
… (in case of "major structural reforms") analyses how changes in assumptions would affect budget and potential growth.			Not applicable
g. Broad economic policy guidelines			
… provides information on consistency with broad economic policy guidelines of budgetary objectives and measures to achieve them.		X	
h. Quality of public finances			
… describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
i. Long-term sustainability			
… outlines strategies to ensure sustainability.		X	
… includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).			Not applicable
j. Other information (optional)			
… includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		

Notes: SCP = stability/convergence programme; CP = convergence programme
[1]To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.

Source:
Commission services

Table 1a. Macroeconomic prospects

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. Real GDP	B1*g	*25100*	6.1	6.4	6.4	6.8	6.9
2. Nominal GDP	B1*g	*25100*	14.7	11.8	12.5	10.9	10.3
Components of real GDP							
3. Private consumption expenditure	P.3	*17362*	7.5	7.1	6.0	6.9	6.4
4. Government consumption expenditure	P.3	*4365*	2.4	0.9	6.2	2.9	4.6
5. Gross fixed capital formation	P.51	*6585*	17.6	26.1	18.3	13.5	12.7
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53	*5.69*	1.9	0.3	-0.2	-0.4	-0.4
7. Exports of goods and services	P.6	*16065*	9.0	8.7	9.0	11.2	11.6
8. Imports of goods and services	P.7	*-20830*	15.2	13.6	11.7	11.1	11.1
Contributions to real GDP growth							
9. Final domestic demand		-	9.9	11.9	10.8	9.6	9.3
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	1.9	0.7	0.2	0.0	-0.1
11. External balance of goods and services	B.11	-	-6.2	-5.7	-4.5	-2.8	-2.3

Table 1b. Price developments

	ESA Code	2006 Level	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change
1. GDP deflator		*100*	8.1	5.0	5.7	3.8	3.2
2. Private consumption deflator		*100*	5.2	6.2	7.0	3.6	3.0
3. HICP[1]		*100*	7.4	7.2	6.9	4.4	3.7
4. Public consumption deflator		*100*	8.2	8.1	9.0	5.2	4.2
5. Investment deflator		*100*	7.3	2.3	-1.3	-0.4	0.7
6. Export price deflator (goods and services)		*100*	11.9	4.4	2.4	3.0	3.2
7. Import price deflator (goods and services)		*100*	8.2	4.9	1.9	1.5	2.2

[1] Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons[1]		*3579.5*	2.4	1.6	1.1	0.6	0.2
2. Employment, hours worked[2]		*5953.8*	2.7	1.8	1.3	0.8	0.4
3. Unemployment rate (%)[3]		*9.0*	-1.1	7.2	6.8	6.5	6.4
4. Labour productivity, persons[4]		*7012*	3.6	4.7	5.3	6.1	6.6
5. Labour productivity, hours worked[5]		*4215.7*	3.3	4.5	5.1	5.9	6.5
6. Compensation of employees	D.1	*8082045*	10.9	18.1	15.9	12.3	10.9
7. Compensation per employee		*3126.3*	8.2	16.0	14.5	11.5	10.5

[1]Occupied population, domestic concept national accounts definition.

[2]National accounts definition.

[3]Harmonised definition, Eurostat; levels.

[4]Real GDP per person employed.

[5]Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	-15.0	-19.9	-20.7	-19.5	-18.6
of which :						
- Balance on goods and services		-18.7	-23.5	-25.1	-24.6	-24.3
- Balance of primary incomes and transfers		3.0	2.5	3.2	3.4	3.3
- Capital account		0.7	1.1	1.2	1.6	2.4
2. Net lending/borrowing of the private sector	B.9	-18.2	-23.0	-23.7	-22.5	-21.6
3. Net lending/borrowing of general government	EDP B.9	3.2	3.1	3.0	3.0	3.0
4. Statistical discrepancy		n.a.	optional	optional	optional	optional

Table 2. General government budgetary prospects

	ESA Code	2006 Level	2006 % of GDP	2007 % of GDP	2008 % of GDP	2009 % of GDP	2010 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	*814*	3.2	3.1	3.0	3.0	3.0
2. Central government	S.1311	*883.8*	3.5	3.3	3.0	3.0	3.0
3. State government	S.1312	*n.a.*	n.a.	n.a.	n.a.	n.a.	n.a.
4. Local government	S.1313	*52.2*	0.2	-0.4	0.0	0.0	0.0
5. Social security funds	S.1314	*-122*	-0.5	0.1	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	*10 113.8*	40.3	42.2	43.7	43.9	43.9
7. Total expenditure	TE[1]	*9 299.8*	37.1	39.1	40.7	40.9	41.0
8. Net lending/borrowing	EDP B.9	*814*	3.2	3.1	3.0	3.0	3.0
9. Interest expenditure	EDP D.41	*329.9*	1.3	1.2	1.1	1.0	1.0
10. Primary balance[2]		*1 143.9*	4.6	4.3	4.0	4.0	4.0
11. One-off and other temporary measures[3]		*0*	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		*6 605.8*	26.3	26.8	28.0	27.5	27.5
12a. Taxes on production and imports	D.2	*4 872.6*	19.4	19.6	20.2	19.8	19.8
12b. Current taxes on income, wealth, etc	D.5	*1 625.4*	6.5	6.6	7.3	7.1	7.1
12c. Capital taxes	D.91	*107.8*	0.4	0.6	0.6	0.6	0.6
13. Social contributions	D.61	*2 203.2*	8.8	8.8	7.8	7.6	7.6
14. Property income	D.4	*317.8*	1.3	1.3	1.0	1.0	1.0
15. Other[4]		*987.1*	3.9	5.3	6.8	7.8	7.9
16=6. Total revenue	TR	*10 113.8*	40.3	42.2	43.7	43.9	43.9
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)[5]			34.4	35.1	35.8	35.1	35.1
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	*4 260.6*	17.0	16.8	16.8	16.2	15.9
17a. Compensation of employees	D.1	*2 269.5*	9.0	8.8	8.7	8.4	8.4
17b. Intermediate consumption	P.2	*1 991.1*	7.9	8.1	8.1	7.8	7.5
18. Social payments (18=18a+18b)		*3 201.0*	12.8	12.1	12.2	11.9	11.5
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	*317.2*	1.3	1.0	1.1	1.0	1.0
18b. Social transfers other than in kind	D.62	*2 883.7*	11.5	11.2	11.1	10.9	10.5
19=9. Interest expenditure	EDP D.41	*329.9*	1.3	1.2	1.1	1.0	1.0
20. Subsidies	D.3	*237.7*	0.9	1.4	1.5	1.7	1.8
21. Gross fixed capital formation	P.51	*1 001.7*	4.0	5.7	6.2	7.0	7.6
22. Other[6]		*269*	1.1	1.7	3.0	3.1	3.1
23=7. Total expenditure	TE[1]	*9 299.8*	37.1	39.1	40.7	40.9	41.0
p.m.: Government consumption (nominal)	P.3	*4 403.7*	17.5	17.0	17.5	17.0	16.9

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

[2]The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).

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

[4] P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).

[5]Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

[6] D.29+D4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2005	2010
1. General public services	1	3.0	3.2
2. Defence	2	2.2	2.0
3. Public order and safety	3	2.7	2.8
4. Economic affairs	4	4.7	6.5
5. Environmental protection	5	1.2	1.6
6. Housing and community amenities	6	0.5	1.3
7. Health	7	4.7	4.3
8. Recreation, culture and religion	8	0.8	0.7
9. Education	9	4.2	4.3
10. Social protection	10	13.0	12.2
11. Total expenditure (=item 7=23 in Table 2)	TE[1]	39.6	41.0

[1]Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4. General government debt developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Gross debt[1]		22.8	19.8	18.3	17.4	16.9
2. Change in gross debt ratio		-6.4	-3.0	-1.6	-0.9	-0.4
Contributions to changes in gross debt						
3. Primary balance[2]		4.6	4.3	4.1	4.0	4.0
4. Interest expenditure[3]	EDP D.41	1.3	1.2	1.1	1.0	1.0
5. Stock-flow adjustment		0.4	2.5	1.3	2.2	2.8
of which:						
- Differences between cash and accruals[4]		0.0	0.0	0.0	0.0	0.0
- Net accumulation of financial assets[5]		2.4	2.5	1.3	2.2	2.8
of which:						
- privatisation proceeds		1.5	0.5	0.3	0.1	0.1
- Valuation effects and other[6]		-2.0	0.0	0.0	0.0	0.0
p.m.: Implicit interest rate on debt[7]		5.2	6.0	6.1	6.4	6.6
Other relevant variables						
6. Liquid financial assets[8]		n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.

[1]As defined in Regulation 3605/93 (not an ESA concept).

[2]Cf. item 10 in Table 2.

[3]Cf. item 9 in Table 2.

[4]The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

[5]Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

[6]Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

[7]Proxied by interest expenditure divided by the debt level of the previous year.

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

Table 5. Cyclical developments

% of GDP	ESA Code	2006	2007	2008	2009	2010
1. Real GDP growth (%)		6.1	6.4	6.4	6.8	6.9
2. Net lending of general government	EDP B.9	3.2	3.1	3.0	3.0	3.0
3. Interest expenditure	EDP D.41	1.3	1.2	1.1	1.0	1.0
4. One-off and other temporary measures[1]		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		5.1	6.5	6.6	7.1	7.5
contributions:						
- labour		1.2	1.9	1.2	1.0	0.9
- capital		2.1	2.8	3.3	3.5	3.6
- total factor productivity		1.8	1.8	2.2	2.6	3.0
6. Output gap		0.9	0.8	0.6	0.4	-0.2
7. Cyclical budgetary component		0.3	0.3	0.2	0.1	-0.1
8. Cyclically-adjusted balance (2 - 7)		2.9	2.8	2.8	2.9	3.1
9. Cyclically-adjusted primary balance (8 + 3)		4.2	4.0	3.9	3.9	4.1
10. Structural balance (8 - 4)		2.9	2.8	2.8	2.9	3.1

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

Table 6. Divergence from previous update

	ESA Code	2006	2007	2008	2009	2010
Real GDP growth (%)						
Previous update		5.9	5.9	6.2	6.1	n.a.
Current update		6.1	6.4	6.4	6.8	6.9
Difference		0.2	0.5	0.2	0.7	n.a.
General government net lending (% of GDP)	EDP B.9					
Previous update		3.2	2.0	1.5	1.5	n.a.
Current update		3.2	3.1	3.0	3.0	3.0
Difference		0.0	1.1	1.5	1.5	n.a.
General government gross debt (% of GDP)						
Previous update		25.3	22.7	22.3	21.1	n.a.
Current update		22.8	19.8	18.3	17.4	16.9
Difference		-2.5	-2.9	-4.0	-3.7	n.a.

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure	42.4	39.6	41.0	38.7	38.7	40.4
Of which: age-related expenditures	17.4	17.7	17.0	15.2	15.2	17.1
Pension expenditure	9.3	8.6	8.2	6.9	6.7	8.2
Social security pension	0.6	0.4	0.3	0.2	0.2	0.2
Old-age and early pensions	8.0	6.8	6.5	5.6	5.6	7.2
Other pensions (disability, survivors)	0.7	1.4	1.4	1.1	0.9	0.8
Occupational pensions (if in general government)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Health care	3.3	4.7	4.3	4.2	4.3	4.8
Long-term care *(this was earlier included in the health care)*	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Education expenditure	4.2	4.2	4.3	4.0	4.1	4.0
Other age-related expenditures	0.6	0.2	0.1	0.1	0.1	0.1
Interest expenditure	4.0	1.6	1.0	0.5	0.5	0.3
Total revenue	41.4	41.6	43.9	43.9	43.7	43.5
Of which: property income	1.6	1.3	1.4	1.4	1.4	1.4
Of which : from pensions contributions (or social contributions if appropriate)	8.3	8.1	6.1	6.1	5.8	5.7
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Assumptions						
Labour productivity growth	8.4	5.8	6.4	4.3	2.7	1.1
Real GDP growth	5.4	6.2	6.9	3.4	1.9	0.1
Participation rate males (aged 20-64)	73.4	74.2	79.1	82.8	83.7	85.8
Participation rates females (aged 20-64)	61.0	63.1	69.4	73.3	74.0	74.2
Total participation rates (aged 20-64)	67.1	68.6	74.2	78.0	78.9	80.0
Unemployment rate	16.2	10.1	6.5	5.8	5.0	5.0
Population aged 65+ over total population	16.5	16.8	17.6	20.1	21.6	26.0

Table 8. Basic assumptions

	2006	2007	2008	2009	2010
Short-term interest rate[1] (annual average)	5.3	5.3	4.8	4.6	4.8
Long-term interest rate (annual average)	3.8	4.3	4.4	4.5	4.5
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.25	1.36	1.40	1.38	1.35
Nominal effective exchange rate	-0.1	0.5	0.2	0.2	0.2
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	2.0	2.0	2.0	2.0	2.0
World excluding EU, GDP growth	5.5	5.1	5.0	5.0	5.0
EU GDP growth	3.0	2.7	2.6	2.6	2.6
Growth of relevant foreign markets	8.7	7.4	6.7	8.5	8.5
World import volumes, excluding EU	8.4	7.8	7.1	7.7	7.7
Oil prices (Brent, USD/barrel)	64.3	68.1	70.3	68.0	67.0

[1]If necessary, purely technical assumptions.

Annex 2: Key indicators of past economic performance

This annex displays key indicators that summarise the past economic performance of Bulgaria. To put the country's performance into perspective, right-hand side of the table displays the same set of indicators for the recently acceded Member States (EU12).

Table: Key economic indicators

	Bulgaria						Recently acceded Member States					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
Economic activity												
Real GDP (% change)	2.3	-0.7	5.3	6.2	6.1	6.3	3.8	3.6	4.1	4.8	6.3	6.0
Contributions to real GDP growth:												
Domestic demand	*4.9*	*1.3*	*8.5*	*11.4*	*12.4*	*12.0*	*4.4*	*4.6*	*4.1*	*4.1*	*7.3*	*7.8*
Net exports	*-2.5*	*-2.0*	*-3.0*	*-4.1*	*-6.2*	*-5.7*	*-0.5*	*-1.0*	*-0.1*	*0.8*	*-0.9*	*-1.8*
Real GDP per capita (PPS; EU27 = 100)	30	27	32	35	36	38	47	45	49	52	54	56
Real GDP per capita (% change)	3.2	0.0	6.4	6.8	6.6	6.8	4.1	3.8	4.4	4.9	6.4	6.1
Prices, costs and labour market												
HICP inflation (%)	7.4	10.5	5.5	6.0	7.4	7.1	7.8	12.9	5.7	3.8	3.4	4.0
Labour productivity (% change)	1.6	-0.4	3.7	3.5	3.6	4.0	4.2	4.3	4.1	3.3	3.6	3.5
Real unit labour costs (% change)	-2.5	-4.3	-0.8	-1.3	-3.4	2.8	-1.3	-1.4	-1.3	-0.6	-1.5	0.4
Employment (% change)	0.7	-0.2	1.5	2.7	2.4	2.2	-0.3	-0.6	0.0	1.4	2.6	2.4
Unemployment rate (% of labour force)	14.8	15.0	14.7	10.1	9.0	7.5	11.3	9.7	12.9	11.9	9.9	7.8
Competitiveness and external position												
Real effective exchange rate (% change)	1.8	1.1	2.5	-1.2	3.6	8.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change)[1]	1.4	-2.6	5.3	3.0	0.7	0.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-3.6	-1.1	-6.2	-10.8	-15.0	-17.0	-4.5	-4.8	-4.3	-4.3	-5.0	-6.1
Public finances												
General government balance (% of GDP)	0.9	1.0	0.9	2.0	3.2	3.0	-4.2	-3.8	-4.4	-3.5	-3.3	-2.7
General government gross debt (% of GDP)	63.4	84.4	46.6	29.2	22.8	19.3	37.7	35.4	39.0	39.6	38.8	37.9
Structural balance (% of GDP)[2]	n.a.	n.a.	1.1	1.4	2.7	2.5	n.a.	n.a.	-3.8	-3.3	-3.6	-3.0
Financial indicators												
Short-term real interest rate (%)[3]	-1.9	-4.8	-0.1	-0.1	-4.1	-2.8	3.9	6.3	2.9	1.4	1.0	0.5
Long-term real interest rate (%)[3]	2.2	n.a.	2.2	0.1	-3.6	-2.6	n.a.	n.a.	n.a.	n.a.	1.6	1.1

Notes:
[1]Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.
[2]Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003.
[3]Using GDP deflator.

Source :
Commission services