COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.2.2008
SEC(2008) 180 final

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Bulgaria, 2007-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

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

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first convergence programme of Bulgaria was submitted in January 2007. In accordance with the Regulation, the Council delivered an opinion on it on 27 March 2007 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Bulgaria, submitted on 7 December 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the January 2007 convergence programme);

(2) the Commission's assessment of the March 2007 national reform programme and the October 2007 implementation report.

1 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The assessment in the Council opinion on the previous programme

In its opinion of 27 March 2007, the Council summarised its assessment of the original convergence programme, covering the period 2006-2009, as follows. “The Council considers that the medium-term budgetary position is sound and the budgetary strategy provides an example of fiscal policies conducted in compliance with the Stability and Growth Pact. However, the planned reduction in the budget surplus during economic good times in 2007 could turn out to imply a pro-cyclical fiscal stance and could add to existing external imbalances. Achieving a higher surplus of 2% of GDP through the budget execution would significantly reduce that risk”. In view of its assessment, the Council invited Bulgaria to “(i) achieve a higher budgetary surplus in 2007 than planned in the programme and to maintain a strong position thereafter in order to foster macroeconomic stability and to contain the high external deficit, and (ii) to further strengthen the efficiency of public spending, in particular through a reform of the healthcare system”.

2.2. 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[2]. This can be summarised as follows.

Bulgaria’s national reform programme identified 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 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.

[2] 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)”, COM(2007) 803, 11.12.2007.

Box: Main points covered by the assessment

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

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

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[3];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[4], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

---

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

4 "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.

Recommendation for a

COUNCIL OPINION

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

On the updated convergence programme of Bulgaria, 2007-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[5], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [4 March 2008] the Council examined the updated convergence programme of Bulgaria, which covers the period 2007 to 2010.

(2) Real GDP growth 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,

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

improving the quality of public finance, ensuring financial sector stability, and stepping up structural reforms.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will pick up from 6.4% in 2007 to 6.7% on average over the rest of the programme period. Assessed against currently available information[6], 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. Against the background of high real GDP growth, the programme projects limited progress towards nominal convergence with inflation remaining relatively high. Moreover, given the projected sustained wage pressures and planned increases in excise duties on tobacco the inflation projections appear to be on the low side in 2009 and 2010. 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.

(4) 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. On balance, however, the higher-than-planned budget surplus in 2007 can be regarded as in line with the invitation in the Council opinion of 27 March 2007 on the January 2007 convergence programme[7]. In view of the continued strong revenue growth, the 2007 budgetary outturn could even be better than envisaged in the programme.

(5) The medium-term budgetary strategy in the programme 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

[6] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

[7] OJ C 89, 24.4.2007, p. 11.

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 the 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. In 2009 and 2010, tax revenues and social contribution are expected to drop slightly. Alos, 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. 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.

(6) The risks to the budgetary projections in the programme appear broadly balanced. Especially in view of growing external and internal imbalances, the macroeconomic scenario could be subject to certain risks. In addition, in 2008, revenue projections are subject to some uncertainty linked to the introduction of the flat-rate personal income tax. However, these 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.

(7) 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.

(8) 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.

(9) The convergence programme seems to be broadly consistent with the March 2007 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. Few concrete steps to improve the efficiency and quality of public spending on healthcare are foreseen. The update seems to reflect public finance implications of the reforms envisaged in the national reform programme. This concerns in particular the planned increase in infrastructure investment. 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.

(10) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides almost all required and most of the optional data[8].

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.

In view of the above assessment and also given the need to ensure sustainable convergence, Bulgaria is invited to:

(i) continue avoiding a pro-cyclical fiscal stance with a view to help contain existing external imbalances, notably by fully saving any revenue over-performance and respecting expenditure ceilings;

(ii) adopt policies to contain inflationary pressures, including through prudent public sector wage policy contributing to wage moderation and preserving competitiveness;

(iii) further strengthen the efficiency of public spending, in particular through full implementation of programme budgeting, reinforced administrative capacity and a reform of the healthcare system.

[8] In particular, no information on one-off measures in 2007 is provided and some data on long-term sustainability are not provided.

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.