



REPUBLIC OF BULGARIA  
Ministry of Finance

# CONVERGENCE PROGRAMME (2012–2015)

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## List of abbreviations

BDB	Bulgarian Development Bank
GDP	Gross Domestic Product
GVA -	Gross Value Added
BNB	Bulgarian National Bank
SLSU	Second-level spending unit
LTI	Large Taxpayers and Insurers
VAT	Value Added Tax
PSS	Public Social Security
GB	Government Bonds
EIB	European Investment Bank
EC	European Commission
EU	European Union
ECB	European Central Bank
LSBRB	Law on State Budget of the Republic of Bulgaria
LGD	Law on Government Debt
LA	Law Amending
LMD	Law on Municipal Debt
FLSU	First-level spending unit
SGP	Stability and Growth Pact
FDI	Foreign direct investments
PPP	Private-Public Partnership
HICP	Harmonised Index of Consumer Prices
SSC	Social Security Code
CFP	Consolidated Fiscal Programme
IMF	International Monetary Fund
MH	Ministry of Health
ICM	International Capital Markets
MF	Ministry of Finance
MTO	medium-term budgetary objective
NHIF	National Health Insurance Fund
NRA	National Revenue Agency
NSI	National Statistical Institute
NSSI	National Social Security Institute
NRP	National Reform Programme
ULC	Unit labour costs
MSTI	Medium-sized Taxpayers and Insurers
MTFF	Medium-term Fiscal Framework
CB	Central Budget
BGN	Bulgarian lev
EDP	Excessive Deficit Procedure
EUR	euro
ERM	Exchange Rate Mechanism
ESA	European System of Accounts
LIBOR	London Interbank Offered Rate
SEPA	Single Euro Payment Area
USD	US Dollar

# 1.—OVERALL POLICY FRAMEWORK AND OBJECTIVES

The Convergence Programme is approved by the government and is examined by the National Assembly.

It comprises of eight parts. The first part contains the overall framework and targets of economic policies for the programming period 2012-2015. Bulgarian macroeconomic policies and priorities are focused at maintaining stable currency board arrangement and the current fixed BGN/EUR exchange rate, continuing implementation of conservative and disciplined fiscal policy, ensuring public finance long-term sustainability, effective targeting of public expenditure towards growth-enhancing activities and factors, as well as implementing income policy geared at improved competitiveness.

The second part presents an analysis of macroeconomic developments in 2011 and the beginning of 2012 with regard to key macroeconomic indicators and respective forecasts. Structural reforms in some of the most important sectors of the Bulgarian economy – pension and social security systems, labour market and education – are presented.

The third part describes strategic fiscal policy objectives with regard to the budget balance and government debt. It sets a medium-term budgetary objective (MTO) of a structural deficit of 0.5% of GDP in 2015 in line with the revised Stability and Growth Pact (SGP). In this part the current budgetary position and the expected developments in 2012 are outlined. Special attention is paid to the structural balance and the fiscal position of Bulgaria. Major trends in debt development position over the programming period are also outlined. The budgetary aspects of major structural reforms, underlying the National Reform Programme of the Republic of Bulgaria (2012–2020) priorities and targets, are also included.

Sensitivity analysis of the forecasts in the baseline macroeconomic scenario is presented in the fourth part, as well as an alternative scenario and the main fiscal risks. Special attention is paid to budgetary forecasts sensitivity in different scenarios and assumptions.

Part five is dedicated to the sustainability of public finances. The main focus here is on the long-term budgetary outlook with a view to ageing impact.

Part six deals with the quality of public finances. It presents the government policy strategy in this area, as well as revenue and expenditure side developments.

The seventh part outlines the institutional characteristics of the public finances in Bulgaria – budgetary procedures, fiscal rules – focusing on the new fiscal rules in the Financial Stability Pact (FSP). Reforms in the revenue administration, institutional changes related to public finances and improving tax revenue collection and fiscal decentralisation are described.

Measures and policies undertaken by the government in response to the excessive deficit procedure and the Council Recommendations in accordance with Article 126 (7) of the Treaty on the Functioning of the European Union with a view to correcting the excessive deficit by 13 January 2011 are outlined in the last part of the Programme.

In Council Recommendation of 12 July 2011 on the National Reform Programme 2011 of Bulgaria and in Council Opinion on the updated convergence programme of Bulgaria, 2011–2014<sup>1</sup>, the Council of the European Union identifies weaknesses and makes recommendations in a number of areas, including public finances, competitiveness, labour market, education system, public services, public procurement, etc.:

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<sup>1</sup> 2011/C 209/02.

- ▶ **Recommendation 1:** Proceed with effective budget implementation so as to correct the excessive deficit in 2011, in line with the Council Recommendation of 13 July 2010 under the EDP. Specify the measures underpinning the budgetary strategy for 2012–2014. Take advantage of the economic recovery to ensure adequate progress towards the medium-term objective, primarily by keeping tight control over expenditure growth, while prioritising growth-enhancing expenditure.
- ▶ **Recommendation 2:** Take further steps to improve the predictability of budgetary planning and the implementation control, including on an accruals basis, in particular by strengthening fiscal governance. To this end, design and put in place binding fiscal rules and a well-defined medium-term budgetary framework that ensures transparency at all government levels.
- ▶ **Recommendation 3:** Implement the agreed steps with social partners under the current pension reform, advance some of its key measures that would help to increase the effective retirement age and reduce early exit, such as through the gradual increase of the social insurance length of service, and strengthen policies to help older workers to stay longer in employment.
- ▶ **Recommendation 4:** Promote, in consultation with the social partners and in accordance with national practices, policies to ensure that wage growth better reflects developments in productivity and sustain competitiveness while paying attention to ongoing convergence. ▼

## 2.—ECONOMIC OUTLOOK

### 2.1 Cyclical Development and Economic Prospects

The current update of the Convergence Programme for the period 2012–2015 is based on the macroeconomic framework for the period 2012–2015, developed using the medium-term macroeconomic model of the Ministry of Finance (MF) with key assumptions for the external environment as of 6 March 2012, provided by the European Commission (EC), the International Monetary Fund (IMF) and the Ministry of Finance of the Republic of Bulgaria (Table 8 of Annex 1). When the medium-term macroeconomic forecast was developed, the baseline scenario was considered i.e. effects from committed but not adopted policy changes were not taken into account.

**Table 1 — Assumptions on Key Macroeconomic Indicators**

	2011	2012	2013	2014	2015
USD/EUR Exchange rate, annual average	1.39	1.32	1.28	1.28	1.27
GDP (in real terms, % change), global economy	3.8	3.3	3.9	4.4	4.6
GDP (in real terms, % change), EU	1.5	0.0	1.5	1.8	2.0
Crude oil price (APSP) (USD/barrel, % change)	31.5	1.6	-3.1	-4.3	-3.2
Six-month LIBOR on USD-denominated deposits	0.51	0.71	0.71	0.73	1.35
Six-month LIBOR on EUR-denominated deposits	1.39	0.89	0.88	1.28	1.91
International non-energy prices – total (% change)	17.8	-10.4	-1.7	-3.4	-3.2
Food	19.7	-10.6	-2.0	-3.8	-3.7
Beverages	16.6	-16.9	1.7	-4.0	-14.5
Agricultural raw materials	22.7	-10.8	-3.9	-1.9	-4.0
Metals	13.5	-8.9	-0.7	-3.4	-0.6

Source: EC, IMF, MF

#### 2.1.1 Economic Growth

In 2011 the GDP growth of Bulgaria reached 1.7%. Just like in 2010, the main driving force was the external demand. The negative contribution of domestic demand decreased to 0.6 p.p. as a result of the slower decrease in investments.

In 2011 investments in fixed capital decreased by 9.7%. The unstable economic environment, characterised with periods of considerable deterioration and high uncertainty in estimating the future returns from investment projects, was the main factor hampering investment activity in Bulgaria. Expenditure on long-term tangible assets during the year was orientated mainly at the services sector, accompanied by growth in the development and dissemination of information and the financial and insurance activities sectors. An increase in investments in the agriculture sector was also reported.

The final consumption in Bulgaria shrunk by 0.3%. Consumer spending by households had the main negative contribution to the GDP growth (0.4 p.p.). The still high unemployment rate and the uncertainty with regard to the future income were the reasons for the low consumer demand. Government expenditure registered a slight increase of 0.5% as a result of the continuing process of fiscal consolidation.

Bulgaria's exports continued growing in 2011 at a rate of 12.8%, reaching their highest levels in terms of constant prices. Imports of goods and services grew by 8.5% triggered mainly by the export-orientated economic activities.

On the supply side, the gross value added in Bulgaria increased by 1.8% and was mainly driven by industry.

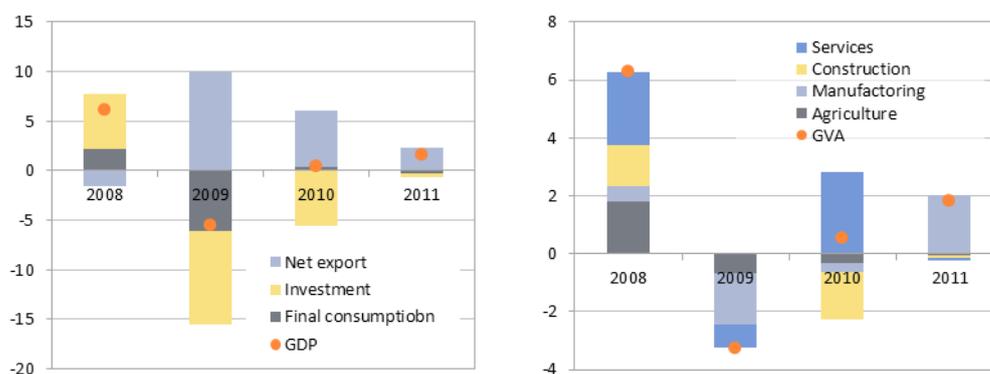
In 2011 the gross value added in industry increased by 9.1% in real terms, supported mainly by the stable domestic demand. Industrial production registered growth of 5.8% during the year, and the turnover of the production realised in domestic markets grew by 25.6% and was influenced by important for the Bulgarian economy export-orientated sectors, which were also positively affected by the commodity prices in international markets during the first half of the year.

The decline in construction slowed down to 1.1% compared to 17.9% in 2010. With regard to the construction output indexes, a more significant decline was registered in civil engineering (20%).

In the services sector no significant change was reported compared to 2010, and the gross value added there decreased by 0.1%. The "Professional activities and research", "Administrative and support service activities" and "Creation and dissemination of information; telecommunications" sectors had a positive contribution to the GVA growth during the year. All other sectors had negative contributions, mostly trade; transport; posts; hotel and restaurant business, where a decline of 1.1% was observed in 2011 after the growth of 14.1%, reported in 2010.

In the agriculture sector, for a third year in a row, a real drop in the gross value added, reaching 1.1%, was reported.

**Figure 1 — Contributions to annual GDP and GVA growth, by component (p.p.)**



Source: NSI

## 2.1.2 Cyclical Position

According to Ministry of Finance estimates<sup>2</sup>, Bulgaria's potential economic growth in 2011 was 0.7%, with total factor productivity having the largest contribution. The contribution of capital decreased due to the continuing decline in investments.

Over the period 2012–2014 the economy will move towards the potential, but will remain below it (-2.4% in 2012, -1.8% in 2013 and -0.8% in 2014) until 2015 when the economic activity is expected to exceed its potential by 0.2%.

Potential growth is expected to reach 1.2% in 2012. In terms of production factors, the negative contribution of employment will decrease, while total factor productivity will remain the leading factor. (Table 5 of Annex 1).

In the medium term, growth will range between 1.9 and 2.9% in 2013–2015, driven both by the better developments in the labour market and the decrease in structural unemployment, together with a higher contribution of capital.

<sup>2</sup> The starting value of capital used is based on the Statistical Yearbook of the Republic of Bulgaria for year 1991. Estimates of the people employed, aged 15-64, prepared using the LFS methodology, were used for the labour factor for the labour factor, people employed (aged 15-64), LFS definition is used.

## 2.2 Medium-term Scenario

The projections about Bulgarian economic development in 2012 are based on the assumption of improved external environment during the second half of the year and that the debt problems in the euro area will be resolved. GDP growth is expected at 1.4%, which will be supported mainly by the gradual recovery of domestic demand. Over the period 2013–2015, exports will recover with domestic demand growing more rapidly, though consumption and investments growth rates are not expected to reach their pre-crisis levels.

As a result of the debt problems deepening in some euro area countries, the outlook for the European economy in 2012 deteriorated. The lower economic activity in the EU will result in a slowdown of the economic growth in Bulgaria in 2012. The latter will come mainly through the lower contribution of net exports. During the period 2013–2015 a moderate acceleration of economic growth in the range of 2.5 and 4% is expected, which is typical for “catching-up” economies.

Consumption will increase slightly in 2012, up 0.7%. Both the stabilisation of the labour market during the second half of 2012 and the slight increase in credit activity will have a positive impact. Credit growth is expected to accelerate from 3.3 to 4% in 2012. Households will remain cautious with regard to expenditure, nevertheless, consumption will have a positive contribution of about 0.3 p.p. to the real GDP growth. In the medium term, as a result of the labour market recovery and consumer confidence improvement, the households expenditures will increase gradually to 4.6% in 2015.

Investment activity in the country is expected to recover in 2012, due to the base effect (the decline in investments, accumulated over the last three years, amounts to approximately 40.3%) and the accelerated absorption of EU funds, mainly for roads, environmental and utility infrastructure. In 2012 the gross capital formation will register an increase of 3.5% and will continue accelerating over the whole forecast period, reaching 8% in 2015. Sustained faster growth rates of productivity in Bulgaria compared to EU average will account for an attraction of foreign investments. The external economic environment had a negative impact on investment activity in the country during 2009–2011.

Exports growth is expected to be considerably lower compared to the pace reported in 2010–2011, taking into account the high base, as well as expectations about world economy. Over the period 2013–2014, the recovery in Bulgaria’s main trading partners will result in a slight increase in the export of goods, which will stabilise to a 4.6% yoy growth in 2005. Export of services will increase moderately over the entire forecast period.

Starting 2012, the recovery of domestic demand will have a positive impact on imports of both goods and services. At the same time, the slowing down of exports growth will continue restraining import of goods. As a result, the increase in total imports will slow down to 3.6% in 2012, and will accelerate moderately over the following years, reaching 6% at the end of the forecast period.

The annual growth of money supply is expected to reach 9% at the end of 2012, and to be within the range of 9–11% during the following years until 2015. The net foreign assets of the banking system will increase during the current and the next year as a result of the continuing repayment of foreign liabilities of banks. As of 2014, these assets will start decreasing again in result of the higher credit activity of banks and the lower growth rates of private sector savings. The increase in bank lending will accelerate marginally to about 4% at the end of 2012. By 2015 credit to the private sector will continue its relatively sluggish recovery, and at the end of the period the growth rate will not exceed 13%.

## 2.3 Sectoral Balances

### 2.3.1 Labour market, wages and labour productivity

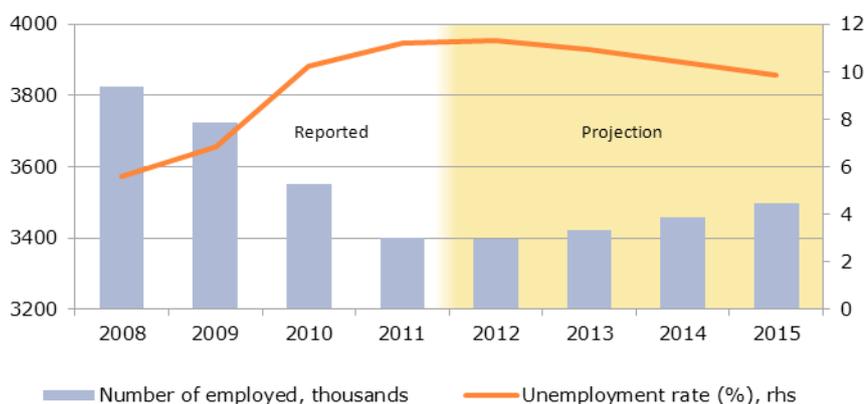
The employment decrease against the backdrop of a growing GDP was due to the different source of economic growth compared with the pre-crisis period and the sluggish recovery in domestic demand (only from the second quarter of 2011).

The annual drop in the number of employed in 2011 slowed down somewhat in comparison with the previous year (4.2% from 4.7%<sup>3</sup> in 2010), largely explained by the slower rate of industrial employment decline, while the decrease in the number of employed accelerated on an annual basis. The higher labour demand in some of the export-oriented sectors (manufacturing of machinery and electrical equipment) was unable to offset the persistent decline in the number of employed in the economic activities, which are highly dependent on the domestic demand.

The seasonal labour market revival in the second and third quarters slowed down, however, it was unable to reverse the negative annual trends in unemployment. Its annual average rate reached 11.2%, increasing by 1 p.p. compared to 2010. As a result of the continuing process of employment restructuring and the narrowed opportunities for hiring people, the participation rate (15+) went down by 0.7 p.p. to 51.3%.

In February 2012 the registered unemployment<sup>4</sup> increased by 0.5 p.p. on a year earlier, reaching 11.5%.

**Figure 2 — Number of Employed\* and Unemployment Rate\*\***



\* National accounts definition; \*\* LFS definition

Source: NSI, MF

Expectations on labour market developments in 2012 are related to stabilisation of the main indicators around their 2011 levels. During the first half of the year the unemployment rate will remain higher on an annual basis, yet in the second half of the year it will settle around its levels from the second half of the previous year. Thus the annual average rate will reach 11.3%<sup>5</sup>, up by a marginal 0.1 p.p. on an annual basis. A more significant labour market improvement is expected from 2013 onwards, when increased domestic demand and investment activity are expected to have a positive impact on employment. Over the period 2013–2015, the annual average increase in the number of employed will be around 1%<sup>6</sup>, with the unemployment rate gradually receding to 9.8% in 2015.

Labour productivity and wage developments in 2011 had a favourable effect on the economy's cost and price competitiveness.

<sup>3</sup> According to data from the National Accounts data.

<sup>4</sup> According to data from the Employment Agency data.

<sup>5</sup> As defined in LFS.

<sup>6</sup> As defined in the System of National Accounts.

In the period under consideration, average wage<sup>7</sup> went up by 9.1% in nominal terms and by 4.7% in real terms<sup>8</sup> compared to 2010. A significant optimisation of spending was observed in the budget sector of the economy, which in turn accounted for the dynamics of incomes in the public sector where the nominal growth of that indicator slowed down to 3.1%, while decreasing by 1.1% in real terms. At the same time, the average wage in the private sector exhibited considerably higher rates of change, up 11.2% and 6.7% in nominal and in real terms, respectively.

The continuing process of employment optimisation supported the increase in labour productivity by 6.1%<sup>9</sup> in 2011. Its development was due to the considerable gains in productivity in the tradable sector<sup>10</sup> of the economy (12.4%). The service sector also registered an increase in value added per person employed, mainly on the back of high growth rates in professional activities and research, real estate transactions, financial and insurance activities and trade.

Current labour productivity developments supported the decrease in real unit labour costs (RULC) by 3.7%<sup>11</sup> compared to the previous year. The positive evolution of that indicator was determined primarily by the tradable sector of the economy, which is directly exposed to competitive pressure and is a main driver of economic growth. During the period under consideration, the tradable sector retained its cost-related competitiveness with a reduction in RULC by 8% on an annual basis.

**Figure 3— Real ULC Dynamics, 2009=100**



Source: NSI, MF

The expected high levels of unemployment will continue to limit the average wage growth rate in 2012. Within the programme period, that indicator is projected to rise at a moderate rate, and the gradual rise in labour demand will push up the compensations of employed as a share of GDP. Average wage will change at rates similar to those of labour productivity, which will not have any adverse effect on the competitiveness of the economy in the medium term.

### 2.3.2 Inflation

Consumer price dynamics in 2011 largely followed international food and energy price developments, while the favourable base effect of the 2010 excise duty hikes on tobacco products and the sluggish recovery of domestic demand had a restricting effect on the rise of consumer prices.

Headline inflation, as measured by the HICP, slowed down to 2% yoy at the end of 2011, while its annual average rate reached 3.4%. The latter was slightly above previous year

<sup>7</sup> According to data from Enterprise Survey data.

<sup>8</sup> HICP-deflated.

<sup>9</sup> Calculated as GDP per person employed at 2005 constant prices (, according to SNA data from NA.).

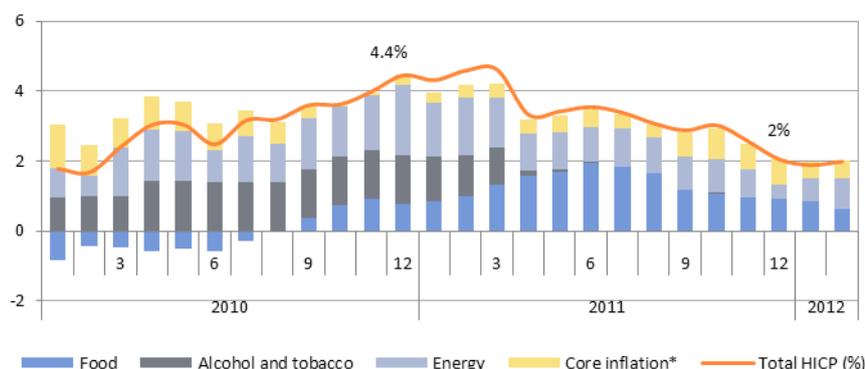
<sup>10</sup> In this analysis, the tradable sector is represented by manufacturing (industry, excluding construction).

<sup>11</sup> Calculated as a ratio between compensation per person employed and GDP per person employed in current prices.

reading due to the carry-over effects (relatively higher inflation rates were reported in late-2010 and early-2011).

**Figure 4 — Inflation rate (%) and contributions by main HICP components (p.p.)**

(corresponding month of the previous year)



\* Overall index excluding energy, food, alcohol and tobacco. According to Eurostat methodology, core inflation comprises about 56% of weights used in the HICP calculation.

Source: NSI, MF

Food prices accelerated their rate of increase during the first half of 2011 mainly as a result of rising international food prices due to global demand strengthening and some supply shortages. With the stabilisation of prices on world markets by mid-year, the annual increase in domestic food prices slowed to 4.5% at the year end (being 9.4% as of June).

Prices of tobacco products had the main contribution in bringing down the overall inflation during the second quarter, due to the favourable base effect of the increased excise duties in 2010. Their annual growth rate reported negative at 0.3% at the end of 2011, after a 32.5% yoy growth at the beginning of the year. The overall index slowdown was additionally strengthened by the almost double weight of cigarettes in the 2011 consumer basket.

Energy goods were the other HICP component with a contribution to the slowdown in the headline rate. The current juncture on the crude oil market and political instability in countries in Northern Africa and the Middle East led to an increase in domestic prices of liquid fuels at the beginning of the year. Thus their annual rate of increase remained relatively high during the first quarter (19.3% on average). Following the stabilisation in international oil prices, the increase in automotive fuel prices started slowing down and decreased considerably to 4% at the year end compared to the 20.3% increase, reported in December 2010. Corrections in excise duties on unleaded petrol and diesel did not have a significant direct impact on their prices and the overall inflation (below 0.1 p.p.).

The slow recovery of domestic demand contained core inflation. It started increasing gradually since the beginning of the year and reached 1.3% in December, largely on account of price hikes in some energy and food related services categories such as transport and catering services. Services followed a trend of gradual price increase since the beginning of the year, thus reaching 2.3% as of December. Some of the components in this group are administratively regulated and, if they are excluded, the change in the prices of market services is estimated at 1.2% at the year end. Weak domestic demand was also a factor behind maintaining the negative annual rates of change in the prices of non-energy industrial goods almost throughout the year; these rates registered a 0.2% decrease in December.

The annual change in administratively regulated prices was 4.5% and accounted for almost 1/3 of the overall increase in consumer prices at the end of the year.

In the first two months of 2012, annual inflation settled at its level at the end of the previous year, while the 12-month moving average rate continued to slow down to 3% in February. Considered by main HICP components, food prices increase kept decelerating to 2.7% yoy. The lower demand continued deterring the prices of services, while the decrease in the prices of non-energy industrial goods deepened to 0.7%. Only energy prices accelerated at the

beginning of the year and reached 6.6% in February. International oil prices started increasing following the geopolitical tension and the EU embargo on Iranian oil exports. On the other hand, the weakening of the Euro against the US dollar also had an impact on the increase of domestic prices.

**Table 2 — Forecast of the development of inflation processes during the period 2012–2015**

	2012	2013	2014	2015
	<b>At year end (%)</b>			
<b>Total HICP</b>	<b>2.6</b>	<b>2.5</b>	<b>2.5</b>	<b>2.4</b>
Food and non-alcoholic beverages	1.4	2.5	2.5	2.6
Alcohol and tobacco products	0.6	1.0	1.0	1.0
Non-energy industrial goods	1.3	2.0	1.8	1.7
Energy goods	6.4	0.9	1.0	1.0
Services	3.2	3.8	4.0	3.8
	<b>Annual average (%)</b>			
<b>Total HICP</b>	<b>2.1</b>	<b>2.4</b>	<b>2.5</b>	<b>2.5</b>

Projected dynamics of consumer prices over the period 2012–2015 indicate a slight acceleration of inflation at the end of 2012 under the influence of higher international prices of energy commodities. The increases in administrative prices of natural gas, electricity and heat, which have already been announced, will also add some upward pressure on the headline rate. Weak consumer demand for durable goods and services will continue to keep core inflation on a relatively low level of 2.4%. With the gradual recovery of domestic demand, prices of services will start a gradual increase to 3.2% at the year end. Its dynamics will result also from some secondary effects from more expensive fuels for transportation services and the increase in administered prices.

The annual average inflation rate is expected to decelerate to 2.1% in 2012, due to the considerable slowdown in inflation rates reported at the end of 2011 and the early months of the current year, to be followed by a slight increase to 2.4–2.5% in the period 2013–2015.

In the coming years, dollar-denominated international commodity prices are not expected to rise and, assuming a stable Euro, inflation is not expected to accelerate under the influence of external factors. With the economic recovery, higher prices of services are expected relative to those of food and non-food goods. During this period the core inflation is estimated at around 3% and is expected to be higher than the overall inflation.

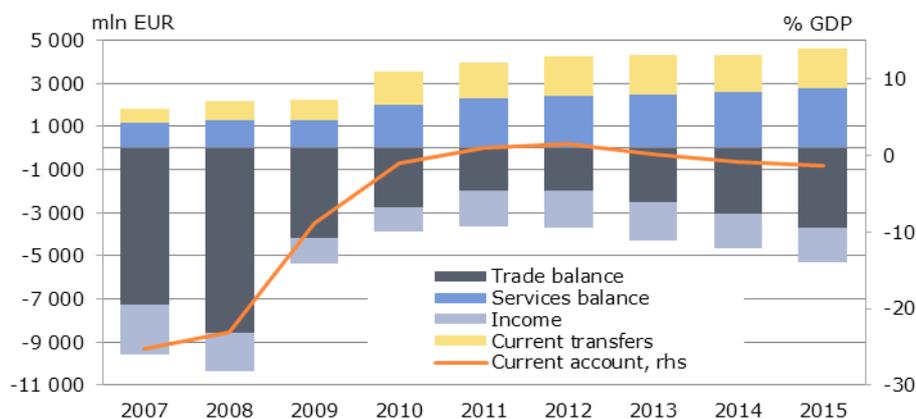
The contribution of administered prices to the overall inflation during the period 2013–2015 is expected to be weak – about 0.2 p.p. at the year end. The impact of tax policy changes will be also modest, since the planned increases in excise duties will have a minor effect on consumer prices. In 2012 and 2013 the direct effect of the higher rates on diesel fuel by 2.4% for each of the years is estimated at 0.01 p.p. The envisaged introduction of an excise duty of 0.85 BGN/GJ for methane as motor fuel and of 0.1 BGN/GJ for natural gas for industrial purposes since June 2012 will not have a direct impact on HICP, since these items are not included in the basket used to calculate inflation.

The main risks to inflation forecast are linked to developments in international prices and the speed of economic growth in Bulgaria. International prices of crude oil may increase more substantially as a result of political crises in the Middle East. The limited supply of some agricultural goods on a global scale as a result of adverse weather conditions, especially for cereals, could further trigger higher inflation in Bulgaria. The debt crisis in the Euro area countries will also continue having an impact along the depreciation of the single European currency vis-à-vis the US dollar. This makes USD quoted imported goods more expensive, and through higher production costs tends to feed into higher prices of a number of goods and services. At the same time, a possible lower economic growth of Bulgarian economy will further limit increases in prices of non-food goods and services (core inflation), since households will adapt to the uncertain economic environment through saving rather than spending.

### 2.3.3 External Sector

In 2011 the overall balance on the current and the capital account came in positive at EUR 855.3 mln<sup>12</sup> (2.2% of GDP) compared to a deficit of EUR 84.9 million (0.2% of GDP) in 2010.

**Figure 5 — Current account performance, 2007–2015**



Source: BNB, Eurostat, MF

This improvement was mainly influenced by the shrinking trade deficit. Trade balance was negative by EUR 1.975 bln in 2011, which is an improvement of EUR 789 mln compared with 2010.

In the medium term the current account surplus will decline and at the end of the forecast period the balance will be slightly negative. Trade balance will be negative, but will be almost entirely covered by services surplus, which will exceed 5% of GDP during the entire forecasted period. The expectations are for growth in tourism receipts, while the pick-up in the import of goods, which will also boost the import of transportation services, will act as a deterrent to the net change in the balance of services. Transfers, mainly from the EU, will also have positive contribution to the CAB dynamics.

In 2011 the balance of the financial account was negative, resulting from the low investment activity in Bulgaria and the repayment of external liabilities by the banking sector. With the recovery of the Bulgarian economy and the improvement in the business climate in the country, the inflow of foreign capital, mainly in the form of foreign direct investments (FDI), is expected to gradually recover. FDI will remain at considerably lower levels compared to the pre-crisis period and will increase to 5% of GDP in 2015, thus providing a full coverage of the current account deficit. A moderate recovery of the external financing of companies is also envisaged. At the same time, as a result of the high liquidity of the banks, no large financial inflows will be observed in the sector in the medium term. The net item in the Portfolio investments account will make a negative contribution to the financial account. The main outflow will be related to the repayment of principal under the government debt in global bonds maturing in 2013 and 2015.

#### ***Adjustment of the current account deficit***

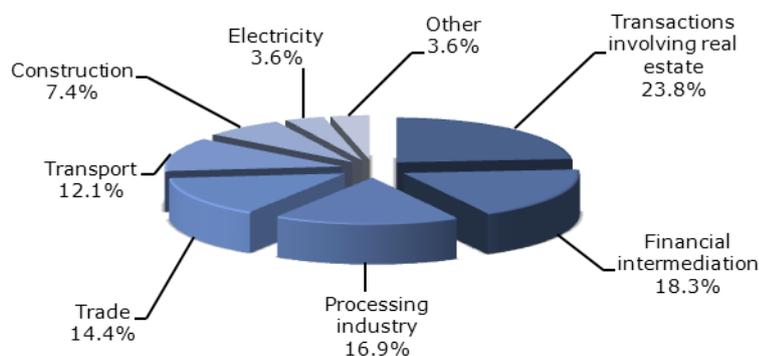
Over the years right before and after the accession of Bulgaria to the European Union (2005–2008) a process of increase of the current account deficit was observed, related mainly to the acceleration of the real convergence. The increasing FDI inflows stimulated internal investment demand and thus resulted in acceleration of the import of investment goods. The current account deficit was fully financed by the inflow of FDI in line with the

<sup>12</sup> Preliminary BOP data as of March 15, 2012

catching-up process and, therefore, did not threaten the sustainable economic development of Bulgaria. The latter was confirmed during the global economic crisis, when the current account adjustment process underwent no shocks, just in line with our expectations.<sup>13</sup>

The financial flows were orientated mainly to the private sector as a result of the need to replace and modernise the already obsolete production equipment. A considerable portion of the financial flows was directed at the export-orientated sector.

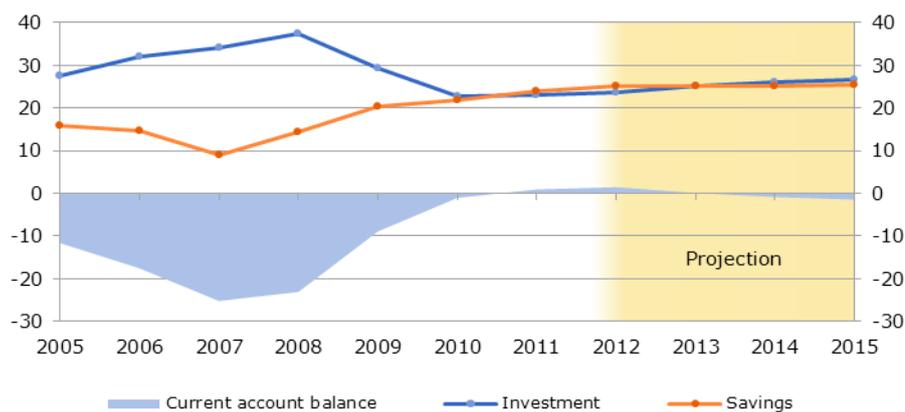
**Figure 6 — FDI amount by economic sectors 2008**



Source: BNB

The global economic crisis was a strong external shock for the Bulgarian economy, which put to the test its stability. Actually, the shrinking of the trade deficit was realised gradually and without shocks. Initially both exports and imports shrunk, the exports decreasing at a slower rate than imports, after which the imports started recovering at faster rates<sup>14</sup>. As a result, the current account deficit dropped to 1.0% of GDP in 2010, and moved to a surplus of 0.9% in 2011. Over the programming horizon the surplus is expected to decrease, thus the balance will turn slightly negative by the end of the period. The current account adjustment reflected the gradual decrease in the FDI flows and the net repayment of foreign liabilities by banks, and by non-financial institutions in 2011 as well.

**Figure 7 — Saving-Investment Gap**

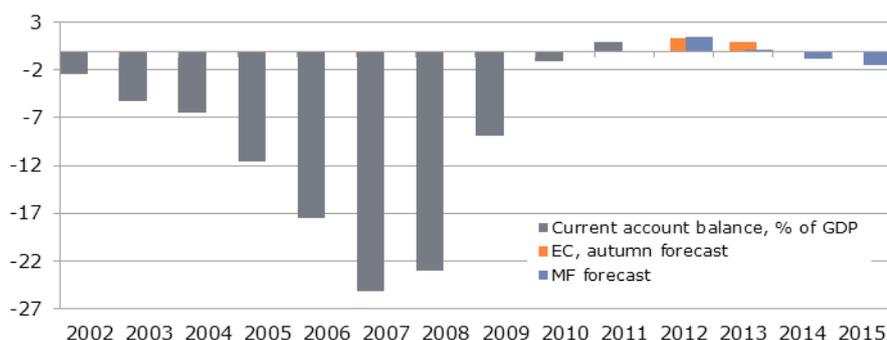


Source: Eurostat, MF

<sup>13</sup> In the text, global economic crisis refers to the 2008 – 2009 crisis.

<sup>14</sup> An initial shrinking of exports during the fourth quarter of 2008 was observed in many countries. During this period the global trade shrunk by about 20%.

**Figure 8 — Current account balance, % of GDP**



Source: BNB, NSI, MF, EC

The inflow of foreign direct investments continued being positive (as of December 2011 FDI accounted for 3.5% of GDP), although at much lower levels compared to the three years prior to the crisis. The low level of FDI was due to the lower gross capital flows and the net repayment of intercompany loans in line with the repayment schedules of enterprises. With the slowdown of the economic activity and the decline in investment demand, along with the increase in the rate of savings, the liquid capital was used for loan repayment from local banks to parent banks abroad as well as from other companies in the private sector. As a result of these flows in the financial account of the balance of payments, the gross external debt started decreasing (from 105% of GDP as of December 2008 to 92% as of December 2011) with the main contribution coming from the banking sector.

### ***Competitiveness of the Bulgarian economy***

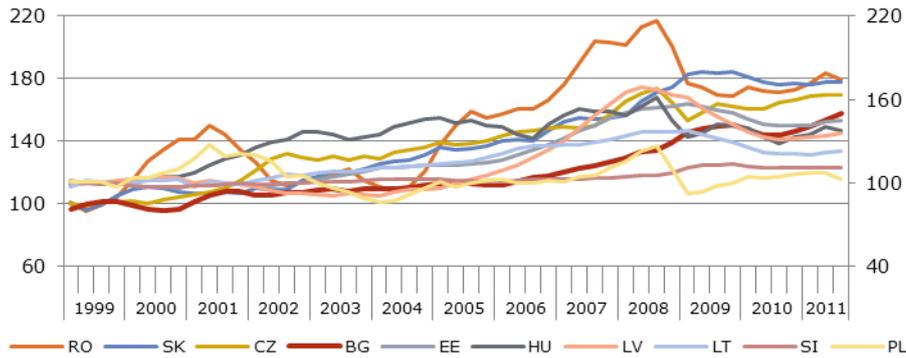
Objective assessment of the competitive position of the economy can be achieved when using a wide set of indicators, which also take into account specific circumstances related to the economic development of a country undergoing real and nominal convergence. An objective assessment shall analyse the deviations of these indicators from the equilibrium trend. The assessment must be based on an analysis of a wide range of indicators in order to overcome the limitations of using the real effective exchange rate (REER) as the only measure of competitiveness. Important aspects and manifestations of the economy's competitiveness are quality and diversity of exported products, export dynamics and the market share of the country on international markets, flexibility of the domestic factor and product markets, labour productivity dynamics, as well as the economy's resilience to shocks.

Real effective exchange rate has been appreciating over the last 10 years in all new EU Member States, mainly due to fundamental factors and to the successful nominal and real convergence, achieved through higher labour productivity growth as compared to the EU average (weighted against the trade volumes realised by the trading partners). The appreciation of the Bulgarian lev shall be considered to be an equilibrium movement, justified by fundamental factors, and not as a loss of competitiveness.

REER based on nominal unit labour costs for the whole economy, as well as REER index based on the nominal unit wage costs in manufacturing, showed that REER in Bulgaria has appreciated over 1999, but not as much as in other Member States, including those with independent monetary policy in the conditions of a floating exchange rate<sup>15</sup>.

<sup>15</sup> In the long term the local currency depreciation does not lead to a sustainable improvement of the competitive position of the country. There are many ways, in which the competitiveness of local manufacturers can deteriorate as a result of the depreciation of the national currency, for example the price increase of the import component in the production activities, the pressure on inflation and wages, as well as the negative impact on the financial position of enterprises. For this reason the labour market flexibility is a much more important factor for maintaining the competitive position of the economy than the possibility for a nominal change in the exchange rate. Cf. also: Convergence programme of the Republic of Bulgaria, 2011-2014, Annex 2. Competitiveness of the Bulgarian Economy.

**Figure 9 — Real effective exchange rate based on unit labour costs (1999=100)**



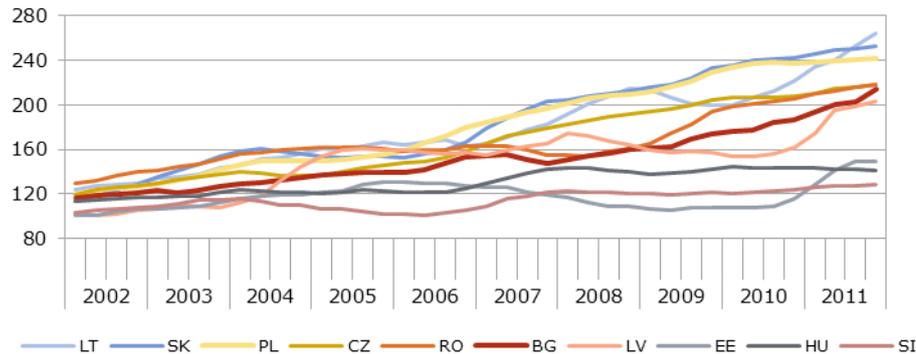
Note: The countries are arranged in a descending order based on the value during the last period  
Source: EC, January 2012

In the medium term REER in all new EU Member States is expected to continue appreciating as a result of the preservation of a positive differential between labour productivity growth and the economic convergence to the more advanced EU Member States.

The trend of the market shares in the EU imports is similar in all Member States. An increase in these shares was observed again after the third quarter of 2010. Bulgaria maintains a growing trend of its market share and the value of the base index reached 214% (2000=100) as of December 2011.

**Figure 10 — Shares of the new Member States in the import of EU-27**

(index on annual basis, 2000=100)

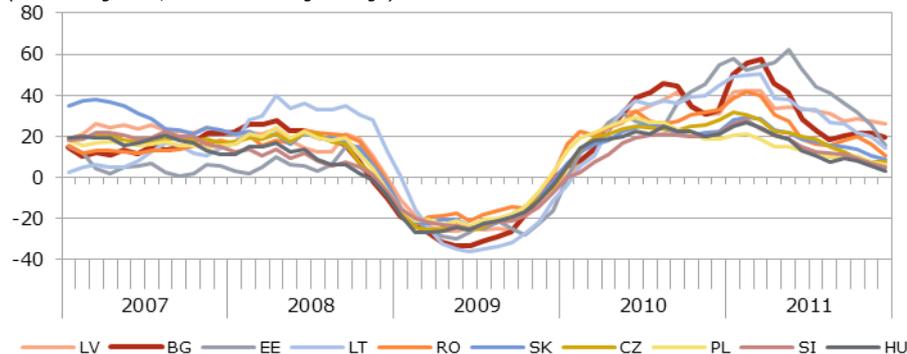


Note: The countries are arranged in a descending order based on the latest value.  
Source: EC

The dynamics of the total exports in Euros of the new EU Member States is also similar. In November 2011, Bulgaria realised some of the highest rates of exports growth in the EU.

**Figure 11 — Dynamics of the total exports in Euros of the new EU Member States**

(% annual growth, 3-month moving average)



Note: The countries are arranged in a descending order based on the value in the last row  
Source: Eurostat, BNB

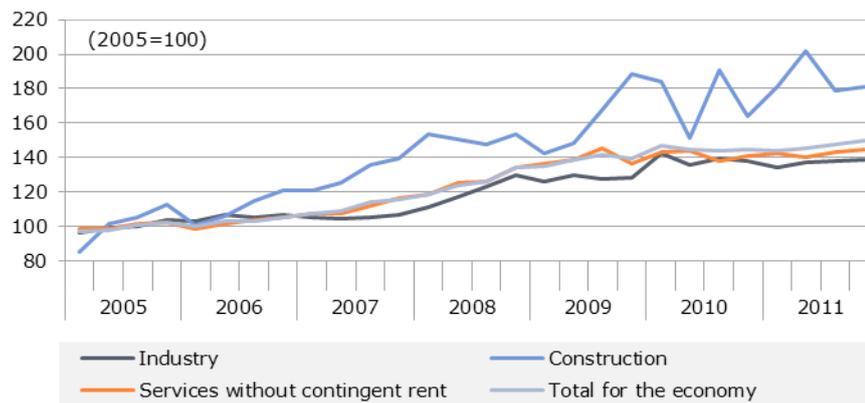
An evidence of the improving export competitiveness is also the stable trend of a gradual increase in the technological level and quality of the exported products. The share of the medium- and high-technology products in exports has increased from 20.7% to 27.6% between 2000 and 2010. During the same period Bulgaria registered the highest increase in the unit value of exports among the new EU Member States, which in combination with the strong dynamics of exports, is an evidence of the improving quality of products.

### ***Labour market flexibility and structural effects on wages***

During the years preceding the global financial and economic crisis, when the Bulgarian economy was characterised by strong economic growth, the nominal unit labour costs (ULC) were ascending as a result of the real and nominal convergence. Nominal ULC in the processing industry were increasing only slightly, while the real ULC were decreasing. In response to the dramatic decline in external demand at the beginning of the global crisis, industry was among the first sectors, in which enhanced and extensive measures to reduce costs, particularly labour costs, were implemented. This provided an adequate adjustment of the nominal and real ULC in industry (the real ULC in industry were at historically low levels in 2011), and, thus, ensured maintaining the cost and price competitiveness of the Bulgarian economy over the period 2008–2011.

**Figure 12 — Nominal unit labour costs**

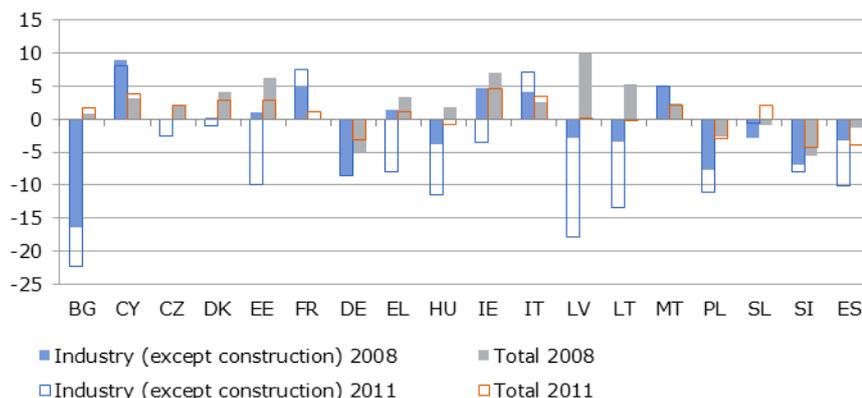
*(seasonally adjusted data)*



Source: NSI, BNB

In addition, as a result of the dynamics of labour costs as a whole, a cumulative decrease was observed in the share of the compensation of employees in the added value in industry, which allowed to maintain competitiveness in the conditions of continuing and significant productivity growth.

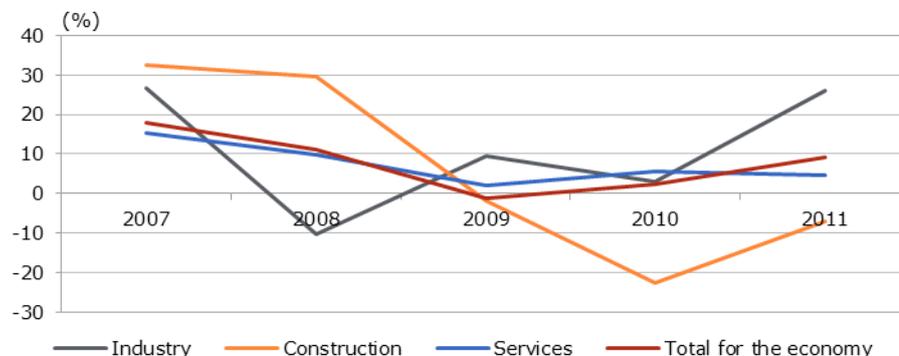
**Figure 13 — Share of the compensation of employees in the gross value added at current prices compared to 2000 – cumulative change, pps**



Source: Eurostat, BNB

The flexibility of Bulgarian enterprises in the course of the global economic crisis allowed maintaining a sustainable productivity growth regardless of its temporary deterioration in 2009. This, in conjunction with adequate adjustments in employment and wages, ensured a decrease in the rate of nominal ULC growth in 2010. The gross operating surplus in the economy increases.

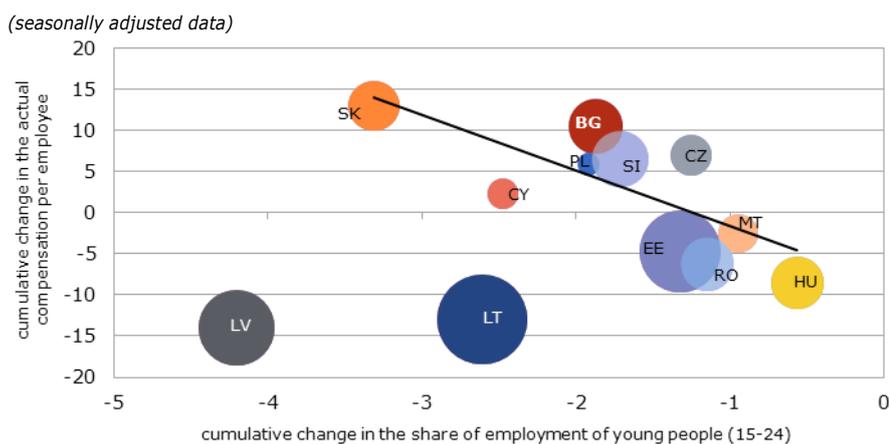
**Figure 14 — Nominal growth of the gross operating surplus and mixed income**



Source: NSI

The average increase in wages was influenced by institutional factors, such as the annual increases in the minimum salary and the minimum insurance income, as well as by compositional effects due to changes in employment structure, mainly resulting from their irregular distribution by sectors<sup>16</sup>, ages/skills. The latter resulted from the considerable decrease in employment among young people and the people working in sectors with lower pay (mainly in 2009 and 2010). Moreover, since the end of 2010 and in 2011, the share of employment in the sectors with higher pay (such as “Creation and dissemination of information and technical products; telecommunications” and “Financial and insurance activities”) has been increasing. Such changes can be observed in other EU Member States with similar decline in economic activities. Some international differences correspond to the differences between the salaries by age groups by countries and to the nominal convergence versus the EU average.

**Figure 15 — Relationship between the changes in the share of employment of young people and the real compensation per employee since the beginning of the decline in GDP until Q3, 2011<sup>17</sup>**



Note: The circles show the degree of the maximum decline of GDP in 2008-2009, i.e. the cumulative decline from the top to the bottom. The line concerns countries with similar declines in GDP and does not include the Baltic countries.

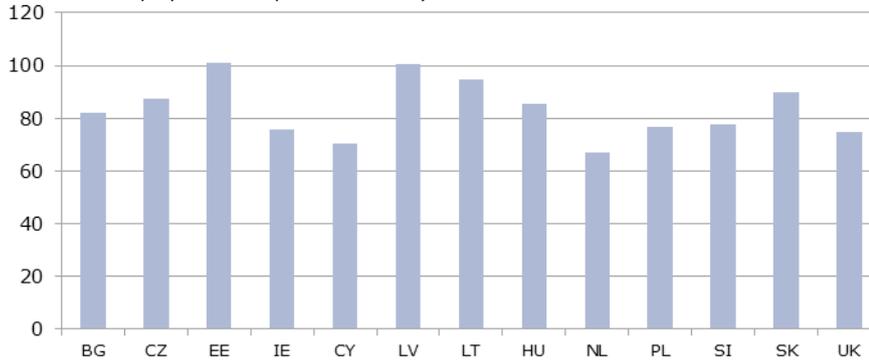
Source: Eurostat, BNB

<sup>16</sup> Cuts in employment were more pronounced in some sectors, such as the construction sector, where employment growth was higher than the average before the crisis, and with the onset of the crisis a sharp drop in investment activity was observed. Therefore, the decrease in wages cannot offset the adjustments of employment in the construction sector.

<sup>17</sup> When interpreting the figure, one should take into account the degree of decline of GDP in 2008-2009, the starting conditions, the degree of convergence of the compensation per employee to the EU average, and the gap between the salaries of young people and the average salaries in each country.

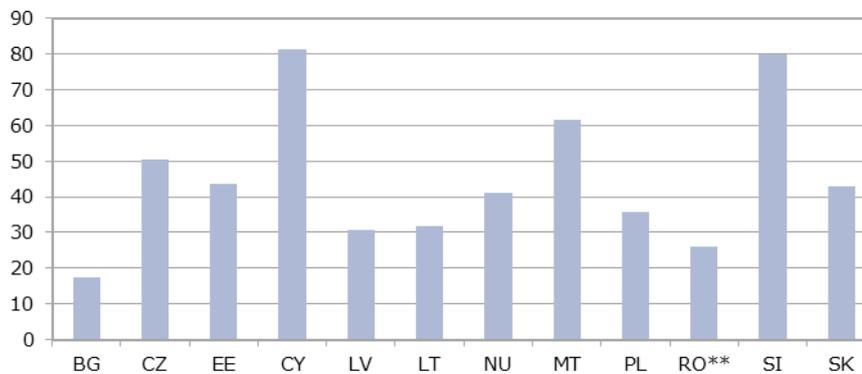
**Figure 16— Share of the hourly pay of employed below the age of 30 in the average hourly pay**

(structure of employment compensation 2006)



Source: Eurostat

**Figure 17— Share of the nominal compensation per one employed in the EU27 average\* (2010)**



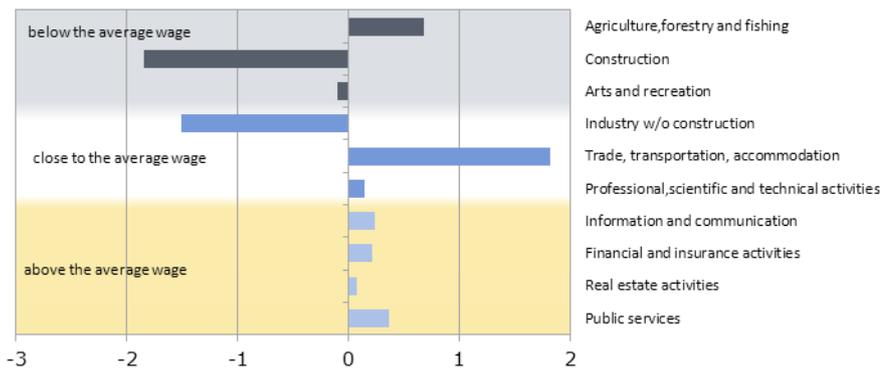
\* EU27 average for 2010., excludes Austria and Romania

\*\* Data for Romania are for 2009

Source: Eurostat

**Figure 18— Change in the share of employed by sectors (Q4 2011 compared to the 2008 average)**

(seasonally adjusted data, percentage points)



Note: The figure presents the change in the share of employed by sectors in the total employment for the period 2008 – Q4 2011. The sectors are grouped into three categories based on the difference between the average salary in the sector for Q1 – Q3 of 2011 and the average for the economy. The "close to the average salary" group is defined as +/- 15% difference, while the differences are in the range of -39% to 12%.

Source: Eurostat, BNB

The decrease in the share of undeclared employment in the medium term (guaranteed by the amendments to the Labour Code, the strengthened control and inspections, described in the 2012 update of the National Reform Programme), as well as the compositional effects related to the continuing changes in the structure of employment, are likely to exert an upward pressure on the average level of wages. Nevertheless, the increased uncertainty regarding the global economic situation and the expected low inflation during the current period of high unemployment rate and discouragement, will most likely curtail the salary

increase in the medium term. Therefore, we see no risks stemming from loss of competitiveness as a result of the nominal developments in ULC or the labour market flexibility.

### 2.3.4 Monetary Sector

The main objective of the monetary policy of Bulgaria is to maintain price stability through securing the stability of the national currency. This objective is achieved within the framework of the Currency Board Arrangement and a fixed exchange rate of the national currency to the Euro.

As of the end of February 2012 the international reserves of Bulgaria reached EUR 12.8 billion, increasing by 3.7% as compared to the same month of the previous year, thus covering 171.4% of the monetary base. At the end of January the reserves covered 6.2 months of imports of goods and non-factor services, and the reserves to short-term external debt ratio increased to 130.8% as of end-2011.

In 2011 the monetary aggregates continued reporting an upward dynamics reflecting the gradual improvement of the economic situation and the increased resident deposits in the banks. As of the end of 2011 the broad money reported an annual growth of 12.2% as compared to 6.4% as of December 2010, with the quasi money contributing the most. During the first two months of 2012 the broad money growth continued being relatively high, amounting to 11.7% in February. The improvement of the conjunctural situation also led to an increase in credit demand in 2011, mainly by non-financial corporations in the services sector. At the same time banks slightly eased their credit standards and conditions during the first half of the year, but tightened them during the second half of the year. As of December 2011 the annual growth of the banks' claims on non-government sector increased by 3.4%. On an annual basis the claims on non-financial enterprises increased by 5.7% while the claims on households contracted by 0.4%. The uncertainty about the future income limited household consumption. During the first two months of 2012, as a result of the lower economic activity, the growth of bank loans slowed down to 2.6% on an annual basis. As of February the annual growth of the loans to non-financial enterprises decelerated to 4.8%, while the decline of the loans to households reached 1% on an annual basis.

Interest rates on deposits in Bulgaria continued decreasing as a result of the sustainable increase in funds attracted from residents and the weak credit activity. In December the weighted average interest rate on new<sup>18</sup> time deposit agreements<sup>19</sup> decreased to 4.4% and was lower by 0.3 p.p. compared to the end- 2010. The banks' ample liquidity and the decrease in the interest rates on deposits had a small impact on the loans' interest rates. Over the January – February 2012 period interest rates on new term deposits continued decreasing, while interest rates on new private sector loans increased.

In 2011 the banking sector in Bulgaria maintained a high level of financial soundness, sustained solid capital buffers and reported relatively good profits. The liquidity increased, influenced by the continuing growth of deposits by residents. Banks had sufficient available funding to finance an increase in their domestic credit activities and in external assets while decreasing their foreign liabilities. At the end of 2011 the banks' foreign liabilities decreased by BGN 2.279 billion (15.4%) on an annual basis while their foreign assets increased by BGN 1.059 billion (13.3%). The liquid assets to total liabilities ratio of banks reached 25.57% at the end of 2011 as compared to 24.4% an year earlier, thus sustaining the stability of the financial intermediation. The capital adequacy of the system is high, at the level of 17.53%, including the capital adequacy of the Tier-1 capital of 15.74%. The banking system ended 2011 with a net (audited) profit of BGN 481 million (EUR 246 million).

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<sup>18</sup> The terms "new" deposit agreements and "new" loan agreements refer to the statistic category "new business".

<sup>19</sup> Weighted average interest rate on term deposits for the household and non-financial enterprises sectors, weighted in terms of currency and term.

In 2011 BNB continued applying the best practices in regulating banks' activities in Bulgaria. In June the Governing Council of BNB adopted an ordinance amending and supplementing Ordinance No. 9 of the BNB on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Specific Provisions for Credit Risk. The ordinance changed the period for realisation of collaterals provided in the form of buildings or regulated landed estates, acceptable for regulatory purposes, from 6 to 12 months. Within this period banks will be able to report the value of these collaterals when determining the risk exposure and the amount of the specific provisions for credit risk. The change in the period for realisation of this type of collateral aims at bringing the supervisory treatment in line with the current market conditions and reflects the comments of the banking system on the need for taking into account the existing procedural and technical difficulties in the process of realisation of the collaterals provided to banks. The amendments in the ordinance are in line with maintaining the counter-cyclical policy in regulating banks' activities in Bulgaria and take into account the current liquidity in the real estate market and the need for maintaining the flexibility vis-à-vis the banks' clients, experiencing temporary difficulties in the conditions of an aggravated economic situation. With these changes the BNB continues the conservative nature of the implemented supervisory policy while ensuring that the capital buffers, accumulated in the system, are kept.

## 2.4 Major Structural Reforms

### 2.4.1 Pension Reform

The latest amendments to the Social Security Code (SSC), effective from 1 January 2012, are in full compliance with the recommendation for accelerating the pension reform.

Higher required retirement age comes into force as of 2012 instead of 2021, with 4 months increase per year, for both men and women and for all categories of workers, until 65 years is reached for men in 2017 and 63 years is reached for women in 2020.

Pension eligibility conditions for both females and males, eligible for pension at the age of 65 and with at least 15 years length of service as of 31 December 2011, also changed. As of 1 January 2012 the statutory requirement age for these individuals also started increasing each calendar year by 4 months per year until 67 is reached in 2017.

Since the payment of survivor's pension to the surviving spouse depends on the statutory retirement age under Article 68 (1) of the SSC (survivor's pensions are granted five years earlier than statutory retirement age), higher age will be also required for survivors' pension eligibility.

The total required length of service for military staff was also raised by 2 years (from 25 to 27 years) as of 1 January 2012.

Expenditures for early retirement of people working in risky conditions will be covered by public social security system by the end of 2014, and as of the beginning of 2015 they will be fully transferred to the professional pension funds.

In addition, the relative weight of each year of length of service, acquired after 1 January 2012, will increase from 3 percent to 4 percent for each additional working year if the individual continues to work after reaching retirement age. This is direct incentive for longer participation on the labour market with indirect impact on increasing the effective retirement age and decreasing early retirement.

The minimum social contribution thresholds for main economic activities and occupational groups are increasing by an average of 5.9% in 2012 in comparison with 2011, and the average social insurance income will go up by 4.5% in comparison with 2011.

Another measure to facilitate older workers to stay longer at work, is in place – an amendment to the Labour Code eliminating the possibility for employers to terminate the employment relationships of workers or officials because they have become eligible for old age pension.

All the above described proves that the Council recommendation to accelerate pension reform, and increase the effective retirement age, has been taken on board: the period of the reform was shortened (it will continue until 2020 instead of 2026), and all measures will become effective in the first half of the period.

To improve pension adequacy, as of 1 June 2012 the minimum monthly size of the old age pension is increased from BGN 136 (EUR 70) to BGN 145 (EUR 74), which leads to increase in the minimum amounts of all contributory pensions. The budgetary impact of this measure was estimated at BGN 42 million (EUR 21.5 million) for 2012.

As of 1 January 2014 the ceiling on newly granted pensions will be abolished and the ceiling on old pensions will be gradually raised.

The pensions will be indexed by 2.1% in 2013, 2.4% in 2014, and 2.5% in 2015<sup>20</sup>, based on the preceding year inflation. Pension indexation is estimated to cost BGN 77.4 million (EUR 39.6 million) in 2013, BGN 91.2 million (EUR 46.6 million) in 2014, and BGN 97.7 million (EUR 50 million) in 2015.

## 2.4.2 Education

In the 2012 State budget, BGN 2.747 billion are earmarked for education, amounting to 3.4% of GDP<sup>21</sup> or 9.5% of the total expenditure. The increase in education expenditure compared to 2011 amounts to BGN 171.2 million, of which BGN 76.9 million in the national budget and BGN 94.3 million from the European Funds (national co-financing and European financing).

### ***Secondary education***

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Government efforts in the field of school education are focused both on system entry, envisaging school admissions to be based on regional needs and on educational standards, more closely linked to abilities and skills. Pre-school and school education measures also emphasise improved access to education and attracting pupils in the education system through flexible education (alternative, parallel, distance), general and additional support, organisation of extracurricular classes and preparation, and improvement of the system passability. A serious step forward is the introduction of mandatory external evaluation of each stage of school education and mandatory qualification of pedagogical staff.

For 2012, the differentiation of the uniform expenditure standards (UES) of the general schools was amended, and new grouping of municipalities was developed. For the implementation of this reform additional BGN 11 million for delegated educational activities, financed under the UES for general schools were allocated. This aims at directing more funds to municipalities with small schools concentration. In the 2012 budget, additional BGN 25 million were provided for amending the UES in the secondary education system. These funds will compensate the increased prices of fuels and energy and the increase in the minimum salary from 01 September 2011.

For gradual introduction of all-day schooling for I to VII grade in state and municipal schools and for the introduction of full-time schooling for II grade pupils, additional BGN 17.9 million were provided in 2012.

Additional resources for all-day schooling for III grade for school year 2012/2013 and for providing the mandatory two years pre-schooling to all 5 year olds during school year 2012/2013, (part of the reform to gradually expand the coverage of mandatory pre-schooling) are also earmarked.

To strengthen measures for early school leaving prevention, transport expenditures for pupils up to 16 amount to BGN 24.5 million, an increase by BGN 1.3 million compared to 2011. In

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<sup>20</sup> Pursuant to the projected average annual consumer price index in the approved new medium-term macroeconomic framework.

<sup>21</sup> According to the Report to the Law on the State Budget of the Republic of Bulgaria for 2012.

2013–2015 BGN 28.4 million for 2013, BGN 29.9 million for 2014 and BGN 31.1 million are earmarked.

### **Higher education**

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Higher education reforms aim at improving the quality of education, and the internationalisation of the system. The main focus lies upon measures to introduce external evaluation by an independent European university accreditation agency and differentiated tuition fees depending on achievements and social status. The inclusion of the 2010 rating system monitoring graduates performance on the labour market in the university financing model is of crucial importance for improving higher education quality and for linking results to financing. Another objective is better linking of training and labour market needs. In-depth analyses of educational level and acquired competences, as well as labour market needs by main economic activities, occupational classes, etc., are planned.

In 2012 the planned subsidy for state universities maintenance is BGN 261.5 million, a BGN 11.2 million increase compared to the previous year. Students' scholarships financing is also increased by BGN 6 million, reaching BGN 31.7 million.

Additional financing is available to universities on the basis of in-depth assessment of the education quality and compliance with labour market needs. The increase for 2012 is BGN 8.2 million, and total amount will reach BGN 15 million.

The 2010 introduction of the university rating system<sup>22</sup> allowed the best-assessed faculties to receive additional financing of up to 10% in 2011 and will receive additional financing of up to 25% in 2012.

In order to implement the reform, aiming at improving access to higher education to individuals regardless of their social status, the amount of the government guarantee under the Law on Undergraduate and PhD Students Loans was increased to BGN 80.5 million in 2012, amounting to an increase of BGN 40.4 million compared to 2011.

### **Science**

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The Law on the 2012 State Budget envisages science expenditure of BGN 193.6 million, of which BGN 122 mln. on science in the Bulgarian Academy of Sciences (BAS) and state universities autonomous budgets.

2012 science expenditures will be primarily focused at programme-competition science financing.

### **Youth**

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Reforms to promote new institutional environment for youth implementation policy in Bulgaria based on strengthened intersectoral cooperation and better coordination among institutions, continue in 2012. Through the adopted National Youth Strategy (2010–2020), the bulk of financing (BGN 207.961 million) is targeted at measures promoting higher participation rates and career development of young people, and BGN 24.524 million at improving the access to information and quality services.

The implementation of the National Youth Programme (2012–2015), based on the reported needs of young people in Bulgaria on the grounds of the assessment of the earlier programmes – Youth Activities Programme (2008-2010) and the "Youth Information and Consultation Centres" National Programme (2007-2010), continues in 2012. The total amount for the entire programming period is BGN 6 million. Programme project financing in 2012 amounts to BGN 1 million.

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<sup>22</sup> CMD No. 168 of 17 June 2011, [www.rsvu.mon.bg](http://www.rsvu.mon.bg).

The new programme will finance projects for youth activities under 4 axes – development of youth information and consultation centres, national youth initiatives and campaigns, youth volunteering and youth work experience recognition. Young people will be informed and consulted on career orientation and work motivation, as well as on opportunities to participate in youth initiatives, voluntary activities, training and other supporting activities.

### 2.4.3 Labour market policy

In 2011 under national programmes, projects and measures for employment promotion were allocated a total of BGN 57.5 million (EUR 29.5 million). Within the National Employment Promotion Action Plan for 2012<sup>23</sup> employment programmes and measures amount to a total of BGN 73 million (EUR 37.3 million). According to the three-year budgetary framework and FLSU expenditure ceilings for 2013–2015 active labour market policy measures are allocated at the 2012 levels.

To enhance the effectiveness and efficiency of the active labour market policies, in 2012 programmes and measures were amended. In order to limit participation over an extended period of time in the National Programme “From social assistance to employment” thus precluding the participation of new unemployed, a rule stating that at least 70% of the unemployed should not have worked under the Programme since the beginning of the previous year. Also, the employed under National Programme “Assistance for retirement” will be able to work for up to 2 years prior to acquiring entitlement to pension (compared to 1 year in 2011).

The 2012 Law on Employment Promotion financing for sustainable employment in the private sector, was increased by almost 35% to BGN 12.9 million (EUR 6.6 million) compared to 2011.

In 2012 Operational Programme “Human Resources Development” 2007-2013 (OPHRD) will continue to be among the main instruments to finance employment policies implementation, enhancing the quality of the labour force, improving educational level and social integration of disadvantaged people. Under the Operational Programme, 137 grant procedures have been launched with a total budget of around BGN 2.3 billion (EUR 1.176 billion), of which 54 new procedures launched in 2011 with a total value of over BGN 1 billion (EUR 0.511 billion).

In 2012 under OPHRD the project “Evaluation of active labour market policies impact” will be implemented. Its main goal is to enhance the quality and effectiveness of active labour market policy.

### 2.4.4 Healthcare

Improving the quality and the access to healthcare services remain the main priorities in the healthcare sector. The measures to improve quality are mainly focused on improving control and increasing the efficiency of the public expenditure. The restructuring of the hospital sector, as well as the completion of the introduction of e-Healthcare, are crucial for the success of the reform.

With a view to improve the effectiveness of public expenditures and improving expenditure control, the following measures are key:

- ▶ improving financing, disbursement and control mechanisms;
- ▶ developing e-Healthcare – by 2014, unification of the electronic registers on different activities in a single register, followed by the introduction of a personal health card and a personal electronic health record file;
- ▶ restructuring the hospital sector on the basis of the National Healthcare Map of Healthcare Institutions adopted in February 2011<sup>24</sup> – the draft Law amending the Law on the Healthcare Establishments, submitted to the National Assembly on 9 December 2011 and adopted at first reading on 15 February 2012, envisages measures for

<sup>23</sup> CMD No 957 as of 29 December 2011

<sup>24</sup> Adopted under CMD No. 103 of 24.02.2011.

continuing healthcare reform on streamlining the existing medical institutions in the country and their planning at national level. Rendering primary care by existing specialized out-of-hospital establishments will be also possible. Daily stationary (daily patient admission, diagnosis, treatment and observation) is also regulated. Minimum required beds in medical establishments ensuring patient hospital access are updated. Planning of healthcare establishments is also changed, it is to be done only at national level through the National Healthcare Map. A list of high-tech diagnosis and treatment is introduced for medical institutions planning. It is also envisaged that the National Healthcare Map shall also determine the maximum number of hospital institutions, implementing these methods, financed by the NHIF / the Republican budget.

### 2.4.5 Social Inclusion

- ▶ Preventive measures are the main focus of the poverty reduction and promoting social inclusion policy. In this regard, the main priorities will be achieved through reforms and innovative measures to incorporate new approaches and models to address poverty and social exclusion and/or to complement current policies.
- ▶ In 2010 new approach for social exclusion of children and families at risk started with the implementation of the Social Inclusion Project, financed with a loan from the International Bank for Reconstruction and Development (the World Bank) amounting to EUR 40 million. The project allows municipalities to develop services for early child development, for risk-prevention in early childhood, for better coverage and readiness to enter the education system, for improving family environment, etc.
- ▶ Social inclusion expenditures in 2012–2015 amount to BGN 2.246 billion.
- ▶ Key component to support vulnerable groups, and thus social inclusion policy is the provision of accessible, quality and effective services, meeting beneficiaries' needs and facilitating and expanding the opportunities for social inclusion. The provision of accessible and quality services is closely linked to the implementation of the following priorities: improving the quality of life of children, including deinstitutionalisation of childcare; abolishing the institutional model of elderly people and disabled people care by developing long-term care services and intersectoral services (linking social services and healthcare); providing accessible environment; improving housing conditions of vulnerable groups and support for homeless people.
- ▶ Synergies and closer coordination between social inclusion policies and active labour market policy will contribute to reaching the national target to decrease the number of people living in poverty by 260 thousand by 2020, as set in the National Reform Programme.

## 2.4.6 Analysis of expenditures per function as a percent of Total budget expenditure

**Table 3**

<b>% of Total expenditure</b>	<b>ESA code</b>	<b>2010</b>	<b>2015</b>
General public services	1	10.3%	9.1%
Defence	2	4.7%	3.0%
Public order and safety	3	7.1%	5.7%
Economic affairs	4	13.4%	13.3%
Environmental protection	5	1.8%	5.4%
Housing and community amenities	6	2.6%	3.3%
Health	7	12.6%	13.3%
Recreation, culture and religion	8	2.1%	1.5%
Education	9	10.0%	11.2%
Social protection	10	35.5%	34.1%
<b>Total expenditure</b>		<b>100.0%</b>	<b>100.0%</b>

In the period 2010–2015 total government expenditures decline from 38% of GDP to 33.1% of GDP. Within this significant consolidation, there is expenditure targeting at growth-significant sectors. There is a strong decline in defence and public order and safety expenditures as a percentage of total expenditure. Defence expenditures decrease to 3% of total budget expenditures, while public order and safety drop to 5.7% in 2015. General public services decrease from 10.3% to 9.1% of total expenditure.

Expenditure for environmental protection, healthcare, education, housing and community amenities increase. Environmental protection expenditures grow by 200% as a share of total expenditures. The new expenditure allocation assigns the highest weight to social protection, economic affairs, health, economic affairs and education. In 2010 general public services belong to this group, but due to the administrative reform and optimization their share declines substantially. ▼

## 3.—GOVERNMENT BALANCE AND DEBT

### 3.1 Policy Strategy and Medium-term Fiscal Policy Objectives<sup>25</sup>

The fiscal policy objectives for the next three-year period do not differ from the ones defined by the government in the first medium-term fiscal framework, covering the government's mandate.

The three-year budget forecasts, the expenditure ceilings and the estimates in the Consolidated Fiscal Programme (CFP) for the period 2013–2015 are based on the updated macroeconomic forecast and are in line with consolidation measures and with fiscal rules limits.

The budget forecast for the period 2013–2015 adjusted the general government deficit target to 1.3% from 1.0% of GDP for 2013, keeping the 2014 and 2015 targets. The main reasons for this correction are the impact of updated forecast parameters and changes in the CFP structure.

The updated macroeconomic forecast for the period 2013–2015 necessitates strict conservative and disciplined fiscal policy, manifested in keeping the assumptions on main horizontal policies unchanged in comparison with previous ones and the continued implementation of consolidation measures to decrease the general government deficit.

This is also reflected in the medium-term key policy assumptions, that were kept as in the previous budgetary framework, except for the level of the annual payroll expenditures in 2015 as a percentage of GDP, the annual indexation of pensions in 2013–2015 based on the consumer price index for the previous calendar year, abolished ceiling on the maximum amount of pensions as of 2014, and raising the minimum salary by BGN 20 each year until 2015.

The estimates under the CFP for 2013 compared to 2012 show an improvement of the national budget balance by 0.7% of GDP due to a decrease in expenditure of about 1% of GDP, while the forecasts for increased absorption of the EU funds (projected growth of 0.3% of GDP in 2013 compared to 2012) imply balance deterioration by 0.7% of GDP. Consequently, overall general government deficit reduction is due to mainly the continued spending cuts in the national budget to compensate for accelerated absorption of funds under EU programmes with a view to the approaching end of the programming period 2007–2013. It should be noted that this reduction is estimated with national co-financing for the implementation of the EU programmes.

According to the 2013–2015 budgetary framework, total revenues decrease. From a level of 36.6% of GDP in 2012 they are expected to shrink to about 33% of GDP at the end of the period due to decreasing EU assistance. Revenues were estimated under the assumption of unchanged current tax and social security policy. The forecast envisages a relatively constant level of tax revenues, with decreasing level of non-tax revenues due to measures for reducing the administrative burden.

The same decreasing trend is also observed with regard to total expenditures. The estimates envisage continuing shrinking from a level of 38% of GDP in 2012 to about 33% of GDP at the end of the period. This has an impact on the implementation of the expenditure policies.

FLSU expenditure ceilings for the period 2013–2015 remain relatively constant, the nominal growths resulting from the impact of horizontal policies (for example, in 2015 – from income policy implementation and the resulting social security disbursements).

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<sup>25</sup> The data in this part are on a cash basis.

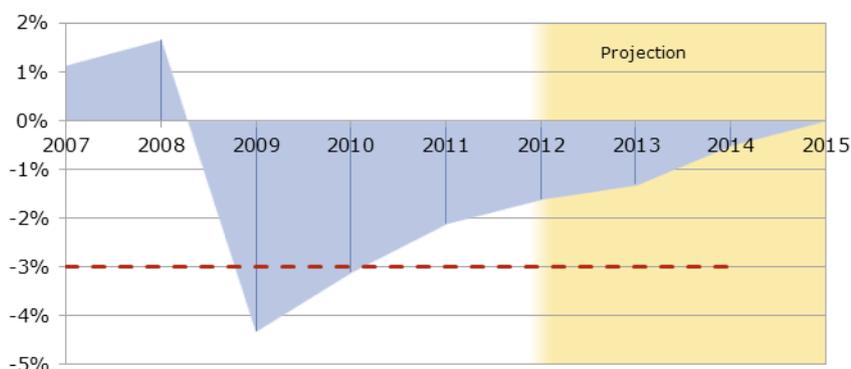
It should also be noted that expenditure ceilings have been estimated with constant main government commitment to a long-term sustainability and predictability of tax and social security policy.

### 3.2 2011 Budget Balance and 2012–2015 Developments

After the general government deficit fell to 3.1% of GDP (ESA 95) still in 2010 due to fiscal consolidation measures, the fiscal framework under the 2011 programme envisaged a 2.5% of GDP deficit target. **The estimated general government deficit for 2011 is considerably below the target and improved to 2.1% of GDP.** The government is determined to continue fiscal consolidation in the medium term to bring the budgetary position of Bulgaria to neutral while continuing tight expenditure policy and maintaining predictable and investment-attractive tax environment in Bulgaria.

In 2011 Bulgaria made additional fiscal effort of 0.4 p.p. of GDP compared to the Convergence Programme (2011–2014) target. This was achieved due to expenditure cuts and the measures to strengthen fiscal discipline in central government, social security funds, and the local government.

**Figure 19 — Budget Balance (ESA 95, % of GDP)**



Source: Eurostat, MF

The fiscal framework in the 2011 programme was to a large extent based on continuing consolidation measures and on measures to improve revenue collection. With a view to the still low economic growth, the recovery on the revenue side is slow and the fiscal consolidation was achieved mainly by expenditure-side measures; as general government expenditures (ESA 95) shrunk by 2.2 p.p. of GDP compared to 2010.

The tax and social security policy in 2011 was orientated towards promoting participation, decreasing the share of the informal economy and improving the business environment. Unchanged tax burden of main taxes, on the one hand, ensured a predictable environment for business and investments and, on the other, was favourable for the gradual recovery of domestic consumption and growth prospects. Reported tax and non-tax revenues were very close to planned. Revenues implementation did not jeopardize the budgetary position regardless of the more pessimistic economic scenario than the one in the macroeconomic framework. This was due to a large extent to the conservative planning and the efforts of revenue administrations to improve revenue collection and counter smuggling, tax crimes and the informal economy.

In January 2011 mandatory real-time remote connection between fuel fiscal devices and the NRA servers was regulated for reporting sales turnover and full control over the movement of goods to identify turnovers in the informal sector. The Ordinance on the registration and reporting of sales in commercial premises put an obligation traders registered under the Law on VAT, to develop a GPRS connection with the NRA system by the end of 2011, and all other traders – by the end of March 2012. This connection and the opportunity to control fiscal devices in real time will seriously assist efforts to fight tax irregularities and illegal

turnover. As a result, declared turnovers under the Law on VAT in registered petrol filling stations, increased by EUR 887 million in 2011 (or by 12% compared to 2010).

On the expenditure side, the nominal expenditure ceilings for payroll expenditures of ministries and institutions were unchanged. Thus the expenditure on compensations of employed shrank by 0.4 p.p. of GDP compared to the previous year. The amendments to the Social Security Code on the disbursement of sickness and unemployment benefits introduced in 2010, were unchanged. In September 2011 the supplement to survival pensions was increased (the widow's pension was increased from 20% to 26.5% of the pension of the deceased spouse). The impact of this increase on expenditure was minimal and fully compensated by cuts from other social payments. Thus social expenditures remained within the annual plans. Social payments also fell by 0.5 p.p. of GDP compared to the previous year.

Fiscal consolidation will continue in 2012, when the programme framework envisages general government deficit will improve by 0.5 p.p. of GDP to a deficit of 1.6% of projected GDP (according to ESA 95). The framework envisages this improvement to be achieved by continuing consolidation measures, improving the control mechanisms and conservative revenue planning. In the medium-term fiscal consolidation will continue until balanced position is reached, while prudent fiscal policy to underpin macroeconomic stability, improved economic sustainability and addressing potential risks of internal and external imbalances will be also pursued.

**The fiscal framework on the revenue side remains cautious.** The main tax policy characteristics are:

- ▶ unchanged direct tax and VAT rates;
- ▶ unchanged amounts and ratios of social security and health insurance contributions;
- ▶ relatively constant level of tax revenues, while non-tax revenues are expected to fall due to measures to reduce administrative burden;
- ▶ increasing only some excise duties rates, in accordance with the agreed transition periods with the European Commission and with a view to reaching the minimum rates for the Community; the impact from the increase in excise duties rates is expected to amount to BGN 40 million in 2012;
- ▶ increasing the minimum insurance thresholds for main economic activities and groups of professions by 5.9 percent for those under an agreement, and the administrative increase is 4.5 percent as compared to 2011. The average contributory income is expected to grow by 4.5% compared to 2011.

On the expenditure side, the ceilings on payroll expenditures in the budgets of ministries and institutions will remain unchanged, practically at the 2010 level. Pension indexation is envisaged, and in view of the need for pension reform acceleration, as from the beginning of 2012 changes to gradually increase the retirement age and length of service were made. Thus the expenditure framework of public social security (PSS) for 2012 covered the envisaged increase in the amount of the minimum pension from BGN 136 to BGN 145 without exerting pressure on the budgetary position – the net effect on the PSS expenditure is estimated to only BGN 42 million (less than 0.1% of the projected GDP).

In 2012 the minimum salary is envisaged to be increased from BGN 270 to BGN 290, effective from 1 May 2012. The effect on the 2012 expenditure is negligible – only BGN 5.2 million.

In the light of the priorities set out in the National Reform Programme of the Republic of Bulgaria (2011–2015) in implementation of “Europe 2020” Strategy and its 2012 update, the budgetary expenditure in 2012 envisages additional resources for the implementation of programmes and activities in the field of education and culture, at the expense of resources for defence, security and public order. The administrative reform continues focused at streamlining the structures of public administration. The results over the last two and a half

years are indicative – during the period July 2009 – February 2012, a total of 29 administrative units were closed down and the number of personnel of the central administration was optimised by 14%.

Efforts towards budget management effectiveness and control continue. Supporting consolidation measures and in the context of strengthened financial discipline and accountability in budget execution and budgetary payments, in the 2012 Law on the State Budget of the Republic Of Bulgaria (LSBRB) maximum ceilings of government obligations towards suppliers and long-term seconded servants as of 31 December 2012 were approved. The 2012 ceilings are nominally decreased by about BGN 200 million (0.2% of GDP) compared to 2011 ceilings.

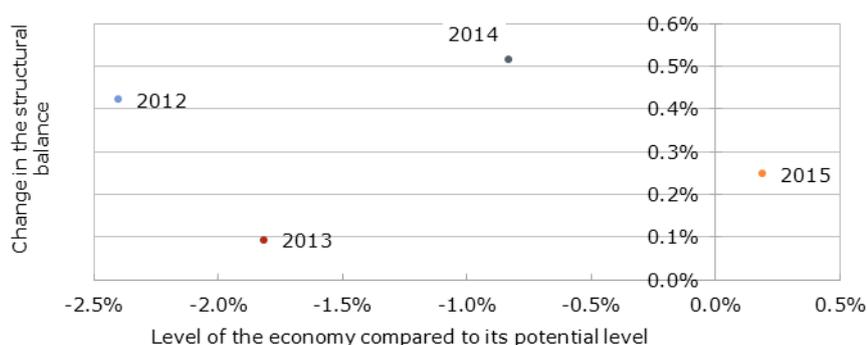
### 3.3 Medium-term Objectives

The medium-term budgetary objective (MTO) of the Republic of Bulgaria is to reach a structural deficit of 0.5% of GDP at the end of the programming period (2015). It is more ambitious than the requirements of the revised Stability and Growth Pact (SGP) and Article 3 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (EMU). Pursuant to the new provisions, for MS with debt levels considerably below the reference value, MTO of a structural deficit of 1% of GDP is allowed.

### 3.4 Structural Balance

In 2011 the budget balance in structural terms reached a deficit of 1.3% of GDP. Compared to the previous year, this reflects fiscal consolidation of 0.6 percentage points. During the period 2012–2014 restrictive budgetary policy is envisaged, aimed at maintaining macroeconomic stability and the confidence of foreign investors in the sustainability of fiscal position. Adherence to more conservative budgetary objectives is underpinned by public finances challenges resulting from ageing populations. At the end of the programming period the structural balance is expected to reach -0.1% of GDP, which is in line with the budgetary objective of a deficit of 0.5% in structural terms.

Figure 20 — Cyclically-adjusted fiscal position



Source: MF

### 3.5 Consolidated Government Debt<sup>26</sup>

In the medium term the government debt management policy will continue to be oriented towards a controlled change in the amount of government debt while strengthening the position of the Republic of Bulgaria as a stable debt issuer in the region and the EU. Priorities are both the maintaining of a stable debt structure and the implementation of an active, predictable and balanced issuance policy by providing the opportunities for free

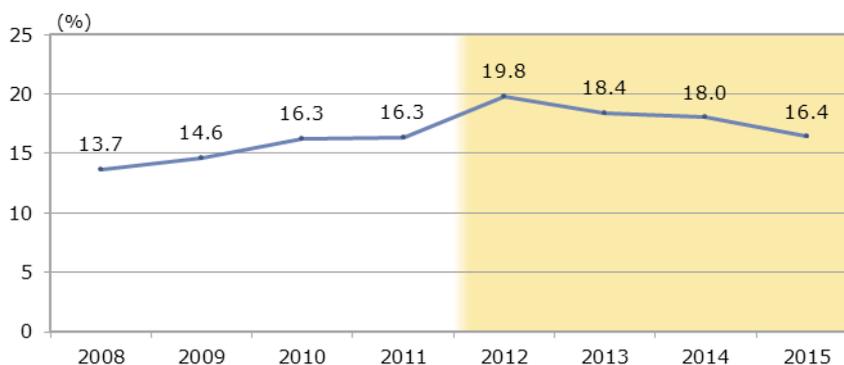
<sup>26</sup> Calculated in accordance with the manual on government deficit and debt under ESA 95.

market-orientated financing both in the domestic and in the international capital markets. The main goal of the debt management policy is to ensure the necessary sources of budget financing and sovereign debt refinancing, at an optimal price and risk level. This is crucial for increasing the macroeconomic stability of the country.

### 3.5.1 General Government Debt Dynamics and Structure

The consistent and targeted fiscal consolidation, in conjunction with the recovery of the Bulgarian economy, helped maintain general government debt (GGD) to GDP ratio<sup>27</sup> at the previous year level. The general government debt in 2011 amounted to EUR 6.3 billion (BGN 12.3 billion), and the “General Government Debt to GDP” ratio remained unchanged at its previous level of 16.3%. The GGD to GDP ratio of the Republic of Bulgaria is the second most favourable among the EU Member States.

**Figure 21 — General Government Debt to GDP ratio**



Source: MF

The central government debt keeps a major share in the structure of the general government debt with 92.76%, and in 2011 increased by about EUR 380 million (BGN 743 million). The reported increase is mainly due to the realised positive net debt financing in the amount of over EUR 525 million (BGN 1.027 billion), of which EUR 78 million (BGN 152 million) external debt and EUR 447 million (BGN 875 million) domestic debt. The gross debt financing in 2011 in the amount of EUR 950 million (BGN 1.86 billion) was provided mainly through market-based transactions in government securities – 60%, followed by government loans: 22% external and 18% domestic. The purpose of external financing in 2011 was primarily related to the implementation of specific programmes and investment projects in key sectors of the economy, and the size of the disbursements on government investment loans (GILs) reached about EUR 130 million (BGN 254 million).

The debt of sub-sector “Local Government” accounted for 7.11% of the general government debt and in 2011 increased to EUR 468 million (BGN 915 million), or by EUR 40 million (BGN 78 million) compared to 2010. Based on the needs of local governments for funds for co-financing the European projects for regional development, environment and transport during the period 2012–2015, the debt of this sub-sector is expected to increase.

The lowest share of the general government debt was held by the “Social Security Funds” sub-sector, in the amount of EUR 8.34 million (BGN 16.31 million) as at 31 December 2011, or 0.13% of the GGD.

In the context of the formation of the general government debt, the level of government securities held by institutional units of the “General Government” sector shall be taken into account (at the end of 2011 they amounted to EUR 212 million (BGN 415 million), since, according to Regulation (EC) No 479/2009 liabilities, the corresponding financial assets

<sup>27</sup> The preliminary estimate of the NSI about the 2011 GDP is BGN 75.265 billion.

related to which are held by the "General Government" sector, shall be excluded from the debt.

With a view to the forthcoming maturity of global bonds in 2013, in the 2012 LSBRB the opportunity is provided for issuing government securities on international markets in the amount of up to EUR 1 billion (BGN 2 billion), if there is a need for financing. Under the assumption of such issue, based on the envisaged issue volumes in the domestic market and the disbursements on external government loans, the general government debt is expected to increase during the current year, but its ratio to GDP will not exceed 20%. For the controlled growth of the "Central government" sub-sector debt, the following limitations are established in the 2012 LSBRB:

- ▶ the maximum amount of the government debt as at the end of 2012 may not exceed EUR 7.8 billion (BGN 15.3 billion);
- ▶ the maximum amount of the new government debt that can be assumed in 2012 is EUR 2.1 billion (BGN 4.2 billion) (including an issue in the international capital markets (ICM);
- ▶ the maximum amount of the new government guarantees that can be issued in 2012 is EUR 0.15 billion (BGN 0.3 billion).

Based on the current maturity structure of the "Central Government" sub-sector debt, which has a decisive importance for the amount required to refinance the outstanding debt, the estimates of the general government debt to GDP ratio show that for the period 2012–2015 it will remain relatively constant in the range of 16-20%. Its level relative to the GDP is expected to increase once to 19.8% at the end of 2012. The weakening of the pressure to finance budget deficits in the period 2013–2015, and the accelerating of the growth of the national economy will lead to a decrease in the GGD to GDP ratio in 2015 to the 2011 level.

The dominant part in the currency composition of the general government debt ("Central Government" sub-sector) in 2011 was held by liabilities in national currency and in EUR (over 80%), which is the result of strict policy followed in the negotiation of new financing, mainly orientated to risk neutral currencies – the EUR and BGN. As a result of the maturing issue of USD Global bonds it is envisaged that at the end of 2015 the relative share of debt in BGN and EUE will reach 90%.

The debt with fixed interest rates accounted for 82.4% at the end of 2011. It is expected that the amount of debt with variable coupon rates will vary within the range of 15-20% during the forthcoming three-year period.

The contingent liabilities, undertaken in the form of government guaranteed debt, are an important factor from the point of view of the risk they generate with regard to the budget indicators and the impact on the sustainability of government debt. The amount of the government guaranteed debt as at the end of 2011 was EUR 590 million (BGN 1.154 billion), and the government guaranteed debt to GDP ratio was 1.52%. In 2011 there were no new government guarantees issued in connection with external loan agreements. In 2012 and the forthcoming three-year period 2013–2015 the expectations are for assuming new guarantee commitments only to support strategic projects in key sectors of the economy.

### 3.5.2 Issuance Policy

In the conditions of high volatility in the international debt markets Bulgaria strengthened its position of a low-risk issuer in the region. This is a prerequisite for strengthening the positive trends in the market of Bulgaria government securities (GS). The results achieved at the auctions held in 2011, in terms of coverage ratios and yield, are an indication the confidence of local investors. The GS issued during the year were allocated in the following maturity segments: 3-month GS in the amount of EUR 7.67 million (BGN 15.0 million); 6-month GS – EUR 13.7 million (BGN 26.8 million); GS maturing in 3 years and 6 months with a nominal value of EUR 141.37 million (BGN 276.5 million); 5-year GS – EUR 144 million (BGN 281.6 million); 7-year GS – EUR 87.2 million (BGN 170.2); 10-year GS – EUR 15.9 million

(BGN 31.1 million), and GS maturing in 10 years and 6 months with a nominal value of EUR 165.1 million (BGN 322.9).

During the period 2012–2015 the issuing policy will remain flexible and adequate to the market situation, using all possible instruments for fostering the development of the domestic GS market. Efforts to achieve a highly liquid benchmark curve, while covering the whole maturity spectrum with securities denominated in BGN and EUR, continue. The priority during the period will be the issuing of medium-term and long-term securities. It is planned to maintain the supply of government securities issued on the principle of open issues with fixed coupons, taking into account the current investors demand. The offering of benchmark issues and the diversification of the maturity and currency structure of domestic debt (in BGN and EUR) contributes to the attracting of a wider range of investors on the Bulgarian debt market. The undertaking of actions for active debt management, including auctions for redemption and exchange, will continue.

In 2012 a positive net internal financing from transactions involving GS in the amount of about EUR 296.5 million (BGN 580 million) is envisaged as a result of the issuing of GS with a nominal value of about EUR 623.78 million (BGN 1.220 billion). In 2012 the opportunity is provided to issue government securities in international capital markets in the amount of the BGN equivalent of up to EUR 1 billion (BGN 2 billion), if the market conditions are favourable. GS issued in the domestic market stand out as a main instrument in the government debt structure and an important investment alternative for institutional investors in the country.

In 2013–2015 the gross nominal value of the new GS issued is envisaged to be in the range of EUR 511–624 million (BGN 1.0–1.22 billion) per annum. The issues will be positioned in the main maturity segments, outlining the benchmark curve, in volumes contributing to their liquidity and stable high levels of demand.

### **3.5.3 Government Loans**

The purpose of the debt financing in the form of government loans in 2011 was primarily intended for supporting the implementation of specific programmes and important investment projects. The second tranche under the Structured Programming Loan from the European Investment Bank in the amount of EUR 82.4 million (BGN 161.16 million) was utilised. Under government investment loans, managed by ministries and state departments, EUR 127 million (BGN 248.4 million) were absorbed as at 31 December 2011. For the purposes of financing the implementation of guarantee schemes under the Rural Development Programme 2007–2013, during the year a government loan agreement was concluded between the government of the Republic of Bulgaria and “Bulgarian Development Bank” AD for granting funds to State Fund “Agriculture” – Paying Agency in the amount of EUR 170 million (BGN 322.5 million).

During the period 2012–2015 the absorption of funds under the Loan Agreement for Structured Programming Loan Bulgaria – co-financing of the EU Funds 2007–2013, concluded between the Republic of Bulgaria and the European Investment Bank, is envisaged to continue. Under well-established relationships, the financial support from the International Bank for Reconstruction and Development (IBRD) in the coming years is expected to be directed towards the implementation of rail operations in the form of three structural development policy loans in the rail sector (DPL) with an indicative amount of EUR 80 million (BGN 156.5 million). An important component of the external debt financing is the absorption of funds under already signed government investment loans. During the period 2012–2015 the amount of these funds is expected to be between EUR 200 million (BGN 391 million) and EUR 250 million (BGN 489 million).

### **3.5.4 Sensitivity Analysis of the Debt Portfolio**

The debt portfolio with its main currency and interest rate characteristics, as described in the debt structure above, was subject to a sensitivity analysis to the change in the main variables (exchange rates and floating interest rates). The aim was to evaluate the influence

on the nominal value of the government debt and the amount of the forthcoming payments in the condition of parameters, higher than these included in the 2012 Law on the State Budget (LSB) and the three-year budgetary framework (TBF) for the period 2012–2014.

The analysis was carried out under assumptions for a more pessimistic scenario, manifested in higher forecasted exchange rates of the USD (de facto parity of the USD to the Euro), the Japanese yen and the Kuwaiti dinar, as well as higher levels of the 6-month USD LIBOR and the 6-month EUR LIBOR<sup>28</sup>. For the purposes of the testing, these parameters were increased by 20% for exchange rates and 200 b.p. for interest rates. Historically, such values of the US dollar and the interest rates have been reached in the past and in this sense the assumptions of their values are realistic.

The calculations made show a relatively low sensitivity of the overall exposure of the debt portfolio to changes in exchange rates and interest rates, and, therefore, low risk indicators generated by the debt structure, the only exception being the amount of funds necessary for the payments upon the maturity of the USD global bonds in 2015.

Debt payments (principal and interest) are most sensitive to changes in the exchange rate of the BGN/EUR to the USD. A depreciation of the national currency in respect of the US dollar would have significant consequences only for the payment of the debt under the USD global bonds (with fixed coupon rates), maturing at the beginning of 2015. Under the scenario including parity of the USD to the Euro, the change in the amount of the principal payments for 2015 is in the direction of increase by 15.63%, which is EUR 187.65 million (BGN 366.45 million) in absolute terms. An appreciation of the US dollar would have a relatively low negative impact on the interest expenditure under the USD-denominated loans and issues – for each of the years during the discussed period it is in the range of 3.3% (EUR 13 million, or BGN 25.4 million), and for the whole period until 2015 the total cumulative effect is about EUR 52 million (BGN 101.7 million). The nominal amount of the debt would increase by about EUR 200 million (BGN 400 million) over the period 2012–2014, and the repayment of the USD global bonds in 2015 would actually minimise to negligible levels this risk, generated by the exposure to the US dollar.

In the second place as a risk component is the change in the 6-month EUR LIBOR. With a view to the fact that 89.5% of the debt with variable interest rates is subject to this variable, a 2 p.p. increase would lead to a cumulative increase in the interest expenditure during the period 2012–2015 by about EUR 100 million (BGN 195 million).

Changes in the other variables, exchange rates of the Japanese yen and the Kuwaiti dinar, and higher levels of the 6-month USD LIBOR, have a minimum impact on the amount of payments, both in relative terms compared to the baseline forecast and in absolute terms. The effect of the changes in the exchange rates of both currencies to the Bulgarian lev on the nominal amount of the debt would be more appreciable. At an expected amount of the debt, denominated in these currencies, of EUR 508 million (BGN 933.993 million) at the end of 2015, a 20% increase in the exchange rate would result in a nominal increase of the debt by EUR 101.5 million (BGN 198 million).

The reported impact of the change in exchange rates in the order described above is among the factors for the growth of government debt, although with a low weight. The main approach to limiting the market risk is the followed strategy of assuming new debt mainly in BGN and EUR and at fixed interest rates. In addition, the legislative framework of government debt management<sup>29</sup> provides the Minister of Finance with the opportunity to execute debt transactions related to the optimisation of the servicing of the government debt, such as issue government securities for redemption of external and internal obligations of the country, conclude agreements for reducing the refinancing risk and settling the maturity structure of the debt, provided that the nominal value of the debt at the end of the year is not increased. ▼

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<sup>28</sup> Share of the government debt with 6-month EUR LIBOR of 13.5% as at the end of 2011

<sup>29</sup> Article 5 of the Law on Government Debt; §15 of the TFP of the 2012 LSBRB.

## 4.—SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

### 4.1 Alternative Scenario – Higher oil prices

The alternative scenario treats an accelerated increase in the international crude oil prices under the impact of the geopolitical tension in the Middle East and the EU embargo on Iranian oil exports. Technically this is manifested in the assumption for an 18.3% increase in price of crude oil in US dollar terms in 2012 as compared to the baseline scenario. This increase, in turn, will strengthen the external inflation factors and will result in higher inflation at the end of 2012 compared to the baseline scenario, both through higher energy prices and some secondary effects on the other HICP components. An increase compared to the baseline scenario is also expected in the average annual inflation in 2012 and 2013.

**Table 4— Comparison between the baseline and the alternative assumptions**

	2012		2013		2014		2015	
	Percentage change	Difference compared to the baseline scenario, p.p.	Percentage change	Difference compared to the baseline scenario, p.p.	Percentage change	Difference compared to the baseline scenario, p.p.	Percentage change	Difference compared to the baseline scenario, p.p.
Average spot price of oil, USD/barrel	20.3	18.6	-18.1	-15.0	-4.3	0.0	-3.2	0.0
Average spot price of oil, EUR/barrel	26.8	19.6	-15.6	-15.5	-4.0	0.0	-2.8	0.0
Harmonised inflation, end-of-period	4.7	2.1	2.5	0.0	2.5	0.0	2.4	0.0
Harmonised inflation, annual average	3.1	1.1	3.4	1.0	2.5	0.0	2.5	0.0

Source: MF

The higher inflation is expected to slow down the recovery of the consumption by 0.4 p.p. during the current year and by 0.3 p.p. in 2013. The subdued consumption will have a negative impact on the real growth of imports, which is expected to decrease by 0.2 p.p. during the current year and by 0.4 p.p. during the following year, the main influence coming through the lower growth of the imports of goods. On the other hand, the oil price increase is expected to have a modest impact on exports real growth in 2012.

The oil price increase will also have a negative impact on the current account balance, mainly through changes in the trade balance. Higher prices of one of the main raw materials imported in Bulgaria will result in a nominal increase in total imports. Their growth will outpace the increase in exports, thus leading to larger trade deficit in 2012. In 2013 the price effect will be offset by the lower quantities and a slight improvement of the trade balance as compared to the baseline scenario is expected. The impact on the other current account items will be limited.

The expectations on the main labour market indicators are slightly more pessimistic, but without significant deviations compared to the baseline scenario. In the first two years the deviation in the employment dynamics will be around or even below 0.1 p.p. The unemployment rate will remain around the baseline scenario levels and after 2013 its value will increase slightly, up by 0.1 p.p.

**Table 5 — Effects from the oil price increase on the main macroeconomic indicators**

Real growth rates	2012		2013		2014		2015	
	Alternative scenario	Difference compared to the baseline scenario, p.p.	Alternative scenario	Difference compared to the baseline scenario, p.p.	Alternative scenario	Difference compared to the baseline scenario, p.p.	Alternative scenario	Difference compared to the baseline scenario, p.p.
GDP	1.2%	-0.2	2.2%	-0.3	3.5%	0.0	4.0%	0.0
Final Consumption	0.3%	-0.4	1.9%	-0.3	3.6%	0.0	4.2%	0.0
Gross capital formation	3.4%	- 0.1	5.6%	-0.1	7.1%	0.0	8.0%	0.0
Exports	3.7%	0.0	3.7%	-0.5	4.4%	0.1	4.3%	0.1
Imports	3.5%	-0.2	4.6%	0.4	5.7%	0.1	6.0%	0.1
Current account balance (% of GDP)	1.1%	0.4	0.3%	0.2	-0.7%	0.1	-1.3%	0.1
Employed, %	-0.2%	-0.1	0.7%	0.1	1.1	0.0	1.1	0.0
Unemployment rate	11.3%	0.0	11%	0.1	10.5%	0.1	9.9%	0.1

Source: MF

## 4.2 Sensitivity of the Budgetary Projections to the Alternative Scenarios

The cumulative effect of the increase in crude oil prices in 2012 by 18.3% compared to the forecast in the baseline scenario will have a largely positive impact on total revenues to the consolidated budget. On the one hand, the lower economic activity as a result of the initial effect of higher energy prices will lead to a modest decrease in some revenue items. On the other hand, the effect of the increase in the nominal value of imports and consumption will be opposite and stronger – it will have a positive impact on the indirect tax revenues through the increase in the nominal revenues from VAT and excise duties. Meanwhile, the higher inflation rate compared to the baseline scenario (by 1.1 p.p. in 2012 and 1.0 p.p. in 2013) is likely to create certain pressures on the current non-interest expenditure. Thus the positive effect on the revenue side will be offset by the increase in the total expenditure and the budget balance will remain unchanged.

## 4.3 Comparison with the Previous Update

The update of the medium-term macroeconomic forecast was imposed by the changed external environment. As a result of the debt problems deepening in some euro area countries, the outlook for development of the European economy in 2012 deteriorated significantly. The European Commission revised twice its forecast for the EU growth downwards in 2012 from 1.9% (after the spring forecast) to 0.6% (according to the autumn forecast) and 0% (according to the interim forecast in February 2012). For comparison, the previous convergence programme was developed under the assumption of a 2% real growth of the European economy in 2012. The lower domestic demand in the EU, which is a major trading partner of Bulgaria, is expected to affect adversely the Bulgarian exports. The uncertain international juncture resulted in a slowdown of domestic demand recovery in the country, thus the latter reported a 0.6% decline in 2011 as compared to the expected growth of 3.5% a year earlier. In addition, the previous update of the Convergence Programme was prepared using reporting data, available as at the beginning of 2011, when there were still no indications for the slowdown of the European and world economy.

**Table 6 — Main macroeconomic indicators**

Real growth rates	2011			2012			2013		
	CP 2012	CP 2011	Difference, p.p.	CP 2012	CP 2011	Difference, p.p.	CP 2012	CP 2011	Difference, p.p.
GDP	1.7%	3.6%	-1.9	1.4%	4.1%	-2.7	2.5%	4.4%	-1.9
Private consumption	-0.6%	3.2%	-3.8	0.6%	4.1%	-3.5	2.3%	4.7%	-2.4
Gross fixed capital formation	-9.7%	5.6%	-15.3	7.1%	6.5%	0.6	5.9%	7.5%	-1.6
Exports	12.8%	8.2%	4.6	3.7%	7.8%	-4.1	4.2%	7.6%	-3.4
Imports	8.5%	7.8%	0.7	3.6%	8.2%	-4.6	5.0%	8.5%	-3.5

Source: MF



## 5.—LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

### 5.1 Policy Strategy

The current fiscal position guarantees the long-term sustainability of the public finances and fully complies with the long-term budgetary restriction, according to which the present value of the primary structural balances shall cover the current government debt level. The check whether this condition is met is reflected in the sustainability indicators S1 and S2.

The small values of both indicators are due to the strong fiscal position with regard to the budget deficit and debt, which are expected to be reached during the programming period – namely debt in the amount of 16.4% of GDP as at the end of 2015 and balanced budget on accrual basis. Effective from the beginning of 2012, significant changes in the public social security were undertaken. The main changes are related to limiting pension expenditure in the long term. As a result of these changes the PSS budget will improve, the participation rate will increase and the burden on the social security system will decrease. The reforms undertaken in the pension system as from the beginning of 2012 result in decreasing the dependency of the budget on the expected long-term demographic changes and in improving the values of the two indicators of the stability of public finances.

**Table 7— Comparison between sustainability indicators under the old and the new Social Security Code (SSC)**

	SSC 2011 scenario		Programme scenario (SSC 2012)	
	S1	S2	S1	S2
Value,	-1.46	1.13	-2.61	0.02
<i>of which:</i>				
Initial budgetary position	-1.20	-0.79	-1.20	-0.79
Debt ceiling in 2060	-1.46	-	-1.46	-
Future changes in the budgetary position	1.20	1.91	0.05	0.82

Source: MF

### 5.2 Long-term Budget Outlook

#### *Pension Expenditures*

Regardless of the indisputable successes of the 2000 pension reform, over the last years the pension system in Bulgaria faced a number of challenges related to:

- ▶ dependence on the state budget – in 2009 the state joined as a “third party insurer”, making a transfer to the “Pensions” Fund in the amount of 12% of the insurance income of each insured person. In 2011 this transfer amounted to EUR 1.27 billion, or 34.8% of all pension expenditures. Together with the additional subsidy for covering the shortage of funds, the state participation amounts to over 50 percent of the expenditure of the public social security system;
- ▶ the global economic crisis – decrease in revenues from social security contributions as a result of the lower number of insured people and the lower insurance income;;
- ▶ the unfavourable demographic developments in Bulgaria – decreasing population, shrinking labour force, and increased number of pensioners.

In order to overcome these negative trends, the Bulgarian government implements a number of measures for ensuring the long-term financial stability of the Bulgarian pension system and for improving the adequacy of pensions. These measures entered into force in two stages on 1 January 2011 and 1 January 2012 with the amendments to the Social Security Code and are described in the 2012 update of the NRP and in the text of this Programme above.

The changes in the pension system will influence the revenues from contributions and the pension expenditures of the PSS, and thus the balance of the PSS funds in the long term. In order to monitor their impact, two main long-term projections were simulated. The first corresponds to the legislative framework provided for by the SSC, as effective in 2011. It is assumed to be the baseline scenario, since it will be included in the 2012 update of the "2012 Ageing Report". In the second projection the parameters of the 2012 SSC are introduced, which include the following differences compared to the baseline scenario:

- ▶ increasing of the retirement age from 2012 instead of 2021, with 4 months per year, for both males and females and for all categories of workers, until the age of 65 years is reached for males in 2017 and the age of 63 years is reached for females in 2020;
- ▶ increasing by 2 years of the acquired length of service for professional military employees from 25 to 27 years;
- ▶ increasing the minimum amount of the old age pension benefit for length of service and age in the social security system from BGN 136.08 to BGN 145.00 as from 1 June 2012, which leads to an increase in the minimum amounts of all pensions linked to labour participation;
- ▶ from 2013 on, pensions'indexation will apply a percentage rate equal to the consumer price index for the preceding calendar year, instead of the "Swiss rule";
- ▶ increasing accrual rate in the pension formula from 1.1 to 1.2 in 2017 only for newly granted pensions instead of for all pensions.

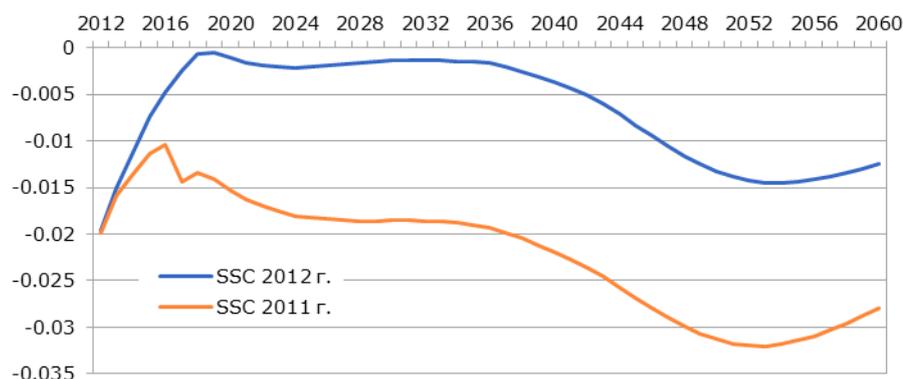
When both projections were prepared, both the latest Eurostat demographic projections EUROPOP 2010 and the macroeconomic forecast, developed by the Ageing Working Group (AWG) to the Economic Policy Committee of the European Commission in connection with the 2012 update of the Ageing Report ("2012 Ageing Report") were used. The NSSI model for long-term forecasting of PSS funds was used as a tool.

#### **Conclusions about the PSS funds balance:**

- ▶ *In the scenario with the 2011 SSC, an improvement of the balance is observed until 2017, after which the situation deteriorates dramatically as a result of the envisaged recalculation of the pensions using accrual rate 1.2 in the pension formula. The deficit in the PSS budget will continue to increase until 2054, when it will reach 3.2% of GDP. After 2054 the balance will start to improve again.*
- ▶ *In the scenario with the 2012 amendments to the SSC (all legislative changes in force as of 2012 are included), during the period 2018-2020 the levels of the PSS funds will be close to balance. Until 2041 the deficit will remain below 0.5% of GDP, after which the situation will start to deteriorate and in 2054 the deficit will reach 1.5% of GDP – half this in the baseline scenario. After 2054 improvement will be observed again.*

The effects from the changes in legislation effective as of the beginning of 2012 are mainly due to the change in the way of updating the pensions, the abolishing of the recalculation of all pensions using the higher accrual rate and the increase in the statutory retirement age starting in 2012 instead of in 2021. The change in the manner of updating the pensions has the greatest effect on the pension expenditure and, thus, on the PSS balance.

**Figure 22 — Balance of the PSS funds, 2012–2060 (% of GDP)**

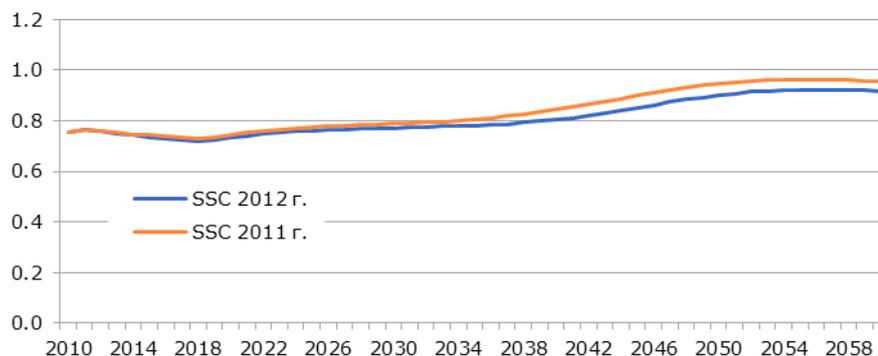


Source: NSI

**Conclusions about the dependency ratio and the income-replacement rate from the first pillar:** The population ageing and the increasing life expectancy significantly affect public social security system in the long term. The ratio between the number of pensioners and the number of socially insured people, also known as dependency ratio, demonstrates an upward trend in both scenarios. The differences result from the fact that the retirement age in the 2011 SSC scenario starts increasing in 2021, and in the 2012 SSC scenario the retirement age increases as early as 2012, which has a downward impact on the dependency ratio. Starting from a value of about 76%<sup>30</sup> in 2012, the dependency ratio in 2060 reaches 95.5% in the 2011 SSC scenario and 91.7% in the 2012 SSC scenario.

**Figure 23 — Dependency ratio 2012–2060**

(number of pensioners to number of socially insured individuals)



Source: NSI

The upward trend of the dependency ratio is accompanied by a long-term downward trend of the replacement rate<sup>31</sup>. The replacement rate for the first pillar is expected to gradually decline, since the formula for calculating pensions changes from using an average value for the last years to using an average value for the entire length of service. Another reason for the lower replacement rate for the first pillar in the long term is the decrease in the amount of the first-pillar pension when a second-pillar pension will be also received. The amount of this decrease depends on the length of service in both pillars and the amount of the social security contribution, which is transferred from the first to the second pillar.

In order to improve the adequacy of pensions, it is envisaged that as of 2017 the weight of each year length of service to accrual rate will increase to 1.2. This change results in higher amounts of the new pensions by about 9 percent in 2017 (in the 2011 SSC this measure was applicable to all pensions). With the amendments to the SSC, which came into force in 2012, the higher accrual rate is envisaged to affect only pensions granted after 2016. This is one reason why the replacement rate in the 2012 SSC scenario is lower compared to the 2011

<sup>30</sup> 76 pensioners for each 100 socially insured individuals.

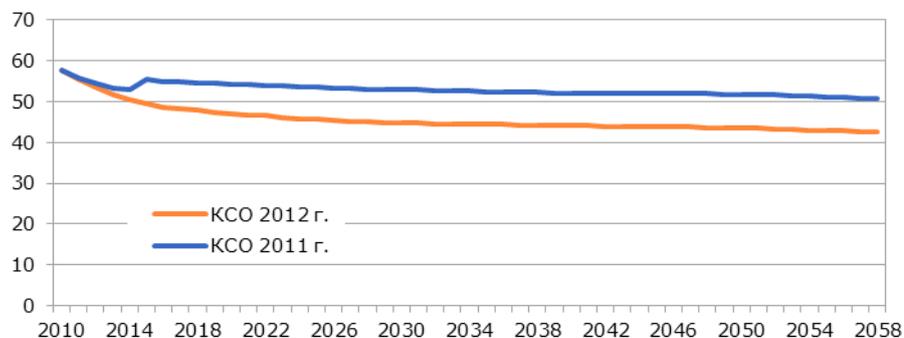
<sup>31</sup> The ratio between the average pension and the average contributory income.

SSC scenario. This difference in scenarios has a diminishing effect with time, i.e. it does not lead to a lower replacement rate at the end of the period.

The most significant impact on the replacement ratio in a downward direction has the transition from annual indexation of pensions using 50% of the consumer price index and 50% of the increase of the average insurance income for previous year to an update only for inflation. The new rule will be implemented as of 2013.

**Figure 24 — Income replacement rate from the first pillar, 2012–2060**

*(average pension to average insurance income)*



Source: NSI, MF forecasts

For 2012 the expected net replacement rate is about 57.5%. In the 2011 SSC scenario the net replacement rate<sup>32</sup> is expected to decrease to about 50% at the end of the period, and in the 2012 SSC scenario – to about 42.5%. ▼

<sup>32</sup>Average pension to average contributory income.

## 6.—QUALITY OF PUBLIC FINANCES

During the next three-year period the government envisages to implement different instruments and measures, directly influencing the quality of the public services and their management, as well as to provide opportunities for linking the results (in terms of quantity, quality and time) with the required financing.

Some of these measures will result in cost reduction for the business. With the introduction of a cost-oriented model for determining the amount of fees, the government aims to bring in line the cost of administrative services provided with the specific costs, as well as to use fee revenues to improve the quality of the corresponding service.

The electronic exchange of documents in the public administration, which was launched last year, has already yielded results. It is expanding to cover the municipal administrations as well. This will further improve public administration work effectiveness, quality and timeliness, by saving time and financial resources.

The commitment undertaken by the government at the end of last year to join the global initiative "Open Government Partnership" is a step forward in Bulgaria's efforts for an open and a more transparent government and building upon achieved results. In the area of effective management of public resources, the measures envisaged are orientated in two directions: to strengthen fiscal discipline by introducing fiscal rules and procedures, and to increase transparency, for example by providing information on tax and other costs.

The forthcoming introduction of a remuneration model of performance-related pay and assessment of public sector employees is another key tool for increasing the efficiency and quality of work in public administration.

The past year 2011 is also characterised by positive results from implementation of the planned government measures for optimisation of the public administration. Improving the inter-institutional coordination and enhancing the quality of public goods and services is reflected in improved effectiveness of public spending.

In terms of its application, the emphasis on programme and results-oriented budgeting is characterised by preservation of the quality of documents, achieved in recent years, especially in terms of the information on performance results. Programme budgets for the most part contain information on the processes and activities, implemented by the relevant administrative units, and in most cases this information is also supported by indicators measuring their outcome.

It should be noted, that institutions continue to face difficulties in the identification of appropriate indicators for measuring the outcomes of the goods/services, provided by them. The prevailing part of the indicators are still quantitative, which is also related to the fact that mainly activities or processes are measured. One of the main reasons for this is that budgetary programmes are to a large extent consistent with the organisational structure, and in most cases the programme objectives coincide with the objectives of administrative units. Regardless of the difficulties, some departments try to use indicators measuring quality or deadlines for implementation.

With regard to the other important component of the programme budgeting, namely the existence of a strategic element, expressed in a medium-term horizon, some consistency is also observed. Ministries and government agencies present planned policy developments within a three-year period, and the main difficulties are related to the identification of clear and measurable indicators of benefit/impact, as well as to the reporting the role of external factors affecting results.

The Ministry of Finance will continue its efforts to support the ministries and state agencies to expand the use of indicators for assessing the effects of policies, as well as to improve the assessment of costs and outcomes of government programmes and policies.

The accumulation of accurate, true and statistically reliable information on the outcomes from the products/services, provided under the programmes, as well as on the effects of their implementation should gradually become the basis for making management decisions. This information is also a guarantee for the government's commitment to raise public awareness and public participation in governance.

### ***Institutional Changes Related to Public Finances and Improving the Collection Rate of Tax Revenues***

Revenue administrations continue working actively to increase the collection rate of revenues, in line with the objectives and economic priorities of the government for providing conditions for preserving the macroeconomic stability, improving the business environment, promoting participation rates and decreasing the share of the informal economy.

The mandatory remote connection of the fiscal devices of all traders with the NRA servers, as well as the implementation of the ordinance on the specific requirements and control exercised over the devices for measuring excise goods by the customs administration, are serious measures in the fight against tax crimes and the attempts to evade tax payments. In addition to this, the National Revenue Agency is pursuing an active information campaign to encourage the voluntary payment of taxes, social security contributions and unpaid public receivables due. The work on the automation of the exchange of information between the NRA and the Customs Agency continues. Together with the Ministry of Interior and the Prosecutor's Office of the Republic of Bulgaria, revenue administrations are actively working to identify tax and social security crimes, as evidenced by the numerous joint operations against tax fraud schemes and VAT evasion over the recent years.

#### ***NRA***

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In order to improve the effectiveness of collection of taxes and mandatory social security contributions, NRA undertakes a number of measures such as centralising the management and audit processes, based on risk assessment, strengthening the control over important for the treasury agents, including focus on the current control and timely VAT refund, as well as carrying out mainly probes of compliance with tax and social security legislation, including increased presence in retail objects during the active tourism season, where the objective is, by the so-called "monitoring of sales", to establish the actual turnovers of the retail objects.

As at 31 December 2011 about 73 000 fiscal devices, including 3 370 electronic systems with fiscal memory (ESFM), were remotely connected to the NRA.

In order to improve compliance, ongoing monitoring of the operations of obligated entities is carried out by defining collection actions and selective approach to debtors on the basis of the degree of risk for tax collections and the debtors' attitude towards compliance with obligations for registration, declaration and payment of tax and social security liabilities and other public state receivables. Techniques for encouraging and compliance with the voluntary discharging of obligations are applied depending on which group the obligated entities fall within: notifications, reminding letters, clarifying options on securing and repayment of liabilities of persons and entities in temporary financial difficulties, the possibility of concluding agreements with the revenue administration.

In line with the optimisation of the processes of public revenue collection and regulation of the interaction with the public creditors, agreements are updated and new instructions for interaction are signed with the National Health Insurance Fund, EA "Medical Audit", the "Road Infrastructure" Agency, the Ministry of Environment and Waters, the Chamber of Private Enforcement Agents, the State Commission on Gambling, the National Audit Office and Ministry of the Interior. Draft instructions for cooperation are prepared with the Financial Supervision Commission, Executive Agency for Fisheries and Aquaculture, State Fund "Agriculture", and State Agency "State Reserve and War-Time Stocks".

In 2012 the NRA will continue its efforts to carry out analyses and develop a system for measuring the gap between the potential and the actually collected revenues (the tax gap) to enhance the effectiveness of the control over compliance with the tax and social security legislation.

### ***Customs Agency***

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Extending the powers of the customs administration to investigate actions, highly dangerous to the public, is an important tool for effective counteraction to customs, currency and tax violations and crimes. The analysis carried out established a large number of discontinued administrative proceedings, with files sent to the corresponding prosecutor's offices with evidence of a crime under Articles 234, 242, 242a, and 251 of the Penal Code. For the period since 2006 these proceedings are over 2 700.

Investigating customs inspectors can now carry out an investigation of three groups of crimes – customs crimes, currency crimes, and crimes related to violations of the special excise goods regime.

By extending the circle of investigative authorities, procedural economy is achieved, making it now possible to work on "hot trails" in the first hours after the criminal act was committed; this contributes to the enhancing of the fight against smuggling in the conditions of economic crisis. Officials, who first establish a criminal offence and came in direct contact with the offender and the evidence left by him/her, can validate the immediate procedural and investigative actions. Also, the acquisition of operational information in the course of customs investigation is of great importance and has a key role in the risk analysis and management. This information contributes to the more accurate identification of the mechanisms of smuggling channels, to more adequate strategic and operational analyses.

The aim of assigning the functions of investigating these crimes to investigating customs inspectors is to achieve greater operativeness, speed and higher efficiency of pre-trial proceedings as a result of the customs officers' specific knowledge and direct access to the materials and documents necessary for the investigation. These amendments have already yielded results and since the beginning of January 2012, 40 preliminary investigations have been conducted, 6 of which are closed and the persons were convicted.

Granting powers to investigate and collect evidence and proofs in the pre-trial phase involves much more the officials of the "Customs" Agency, who are also directly responsible for putting an end to and punishing smuggling, currency crimes and crimes related to excise duties. Investigating customs inspectors are already part of the customs intelligence and investigation departments, thus ensuring the necessary close operational and functional relationship between the official carrying out the first act of the investigation and the investigative body – the investigating customs inspector.

The introduction of the customs investigation in criminal law is a necessary step not only towards improving the effectiveness of the investigation of such crimes, but towards their prevention by registering progress in detecting and punishing such acts. As a direct consequence, increased budget revenues will follow. ▼

## 7.— INSTITUTIONAL FEATURES OF PUBLIC FINANCES

The past year 2011 was extremely important with regard to the priorities, objectives and instruments of the policy for sustainable and transparent public finances. Taking into account the role of the fiscal policy as a key factor for the sustainable development of Bulgaria, which, together with the currency board arrangement, establishes a favourable environment for economic development, the government adopted a resolution for institutionalisation of its main instruments and prepared the legislative changes required.

The limitations on making commitments, introduced with the annual laws on the budget, in conjunction with specific actions for optimisation of the administrative structures, their staff number and expenditure resulted in the achieved degree of fiscal consolidation. This justified a thorough political debate on finding a sustainable solution on financial discipline, over a longer-term perspective than the medium-term nature of the fiscal and budgetary frameworks. Another impetus were the forthcoming commitments of Bulgaria, as a Member State, to implement the European requirements for reinforced economic governance and strengthened coordination of the economic, fiscal and budgetary policies of Member States.

At the beginning of 2011, after a thorough analysis of the implementation of budgetary procedures during the past few years, as well as of the deadlines and procedures, as part of the new mechanism for strengthened ex-ante coordination of economic policies "European Semester", the Ministry of Finance synchronised the 2012 budgetary procedure with this European framework. In parallel, the fiscal rules, included in the initiated by the Minister of Finance "Pact for Financial Stability", were prepared. They politically discussed within the country and also with several international financial institutions such as the European Commission, the International Monetary Fund, the World Bank, the Organisation for Economic Cooperation and Development, as well as by leading credit rating agencies.

The main objective of the Pact was to prepare legislative changes to guarantee financial discipline and, as a result, economic stability in the long run. The efforts towards financial and budgetary discipline need to become a permanent policy, defined by clear and strict rules, not subject to political manipulation. This reasoning led to the revision of the initial draft of the rules in the Pact to decrease their flexibility and strengthen their disciplining effect.

In the middle of 2011 the National Assembly approved the amendments to the Organic Budget Law, setting ceilings for the budget deficit and the government expenditure as a percentage of projected GDP. The amendments entered into force on 1 January 2012, and the government drafted the 2012 law on the state budget in full compliance with the adopted rules, thus assuming full responsibility for its fiscal policy.

Maintaining strict budgetary discipline continues to be government priority. The Ministry of Finance exercises strengthened expenditure control over budget execution, in line with expenditure ceilings for spending units, introduced by the annual law on the state budget.

In 2012 the efforts of the Ministry of Finance will be oriented towards implementing the Council Recommendations on the National Reform Programme 2011 of Bulgaria and the Council Opinion on the Convergence Programme, 2011–2014 on improving the content and transparency of the medium-term fiscal framework, strengthening its binding character and including information on the costs and obligations of state enterprises, included in the "General Government" Sector. Another important area will be further improvement of reporting on an accrual basis by improving financial management and accountability in the state enterprises and the municipalities.

In 2012, the Ministry of Finance will strengthen efforts on implementing the EU legislation, adopted at the end of 2011 by the so-called "Six-pack", to be reflected in the budgetary

rules, procedures and instructions of the Minister of Finance until it is fully transposed into national legislation.

## 7.1 National Budgetary Rules

Since the beginning of 2012, with the entry into force of the amendments to the Organic Budget Law, Bulgaria applies three types of fiscal rules – regarding government balance, government expenditures and government debt. The first two are included in the Organic Budget Law, and the third one – in the Law on Government Debt and the Law on Municipal Debt.

**The budget balance rule** sets a ceiling on government deficit on a cash basis as a percentage of GDP. If the budget balance is a deficit, it may not exceed *2 percent* of the gross domestic product<sup>33</sup>.

For the next three-year period, the deficit targets as a percentage of GDP on a cash basis are: 1.3% for 2013, 0.5% for 2014 and a balanced position for 2015.

**The government expenditure rule** sets a ceiling on government expenditure as a percentage of GDP. It may not exceed *40 percent* of the projected gross domestic product. Clearly, it does not allow additional adjustments by specifying the scope of the ceiling.

The **rule on the debt ceiling**, defined in the Law on Government Debt, remains unchanged and specifies that the ratio of general government debt as at the end of each year to the projected GDP may not exceed the previous year ratio, until this ratio is above 60 percent. General government debt comprises the nominal values of outstanding government debt, the municipal debt and the debt of the social security funds.

The rule provides certain flexibility in determining the debt ceiling, regulated with a specific provision in the Law on Government Debt. Pursuant to this provision, in the event of risk of non-compliance with the rule, the Council of Ministers may propose restrictions on the issuance of municipal debt and social security funds debt in the state budget law for the respective year. The Law on the State Budget each year defines the maximum amount of the new government debt and of the new government guarantees that can be issued during the year, as well as the maximum amount of the government debt as at the end of the budget year. The Minister of Finance develops a three-year government debt management strategy, adopted by the Council of Ministers and updated on an annual basis in its submission to the Council of Ministers with the three-year budget forecast.

At local government level the debt rule is supported by rules on the maximum amount of the new municipal debt, the amount of the municipal guarantees issued during the year, as well as the maximum amount of the municipal debt and the municipal guarantees as at the end of the budget year. Pursuant to the rule, the annual amount of debt payments during each year may not exceed 15 percent of own revenues and the general balancing subsidy in the latest certified annual municipal report. Another rule states that nominal municipal guarantees may not exceed 5 percent of own revenues and the general balancing subsidy in the latest certified annual municipal report.

All three rules apply to the central government, the local governments and the social security funds, and are multiannual, i.e. have target values for a period, covered by the three-year budget forecast (the budget balance rule and the expenditure rule) or, respectively, the government debt management strategy. The target values and the reporting on the implementation of the rules are on a cash basis.

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<sup>33</sup> Pursuant to the Organic Budget Law, the draft budget shall be accompanied by a consolidated fiscal programme, including general government budget, the Public Social Security budget, the National Health Insurance Fund budget, the municipalities budget, the Bulgarian national television budget, the Bulgarian national radio budget, the Bulgarian News Agency budget, the state higher schools budget, the Bulgarian Academy of Science budget, the off-budget accounts and funds and the other budgetary organisations in the meaning of § 1, item 1 of the Law on Accounting.

In 2010 an additional rule in the annual law on the state budget setting expenditure ceilings on spending units, as well as specific rules on changes in the liabilities amount and compensated changes were introduced.

All three rules are characterised by the lack of escape clauses, and the Ministry of Finance is the institution responsible for the monitoring of their implementation. The Ministry of Finance monitors the implementation of the consolidated fiscal programme on a monthly and quarterly basis. No real-time monitoring on the budget balance and expenditure rules is carried out. This does not apply to the debt rule monitored in real time with the help of a specific system. The Ministry of Finance provides quarterly and annual data on government debt and issues monthly and annual bulletins, published in the ministry's web site. The Minister of Finance prepares an annual report on the government debt position. This annual report is reviewed by the Council of Ministers and is submitted to the National Assembly as a part of the report on state budget implementation for the corresponding year.

For all three rules, there are neither provisions in cases of non-compliance, nor specific rules for imposing sanctions and corrections. The Ministry of Finance is responsible for enforcing the budget balance rule and the expenditure rule. Pursuant to a provision of the Organic Budget Law, the Minister of Finance can stop the transfer of subsidies, as well as freeze the accounts of budget organisations in case of failure to fulfil the provisions of legislation in force or in cases of established violations of financial discipline. The Minister of Finance can also submit to the Council of Ministers specific measures to cut the government expenditures and transfers.

The National Assembly is the authority, responsible for compliance with the debt rule. The government, through the Ministry of Finance, is obliged to make proposals to the National Assembly with specific corrective measures. In case of non-compliance with the debt rule, with the state budget law for the corresponding year the Council of Ministers may propose limits on debt issuance by municipalities and / or social security funds.

## 7.2 Budgetary Procedures

With the 2013 budgetary procedure the government institutionalised the discharging of its commitments under the second European semester on preparation of the main macroeconomic assumptions, the three-year budget forecast and the expenditure ceilings by FLSU, excluding municipalities, for the period 2013–2015 and the draft 2013 state budget law.

The 2013 budget procedure takes into account the Council Recommendations of 12 July 2011 on the National Reform Programme of the Republic of Bulgaria (2011–2015) and Council Opinion on the Convergence Programme of the Republic of Bulgaria (2011–2014) and reflects the European Commission recommendation on strengthening the binding nature and contents of the three-year budget forecast and the expenditure ceilings by FLSU, further improvement of the budgetary process and the quality of reporting and control systems.

With the 2013 budgetary procedure the Ministry of Finance implemented some of the European Commission recommendations by closer monitoring of the general government balance. The scope of the assessments and estimates was extended to include forecasts of the operations of non-financial enterprises and non-profit legal entities, controlled by the state and/or the municipalities. By the virtue of the decision of the Council of Ministers on the 2013 budgetary procedure, the Minister of Health, the Minister of Transport, Information Technology and Communications and the Minister of Regional Development and Public Works were included in this process. Over the next years this should be deepened and extended, with the Ministry of Finance ensuring the necessary compliance with the requirements of the European System of National and Regional Accounts.

The 2013 budgetary procedure preserves the main components of the procedures, introduced over the last few years. This aims at maintaining the sustainability and continuity of the processes and procedures for allocation and management of financial resources. The

procedure is divided into two main stages. The first stage is concluded with the approval by the Council of Ministers of the main macroeconomic assumptions, the three-year budget forecast and the expenditure ceilings of FLSUs, except for municipalities, for the period 2013–2015, and the second stage concludes with the approval by the Council of Ministers of possible updates thereof, as well as of the draft 2013 Law on the State Budget of the Republic of Bulgaria and its submission to the National Assembly. The procedure envisages the Council of Ministers to submit the Draft Law on the State Budget in the National Assembly not later than 14 September 2012, thus lengthening the time for its discussion and adoption by one and a half months.

Frontloading is also envisaged with regard to procedures on submitting to the Council of Ministers draft laws amending tax laws, the draft Law on the Budget of the National Health Insurance Fund for 2013 and the Draft Law on the Budget of the Public Social Security for 2013.

At both stages coordination mechanisms between the main fiscal and budgetary documents of the government with the National Reform Programme, the Convergence Programme, as well as with the opinion of the European Commission and the Council recommendations are envisaged.

To support budget forecast and expenditure ceilings planning and development for the period 2013–2015, and the draft budgets of spending units for 2013, including in programme format, the Minister of Finance gave detailed instructions, initiating the two major stages of the procedure.

The 2013 budgetary procedure envisages mechanisms for improving budgetary transparency and public participation in the discussion of the implemented policies and reforms. While developing the three-year budget forecast for the period 2013–2015 and the draft budget for 2013, consultations / dialogues between the Minister of Finance and the FLSU (excluding municipalities) to specify the parameters of their three-year budget forecasts and their draft budgets for 2013, including by programmes, are envisaged as well as with the National Association of Municipalities in Bulgaria to clarify their budgetary relations with the 2013 central budget. During the second stage of the procedure, the National Council for Tripartite Cooperation is to meet and discuss the Draft Law on the State Budget of the Republic of Bulgaria for 2013. ▼

## 8.— EXCESSIVE DEFICIT PROCEDURE (EDP)

In January 2011 the ECOFIN Council decided that Bulgaria has taken measures that represent a sufficient progress for correcting the excessive deficit within the deadline of 13.01.2011. The Council called for more effective measures for strengthening the binding nature of the medium-term budgetary framework.

The Bulgarian government ensured the achievement of timely and sustainable correction of the excessive deficit to levels below the reference value of 3% of GDP by the end of 2011. The 2012 budget envisages further consolidation measures, while maintaining current levels of direct taxation. In 2012 Bulgaria will remain among the MS with the lowest debt levels, considerably below the reference value of 60% of GDP.

The deficit for 2011 fell to 2.1% of GDP, which is an improvement compared to the 2.5% target, set in the Convergence Programme of the Republic of Bulgaria for the period 2011–2014. The gross general government debt as at the end of 2011 amounted to 16.3% of GDP, the second lowest in the EU.

The Government is determined to maintain strict fiscal discipline and continue the fiscal consolidation in the coming years to achieve its MTO of 0.5% of GDP in accordance with the Fiscal Compact. In 2013–2015 the GDP shares of current non-interest expenditures and of capital expenditures are projected to fall respectively from 28% to 25.6% and from 6.6% to 5%.

The planned deficit for 2012 is 1.6% of GDP, and for the period 2013–2015 the target is to bring the budgetary position to neutral. Such further consolidation will limit the negative consequences from the growth slowdown in Europe.

The developments described above were positively assessed by the leading credit rating agencies. In July 2011 Moody's increased the rating of Bulgaria to Baa2 from Baa3, and in December 2011 Standard and Poor's confirmed the rating of the country with a stable outlook. ▼

# ANNEX 1

**Table 1a — Macroeconomic Prospects**

	ESA code	2011	2011	2012	2013	2014	2015
		Level (EUR million)	Rate of change				
1. Real GDP (at 2011 prices)	B1*g	38 483	1.7	1.4	2.5	3.5	4.0
2. Nominal GDP	B1*g	38 483	6.7	4.4	5.4	6.4	6.8
<b>Components of real GDP</b>							
3. Private consumption	P.3	23 361	-0.6	0.6	2.3	3.9	4.6
4. Government consumption expenditure	P.3	5 984	0.5	1.0	1.6	2.3	2.7
5. Gross fixed capital formation	P.51	8 049	-9.7	7.1	5.9	7.3	8.2
6. Change in inventories and net acquisition of valuables (% of GDP)	P.52+P.53	829	1.9	1.4	1.5	1.5	1.5
7. Exports of goods and services	P.6	25 596	12.8	3.7	4.2	4.4	4.4
8. Imports of goods and services	P.7	25 335	8.5	3.6	5.0	5.8	6.0
<b>Contributions to real GDP growth (In percentage points)</b>							
9. Final domestic demand		-	-2.5	2.0	2.9	4.4	5.2
10. Change in inventories and net acquisition of valuables	P.52+P.53	-	1.8	-0.7	0.0	0.1	0.1
11. External balance of goods and services	B.11	-	2.3	0.1	-0.5	-1.0	-1.2

**Table 1b — Price Developments**

	ESA code	2011	2011	2012	2013	2014	2015
		Level	Rate of change <sup>34</sup>	Rate of change	Rate of change	Rate of change	Rate of change
1. GDP deflator		100	5.0%	2.9%	2.9%	2.8%	2.7%
2. Private consumption deflator		100	3.8%	2.6%	3.0%	3.0%	2.6%
3. HICP <sup>35</sup>		100	3.4%	2.1%	2.4%	2.5%	2.5%
4. Public consumption deflator		100	1.7%	1.6%	2.1%	2.1%	2.5%
5. Investments deflator		100	9.3%	3.5%	5.8%	2.6%	2.2%
6. Export price deflator (goods and services)		100	9.6%	4.6%	5.3%	2.6%	2.5%
7. Import price deflator (goods and services)		100	9.2%	4.2%	6.3%	2.5%	2.2%

**Table 1c — Labour Market Developments**

	ESA code	2011	2011	2012	2013	2014	2015
		Level	Rate of change				
1. Employment (thousand people) <sup>36</sup>		3 401.6	-4.2%	-0.2%	0.8%	1.1%	1.2%
2. Employment (million of hours worked) <sup>37</sup>		5 617.8	-4.3%	-0.2%	0.8%	1.1%	1.2%
3. Unemployment rate <sup>38</sup>		11.2%	1.0 <sup>39</sup>	0.1	-0.4	-0.5	-0.6
4. Labour productivity (Euros per person employed) <sup>40</sup>		11 313.2	6.1%	1.6%	1.7%	2.4%	2.8%
5. Labour productivity (Euros per hour worked) <sup>41</sup>		6.9	6.2%	1.6%	1.6%	2.3%	2.8%
6. Compensation of employees	D.1	14 298 765.2	3.1%	3.1%	6.1%	7.7%	8.9%
7. Compensation per employee		5 781.3	7.3%	3.3%	5.2%	6.4%	7.5%

<sup>34</sup> Percentage change as compared to the previous year.

<sup>35</sup> Optional for Stability Programmes.

<sup>36</sup> Occupied population, domestic concept, national accounts definition.

<sup>37</sup> National accounts definition.

<sup>38</sup> Harmonised definition, Eurostat; levels.

<sup>39</sup> The change of the unemployment rate, is in percentage points.

<sup>40</sup> Real GDP per person employed.

<sup>41</sup> Real GDP per one hour worked.

**Table 1d. — Sectoral Balances**

% of GDP	ESA code	2011	2012	2013	2014	2015
1. Net lending/borrowing vis-à-vis the rest of the world	B.9	3.2	2.6	1.3	0.4	-0.1
of which:		1.4	1.2	-0.1	-1.1	-1.9
- Balance of goods and services						
- Balance of primary incomes and transfers		0.5	0.3	0.2	0.2	0.5
- Capital account		1.3	1.2	1.2	1.2	1.3
2. Net lending/borrowing of the private sector	B.9	5.3	4.2	2.6	0.9	-0.1
3. Net lending/borrowing of the general government	EDP B.9	-2.1	-1.6	-1.3	-0.5	0.0
4. Statistical discrepancy						

**Table 2a. — General government budget projections**

	ESA 95	2011	2011	2012	2013	2014	2015
		Level	% of GDP				
<b>Net lending (EDP B.9) by sub-sector</b>							
1. General government	S.13	-805.7	-2.1	-1.6	-1.3	-0.5	0.0
2. Central government	S.1311	-891.8	-2.3	-1.6	-1.3	-0.5	0.0
3. State government	S.1312						
4. Local government	S.1313	-9.0	0.0	-0.1	-0.1	-0.1	-0.1
5. Social security funds	S.1314	95.1	0.2	0.1	0.1	0.1	0.1
<b>General government (S13)</b>							
6. Total revenue	TR	12 741.1	33.1	36.3	35.7	34.0	33.1
7. Total expenditure	TE	13 546.8	35.2	37.9	37.0	34.5	33.1
8. Net lending / borrowing	EDP B.9	-805.7	-2.1	-1.6	-1.3	-0.5	0.0
9. Interest expenditure	EDP D.41	244.4	0.6	0.9	1.1	0.9	0.9
10. Primary balance		-561.3	-1.5	-0.7	-0.2	0.3	0.9
11. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0	0.0
<b>Selected components of revenue</b>							
12. Total taxes (12=12a+12b+12c)		7 566.5	19.7	20.2	20.3	20.4	20.5
12a. Taxes on production and imports	D.2	5 606.4	14.6	15.0	15.1	15.1	15.1
12b. Current taxes on income, wealth, etc	D.5	1 863.2	4.8	5.0	5.1	5.1	5.1
12c. Capital taxes	D.91	96.9	0.3	0.2	0.2	0.2	0.2
13. Social contributions	D.61	2 817.0	7.3	7.1	7.0	6.8	6.7
14. Property income	D.4	336.4	0.9	0.8	0.7	0.5	0.6
15. Other		2 021.2	5.3	8.1	7.6	6.2	5.3
16=6. Total revenue	<b>TR</b>	12 741.1	33.1	36.3	35.7	34.0	33.1
Tax burden (D.2+D.5+D.61+D.91-D.995)		10 383.5	27.0	27.3	27.3	27.2	27.2
<b>Selected components of expenditure</b>							
17. Compensation of employees + intermediate consumption	<b>D.1+P.2</b>	5 657.3	14.7	14.4	13.8	13.0	12.3
17a. Compensation of employees	D.1	3 420.0	8.9	8.5	8.1	7.7	7.6
17b. Intermediate consumption	P.2	2 237.3	5.8	5.9	5.6	5.3	4.7
18. Social payments (18=18a+18b)		5 265.9	13.7	13.7	13.3	12.8	12.3
18a. Social transfers in kind	D.6311, D.63121, D.63131	704.4	1.8	2.1	2.0	1.8	1.7
18b. Social transfers other than inkind	D.62	4 561.5	11.9	11.6	11.3	11.0	10.6
19=9. Interest expenditure	EDP D.41	244.4	0.6	0.9	1.1	0.9	0.9
20. Subsidies	D.3	335.8	0.9	1.1	1.4	1.3	1.4
21. Gross fixed capital formation	P.51	1 245.6	3.2	5.9	5.6	4.6	4.3
22. Capital transfers	D.9	127.3	0.3	0.6	0.5	0.5	0.5
23. Other		670.5	1.7	1.4	1.4	1.3	1.3
24=7. Total expenditure	TE1	13 546.8	35.2	37.9	37.0	34.5	33.1
Government consumption (nominal)	P.3	5 985.6	15.6	15.3	15.0	14.8	14.5

**Table 2b — Breakdown, revenue**

	2011	2011	2012	2013	2014	2015
	Level	% of GDP				
1. Total revenue at unchanged policies	12 741.1	33.1	36.3	35.7	34.0	33.1
2. Discretionary revenue measures	-	-	-	-	-	-

**Table 2c.— Expenditure not included in the expenditure benchmark**

	2011	2011	2012	2013	2014	2015
	Level	% of GDP				
1. Expenditure under European programmes, fully covered with revenues from the European Funds	676.9	1.8	4.8	4.5	3.4	2.1
2. Expenditure, fully covered with statutory increases in revenue						
3. Non-discretionary changes in unemployment benefit expenditures	8.9	0.0	0.0	0.0	0.0	0.0

**Table 3 — General government expenditure by function**

% of GDP	ESA code	2010	2015
1. General public services	1	3.9	3.0
2. Defence	2	1.8	1.0
3. Public order and safety	3	2.7	1.9
4. Economic affairs	4	5.1	4.4
5. Environmental protection	5	0.7	1.8
6. Housing and community amenities	6	1.0	1.1
7. Health	7	4.8	4.4
8. Recreation, culture and religion	8	0.8	0.5
9. Education	9	3.8	3.7
10. Social protection	10	1.,5	11.3
<b>11. Total expenditure (= item 7 = 23 of Table 2)</b>	<b>TE<sup>1</sup></b>	<b>38.0</b>	<b>33.1</b>

**Table 4 — Consolidated government debt**

% of GDP	ESA code	2011	2012	2013	2014	2015
1. Gross debt <sup>42</sup>		16.35	19.80	18.41	18.02	16.43
2. Change in gross debt ratio		0.10	3.45	-1.38	-0.39	-1.59
<b>Contributions to the changes in gross debt</b>						
3. Primary balance <sup>43</sup>						
4. Interest expenditure <sup>44</sup>	EDP D.41					
5. Stock-flow adjustment		0.80	3.25	-2.28	-1.59	-3.39
of which:						
Differences between cash and accruals <sup>45</sup>						
Net accumulation of financial assets <sup>46</sup>		0.40	2.99	-2.54	-1.85	-3.50
of which: privatisation proceeds		0.3	0.2	0.2	0.2	0.0
Valuation effects and other <sup>47</sup>		0.1	0.1	0.1	0.1	0.1
Implicit interest rate on debt <sup>48</sup>		4.3	4.5	6.0	5.0	5.5
<b>Other relevant variables</b>						
6. Liquid financial assets <sup>49</sup>						
7. Net financial debt (7=1-6)						
8. Debt repayment since the end of the previous year		1.51	1.64	2.56	1.32	2.24
9. Percentage ratio of foreign currency denominated debt		28.1	23.0	28.9	30.7	37.9
10. Average maturity		6.6	7.34	7.76	7.46	8.25

<sup>42</sup> As defined in Regulation 3605/93 (not an ESA concept).

<sup>43</sup> Cf. item 10 of Table 2.

<sup>44</sup> Cf. item 9 of Table 2.

<sup>45</sup> The differences concerning interest expenditure, other expenditure and revenues shall be specified where necessary or in the event that the GDP/debt ratio is above the reference value.

<sup>46</sup> Including liquid assets, assets in third countries, government controlled enterprises, where the difference between quoted and non-quoted assets shall be specified where necessary or in the event that the GDP/debt ratio is above the reference value.

<sup>47</sup> Changes due to exchange rate movements and operation in secondary markets shall be specified where necessary or in the event that the GDP/debt ratio is above the reference value.

<sup>48</sup> Proxied by interest expenditure divided by the debt level of the previous year.

<sup>49</sup> 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	2011	2012	2013	2014	2015
1. GDP growth (%)		1.7	1.4	2.5	3.5	4.0
2. Net lending of general government	EDP B.9	-2.1	-1.6	-1.3	-0.5	0.0
3. Interest expenditure	EDP D.41	0.6	0.9	1.1	0.9	0.9
4. One-off and other temporary measures [1]		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		0.7	1.2	1.9	2.5	2.9
Contributions:						
labour		-1.1	-0.9	-0.3	0.1	0.4
capital		0.6	0.7	0.8	1.0	1.1
total factor productivity		1.3	1.3	1.3	1.4	1.4
6. Output gap		-2.6	-2.4	-1.8	-0.8	0.2
7. Cyclical budgetary component		-0.8	-0.7	-0.5	-0.2	0.1
8. Cyclically-adjusted balance (2-7)		-1.3	-0.9	-0.8	-0.3	-0.1
9. Cyclically-adjusted primary balance (8+3)		-0.7	0.0	0.3	0.6	0.8
10. Structural balance (8-4)		-1.3	-0.9	-0.8	-0.3	-0.1

**Table 6 — Divergence from previous update**

	ESA code	2011	2012	2013	2014	2015
Real GDP growth (%)						
Previous update		3.6	4.1	4.4	4.2	-
Current update		1.7	1.4	2.5	3.5	4.0
Difference (p.p.)		-1.9	-2.7	-1.9	-0.7	-
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.5	-1.5	-1.0	-0.5	-
Current update		-2.1	-1.6	-1.3	-0.5	0.0
Difference (p.p.)		0.4	-0.1	-0.3	0.0	-
General government gross debt (% of GDP)						
Previous update		16.4	19.0	17.4	17.1	-
Current update		16.4	19.8	18.4	18.0	16.4
Difference (p.p.)		0.0	0.8	1.0	0.9	-

**Table 7 — Long-term Sustainability of Public Finances**

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	39.8	39.1	36.1	36.0	37.1	38.6	39.0
Of which: age-related expenditures	15.5	18.2	15.1	15.1	16.2	17.7	18.1
Pension expenditure	7.8	9.9	6.8	6.5	7.1	8.2	8.4
Social security pensions	7.8	9.9	6.8	6.5	7.1	8.2	8.4
Old-age and early pensions	6.1	7.8	5.4	5.1	5.8	6.9	7.0
Other pensions (disability, survivors)	1.6	2.1	1.4	1.3	1.3	1.3	1.4
Occupational pensions (if in general government)	-	-	-	-	-	-	-
Healthcare	4.1	4.8	4.1	4.4	4.9	5.2	5.2
Long-term care	-	-	-	-	-	-	-
Education expenditure	3.8	3.8	3.8	4.0	3.9	4.1	4.2
Other age-related expenditures	0.1	0.4	0.4	0.3	0.3	0.3	0.3
Interest expenditure	1.2	0.6	0.5	0.3	0.1	0.3	0.4
Total revenue	40.9	34.9	34.5	34.5	34.5	34.5	34.5
Of which: property income	1.3	1.1	1.0	0.3	0.3	0.3	0.3
Of which: from pension contributions (or social security contributions if appropriate)	6.0	8.0	7.7	7.7	7.7	7.8	8.0
Pension reserve fund assets	-	-	-	-	-	-	-
Of which: consolidated public pension fund assets (assets other than government bonds)	-	-	-	-	-	-	-

% of GDP	2007	2010	2020	2030	2040	2050	2060
<b>System pension reforms<sup>50</sup></b>							
Social security contributions, directed to mandatory additional pension insurance <sup>51</sup>	0.8	1.0	-	-	-	-	-
Pension expenditure for mandatory additional pension insurance <sup>52</sup>	0.0	0.0	-	-	-	-	-
<b>Assumptions</b>							
Labour productivity growth	3.1	4.8	2.9	2.6	2.3	1.6	1.5
Real GDP growth	6.4	0.2	2.9	1.7	1.1	0.8	0.2
Participation rate males (aged 20–64)	78.3	77.3	82.5	82.6	81.9	82.5	84.0
Participation rate females (aged 20–64)	68.4	68.0	70.9	70.2	69.3	70.6	72.7
Total participation rate (aged 20–64)	73.3	72.6	77.8	76.9	76.7	77.6	79.5
Unemployment rate (% , aged 15–64)	6.9	10.3	8.5	7.3	7.3	7.3	7.3
Population aged 65+ over total population	17.3	17.5	21.0	24.3	27.6	31.2	32.6

**Table 7a — Contingent liabilities**

% of GDP	2011	2012
Government guaranteed debt	1.54	1.55
<i>Of which: related to the financial sector</i>	0.15	0.12

**Table 8. — Basic assumptions**

	2011	2012	2013	2014	2015
Short-term interest rate (annual average), 3-month EUR LIBOR, %	1.39	0.89	0.88	1.28	1.91
Short-term interest rate (annual average), 6-month USD LIBOR, %	0.51	0.71	0.71	0.73	1.35
Long-term interest rate (annual average), %	5.2	4.6	7.3	5.7	7.7
USD/EUR exchange rate (annual average)	1.39	1.32	1.28	1.28	1.27
Nominal effective exchange rate, percentage change, previous year = 100 <sup>53</sup>					
Exchange rate vis-à-vis the EUR (annual average)	1.95583	1.95583	1.95583	1.95583	1.95583
World economy (excluding EU), GDP growth, %	3.8	3.3	3.9	4.4	4.6
EU GDP growth, %	1.5	0.0	1.5	1.8	2.0
Growth of relevant foreign markets, %					
World import volumes, excluding EU, %					
Oil price (weighted average spot price, USD/barrel)	103.9	105.7	102.4	98.0	94.8
International prices of non-energy goods (% , on an annual basis)	17.8	-10.4	-1.7	-3.4	-3.2
International prices of food products (% , on an annual basis)	19.7	-10.6	-2.0	-3.8	-3.7
International prices of agricultural commodities (% , on an annual basis)	22.7	-10.8	-3.9	-1.9	-4.0
International prices of metals (% , on an annual basis)	13.5	-8.9	-0.7	-3.4	-0.6

<sup>50</sup> Pension reforms, including mandatory additional pension insurance.

<sup>51</sup> Revenue from social security contributions or other revenue for the mandatory additional pension insurance, with which the accounts payable can be covered.

<sup>52</sup> Pension expenditure or expenditure on other benefits of the mandatory additional pension insurance.

<sup>53</sup> The positive values reflect appreciation, the negative – depreciation.