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Assessment of the 2016 Convergence Programme for Bulgaria

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

The 2016 Convergence Programme of Bulgaria was submitted to the European Commission on 15 April 2016 in the original language.[1] The Convergence Programme covers the period of 2016-2019. It was adopted by the Council of Ministers on 13 April 2016. The Convergence Programme is aligned with the 2016 budget and also with the medium-term fiscal framework.

Bulgaria is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its medium-term budgetary objective (MTO).

This document complements the Country Report published on 26 February 2016 and updates it with the information included in the Convergence Programme.

Section 2 presents the macroeconomic outlook underlying the Convergence Programme and provides an assessment based on the Commission 2016 spring forecast. Section 3 presents the recent and planned budgetary developments, according to the convergence Programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the Convergence Programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

In 2015 the Bulgarian GDP growth reached 3% - the highest value since 2008, driven by both external (2.1 pp) and domestic (0.9 pp, including inventories) demand. In 2016, the growth of the Bulgarian economy is expected to slow down to 2.1% according to the Convergence Programme. This is close to the projected GDP growth of 2% in the Commission 2016 spring forecast. The lower GDP growth is the result of the declining positive contribution of net exports and the fall in public investment. At the same time, the favourable development of employment and the increase in the real disposable income of households are expected to support growth in consumer expenditure.

In 2017, the authorities assume that the growth of the Bulgarian economy will accelerate to 2.5%, with private consumption being the main contributor benefitting from an increase in employment and improving expectations on income developments of households. The GDP growth in the Commission 2016 spring forecast for 2017 is 2.4%.

According to the Convergence Programme, during the 2018–2019 period the economic growth is projected to gradually accelerate to 2.7%, with private consumption and investment being the main contributors.

The output gap as recalculated by Commission based on the information in the programme, following the commonly agreed methodology, amounts to -0.7% of GDP both in 2016 and 2017, indicating no improvement in the cyclical position. According to the authorities, the negative output gap is expected to diminish in 2018 and to turn positive in 2019.[2]

[1] Its English version was submitted to the European Commission on 28 April 2016.

[2] There is no significant difference between the programme's recalculated output gaps and output gaps as presented in the programme itself over the period of 2015-2018. In 2019, however, the recalculated output gap turns positive while the output gap presented in the programme remains negative.

By and large, there are no notable differences between the Commission 2016 spring forecast and the Convergence Programme as regards both the overall real GDP growth rate and its composition. The 2016 Convergence Programme is based on plausible macroeconomic assumptions.

Table 1: Comparison of macroeconomic developments and forecasts

	2015		2016		2017		2018	2019
	COM	CP	COM	CP	COM	CP	CP	CP
Real GDP (% change)	3.0	3.0	2.0	2.1	2.4	2.5	2.7	2.7
Private consumption (% change)	0.8	0.8	2.0	2.1	1.7	2.6	2.8	2.8
Gross fixed capital formation (% change)	2.5	2.5	-2.4	-1.8	2.2	-0.1	2.7	3.5
Exports of goods and services (% change)	7.6	7.6	4.6	4.5	5.0	4.7	4.9	5.1
Imports of goods and services (% change)	4.4	4.4	3.1	2.6	4.1	3.6	4.7	5.2
Contributions to real GDP growth:								
- Final domestic demand	1.0	1.0	0.9	0.8	1.7	1.7	2.4	2.6
- Change in inventories	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	2.1	2.1	1.0	1.3	0.7	0.8	0.3	0.1
Output gap[1]	-0.3	-0.3	-0.6	-0.7	-0.5	-0.7	-0.3	0.3
Employment (% change)	0.4	0.4	0.3	0.5	0.5	0.6	0.6	0.6
Unemployment rate (%)	9.2	9.1	8.6	8.5	8.0	7.9	7.4	7.1
Labour productivity (% change)	2.6	2.6	1.7	1.6	2.0	1.9	2.0	2.0
HICP inflation (%)	-1.1	-1.1	-0.7	-0.8	0.9	1.1	1.2	1.4
GDP deflator (% change)	0.3	0.3	0.1	1.2	1.2	1.1	1.1	1.2
Comp. of employees (per head, % change)	1.8	1.8	3.6	2.7	4.3	3.4	3.8	4.0
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	3.1	4.6	3.5	3.3	3.8	3.9	3.7	4.1

Note:

[1] In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2016 spring forecast (COM); Convergence Programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. Deficit developments in 2015

In 2015, the general government balance improved to 2.1% of GDP from 5.4% of GDP in 2014. The structural deficit decreased only marginally in the same period. The huge improvement in the headline balance mainly reflects that the 2014 budget included a one-off capital transfer to the financial sector of around 3% of GDP. Tax increasing measures and steps enhancing tax compliance raised revenues by 1% of GDP in 2015. Also, public investments financed from national resources were reduced by around 0.5% of GDP. Measures also ensured that the public wage bill, the purchase of goods and services and the social transfers altogether were maintained constant as a ratio of GDP. Altogether, these factors altogether more than counterbalanced the decrease of sales and higher other current revenues, each amounting to around 0.5 % of GDP.

The general government balance was 0.7% of GDP better than envisaged in the 2015 Convergence Programme. The better outcome reflects mainly higher tax-revenues of around 1.5% of GDP attributable to improved tax compliance and to the stronger-than-previously expected economic recovery. The additional revenues more than offset various expenditure slippages compared to the Convergence Programme, such as the incomplete implementation of the planned reduction of the public wage bill and higher purchase of goods and services.

3.2. Medium-term strategy and targets

The main goal of the programme is to improve the headline general government deficit from 2.1% of GDP in 2015 to 0.2% of GDP in 2019, i.e. reaching a broadly neutral budget balance in the medium term. The envisaged reduction of the headline deficit is frontloaded as the largest improvement is planned to be achieved in 2017. According to the authorities, the structural deficit is estimated to improve from 1.9% of GDP in 2015 to 0.3% of GDP in 2019.[3] The MTO (-1% of GDP), which is unchanged compared to last year, is more stringent than what the Pact requires and also aims at taking into account the requirements of the Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union. The MTO is foressen to be achieved in 2017 according to the Convergence Programme.

Compared to the 2015 Convergence Programme, the current programme targets a more ambitious deficit reduction path over the entire forecast horizon. It reflects the result of the better-than-previously expected outcome of the 2015 general government deficit, the more optimistic macroeconomic forecast as well as some new deficit improving measures.

In 2016, in the Convergence Programme, the headline deficit is set to slightly decrease from 2.1% of GDP in 2015 to 1.9% of GDP, which is the result of several factors. Firstly, despite revenue increasing measures of around 0.5% of GDP, the ratio of tax revenues is expected to remain broadly unchanged compared with 2015, which demonstrates conservative projection. Secondly, sales and other current revenues are forecast to increase by around 1% of GDP. Thirdly, on the expenditure side, savings in intermediate consumption of 0.5% of GDP are foreseen. Finally, these deficit improving developments amounting to around 1.5% of GDP are forecast to be largely counterbalanced by higher nationally financed investments of

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

around 1.3% of GDP. The hike of nationally financed investments are planned to partly offset the temporary drop in investment matched by EU funds in light of the phasing-in period of the new EU multiannual financial framework. Importantly, regarding the 2016 general government balance, there is no substantial difference between the Commission 2016 spring forecast of 2% of GDP and the projection of 1.9% of GDP in the 2016 Convergence Programme.

The 2016 general balance forecast of -1.9% of GDP in the 2016 Convergence Programme represents an improvement of 0.5% of GDP compared to the target of a deficit of 2.4% of GDP in the 2015 Convergence Programme. This improvement reflects (i) higher taxes of 0.3% of GDP, (ii) higher sales and (not EU-fund related) other current revenues of 1% of GDP and (iii) lower capital expenditures amounting to 0.4% of GDP, which is projected to be partly counterbalanced by an increase in nationally financed public investments of 1.2% of GDP.

In 2017, according to the 2016 Convergence Programme, the headline deficit is expected to improve further from 1.9% of GDP in 2016 to 0.8% of GDP. Compared to 2016, the ratio of tax revenues is projected to increase by 0.3% of GDP mainly due to the increase of excise duties and social security contributions. Moreover, the nationally financed public investments are planned to be reduced by 0.8% of GDP, although details are not provided in the Convergence Programme.

The Commission 2016 spring forecast foreseen a 2017 general government balance of -1.6% of GDP. The higher deficit compared to the Convergence Programme reflects that the Commission 2016 spring forecast envisages a stagnation of nationally financed public investments compared to 2016 while the Convergence Programme plans a significant decrease of them.

The 2017 deficit projection of 0.8% of GDP in the 2016 Convergence Programme is a significant improvement compared to the target of a deficit of 1.8% of GDP in the 2015 Convergence Programme, which reflectes several factors. Firstly, tax revenues are expected to increase by 0.8% of GDP due to enhancing tax compliance and higher tax rates. Secondly, sales and (not EU-fund related) other current revenues are projected to increase by 1.2% of GDP. Finally, these higher revenues of 2% of GDP are foreseen to be partly off-set by (i) higher public wage bill and purcahes of goods and services amounting to 0.4% of GDP and by (ii) higher nationally financed public investments of 0.6% of GDP.

A further cumulative improvement of 0.6% of GDP of the headline budgetary balance in 2018 and in 2019 is projected by the Convergence Programme, which is mainly driven by a decrease in the ratio of compensation of employees and intermediate consumption. The details of these savings measures are not specified in the Convergence Programme.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2015	2016		2017		2018	2019	Change: 2015-2019
	COM	COM	CP	COM	CP	CP	CP	CP
Revenue	**38.2**	**37.0**	**36.5**	**37.2**	**36.8**	**36.7**	**36.5**	**-1.7**
of which:								
- Taxes on production and imports	15.5	15.7	15.5	15.7	15.6	15.6	15.7	0.2
- Current taxes on income, wealth, etc.	5.5	5.6	5.5	5.5	5.6	5.6	5.6	0.1
- Social contributions	8.1	8.2	8.0	8.4	8.2	8.3	8.2	0.1
- Other (residual)	9.1	7.5	7.5	7.5	7.4	7.2	7.0	-2.1
Expenditure	**40.2**	**38.9**	**38.5**	**38.7**	**37.5**	**37.1**	**36.7**	**-3.5**
of which:								
- Primary expenditure	39.3	37.9	37.5	37.7	36.5	36.1	35.7	-3.6
of which:								
Compensation of employees	9.3	9.4	9.3	9.3	9.2	8.9	8.7	-0.6
Intermediate consumption	5.8	5.4	5.3	5.3	5.1	5.0	4.8	-1.0
Social payments	14.3	14.7	14.6	14.8	14.6	14.4	14.4	0.1
Subsidies	1.2	1.3	1.3	1.3	1.3	1.2	1.2	0.0
Gross fixed capital formation	6.2	5.0	5.0	4.9	4.1	4.4	4.6	-1.6
Other (residual)	2.4	2.1	2.0	2.2	2.1	2.1	2.2	-0.2
- Interest expenditure	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.0
General government balance (GGB)	**-2.1**	**-2.0**	**-1.9**	**-1.6**	**-0.8**	**-0.4**	**-0.2**	**1.9**
Primary balance	**-1.1**	**-0.9**	**-0.9**	**-0.5**	**0.3**	**0.6**	**0.8**	**1.9**
One-off and other temporary	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
GGB excl. one-offs	**-2.0**	**-2.0**	**-1.9**	**-1.6**	**-0.8**	**-0.4**	**-0.2**	**1.8**
Output gap[1]	-0.3	-0.6	-0.7	-0.5	-0.7	-0.3	0.3	0.6
Cyclically-adjusted balance[1]	-2.0	-1.8	-1.7	-1.4	-0.6	-0.3	-0.3	1.7
Structural balance[2]	**-1.9**	**-1.8**	**-1.7**	**-1.4**	**-0.6**	**-0.3**	**-0.3**	**1.6**
Structural primary balance[2]	-1.0	-0.7	-0.7	-0.4	0.4	0.7	0.7	1.7

Notes:

[1] Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

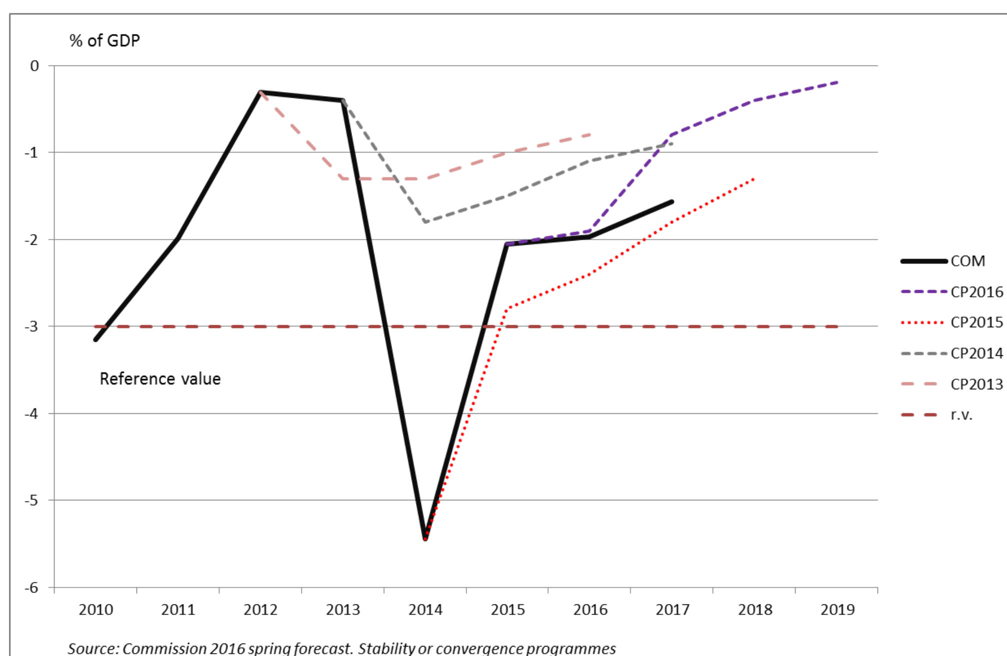
[2] Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence Programme (CP); Commission 2016 spring forecasts (COM); Commission calculations.

The planned targets in successive programmes significantly changed in the last few years (Figure 1.). Nevertheless, the current programme, which aims at achieving a broadly neutral headline general government balance in the medium-term, is the most ambitious of the previous three programmes.

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



3.3. Measures underpinning the programme

Overall, the programme contains revenue increasing measures amounting to around ½% of GDP per year for the 2016-2018 period.

In 2016, on the revenue side, higher excise duty revenues in light of increased excise tax rates for both tobacco and energy products amount to close to 0.2% of GDP. Measures aiming at enhancing tax compliance are expected to result in higher revenues of around 0.1% of GDP. Additional revenues stemming from the transfer of accumulated capital in a Universal Pension Fund to the Pension Funds of Public Social Security are estimated at 0.1% of GDP. The increase of the minimum insurance income is expected to generate further revenues of 0.1% of GDP. The programme also includes expenditure increasing measures for 2016. In particular, higher outlays related to the defence policy result in additional expenditures of around 0.2% of GDP. The increase of the wage bill in the education system is expected to raise public expenditures by 0.1% of GDP. Moreover, fuel vouchers granted to agricultural producers are projected to result in higher expenditures of 0.1% of GDP. As the above mentioned measures are credible and sufficiently specified, the Commission 2016 spring forecast took them and their budgetary impact into account with the exception of the further enhancing tax compliance, which cannot be taken as granted at the current stage.

In 2017, higher excise duty revenues of 0.2% of GDP are expected in light of increased excise tax rates for tobacco products. Measures aiming at enhancing tax compliance are foreseen to result in higher revenues of around 0.1% of GDP. The increase in the social security contributions by 1 pp. is estimated to raise the public revenues by 0.2% of GDP. These measures were included in the Commission 2016 spring forecast, except the projected further increase of enhancing tax compliance.

In 2018, further increase of the excise tax rates for tobacco products is projected to generate higher excise duty revenues of 0.2% of GDP. Beyond, the social security contributions are

planned to be increased by an additional 1 pp., which is expected to result in higher revenues of 0.2% of GDP.

Importantly, the improvement of the general government balance as set in the Convergence Programme also relies on expenditure decreasing plans, including (i) the significant drop of national financed public investments in 2017 as well as significant reduction of public wage bill and purchase of goods and services as a ratio of GDP. However, the Convergence Programme does not include measures that support these expenditure reductions.

Main budgetary measures

Revenue	**Expenditure**
2016	
• Increase of excise duty on tobacco (0.1% of GDP) • Increase of excise duty on energy products (0.1% of GDP) • Enhanced tax compliance (0.1% of GDP) • Transfer of the pension rights (0.1% of GDP) • Increase of the minimum insurance income (0.1% of GDP)	• Increase of expenditures on defence (0.2% of GDP) • Increase of the remuneration in the education sector (0.1% of GDP) • Fuel vouchers for agricultural producers (0.1% of GDP)
2017	
• Increase of excise duty on tobacco (0.2% of GDP) • Enhanced tax compliance (0.1% of GDP) • Increase of the social security contribution (0.2% of GDP)	
2018	
• Increase of excise duty on tobacco (0.2% of GDP) • Increase of the social security contribution (0.2% of GDP)	
Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.	

3.4. Debt developments

According to the Convergence Programme, the public debt ratio is foreseen to increase from 26.7% in 2015 to 30.8% in 2019. Over this horizon, government debt is projected to peak in 2018 at 31.8% of GDP.

In 2016, the projected increase of the gross public debt by 5% of GDP (from 26.7% of GDP in 2015 to 31.7% of GDP in 2016) is mainly related to the stock-flow adjustment amounting to 4% of GDP, which, to a large extent, reflects the advanced financing of the EU-funds and the higher issuance of public bonds in view of the favourable macroeconomic environment, in particular the low interest rates. Also, the primary balance is expected to drive up the public debt ratio by 0.9 pp.. Moreover, the "snow-ball" effect is debt-increasing (0.2 pp.) as the interest expenditures exceed the debt-decreasing impact of the nominal economic growth.

In 2017, the gross public debt is foreseen to start decreasing. The primary balance contributes to declining debt in light of its expected significant improvement. Besides, the impact of the economic recovery fully counterbalances the interest expenditures. Furthermore, the stock-flow adjustment is projected to slightly decrease the debt.

In 2018 and in 2019, the primary balance, in line with its gradual further improvement, is a debt-decreasing factor. Similarly, over this period, the "snow-ball" effect is estimated to contribute to lower debt in light of the projected relatively strong economic growth. These favourable developments are temporarily more than off-set by debt-increasing stock-flow adjustments in 2018.

The Commission 2016 spring forecast foresees lower public debt in 2016 and 2017: although it projected a higher primary deficit, it did not calculate with deficit-increasing stock-flow adjustment.

Table 3: Debt developments

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019
			COM	CP	COM	CP	CP	CP
Gross debt ratio[1]	**18.3**	**26.7**	**28.1**	**31.7**	**28.7**	**31.2**	**31.8**	**30.8**
Change in the ratio	2.7	-0.3	1.4	5.0	0.6	-0.5	0.6	-1.0
Contributions [2] *:*								
1. Primary balance	**1.5**	**1.1**	**0.9**	**0.9**	**0.5**	**-0.3**	**-0.6**	**-0.8**
2. "Snow-ball" effect	**0.4**	**0.1**	**0.5**	**0.2**	**0.0**	**0.0**	**-0.1**	**-0.2**
Of which:								
Interest expenditure	0.8	1.0	1.0	1.0	1.0	1.1	1.0	1.0
Growth effect	-0.1	-0.8	-0.5	-0.5	-0.7	-0.8	-0.8	-0.8
Inflation effect	-0.3	-0.1	0.0	-0.3	-0.3	-0.3	-0.3	-0.4
3. Stock-flow adjustment	**0.8**	**-1.5**	**0.0**	**4.0**	**0.0**	**-0.2**	**1.3**	**0.0**
Of which:								
Cash/accruals diff.				0.0		0.0	0.0	0.0
Acc. financial assets				0.0		0.0	0.0	0.0
Privatisation				0.0		0.0	0.1	0.0
Val. effect & residual				0.0		0.0	0.0	0.0

Notes:

[1] End of period.

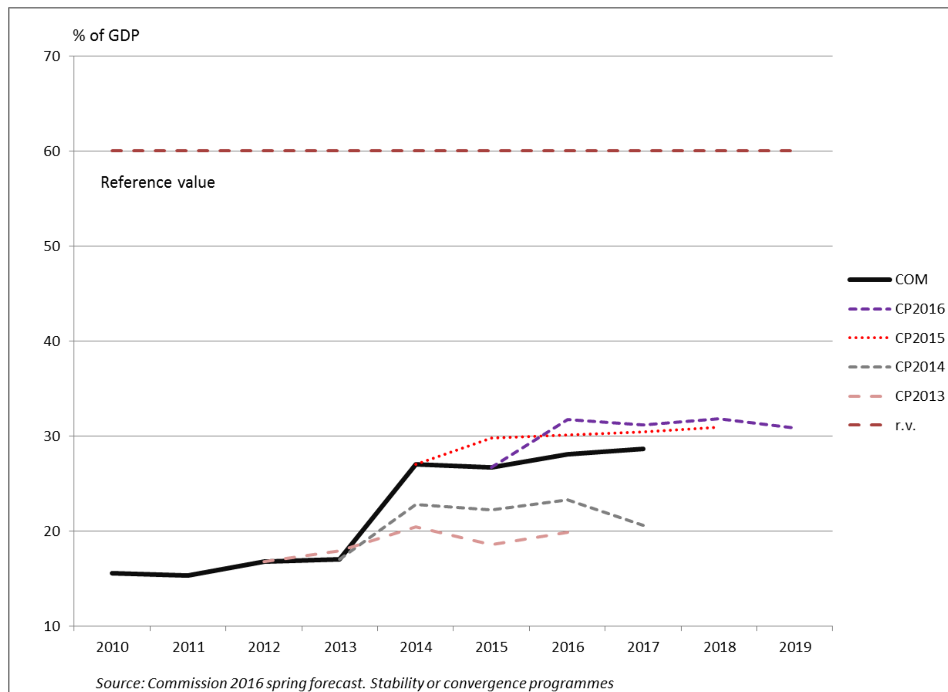
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets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

Source :

Commission 2016 spring forecast (COM); Convergence Programme (CP), Comission calculations.

In previous updates the medium-term increase of the public debt ratio was usually underestimated. This underestimation is related to the one-off hike of the public debt in 2014, which increased from 18% of GDP in 2013 to 27% of GDP in 2014. This reflected not only the underlying budget deficit in 2014 but also the pay-out of guaranteed deposits, support to the financial sector via a liquidity scheme, and pre-financing for a roll-over of a large bond maturing in January 2015.

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



3.5. Risk assessment

Based on the Commission 2016 spring forecast, some risks can be identified related to the achievement of the budgetary targets of the Convergence Programme.

First, Bulgaria, as a small and very open economy, is particularly exposed to external factors. A stronger deceleration in demand from trading partners would reduce the contribution of the external sector to GDP growth and job creation, which could have adverse impact on the general government balance, too.

Second, the Commission 2016 spring forecast does not incorporate additional revenues stemming from further improvements in tax compliance. Although the implementation of measures aiming at enhancing tax compliance were successful in 2015, those only off-set the deterioration of tax compliance in the previous two years. Consequently, the budgetary impact of further measures aimed at fighting tax evasion is subject to risks.

Third, any further support to the financial sector, in particular related to the recently launched reviews of the banking, insurance and pension fund sectors could have a deficit-, and/or debt-increasing effect.

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

Box 1. Council recommendations addressed to Bulgaria

On 14 July 2015, the Council addressed recommendations to Bulgaria in the context of the European Semester. In particular, in the area of public finances the Council recommended for Bulgaria to avoid a structural deterioration in public finances in 2015 and achieve an adjustment of 0,5 % of GDP in 2016.

In 2015, while no adjustment was required, the structural balance improved by 0.1% of GDP. Also, based on the outturn data, the (real) growth rate of government expenditure, net of discretionary revenue measures, did not exceed the applicable reference rate (2.1%) in 2015. Consequently, an assessment over one year suggests that Bulgaria was in line with the requirements of the preventive arm based on both the structural balance pillar and the expenditure benchmark pillar. However, over 2014 and 2015 taken together, there is an estimated significant deviation based on the structural balance pillar (annual average gap of -0.7% of GDP). At the same time, the expenditure benchmark points to compliance (positive annual average gap of 2.1% of GDP). This calls for an overall assessment. The deviation over two years is partly due to sizable revenue shortfalls in 2014 (yearly impact of 0.8% of GDP). This can be related to lower tax compliance in 2014, which improved in 2015. In addition, the large increase in public investment in 2014, assessed to be partly temporary in light of the phasing-out period of the 2007-2013 EU multiannual financial framework, contributed to a deterioration of the structural balance, whereas this is smoothened in the calculation of the expenditure benchmark. At the same time, the expenditure benchmark is positively impacted by one-off transactions (impact of 3.2% of GDP) in 2015. Therefore, taking the above factors into consideration, the overall assessment points to some deviation over the years 2014 and 2015 taken together.

In 2016, considering the projections of the Convergence Programme, the planned structural effort of 0.2% of GDP falls short of the required structural improvement of 0.5% of GDP, pointing to some deviation. The expenditure benchmark pillar points to compliance. That is, overall assessment is needed. The expenditure benchmark appears to better reflect the underlying position as the structural balance is distorted positively by the revenue windfalls (0.3% of GDP) and negatively by the hike of the nationally financed public investments aiming at off-setting the temporarily dropping absorption of EU-funds (0.9% of GDP). Consequently, the overall assessment points to compliance with the requirements of the preventive arm.

Based on the Commission 2016 spring forecast, the structural balance is projected to improve by 0.1% of GDP pointing to a risk of some deviation from the required effort (gap of -0.4% of GDP). The expenditure benchmark pillar also points to a risk of some deviation (gap of -0.2% of GDP). This calls for an overall assessment. The expenditure benchmark appears again to better reflect the underlying position as the structural balance is distorted positively by the sizable revenue windfalls (1% of GDP) and negatively by the temporary hike of the nationally financed public investments (0.9% of GDP). Therefore, the overall assessment points to the risk of some deviation in 2016.

In 2017, according to the Convergence Programme, the structural balance would improve by 1.1% of GDP, i.e. more than the required adjustment of 0.5% of GDP. However, the real growth rate of government expenditure, net of discretionary revenue measures, would exceed the applicable reference rate (positive gap of 0.3% of GDP). Thus an overall assessment is needed. The expenditure benchmark reflects the sharp fall of the nationally financed public

investments included in the Convergence Programme only to a limited extent and so the change of the structural balance appears to better reflect the underlying position. Accordingly, the overall assessment points to compliance with the requirements of the preventive arm.

Based on the Commission 2016 spring forecast, the structural balance is projected to improve by 0.4% of GDP pointing to a risk of some deviation from the required effort (gap of -0.1% of GDP). The expenditure benchmark pillar points to a risk of a significant deviation (gap of -0.6% of GDP). This calls for an overall assessment. First, the expenditure benchmark does not fully reflect that the nationally financed public investments are expected to be kept broadly unchanged in 2017 compared to 2016 by the Commission 2016 spring forecast. Second, the benchmark rate used for the computation of the expenditure benchmark reflects the notable economic adjustment with close to zero potential growth rates in 2010-2012 and is therefore considered to underestimate the relevant medium-term potential growth rate at the current juncture, although privileging the potential growth in one year- one point estimate-, especially in years where the potential growth is high, would go against setting a prudent benchmark for fiscal policy. In this respect, the signal provided by the expenditure benchmark should not be disregarded anyway. All in all, the change in the structural balance appears to better reflect the underlying position while the signal provided by the expenditure benchmark pillar should not be ignored. The overall assessment points to the risk of some deviation in 2017.

Based on outturn data and the Commission 2016 spring forecast, the ex-post assessment suggests some deviation from the adjustment path towards the MTO in 2015. Following an overall assessment, some deviation from the adjustment path towards the MTO is to be expected in 2016 and 2017, based on the Commission 2016 spring forecast.

Table 4: Compliance with the requirements under the preventive arm

(% of GDP)	2015	2016		2017	
Initial position[1]					
Medium-term objective (MTO)	-1.0	-1.0		-1.0	
Structural balance[2] (COM)	-1.9	-1.8		-1.4	
Structural balance based on freezing (COM)	-1.9	-1.8		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2015**	**2016**		**2017**	
	COM	**CP**	**COM**	**CP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.5		0.5	
Required adjustment corrected[5]	0.0	0.5		0.5	
Change in structural balance[6]	0.1	0.2	0.1	1.1	0.4
One-year deviation from the required adjustment [7]	0.1	-0.3	-0.4	0.6	-0.1
Two-year average deviation from the required adjustment [7]	-0.7	-0.1	-0.1	0.2	-0.2
Expenditure benchmark pillar					
Applicable reference rate[8]	2.1	0.7		0.3	
One-year deviation [9]	3.1	0.0	-0.2	-0.2	-0.6
Two-year average deviation [9]	2.1	1.6	1.5	-0.1	-0.4
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Overall assessment

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Convergence Programme (CP); Commission 2016 spring forecast (COM); Commission calculations.

5. FISCAL SUSTAINABILITY

Bulgaria does not appear to face fiscal sustainability risks in the short run[4].

Based on the Commission forecast and a no-fiscal policy change scenario beyond forecasts, government debt, at 26.7% of GDP in 2015, is expected to rise to 27.6% in 2026, thus remaining below the 60% of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2019 at 28.9% of GDP. This highlights low risks for the country from debt sustainability analysis in the medium term. The full implementation of the Convergence Programme would put debt on a clearly decreasing path by 2026, remaining below the 60% of GDP reference value in 2026.

The medium-term fiscal sustainability risk indicator S1 is at -2.9 pps. of GDP, primarily thanks to the government debt ratio below the 60% Treaty reference value translating into a negative distance to the debt target (contributing with -1.4 pps of GDP), thus indicating low risks in the medium term. The full implementation of the Convergence Programme would put the sustainability risk indicator S1 at -4.5 pps. of GDP, leading to similar medium-term risk. Overall, risks to fiscal sustainability over the medium-term are, therefore, low. Fully implementing the fiscal plans in the Convergence Programme would further decrease those risks.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is at 1.3 pps. of GDP. In the long-term, Bulgaria therefore appears to face low fiscal sustainability risks, primarily related to the initial budgetary position. Full implementation of the programme would put the S2 indicator at 0.7 pps. of GDP, leading to a similar long-term risk.

The long-term sustainability assessment of the pension system does not take into account the pension reform adopted in July 2015[5]. Important measures include the raising and equalisation of pensionable ages (to 65 years for men by 2029 and for women by 2037) and the rise in required contribution periods to 37 years for women and 40 years for men. Moreover, social contributions increase by 2 pps. and the socially insured can choose more freely between the first and second pension pillar. The accrual rate for each working year will increase from 1.1 to 1.5, which has a positive impact on future pension entitlements for those who can meet the higher required contribution periods.

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4 This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 14 fiscal and 14 financial-competitiveness variables. The fiscal and financial-competitiveness sub-indexes (reported in table 5) are based on the two sub-groups of variables respectively. For sustainability risks arising from the individual variables, by country, see the Commission's Fiscal Sustainability Report 2015 (page 67).

5 The EPC endorsement of the pension projections is ongoing; hence the pension reform is not included in the calculation of the above-mentioned fiscal sustainability risk indicators S1 and S2.

Table 5: Sustainability indicators

Time horizon				No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term				LOW risk			
	S0 indicator [1]			0.2			
		Fiscal subindex (2015)		0.2	LOW risk		
		Financial & competitiveness subindex (2015)		0.2	LOW risk		
Medium Term				LOW risk			
	DSA [2]			LOW risk			
	S1 indicator [3]			-2.9	LOW risk	-4.5	LOW risk
	of which						
		IBP		0.0		-1.6	
		Debt Requirement		-2.3		-2.6	
		CoA		-0.6		-0.3	
Long Term				LOW risk		LOW risk	
	S2 indicator [4]			1.3		0.7	
	of which						
		IBP		0.8		-0.2	
		CoA		0.5		0.9	
		of which					
			Pensions	0.0		0.5	
			HC	0.3		0.2	
			LTC	0.1		0.1	
			Other	0.1		0.1	

Source: Commission services; 2016 stability/convergence programme.

Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2016 forecast until 2017. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.

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

[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections. See Fiscal Sustainability Report 2015.

[3] The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

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

6. FISCAL FRAMEWORK

In 2015, the general government deficit in cash terms amounted to 2.9% of GDP, in line with the original budget. Consequently, it violated the national nominal deficit rule that stipulates that the deficit in cash terms cannot exceed 2% of GDP.[6] Similarly, the general government total expenditures in cash terms increased to 40.2% of GDP. i.e. exceeded somewhat the threshold of 40% of GDP set by the national fiscal rule.[7]

Regarding 2016 and the outer years, the general government deficit in cash terms is set to gradually improve from 1.9% of GDP in 2016 to 0.5% of GDP in 2019 and thereby comply with the national threshold on cash deficit. Also, the projected trajectory for general government expenditures is respecting the national 40% threshold: these are planned to decrease to 39% of GDP in 2016 and gradually further decline to 37.2% of GDP in 2019.

The domestic fiscal rules also require that the general government debt-to-GDP ratio is below 60%. This provision was fulfilled by a large margin in 2015 and foreseen to continue to do so in 2016-2019 as the general government debt is planned to increase from 26.7% of GDP in 2015 only slightly above 30% of GDP throughout the programme period.

Based on information provided in the Convergence Programme and in national budget documents, the past fiscal performance in Bulgaria appears to comply only partially with the requirements of the applicable national numerical fiscal rules. However, regarding the programme period of 2016-2019, the fiscal developments are set to comply with all national numerical rules.

The recently established Fiscal Council has recruited a small support staff and expected to become soon fully operational. The Fiscal Council is not involved in the endorsement or the ex-ante assessment of the macroeconomic scenario underpinning the Convergence Programme.

[6] The general government deficit in ESA-terms did not exceed 3% of GDP in 2015 and is set to improve further in the programme period. That is, the deficit outcome in 2015 and the outlook for the period 2016-2019 complied with the national threshold for the maximum general government deficit of 3% of GDP in ESA-terms, which is in conformity with the provisions of the Stability and Growth Pact. For more details see section 4.

[7] The Bulgarian fiscal rules also contain provisions on the maximum growth of the general government expenditures in line with the preventive arm of the Stability and Growth Pact. The expenditure developments in 2015 complied with these provisions. In the period of 2016-2019 some deviations from the expenditure benchmark defined by the rules are foreseen. For more details see section 4.

7. CONCLUSIONS

In Bulgaria, over 2014 and 2015 taken together, the structural balance pillar indicates an annual average gap of -0.7% of GDP. On the other hand, in the same period, the growth rate of government expenditure, net of discretionary revenue measures, is lower than the applicable reference rate resulting in a positive annual average gap of 2.1% of GDP. Following an overall assessment, this points to some deviation from the recommended adjustment path towards the MTO.

In 2016, considering the projections of the Convergence Programme, although the planned structural effort of 0.2% of GDP falls short of the required structural improvement of 0.5% of GDP, the overall assessment points to compliance with the requirements of the preventive arm. Based on the Commission 2016 spring forecast, however, both pillars of the preventive arm indicate some deviation and the overall assessment also points to the risk of some deviation from the required adjustment path towards the MTO in 2016.

In 2017, according to the Convergence Programme, although the expenditure benchmark pillar indicates some deviation, the overall assessment points to compliance with the requirements of the preventive arm. However, according to the Commission 2016 spring forecast, the change of the structural balance points to significant deviation while the expenditure benchmark pillar indicates some deviation. The overall assessment points to the risk of some deviation in 2017.

8. ANNEX

Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
Core indicators								
GDP growth rate	2.4	6.7	0.7	1.3	1.5	3.0	2.0	2.4
Output gap [1]	0.7	1.4	0.0	-0.3	-0.7	-0.3	-0.6	-0.5
HICP (annual % change)	8.9	5.9	4.6	0.4	-1.6	-1.1	-0.7	0.9
Domestic demand (annual % change) [2]	8.3	9.9	-1.4	-1.3	2.7	0.9	0.9	1.7
Unemployment rate (% of labour force) [3]	15.5	10.4	9.3	13.0	11.4	9.2	8.6	8.0
Gross fixed capital formation (% of GDP)	17.3	24.4	25.2	21.2	21.1	21.2	20.5	20.4
Gross national saving (% of GDP)	18.3	13.6	18.6	22.9	24.2	23.2	22.9	23.3
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	**0.1**	**1.1**	**-1.6**	**-0.4**	**-5.4**	**-2.1**	**-2.0**	**-1.6**
Gross debt	**66.5**	**28.6**	**14.9**	**17.1**	**27.0**	**26.7**	**28.1**	**28.7**
Net financial assets	**9.1**	**5.5**	**4.0**	**-1.9**	**-6.7**	**n.a**	**n.a**	**n.a**
Total revenue	39.2	38.0	34.8	37.2	36.6	38.2	37.0	37.2
Total expenditure	39.1	36.9	36.4	37.6	42.1	40.2	38.9	38.7
of which: Interest	3.6	1.6	0.8	0.7	0.9	1.0	1.0	1.0
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	**2.6**	**-5.0**	**1.0**	**6.2**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets; non-financial corporations	**-64.2**	**-112.8**	**-171.5**	**-168.8**	**-159.9**	**n.a**	**n.a**	**n.a**
Net financial assets; financial corporations	**2.0**	**-18.9**	**7.1**	**4.0**	**-5.4**	**n.a**	**n.a**	**n.a**
Gross capital formation	15.2	22.8	20.2	15.4	n.a	n.a	n.a	n.a
Gross operating surplus	24.9	26.8	28.8	29.5	n.a	n.a	n.a	n.a
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	**-4.8**	**-8.6**	**-4.9**	**-1.9**	**n.a**	**n.a**	**n.a**	**n.a**
Net financial assets	**47.9**	**57.4**	**63.3**	**97.7**	**100.4**	**n.a**	**n.a**	**n.a**
Gross wages and salaries	28.6	30.9	31.1	34.7	n.a	n.a	n.a	n.a
Net property income	0.0	0.4	0.1	0.1	n.a	n.a	n.a	n.a
Current transfers received	13.6	14.0	14.5	16.0	n.a	n.a	n.a	n.a
Gross saving	-4.5	-7.8	-3.3	-0.1	n.a	n.a	n.a	n.a
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	**-1.5**	**-14.1**	**-6.8**	**2.8**	**4.2**	**3.1**	**3.5**	**3.8**
Net financial assets	**7.8**	**71.1**	**100.3**	**71.8**	**74.6**	**n.a**	**n.a**	**n.a**
Net exports of goods and services	-4.1	-14.4	-6.5	-0.6	-0.9	1.4	2.7	3.4
Net primary income from the rest of the world	0.1	-2.7	-4.0	-1.8	0.1	-3.1	-3.4	-3.5
Net capital transactions	0.0	0.1	1.0	1.3	1.4	1.3	1.2	1.1
Tradable sector	50.8	48.5	45.6	47.3	47.7	46.6	n.a	n.a
Non tradable sector	37.8	36.9	40.7	38.8	39.2	38.9	n.a	n.a
of which: Building and construction sector	4.4	5.2	6.5	4.2	3.9	4.0	n.a	n.a
Real effective exchange rate (index, 2000=100)	68.1	76.3	99.3	114.5	119.7	115.2	116.0	116.1
Terms of trade goods and services (index, 2000=100)	79.8	90.0	100.2	101.0	102.2	102.7	103.2	103.2
Market performance of exports (index, 2000=100)	80.4	80.7	100.5	117.2	112.0	116.0	116.2	116.0

Notes:

[1] The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.

[2] The indicator on domestic demand includes stocks.

[3] Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.

Source :
AMECO data, Commission 2016 spring forecast