

**THE FISCAL POLICY OF BULGARIA IN THE PROCESS OF
INTEGRATION TO THE EUROPEAN UNION**

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Info Articles

Abstract

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integration.

The fiscal policy of Bulgaria has undergone important changes in the last two decades under the process of accession to the EU. The macroeconomic aspects of Bulgaria's participation in the EU in the field of fiscal policy coordination are analyzed as results achieved. The fiscal policy has contributed for the compliance with the Maastricht criteria for convergence with the EU as well as for implementing the reforms of the EU economic governance in the post-crisis period. The maintenance of fiscal stability has been undertaken in medium-term but challenges have been encountered to carry out fiscal adjustment without undermining economic recovery and maintain funded by Government expenses public systems. The fiscal policy performance of Bulgaria is revealed with regard to problems of improving its socio-economic efficiency and preparation to join the EMU.

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INTRODUCTION

The economic and financial integration of Bulgaria to the European Union (EU) since the start of its official membership in 2007 coincided with the Global financial and economic crisis and the European sovereign crisis in the European Monetary Union (EMU) as the “core” of the EU integration.

Bulgaria’s integration has encountered the changes in the EU under the impact of two mutually interdependent processes in the economic integration in the EU. The fiscal policy has been engaged with the task of implementing adjustment strategies as EU Member State and stimulating economic recovery and growth. The integration has increased its importance for the Bulgarian economy and the difficulties encountered in the EU integration process have raised a number of issues for the overall impact of the fiscal policy.

On one hand, due to the Global crisis and the European sovereign debt crisis some of EMU countries have encountered difficult challenges of fiscal consolidation and overcoming sovereign crisis made necessary introduction of new institutional and functional arrangement in the Euro area. For the fiscal policy of the EU countries, the dilemma of future choice should be exacerbated: to introduce new requirements for the coordination of budgetary policies or to adopt a transition to a higher degree of mandatory Community-wide choice of policy within the framework of the future Fiscal Union. The debate on the amendment of the concept of fiscal sovereignty of individual EU Member States in connection with the new choice of stricter fiscal policy rules in the EMU is set on the agenda, also for non-EMU countries like Bulgaria. As a country with derogation Bulgaria has the obligation to prepare for membership in the EMU which would have to involve more strict fiscal rules. Bulgaria has already joined the Fiscal Compact (i.e. the fiscal part of the Treaty on Stability Coordination and Governance in the European Monetary Union), which sets the rules designed to strengthen the consistency between the national and European fiscal frameworks and enhance their ownership in Member States. Besides Bulgaria has undertaken the implementation of the changes introduced to improve transparency and to reduce complexity of the current fiscal rules for the EU Member States.

On the other hand, Bulgaria is already part and subject of the processes of "differentiated integration" between EMU Member States and EU Member States not participating in the EMU. This process has certain negative consequences under the conditions of the crisis trends in the EU since 2007. The introduction of new regulative and institutional arrangements in the EMU as well as the implementation of the non-conventional monetary policy of the European Central Bank has substantiated the differentiated integration. As a country non-participating in EMU, Bulgaria has had no access to the broad range of functional and institutional supportive interventions of the ECB's monetary policy. Bulgaria's financial and credit sphere remains not only segmented out of the EMU but continues to be characterized by the maintenance of greater differentiation as regards monetary measures in the Euro area. Although at the Bulgarian financial market the subsidiaries and branches of EMU countries’ banking groups have dominant share in financial intermediation, the credit resources retain their higher price compared to EMU. The segmentation of the Bulgarian financial sector and market out of the EMU ultimately leads to more limited access to external financing of the economy. Credit crunching difficulties considerably burden the business's ability to absorb new debt and, ultimately, lending is not developing at rates that stimulate business growth. Under the condition of the Currency Board as implemented monetary regime in Bulgaria since 1997, the Bulgarian National Bank does not have any monetary policy (the only exception being the minimum reserve requirements).

Thus the fiscal policy of Bulgaria is responsible for the macroeconomic and financial stability and it has to play major role in the overall economic development and the EU integration of Bulgaria. Its role has become much more significant in the undergoing process

in the EU at present for new choice of the model of further deepening of the integration as set on the agenda by the five presidents' report.¹ In 2018 Bulgarian Government chose a new approach to enhance the process of joining the euro area in close co-operation with the ECB. An Action plan and a Road map have been set in implementation to adapt to the reforms in the EMU, part of which are the Banking Union, the money-laundering measures and the insolvency legal engagements.²

The paper aims to reveal the fiscal policy's tasks and achievements during the accession to the EU. In the first part the characteristic features of Europeanisation of the fiscal policy of Bulgaria in 2000-2018 are presented. The second part analyses the main results of the fiscal policy and summarizes some conclusions.

1. Trends and problems of fiscal policy's development in the process of accession and integration to the EU (2000-2016)

During Bulgaria's preparation and membership in the EU the fiscal policy has undergone profound changes in the programming, development, as well as implementation of public financial management and control system. In fiscal policy assessment over the last two decades, there have been achieved more clearly set and solved economic and social issues as progress has been made in fiscal discipline and in the overall Europeanisation of macroeconomic policy. From the point of view of the functional and institutional changes in the public finances in view of the EU requirements and the projected expectations, several stages can clearly be distinguished: 1) pre-accession stage; 2) post-accession period (2007-2016); 3) a forthcoming period (2019-2021) of preparation for inclusion in the EU Economic and Monetary Union and finalizing the implementation of the 2020 Strategy objectives.

The change in the state of public finances during the period of preparation and membership in the EU (1999-2016) reflects also the impact of the fiscal consolidation, which started with the introduction of Currency Board monetary regime in mid-1997. It is supported by the applicable rules for budgetary discipline, stemming from the requirements of the Currency Board. It is sufficient to highlight the two "pillars" of fiscal discipline under the terms of the Currency Board: the obligation to maintain fiscal reserves and discontinue the ability of the Bulgarian National Bank to credit the Government directly. On the one hand, the government is not entitled or lending to the BNB as a central bank, and in turn the BNB as a central bank cannot provide direct loans to the Government. On the other hand, the Government's obligation to maintain fiscal reserves in the BNB Issue Management Balance in compliance with the Currency board plays an important role as a "pillar" of money supply by the BNB and maintaining its stability.³ To the extent that the BNB is deprived of the discretionary monetary intervention according to the real changes, fiscal policy challenges are closely dependent on the challenges of managing Government budget revenues and expenditures according to the fiscal constraints.

The integration of Bulgaria from the very beginning of the process for the EU accession (during the stage of association to the EU as started in 1995 and in the pre-accession period since 1999)

¹ Five Presidents' Report: Completing Europe's Economic and Monetary Union, 22 June 2015

² On 22 August 2018 the Government approved an Action Plan with measures in response to the Republic of Bulgaria's intentions to join the ERM II and the Banking Union by July 2019. The document has been drafted as a consequence of the [joint letter](#), sent on 29 June 2018, of the Minister of Finance and the Governor of the Bulgarian National Bank concerning the participation of the Republic of Bulgaria in the Single Supervisory Mechanism (SSM) by means of establishing close cooperation with the European Central Bank within the meaning of Regulation (EU) No 1024/2013 as well as the intentions of the country to apply for participation in the ERM II mechanism, which has also received the political support of the [Eurogroup](#).

³ In the absence of a monetary policy of the BNB due to the introduction of the Currency Board, the only instrument that the BNB can apply is the requirement for banks to maintain minimum reserve requirements on deposits.

depends increasingly on the fiscal policy and on its more effective coordination according to the EU requirements.⁴ Under the direct supervision of the European Commission, comprehensive reforms have been carried and are underway in the public finances' system to meet the requirements for membership. In the EU, conceptually, fiscal policy is subject to the implementation of fiscal consolidation programs based on the Community and the open method of co-ordination as well as to the implementation of Policy Guidelines in order to achieve the goals of the 2000 Lisbon Strategy.

The main challenge during the pre-accession period (1999-2006) for Bulgaria's fiscal policy in macroeconomic aspect is the transition to indicative forecasting, planning and implementation of the Government budget as well as the building up of sustainable institutional capacity for the management of public funds. Under the conditions of structural adjustment of the Bulgarian economy caused by the adaption to market forces at the Single European market these tasks have raised substantially the role of the fiscal policy during the transition to market economy. Since 1996, the EU law has been transposed in the field of public procurement. Since 2003 the program budgeting and decentralization of local finances have been introduced with strategy of gradualism which has been kept until present times. In the pre-accession period, Bulgaria not only pledged but also transposed EU legislation in the field of public finances and public accountability in a timely manner, including a comprehensive reform of the system for management and control of public funds. Bulgaria has introduced a fully harmonized EC system of management and control over its own public funds and the European Union funds by improving public accountability of budgetary resources from the Republican Government budget as well as of municipal budgets.

Fully in line with European law, the reform of the customs policy has been implemented with a view to the introduction of the EU Common Customs Tariff as of 2007, as well as the commitments to tax and excise harmonization with the EU and the protection of the euro and the European funds. At the same time, it has proceeded with the transposition of EU law in order to be able to have the status of a Member State with derogation as regards the adoption of the euro. These requirements include:

- The completion of the liberalization of capital movements (Article 56)
- The ban on any direct financing of the public sector by the BNB as a central bank;
- A ban on any privileged access of the public sector to financial institutions (Article 103);
- achieving compliance of the status of the national bank with the EU Treaty, including ensuring the independence of the monetary authorities.

These requirements are the first "block" of the macroeconomic framework that has been fulfilled as a prerequisite for Bulgaria's accession to the EU. The ban on direct financing of the public sector is an essential element of fiscal discipline and independence of the BNB. The ban on privileged access to financial institutions adds up to the BNB's independence as a central bank and guarantees market discipline in public sector involvement in the financial market, strengthens the free movement of capital and ensures that market criteria are to be applied to the public sector in cases of getting loans from the banking system. Thus the independence of the BNB, as a central bank, has been envisaged to fulfill its future function of being committed to maintaining price stability in line with the 2004 Bulgarian National Bank Strategy for the

⁴ European Union The Stability and Growth Pact (SGP) is the rule-based fiscal framework of the European Union (EU). EU members are bound to avoid excessive deficits (defined with reference to a 3 percent of GDP threshold for the general government deficit) and reduce their public debt-toGDP ratio to below 60 percent. In addition, they commit to aiming at structural balances close to balance or in surplus (with country-differentiated margins). The provisions of the SGP apply to all EU members, although provisions for imposing sanctions for non-compliance apply only to members of the Euro area. The SGP, in force since 1997, is based on the Treaty of the European Union ("Maastricht Treaty)," adopted in 1992, and consists of two EU regulations with force of law complemented by European Council resolutions..

adoption of the euro by 2010. Under these conditions, the Currency Board Regime has become instrumental for contributing to enhancing the fiscal discipline.

On the other hand, in 2000-2006 capital liberalization supported the more efficient allocation of financial resources through the market. The inflow of foreign direct and portfolio investment increased by 2008 when the slowdown started and the foreign investments were greatly reduced. The inflow of capital investment in the period up to Bulgaria's entry into the EU has been coupled with credit expansion that allowed to attain higher growth rates and macroeconomic policy targeted at higher economic efficiency.

During the period of Bulgaria's membership in the EU (2007-2016), the budget policy is committed to fulfilling the Maastricht criteria for stable Government finances by implementing the Convergence Programs and the National Reform Program.

Firstly, since 2007, the macroeconomic policy framework has become more restrictive, with stronger fiscal discipline and the further deepening of integration of economic policy. In 2009 Bulgaria's failure to comply with the fiscal deficit Maastricht requirement has caused a monitoring procedure for the excessive Government deficit. The economic policy has become engaged to comply with EU policies of achieving the Community priorities and has therefore become subject to strict procedures of coordination and multilateral surveillance.

The main instruments for coordination of the economic policy of Bulgaria as an EU member state are the Stability and Convergence Programs, the Broad Economic Policy Guidelines and the increasing number of Community instruments, including the European Semester, the Macroeconomic imbalances procedure programming concerning structural policies. Bulgaria's fiscal policy has become fully involved with implementation of Community procedures for better economic governance since 2010. This complements with new mechanisms the requirements for compliance with the criteria for EMU and the complementary requirements of the Fiscal Pact which is based on the Stability and Growth Pact in EMU. With Bulgaria's participation in the implementation of the new EU economic governance approaches, the chances of participation in the EU Economic and Monetary Union should be improved.

An additional importance for strengthening the role of fiscal policy is the fact that Bulgaria, together with 24 other EU Member States since March 2012, has become a party to the Stability, Coordination and Governance Treaty in EMU. The Treaty is introduced for the improvement of the Stability and Growth Pact of the EMU and comes into force on 1.01.2013. Under Part III of this Treaty (known as the Fiscal Pact) the main tasks of achieving better fiscal discipline are treated. In this context, the role of government finances for the revival of economic growth has been raised by underlying the role of fiscal discipline.

The implementation of the EU Multiannual Budgetary Programming and Planning 2014-2020 supports the implementation of integration policy at macroeconomic level. In principle, this is a priority for which Bulgaria has made efforts and has achieved compliance with the macroeconomic convergence criteria. The overall strategy of economic governance of EU integration is subject to the objectives of restoring the conditions for sustainable growth and employment in the Member States.

At the same time, the requirements towards government finances in the new EU economic governance are considerably more complicated and the conditions for the entry of EMU are becoming more comprehensive as conditionality. The Europe 2020 Strategy reflects the recognition that the Union's economic and monetary union complicates the implementation of fiscal sovereignty of the countries of the European Union because the possibilities of matching national budgets to the needs of financing growth through budget deficits become strategic issues of the economic governance.

Progress and coherence in the area of financial management and control systems in the budgetary sector of Bulgaria, as well as the absorption of European funds, are significant. After some delay in 2013-2014, the framework for public finance management in Bulgaria has

been updated by the adoption in 2015 of the Fiscal Council and Automatic Remedies Act and the inclusion of our Fiscal Council in the EU Fiscal Council Committee. The independence of government finances is supported by the lawfulness of fiscal rules in line with European requirements.

The main recognition in the theoretical and applied debates about fiscal and financial liberalization rules is that they are a "good" drug against economic stagnation, but only on the premise that this "drug" has no harmful side-effects. In applying the fiscal rules, Bulgaria shows discipline, but in practice there is not a completely satisfactory improvement in the effectiveness of fiscal policy, especially in some areas funded with the public money. This is a challenge to make better use of the freedom to implement the fiscal sovereignty of our country and to make better the national choice of policy targets in order to respond more adequately to the needs of the real economy and its ongoing structural adjustment in the future.

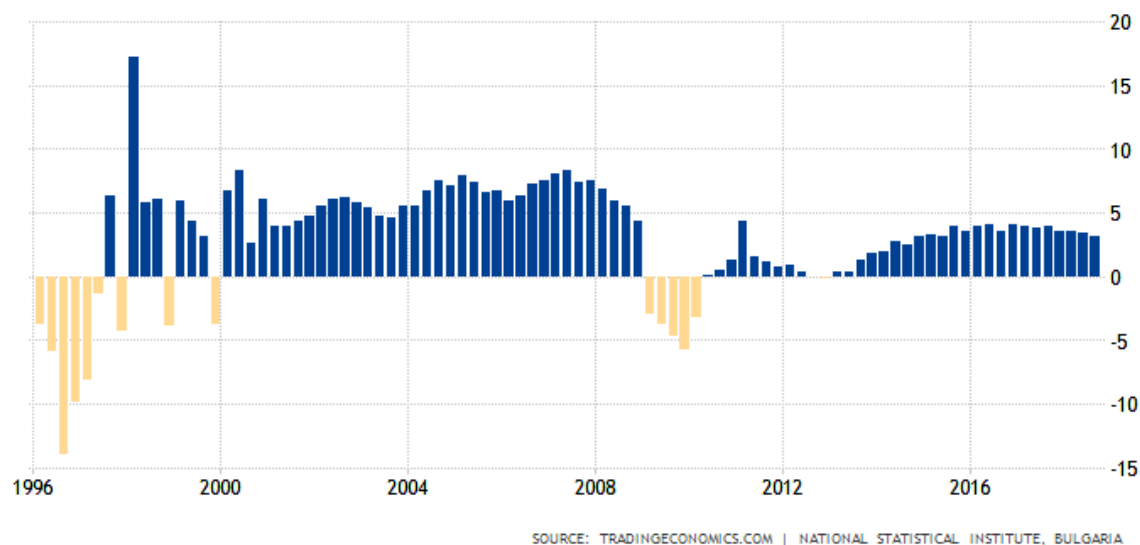
Undoubtedly, the policies that are implemented through the Government budget are the most important, and their choice (with the exception of the EU's common policies) remains fully in the mandate of each Bulgarian government. In general, empirical research has already shown that the application of good practices and rules of economic liberalization should not only lead to better results in purely financial accounting terms (higher budget revenues, higher budget balances, lower government debt), but these practices and fiscal rules have to contribute for the achievement of higher efficiency of macroeconomic policy. Thus the importance of the policies implemented through the Government budget has been increasing.

2. Main results of Bulgaria's fiscal policy implementation

The fiscal policy has the primary responsibility for maintaining the financial stability in Bulgaria under the Currency Board regime because of the lack of monetary and exchange rate policy to influence macroeconomic liquidity, including the change in money supply and demand. The goals of meeting the Maastricht criteria of sound public finance have become inseparable part of the achieving the overall fiscal policy sustainability.

For the entire period 2000-2016 Bulgaria's government budget deficit shows a trend of fiscal stabilization and consolidation which to a great extent allows the sustainability of macroeconomic stability. There have been only for short periods some deviations to higher negative values compared to the reference Maastricht criterion. The fiscal policy has been influenced by the higher rates of the economic growth as well by the cyclical changes in the period under review. (See Fig.1).

Figure. 1. The Annual Rate of Growth of the GDP of Bulgaria (1996 - 2017)
(market prices, %)



For the period (2002-2008) has been kept on comparatively stable track record due to the increased aggregate supply and consumption and fiscal consolidation. The foreign capital inflows as a substantially increased external source of finance and the maintenance of credit expansion stimulating aggregate demand and growth rates. GDP growth rate for the period (2005-2008) has averaged annually 6.4%. Compared to other EU member states Bulgaria has experienced since the start of the new millennium high rates of economic growth which have raised the expectations as well as some doubts for the continuity of the “catch up” type of growth after joining the EU. The growth of domestic and foreign capital investments has been concentrated predominantly in construction, real estate, tourism and services which contributed to overheating the economy. During the period 2005-2008, Bulgaria's GDP grew by a relatively rapid pace but in 2009, due to the impact of the Global economic crisis the GDP contracted by 5% and a slowdown of economic growth followed (Fig. 1).

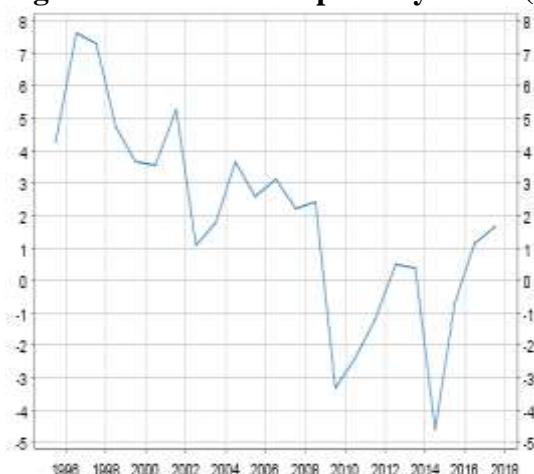
The step-by-step process of aligning fiscal policy with EU requirements has progressed in the 2005-2007 period when Bulgaria achieved positive economic growth rates. Thus a budget surplus has been maintained by 2008. Two "episodes" of increased *primary Government budget deficit* should be reported respectfully: in 2009 of 3.32% of GDP and in 2014 of -4.58% of GDP. Due to the exceedance of the reference value of the accrual budget deficit indicator, the European Commission applied the excessive deficit procedure to Bulgaria. Since 2010 began a gradual recovery of the Bulgarian economy, but at a very slow pace. In 2010, growth was only 0.7%, in 2011 rose to 2% and in 2012 was only 0.2%. In 2011, and further up to mid-2012 there was some reduction of the Government deficit. In 2013 and 2014 the economic growth remained rather modest at the rate respectively of 1.1 and 1.7%. For achieving the pre-crisis level of growth it has taken five years. In 2015 the rate of growth has increased to 2.9% and higher rate of 3.4% in 2016.

However, since 2012 the unsatisfactory economic growth record has been accompanied by relatively modest fiscal deficits, low inflation and a stable currency. Growth has been deprived of new capital inflows from abroad as direct and portfolio investments have fallen considerably as result of the Global and the European sovereign crisis and still remains at very low level in mid-2017. The economic growth has become largely dependent on domestic factors.

Fiscal policy has complied with the EU fiscal rules. Nevertheless the economic cost of this

restrictive policy has become too high not only for systematically underfunded budget systems such as internal order, health, education, social services, defense, science and culture but also for the economy as a whole. Social tensions have exacerbated political uncertainty and economic instability and triggered early parliamentary elections in 2013. In the ensuing period until mid-2014, the slowdown in fiscal policy was a consequence of both government interventions due to the banking system crisis and increased budget spending in the public sector, which increased the government budget deficit above the reference value for 2014 and 2015 respectively (see Figure 2).

Figure 2. Government primary deficit(-) or surplus(+) (as % of GDP)for 2000-2018

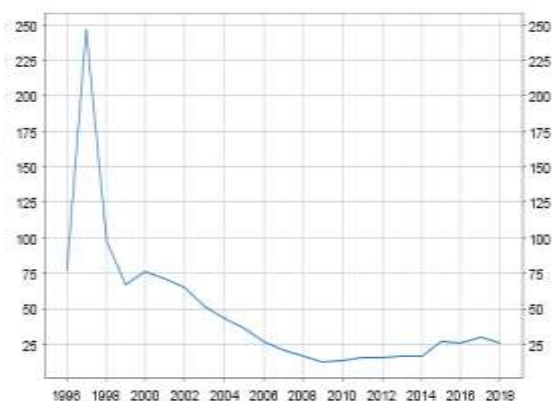


Source: Eurostat, 2018.

As regards the indicator for an average annual rate of growth of the public debt-to-GDP Bulgaria has had consistently consolidated its fiscal policy throughout the period (1998-2018). Fiscal discipline has been much strict if compared with other EU countries. Since the end of the 90s the fiscal policy of Bulgaria has a priority target for a long-term decline in the public debt-to-GDP ratio, not just its stabilization at post-crisis levels. Having gained from own experience that high public debt tends to raise interest rates, lower potential growth, and impede fiscal flexibility Bulgaria has maintained fiscal consolidation aim the period under review.

The public debt was raised in 2014 as the fiscal policy reacted as the ultimate absorber of negative shocks in the financial sector. The need to provide state aid to meet the needs of the deposit guarantees repayments after the closure of Corporate commercial bank and the liquidity support for other 2 domestic banks in crisis has caused fiscal readjustment. The steep rise of the ratio of the public debt-to-GDP caused the assessment of Bulgaria as a country with imbalances by the European Commission's Alert mechanism for macroeconomic imbalances. By end of December 2015 the Government debt-to-GDP ratio is 26.4%, with the share of domestic Government debt being 8.5% and of external Government debt – respectively equal to 17.9% of GDP. In the Government debt structure, domestic debt at the end of 2015 amounts to 32.1%, and external debt - to 67.9% of the total debt. Any further rise of the external debt indicator for the Government debt may present a challenge to fiscal policy sustainability.

Figure 3. Government debt (consolidated) of Bulgaria (as % of GDP)



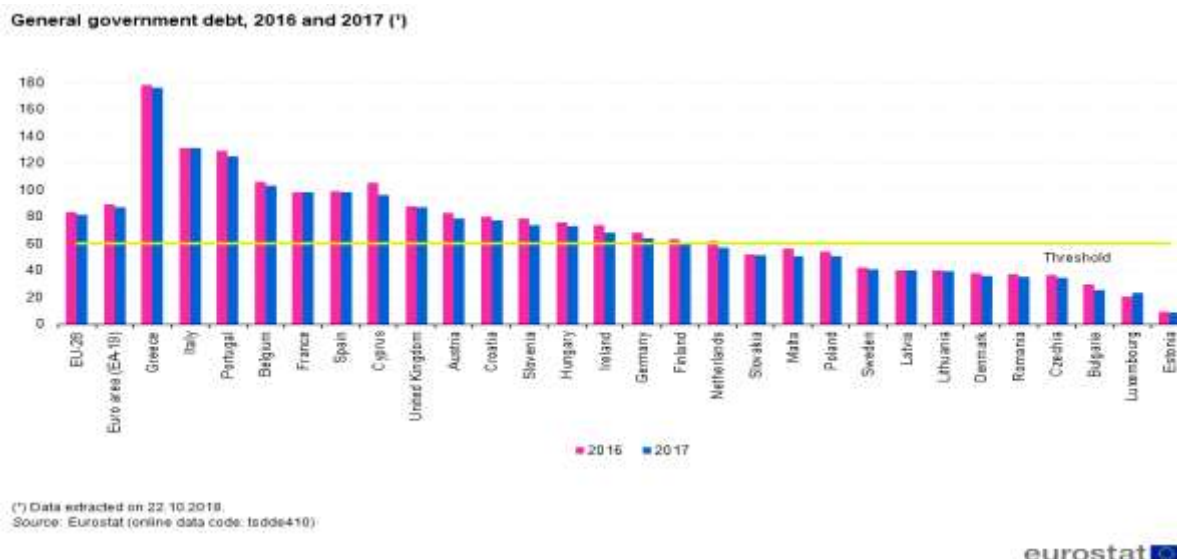
Source: Eurostat, 2018.

The debt-to-GDP ratio is subject to the threshold of the Maastricht criteria on public debt. The government debt-to-GDP ratio rose but remained well below the required Maastricht benchmark, from 13.7% in 2009 to 17.1% of GDP in 2013. A new increase in government debt followed with the subsequent 2015 new government debt issues on the international market, where the country's credit rating allowed to borrow resources at favorable interest rates levels. But overall, the government debt/GDP ratio of 28.1% in 2016 remained well below the 60% reference value during the entire eurozone crisis and in the post-crisis period. In the present decade, Bulgaria has maintained strict fiscal discipline keeping compliance with the Maastricht criteria and adjusting to more strict fiscal rules of the Fiscal pact (See Fig.3).

By the average annual growth rate of government debt in relation to GDP, Bulgaria has performed well and it is among EU Member states with low levels of Government debt as per cent of GDP. In 2016-17 the lowest ratios of government debt-to-GDP were recorded in Estonia (8.7 %), Luxembourg (23.0 %), Bulgaria (25.6 %), Czech Republic (34.7 %), Romania (35.1 %) and Denmark (36.1 %). At the end of 2017 the highest debt ratio above 60 % of GDP was registered by some EMU countries including Greece (176.1 %), followed by Italy (131.2 %), Portugal (124.8 %), Belgium (103.4 %), France (98.5 %) and Spain (98.1 %)(see Figure 4).

Assessing the state of general government debt during Bulgaria's accession to the EU, it should be pointed out that the predominant trend towards debt reduction in the period 2000-2014 is a direct consequence of the sustainability of fiscal consolidation. The most "steep" is the decrease in the total government debt in the period up to 2007, which is also a consequence of the higher average annual rates of economic growth as well as of the inflow of foreign capital reaching their peak in 2007. The positive fiscal balance made it possible in 2006 the Government to repurchase part of the Bulgaria's external debt as well as to make unnecessary a new issue of sovereign debt as there had been high fiscal reserve achieved.

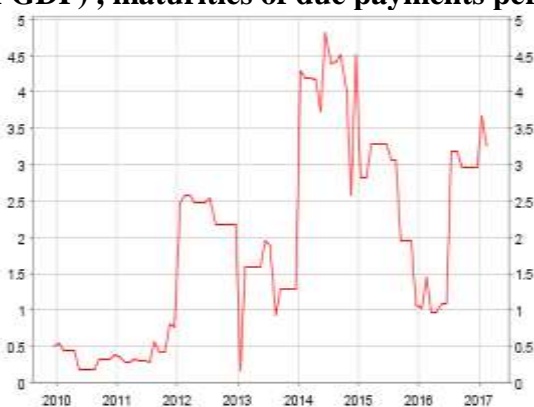
Fig.4. EU Member States' General Government Debt, 2016 And 2017 (¹) (General Government Consolidated Gross Debt, % of GDP)



Eurostat, October 2018.

A positive assessment of fiscal policy and government debt management also deserves the fact that government debt service has been carried with no additional negative consequences. Uncourtly it has been the overall restrictiveness of fiscal policy which has limited budget expenditures. Thus the worsening of the insufficient funding of the public budget systems has lead to the negative trends in a number of subsectors and areas of the Bulgarian economy, such as pension system, health care, education and social services. In the context of the European debt crisis and the sharp deterioration in the government debt management of several EMU countries, the fiscal discipline in Bulgaria needs to be taken into account given the increasing rigor of EU requirements for macroeconomic stability as conditions for EMU participation. The discussion on the issues of the Government expenditure to service the Government debt shows that Bulgaria's fiscal position allows moderation and tolerance of debt service, which is undoubtedly a prerequisite for macroeconomic stability (Fig.5). Even in the conditions of slowdown of economic growth which is expected to occur after 2008 in the global economy servicing the public debt won't present any problems.

Figure.5. Due payments for servicing the Government debt of Bulgaria in 2000-2017 (as % of GDP) , maturities of due payments per month /



Source: Eurostat, 2017.

An important feature of Bulgaria's fiscal policy is the "return" to borrowing of financial resources for the state budget through new government debt issues. The incurrence of new

liabilities is observed since 2014 when the issues of new loans have raised the level of total Government debt. (Fig.6).

Figure 6. Bulgaria: Government consolidating amounts in net incurrence of debt (in Millions BGN)



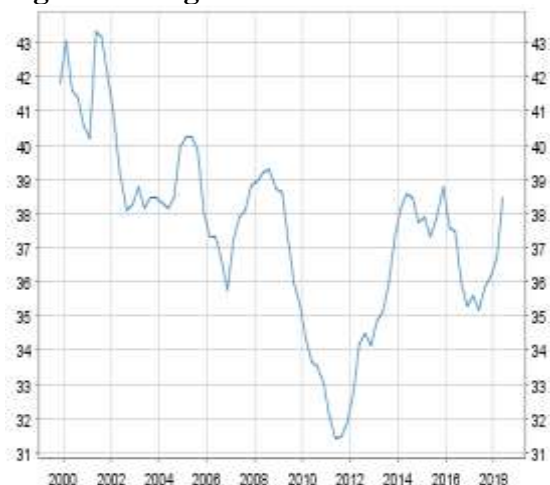
Source: Eurostat, 2018.

The fiscal policy has undergone deep changes as regards the ratio of fiscal revenue to GDP and the sources and structure of fiscal revenues.

The ratio of fiscal revenue to GDP has reflected two main tendencies of the economic development. On one hand, it has reflected cyclical changes. Since 2001 there was a downward trend of reduction of the fiscal revenues as a result of disinflation trends and fiscal consolidation. For the pre-accession period, a certain increase of the fiscal revenues from the beginning of 2002 to 2005 when the rate of growth was increased and credit expansion contributed to it. At the end of the membership negotiations in 2005 and under implementation of the Pre-Accession Programs, the fiscal revenue was marked by a certain increase, not least due to the higher rate of inflow of foreign investments and higher rate of economic growth.

On the other hand, this indicator reflects the Bulgaria's concept of economic liberalization which has been followed for the transition to market economy and the accession to the EU. This concept involves the diminishing of public ownership through privatization and stimulating business growth by reducing fiscal burden in order to encourage the nascent private sector and business entrepreneurship.

Figure 7. Bulgaria: Government total revenue (as % of GDP)



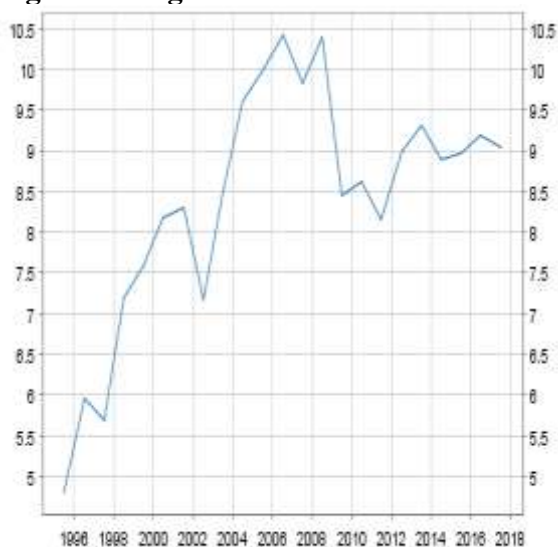
Source: Eurostat,2018.

During Bulgaria's EU membership, the fiscal revenues started to rebound to about 39 % of GDP by the end of 2007. The introduction of the 2008 flat tax of 10 per cent on income of physical persons and on corporate profits caused steady trend of reducing the fiscal revenues. The downward cyclical trends have also contributed causing less Government revenue from all sources, including taxes. Ever since that time the problems of tax collection and prevention of tax avoidance have been set on the agenda of public financial management and control and the tax collecting agencies. By the end of 2018 the ratio of Government revenue as per cent of GDP amounts to 38 per cent.

An important source of fiscal revenue in Bulgaria is the VAT.⁵ The contribution of the VAT has been reduced to some extent since 2007 and nearly kept at an even average level of about 9 % of the GDP in 2012-2017.

⁵Bulgaria follows the EU rules on VAT compliance, which stipulate minimum rate of 15% per cent for the VAT in EU Member States as tax harmonization. But following the rules Bulgaria makes use of fiscal sovereignty and has introduced a standard rate on goods and services of 20 per cent. The reduced rate of 9 % is valid for hotel accommodation and zero rate is provided for intra-community and international transport.

Figure 8. Bulgaria: Value added taxes' contribution to Government budget (as% of GDP)



Source: Eurostat, 2018.

As a result of the 2007 integration process the liberalization of the movement of goods, services, capital and labor has made a significant impetus due to a certain nominal increase in tax revenue collected (notably excise duties have increased since 2007 as a result of tax harmonization with EU / as well as from social security contributions. At the same time the Government revenue from taxes on production and imports has declined.

The introduction of flat tax from 2008 is a factor for reducing the fiscal burden. The flat tax has been targeted to stimulate investments and attract foreign investors. But the negative trend of reduced revenues from corporate taxation (See Fig.9) is indicative of unexpected negative trends since 2008, namely the lower rate of investments and the lack of inflow of foreign investments. Besides, a process of restructuring the fiscal burden from flat tax for income of physical persons has been under way at the expense of laying higher burden on lower income groups of the population. After 2008 the redistribution ability of the income tax on persons is almost neutral which positions the poor part of income taxpayers in unfavorable state.⁶ In spite of the fact that the effective tax burden on labor income as measured by the implicit tax rate on labor is among the lowest in the EU, the tax wedge on low-income taxpayers remains high.⁷

This tax system has been subjected to legitimate criticism and discussion about a future tax reform that may introduce tax reform aimed at greater contribution to the Government revenues. The present situation is characterized by a prevailing share of the indirect taxes compared to direct taxes as contribution to the Government revenue. This structure differs considerably from the practice in the other EU member states where the direct taxes have major contribution.⁸

The proposals for tax reform so far have not gained official support though it is recognized that

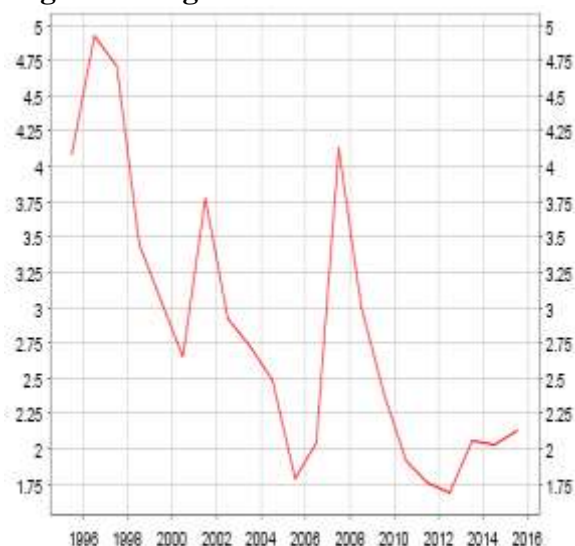
⁶ Brusarski, R., (2012) Economic Analysis "Cost-Benefit", Univ. Publ. House Stopanstvo, 2012. 161 p., [p.25]

⁷ Popova, N. (2017) Taxation of Personal Income in Bulgaria and the European Union, In: "The Economy of Bulgaria in the European Union", FastPrint Publ. House, 229. p. [pp.105-115] ISBN: 978-619-7312-63-8.

⁸ Yotzov, V. (2017) Fiscal policy, in: "Annual Report 2015 "Economic Development and Policies in Bulgaria: Evaluations and Prospects. Focus: The Path to the European Union and the Balance-Sheet of the First 10 Years", pp. 46-48, Victor Yotzov ERI-BAS Books, Bulgarian Academy of Sciences - Economic Research Institute, number 35:p:1-202 edited by Victor Yotzov (Виктор Йоцов), December 2017.

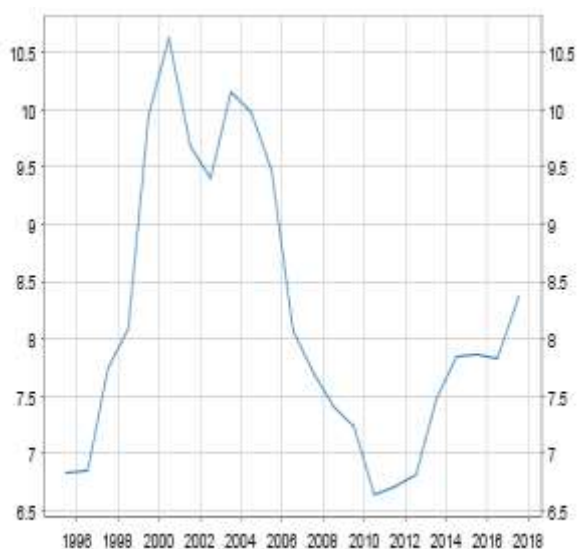
higher revenue may improve the Government budget's spending capacity for on investment, education, healthcare and demographic crisis and poverty. The contribution of corporate earnings tax revenues is highly sensitive to the decline in business growth. Under the impact of the Global and European Debt Crisis there has been sharp decline of the revenue of corporate taxes as per cent of GDP. (See Fig.9) The unfavorable business environment in European and international aspect testifies to maintaining a low tax rate for corporations. Front loading fiscal adjustment through tax reform would have been inappropriate in times of economic recovery.

Figure.9.Bulgaria: Government revenue from the tax on corporate profit (as % of GDP)



Source: Eurostat,2018.

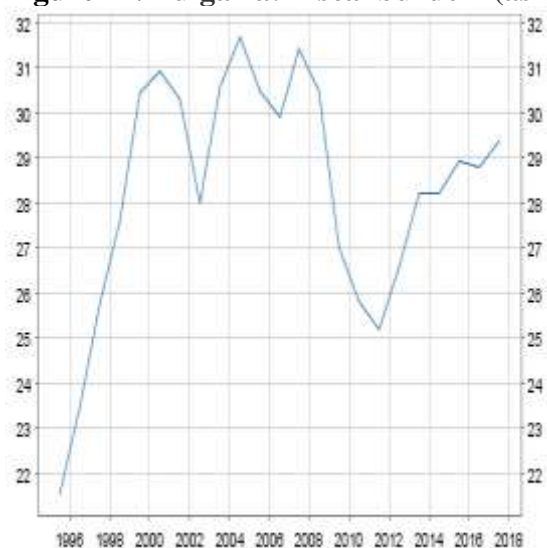
Figure 10: Bulgaria: Government revenue from net social contributions (as % of GDP)



Source: Eurostat,2018.

The trend of reducing the net social security contributions as a share of GDP is another feature of the economic reforms in the last decades. After a slowdown in the crisis years 2008-2010 the increase of social security' contributions to the Government revenues has been resumed in the subsequent period but there share is below 9% of GDP in 2017(Fig.10).

Figure 11. Bulgaria: Fiscal burden*(as % of GDP)



* Total receipts from taxes and social contributions (including imputed social contributions) after deduction of amounts assessed but unlikely to be collected

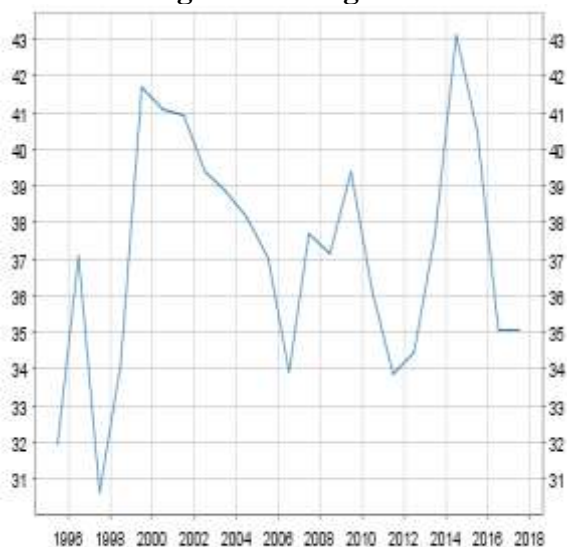
Source: Eurostat, 2018.

The trend of Government' expenditures has undergone also significant changes in the period under review. The overall utilization of the Government expenditures is aimed to provide public money for the functioning of the public systems but to maintain fiscal constraints (Fig.11). The Government expenditures depend on cyclical changes and the capacity of the Government budget to execute its redistribution function.

The Government revenue as fiscal burden has been decreased since 2007-2008 for two reasons; 1) due to the reduction of revenues from custom duties as with the entry of the EU these revenues have become own resources of the EU budget; 2) the flat rate of 10 per cent introduction in 2008. But the reduction of Government revenues remains an issue due to the fact the Government budget of Bulgaria has not got capacity good enough to fulfill its redistribution function. In comparison to other EU member states this is indicative of the existing challenges to the modernization of the contemporary fiscal and public policies as regards providing for public goods in demand, especially public services, education, healthcare and medical care, internal security and defence, social integration, etc.

The level of combined ratio of revenue and expenditure as per cent of GDP for Bulgaria is less than 80% of GDP while in the advanced EU member states it is in excess of 100% of GDP. It is true that the level of general government expenditure and revenue varies considerably between the EU Member States. Besides Bulgaria in 2017 relatively low combined ratios (less than 80 % of GDP) have been reported by other 10 countries, including Ireland, Romania, Lithuania, Latvia, Malta, Cyprus, Estonia, Spain, Czech Republic and Slovakia.

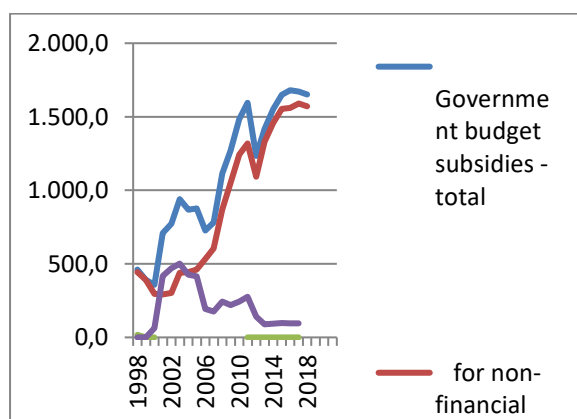
Figure 12. Bulgaria: Government total expenditure (as % of GDP)



Source: Eurostat,2018.

Commitments to the EU to implement strict fiscal rules underpin the maintenance of a restrictive fiscal policy framework in terms of budget spending especially for some subsectors as health care and medical help which have been kept at a low level of funding in the post-crisis period (Fig.12).

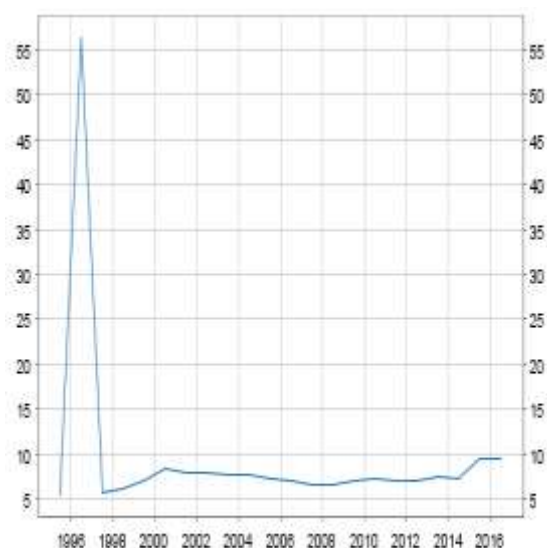
Figure.13.Bulgaria: Government expenditures for the public sector in 1998-2017 (In Mill. BGN)



Source: NSI, Bulgaria; Eurostat,2018.

Another case of the restrictions observed as regards Government social expenditures is presented by the indicator for the old age pensions and survivors' pensions. The Government subsidy for the public pension system has been around 5-6 % of GDP until 2015 and increased up to 10 % in 2018 .(Fig.13).

Figure 14. Bulgaria: Government expenditure related to old age pensions and survivors' pensions (as % of GDP) in 1998-2018



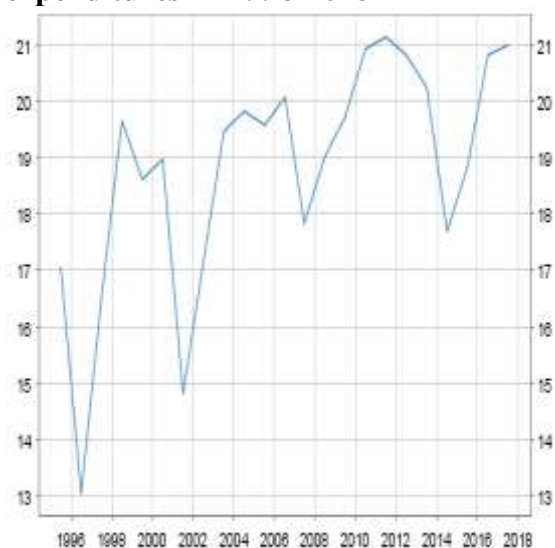
Source: Eurostat,2018.

As the ageing of the population of Bulgaria has increased as share of the total population this trend is unfavorable. The pensions have been maintained at low level which changed after some indexation in 2016. The negative demographic trends may aggravate further the problems of rising poverty among old people. The World Bank “Report on Bulgaria’s potential for sustainable growth and shared prosperity: systematic country diagnostic” in 2015 has underlined: “Declining pension coverage plus sizable subsidies from general Government revenue, which are increasingly directed to higher-income groups, tend to redistribute wealth from the unsubsidized poor to subsidized wealthier population. Transfers of about 5.8 percent of GDP already crowd out productivity-enhancing investments in such areas as education, innovation, and infrastructure. It is also likely that the projected contraction in the working-age population will result in a further decline in state revenues as fewer workers join the labor market and pay income taxes. It is reasonable to expect that fewer resources will be available to cover the PAYG deficit as general tax revenues shrink, jeopardizing the back-up financing vehicle for the pension system.”⁹

The unfavourable impact of fiscal constraints is revealed as well by the trend of the retention of the wages’ level in the public sector as a share of the overall Government expenditures. The wages and salaries have not been raised above 21 per cent of the Government expenditures for more than a decade. Besides there have been cyclical phases of falling below this level. (See Fig.14).

⁹ World Bank. 2015. *Bulgaria’s potential for sustainable growth and shared prosperity : systematic country diagnostic (English)*. Washington, D.C. : World Bank Group.
<http://documents.worldbank.org/curated/en/521881467994600656/Bulgaria-s-potential-for-sustainable-growth-and-shared-prosperity-systematic-country-diagnostic>

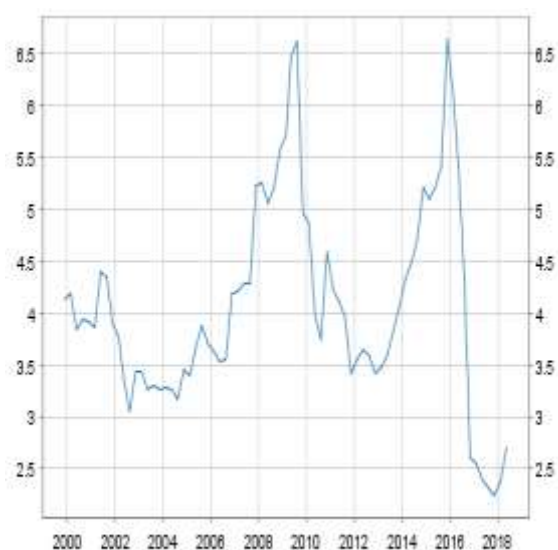
Figure 15. Bulgaria: Wages and salaries as share of the total Government budget expenditures in 1998-2018



Source: Eurostat, 2018.

The Government expenditures for gross capital formation have shown an uprising trend in the pre-accession period from 2003 to 2007 because of the higher rate of economic growth and ongoing structural reforms. The absorption of EU funds under pre-accession funds has also contributed to this trend. It should be noted that during the first years of Bulgaria's EU membership, the gross capital expenditures as a share of the GDP decrease in 2009-2013 (Fig.15). This is a direct reflection of the impact of the crisis in the EU and the slowdown in the economic growth of the Bulgarian economy. The trend towards gradual increase of this relative share after 2013 was overcome to reach 6.56 per cent of GDP in 2016. This result has been largely due to the implementation of infrastructure projects and the participation of the Government budget in the co-financing of the absorption of European funds at the end of the multiannual financial programming period (2007-2014). In 2016-2018 the gross capital formation has dropped sharply and unprecedentedly for recent decades to a level of below 2 % of GDP. The main reason for this drop is considered the reduced utilization of EU funds under Programmes funded for the present 2014-2020 multiannual period by the EU budget.

Figure 16. Bulgaria: Government total capital expenditure (as % of GDP)



Source: Eurostat.2018.

A significant problem for Bulgaria in terms of EU accession is that low net public investment (an average of about 1-2 percent of GDP in 1993-1998) have hampered structural reforms to meet EU requirements in the run-up to accession. According to the Government investment program for the period 2000-2004, public capital investment was expected to grow on average by 3-3.5 per cent of GDP annually.

Given the forthcoming higher needs for public investment in structural reform, infrastructure and human capital development, Bulgaria's fiscal policy has encounters challenges for: 1) ensuring the desired growth of capital investment on an annual basis; 2) implementation of public-private partnerships for the realization of public capital investments that are of importance for the economic growth and ensuring the respective publicity and transparency of their realization; 3) Effective absorption of EU funds for the purposes of economic and social cohesion and implementation of infrastructure projects. The increase in budget capital expenditure would not contradict the general focus on financial consolidation as far as they can contribute to accelerating economic growth. increased investment and capital transfers costs will contribute to improving the overall business environment and increased business growth rates would be more in line with the underlying e the EC to prioritize investment as a key objective of European policies and funds.

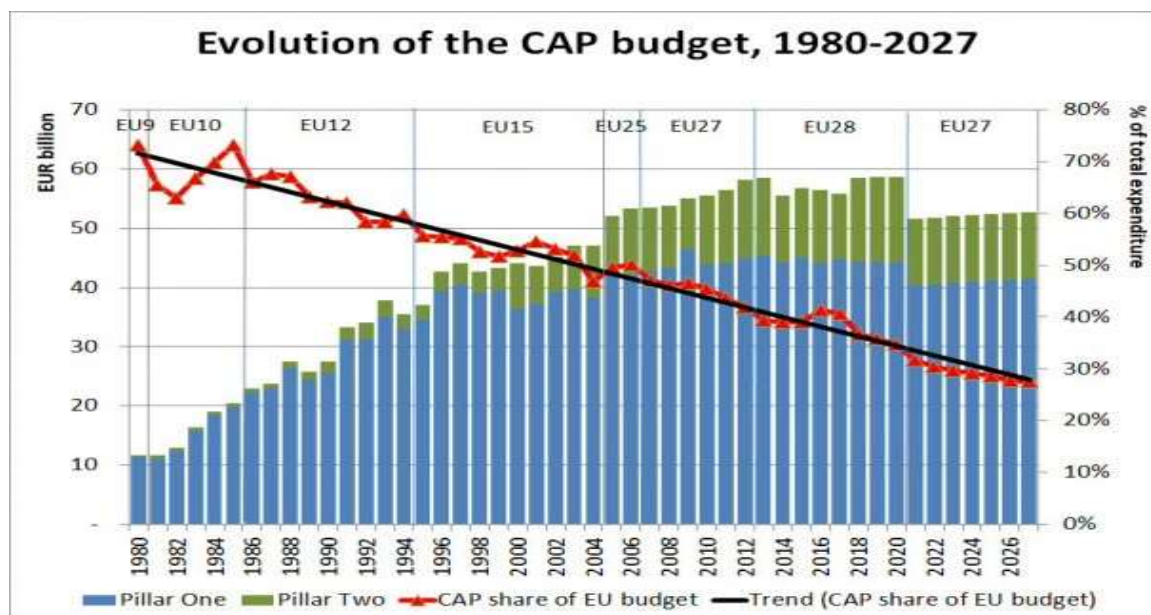
Regardless of the good discipline of Bulgaria's public finances, in the context of a longer-than-expected economic and financial crisis in the EU, there is an objective need to take into account the need for better integration capacity. The fulfillment of the required benchmarks under the Maastricht criteria does not prove to be sufficient to achieve the desired integration effect in terms of socio-economic convergence with the EU. The changed mechanism of economic governance in the EU in fact gives better opportunities for the choice of fiscal policy in Bulgaria according to the Government medium term strategies in line with the recommendations and consistency of EC monitoring for better coordination. The long-term target is accelerating growth in favor of sustainable macroeconomic development.

Bulgaria fulfills its obligation to contribute to the EU budget (Fig.16). Bulgaria is one of the EU countries that receive more money than the EU budget than their installment in the EU, and this will remain the same in the current budget period (2014-2020).

The largest share of the funds that Bulgaria receives from the EU budget is for agriculture and rural development. The agricultural policy of EU aims to help farmers and promote the production of safe and quality food, as well as the protection of the environment and the development of the rural economy. Farmer per worker's earnings increased by 49% in 2012 compared to 2007's level when Bulgaria joined the EU.

Bulgaria's EU accession has coincided with a period of deep reform of the EU Common Agricultural Policy, where its funding as a share in the EU budget dropped from 70% in 1985 to around 40% today and will fall further to 33% in 2020. With the new reform, which entered into force in the EU in 2014, the Common agricultural policy aims to reduce disparities in countries such as Bulgaria, which receive funds less than the EU average. But the forthcoming reform of direct payments from the EU budget for agriculture aims to reduce the share of the Common Agricultural Policy for the next Multiannual programming period after 2020 (See Fig. 17). This trend should draw attention to make timely a nationally responsible policy choice for Bulgaria to support the development of agriculture by raising the role and efficiency of own Government expenditures for the agricultural sector.

Figure 17. The Common Agricultural Policy of the EU as share of total expenditures of the EU Budget (1980-2027)



Bulgaria's second largest area of budget expenditures related to European policies is co-financing from the state budget of European regional policy projects. Government expenditures are made to co-finance projects for job creation, competitiveness, economic growth, improvement of quality of life and sustainable development. Ecological and transport infrastructure are top priorities for Bulgaria. Despite the progress made in implementing the European Cohesion Policy for the regions, however, the issue of significant and deepened disproportions in regional development remains open to our country. Regarding the achievement of a certain ratio of GDP per capita in Bulgaria to the average for the regions in EU 28, the Southwestern is the only region in Bulgaria that has reached the target value. Other regions lag behind this benchmark, with the lowest GDP per capita in the EU - 30% of the EU-28 average (at 45% target). Regional imbalances complicate the problems of the Republican budget to maintain budget systems and public spending in lagging regions and make municipal finance more decentralized.

In the context of the new EU 2010 requirements on the assessment of macroeconomic imbalances, our country does not show persistent sources of imbalances that carry medium to long-term risk. It is a fact that in 2014 our country was in the group of countries with macroeconomic imbalances, mainly due to the banking crisis and the necessary actions to overcome it with state aid.

The future integration has to contribute to Bulgaria's economic development by further fiscal adjustment. The conditionality applied by the European institutions regarding the assessment of the macroeconomic convergence has been given due attention. Having aspired to join the European Monetary union Bulgaria has undertaken measures to implement policies for better compliance with the EU criteria especially in the reform areas of public education, science, internal order, health system. According to British researcher K. Dyson, it is precisely from the way in which conditionality is applied to the new EU countries that the enlargement of the Eurozone is subject to multidimensional conditionality, which is changing dynamically over time.¹⁰

In summary, in spite of the macro-constraints faced by fiscal policy, it should be stressed that it may contribute better to focus on reforms to improve the business environment, to stimulate economic growth and raise the living standard. At the same time, it should be borne in mind that the implementation of structural reforms does not always have an immediate direct beneficial effect on economic growth, as shown by the experience of the Eurozone itself. The example of some Eurozone members states shows that delayed structural reforms can be with negative consequences for the fiscal sustainability of the countries concerned. In this sense, it is important for Bulgaria that fiscal policy undertakes due reforms to improve the business environment and increase growth.

Conclusion

Assessing the importance of Europeanization of Bulgaria's fiscal policy, we can summarize the following conclusions:

- Significant functional and institutional progress has been achieved through the implementation of EU law and Community multilateral surveillance procedures. This is a good prerequisite for a balanced participation of our country in the coordination of the budgetary and economic policies of the member states in the EU. The introduction of the European Semester and the Peer review on specific areas of public finance management also confirms the capacity of our country to participate in oversight at Community level.
- Presenting the fiscal framework that integrates the budgetary effects of structural reforms in practice strengthens the responsibility and the need for greater managerial accountability not only for policy coherence with public funds with the EU priorities but for resolving the national specific problems of social and economic development.

The Convergence Program of the Republic of Bulgaria for 2015-2018 foresees further cost constraints in the public sector, the implementation of which is inevitably linked to the implementation of the structural and functional reform programs in the respective sectors. Consolidation of expenditure is most significant in intermediate consumption - mainly maintenance costs. Although the setting of goals and targeting of the main parameters of the Convergence Framework 2015-2018 are bound to the objectives of EU requirements for fiscal policy, the challenges are increasing due to the necessity to raise the efficiency of public spending and to stimulate economic growth. The forecasts of the international institutions for the economic growth rates of Bulgaria envisage maintaining the current rates and eventually some reduction of the rate of growth for the period up to 2020-2022 under the impact of the

¹⁰ Dyson, K. (2008) Euro Entry as Defining and Negotiating Fit: Conditionality, Contagion and Domestic Politics, in: External Empowerment and Domestic Transformation in East Central Europe, ed. by K. Dyson, Oxford University Press p.4-45.

openness of the Bulgarian economy and the expectations for the global economy as a whole. Fiscal policy's results highlight the need to ensure a more targeted implementation of incentives to boost economic growth.

As a country with derogation but being on the road to prepare for the EMU Bulgaria applies strictly fiscal policy requirements. It has consistently taken into account the necessary changes in the economic governance of the EU countries and under the Fiscal Pact the more strict fiscal rules. The abundance of institutional changes for economic governance in the EU and EMU impose the need of further improvement of policy co-ordination. Thus, under the conditions of the Currency Board for the Bulgarian economy, the issue of the strictness of the fiscal policy is more acute, as it has main responsibility to maintain macroeconomic and financial stability. In its preparation to join the EMU Bulgaria has to encounter the changes in the regulatory framework of fiscal rules which further co-ordinate the budgetary policies of the participating countries.

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