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(Resolutions, recommendations and opinions)

OPINIONS

COUNCIL

COUNCIL OPINION
of 4 March 2008
on the updated convergence programme of Bulgaria, 2007-2010

(2008/C 73/01)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

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

(2) Real GDP growth has been high at over 6 % per year since 2003, while large external deficits have accumulated. Accordingly, the general government balance has been raised from a position close to zero to a surplus of over 3 % of GDP in 2006, with the fiscal stance being counter-cyclical or broadly neutral since 2003. At the same time, monetary conditions have been accommodative within the context of the currency board framework. Strong economic growth has been accompanied with signs of overheating and increasing macroeconomic imbalances reflected in a widening external deficit, re-acceleration of bank credit growth, and rising inflation.

However, the growing external deficits in Bulgaria reflect to a large extent an investment boom driven by considerable FDI inflows. Inflation was mainly triggered by externally induced increases of food and energy prices. However, with unemployment falling sharply, the labour market has tightened and in 2007 wage growth also accelerated considerably, clearly outpacing productivity growth for the first time in several years. If these developments were to continue, they could lead to an erosion of competitiveness and call into question the sustainability of high growth, even though, thanks to moderate real wage increases until 2006 and accumulated productivity gains since 1998, the cost competitiveness has been largely preserved. Looking ahead, Bulgaria is confronted with the challenges

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

of tackling these imbalances while strengthening the conditions for sustained catching-up through maintaining prudent fiscal policy and wage moderation, improving the quality of public finance, ensuring financial sector stability, and stepping up structural reforms.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will pick up from 6,4 % in 2007 to 6,7 % on average over the rest of the programme period. Assessed against currently available information ([1]), this scenario appears to be based on broadly plausible growth assumptions, although slightly favourable especially towards the end of the programme period when growth in domestic demand, in particular investments, appears to be on the high side. Against the background of high real GDP growth, the programme projects limited progress towards nominal convergence with inflation remaining relatively high. Moreover, given the projected sustained wage pressures and planned increases in excise duties on tobacco the inflation projections appear to be on the low side in 2009 and 2010. Although the composition of growth is expected to become slightly more balanced on the back of higher export growth, the external deficit would widen further and is projected to peak at 20,75 % of GDP in 2008, which appears broadly plausible in light of recent developments.

(4) For 2007, the general government surplus is estimated at 3,1 % of GDP in the most recent update of the programme, against a target of 0,8 % of GDP set in the January 2007 convergence programme. This budget over-performance is entirely due to higher than expected revenues, while expenditure control was not fully maintained. Initially envisaged savings of 10 % of budgeted non-interest current expenditures were not implemented and an additional expenditure programme, mostly on infrastructure, of around 2,25 % of GDP was adopted in December 2007. Moreover, pensions were increased twice by 10 % in 2007 and thus by more than the 8,5 % implied by the indexation formula in place. Finally, wage pressures have also started to spill over into the public sector, with a clear acceleration of public sector wage growth in the second half of the year. On balance, however, the higher-than-planned budget surplus in 2007 can be regarded as in line with the invitation in the Council opinion of 27 March 2007 on the January 2007 convergence programme ([2]). In view of the continued strong revenue growth, the 2007 budgetary outturn could even be better than envisaged in the programme.

(5) The medium-term budgetary strategy in the programme aims at maintaining a neutral fiscal stance over the entire programme period. The medium-term objective (MTO) presented in the programme has been revised from a balanced position in structural terms (i.e. cyclically adjusted net of one-off and other temporary measures) to a surplus of 1,5 % of GDP, which would be respected throughout the programme period. Although the MTO endorsed by the Council in its opinion on the original programme was already more demanding than required by the Pact, the significant upward revision is justified in the programme by the rising external imbalances, accelerating inflation and the projected population ageing impact. Both the general government balance and the primary balance are projected to remain stable over the programme period at a surplus of around 3 % and 4 % of GDP, respectively. According to the programme, revenue- and expenditure-to-GDP *ratios* will increase by around 1,75 pp. each over the programme period, with the adjustment occurring mainly in 2008. On the revenue side, the programme projects an increase of 'other revenue' by 2,25 % of GDP, mainly reflecting an increase in EU transfers over the programme period.

In 2008, tax revenues are expected to increase by 1,25 % of GDP due to rate hikes on certain excises, improvements in tax compliance, and a favourable composition of growth. The introduction of the flat rate personal income tax is expected to be fully financed by a further de-shadowing of the informal economy and suppression of certain tax breaks. In 2009 and 2010, tax revenues and social contributions are expected drop slightly. Also, in 2008, social contributions are projected to decrease by 1 % of GDP due to a reduction in contribution rates, which should, however, be largely off-set by an increase in the contribution base. On the expenditure side, the programme projects a considerable restructuring, with capital expenditures increasing by around 2 % of GDP, increasingly financed by EU transfers, and 'other expenditures' by around 1,5 % of GDP over the programme period. This increase would be partly compensated by lower interest expenditures, lower social transfers and a reduction in the government wage bill thanks to planned reductions in public sector employment.

([1]) The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.
([2]) OJ C 89, 24.4.2007, p. 11.

Building on the better-than-expected 2007 outturn, the current budgetary targets are significantly more ambitious than in the January 2007 programme, also against the background of a somewhat stronger economic outlook.

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

(7) In view of this risk assessment, the budgetary stance in the programme implies that the MTO is maintained by a large margin throughout the programme period. The fiscal policy stance implied by the programme is in line with the Stability and Growth Pact throughout the period. The envisaged neutral fiscal stance would avoid adding to the existing domestic and external macroeconomic imbalances. Given the limited scope of monetary policy within the framework of the currency board, saving any revenue over-performance could help reduce them.

(8) In the absence of the long-term projections of age-related expenditures, based on the common macroeconomic assumptions as carried out by the EPC/Commission, it is not possible to assess the impact of population ageing in Bulgaria on a comparable and robust basis as it is currently done for the 25 Member States, for which the projections on this basis are available. While a significant impact of ageing on expenditure cannot be excluded given the current demographic structure, the budgetary position in 2007, with a large structural surplus, contributes significantly to reducing the already low level of debt. Maintaining high primary surpluses over the medium-term would contribute to limiting risks to the sustainability of public finances.

(9) The convergence programme seems to be broadly consistent with the March 2007 national reform programme and the October 2007 implementation report. In particular, the budgetary strategy and the measures envisaged to promote the quality of public expenditures, including through further implementation of programme budgeting, are fully in line with the priorities identified in the national reform programme. Few concrete steps to improve the efficiency and quality of public spending on healthcare are foreseen. The update seems to reflect public finance implications of the reforms envisaged in the national reform programme. This concerns in particular the planned increase in infrastructure investment. However, the update provides relatively little information on the direct budgetary costs of key measures, such as those linked to strengthening administrative capacity or active labour market policy.

(10) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides almost all required and most of the optional data ([1]).

The overall conclusion is that the programme aims at maintaining a sound budgetary position throughout the period, planning the continuation of high general government surpluses. The budgetary targets seem plausible. The programme proposes a significant upward revision of the MTO from a balanced structural position to a surplus of 1,5 % of GDP, which will be comfortably met throughout the programme period. Safeguarding macroeconomic stability and sustaining catching-up in a context of rising external imbalances and high inflation requires the continuation of tight fiscal policies, further improvements in the quality of public spending, including in healthcare, and fiscal institutions and a public sector wage policy that contributes to overall wage moderation in line with productivity gains.

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

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

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

(ii) strengthen policies to contain inflationary pressures, including through prudent public sector wage policy contributing to wage moderation;

(iii) further strengthen the efficiency of public spending, in particular through full implementation of programme budgeting, reinforced administrative capacity and reforms in the areas of labour market, education and healthcare.

Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Dec 2007**	**6,1**	**6,4**	**6,4**	**6,8**	**6,9**
	COM Nov 2007	6,1	6,3	6,0	6,2	n.a.
	CP Jan 2007	*5,9*	*5,9*	*6,2*	*6,1*	*n.a.*
HICP inflation (%)	**CP Dec 2007**	**7,4**	**7,2**	**6,9**	**4,4**	**3,7**
	COM Nov 2007	7,4	7,1	7,3	5,8	n.a.
	CP Jan 2007	*7,4*	*4,0*	*3,0*	*3,0*	*n.a.*
Output gap [1] (% of potential GDP)	**CP Dec 2007**	**0,8**	**0,6**	**0,0**	**– 0,4**	**– 0,2**
	COM Nov 2007 [2]	1,1	0,7	– 0,1	– 0,6	n.a.
	CP Jan 2007	*0,1*	*– 0,4*	*– 0,8*	*– 1,0*	*n.a.*
Net lending/borrowing *vis-à-vis* the rest of the world (% of GDP)	**CP Dec 2007**	**– 15,0**	**– 19,9**	**– 20,7**	**– 19,5**	**– 18,6**
	COM Nov 2007	– 15,0	– 17,0	– 16,0	– 15,8	n.a.
	CP Jan 2007	*– 14,1*	*– 13,6*	*– 12,8*	*– 12,4*	*n.a.*
General government balance (% of GDP)	**CP Dec 2007**	**3,2**	**3,1**	**3,0**	**3,0**	**3,0**
	COM Nov 2007	3,2	3,0	3,1	3,1	n.a.
	CP Jan 2007	*3,2*	*0,8*	*1,5*	*1,5*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2007**	**4,6**	**4,3**	**4,0**	**4,0**	**4,0**
	COM Nov 2007	4,6	4,1	4,1	4,0	n.a.
	CP Jan 2007	*4,6*	*2,2*	*2,8*	*2,7*	*n.a.*

		2006	2007	2008	2009	2010
Cyclically-adjusted balance [1] (% of GDP)	**CP Dec 2007**	**2,9**	**2,9**	**3,0**	**3,1**	**3,1**
	COM Nov 2007	2,9	2,8	3,1	3,3	n.a.
	CP Jan 2007	*3,2*	*1,0*	*1,9*	*2,0*	*n.a.*
Structural balance [3] (% of GDP)	**CP Dec 2007**	**2,9**	**2,9**	**3,0**	**3,1**	**3,1**
	COM Nov 2007	2,9	2,9	3,1	3,3	n.a.
	CP Jan 2007	*3,2*	*1,0*	*1,9*	*2,0*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2007**	**22,8**	**19,8**	**18,3**	**17,4**	**16,9**
	COM Nov 2007	22,8	19,3	15,9	12,9	n.a.
	CP Jan 2007	*25,3*	*22,7*	*22,3*	*21,1*	*n.a.*

Notes:

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

(2) Based on estimated potential growth of 6,2 %, 6,7 %, 6,8 % and 6,8 % respectively in the period 2006-2009.

(3) Cyclically-adjusted balance excluding one-off and other temporary measures. The most recent programme provides no information on one-off and other temporary measures; according to the Commission services' autumn forecast, they are 0,1 % of GDP (surplus-reducing) in 2007. The structural balance in the Commission services' autumn forecast has been recalculated following a revision of the budgetary sensitivity for Bulgaria.

Sources:

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