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**REPORT FROM THE COMMISSION**

**Bulgaria**

**Report prepared in accordance with Article 126(3) of the Treaty**

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#### 1. INTRODUCTION

Article 126 of the Treaty on the Functioning of the European Union (TFEU) lays down the excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 “on speeding up and clarifying the implementation of the excessive deficit procedure”<sup>1</sup>, which is part of the Stability and Growth Pact (SGP).

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) TFEU stipulates that, if a Member State does not fulfil the requirements under one or both of the above criteria, the Commission has to prepare a report. This report also has to “take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State”.

This report, which represents the first step in the EDP, analyses the question of Bulgaria's compliance with the deficit criterion of the Treaty, with due regard to the economic situation and other relevant factors.

Data notified by the Bulgarian authorities on 31 March 2015 stated that the general government deficit amounted to 2.8% of GDP in 2014, thus below the 3% of GDP reference value. However, on 21 April 2015, Eurostat issued a reservation on the quality of the data reported by Bulgaria in relation to the sector classification of the Deposit Insurance Fund and the impact on the government deficit of the fund's repayment of the guaranteed deposits in the Corporate Commercial Bank<sup>2</sup>. Data notified by the authorities on 15 October 2015<sup>3</sup> and subsequently validated by Eurostat<sup>4</sup> show that the general government deficit in Bulgaria reached 5.8% of GDP in 2014, thus exceeding the 3% of GDP reference value, while the

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<sup>1</sup> OJ L 209, 2.8.1997, p. 6. The report also takes into account the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 3 September 2012, available at: [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/legal\\_texts/index\\_en.htm](http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm).

<sup>2</sup> Eurostat news release No 72/2015 - 21 April 2015.

<sup>3</sup> According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Bulgaria can be found at: <http://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit-procedure/edp-notification-tables>

<sup>4</sup> Eurostat news release No 186/2015 - 21 October 2015.

general government debt stood at 27.0% of GDP in 2014, below the 60% of GDP reference value. According to the same notification, the deficit is planned to reach 2.8% of GDP in 2015, thus below the 3% of GDP reference value. This is confirmed by the Commission 2015 autumn forecast.

**Table 1. General government deficit and debt (% of GDP)**

		2011	2012	2013	2014		2015		2016		2017	
					COM	National authorities	COM	National authorities	COM	National authorities	COM	National authorities
Deficit criterion	General government balance	-2.0	-0.6	-0.8	-5.8	-5.8	-2.8	-2.8	-2.7	-2.0	-2.7	-1.4
Debt criterion	General government gross debt	15.3	17.6	18.0	27.0	27.0	31.8	NA	32.8	NA	33.6	NA
	Change in structural balance	0.6	1.5	-0.3	-1.7	NA	-0.1	NA	0.1	NA	0.0	NA

*Source: Eurostat, Commission 2015 autumn forecast and Ministry of Finance.*

The notified budget deficit for 2014 provides *prima facie* evidence on the existence of an excessive deficit in Bulgaria in the sense of the Treaty and the Stability and Growth Pact, before however considering all factors as set out below.

The Commission has therefore prepared the following report to comprehensively assess the excess over the reference value, in order to examine whether the Treaty reference value is complied with after all relevant factors have been considered. Section 2 of the report examines the deficit criterion, Section 3 discusses debt developments. Section 4 deals with relevant factors. The report takes into account the Commission 2015 autumn forecast released on 5 November 2015.

## 2. DEFICIT CRITERION

In 2014, according to the data notified by the Bulgarian authorities and validated by Eurostat, the general government deficit reached 5.8% of GDP, up from 0.8% of GDP in 2013 and significantly above the Treaty reference value.

The excess over the 3% of GDP reference value can be considered exceptional. In particular it resulted from an unusual event outside the control of the government in the sense of the Treaty and the Stability and Growth Pact, as the 2014 deficit was negatively affected by the statistical re-classification inside the general government of the Deposit Insurance Fund following the repayment of the guaranteed deposits in the Corporate Commercial Bank amounting to around 3.0% of GDP. This upward revision compared to the spring notification explains the excess over the 3% of GDP Treaty reference value and was not known when the initial budget for 2014 had been adopted. In view of the unexpected nature outside the control of the government and the fact that it became known late in the year, it should not lead to procedural consequences under the Excessive Deficit Procedure.

Furthermore, the excess over the 3% of GDP reference value is temporary in the sense of the Treaty and the Stability and Growth Pact. In particular, the Commission's 2015 autumn forecast indicates that the deficit is expected to fall below the reference value as of 2015. At unchanged policy, the deficit will remain below 3% of GDP in 2016 and 2017<sup>5</sup>.

<sup>5</sup> In view of the consolidation measures included in the approved 2015 budget, the general government deficit is set to decline to 2.8% of GDP in 2015 and further to 2.7% in 2016-17.

In sum, the deficit outcome in 2014 was above and not close to the 3% of GDP reference value but the excess over the reference value is both exceptional and temporary in the sense of the Treaty and the Stability and Growth Pact. This analysis suggests that the deficit criterion in the Treaty is not fulfilled before analysing the relevant factors.

### 3. DEBT DEVELOPMENTS

The general government gross debt increased from 18.0% of GDP in 2013 to 27.0% in 2014. This reflects several factors: i) the financing of the 2014 budgetary deficit; ii) the pre-financing for a roll-over of a large bond maturing in January 2015; iii) the debt issued to support the stabilisation of the financial sector via a liquidity scheme in mid-2014 and iv) the pay-out of guaranteed deposits in the last part of the year. Applying the no-policy change assumption, the Commission 2015 autumn forecast does not include any potential further debt issuances for financial-sector stabilisation measures, since they were not known at the time of forecast preparation. The debt ratio is forecast to increase to 33.6% of GDP by 2017, reflecting primarily the financing needs related to the budgetary deficit.

### 4. RELEVANT FACTORS

Article 126(3) of the TFEU provides that the Commission report “*shall also take into account whether the government deficit exceeds government investment expenditure and take into account other relevant factors, including the medium-term economic and budgetary position of the Member State*”. These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that “*any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council*” need to be given due consideration. Finally, Article 2(5) of the Regulation provides that the implementation of pension reforms that introduce a multi-pillar system, which includes a mandatory, fully-funded pillar, should be considered in all assessments in the framework of the excessive deficit procedure.

As the debt-to-GDP ratio is below the Treaty reference value, the relevant factors shall be taken into account in all the steps leading to a decision on the existence of an excessive deficit even if the excess over the 3% of GDP reference value is neither close nor temporary (as per Article 2(4) of Council Regulation (EC) No 1467/97).

In view of the above provisions, the following subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position; (3) medium-term government debt position; (4) systemic pension reform; (5) other factors put forward by the Member State.

#### 4.1. Medium-term economic position

**Cyclical conditions and potential growth.** After the global economic crisis in 2009, economic activity in Bulgaria remained weak, with average real GDP growth over 2010-14 amounting only to about 1%. Also Bulgaria's potential growth is estimated to have declined substantially compared to the pre-crisis boom years: potential growth is estimated to have been reduced down to 0.5% on average over 2010-14 from over 5% in pre-crisis years, reflecting declining investment and a lower contribution to growth from labour. Nevertheless, growth potential is estimated to have gradually recovered to about 1.7% in 2014, reflecting the catching-up potential of the Bulgarian economy through capital accumulation and total

factor productivity (TFP) increase. Taking account of the potential growth profile and the actual growth outcomes, the output gap in the Bulgarian economy is estimated to have almost closed in 2013 and stayed at the same level over 2014-15. However, the small negative output gap is expected to widen moderately over 2016-17 mainly due to a drop in investment from projects co-financed by EU funds.

**Table 2: Macroeconomic and budgetary developments<sup>a</sup>**

	2011	2012	2013	2014		2015		2016		2017	
	COM	COM	COM	COM	National authorities	COM	National authorities	COM	National authorities	COM	National authorities
Real GDP (% change)	2.0	0.2	1.3	1.5	1.5	1.7	2	1.5	2.1	2.0	2.5
Potential GDP (% change)	0.3	0.4	0.9	1.7	1.6	1.9	2.4	1.9	2.4	2.0	2.4
Output gap (% of potential GDP)	-0.3	-0.5	-0.1	-0.2	-0.1	-0.4	-0.5	-0.8	-0.8	-0.8	-0.7
HICP inflation	3.4	2.4	0.4	-1.6	-1.6	-0.8	-0.9	0.7	0.5	1.1	1.0
General government gross debt	15.7	17.6	18.0	27.0	27.0	31.8	NA	32.8	NA	33.6	NA
General government balance	-2.0	-0.6	-0.8	-5.8	-5.8	-2.8	-2.8	-2.7	-2.0	-2.7	-1.4
Primary balance	-1.3	0.2	0.0	-4.9	-4.9	-1.8	-2.3	-1.7	-1.1	-1.6	-0.4
One-off and other temporary measures	0.0	0.0	0.0	-3.0	-3.0	-0.1	NA	0.0	NA	0.0	NA
Government gross fixed capital formation	3.4	3.4	4.1	5.2	5.2	5.4	NA	4.7	NA	4.7	NA
Cyclically-adjusted balance	-2.0	-0.5	-0.8	-5.7	NA	-2.6	NA	-2.4	NA	-2.4	NA
Cyclically-adjusted primary balance	-1.2	0.3	-0.5	-2.6	NA	-1.9	NA	-1.6	NA	-1.6	NA
Structural balance <sup>b</sup>	-2.0	-0.5	-0.8	-2.5	-2.6	-2.6	NA	-2.4	NA	-2.4	NA
Structural primary balance	-1.3	0.3	0.0	-1.6	NA	-1.6	NA	-1.4	NA	-1.5	NA

Notes:  
a In percent of GDP unless specified otherwise.  
b Cyclically-adjusted balance excluding one-off and other temporary measures.

Source: Eurostat, Commission 2015 autumn forecast and Ministry of Finance.

#### 4.2. Medium-term budgetary position

**General Government deficit.** According to the Commission 2015 autumn forecast, the general government deficit has deteriorated rapidly from 0.8% in 2013 to 5.8% in 2014 and is projected to improve to 2.8% of GDP in 2015 and to 2.7% in both 2016 and 2017. The deficit increase in 2014 was largely driven by the sizeable support to the financial sector related to the repayment of the guaranteed deposits in the Corporate Commercial Bank (amounting to around 3% of GDP). Moreover, weaker-than-expected government revenues, in particular VAT, had a negative impact on the headline deficit of around 1% of GDP. The remainder of the increase in 2014 can be attributed to higher current and capital expenditure. Current spending was higher in particular in social expenditure and the public sector wage bill. Capital investments also increased substantially in 2014, related to the peak in the EU funds absorption at the end of the 2007-13 programming period. Capital expenditure is, however, projected to drop in 2016 due to an expected slowdown in the implementation of EU projects at the start of the new programming period. On the revenue side, the Commission's 2015 autumn forecast projects current revenue to grow over 2015-17 in line with the respective tax bases without major changes in tax elasticities. Together with gradually increasing interest expenditure from 0.8% of GDP in 2014 to 1% of GDP in 2016, this implies that the primary balance would decline to -1.8% of GDP in 2015 and -1.7% in 2016.

**Structural deficit and departure from the MTO.** In 2014, Bulgaria had to reinforce the budgetary measures in the light of the emerging gap relative to the preventive arm of the Stability and Growth Pact requirements. On 14 July 2015, the Council recommended Bulgaria to avoid a deterioration in the structural deficit in 2015 and achieve an adjustment of 0.5% of GDP in 2016.

In 2015, the structural balance pillar points to a risk of some deviation (gap of -0.1% of GDP), while the expenditure benchmark pillar is expected to be complied with. However, over 2014 and 2015 taken together, there is a risk of significant deviation based on the structural balance pillar (annual average gap of -0.8% of GDP), while the expenditure benchmark points to compliance (positive annual average gap of 2.3% of GDP). This calls for an overall assessment. The deviation over two years is partly stemming from sizable revenue shortfalls in 2014 which negatively affect the structural balance. Also the large increase in public investment in 2014 contributed to a deterioration of the structural balance whereas this is smoothed in the calculation of the expenditure benchmark. After correcting for these factors, the structural balance still points to a risk of some deviation. Therefore, on balance, the overall assessment points to a risk of some deviation over the years 2014 and 2015 taken together.

In 2016, there is a risk of some deviation (gap of -0.4% of GDP) based on the structural balance pillar while the expenditure benchmark pillar points to a risk of significant deviation (gap of -0.9% of GDP). This calls for an overall assessment. The significant deviation from the expenditure benchmark is due to the negative impact of the significant and sudden drop in EU-funded investments<sup>6</sup>. Considering this factor, the structural balance seems to be a better indicator of the fiscal effort at the current juncture. Therefore, the overall assessment points to a risk of some deviation from the adjustment path towards the MTO in 2016.

**Quality of public finances.** The implementation of the current Bulgarian fiscal framework has been delayed and the framework has not been able to prevent the fiscal slippage in 2014, namely the expenditure overruns not related to the financial sector. While a new public finance law came into force in January 2014 as planned, related secondary legislation was delayed during 2013-14, in particular on the ‘fiscal council’ and the ‘correction mechanism’. The Public Finance Act required the government to submit a proposal on setting up an independent body, the ‘fiscal council’, to parliament by mid-2013. Parliament approved the relevant legal act in 2015, well after the deadline for transposing Council Directive 2011/85 on requirements for budgetary frameworks and the Fiscal Compact to which Bulgaria is bound. As part of the 2014 European Semester, Bulgaria was recommended to ensure the capacity of the new fiscal council to fulfil its mandate, but the fiscal council is still not operational. Bulgaria was also recommended to improve tax collection and address the shadow economy, based on a comprehensive risk analysis and evaluation of past measures. The above recommendations remain valid.

**Public investment.** Public investment in Bulgaria has been closely linked to the implementation of EU-funded projects and thus follows the cycle of the programming periods. Capital expenditure, including the EU-funded and national co-financing parts, is

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<sup>6</sup> Total investment expenditure under the expenditure benchmark is smoothed to reduce the inherent volatility of investment. In the case of Bulgaria, investment projects (GFCF) are to a large degree funded by EU programmes. However, such EU-funded expenditures are excluded from the net expenditure growth rate underlying the expenditure benchmark, whereas they are included in the smoothed investment amount underlying the expenditure benchmark. As EU-funded investments are expected to decrease substantially in 2016, the smoothed value of investment expenditure for 2016 as included in the expenditure benchmark is substantially higher than the actual value in 2016. Therefore, due to smoothing of the total investments instead of the non-EU funded investments, the expenditure benchmark pillar overestimates the net expenditure growth. Correcting for this issue, the deviation from the required adjustment on the basis of the expenditure benchmark would be lower, pointing to some deviation instead of a significant deviation in 2016.

expected to peak at around 5.4% of GDP in 2015 from a low of 3.4% in 2011. It is then projected to decrease to around 4.7% in 2016 and gradually increase as the 2014-2020 programming period advances.

#### **4.3. Medium-term government debt position**

According to the 2015 Ageing Report published on 12 May 2015, general government gross debt in Bulgaria is expected to rise from 27.0% of GDP at the end of 2014 to 39% in 2025, remaining well below the 60%-of-GDP reference value in the Treaty. The report includes long-term budgetary projections of age-related expenditure such as pension, health care, long-term care, education and unemployment benefits.

Moreover, based on the sustainability indicators developed by the Commission, Bulgaria appears to face low fiscal sustainability risks in the medium term and medium fiscal sustainability risks in the long term. The medium-term sustainability gap is at -1.3% of GDP, indicating low risks in the medium-term. In the long term, Bulgaria appears to face medium risks. The long-term sustainability gap, which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path, amounts to 2.3% of GDP.

#### **4.4. Other factors put forward by the Member State**

In a letter of 28 October 2015, the Bulgarian authorities communicated what they consider relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97.

The above analysis largely covers the key factors put forward by the authorities. The authorities noted that the statistical re-classification inside the general government of the Deposit Insurance Fund drove the general government deficit above the 3% of GDP Treaty reference value. In further explaining the unexpected increase in the 2014 deficit, the authorities stressed the underperformance of revenues due to low nominal growth in a deflationary environment. In addition, the authorities noted that unexpected expenditures related to increased immigration flows and natural disasters in 2014 had required additional expenditure of about 0.1% of GDP. The authorities also referred to the temporary suspension of payments by the EU for some EU funded programmes. This necessitated bridge-financing by the national budget, creating a significant budgetary deficit in cash terms, but not in accrual terms.

#### **4.5. Systemic pension reforms**

With the pension reform in 2000, Bulgaria introduced a mandatory second pillar of private pension funds alongside the pay-as-you-go pillar. According to the data delivered by authorities to Eurostat, the annual cost of the second pillar is on average close to 1.0% of GDP in the period 2009-2012, and can be expected to remain at around that level until 2014. However, starting from 2015, the government has introduced the option for employees to redirect their pension savings between the private "second" pillar pension funds and the state system up to five years before retirement. Depending on the volume of redirected pension contributions, this could improve the general government deficit and proportionally decrease the cost of the fully-funded pillar.

## **5. CONCLUSIONS**

While general government gross debt remains below the 60%-of-GDP reference value, the general government deficit in Bulgaria reached 5.8% of GDP in 2014, above and not close to the 3% of GDP reference value. The excess over the reference value can be qualified as exceptional within the meaning of the Stability and Growth Pact. Furthermore, it can be considered temporary.

This report also examined relevant factors. Notably, Bulgaria is projected to be broadly compliant with the required adjustment path towards the MTO both in 2015 and 2016. Moreover, capital expenditure, including the EU-funded and national co-financing parts, has strongly increased in recent years and is expected to peak at around 5.4% of GDP in 2015, before declining to 4.7% of GDP in 2016. On this basis, the analysis presented in this report including the assessment of all the relevant factors suggests that the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with.