

REPUBLIC OF BULGARIA

COUNCIL OF MINISTERS

REPORT

**TO THE DRAFT 2012 STATE BUDGET OF THE REPUBLIC OF
BULGARIA ACT**

SOFIA

OCTOBER 2011

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Abbreviations and Acronyms

AAQ	Ambient Air Quality
BAS	Bulgarian Academy of Science
BDZ	Bulgarian State Railways
BFSA	Bulgarian Food Safety Agency
BNB	Bulgarian National Bank
CAP	Common Agricultural Policy
CFP	Consolidated Fiscal Programme
CIT Act	Corporate Income Taxation Act
CMD	Council of Ministers Decree
CMD	Council of Ministers Decision
CoM	Council of Ministers
CSDP	Common Security and Defence Policy
CT	Corporate Tax
EAFRD	European Agricultural Fund for Rural Development
EAGF	European Agricultural Guarantee Fund
EC	European Community
ECJ	European Court of Justice
EEA	European Economic Area
EEC	European Economic Community
EFF	European Fisheries Fund
EMEPA	Enterprise for Management of Environmental Protection Activities
ETW Act	Excise and Tax Warehousing Act
EU	European Union
FBC Act	Family Benefits for Children Act
FDI	Foreign Direct Investment
FLSU	First-Level Spending Unit
GDP	Gross Domestic Product
GNI	Gross National Income
HCPI	Harmonized Consumer Price Index
ICA	Intra-Community Acquisition
ISPA	Instrument for Structural Policies for pre-Accession
MoF	Ministry of Finance
MoH	Ministry of Healthcare
MoI	Ministry of Interior
MoLSP	Ministry of Labour and Social Policy

MoRDPW	Ministry of Regional Development and Public Works
NATO	North Atlantic Treaty Organisation
NHIF	National Health Insurance Fund
NRA	National Revenue Agency
NSSI	National Social Security Institute
OP	Operational Programme
OPDFS	Operational Programme for the Development of the Fisheries Sector
OPTA	Operational Programme for Technical Assistance
OSB Act	Organic State Budget Act
PIT Act	Personal Income Taxation Act
RDP	Rural Development Programme
RES	Renewable Energy Sources
SAPARD	Special Accession Programme for Agriculture and Rural Development
SAPS	Single Area Payment Scheme
SBRBG Act	State Budget of the Republic of Bulgaria Act
SEECN	Single European Emergency Call Number
SF	State Fund
SILs	State Investment Loans
SSC	Social Security Code
SSS	State Social Security
TFP	Total Factor Productivity
TPF	Teachers' Pension Fund
VAT	Value Added Tax
WCGF	Wage Claims Guarantee Fund

I. INTRODUCTION

The principal commitment of any Government is to identify the main challenges faced by their country in the short- and in the long-term, and to map out a plan with the relevant financial provisions to enable the nation to benefit from opportunities and advantages, and to overcome and mitigate any weaknesses or shortcomings.

The preparation of the 2012 Budget as a key tool to deliver on this commitment began early in the current year. For the first time, it has been integrated in the European Semester, the new European framework for enhanced preliminary economic policy coordination. The European Semester also provides for an early peer review of national budgets so that any recommendations that may be made by the European Commission can be taken into account in national budgets prior to their adoption by national parliaments.

Alongside the budget procedure and in the framework of a broad political dialogue, the Government reached consensus on a range of fiscal rules put together in a so-called “Financial Stability Pact”, to ensure the long-term macroeconomic and financial sustainability of Bulgaria.

These rules became part of the national legislation and shaped the framework for the fiscal policy for the next three-year period. Their institutionalization provided the desired policy continuity and safeguards, both nationally and internationally, ensuring that Bulgaria can maintain fiscal and budgetary discipline.

Taking into account the volatile macroeconomic environment, in its budget projections for the period 2012-2014, the Government declared its intentions to stick to a fiscal policy based on low tax rates and a limited redistribution role for the state, while keeping within the required fiscal constraints, which will ensure a stable basis for economic growth and for attracting investment.

The 2012 Budget is an expression of the Government’s determination to realize its stated intentions to achieve fiscal consolidation and a balanced budget position in the 2014 budget. This is manifested in the capping of spending envisaged for first-level spending units for the period 2012-2014 which the Council of Ministers adopted.

Recent economic and financial developments, both global and in the Eurozone, required a revision of the macroeconomic forecast, resulting in a less optimistic scenario concerning the growth of the national economy over the three-year period, with a projected growth rate of 2.9% in GDP terms for 2012.

The 2012 Budget Framework was developed assuming an economic growth fuelled both by export and by an expected recovery of domestic demand.

With the present budget, the Government revises the fiscal target for 2012, projecting a CFP deficit of 1.3% of GDP while sticking to its commitment to a long-term sustainability and predictability of tax and social security policies. The additional fiscal consolidation serves as a buffer which will allow a mitigation of the negative budget effects resulting from the slow-down in the economic growth trend and from the on-going changes in the structure of growth.

Consistent taxation and social security policies pursued in recent years have had a significant contribution in mitigating the negative consequences of the global financial and economic crisis on Bulgaria’s economy and in maintaining its macroeconomic stability.

Low tax rates in corporate and personal income taxation serve as one of the most important incentives for investment and economic growth; hence, in 2012, taxation rates in direct taxes will remain low and the tax burden will continue to shift from direct to indirect taxes by means

of a gradual increase in the excise rates applicable to certain energy products in order to reach the de minimis taxation rates in the EU, as per the agreed transitional periods.

A major policy goal in the area of public spending is to ensure the observance of strict budget constraints by all public sector entities, and efficient control for targeted, appropriate and economic use of budget resources.

In budgeting 2012 expenditure, the guiding principle was again to make priority provisions for the main social responsibilities of the state and ensure equal treatment among the various budgets in an austerity environment.

The increase in income levels for employed persons through next year's budget is linked to implementing intensive and consistent structural reforms and improving the connection between the labour market and the educational system, which are expected to boost labour productivity and the competitiveness of the economy.

In 2012, Bulgaria will continue to rank among the EU countries with the lowest values of consolidated sovereign debt-to-GDP ratio, and its consolidated sovereign debt-to-GDP ratio is expected to reach about 19%.

As a result of its fiscal discipline, improved institutional sustainability and the relative flexibility of its the financial system in a volatile regional environment, Bulgaria became the only country in the EU to improve its credit rating in the conditions of a global crisis, when, in July 2011, the international credit rating agency Moody's raised its rating from Baa3 to Baa2 with a stable outlook.

II. ECONOMIC OUTLOOK

1. Development Trends in the Global Economy

Global slow-down in economic activity

Following the growth registered in 2010, the first half of 2011 saw a slow-down in the global economy. There are indications that economic activity will recover at a slower rate than earlier expected.

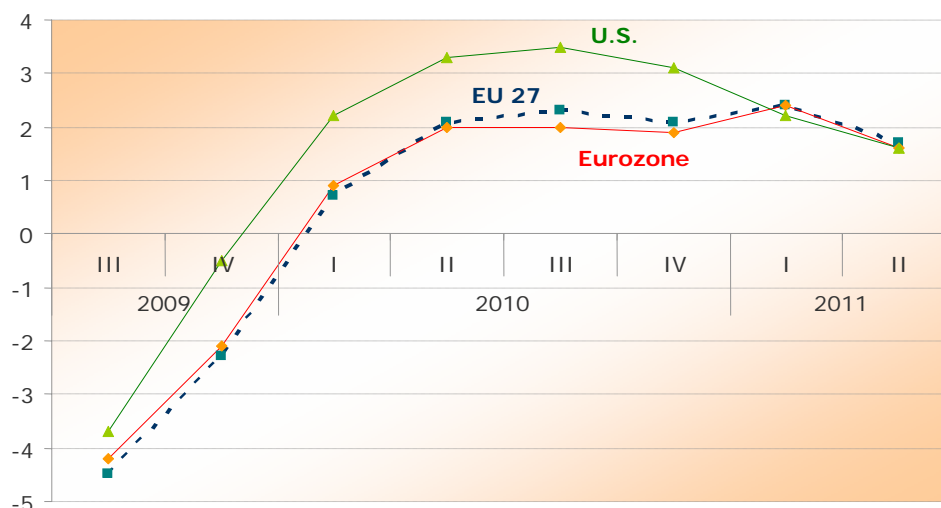
The sluggish response of private consumption to fiscal stimuli in advanced economies resulted in a weaker growth and unemployment rates plateaued at high levels. In addition, the devastating earthquake in Japan, the turmoil in the Middle East and North Africa and the related jump in oil prices had an adverse short-term effect on manufacturing and increased the risks in the global economic recovery.

Markets fluctuate due to uncertainty about developments in the Eurozone and the debt crisis

In recent months, volatility in the financial markets has gone up considerably due to uncertainty about developments in the Eurozone and the debt crisis. Other negative impacts came from the slow-down in global economic activity and the lengthy political negotiations about raising the ceiling of US federal debt.

The upward dynamics of prices of energy products and food on world markets contributed to a growing global inflation. In developing countries, inflationary pressure rose considerably, reflecting the higher share of food and fuel in final consumption. In the EU, inflation is expected to calm down faster by the end of 2011 as the slow-down in global demand takes its effect on international commodity prices.

Chart: Real GDP (% change from corresponding quarter of previous year)



Source: Eurostat, US Bureau of Economic Analysis

US economy adversely affected by external shocks

The economic slow-down was particularly pronounced in the U.S. where Q1 and Q2 annualized growth rates were reported at 2.2 and 1.6%, respectively¹. The shrinking economic activity was mostly due to external shocks. On the one hand, the rise in oil and food prices accompanied by high unemployment rates put pressure on disposable income of households. On the other hand, the Japan earthquake in March had a negative impact on manufacturing activity in the U.S. as well, causing disruptions in the supply chain for parts and components in car making. Cuts in government spending also had an adverse effect.

Growth slow-down reported in the European economy

Following a strong first quarter, the growth of the European economy also slowed down to 1.7% for the EU, and 1.6% for the Euro area in the second quarter, from a 2.4% growth in the previous period.

The deterioration in the economic development outlook in the short term was the result of the interplay of several factors: failed expectations about a revamp in private consumption, negative impacts of the debt crisis, tension building up on the financial markets, and adverse external environment.

Considerable volatility in international prices

The rise in the main commodity prices in 2010-2011 was due to the recovery of global demand and a range of constraints on the supply side. Food and metals even exceeded their peak levels from mid-2008. Bad weather in 2010 affected food prices which continued to rise in the first quarter of 2011. This upward trend slowed down in the second quarter.

¹ Based on data from the third U.S. GDP estimate released on 29 September 2011 by the US Bureau of Economic Analysis (BEA).

In addition to growing demand for oil, the insecurity associated with the war in Libya and the political tension in the Middle East contributed to the rise in oil prices. Rising prices of energy products also increased the risks faced by growth in the global economy.

Increased risk for global economic recovery

Although the observed slow-down can be attributed to short-term factors such as spiking international prices and global interruptions in the supply chain, the growth outlook remains weak in the short term. The main risks for the slower recovery of the global economy have to do with the uncertainty surrounding the dynamics of sovereign debts, and the lack of improvement in private consumption. Similar indications also come from the various measures of confidence which point to a certain return to more pessimistic views among the economic agents. In addition, the slower recovery in employment and consumption continue to weigh down on economic expectations.

2. Development Trends in the National Economy

Gross Domestic Product

Exports contributing most for economic growth

Following the 2009 drop in economic activity, in 2010 the Bulgarian economy was back on the way to a gradual recovery, with an annual growth rate of 0.2%. A major growth driver was exports, riding on the upturn in global demand.

In 2011, GDP grew at an annualized rate of 3.3% in the first quarter, and at 2% in the second quarter (seasonally adjusted data). International trade remained the leading contributor but there was noticeable improvement in domestic demand as well, which picked up pace in the second quarter of the year.

The share of net export in the first half of 2011 was 3.8 pp. Exports of goods and services continued to rise at a steady rate of 21.6% in the first quarter, and 12.2% in the second quarter, with the slow-down in Q2 due primarily to base effects. Imports of goods and services remain limited by domestic demand, while demand for raw materials on the part of export-oriented industries accounts for the increase in imports by 8.7% for the January – June period.

Domestic demand recovery under way

Investment activity in Bulgaria was strongly subdued in 2009 and 2010 but started to turn around in 2011. Investment in fixed capital exhibited a positive growth in the first half of the year, with a growth rate on a seasonally adjusted basis accelerating to 8.4% in the second quarter.

Private consumption grew at 1.2% in the first six months of 2011. Household consumer spending remains low. It grew slightly to 1.2 and 1%, respectively, in the first and second quarters of the year. Due to fiscal consolidation, collective consumption has a negative contribution to GDP dynamics.

The manufacturing sector

In 2010, the largest part of the growth registered in gross value

was the biggest contributor in the overall GVA formation in the economy

added in Bulgaria came from manufacturing. This trend persisted into 2011, with a 1.5% increase in real terms for this indicator in the first six months.

For the period January-June 2011, gross value added in the manufacturing sector went up by 5.7%. The highest share came from export-oriented industries, which contributed to improving the situation in manufacturing. The first quarter of the year reported a 54.6% increase in sales on the international market. Value added in the sector grew by 11.6 and 7.7%, respectively, in the first and the second quarter of the year. At the same time, construction continues to struggle. Construction output in the first six months was down by 14.6% and that translated in a 7% decrease in the value added generated in the sector.

In the first half of 2011, services showed no significant change compared to a year earlier. The second quarter reported a positive change in value added in financial and insurance services (an increase of 1.8%). At the same time, there was a drop in key sectors such as trade, transport and tourism (a decrease of 2.7% year-on-year), and in public administration and defence, education, healthcare and social activities (a decrease of 2.3%).

In agriculture, value added went down by 1.9% on an annual basis for the first half of the year.

Labour Market and Income Levels

Decline in employment in 2010 and 2011

Developments on the labour market in 2010 were marked by a considerable decrease in employment due to the delayed effect of the economic crisis of the previous year and the new export-oriented profile of economic growth in 2010. The unemployment rate rose to 10.2%, but that was accompanied by an increase in labour productivity and an improvement in the cost-related competitiveness of the economy.

In the first half of 2011, the dynamics of employment again fell behind the recovered positive growth of GDP on an annual basis. The fall in the number of employed persons reached 3.5% in the first six months and was caused by job cuts in both the manufacturing industries and in the service sector. Seasonal spikes in activity in agriculture and tourism were at the root of the revival observed in the second quarter of the year. However, the annual trends remained negative, due to restructuring from labour-intensive to capital-intensive industries, problems in the construction sector and the sluggish recovery of domestic demand. A certain recovery in labour demand on an annual basis was noticeable in certain export-oriented sectors of processing industries. These, however, have a relatively small share in total employment.

Seasonal revival in the labour market in the second and third quarter of 2011

The unemployment rate retreated from the 12% level reached in the first three months of 2011, to 11.2% in the second quarter.

The seasonal revival in the labour market continued into the third quarter, which was reinforced by the downward monthly dynamics of registered unemployment which reached 9.6% as of the end of August.

In an environment of subdued labour demand, incomes continued to exhibit slow growth. In 2010, average monthly wages went up by 6.3% in nominal terms and 3.2% in real terms compared to the previous year. In the first half of 2011, the growth under this indicator continued to slow down, and this was particularly evident in real terms. In the period under review, average monthly wages showed a nominal increase of 8.9%, against 10% in the second half of 2010, while in real terms the indicator value slowed down to 4.8% from 6.8%.

Current dynamics is determined, above all, by the Government's efforts to optimize public sector spending, where the nominal growth under this indicator stood at 2.8%, while in real terms it showed a decrease of 1.1%. In the private sector of the economy, average monthly wages exhibited a considerably higher rate of change, with 11.2% in nominal terms and 7.5% in real terms.

An analysis in terms of economic activities reveals that in the trade sector, the increase in income had to do with the growth in value added and the high labour productivity in the sector. In some of the economic activities in the area of services (trade, the production and dissemination of information, and telecommunications), growth in wages was considerably affected by the restructuring of labour, away from unskilled and towards highly skilled jobs.

Growth in labour productivity resulting from employment optimization

The on-going processes of employment optimization had a positive effect on the dynamics of labour productivity in Bulgaria's economy. In 2010, labour productivity grew considerably in real terms at 6.4%, and at 5.6% in the first six months of 2011 year-on-year.

Continuing improvement of cost-related competitiveness

The upward dynamics of labour productivity on the one hand, and constraints on income growth on the other, had a favourable effect on employers' labour cost per unit of production. In the first half of 2011, this indicator showed a 7% drop against the respective period in 2010, with extraction, industrial processing and trade contributing the largest shares.

Stabilization in general inflation at a level close to the EU average

Inflation

In the first half of 2011, general inflation, measured by the Harmonized Consumer Price Index (HCPI) by month year-on-year, was relatively stable and despite the continuing rise in international commodity prices remained at a level which was slightly higher than the EU average. Inflation in Bulgaria slowed down in the second quarter, with the wearing out of the base effect of the adoption of higher excise rates for tobacco products in the first quarter of 2010. Inflation reported as of August was 3.1% year-on-year, exceeding the average for EU countries by 0.2 percentage points.

Foodstuff prices rose faster in the first half of 2011, due to the dynamics of international food prices.

The rate of increase in domestic prices of energy goods slowed down from 12.9% in January to 8.4% in August annualized. This

was due to the nominal depreciation of the US dollar against the euro (and hence, the lev) in that period, despite the increase in the international price of crude oil in dollar terms.

Low base inflation resulting from the weak domestic demand

A deterrent to acceleration in general inflation was the weak domestic demand, which affected mostly base inflation. The annual value of this indicator in August was 0.7%, which is equal to the average rate for the period, and its relatively slight increase reflected primarily the effect of higher prices of foodstuff and energy goods on related services such as transport and catering. In addition to services, base inflation includes non-energy industrial goods. They in their turn exhibited negative rates of change (an average of -0.5%) for the period since the beginning of the year.

Balance of Payments

Considerable reduction in the current account imbalance in 2010 and a surplus in the first seven months of 2011 (2.3% of GDP)

The slow and uncertain recovery of the global economy has reflected on the dynamics of the external sector of Bulgarian economy in the current year. The revival of economic activity in our main international trade partners resulted in a high growth in exports. On the other hand, the lingering high uncertainty among investors was the reason why the inflow of foreign direct investments was low compared to previous years.

As a result of these factors, there have been some material adjustments in Bulgaria's balance of payments. In 2010 the current account deficit was down to 1.3% of GDP. In the current year, the current account balance continued to improve, and for the first seven months of 2011 it has been positive, reaching 2.3% of GDP. Expectations are that it will stay positive throughout the year.

Trade balance improvement for goods and services

The largest contribution to the positive current account balance came from the improvement of the trade balance. Bulgarian exports grew at an accelerated rate throughout 2010, and since the end of the first quarter, imports also started to go up. The upward trend persisted into early 2011, and the rate of increase remains high. For the first seven months, exports grew by 37.2%, and imports rose by 21.2%. The latter increase is due mostly to increased demand for raw materials necessary for production in export-oriented industries. The balance of trade deficit in January-July 2011 went down to -1.5% of GDP, against -4.4% of GDP for the same period in 2010.

In the first half of 2011, there was improvement also in the balance of services. The main contribution came from increased revenue from transport services and tourism.

Higher absorption of EU funds makes a positive contribution to current account improvement

Current transfers had a positive contribution to improving the current account in the period under review, which is due to the higher EU funds absorption rate.

Net income has a negative contribution to the improvement in the current account for the first seven months of 2011 mostly due to the rise in the investment income pay-outs.

Deficit in the financial account resulting from lower FDIs and

In 2010, the inflow of foreign direct investments (FDIs) was 27% less than in 2009. There was a decrease in investment activity across all sectors. The negative trend in the financial account

retirement of loans and deposits generated in previous years

persisted into the current year. Over the period January-July 2011, FDIs amounted to a modest EUR 183.8 million. There has been a considerable drop in primary capital investments, while the balance of other capital is negative, which is due to net repayments of intra-company loans.

Net retirement of loans and deposits generated in previous years by Bulgarian banks continued and increased its rate in the current year. Due to the significant decrease in incoming FDIs and in bank activity for the period January-July 2011, the financial account reports a deficit of EUR 1.7 billion (for comparison, in the same period last year, the deficit in this account amounted to EUR 585 million).

Monetary Sector

Stable functioning of the financial system

The currency board arrangement has been stable and functioning, which continued to contribute to the overall macroeconomic stability.

As of the end of 2010, Bulgaria's foreign exchange reserves reached EUR 13 billion (a 0.4% growth compared to the end of 2009). Following a dip in the first months of 2011, foreign exchange reserves began to grow in most of the second and third quarters of the current year. As of the end of September, foreign exchange reserves amounted to EUR 13.1 billion.

As of the end of July, the Bulgarian National Bank has reserves sufficient to cover 115.1% of Bulgaria's short-term external debt and 6.4 months of annualized imports of goods and non-factor services (against 114.5% and 7.3 months at the end of 2010, respectively).

Breaking the downward trend of credit growth for private sector lending

Credit for the private sector followed a smooth downward trend throughout most of 2010, with an annual growth rate declining from 3.8% at the end of 2009 to 1.1% at the end of 2010. The main causes for the low credit growth rate include both the weak demand for credit by companies and households, and the retention of conservative standards according to which banks are willing to lend.

Over the past months of 2011, the downward trend can be seen breaking and at the end of August the credit growth rate for lending to the private sector reached 3.3%. Its recovery was determined almost entirely by the acceleration in the credit growth for non-financial enterprises which rose from 2.4% at the end of the previous year to 6.1% at the end of August.

In the second quarter of 2011, the decline in consumer loans to households began to decelerate, reaching 0.7% at the end of August. Housing loans, in their turn, slowed down their increase to 2.3% in the same period.

Well capitalized and liquid banking system

Banks experienced no liquidity difficulties throughout the period under review, due to the continuing increase of new deposits generated on the domestic market. The total amount of deposits grew at steady annual rates. At the end of 2010, deposits grew by 6.9%, and at the end of August 2011 their year-on-year growth

went up to 10.4%. The increase in resources attracted by banks from resident clients provided liquidity which banks then used to invest in foreign deposits and make payments towards their external liabilities.

3. Macroeconomic Expectations and a Forecast Update Concerning Key Macroeconomic Indicators

Expectations of a slow-down in the global and the European economies

Basic assumptions in developing the macro framework

The current forecast has been developed based on expectations that the fiscal and debt problems faced by certain countries in the Eurozone would result in a slow-down in the European economy in the second half of 2011 and over next year. As a result of the volatile macroeconomic situation, growth in the EU will reach 1.9% in 2011 and 1.8% in 2012. In that period, the global economy will grow at 4.3% in 2011 and 4.5% in 2012.

Slow-down in the rise of international commodity prices

Following the 2011 rise in international prices, expectations in the mid-term include a slow-down in the price increase of the main commodities which are very significant for the development Bulgarian economy (oil, metals and agricultural products).

Table: Key Macroeconomic Indicators

Macroeconomic indicators	2010 Reported	2011 Expected	2012 Projections
GDP (in BGN million)	70,474	76,606	81,629
- Real growth (%)	0.2%	2.8%	2.9%
Harmonised inflation (%)			
- End of year	4.4%	3.9%	2.8%
- Average for the period	3.0%	3.8%	3.2%
Exchange rate (USD/BGN)			
- End of year	1.48	1.38	1.39
- Annual average	1.47	1.38	1.39
Current account (as a percentage of GDP)	-1.3%	1.9%	1.0%
Foreign direct investments (as a percentage of GDP)	4.9%	2.1%	2.8%

Expectations about developments in key macroeconomic indicators

Gross Domestic Product

Compared to current year, economic growth structure to change in 2012, domestic demand expected to contribute

In 2011, the Bulgarian economy is expected to grow at 2.8%. Growth will be affected positively by developments in both exports and consumption. Although the first six months have been strong for exports, growth rates towards the end of year are expected to slow down as a result of the base effect and due to the slow-down in economic growth rates in the EU countries. This will lead to a weaker external demand. For 2011 as a whole, the increase in export volume will be 11.7%, and 5.4% in 2012.

A 2.9% GDP growth expected in 2012, against 2.8% in 2011

In 2011, domestic demand recovery remains weak, with a positive growth expected in 2012. As a result of the deterioration in labour market conditions, actual spending by households on goods and services will grow only slightly, to 0.6% in the current year and by up to 1.9% in 2012.

Investment will continue to decline in 2011 but at a considerably lower rate (-5.0%) compared to the previous year. The stable macroeconomic situation in Bulgaria, together with the strict fiscal discipline are expected to lead to a higher investment activity in 2012 and hence to a 4.7% increase in gross capital formation.

Recovery in domestic demand will result in an increase in imports. The expected slow-down in external demand will have the opposite effect, since there will be a smaller demand for export-oriented products. As result, imports are expected to increase by 6.2% in real terms in 2011 and by 4.9% in 2012.

Labour Market and Income Levels

Expectations for stabilization in employment in 2012 and a similar level of unemployment

In 2011, the level of unemployment is expected to reach an average rate of 11.5%, while employment will go down by 2.6% from its 2010 level. The revival observed in the labour market in recent months still does not evidence the creation of sustainable employment. The slower recovery in domestic demand and in certain labour-intensive industries with a traditionally high number of jobs is the key obstacle to breaking the negative trend in the dynamics of employment.

With a gradual recovery in domestic demand in 2012, the number of employed persons is expected to stabilize, while the unemployment rate is expected to remain high, close to its level in the previous year. Stabilization in the labour market will also have to do with the slow-down in labour productivity growth following the high growth rates under this indicator in the previous two years. A more significant improvement in the dynamics of employment and unemployment is expected from 2013 onwards.

Real growth in wages to match the increase in labour productivity

Until the end of 2011, the growth in labour productivity will remain high, at the level observed in the first six months. It will continue to develop at a rate exceeding the growth in income levels.

In 2012, labour productivity will slow down by about 3 pp. in real terms, which will determine also the lower growth of average monthly wages in the economy on an annual basis. In terms of income levels in the public sector, these are projected to change at a rate which reflects the overall economic development and fiscal position of Bulgaria.

Inflation

Relatively low inflation in 2012 tied to domestic demand

By the end of 2011, the annualized inflation rate will go up slightly, driven by the seasonal increase in food prices and stronger domestic demand. The latter will be felt via a higher base inflation. Inflation at the end of the year is expected to reach 3.9%, with an annual average expected at 3.8%.

In the 2012-2014 period, inflation is not expected to experience

any strong influences from increases in administrative prices, nor from the process of harmonizing excise rates to achieve the *de minimis* levels agreed for EU countries.

In 2012, inflation will be due to a larger extent to domestic demand, with a higher share attributable to increases in prices of services. Foodstuff and energy goods will exhibit a relatively small price increase, since international commodity prices will remain close to their 2011 levels.

Balance of Payments

A positive current account balance expected in 2011 and 2012

Till the end of 2011, the current account balance is expected to remain positive, at 1.9% of GDP, against a deficit of 1.3% in 2010. Weak domestic consumption will continue to act as a deterrent to imports and they will increase more -slowly (by 18% on an annual basis). Hence, the trade balance deficit will drop from 7.7% of GDP in 2010 to below 5% of GDP in 2011.

With the gradual recovery of consumption, 2012 is expected to see imports increasing at a rate slightly higher than that of exports, which will result in an increase of the balance of trade deficit in the mid-term.

The positive contribution by services and transfers to the current account performance will be retained throughout the entire period of the forecast. Taking into account the expected steady growth in income from tourism and increased export of transport services, income in those lines is expected to amount to approximately 10% of GDP at the end of 2011 and remain at that level throughout the period ending in 2014. As a result, the current account balance will be limited to a surplus of 1% of GDP in 2012.

Gradual recovery of incoming FDIs from 2012 on

From 2012 onwards, repayment of external liabilities of banks to parent banks and of the private sector is expected to be limited and the FDIs inflow is expected to revive gradually. The amount of FDIs in Bulgaria will remain considerably below the levels reached in 2005-2007, while providing sufficient cover for the expected post-2013 current account deficit.

III. THE 2011 CONSOLIDATED FISCAL PROGRAMME: EXECUTION REVIEW

1. Execution of the consolidated fiscal programme as of September 2011

Negative budget balance under CFP - 1.1 % of projected GDP as of the end of September 2011

As of the end of September 2011, the budget balance under the consolidated fiscal programme (CFP) was negative, amounting to BGN 826.0 million (1.1% of projected GDP). It consists of a deficit under the national budget in the amount of BGN 438.4 million and a deficit under European funding in the amount of BGN 387.5 million. For comparison, deficit for the period January-September 2010 amounted to BGN 1,517.8 million (2.2% of GDP), or, on a cash basis, CFP deficit in 2011 is improving in nominal terms by BGN 691.8 million, or 1.1 pp. of GDP.

As of 30 September 2011, the fiscal reserve estimated in current exchange rates amounted to BGN 5.1 billion.

Table: Performance under key CFP parameters as of 30 September 2011 (in BGN million)

INDICATOR	Programme 2011 CFP	Reported as of 30 September 2011			Performance reported/allo- cated
		CFP	National budget	European funding ¹	
Col. 1	Col. 2	Col. 3 = Col. 4+ Col. 5	Col. 4	Col. 5	Col. 6 = Col. 3/ Col.2
REVENUE AND GRANTS	26,208.5	18,353.6	17,714.5	639.0	70.0%
Tax revenues	20,702.6	15,082.4	15,081.4	1.0	72.9%
Direct taxes	3,795.1	2,791.7	2,791.7		73.6%
Indirect taxes	10,400.0	7,666.2	7,666.2		73.7%
Revenue from social security and health insurance contributions	5,740.3	4,031.3	4,031.3		70.2%
Other taxes*	767.1	593.1	592.1	1.0	77.3%
Non-tax revenues and grants	5,505.9	3,271.2	2,633.2	638.0	59.4%
EXPENDITURE AND CONTRIBUTION TO THE EU GENERAL BUDGET	28,171.5	19,179.5	17,856.7	1,322.8	68.1%
Non-interest	26,171.6	18,161.7	16,838.8	1,322.8	69.4%
Current	22,476.8	16,294.3	15,904.3	390.0	72.5%
Capital	3,694.8	1,867.4	934.5	932.8	50.5%
Interest	661.1	489.8	489.8		74.1%
Reserve item for contingency and urgent needs ²	527.4				
Contribution to the EU general budget	811.5	528.1	528.1		65.1%
Transfer from the central budget			-296.3	296.3	
BUDGET BALANCE	-1,963.0	-826.0	-438.4	-387.5	

* Including proceeds from sugar levies

Execution on the Revenue Side

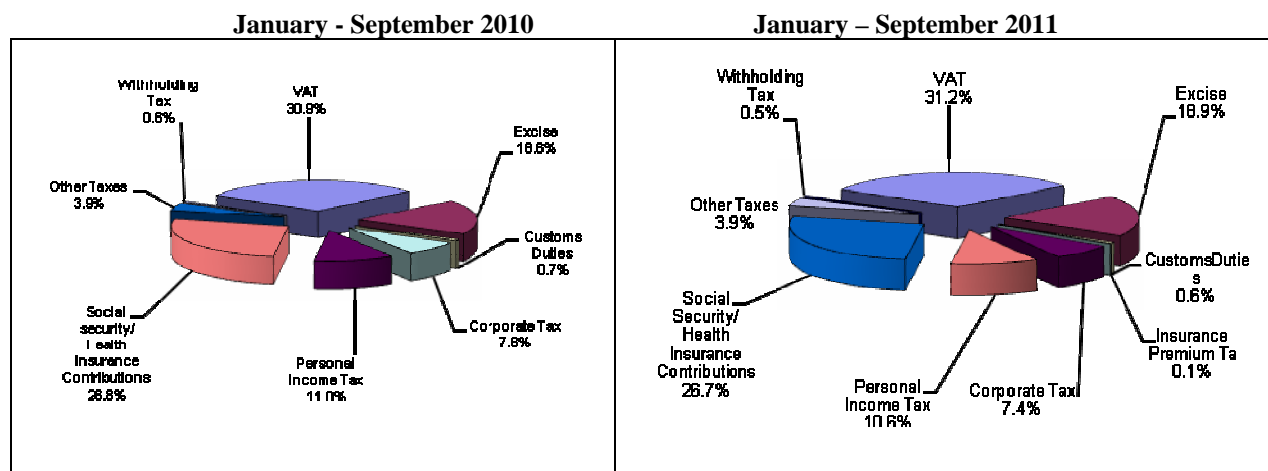
Revenues under the Consolidated Fiscal Programme (CFP) as of 30 September 2011 amounted to BGN 18,353.6 million, which is 70.0% of annual projections. Tax revenues amounted to BGN 15,082.4 million, or 72.9% of the total amount projected for the year. Non-tax revenue and grants amounted to BGN 3,271.2 million, which is 59.4% of the amount projected.

Proceeds under CFP as of the end of September grew by 5.7% (BGN 997.8 million) year-on-year, which is due to higher proceeds from indirect taxes. Indirect tax revenues increased by BGN 865.1 million (12.7%) compared to the end of September 2010, including BGN 512.8 million in VAT revenue and BGN 334.7 million from excise charges.

¹ European funding includes funds disbursed under EU pre-accession instruments, funds under operational programmes funded by the EU Cohesion and Structural Funds (managed by the National Fund within the Ministry of Finance), and the European Agricultural Fund for Rural Development and the European Fisheries Fund (managed by the Payment Agency within State Fund Agriculture). European funding includes also national co-funding for European programmes.

² Line item "Reserve item for contingency and urgent needs" shows projections only.

Chart: Tax Revenue Structure



The execution of annual projections in the main compound budgets was as follows: revenue and grants received in the national budget for the reporting period amounted to BGN 11,981.2 million, or 74.5% of projections budgeted in the 2011 SBRBG Act; proceeds to the budgets of social security and health insurance funds amounted to BGN 4,084.5 million, or 70.5% of revenues budgeted for the year; the revenue in the budget of the judiciary amounted to BGN 101.7 million, which is 96.4% of annual projections, municipal budgets received BGN 1,206.4 million, or 71.5% of the amount projected for the year.

Tax proceeds as of the end of the nine months of 2011 amount to BGN 15,082.4 million (72.9% of annual projections)

Tax proceeds (including revenue from social security and health insurance contributions) amounted to BGN 15,082.4 million or 72.9% of annual projections.

Revenue under the heading of *direct taxes* amounted to BGN 2,791.7 million, which is 73.6% of the annual projections, against BGN 2,609.4 million as of September 2010. In nominal terms, revenue from direct taxes grew by BGN 182.3 million compared to the previous year.

Revenue from *indirect taxes* amounted to BGN 7 666.2 million, which is 73.7% of the amount programmed for the year, compared to a 69.0% execution for the same period of 2010. VAT revenue amounted to BGN 4,702.5 million, or 72.6% of the amount projected, with a nominal growth of 12.2 % compared to the first nine months in 2010. VAT proceeds were positively affected by the introduction of the obligation to deploy a remote connection between the fiscal memory devices at points of sale of fuel and the NRA system, and by the current situation in international energy markets, crude oil in particular. Proceeds from excise charges for the period amounted to BGN 2,853.4 million, or 75.1% of the amount projected for the year, and 13.3% higher than as of the end of September 2010. Proceeds from customs duties and fees as of the end of September 2011 amounted to BGN 95.1 million, or a 95.1% execution of annual projections.

Revenue from *other taxes* (which includes other taxes levied under the Corporate Income Taxation Act (CIT Act), property taxes, proceeds from sugar levies, etc.) amounted to BGN 593.1 million,

which is 77.3% of the amount projected for the year.

Revenue from social security and health insurance contributions as of 30 September 2011 amounted to BGN 4,031.3 million, or 70.2% of the annual projections.

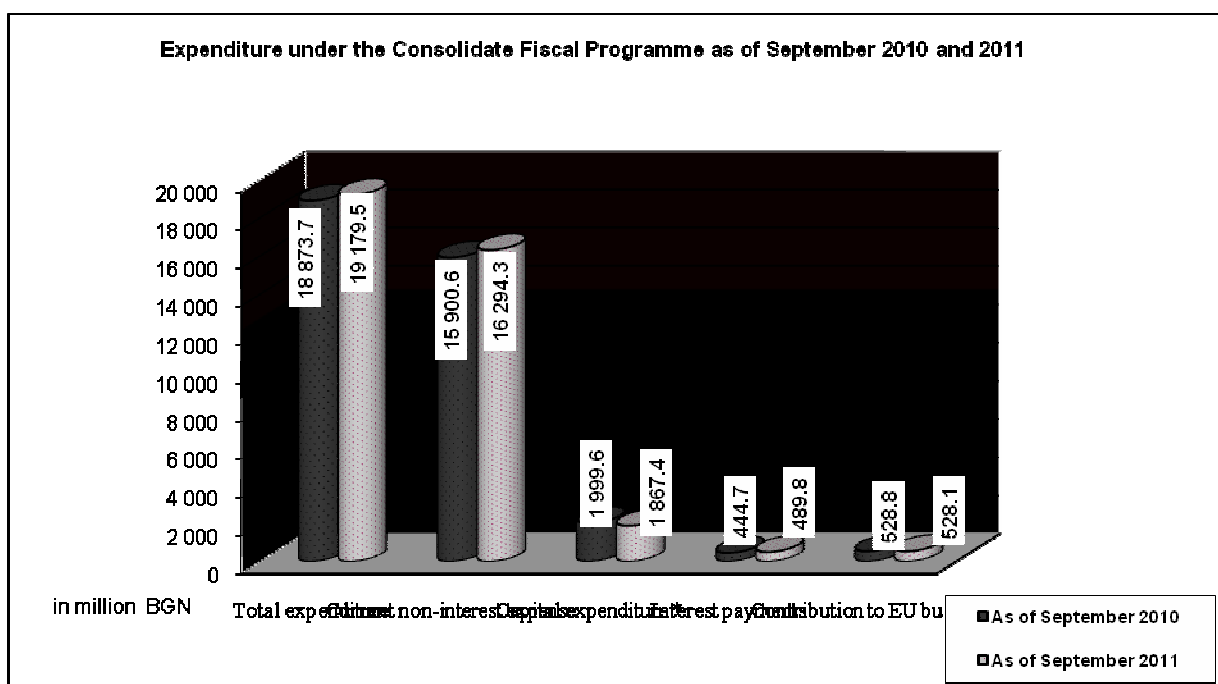
Non-tax revenues and grants collected over the first nine months of the year under the consolidated fiscal programme amounted to BGN 3,271.2 million, which is 59.4% of the total amount projected for the year. Non-tax revenues and grants received in the budgets of ministries and agencies amounted to BGN 990.6 million. The execution of non-tax revenue in the central budget amounted to BGN 409.8 million, including BGN 200.9 million pay-out received from the surplus of BNB's income over expenditure in 2010, and BGN 147.2 million in dividends from companies with government equity. As of the end of September, budgets of municipalities received BGN 737.3 million, or 68.2% of the amounts projected for the year.

Execution on the Expenditure Side

Execution of expenditures planned under the CFP as of the first nine months of 2011 was BGN 19 179.5 million (68.1% of the annual projection)

Expenditures under the consolidated budget (including the contribution of the Republic of Bulgaria to the EU General Budget) in the first nine months of 2011 amounted to BGN 19,179.5 million, which is 68.1% of the annual projection. Interest payments amounted to BGN 489.8 million (74.1% of the total budgeted for 2011), current non-interest expenses were BGN 16,294.3 million (72.5% of the amount projected for the year), and capital expenditure (including the increase in government reserves) stood at BGN 1,867.4 million (50.5% of projections for 2011). A year-on-year comparison against the same period in 2010 shows a nominal increase in interest expense (10.2%) and in social security and health insurance expenditure (3.9%).

Chart: Key CFP Expenditure Indicators as of September 2010 and 2011



* Including net gain in government reserves

Expenditure in Key Compound Budgets under CFP

National Budget

As of 30 September 2011, the total amount of **expenditure in the national budget** (including transfers to other budgets and the contribution to the EU budget) was BGN 11,702.8 million, or 64.2% of estimates in the 2011 SBRBG Act.

Non-interest expenditure in the national budget (excluding transfers to other budgets) incurred in the reporting period amounted to BGN 4,709.0 million, which is 63.1% of the amount budgeted in the 2011 SBRBG Act. *Current non-interest expense* amounted to BGN 4,242.9 million, or 65.9% of the projected amount. Expenditure for salaries and other personnel remuneration, and for social security and health insurance contributions totalled BGN 1,876.2 million, or 71.1% of the annual projections. Current maintenance cost amounted to BGN 1,283.4 million, (55.8% of the amount projected for the year). Social spending (including scholarships) amounted to BGN 598.9 million, or 67.6% of the relevant expenditure item in the 2011 SBRBG Act, and consists mainly of expenditure planned in the budget of MoLSP for entitlements under the Integration of People with Disabilities Act, the Family Benefits for Children Act, the Social Assistance Act, etc. Expenditure for subsidies amounted to BGN 484.4 million, or 79.6% of the amount projected for the year. *Capital expenditure and net gain in government reserves* amounted to BGN 466.1 million, or 45.1% of the amount projected for the year.

Interest payments made from the national budget as of the end of September 2011 totalled BGN 463.8 million, of which interest paid on external loans amounted to BGN 301.9 million, and interest paid on domestic loans was BGN 161.9 million.

Transfers from and to other budgets comprised in the national budget amount to net transfers paid out in the amount of BGN 6,002.0 million, or 66.4% of the annual projections.

Expenditure under the Budgets of Social Security and Health Insurance Funds

Spending in the budgets of social security and health insurance funds (SSS, NHIF, TPF and WCGF) as of September 2011 amounted to BGN 7,795.7 million, which is 73.9% of the amount projected for the year, of which pensions, aid and benefits under the SSC in the amount of BGN 6,082.3 million, a health insurance payments in the amount of BGN 1,612.8 million.

Expenditure under Municipal Budgets

Expenditure incurred in local budgets amounted to BGN 2,953.8 million, or 80.4% of projections in the 2011 SBRBG Act, including from special transfers made to that purpose from other budgets. Current expenditure amounted to BGN 2,549.8 million (84.6 % of the annual projection), while capital expenditure amounted to BGN 404.0 million, or 61.2% of the amount budgeted for 2011.

2. Estimate of the implementation of the consolidated fiscal programme till the end of 2011

Over the past nine months of 2011, performance under the key indicators of budget execution in terms of revenues and expenditures has been in line with the 2011 fiscal framework. Compared to the same period in 2010, proceeds exhibit a 5.7% growth (BGN 997.8 million.), which is due primarily to growth in the subheading *tax proceeds*. Overall tax revenues grew in nominal terms by 11.1% (about BGN 1,506.2 million) compared to the first nine months of 2010, mostly due to the growth reported in indirect taxes (12.7%) and revenue from social security and health insurance contributions (11.0%). In nominal terms, CFP spending remains close to the amount reported for the same period last year (a nominal growth of 1.6%), and along with the positive development in the *Revenues* heading, it translated into a considerable improvement of the budget position from the previous year.

Expected execution of tax revenues planned under the CFP, with a surplus under the national budget compared to the annual projections set in the 2011 SBRBG Act

In the tax revenue subheading of the national budget, there are indications for a possible surplus over the annual projections in the 2011 SBRBG Act, which, on a consolidated basis, will largely offset the emerging tension in the execution of annual revenue projections for social security and health insurance contributions. Potential pressure in the tax revenue subheading as of the first nine months of 2011 is weak, and is expected to be resolved by the additional measures in the revenue area, the expected surplus in proceeds from certain taxes, and savings in the expenditure area. Overall, the execution of tax proceeds on a consolidated basis for the year is expected to come close to the projections set in the 2011 SBRBG Act.

Introduction of oversight measures with an expected long-term disciplining effect, and pressure on the grey economy

Active measures to strengthen controls in trade in excisable goods, eliminate contraband, more intense inspections by NRA, and counteracting any attempts at tax irregularity and fraud are all part of the efforts to raise the tax collection rate.

Some of the steps undertaken are already working, such as the obligation, effective as of January 2011, to deploy a remote real-time connection between the fiscal memory devices at fuel retail points of sale and NRA servers in order to keep account of turnover volumes and full oversight of the movement of goods, which takes grey sector turnover out into the sunshine. The Ordinance concerning the Registration and Reporting of Sales in Commercial Establishments by Means of Fiscal Memory Devices requires all traders in Bulgaria to set up a GPRS connection with the NRA system next year. The adoption and implementation of the Ordinance concerning Specific Requirements and Controls Implemented by Customs Authorities on Excise Goods Metering Devices resulted in a 25% increase in the collection of excise charges on spirits and beer, with an annual effect estimated at about BGN 50 million. The systematic application of these

measures should have a long-term disciplining effect and exert pressure on the grey economy.

Expenditure parameters fall within the projections set in the 2011 SBRBG Act. The retained cap on appropriations for salaries in ministries and agencies and the optimization of organizational arrangements and staffing in budget systems achieved by implementing administrative reform measures help keep salary costs lower in nominal terms compared to those reported in the first nine months of 2010. Capital expenditure also remains lower than in 2010, partly due to payments in 2010 of commitments from previous years.

A trend of steady improvement in the budget position on a cash basis

As a result of the emerging recovery trend on the revenue side, and the policy of austerity in terms of spending, the budget position on a cash basis exhibits a lasting improvement compared to the previous year. As of September 2011, the CFP deficit went down by BGN 691.8 million (1.1 pp. of GDP) compared to the deficit as of September 2010.

In view of these trends in revenues and expenditures, it is expected that the 2011 fiscal target will be met and the budget position on a cash basis will improve by 1.4 pp. of GDP compared to the previous year.

IV. OUTLOOK FOR THE DEVELOPMENT OF PUBLIC FINANCE

1. Key Aspects of Budget Policy and Fiscal Position Sustainability

Bulgaria's fiscal policy is a key factor in the country's sustainable development which, paired with the currency board arrangement, created a favourable environment for the development of its economy.

The choice of measures and instruments for implementing the 2012 budget policy will play a key role in achieving fiscal policy goals, and in particular, in ensuring fiscal position sustainability and maintaining the parameters of the other fiscal aggregates within the range of their respective target values. The fiscal policy goals for 2012 do not deviate from the context of goals set by the Government in the first mid-term fiscal framework which covers the length of its term of office.

The Government undertook and successfully implemented the necessary steps to release Bulgaria's public finance from the excessive budget deficit procedure

During the past two years of its implementation, the national economy was exposed to serious adverse developments as a consequence of the global financial and economic crisis, the influence of which has not yet subsided. Nevertheless, the Government undertook and successfully implemented the necessary steps to release Bulgaria's public finance from the excessive budget deficit procedure. In January 2011, the European Commission concluded that Bulgaria and Denmark have undertaken the necessary measures in line with the recommendations of the July 2010 Council. This success was manifested not only in the short time in which the Government managed to bring the situation under control but also in the consistent fiscal policy, supported by the relevant budget measures employed in the process of budget execution and control, which ensured the necessary level of budget discipline. The capping of commitments imposed through the previous annual budget acts, in

an effective combination with concrete measures for the optimization of administrative entities in terms of their number and costs served as a basis for the present level of fiscal consolidation.

In the current year, fiscal policy, for both 2012 and over a longer-term, was the topic of a focused policy debate at various levels, and the subject of review by various international financial institutions such as the European Commission, the International Monetary Fund, the World Bank, the Organisation for Economic Cooperation and Development, and leading credit rating agencies. The out-going 2011 will be remembered in modern Bulgarian history of public finance governance for the institutionalization, through the Financial Stability Pact, of fiscal rules and targets in the regulatory basis, and for synchronizing the 2012 budget procedure with the European framework for enhanced preliminary coordination of economic policies, the European Semester. By keeping with these commitments, Bulgaria has, to a large extent, applied the European requirements concerning the strengthening and improvement the economic governance and for enhanced coordination of economic, fiscal and budget policies of the Member States.

The preparation of the draft budget as the final stage in the budget procedure for 2012 was based on the CFP deficit targets defined in the fiscal framework, namely, 1.5% of GDP for 2012, 1.0% of GDP for 2013, and 0.5% of GDP for 2014. These lay out, year by year, the consolidation efforts required to reach a balanced position. These aggregate targets served as a starting point in preparing the three-year budget forecast and the spending ceilings for each FLSU for the period 2012-2014, and the Government ensured the necessary consistency with commitments undertaken under the 2011-2015 National Reform Programme in implementing the Europe 2020 Strategy, and the 2011-2014 Convergence Programme.

It should be noted that the target values set for the CFP deficit and the step in achieving fiscal consolidation were estimated under the assumption for a sustainable recovery of the global and the European economies in the mid-term which is expected to have a positive impact on the national economy as well. The forecasts for the next three-year period developed for the purposes of preparing both the fiscal and the budget frameworks were based on expectations for modest growth rates in the national economy, in the range of 3.6% to 4.4%, assuming also a gradual increase in the foreign capital inflows from the very beginning of the period.

Recent economic and financial developments both globally and within the Euro area called for a revision of macroeconomic forecasts towards a more-pessimistic scenario for the growth rate of the national economy over the three-year period, and a growth rate of 2.9% in GDP terms is projected for 2012.

Under these circumstances, through the present budget, the Government is introducing a revision of the fiscal goal for 2012, planning for a CFP deficit of 1.3% of GDP, while sticking to its

commitment to a long-term sustainability and predictability of tax and social security policies. The planned reduction in deficit will be achieved while retaining the existing tax rates in direct taxes, a gradual increase of certain excise rates with a view of achieving the *de minimis* Community levels within the agreed time periods, and an increased collection rate.

The revenue forecast developed for the purposes of the draft for the 2012 State Budget Act reflects this more prudential forecast for economic growth and consists of a decrease in total revenue by a little over half a per cent of GDP from the value projected in the three-year budget forecast for the period 2012-2014. In structural terms, the slow-down in the economic growth rates is reflected in the projections for tax revenues, with a decrease from the estimate in the three-year budget forecast, while the planned increase in non-tax revenues reflects the measures aimed at increasing their collection rate, and the increase in certain stamp duties and court service fees. The forecast for assistance, donations and other grants received from abroad has also been updated, with a significant increase in nominal terms compared to projections for the current year, which is due to the optimistic forecast concerning the absorption of EU funding.

An additional consolidation effort in terms of the 2012 projections made in the last three-year budget forecast has been made on the spending side of the CFP. Despite the outlook for a significant comfort zone for the Government in terms of reaching the limit of 40% of GDP, as planned in the fiscal rule on the maximum amount of consolidated expenditures which was adopted through a recent amendment to the Organic State Budget Act, the execution of the spending side of the budget will continue to take place under enhanced oversight and measures ensuring budget discipline.

It should be noted that by opting for the pessimistic scenario from the latest three-year budget forecast when preparing the draft for the 2012 State Budget Act, the Government is implementing a transparent and predictable fiscal policy, taking into full account the declared fiscal risks. With the CFP projections for 2012, the Government revises the target value and declares its intentions to update targets for the CFP balance for the following years within the CFP period, increasing the consolidation effort and reducing the number of steps until a balanced position is achieved.

A key role for a successful fiscal policy in 2012 will be played by the issuance policy as one of the main tools for sovereign debt management. In 2012, Bulgaria will continue to rank among the EU countries with the lowest levels of consolidated sovereign debt-to-GDP ratio. In 2012, the rate of increase of the consolidated sovereign debt-to-GDP ratio is expected to go up and reach values of about 19%, a forecast which factors in the possibility to issue debt on the international markets.

The Government introduced a rule requiring the adoption of allowable maximum levels of payment liabilities by spending units, and concrete rules on how to change the total amounts of

such liabilities and to make off-set changes within the amounts approved, as a way to ensure that budget discipline is observed in 2012 as well. This rule replaced the traditional 90-per cent rule, which was aimed at limiting any growth in spending and served an anti-cyclical role in years marked by a budget surplus, yet it used to generate a significant degree of unpredictability concerning the performance of spending units.

As of 2012, expenditure for salaries, other remuneration and obligatory social security and health insurance contributions allocated to budgets of first-level spending units within the national budget are to be put together in a general budget appropriation for expenditure for personnel in order to provide more flexibility in managing this spending item.

In a comparison among the EU Member States based on data under the key fiscal parameters, Bulgaria performs well in term of a consolidation effort which needs to be achieved over a short period of time and in lesser steps before a balanced budget can be achieved.

Bulgaria became the only EU country with a credit rating upgrade

As a result of maintaining its fiscal discipline, improved institutional sustainability and the relative flexibility of its the financial system in a volatile regional environment, Bulgaria became the only country in the EU to have improved its credit rating in the conditions of a global crisis, when in July 2011 the international credit rating agency Moody's upgraded its rating from Baa3 to Baa2 with a stable outlook.

The credit rating of Baa2 takes into account the data reflecting the successful management of public finance for more than ten years and a clear determination to maintain that discipline. The upgrade was motivated by the efficient fiscal consolidation, complemented with the on-going structural reforms which are expected to retain the very low levels of Bulgaria's sovereign debt. The high capacity of BNB to support the currency board system and implement efficient oversight and regulation of the banking sector is cited as an additional factor in upgrading Bulgaria's credit rating.

Moody's evaluation included the efforts of the Ministry of Finance which undertook significant fiscal consolidation measures such as the introduction of new fiscal rules and strict expenditure control procedures. In addition to the new Financial Stability Pact which sets clear and strict rules, the Convergence Programme outlines a plan for reducing the budget deficit over the next three years, and the National Reform Programme envisages the structural reforms needed in order to meet long-term challenges faced by fiscal stability and productivity as a result of the pressure caused by the ageing of the population and the declining labour force.

2. Evaluation of Public Finance Sustainability and Fiscal Risks

Long-term Sustainability of Public Finance

Long-term sustainability of the fiscal position is strongly influenced by current levels of budget balance and debt, and by their projected movement as a result of the ageing population. On

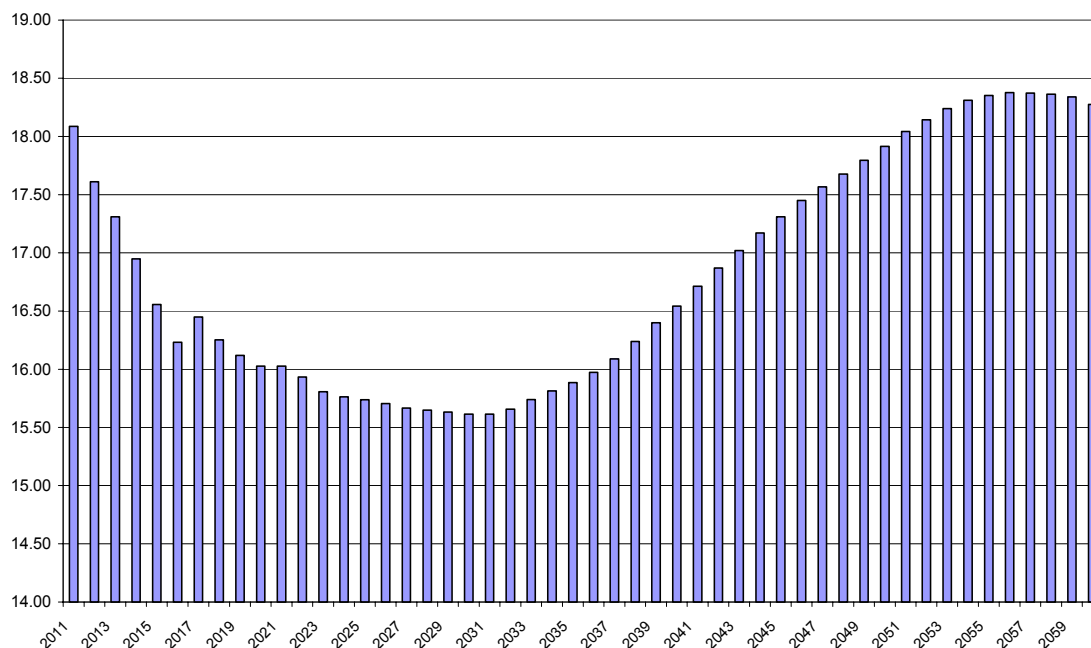
the one hand, the current budget deficit and debt levels which determine the current fiscal policy position do not pose any threat in terms of the long-term sustainability of the public sector. Thus the current fiscal position is found to be stable enough to ensure observation of the criteria of the Pact for Stability and Growth for capping sovereign debt at 60% of GDP in the long-term. On the other hand, the process of ageing of the population carries a considerable risk for public finance, since it will exert considerable pressure towards pushing up budget expenditure for pensions and healthcare in the future.

The impact of the ageing population will be felt in the balance of revenues and expenditures in the budget of state social security. The ageing population will translate in a decrease in the labour force, the number of employed persons, and hence, in the number of covered persons paying social security and health insurance contributions.

Healthcare spending is also expected to increase as a result of the growing share of people in the 65+ age group, since the expenditure for treatment per person is the highest in that group. The share of this expenditure is expected to go up by 0.2 pp. of GDP. Other types of expenditure related to the demographic processes such as expenditure for education and for social care are not expected to have a considerable negative impact on budget spending. Expenditure for education is expected to decrease in GDP terms until 2060, due to a gradual decline in the number of people using the system, and expenditure for social care is also expected to fall slightly, by 0.1 pp. in GDP terms.

Overall, the ageing population is not a minor problem and in the future it will exert considerable pressure on public finance and the economy's potential for growth. This highlights the significance of, and the need to, maintain a strict fiscal policy in order to mitigate the negative impact of demographics and ensure compliance with the rules of the Stability and Growth Pact.

Chart: *Expenditure related to ageing population (% of GDP)*



Potential Growth and Deviation from Potential GDP

In 2011, Bulgaria’s potential economic growth is expected to slow down to 1.3%. The main factors behind that decrease are the decline in investment and employment.

As a result of the slow-down in investment activity in 2009 and 2010, potential growth is expected to reach its lowest level in 2011, and in 2012 it is expected to go back up to 1.7%. In the remaining years of the period under review, the increase in economic activity is expected to bring an increase in potential growth. This will be due both to an accumulation of capital in the economy, and to an increase in total factor productivity (TFP).

Deviation from potential GDP in 2011 is expected to reach a negative value of -3%. Despite expectations for active processes of recovery in Bulgaria’s economy in the remaining years of the period, these will not be sufficient to off-set the dramatic cool-down, and the deviation from potential output will go down but remain negative up to 2014.

Table: Potential Growth and Deviation from Potential GDP

Year	Potential Growth, in %	Deviation from Potential GDP, in %
2010	1.4	-4.5
2011	1.3	-3.0
2012	1.7	-1.8
2013	2.2	-0.9
2014	2.8	-0.2

Table: Contributions to Potential Growth (in percentage points)

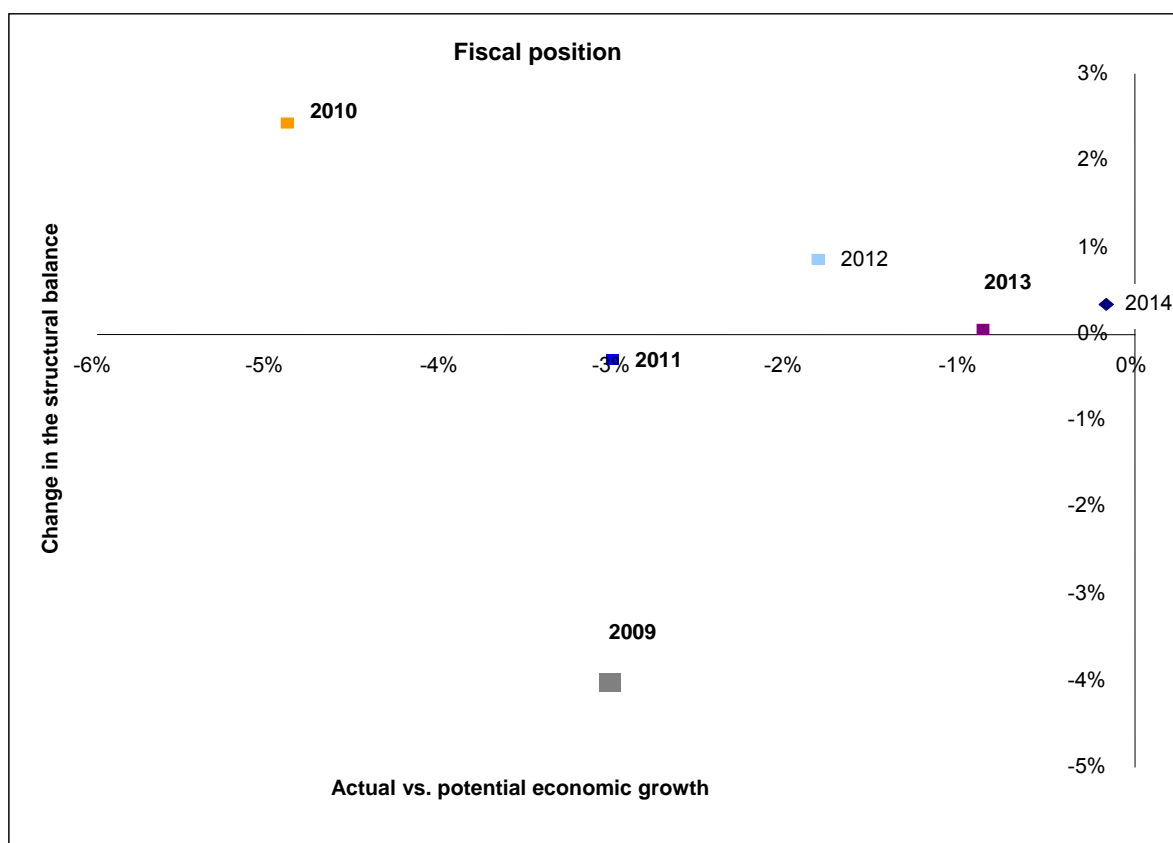
Year	Labour	Capital	TFP
2010	-1.1	1.0	1.5
2011	-1.0	0.8	1.5
2012	-0.7	0.8	1.5
2013	-0.3	0.9	1.6
2014	0.1	1.0	1.6

Fiscal Policy Cyclicity

In 2011, the budget balance (as adjusted for the respective stage in the economic cycle) reached 1.68% of GDP. Compared to the previous year, this reflects a minor restrain in fiscal policy, by 0.3 pp. In the period 2012-2014, the economy will move up closer to its potential but will still remain at a level below optimal output (-1.8% in 2012, -0.9% in 2013 and -0.2% in 2014). In this period, a restrictive budget policy is planned, in order to retain macroeconomic stability and due to the need to maintain investor confidence in the sustainability of the fiscal position. The need to stick to more-conservative budget targets is determined also by efforts to ensure Bulgaria's fiscal stability and meet the challenges faced by public finance as a result of the ageing population.

Chart: Fiscal Position Cyclicity

Графика: Цикличност на фискалната позиция



Maintaining a low budget deficit in view of the immediate and long-term risks for public finance

Fiscal Risks

Fiscal policy accounts for the need to maintain a low budget deficit in view of the immediate and long-term risks for public finance.

The main risks for the execution of the budget have to do with the following:

- A new period of instability for the global economy, a decline in domestic and external demand and the related non-performance on the revenue side of the budget;
- Funding the budget deficit;
- Ageing population resulting in pressure on the pension system.

A possible slow-down in global economic growth may result in an underperformance in Bulgarian exports, which can have an adverse effect on total growth and tax revenues. The financial and economic crisis may affect negatively the revenue side of the budget not only through external demand but also through domestic demand within Bulgaria, since an increased uncertainty in the economy could bring about a fall in investment and consumption.

The financial and economic crisis and the reassessment of investor confidence in terms of the solvency of some European economies may also lead to problems with funding the budget. Countries with high budget deficits and considerable sovereign debt experience difficulties in placing new sovereign debt issues. Being a country which implements a strict fiscal policy, Bulgaria enjoys investor confidence, which is expressed in a high demand for government securities and low yield levels achieved at auctions for government security issues. The clear statement of intent to press on with fiscal consolidation in the public sector is the key factor in retaining strong interest in debt issued by the central government as an attractive investment option for investors, given the current situation on international capital markets which are

marked by high volatility.

One of the fiscal challenges faced by the Bulgarian economy is to ensure the fiscal stability of the state social security system. The measures undertaken aim to contain the pressure on spending and increase revenue in the mid- and long-term.

In the long-term, forecasts indicate a considerable increase in the share of older people and a deterioration of the demographic structure of the population, which holds a significant risk for the fiscal policy and may result in a pressure on budget expenditure for pensions and healthcare. This process is a considerable challenge for maintaining the sustainability of public finance and makes it necessary to pursue a conservative policy in terms of the budget balance, to continue reforms in the pension system and improve the quality of public spending in the healthcare system.

To attain pension system stability, it is projected to increase the required length of pension-scheme covered work experience for employees in third-category labour conditions gradually by four months each calendar year until it reaches 37 years of covered service for women and 40 years for men in 2020, starting from the beginning of 2012.

V. KEY PARAMETERS IN THE CONSOLIDATED FISCAL PROGRAMME AND POLICIES IN THE 2012 BUDGET

1. Key parameters in the Consolidated Fiscal Programme for 2012

This section presents the projections under the key parameters of revenue and expenditure, and the fiscal target for the budget balance for next year.

The consolidated fiscal programme (CFP) for 2012 is based on the updated macroeconomic forecast and has been developed in line with the fiscal policy goals adopted by the Council of Ministers, including fiscal consolidation measures.

CFP parameters reflect the amounts allocated to funding the Government's priorities and policies as projected in the draft for the State Budget Act, expectations about the absorption of funds under European programmes, projections in the SSS consolidated budget, the NHIF budget, local budgets, the autonomous budgets, and the other CFP components.

Planned step for restricting the deficit under CFP on a cash basis to 1.3% of GDP for 2012

For 2012, the planned budget position under CFP amounts to BGN -1,092.3 million or -1.3% of projected GDP. The fiscal target set for 2012 is to be achieved with CFP expenditures amounting to BGN 29,824.3 million (36.5% of GDP) due to implementing an austerity policy in terms of spending.

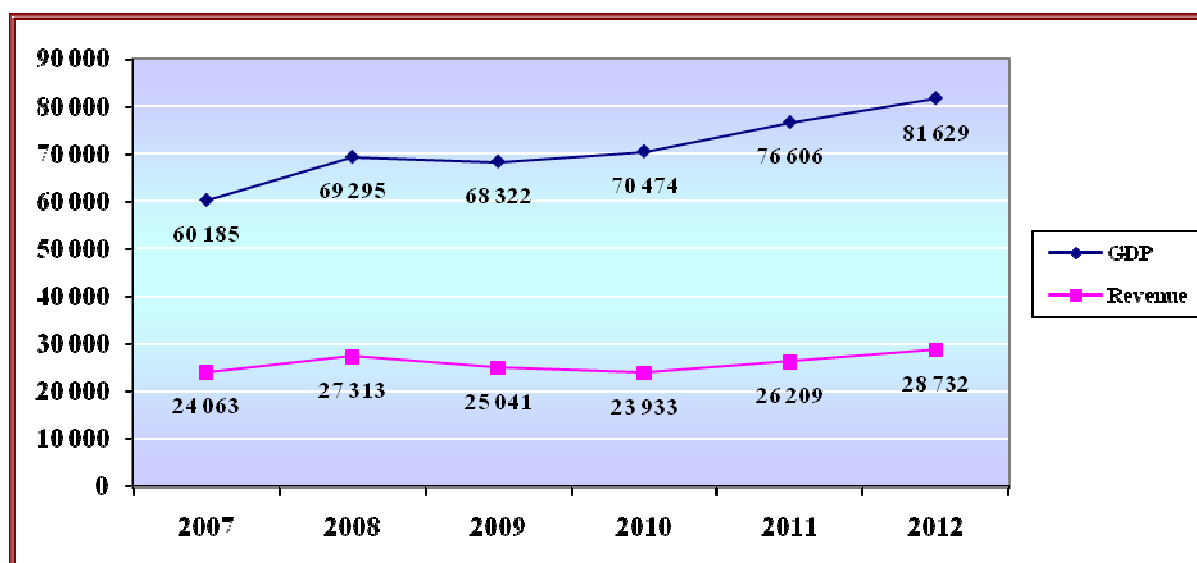
In order to observe the necessary budget constraints and the planned steps for reducing the deficit, the execution of the spending side of the budget will be achieved by implementing enhanced control of expenditures and measures ensuring the observation of budget discipline. This will also fulfil the Government's declared intention to limit the redistribution role of the state to 40% of GDP.

Table: Consolidated Fiscal Programme (2011 and 2012)

Indicators (in BGN million)	CFP		Of which:			
			National Budget		European Funds*	
	2011	2012	2011	2012	2011	2012
Revenue	26,208.5	28,732.0	24,063.7	24,911.1	2,144.8	3,820.9
(% of GDP)	34.2%	35.2%	31.4%	30.5%	2.8%	4.7%
Expenditure	27,360.0	28,928.5	24,366.7	24,392.2	2,993.3	4,536.3
(% of GDP)	35.7%	35.4%	31.8%	29.9%	3.9%	5.6%
Contribution to the EU general budget	811.5	895.7	811.5	895.7		
(% of GDP)	1.1%	1.1%	1.1%	1.1%		
Transfer, national co-funding in addition to EU funding			-823.9	-931.2	823.9	931.2
(% of GDP)			-1.1%	-1.1%	1.1%	1.1%
Budget balance	-1,963.0	-1,092.3	-1,938.4	-1,308.1	-24.6	215.9
(% of GDP)	-2.5%	-1.3%	-2.5%	-1.6%	0.0%	0.3%

* Expenditures include also resources for national co-funding which, however, are not included in estimating the budget balance of funds received from the EU.

Chart: GDP and Public Revenue for the Period 2007-2012 (in BGN million)



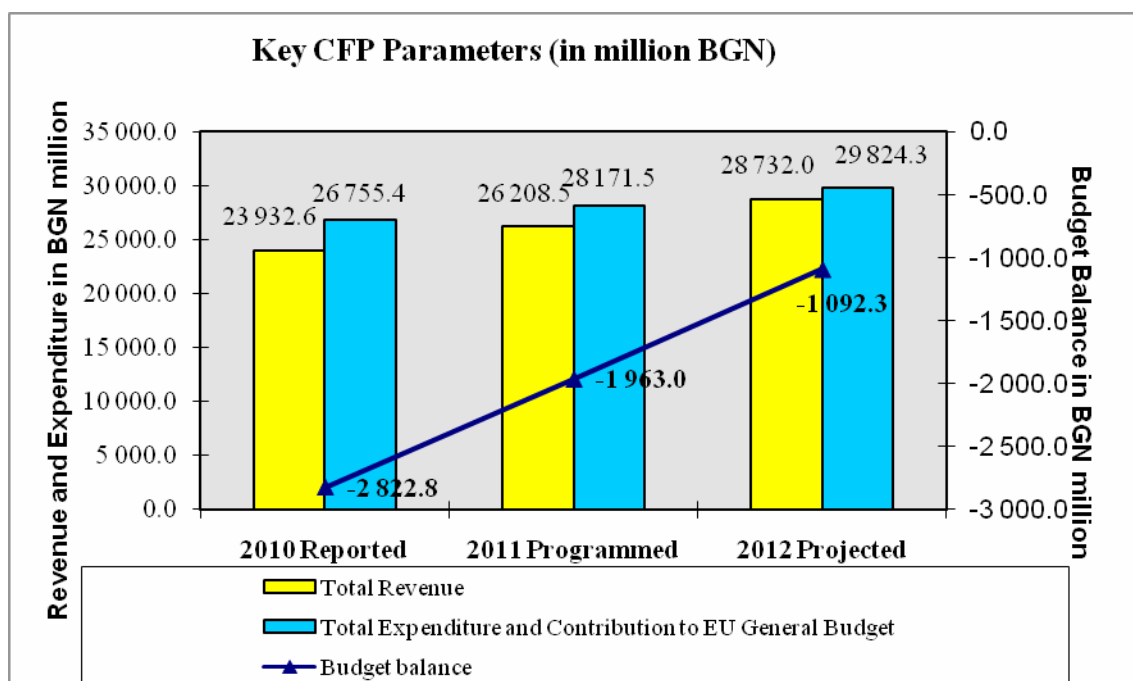
Projected revenue under CFP at 35.2% of GDP

In 2012, revenues under CFP are projected at BGN 28,732.0 million (35.2% of GDP), assuming a nominal increase of BGN 2,523.5 million, which is a growth of 9.6% compared to the 2011 programme figure. Compared to 2011, the share of revenues in real terms is expected to rise by 1% of GDP next year.

Limiting the redistribution role of the state and a CFP expenditure projection of 36.5% of GDP

In 2012, expenditures under CFP are projected at BGN 29,824.3 million (36.5% of GDP), assuming a nominal increase of BGN 1,652.7 million, which is a growth of 5.9% compared to the 2011 programme figure. Compared to 2011, the share of expenditures in real redistribution is expected to be reduced by about 0.3% of GDP.

Chart: Key Parameters under the Consolidated Fiscal Programme (CFP)



2. Tax and Social Security Policy and Public Revenue Projections by Source

Significant contribution of stable tax and social security policy in recent years to mitigating the negative consequences of the global crisis

The achievement of fiscal sustainability and economic growth pose key challenges for EU countries in the current economic situation. In addition to measures to stimulate economic growth, tax policy is aimed at public finance consolidation. The stable tax and social security policy in our country in recent years has made a significant contribution to mitigating the negative consequences of the global financial and economic crisis on Bulgarian economy and to maintaining its macroeconomic stability.

The tax system is an important aspect of the multilateral concept concerning taxation standards. It facilitates achieve the set policy goals, promote economic growth and employment, reduce administrative burden for business and citizens, and increase budget revenues by reducing the share of the grey economy. Low tax rates in corporate and personal income taxation serve as one of the most important incentives for investment and economic growth; hence, in 2012, taxation rates in direct taxes will remain low and the tax burden will continue to shift from direct to indirect taxes by means of a gradual increase in the excise rates applicable to certain energy products in order to reach the *de minimis* taxation rates in the EU, as per the agreed transitional periods.

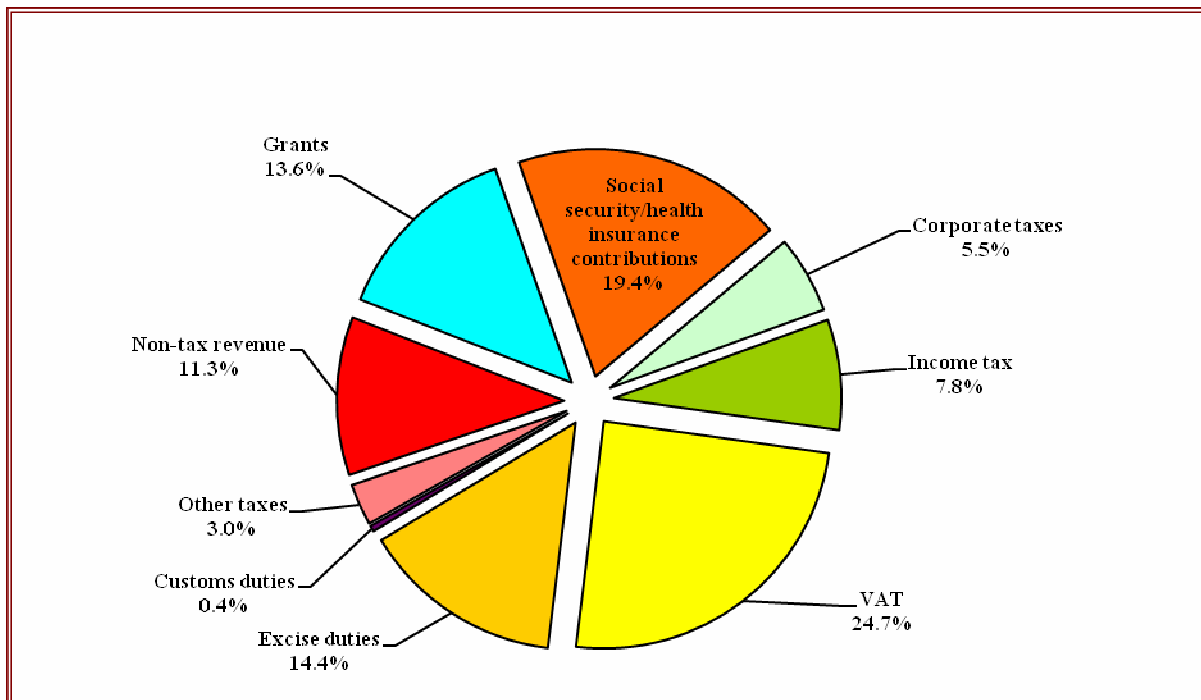
The clear vision about tax policy provides predictability and enables companies to prepare realistic business plans and

forecasts.

The main changes in tax law envisaged for 2012 have been prepared in connection with aligning the national tax legislation with EU acquis, and in order to improve tax legislation and reduce the administrative burden. They envisaged also some concrete measures to strengthen oversight of the collection of indirect taxes by revenue administrations and improve the existing measures against tax fraud and tax evasion.

The amount and structure of tax revenue in the 2012 Budget reflect the forecasted proceeds for the various revenue sources in the consolidated fiscal programme in accordance with the Government's tax and social security policy.

Chart: Structure of 2012 Public Revenue



Corporate taxes (including withholding tax on dividends, liquidation shares and income)

One of the most important elements of the tax system of the Republic of Bulgaria is the 10% corporate tax rate, which is one of the lowest in the European Union. The low tax rate makes Bulgaria an attractive place for local and foreign investment from a tax perspective.

Due to the improvement trend in the economic situation in Bulgaria, proceeds from corporate taxation (CT) are expected to go up. According to the macroeconomic indicators for 2012, the revenue from CT is projected at BGN 1,584.3 million, or about 5% higher than the expected in 2011.

Other Taxes Levied under the CIT Act

No change is envisaged for the legal framework for alternative taxes levied under the CIT Act. Proceeds are estimated to reach BGN 190.5 **million**.

	<p><i>Personal Income Taxes</i></p> <p>Envisaged amendments to the Personal Income Taxation Act for 2012 are aimed at improving tax legislation and reducing the administrative burden for natural persons. They involve:</p> <ul style="list-style-type: none"> ➤ A waiver from the obligation to file an annual tax return for individuals who have earned their income for the year only from employment contracts under the Labour Code and do not have any additional tax liabilities or do not claim any tax breaks; ➤ A change in the procedure for taxing income from renting out real property in apartment buildings managed by a general assembly of the home owners, where rental income originates from enterprises and self-employed individuals; ➤ Simplification of the annual tax assessment by introducing the rule to round off the tax payable to the first full lev; ➤ Introduction of the obligation to declare any winnings from games of chance and income from operations with financial instruments exceeding BGN 5,000 per annum. Such income is tax-exempt, and the introduction of the reporting requirement is a measure aimed at curbing abuses involving income from gambling or transactions with financial instruments in order to evade taxation by improper use of this type of tax-exempt income as an argument to legitimize one's financial position; ➤ A proposal to offer the tax deduction in the amount of 5 per cent of the tax liability for people who pay their tax due according to their tax return earlier (by February 10 of the following year) or file their tax return electronically only provided they have paid the advance tax on time. <p>Proceeds from 2012 taxes levied under the PIT Act are estimated at BGN 2,253.1 million.</p> <p>Revenue from personal income taxation in 2012 is estimated based on the assumption of retaining the 10% flat tax rate applicable to all taxpayers (without any tax-exempt minimum amount), with the exception of income from economic activity as a sole proprietorship, to which the applicable rate is 15%.</p>
	<p><i>Value Added Tax (VAT)</i></p>
	<p>The envisaged amendments to the Value Added Tax Act for 2012 are designed to bring national legislation in compliance with European legislation, Directive 2006/112/EU in particular, and the case law of the European Court of Justice (ECJ). The main changes have to with the infringement procedure against Bulgaria for non-compliance of the Value Added Tax with Directive 2006/112/ EU.</p> <p>The standard tax rate for this tax is retained at 20%. The hotel accommodation tax rate is 9%.</p> <p>With an increase of the VAT weight in final consumption by 0.1 percentage point, VAT revenue in 2012 is expected to reach</p>

	BGN 7,100 million. With the application, in 2012, of higher excise rates on diesel fuel, and of Ordinance No. 3 concerning Specific Requirements and Controls Implemented by Customs Authorities on Excise Goods Metering Devices, additional proceeds are estimated at about BGN 70 million.
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Table: VAT Revenue in 2011 and 2012 (in BGN million)

REVENUE	Expected execution 2011	Projections 2012	Growth 2012/11 (in %)
VAT if the 2011 legislation is retained as is, including	6,600.0	7,030.0	106.5%
- from domestic transactions and ICAs	3,255.0	3,450.0	106.0%
- from third countries	3,345.0	3,580.0	107.0%
Impact of legislative changes	50.0	70.0	
VAT under CFP	6,650.0	7,100.0	106.8%
Relative share of VAT revenue in final consumption	11.5%	11.6%	

	<p><i>Excise Charges</i></p> <p>Envisaged amendments to the Excise and Tax Warehousing Act are related to undertaken commitments to achieve the EU <i>de minimis</i> levels of excise taxation of certain energy products, and to clarifying certain provisions in order to facilitate the practical application of the law.</p> <p>The main changes have to do with increasing excise rates for gas oil and kerosene. Under the Treaty concerning the Accession of the Republic of Bulgaria to the EU, and in particular Negotiation Chapter 10, Tax Policy, a transition period till 01 January 2013 was agreed. Within that period, the <i>de minimis</i> excise rates for gas oil and kerosene in the amount of EUR 330/1,000 litres (BGN 645 /1,000 litres) should be reached. The proposed legislative change has to do with the gradual increase in excise rates for these two energy products.</p> <ul style="list-style-type: none"> ➤ Gas oil – a rate increase from BGN 615/1,000 litres to BGN 630/1,000 litres. The increase will have a positive effect on the budget estimated at about BGN 30 million; ➤ Kerosene - a rate increase from BGN 615/1,000 litres to BGN 630/1,000 litres No budget effect is expected, since kerosene is used primarily as fuel in aircraft in international services and excise payments is refunded to the parties concerned within the time periods specified in the Excise and Tax Warehousing Act. <p>Several other changes are envisaged:</p> <ul style="list-style-type: none"> ➤ Introduction of a lower excise rate for beer supplied within

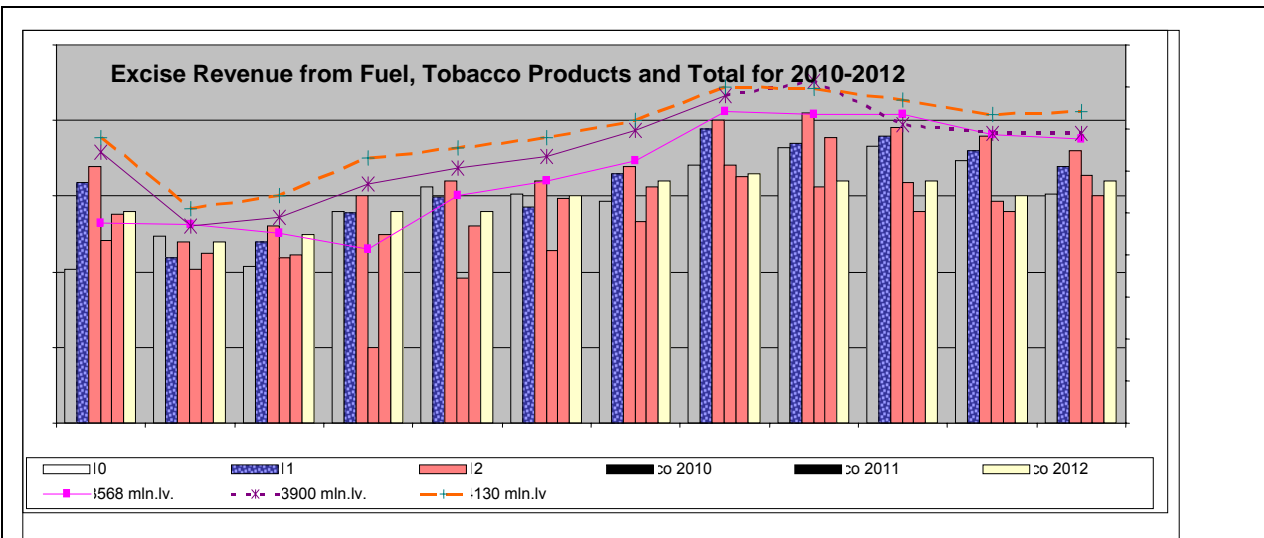
	<p>the territory of Bulgaria by independent small breweries registered in another Member State. The proposal transposes fully Article 4, paragraph 3 of Council Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages.</p> <p>➤ Includes energy products with CN code 3811 within the scope of the procedure for deferred payment of excise. The amendment proposal is triggered by the publication of European Commission Implementing Decision of 16 September 2011 concerning the application of the control and movement provisions of Council Directive 2008/118/EC to products falling within CN code 3811, in accordance with Article 20, paragraph 2 of Council Directive 2003/96/EC.</p> <p>For 2012, revenue from excise charges is estimated at BGN 4,130 million.</p>
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Table: Revenue from Excise Tax by Group of Excisable Goods (in BGN million)

GROUPS OF EXCISEABLE GOODS	Expected execution 2011	Projection 2012	Growth 2012/11 (in %)
1. Tobacco products	1,700.0	1,775.0	104.4%
2. Fuel	2,110.0	2,270.0	107.6%
3. Spirits and beer	265.0	275.0	103.8%
4. Other (Electricity, etc.)	45.0	50.0	111.1%
Excise revenue, gross	4,120.0	4,370.0	106.1%
Refunded Excise Tax	220.0	240.0	109.1%
Excise revenue in the national budget	3,900.0	4,130.0	105.9%

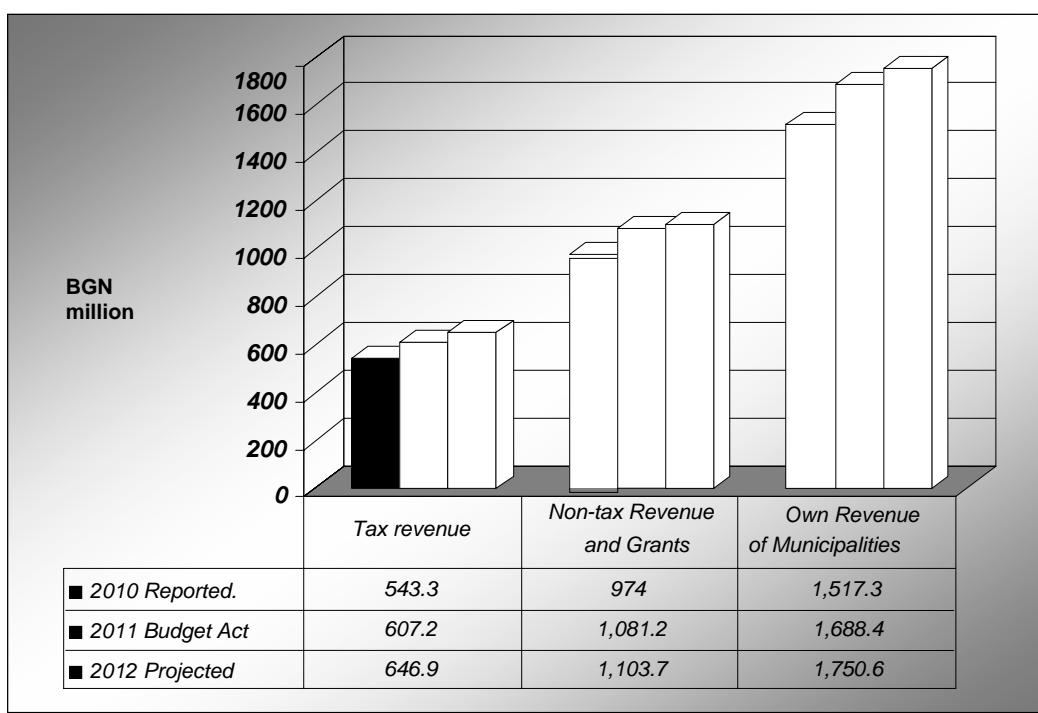
The chart below presents a comparison among annual revenues from excise charges on the main groups of excise goods: fuel and tobacco products, for 2010 (reported data), 2011 (estimates) and 2012 (projections).

Chart: Excise Revenue from Fuel, Tobacco Products and Total for the 2010-2012 Period



	<i>Customs Duties</i>
	The projected revenue from import duties for industrial and agricultural goods for 2012 amounts to BGN 120 million, adjusted for the effects of trade liberalization (decrease on duty rates).
	<i>Tax on Insurance Premiums</i>
	<p>The Taxation of Insurance Premiums Act introduced a tax on insurance premiums from taxable insurance policies (general insurance, with the exception of certain types of insurance). The taxable basis is the insurance premium earned by the insurance company, and the tax rate is 2 per cent.</p> <p>In 2012, projected revenue from this tax amounts to BGN 24 million.</p>
	<i>Local Taxes and Fees</i>
	All in all, the planned amount of proceeds from local revenue under all municipal budgets for 2012 is BGN 62.2 million higher than the amount projected in the Consolidated Fiscal Programme accompanying the 2011 SBRBG Act. This takes account of changes in concessions legislation which involve an increase in the percentage (from 30% to 50%) of concession payment for extraction of ores and minerals for municipal budgets, and the adverse trend in sales of municipal assets.

Chart: Own Revenue of Municipalities



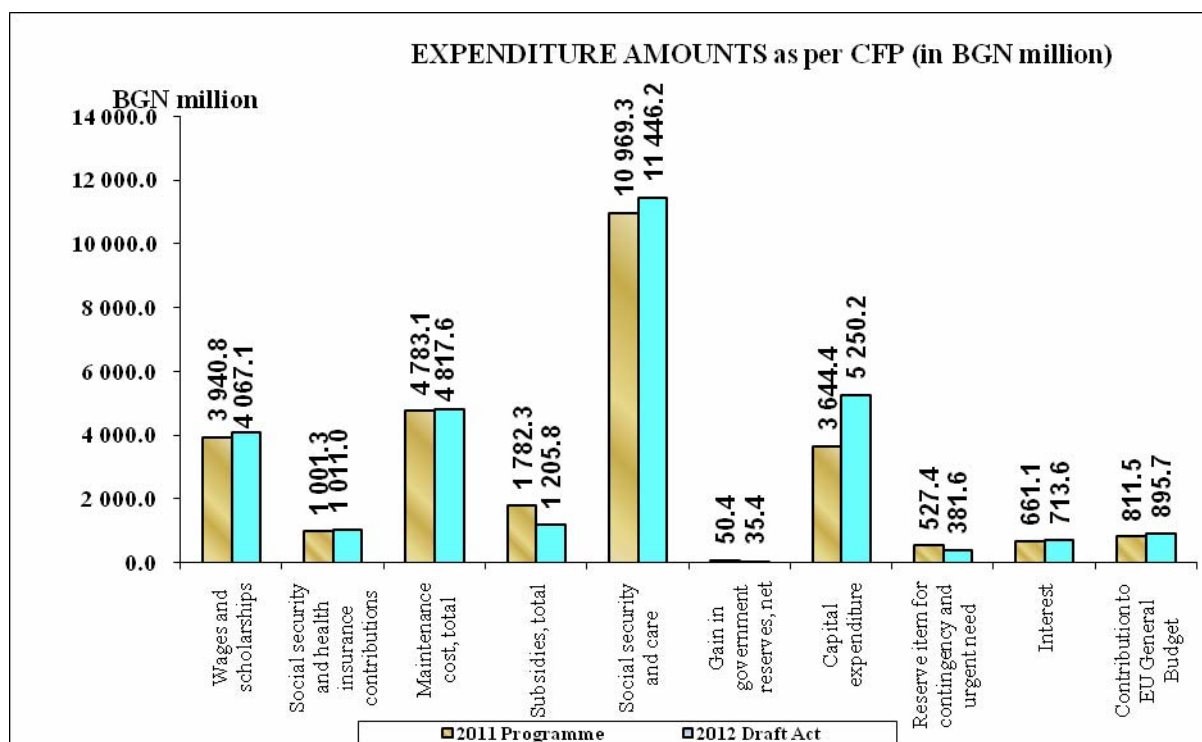
*Note: As of 2011, tourist fee is now a tourist tax, according to the amended Local Taxes and Fees Act.

	In 2012, revenue from real property taxes is expected to reach BGN 628.8 million, and occupational tax revenue is projected at BGN 16.6 million.
	Social Security and Health Insurance Policy
	<p>The rates and ratios of contributions to state social security, Teachers' Pension Fund, Wage Claims Guarantee Fund, contributions to additional mandatory pension funds, and health insurance contributions are planned to remain unchanged.</p> <p>In 2012, revenue for social security and health insurance is projected at BGN 5,561.0 million, or 6.8% of GDP.</p>

3. Spending Policies and Priorities

In line with the priorities set by the Government, the national targets and priorities adopted in the National Reform Programme of the Republic of Bulgaria for implementing the Europe 2020 Strategy, as well as with the recommendations of the European Council concerning the National Reform Programme of the Republic of Bulgaria (2011-2015) and the opinion of the Council for Bulgaria's Convergence Programme (2011-2014), in developing the 2012 budget framework, the Government focused its efforts on ensuring the necessary national resources to fund the implementation of programmes and activities in the area of education and culture at the expense of reducing funds allocated to defence, security and internal affairs when making provisions for funding the main functions in the respective sectors.

Chart: Expenditure by Economic Element



	Income Policy
<i>Policy of maintaining income levels and steps for gradual increase</i>	Over the past two years, the Government focused its efforts on implementing an income policy which takes into consideration the limited budget resources while maintaining the tax and social security burden unchanged and without reducing the level of income from salaries and pensions. In an environment of economic recovery, measures are undertaken to streamline the existing entities and their staffing so as to reduce their numbers, which will provide financial resources for raising salary levels.
	With the first indications of stabilization of the economy, the Government decided to increase income levels gradually from 1 September 2011, starting with widows' allowances added to pensions (an increase of 6.5 pp.), and minimum wages which were increased from BGN 240 to BGN 270 (an increase c 12.5%).
<i>Linking the increase in income levels to the implementation of structural reforms</i>	The increase in income levels for employed persons through next year's budget is linked to implementing intensive and consistent structural reforms and improving the connection between the labour market and the educational system. These are expected to boost labour productivity and the competitiveness of the economy.
	In terms of income levels in the budget sector, determination of individual salary levels will depend on the implementation of reforms aimed at the optimization of budget entity structures and staffing levels.
<i>Introduction, in 2012, of</i>	The main goal of the new remuneration model in public

<i>a new remuneration model in public administration</i>	administration, which is planned to be launched as of the beginning of 2012, is to set clear and transparent rules for determining the salaries of employees on the basis of their contribution to achieving the goals set and improving the performance of administrative entities.
SUBSIDIES	
Subsidies for Non-Financial Enterprises	
<i>Railway transport: infrastructure and haulage services</i>	In implementing the main priorities set in the European Transport Policy, the government participates in funding public haulage services of general economic interest and in providing funding for the maintenance and operation of railway infrastructure. This is done on the basis of long-term contracts with the state-owned enterprise Railway Infrastructure National Company and BDZ Passenger Transport Services EOOD which provides the obligatory public haulage services commissioned by the government.
	The economic environment during the transitions years had an adverse effect on railways in terms of market conditions, a lack of investment and technology upgrades, and limited support by the state. The amount of subsidies budgeted for railway haulage takes into account the change in the level of GDP for the period, and the funds necessary to ensure that the passenger haulage obligation can be met. The 2012 appropriation is planned at BGN 170 million.
	The amount required for funding railway infrastructure in 2012 was determined on the basis of an approach which takes into account the changed structure of infrastructure fees charged by the railway infrastructure manager, makes sure that reimbursement will not exceed actual cost, and that the parameters projected in the state budget will be met. The amount planned for 2012 is BGN 127 million.
	<p>The purpose of the appropriation for road transport under the heading of state budget subsidy for urban and regional passenger services within Bulgaria is to cover the current losses from passenger transport activities which result from maintaining the level of regular transport fares below cost.</p> <p>The amount envisaged for 2012 as a subsidy for domestic urban and regional passenger services under <i>road transport</i> is BGN 22 million. Through this type of financial support, the state makes provisions for meeting the demand for passenger services for the population at a certain guaranteed level of quality and affordability, with prices which take account of the purchasing power of the population by introducing certain obligations for fare levels charged by road carriers.</p>
<i>Compensation payments for preferential travel by railway and road transport in domestic</i>	The effective legal framework (primary legislation and acts of the Council of Ministers) entitles certain groups of citizens (war veterans, ex-military personnel with disabilities or injuries, old persons, students, etc.) to price discounts for domestic travel on

<p><i>services</i></p>	<p>railway and public urban and regional road transportation, under certain approved transport schemes. The relevant funding is provided to passenger carriers in the form of full or partial payment up to the full price specified in the effective fare plans to substitute regular fare payment by the entitled persons.</p> <p>Financial support for compensation for preferential travel by railway and road transport for 2012 amounts to BGN 99 million, which is an increase of 1.33 per cent and takes into account the projected level of GDP. The funding for free commuting for children and students aged up to 16 to cluster schools is increased by 5.6 per cent.</p>
<p><i>Payments for covering transport costs for delivery of bread and essential goods to small settlements and mountainous areas</i></p>	<p>In performing the social functions of the state, the state budget includes annual appropriations for covering transport costs incurred in supplying the population of mountainous areas and small settlements with less than 500 inhabitants with bread, bakery products and essential foodstuffs. Distribution costs to such settlements involve higher transport cost, which makes the operation unprofitable for economic agents. Covering part of the transport cost provides conditions for aligning food prices in those places with the rest of the settlements and serves as an incentive for individuals and companies to engage in this activity. In 2012, this support is envisaged to amount of BGN 3.6 million.</p>
<p><i>Funding liquidation measures</i></p>	<p>In 2012, state budget funding will support the implementation of programmes for technical liquidation, environmental conservation and improvements for companies and facilities in coalmining, ore mining and uranium mining. It will be used for facilities which pose hazard to people and animals and require considerable financial resources for project implementation. The amount envisaged for 2012 is BGN 5 million. Eligible projects will be identified by the Minister of Economy, Energy and Tourism, in coordination with the Minister of Environment and Water Resources and the Minister of Finance.</p>
<p><i>Funding for programmes and projects aimed at remediation of old environmental damages caused by the operation of privatised enterprises</i></p>	<p>In 2012, the implementation of remediation programmes for removing old environmental damages caused, through action or inaction, by privatised enterprises prior to their privatization will continue. Of the 21 old environmental damages remediation programmes approved, 9 programmes will be completed by the end of 2011, and another 12 programmes will continue to be implemented. Of those, 6 programmes will be completed by the end of 2012, and another 4 programmes are expected to complete their activities in the period 2013-2015. The rest are expected to end by 2016. Funding appropriated for 2012 under this item amounts to BGN 5 million.</p>
	<p>The implementation of these programmes aims to remove permanently environmental pollution of surface and ground water and soil caused by industrial and extraction activity in order to improve the working and natural environment of workers and inhabitants in the area of those companies.</p>
<p><i>CAPITAL TRANSFERS</i></p>	

	<p>Appropriations for 2012 include the amount of BGN 90 million under capital transfers to the Railway Infrastructure National Company as support for the implementation of the company's investment programme and for bridging the financial shortfall for the implementation of projects under the Operational Programme in Transport.</p>
	<p>Despite the refurbishment efforts under way, 70 per cent of the rail cars of BDZ Passenger Transport Services EOOD are outdated and worn off and cannot be retrofitted to meet modern requirements such as automatic operation of doors, air conditioning, fire alarm systems, etc.</p> <p>To support the implementation of the company's investment programme, the 2012 budget provides for capital transfers in the amount of BGN 20 million. This support will provide the financing necessary for the most urgent repair work and the purchase of the necessary rolling stock.</p>
CAPITAL EXPENDITURE	
<p><i>A 44.1% increase in capital expenditure planned under CFP for 2012 compared to 2011</i></p>	<p>In 2012, capital expenditure will increase as part of measures to stimulate total economic growth. Capital expenditure projected under the Consolidated Fiscal Programme amounts to BGN 5,250.2 million, an increase of 44.1% compared to 2011. This growth comes largely from the higher expenditure projected by the National Fund for implementing European projects and programmes.</p> <p>Capital expenditure in the national budget register a minimal decrease of 3.5% compared to 2011, due to a decrease in the spending appropriations in the budgets of ministries and agencies.</p>
4. Distribution of Expenditure under the Consolidated Fiscal Programme by Core Function	
<p>An overview of functional groups provides a snapshot of government policies and their financial contribution in each specific area. Some areas are entirely the responsibility of central government, while in others the state provides a certain level of support in the shared provision of public services in which municipalities are also involved.</p>	
<p><i>Chart: Share of Core Functions in Total Consolidated Non-Interest Expenditure for 2012, including reserves, not including the contribution to the EU General Budget (in BGN million and in percentage)</i></p>	

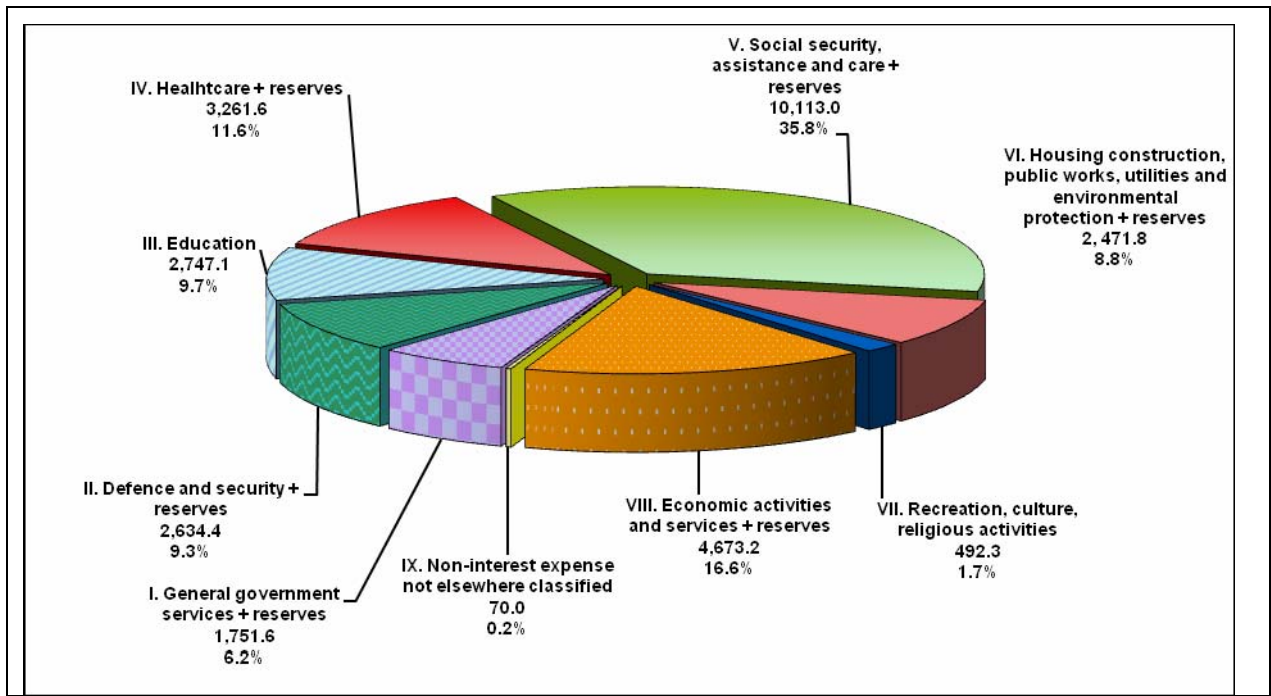
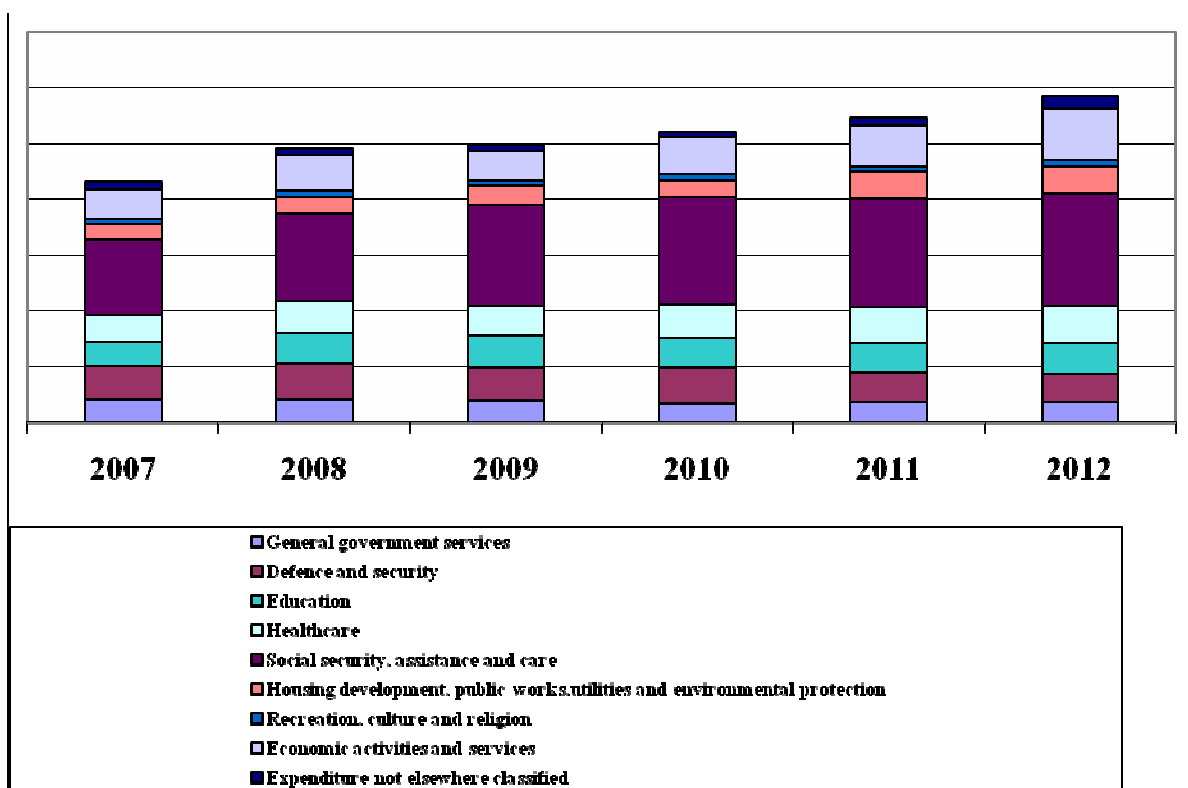


Chart: Public Spending by year, 2007-2012 (in BGN million)



GENERAL GOVERNMENT SERVICES

A decrease in expenditure for funding public administration resulting from streamlining administrative entities

Expenditure for general government services planned for 2012 amounts to BGN 1,751.6 million (2.1% of GDP), or 6.1% of total spending, and includes funding for public administration both for central and local levels. The decrease in projected expenditure from its 2011 level is due to measures undertaken to streamline the structure of administrative entities.

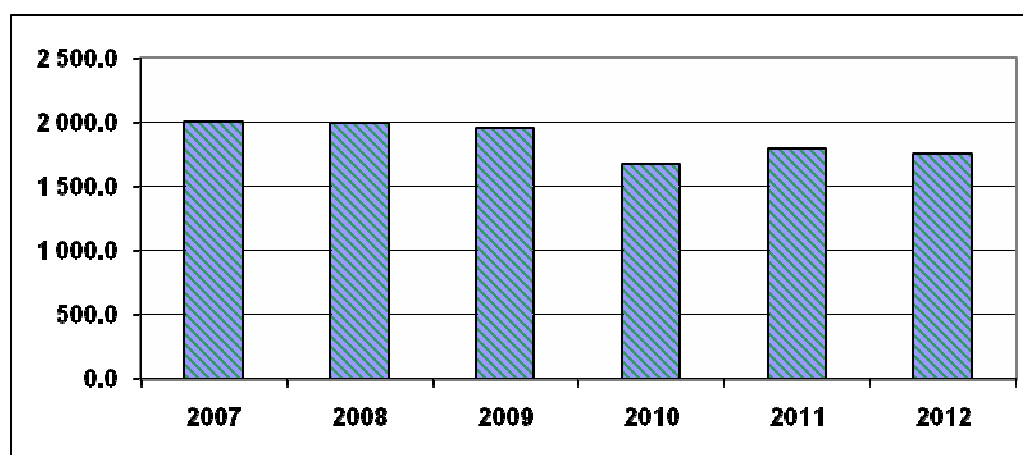
This function heading includes expenditure associated with the performance of the main functions of the President, the Vice President, the National Assembly, the Government, and the activities of the central administration of ministries, state commissions, executive agencies, regional administrations, commercial services in other countries, embassies and consular offices abroad.

This includes also budget funding for science. Out of the total appropriation for science in 2012, the autonomous budgets of state institutions of higher education, the Bulgarian Academy of Science and the National Assembly envisage spending in the amount of BGN 103.1 million.

In terms of *activities delegated by the state and funded through municipal budgets*, the 2012 budget projection under the activity heading of Municipal Administration within the “General government services” function includes appropriations totalling BGN 217.2 million.

The purpose of these appropriations is to provide for the functioning of the said administrations, enabling them to perform their activities and tasks relating to implementing the internal and external policies of the Bulgaria in all of their aspects, payment of membership contributions in international organisations, establishment and operation of a sustainable system for maximizing efficiency in the collection of taxes and social security/health insurance contributions, curbing corruption, improving the standards of administrative services, improving customs control, counteracting customs and currency regime violations, etc.

Chart: Expenditure under the General Government Services for the period 2007-2012 (in BGN million)



DEFENCE AND SECURITY

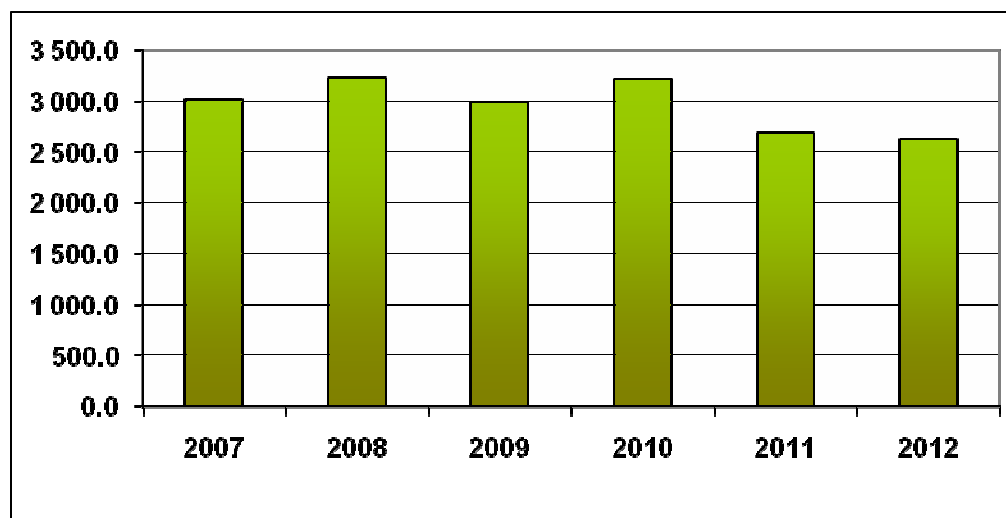
Decrease in expenditure while ensuring full funding for defence, security and internal affairs functions

Expenditure for defence and security in 2012 is envisaged to amount to BGN 2,634.4 million (3.2% of GDP), or 9.1% of total expenditure. This function includes expenditure for Bulgaria's defence and security, the judiciary, prison administration, response activities in case of crises, natural and industrial disasters. The highest relative share in total expenditure under this function belongs to expenditure for security and protection of public order.

For 2012, spending appropriations under this function are down from 2011 for line items Internal Affairs, Security and Defence, which is due to on-going reforms and measures to streamline expenditure in those sectors.

Under the function heading of Defence and security, the 2012 draft budget envisages a total of BGN 24.5 million for *activities delegated by the state and funded through municipal budgets*.

Chart: Expenditure under the Defence and Security Function for the Period 2007-2012 (in BGN million)



EDUCATION

A BGN 171.2 million increase in expenditure for education as a key Government priority

In 2012, expenditure for education is envisaged to amount to BGN 2,747.1 million, (3.4% of GDP) or 9.5% of total expenditure.

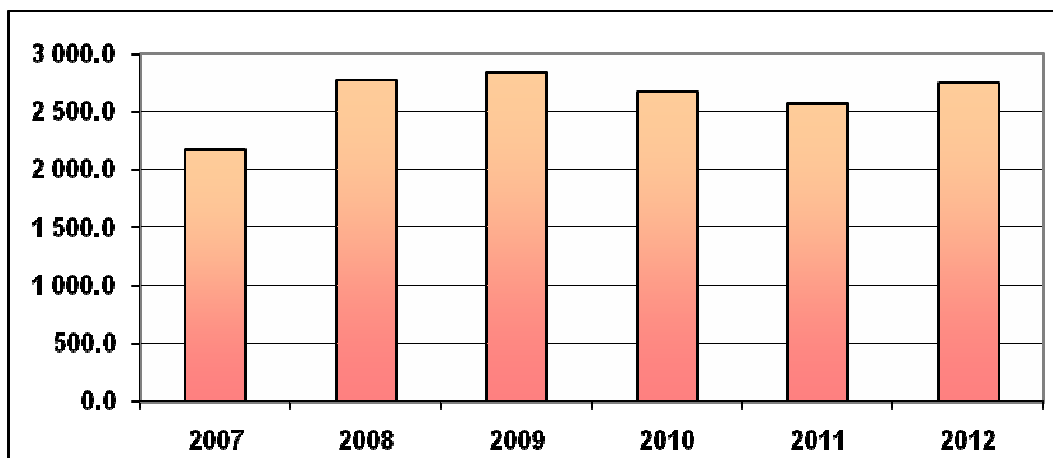
The increase in appropriations for education in 2012 from 2011 is in the amount of BGN 171.2 million. This is due to the priority measures planned for secondary education.

For the 2012 policy in the area of secondary education, under *activities delegated by the Central Government* and funded through municipal budgets, a total of BGN 1,282.2 million is planned on the basis of the modification in the unified spending standards for activities delegated by the Central Government.

The 2012 appropriations include funding for the introduction of a new model of funding for comprehensive schools, all-day organisation of education for school students in grades II and III, and the obligatory pre-school education of 5-year olds.

In the policy area of higher education, resources for 2012 are aimed at introducing quality evaluation of education provided in state schools of higher education, funding for a higher admission levels for students in bachelor's, master's and PhD programmes, and for an increase in financial provisions for scholarships.

Chart: Expenditure under the Education Function for the Period 2007-2012 (in BGN million)



Maintaining the total amount of healthcare expenditure while factoring in commitments resulting from the redistribution of functions and responsibilities between MoH and NHIF

HEALTHCARE

In 2012, expenditure under the functional heading of Healthcare is envisaged at BGN 3,261.6 million (4.0% of GDP), or 11.3% of total expenditure.

Expenditure for healthcare in 2012 register a minimal increase from 2011 (BGN 10.7 million), and take into account the role of healthcare as one of the main priorities in the budget area, the government policy in the area of healthcare, and the next steps in reforming the sector by redistributing functions and responsibilities between the Ministry of Healthcare and the National Health Insurance Fund.

The 2012 draft of the national budget envisages BGN 580.2 million in expenditure for funding the main public healthcare systems and certain specific activities, carried out by medical and health institutions with the Ministry of Healthcare, Ministry of Transport, Information Technology and Communications, Ministry of Defence, Ministry of Interior, the Council of Ministers and the Ministry of Physical Education and Sports.

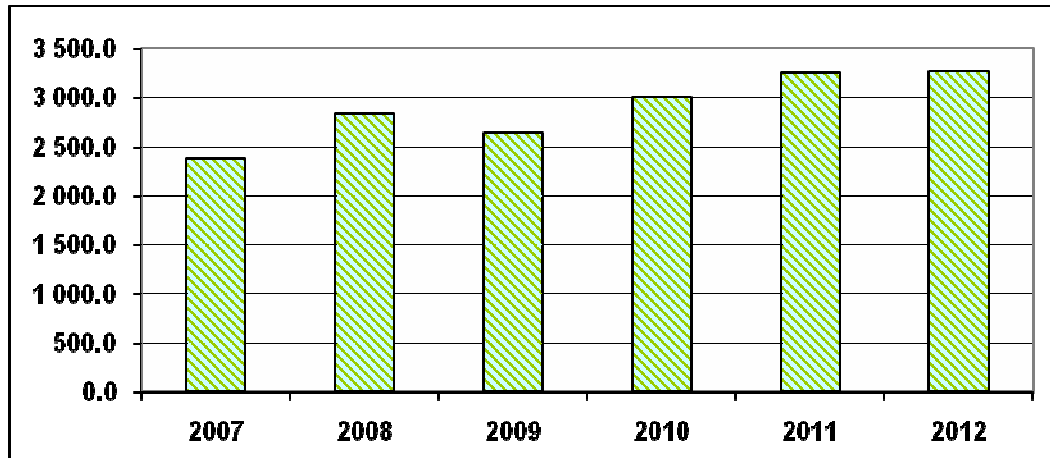
Through the budget of the Ministry of Healthcare, funding will be provided for activities relating to the main functions of public healthcare, emergency care, in-patient psychiatric care, for national health programmes relating to control, treatment and prevention of social diseases, for specialization training in the healthcare system, etc.

The commitments of the state, i.e. the national budget, relate to funding certain activities in medical institutions for hospital care which remain the responsibility of the state, such as transfusion haematology, treatment of HIV/AIDS patients, transplantation of tissue, organs and cells, expert medical opinions on work capacity.

The 2012 autonomous budget of the National Health Insurance Fund envisages expenditure and transfers in the amount of

BGN 2,633,7 million. Total expenditure amounts to BGN 2,530.6 million, including reserves. Health benefit payments amount to BGN 2,214.5 million.

Chart: Expenditure under the Healthcare Function for the period 2007-2012 (in BGN million)



SOCIAL SECURITY, ASSISTANCE AND CARE

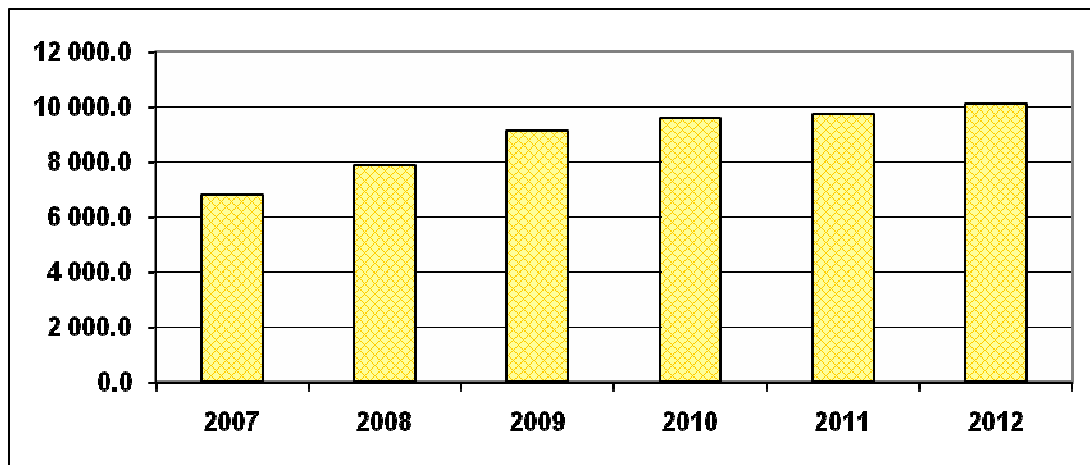
An increase of BGN 377 million in expenditure for social security, assistance and care

In 2012, the social sector amounts to BGN 10,113.0 million (12.4% of GDP) and continues to hold the largest share in total expenditure, at 35.0%.

The increase in appropriations for social security, assistance and care for 2012 from 2011 is in the amount of BGN 377.0 million, including a growth in expenditure for pension benefits in the amount of BGN 238.7 million, and BGN 139.4 million for programmes, activities and government services involved in social security, assistance and employment.

The 2012 budget function heading “Social security, assistance and care” envisages a total of BGN 161.8 million for *activities delegated by the state and funded through municipal budgets*.

Chart: Expenditure under the Social Security, Assistance and Care Function for the Period 2007-2012 (in BGN million)



Pensions

This expenditure group includes pension benefits paid out from the

budget of state social security, and pension benefits paid out from the Teachers' Pension Fund, as well as the postage fee, and the respective VAT on postage, due on pension benefit payment transactions.

The expenditure items for pension benefits under the SSS budget for 2012 are estimated taking into account the new conditions for acquiring pension eligibility for length of state-pension-scheme covered work experience and old age according to which the retirement age is retained at 63/60 for men/women, respectively, and the required length of covered work experience is to grow by 4 months each year, starting from 1 January 2012. In estimating the amounts necessary for pension benefit payments in 2012, the legislative changes in terms of the increase in the so-called "additional widow allowances" from 20 to 26.5 per cent of the pension benefit of the diseased spouse (Act Amending the SSC published in the State Gazette No. 60 of 2011). No pension indexation is planned for 2012.

The maximum amount of pensions in 2012 is retained at 700 BGN per month.

Due to the above assumptions, pension expenditure in the 2012 budget of SSS reach BGN 7,270.0 million, or an increase of BGN 238.0 million from the amount projected in the 2011 Act (the 2011 Act does not reflect the increase related to the change in the rate of the so-called "additional widow allowances") and are up by about BGN 170 million compared to expected expenditure for pensions in 2011.

For 2012, the budget of the Teachers' Pension Fund (TPF) includes an appropriation of BGN 17.3 million for payments of additional allowances to pensions and pensions for early retirement, and the respective postage and VAT accruing on such payments. This expenditure is related to provisions for early retirement of teaching staff employed in pre-school, basic, primary and secondary education.

Social Assistance and Benefits

This expenditure group includes assistance and payments to citizens eligible on the basis of the Social Assistance Act, the Integration of People with Disabilities Act, the Social Security Code, and the Family Benefits for Children Act.

The 2012 draft budget of the Ministry of Labour and Social Policy plans for a total of BGN 791.7 million, including the following:

- Assistance entitlements under the Social Assistance Act and its Implementing Regulation: BGN 54.3 million;
- Energy assistance payments under the Social Assistance Act and its Implementing Regulation: BGN 87.4 million;
- Special funding for diagnostics and treatment at medical institutions for hospital care of Bulgarian citizens who do not have any income and/or personal assets to afford personal participation in the health insurance process: BGN 2.5 million;

- Assistance entitlements under the Integration of People with Disabilities Act: planned expenditure amounts to BGN 154.2 million;
- Funding for implementing measures and programmes under the Child Protection Act: BGN 8.9 million, or BGN 1.5 million more than the amount projected in 2011;
- Expenditure under the Family Benefits for Children Act amounts to BGN 484.4 million, or BGN 5.5 million higher than in 2011; this appropriation is estimated under the assumption of keeping the income per family member according to Article 4 of the FBC Act at BGN 350 and retaining monthly child benefits until completion of secondary education but no longer than the child's 20th birthday at BGN 35, and an increase in the monthly allowance for children with long-term disabilities up to age 18 and until completion of secondary education but no longer than the child's 20th birthday from BGN 168 to BGN 189.

In 2012, the budget of the State Social Security system includes appropriations of a total of BGN 1,062.9 million for assistance and benefit payments.

In this expenditure group, the budget of the Wage Claims Guarantee Fund provides for BGN 1.6 million for payment of guaranteed wage claims accrued and not paid out in case of bankruptcy of the employer and the social security/health insurance contributions due on them.

In 2012, expenditure for short-term benefits is estimated on the basis of the following key parameters:

- Payment of benefits for temporary incapacity for the first three days is set at 70 per cent for the account of contributor;
- The maximum amount of unemployment benefits is set at 60 per cent of the reference income of the insured person before the job loss, and the minimum daily amount of benefits is retained at BGN 7.20;
- The eligibility period for payment of cash benefits for pregnancy and birth remains unchanged at 410 days;
- The amount of the benefits for raising an infant between 1 and 2 years of age remains BGN 240.

Programmes, Activities and Services in the Area of Social Security, Assistance and Employment

Appropriations for the implementation of active intervention measures in the labour market total BGN 73.0 million which supports the policy aimed at reducing unemployment, and retaining and maintaining the labour force.

In line with reforming and closing down specialized institutions for the provision of child social services, provisions in the 2012 budget in the area of social services will be used to set up new facilities for community-based social services, namely Day Care Centre for Children with Disabilities, Centre for Community Support, sheltered housing, Family-Type Accommodation Centre, supervised

housing and transitional housing.

HOUSING DEVELOPMENT, PUBLIC WORKS, UTILITIES AND ENVIRONMENTAL PROTECTION

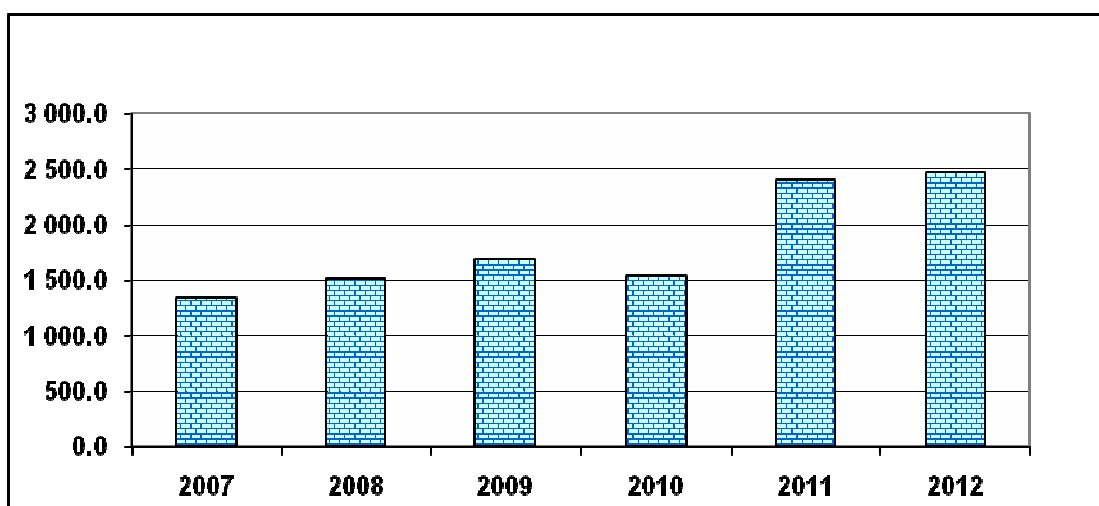
An increase in the appropriation for environmental protection as a national priority sector supported through EU programmes as well

Public expenditure for housing development, public works, utilities and environmental protection in 2012 is budgeted at BGN 2,471.8 million (3.0% of GDP), or 8.5% of total spending.

For 2012, expenditures under this functional heading exhibit an increase of BGN 65.5 million from 2011, with environmental protection being one of the main priorities. It is supported also through European programmes. Expenditure in this line item marks a growth against 2011, in the amount of BGN 207.4 million.

Appropriations for 2012 capital expenditure for *local activities of municipalities* under the function heading of housing development, public works, utilities and environmental protection are budgeted at BGN 424.0 million.

Chart: Expenditure under the Housing Development, Public Works, Utilities and Environmental Protection Function for the Period 2007-2012 (in BGN million)



Housing Development, Public Works, Utilities

For the Ministry of Regional Development and Public Works, appropriations amount to BGN 24.4 million. This expenditure group supports a large part of the activity of MoRDPW and the budget entities within the National Construction Supervision Directorate and the Geodesy, Cartography and Cadastre Agency.

Provisions for *local activities* of municipalities for 2012 under the appropriations group of housing development, public works and utilities amount to BGN 327.6 million and are designed to support public works in various settlements, including for water supply and sewerage, and for street asphalt work.

Environmental Protection

For the Ministry of Environment and Water Resources, 2012 appropriations for implementing environmental protection activities amount to BGN 28.1 million.

For the Ministry of Regional Development and Public Works, appropriations amount to BGN 1.2 million in funding for activities under the Programme for dealing with land slide, erosion and abrasion processes.

Under the 2012 budget of the Enterprise for Management of Environmental Protection Activities, appropriations amount to BGN 62.8 million, including BGN 59.1 million in capital expenditure, i.e. transfers to municipalities and budget entities which will be disbursed upon presentation of eligible project proposals and upon a decision of the EMEPA Management Board. Capital expenditure allocations are earmarked for the construction of small water supply facilities, waste water treatment plants, sewerage networks and inlet collectors, and adjustments of riverbeds and ravines, community landfills, waste separation facilities and waste recycling systems, replacement of green fuel facilities and energy saving technology, projects concerning bio diversity and eco-tourism, information and awareness activities relating to environmental protection, etc.

Expenditure for 2012 *local activities* of municipalities in the appropriations group of environmental protection amounts to BGN 96.4 million, and is directed at earmarked for “Urban sanitation” activity for the acquisition of waste bins and waste collection equipment; activity subheading “Green Areas” and activity subheading “Other Environmental Protection Activities”.

RECREATION, CULTURE, RELIGIOUS AFFAIRS

An increase in expenditure for promoting Bulgarian culture as a leading priority for the Government

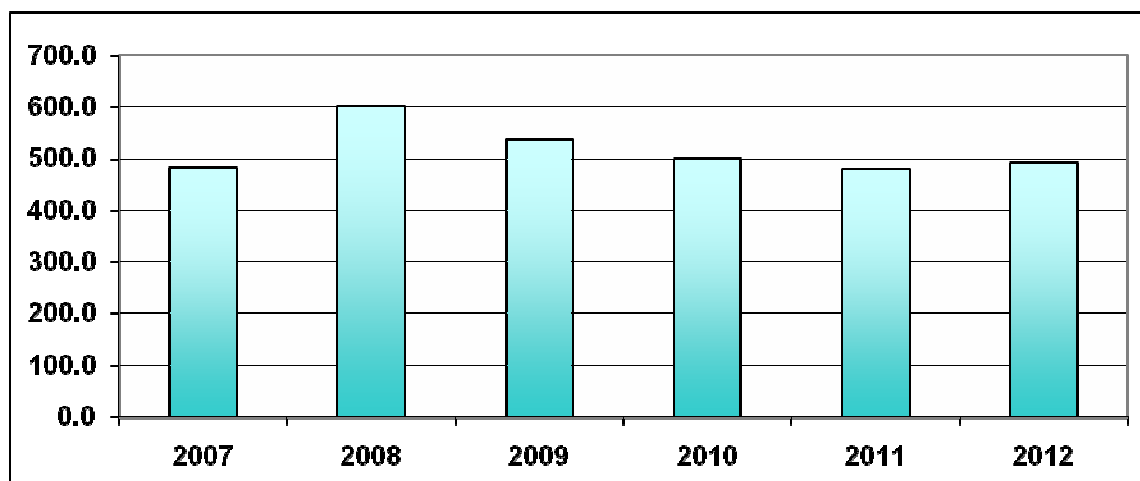
For this function, the 2012 consolidated fiscal programme includes appropriations in the amount of BGN 492.3 million BGN (0.6% of GDP), or 1.7% of total expenditure, covering activities in the area of recreation, physical culture and sports, culture and religious affairs.

For 2012, expenditure under this function heading shows an increase of 13.7 million BGN from the 2011 budget.

Main contribution is attributed to the increased spending for culture, in the amount of BGN 15.1 million, by which the Government manifests its commitment to support the development of Bulgarian culture.

Appropriations in support of the development of physical education and sports in Bulgaria show an increase of BGN 0.2 million.

Chart: Expenditure under the Recreation, Culture and Religious Affairs Function for the period 2007-2012 (in BGN million)



Recreation

The Recreation group includes provisions necessary for the operation of recreational facilities and for providing conditions for social leisure activities.

Physical Culture and Sports

Appropriations in the group “Physical culture and sports” are earmarked for support the development of physical education and sports in Bulgaria, implementation of activities under programmes for preparation for participation in the Olympics and for development of high achievement sports, for funding of sports projects and activities under special programmes for the development of school sports and recreational sports.

Culture

Through the expenditure envisaged under the Culture appropriations group, the Ministry of Culture implements the major part of its activities in the area of protection of cultural heritage and support for the creation//production and dissemination of art and cultural products and services, and its policy concerning the promotion of cultural products and values.

Some of the culture activities for which the 2012 budget makes provisions are:

- support for the activities of a museum of education (Ministry of Education, Youth and Science);
- activities related to protection and conservation of archive funds of the Archives State Agency (Council of Ministers);
- activities of a state cultural institute (Ministry of Foreign Affairs);

- activities of the museum of military history, the activity of the Ensemble of the Bulgarian Army, and the military TV channel (Ministry of Defence);
- activities of the archaeological institute cum museum within BAS;
- activities of the Bulgarian National Radio and the Bulgarian National Television in applying their programme licences issued under the Radio and Television Act to produce and broadcast national and regional radio and TV programmes, etc.

For *activities delegated by the state and funded through municipal budgets*, the appropriations group “Culture” includes a total of BGN 67.1 million for 2012. This funding provides for maintenance costs of libraries, museums and art galleries of regional significance, and community cultural centres. In 2012, BGN 2.0 million are allocated for the implementation of the second stage of the Global Libraries Programme, and for new activities and regional divisions of museums and art galleries.

Religious Affairs

The draft 2012 budget of the Council of Ministers and its Religious Denominations Directorate in particular, envisages a subsidy in the amount of BGN 3.0 million to be provided as support for registered religious denominations in the Republic of Bulgaria.

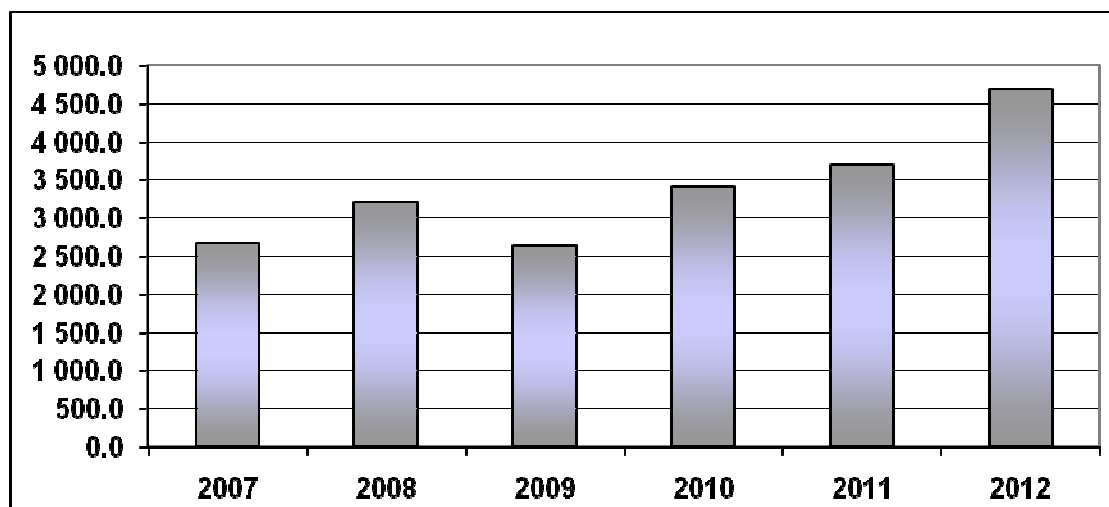
ECONOMIC ACTIVITIES AND SERVICES

For 2012, appropriations under the consolidated fiscal programme for this function amount to BGN 4,673.2 million (5.7% of GDP), or 16.2% of total expenditure. This includes appropriations for agriculture, forestry, hunting and fishing; mining, fuel and energy; transport and communications; manufacturing and construction, tourism and other activities relating to the economy.

Expenditure planned under this function heading for 2012 is BGN 984.6 million higher than in 2011, with transport and communications accounting for most of the increase (BGN 847.6 million).

Under *local activities* of municipalities, capital expenditure for 2012 is budgeted at the amount of BGN 121.5 million.

***Chart: Expenditure under the Economic Activities and Services Function for the Period 2007-2012
(in BGN million)***



Mining, Fuel and Energy

Appropriations under the group of Mining, Fuel and Energy are earmarked as maintenance cost and for achieving the following tasks:

- Decommissioning of nuclear facilities;
- Safe storage of nuclear waste;
- Expert examinations and audits of energy consumers;
- Development of measures for reducing energy intensity in industrial production;
- Energy efficiency activities and programmes, etc.

Agriculture, Forestry, Hunting and Fishing

Appropriations for agriculture, forestry, hunting and fishing for 2012 have been increased from 2011 by BGN 40.9 million due to an increase in amounts under EU programmes.

The group of “Agriculture, forestry, hunting and fishing” includes appropriations for the normal implementation of activities relating to agriculture and forestry, fisheries and aquaculture. This group includes expenditure budgeted for the Ministry of Agriculture and Food relating to:

- Food safety, control of infectious and parasitic diseases affecting animals and plants, purchase of vaccines and diagnostic kits;
- Purchase of anti-hail rockets;
- Ranger services to ensure protection of forests and game, and forest reproduction;
- Protection, restoration and improvement of soil fertility and the environmental functions of soil cover;

- Development of the vine and wine sector in Bulgaria in accordance with EU requirements;
- Protection of stockbreeding selection with the purpose of improving stock pedigrees;
- Oversight of grain and fodder;
- Protection and reproduction of fish stocks and aquaculture, protection and increase in fishing resources in Bulgaria;
- Testing, research and certification of agricultural and forestry equipment; variety testing, certification and control of seed and planting material;
- National protection against entry and spreading of pests affecting plants and plant products;
- Protection of national sites and facilities.

The functions and funding operations of SF Agriculture related to the implementation of national programmes in the area of agriculture are to be maintained. To this end, the 2012 state budget makes provisions in the amount of BGN 340.1 million in payment appropriations for approved state aid schemes, for national co-payments and for support for specific purposes.

The parameters for investment lending to agricultural producers, of up to BGN 80 million, and for temporary financial aid of up to BGN 20 million also remain unchanged.

Significant growth by BGN 847.6 million in appropriations under the CFP for the transport and communications sector to be achieved through funding under EU programmes

Transport and Communications

The group of Transport and Communications includes a total of BGN 2 850.4 million budgeted in financial provisions to implement the Government's policy in the area of transport and communications.

The amount of BGN 41.2 million is allocated to the budget of the Ministry of Transport, Information Technology and Communications for expenditure relating to the following: creating optimal conditions for the development of transport infrastructure by speeding up construction, efficient maintenance and upgrading of existing transport infrastructure, and promoting the development of intermodal transport, including by applying public/private partnership schemes. In addition, efforts to improve the system of infrastructure fees in the various modes of transport will continue.

In 2012, the group heading of Transport and Communications makes the following provisions for state investment loans (SILs):

- Total expenditure in the amount of BGN 173.6 million for SILs „Rehabilitation and reconstruction of roads from the national road network, Classes II and III”, and “Transit roads V”;
- Total expenditure in the amount of BGN 129.3 million for SILs for the reconstruction and electrification of the rail route Plovdiv – Svilengrad, the second bridge across the Danube, and the construction of container terminals in the

seaport of Bourgas and in the Varna-East seaport.

Through an amendment to the Road Act, the National Company for Strategic Infrastructure Projects was set up, with the statute of a state-owned enterprise in the meaning of Article 62 paragraph 3 of the Commercial Act. The main scope of business activity of the company is financing, engineering, development, management, maintenance and rehabilitation of the Struma, Hemus and Cherno More highways, including by using funding provided from the national budget.

In 2012, efforts will continue to focus on ensuring conditions for free and efficient competition in the market for electronic communications and postal services. Other on-going tasks include the deployment and support of communications connectivity between all public administrations. The use of e-services by citizens and the business community will continue to be encouraged.

For the Communications Regulation Commission, appropriations in the amount of BGN 9.5 million are envisaged for the following: transposition of European Commission Decisions concerning the harmonised use of the radio frequency spectrum; maintaining the National System for Monitoring the Radio Frequency Spectrum; improving access and mutual connectivity conditions, including in terms of access to the cable duct grid, etc.

The envisaged appropriation in the amount of BGN 7.2 million ensures the necessary financial means enabling the flight operations of the Special Air Team 28 and the provision of high-quality and efficient air service, guaranteed timeliness a high level of air flight safety.

For *activities delegated by the state and funded through municipal budgets* in 2012, the group heading of “Transport and communications” includes the amount of BGN 1.2 million, which provides for the maintenance cost of the Beloslav ferryboat facility.

Under *local activities* in this group, planned capital expenditure for 2012 is in the amount of BGN 113.4 million, earmarked for rehabilitation and construction of municipal roads, and for continuing the extension of the Sofia Metro.

Manufacturing and Construction

Appropriations grouped under “Manufacturing and construction” make financial provisions for carrying out the following activities:

- Micro, small and medium-sized business promotion and development (support for business through the provision of targeted assistance to promote entrepreneurship in starting and developing micro, small and medium-sized enterprises;
- Promote business start-ups based on innovative ideas, provide incentives for research and development, stimulate market-oriented applied research for industrial purposes and create conditions for attracting private funding for innovation;
- Improve the business environment, including pro-innovative

infrastructure, provide timely and high-quality information about international markets, provide more affordable and high-quality consulting and information services to businesses, etc.

Tourism

Appropriations budgeted for 2012 under the group of “Tourism” make provisions for the implementation of activities in the area of tourism aimed at increasing its competitiveness and profitability, including:

- National tourist promotion;
- Encouragement of the provision of quality services and protection of consumer rights and safety;
- Development and introduction of modern tourist regional planning;
- Efficient coordination between the institutions involved in the tourism policy-making and implementation;
- Interaction with the tourism business community;
- Increase income from international tourism in Bulgaria by attracting more affluent tourists, taking into account the upgraded category structure of accommodation facilities;
- Improve Bulgaria’s position on target markets through diversification of the tourist product offered (package tours and special-interest tourism); increase the variety of offered products in order to make better use of Bulgaria’s tourism potential all the year round, increase the share of the domestic market, promote the development of sustainable tourism, etc.).

5. Debt Management and Financing

The maximum amount of sovereign debt as of 2012 year-end is projected at BGN 15.3 billion, or 18.7 % of GDP, or lower

Sovereign Debt

In 2012, the sovereign debt management policy will focus on ensuring the availability of resources necessary to fund the budget and refinancing the debt at the lowest possible cost in the mid- and long-term, with a thrust on maintaining a stable debt structure and a reasonable level of risk.

In an environment of volatility and uncertainty in international capital markets, priority will be given to efforts to stimulate and encourage the development of an efficient and liquid domestic market, in line with the new Sovereign Debt Management Strategy for the period 2012-2014.

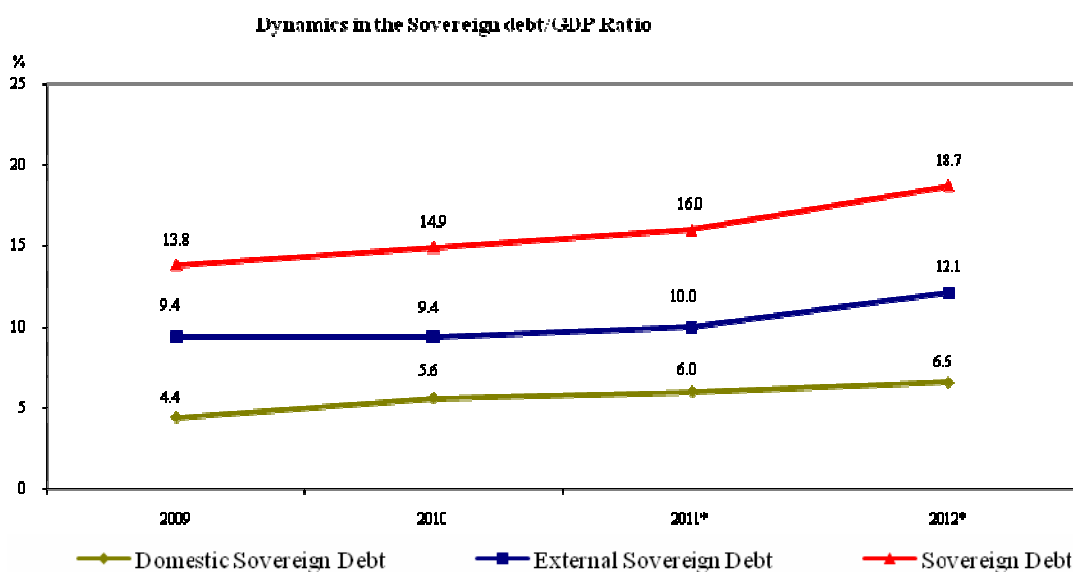
As of 31 July 2011, in terms of debt structure, external

As of 31 July 2011, the nominal amount of sovereign debt totalled BGN 10,532.1 million, including external debt of

debt accounted for 61.4%, and domestic debt was 38.6%

BGN 6,469.8 million and domestic debt of BGN 4,062.3 million. In structural terms, external debt accounted for 61.4%, and domestic debt was 38.6%. The sovereign debt/GDP ratio for the same period amounted to 13.9%, and in comparison to 2010 reported data exhibits a decrease of 1.0 pp. In nominal terms, sovereign debt decreased by BGN 0.1 million in comparison to the reported amount at the end of 2010, largely due to foreign exchange loss/gain. As of the end of 2011, the relative share of domestic sovereign debt is expected to consolidate at about 38%, and external debt is projected at 62% (37.4% to 62.6% in 2010, respectively).

The sovereign debt/GDP ratio in the same period amounted to 13.9%, and it is projected not to exceed 16% of GDP as of the end of 2011, and 18.7% as of 31 December 2012.



*Projections.

Euro-denominated debt is expected to retain its predominant share in the currency structure of external debt

As of 31 July 2011, external sovereign debt was down from its level as of the end of 2010, with a drop of BGN 128.2 million. For the same period, the external sovereign debt/GDP ratio was 8.6%, or a decrease of 0.8 pp. in comparison to the end of the previous year (9.4% at the end of 2010, respectively). As of the end of 2011, external sovereign debt is expected to be about BGN 7.1 billion, and the external debt/GDP ratio is projected to stand at around 10.0%.

In terms of the currency structure of the external sovereign debt, it is expected that at the end of 2011 the Euro-denominated debt will retain its predominant share which was reported at 71.9% in July 2011. The share of U.S. dollar-denominated debt in the same period was 23.8%, with 4.3% in other currencies.

In the interest structure of external debt as of July 2011, the relative weights of floating and fixed rate debt remained the same as at the end of 2010, at 28.1% and 71.9% respectively. Stabilizing the relative share of fixed-interest debt is a tool for reducing interest-rate risk and for more realistic estimates and forecasts for interest expenditure in the public budget.

Until the end of 2011 and in 2012, external debt payments will be influenced both by fluctuations

in interest rates, USD/EUR and JPY/EUR exchange rates and by the external debt amount which is closely linked to disbursements on pre-agreed state investment loans for financing the implementation of important infrastructure projects.

The issuance policy of the Ministry of Finance in 2011 has an increasing role to play, in line with economic stability measures and the key parameters planned in the State Budget of the Republic of Bulgaria Act.

As of the end of the year, the nominal amount of domestic sovereign debt is expected to grow to BGN 4.5 billion, and the relative share of domestic debt in GDP is estimated to reach 6.0%.

In an environment of extreme volatility and uncertainty in international capital markets, ensuring the necessary sources of funding for the state budget and for refinancing the outstanding debt at the lowest possible price and the most acceptable level of risk is key to increasing the macroeconomic stability and confidence in the domestic capital market. To achieve that, until the end of the current year and in 2012, the issuance policy will employ the full range of available instruments to promote the development of the domestic market for government securities, with maximum smoothing out of the retirement profile of sovereign debt and preventing any market volatility and fragmentation.

The investment-class rating of Bulgaria and its macroeconomic fundamentals ensure its ability to obtain freely market financing both at the domestic and international capital markets.

As of 31 July 2011, financing for the budget through new issues of government securities amounts to a total par value of BGN 514.4 million. In January 2011, a new government benchmark bond was offered, with an original maturity of 10-and-a-half years, with the auction reopening three times, with a total volume of BGN 152.9 million. This issue has been used as the basis for calculating the long-term interest rate in measuring the convergence rate in the current year, which is one of the Maastricht criteria for membership of the Eurozone. Also in the current year, an auction for 5-year government securities denominated and payable in euro was held, which is also a new benchmark instrument in the mid-term segment of the debt curve. The issue has been reopened three times, with the total volume of approved bids reaching of EUR 74 million. The MoF reopened four times the 2010 issues of government securities with a tenor of 3-and-a-half years (with a residual maturity of 3 years) and a total value of BGN 175.0 million. Six-month treasury bills with a par value of BGN 26.8 million, and 3-month T-bills of with a par value of BGN 15.0 million BGN were also put on the market. Results correspond to the trend of declining yields along the full length of the sovereign debt curve and indicate a positive attitude among investors towards the Government's issuance policy as part of the overall fiscal policy of the Government.

As a result of these active management activities, the average duration of issues outstanding as of the end of July 2011 reached 8.5 years, with a prevalence of the BGN-denominated component at 67.2%. The shares of government securities denominated in US dollars and in Euro are 30.2% and 2.6%, respectively. This structure largely eliminated the effects of the market fluctuations in the rates of the remaining currencies and is aimed at keeping the share of Euro- and BGN-denominated debt at volume levels above 75%. The interest structure of domestic debt is characterized by retaining the share of fixed interest liabilities as of 2010 up to the 94.0% level.

In 2012, it is projected to raise about BGN 1 200 million gross on the domestic debt market, mostly through fixed-coupon BGN- and EUR-denominated issues along the entire range of the debt curve. To ensure a more even distribution in planned debt service cost, in the coming year MoF will refrain from putting out issues maturing in 2013 and 2015, when the global bonds of the Republic of Bulgaria mature. Also, it will continue actively to reopen issues from previous years in order to promote liquidity in the secondary market. In 2012, the Minister of Finance will again have the option of issuing government securities on international markets in the amount of up to BGN 2 billion subject to subsequent ratification. This measure will allow the placement, under favourable market conditions, of new benchmark Eurobonds which, in addition to raising financing for the budget, would serve to regain the interest of global investors in Bulgaria. Priority will be given to

stimulating the development of an efficient and liquid domestic market, and the characteristics (volume, maturity, interest terms, etc.) of new issues of government securities will be defined depending on current market configurations and in line with the new Sovereign Debt Management Strategy for the period 2012-2014 to be adopted in 2012.

MoF will continue with its practice of publishing monthly debt issue calendars, and quarterly indicative calendars in all maturity segments in order to attract a broader investor base and increase the relative share of BGN- and EUR-denominated debt.

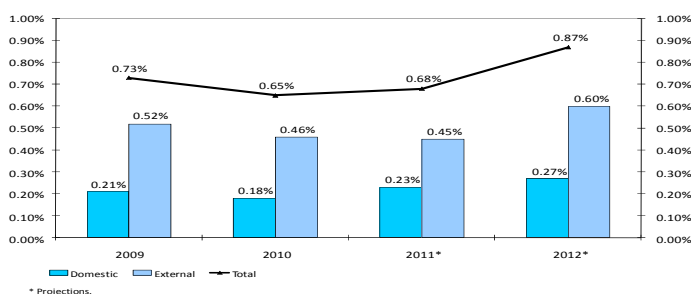
Risks associated with servicing domestic debt will be minimized

The increase in domestic debt in 2012 will take account, on the one hand, of the current macroeconomic situation in Bulgaria, and on the other hand, the situation, dynamics and outlook for developments on the local and international financial markets. The risks related to servicing domestic debt will be minimized, in view of the prevailing share of BGN- denominated government debt issues and payments on issues with fixed interest coupon. This approach will also minimize the impact of fluctuations in international interest and exchange rates on payments due on government securities issued in connection with the structural reform.

Interest Expenditure

In 2012, projections indicate an increase in interest expenditure related to sovereign debt in absolute terms as a result of increasing size of the debt but the interest expenditure/ GDP ratio will be kept under 1%.

Sovereign Debt Interest in GDP Terms



Interest expense on external loans is projected to reach approximately BGN 490.0 million. The major portion of this expenditure will be related to state loans, and about BGN 72.0 million will refer to state investment loans (SILs).

Interest expense on domestic debt is expected to amount to about BGN 220 million.

In considering the debt structure, one should take account of the sensitivity of interest payments to any changes in international interest rates and the US dollar/EUR and JPY/EUR rates. In 2012, approximately 18.8% of liabilities are pegged to variable interest

rates, making this portion of payments dependent on the latter's movements. Exchange rate fluctuations also have an effect on the amount of expenditure due to the fact that the relative shares of sovereign debt denominated in US dollars and in other currencies are expected to be 16.3% and 3.8%, respectively.

Financing

External net financing under the central budget in 2012 is expected to be a positive value, in the amount of around EUR 1.2 billion.

No new financing through external state loans is projected for investment projects and special programmes

In 2012, disbursements are expected under the Bulgaria Credit Agreement for a Structural Programme Loan to support co-financing to complement EU funds in 2007-2013 signed between the Republic of Bulgaria and the European Investment Bank, to the amount of approximately EUR 120 million.

In 2012, the implementation of the new World Bank Strategy for partnership with the Republic of Bulgaria for the period 2011-2013 is expected to begin. The Country Strategy includes a sequence of three development policy loans (DPL). These structural loans, each in the amount of EUR 80 million, are earmarked for the development and implementation of railway sector reforms. If necessary, and following an analysis of the market situation, an issue of government securities at a total par value of about EUR 1 billion may be put on the international capital markets.

No new financing through external state loans is projected for investment projects and special programmes.

Disbursements from SILs administered under the budgets of ministries considerably exceed the amount of all regularly made repayments in accordance with agreed loan retirement plans. As a result, net external financing from those sources is expected to be a positive value, to amount to about BGN 160.0 million.

In 2012, positive net domestic financing is expected under the central budget, from transactions in government securities in the amount of about BGN 484.3 million. It is envisaged to issue government securities with a total par value of about BGN 1,220 million.

6. Highlights of Government Policy Priorities Implemented through Ministry Budgets

Policy in the area of managing EU funding

This policy is aimed at creating conditions for sustainable economic growth accompanied by high levels of employment, social inclusion and regional cohesion and development of a competitive economy based on knowledge and innovation, by increasing the absorption of funding available under programmes co-financed by the European Union through efficient coordination mechanism for programming, management, monitoring and evaluation.

The benefits from this policy will be manifested in the achievement of a significant improving in the economic and social environment for Bulgarian citizens, improvement of the overall system of coordination, control and management of EU funding,

simplification of implementation procedures of programmes co-funded by the European Union, an efficient evaluation mechanism examining the link between funding provided under the structural instruments of the European Union and the achievement of goals set in the national strategic reference framework and OPs, increasing the administrative capacity of potential beneficiaries of operational programmes, and increasing the absorption rate of OPTA.

Policy concerning the implementation of central government functions at the level of administrative regions in the Republic of Bulgaria

The goal of this policy is to implement efficient regional policy and national government at the local level, ensure compatibility between national and local interest in order to provide a favourable living environment and upgrade infrastructure to ensure conditions for growth, employment and improving living standards through improved governance at the regional level in implementing the central government policy, protection of the national interest, rule of law and public order and carrying out administrative oversight functions.

Policy in the area of freedom of worship

The goal of this policy is to ensure the free and unhindered exercise of the freedom of worship, maintaining tolerance and respect among believers of the various religious denominations, and between believers and non-believers in the long-term. Through this policy, an active position in the area of religious denominations in deciding matters of great public import will be formed, the historical tradition of religious tolerance among the Bulgarian public will continue, and the positive image of the Bulgarian state in the European Union and the international community will be reinforced.

Policy in the area of archives

This policy is aimed at the conservation, preservation, enlargement and promotion of the national archives fund by ensuring the openness and transparency, improvement of archive-related activities and compliance with European standards, improvement of the expertise and qualification of personnel and the infrastructure supporting archive-related activities.

CULTURE

Policy in the area of cultural heritage protection and support for the creation and dissemination of art, cultural products and services

Priorities in the implementation of this policy relate to:

- Archaeological exploration, restoration and accompanying conservation of significant archaeological sites and immoveable cultural values;
- Updating the national register of immoveable cultural values, its digitalization and setting up a single database of moveable cultural values;
- Resource provisions and security in the system of cultural heritage protection by ensuring sound oversight;
- Development of the museum network in Bulgaria;
- Conservation and restoration, purchases, building new exhibit collections, collection mobility and other expenditure contributing to the creation of real cultural products;

- Support for publishing activities and the promotion of Bulgarian books around the world and creation of conditions for the development and strengthening of libraries as modern facilities;
- Reorganization and optimization of the network of cultural institutions. A draft Performance Arts Act is to be prepared;
- Support for the production of new Bulgarian films;
- Development of the museum network in Sofia, with a particular focus on implementing the project for establishing a National Museum of Visual Arts.

Policy in the area of promoting culture

Efforts will focus on continuing the establishment, expansion and improvement of the existing network of Bulgarian cultural institutions abroad, and on redefining their goals and the organisation of their activity.

EDUCATION

Policies in the area of education

Education

Funding planned for programmes and activities in the area of education for 2012 r are aimed at:

- Providing resources for the educational process in state schools supported by the Ministry of Education, Youth and Science, the Ministry of Agriculture and Food, the Ministry of Culture and the Ministry of Physical Education and Sports;
- Improving the facilities and technical equipment in state schools and ancillary units;
- Management, evaluation, oversight and licencing of activities in the educational system carried out by regional education inspectorates, the National Evaluation and Accreditation Agency and the National Agency for Vocational Education and Training;
- Improving educational standards in secondary education, including: setting up an external testing and evaluation system, introduction of an internal evaluation system, improving the qualifications of pedagogic staff, etc.;
- Increasing the coverage and facilitating equal access to secondary education through a set of instruments: scholarships for pupils, free textbooks and training aids, school dormitories, special measures to facilitate educational integration and reintegration of children and pupils from disadvantaged social groups, free transport for pupils, support for catering services for pupils, etc.;
- Funding for sheltered schools;
- Funding for measures for supporting children with manifest talents;

- Provisions for the education, in state institutions of higher education, of an average equivalent number of students;
- Support for equal access to higher education through a system of student scholarships, student hostels and canteens;
- Education and training of cadets and officers at higher military schools and the G. S. Rakovski Military Academy;
- Introduction of a new model of funding for comprehensive schools;
- Funding for all-day organisation of education for school students in grades I, II and III;
- Funding for the obligatory pre-school education of 5-year olds;
- Introduction of quality assessment for educational and training activities in state schools of higher education;
- Funding for national programmes for the development of secondary education;
- Funding for indexation of scholarships for pupils and students;
- Financial aid to students in full-time educational programmes and government-sponsored schemes for covering their housing rental costs.

HEALTHCARE

Policy in the area of public health promotion, prevention and control

In the area of public healthcare, the implementation of national prevention programmes aimed at reducing incidence and mortality rates for the most frequent socially significant transmittable and non-transmittable diseases which affect various age and socially vulnerable groups will continue.

Policy in the area of diagnostics and treatment

The achievement of the goals set in this policy is aimed at meeting the needs for quality primary and specialized out-patient medical care for the population; provision of quality and affordable hospital medical care, including provision of adequate intensive care; provision of sure access of the population to emergency medical care as a first-rate concern and obligation for the state; provision of quality organs and tissue for transplantation; provision of diagnosed and processed blood and blood components; provision of medical and social care for underprivileged children, provision of prevention, diagnostics, treatment, rehabilitation and special care for children, raising prematurely born children, bringing-up, education, training and preparation for social integration of children deprived of parental care, provision of community care as alternative to institutional care; provision of timely, accessible and efficient medical expert evaluation of labour capacity by improving the medical expert evaluation system; provision of rehabilitation and long-term recovery treatment.

Policy in the area of medicinal products and medical products

For the purposes of providing timely access to medicinal products and medical products complying with quality, safety and efficiency standards, policy priorities focus on updating legislation in the area of medicinal products and medical products in line with the European Union acquis, ensuring control and monitoring of the quality, safety and effectiveness of drugs allowed for use in Bulgaria; on-going updating of norms and standards for manufacturing, approval for use, distribution, prescription and dispensation of drugs and medical products, updating of the national health standards, setting transparent criteria and clear procedures for compiling a uniform positive reimbursement list, improvement of the methods for regulating ceiling prices for prescription medicinal products, registration of prices of over-the-counter drugs, etc.

PHYSICAL EDUCATION AND SPORTS

Policy in the area of sports for pupils and students and leisure sports

This policy is focused on promoting physical education and sports as a means of a healthy lifestyle and expanding the coverage of pupils and students who systematically practice physical exercise and sports. Implementation will be achieved by creating conditions and opportunities for carrying out high-quality, modern and efficient educational, training and competition process in sports schools, realization of sports talent of young athletes and raising Bulgaria's prestige by winning medals at Olympic Games, world and European championships, and by improving conditions for practicing leisure sports, opportunities for participation and personal sports achievement and improving health through physical activity exercise.

In 2012, this policy area will be implemented through the development, funding and implementation of programmes covering the entire country, namely "Leisure Sports for Children", "Learn to Swim" and "Programme for Development of Sports for All", and through coordination and monitoring of the implementation of projects related to the development of sports for pupils and students and leisure sports.

Policy in the area of sports for high achievement

The goals of this policy focus on the creation of conditions for raising the sports prestige of our nation at the global level, optimization, management and oversight of the training process of elite Bulgarian athletes, keeping the character values typical for sports, developing a programme for prevention of the use of doping in sports, and the creation of conditions for strengthening research and development.

Activities planned for 2012 refer to improving the training process and sports preparation, provisions for the training and competition process in compliance with the requirements of international sports federations, adoption of methods for evaluating the dynamics of development in the sports preparation of elite Bulgarian athletes, introduction of new equipment and methods for researching athletic and technical skills, accreditation of the Anti-Doping Centre and the Doping Laboratory, introduction of international laboratory

practices and standards, and improvement of qualifications of laboratory staff and the level of knowledge and awareness on issues related to the use of prohibited substances and prohibited methods by athletes.

Policy of bringing sports facilities and equipment up to modern international standards

Plans for 2012 include reconstruction and modernization of sports facilities and equipment and improving the training conditions for pupils in the General V. Stoychev sports school, increase in the number of seats for people with disabilities in sports facilities and equipment to meet international standards. It is planned to improve the financing model and achieve of profitability and return on investment from rehabilitation and construction works of buildings and facilities. There are plans to build and rehabilitate open-air sports facilities for physical development of the general population, promote the development of mass and school sports, integrate minority groups in regions with mixed population, and reconstruction and rehabilitation of sports halls.

AGRICULTURE, FISHERIES AND AQUACULTURE, FORESTS AND GAME

Policy in the area of agriculture and rural development

The long-term vision for the development of this policy is closely linked to reviving Bulgarian agriculture, finding solutions for problems and priority areas in agricultural policy and turning agriculture into an attractive business; development of competitive and economically sustainable agricultural holdings by implementing the Community policy for steady improvement of, and prevention of market shocks in agricultural markets; improving the practical application orientation of research in agriculture and foods; optimization of the use of agricultural land and protection of the interests of the Bulgarian agricultural sector and agricultural producers; uniform official control for food safety and food quality at all stages in the food chain, and last but not least, improving living standards, development of infrastructure and basic services for businesses and the population in rural municipalities.

Policy in the area of fisheries and aquaculture

The vision for the sector development includes implementing activities to facilitate:

- Maintaining biodiversity in aquatic ecosystems;
- Recovery and maintaining optimal fish stocks of species of interest for commercial and non-commercial fishing in natural water reservoirs;
- Supply of affordable food for the population and promotion of healthy diet;
- Observation of European standards in terms of production, processing and marketing of fish and aquaculture;
- Turning fishing into a modern and competitive sector by applying innovative activities supported by scientific research and development in the area of aquaculture.

Policy in the area of conservation and increase in forests and game

The development vision in this policy includes performance of activities on the basis of the principles of sustainable forest management in the context of a well-developed market

environment, with broad public support, and with mutual recognition of the interests of all stakeholders. Policy implementation is related also to maintaining the balance between environmental, social and economic benefits for society, which involves a range of aspects.

The environmental aspect envisages afforestation of barren and deforested areas, areas affected or threatened by erosion, ensuring a wide diversity of species in forest growing stock, application of plantation systems supporting natural forest reproduction, acceleration of forest growing measures and improving forest plant health.

The social aspect includes the creation of more employment opportunities in the sector on the basis of the forest activities planned, particularly in rural areas, and the expected development of ecotourism and related auxiliary services.

The economic aspect of benefits includes increased revenue flows in the sector and for the state budget generated by the increase in forest usufructs, the increase in game stocks through efficient management, improved efficiency of control and ranger oversight of forests, game and fish stocks, fire safety, and curbing illegal activities.

TRANSPORT AND COMMUNICATIONS

Policy in the area of transport

This policy is focused on the development of basic transport infrastructure as an important prerequisite for sustaining Bulgaria's economic growth and mitigating adverse environmental impact. In 2012, key priorities will include: improving the standards of transport services offered and sustainable transport development; reducing the negative environmental impact of the various modes of transport, and ensuring a high level of safety and security.

In implementing the strategy for the development of the transport system of the Republic of Bulgaria until 2020, priority will be given to transport infrastructure modernization which is necessary for the successful integration into the European transport network.

The railway sector development and its capacity to compete successfully with other modes of transport continue to experience difficulties due to considerable problems, largely as a result of insufficient financing in railway infrastructure. The development of a modern national railway infrastructure and its interoperability with the European railway network is part of the Government's strategic programme and hence remain a priority in the work of the Ministry of Transport, Information Technology and Communications in 2012 as well.

A special role in this policy is assigned to organisation, management, and provision of safety, security and environmental compliance in transport. Plans focus on updating, further development and improvement of the national transport scheme in order to bring transport services closer to the actual requirements of

the population in terms of location, timing and frequency and increase service efficiency.

In order to increase labour productivity and effectiveness in the railway sector, a Programmatic Railway Sector Development Policy Loan aimed at the financial stabilization for Bulgaria's railways in three tranches over the period 2011–2013, and a Specific Investment Loan to be extended to the Railway Infrastructure National Company (a state-owned enterprise) are expected to be concluded with the World Bank. The 2010-2016 Action Plan will be adapted to the updated 2011 Restructuring and Financial Stabilization Plan for BDZ Holding EAD.

Policy in the area of communications, e-government, information society

In the area of digital communications, this policy envisages meeting the demand expressed by businesses and the general population for modern, efficient and quality communication and information services. In the postal sector, key importance will be given to support for its sustainable development by creating conditions conducive to the functioning of an economically stable market for postal services which is fully open for efficient competition and meeting the increasing requirements of consumers.

In the national policy for the development of e-government, in 2012, priority will be given to building a digital administration by switching to electronic document flow within and between administrations, optimization of the process of introducing e-services, and joining the electronic data exchange among EU countries.

In 2012, again, a strategic policy goal in the area of information society will be to coordinate the process of preparing a strategic framework for the development of information society in the Republic of Bulgaria, and promoting scientific research, technology development and innovation in the area of information and communication technology.

PUBLIC FINANCE MANAGEMENT

Policy of sustainable and transparent public finance

The priorities and goals of this policy remain unchanged and continue to support the Government's conservative and disciplined fiscal policy, providing flexibility instruments for avoiding risks brought about by the economic crisis. The 2012 consolidated fiscal programme has been developed in compliance with the requirements of the Financial Stability Pact, thus providing the necessary fiscal consolidation.

In order to enable the economy to recover quickly, the country will continue to observe strict fiscal discipline by applying enhanced control over expenditure and following the rules and procedures for improving the quality of public finance.

Active interaction with international financial institutions will continue in order to obtain any necessary external financing and support for the state budget and the Bulgarian economy.

Policy of efficient collection of all public revenue

In 2012, efforts will focus on tax and social security policy in support of economic growth and maintaining budget stability, and

on the functioning of a modern and efficient revenue administration working to serve the public and ensure efficient collection of taxes, social security and health insurance contributions and other revenues of the state budget. The process of consistent shifting of the tax burden towards indirect taxes will continue.

Policy of safeguarding the public and the economy against financial fraud, smuggling of goods, human trafficking, money laundering and financing of terrorism

Priorities will focus on facilitation of legal trade; increasing efficiency in the collection of claims related to import of goods and to excise charges on domestic transactions; deepening cooperation with other customs administrations, law enforcement authorities, economic operators and the general public; protection of society, national interest and the financial interest of the EU by efficient measures to counteract breaches of customs, currency and excise legislation, trafficking in illegal drugs and precursors, and arms, dual-use products and technology, protection of intellectual property rights, etc.

Priorities in the area of regulating the terms and conditions for organizing and participation in games of chance, and gambling supervision will focus on preventing unauthorized organization of games of chance; developing new methods for more efficient inspections and examination of applications for organization and operation of games of chance, with a view of detecting possible cases of money laundering; carrying out more thorough supervision of organizers of games of chance on the territory of Bulgaria, with a view of preventing possible financial fraud by such organizers against players in gambling facilities; implementation of EU practices in the area of gambling.

Debt management policy

In 2012, the Government's debt management policy will remain focused on ensuring a reasonable level and controlled rates of increase of sovereign debt, a smooth distribution of debt servicing expenditure and the development of an efficient, transparent and liquid local market for government securities.

The achievement of the set goals demands targeting efforts on activities ensuring the implementation of a restrictive and prudent debt management policy in support of the efforts to maintain Bulgaria's macroeconomic stability, while taking into consideration its impact on the state budget, the balance of payments, the financial system and the capital market, and as an approach to meeting convergence criteria.

STATE RESERVE AND WARTIME STOCKS

Policy in the area of state reserves, wartime stocks and obligatory stocks of oil and oil products

In 2012, the priority will be to replenish the stock of bread wheat to reach 100% of the statutory target and replace the released amount in order to rotate stocks, and to achieve a higher level of security for nomenclature items and target quantities of state reserves and wartime stocks.

A primary task is to perform government supervision of the compilation, storage, utilization and recovery of obligatory stocks of oil and oil products in order to secure the supply of liquid fuel in case of difficulties in the delivery of oil and oil product supplies in Bulgaria with a view of ensuring the energy security of Bulgaria

and the Community.

ENVIRONMENTAL PROTECTION

Policy in the area of water resource management

The goal of this policy is to achieve and maintain a sound quantitative, chemical and environmental condition of water resources on the territory of Bulgaria. This is further complemented with the management of a range of issues relating to protection and maintaining sound environmental condition of the marine environment в Black Sea. Expanding the scope of the policy in the area of water resource management to include marine environment issues follows the European trend of integrated water resource management, which covers as integral elements the seas and oceans. In connection with the implementation of requirements set by Directive 2008/56/EC of the European Parliament and of the Council of 17 June 2008 establishing a framework for community action in the field of marine environmental policy (Maritime Strategy Framework Directive), an initial assessment of the condition of the environment in marine water should be carried out, environmental targets and monitoring indicators should be set and notified to the European Commission by 15 July 2012.

Policy in the area of waste management, ground and soil protection

The policy is aimed at preventing or reducing the quantity and hazardous properties of generated waste, recycling, reuse and/or recovery of raw materials and energy from waste the production of which cannot be prevented, and finally, waste disposal, where it is impossible to prevent, reduce and/or reuse waste. In 2012, 25 waste treatment facilities and installations are expected to be commissioned into operation.

Policy in the area of protecting ambient air

The strategic goal in the area of this policy is to improve air quality, which will be expressed in achieving the EU standard levels for ambient air quality (AAQ) across the territory of the country, reducing hazardous emissions in the atmosphere and improving the quality of liquid fuel.

Policy in the area of biodiversity protection

The three groups of priority measures envisaged refer to expanding and strengthening the network of protected territories, strengthening the scientific basis for biodiversity protection, and the establishment of the national environmental network. The main tasks include: development of the networks of protected territories and protected areas and improving their management; protection of habitats and species of European and national significance on the territory of Bulgaria.

Policy in the area of the national system for environmental monitoring and information support

The provision of easily accessible, understandable and representative public information about the environment requires coverage availability and expansion of Internet-based information offering direct public access. To this end, public registers and web applications are being developed, providing a direct link to information available in the National Environmental Database.

Policy of increasing environmental awareness and culture

The objective is to form environmental awareness and conscious care for the environment, keep the public better informed on environmental matters and ensure civil participation in the decision-making process, environmental legislation implementation and

enforcement through control activities.

Policy of pollution prevention and control and chemicals management

The goal of this policy is to mainstream environmental policy into development policies relating to the various industries in the Bulgarian economy in order to achieve sustainable development. This policy is central to ensuring protection of the environment and human health and responds to the growing environmental requirements of society.

Policy in the area of climate change activities management

This policy is aimed at preventing adverse impact of climate change by reducing greenhouse gas emissions, supporting the sustainability of natural ecosystems and adjusting the economy, agriculture and forestry.

REGIONAL DEVELOPMENT AND PUBLIC WORKS

Policy of creating conditions for a balanced and sustainable regional development, applying a strategic approach to planning, monitoring and evaluation, and implementation of the process of decentralisation and strengthening local government

A strategic goal of this policy is to strengthen the strategic approach to the development of regions in the Republic of Bulgaria based on integrated planning and concentration of resources for regional and local development by: providing the prerequisites for reducing disparities among and within regions in terms of the level of economic, social and territorial development of regions and bringing them up to the average levels in the EU; providing the set of conditions conducive of accelerated economic growth, development of human capital, high employment rate and social integration while observing the principles of sustainability and resources concentration; opening up the national space and promoting the development of transborder and inter-regional cooperation in order to solve the problems of regional and local development.

Another goal of this policy is to improve the administrative planning structure of Bulgaria, implement the decentralisation strategy and promote citizen participation.

Policy of improving the investment process through development of spatial planning, improving the cadastre and the property register information systems, promoting public/private partnerships, improving the quality of ex-ante and on-going control, and applying EU standards

This policy aims to ensure sustainable development of the territory of the Republic of Bulgaria, creation of conditions conducive of sustainable and balanced economic development through planning the territory at the national level, in synergy with the overall sustainable social and economic development in line with the national strategic documents and priorities, and reforming and ensuring synergies and coordination between spatial planning and the strategic planning of regional and local development.

Another priority is to ensure sustainable development of municipalities along the Black Sea and small municipalities, provide a planning basis for the development of national and regional infrastructure facilities and the development of national resorts.

An important task is to improve overall tourism conditions along the Black Sea coast and continue the process of granting concessions for the provision of beach services.

A strategic goal is to ensure sustainable development of the territory of the Republic of Bulgaria by providing adequate legal basis for the design, construction and maintenance of safe, energy efficient

and accessible buildings and facilities and for the adoption and implementation of EU directives and standards in the area of construction, ensuring a system of efficient ex-ante, on-going and ex-post control of the activities of parties performing compliance assessment of construction products, design, construction and supervision of buildings.

Policy of efficient and effective use of funding provided from European Union funds and of public investment, and improving the trust of our European partners

The policy sets the priority objective of efficient management and implementation of Operational Programme “Regional Development”, strengthening cooperation and communications with EU partners, ensuring transparency of operations and combating corruption practices, which will contribute to increasing the absorption rate and successful implementation of Operational Programme “Regional Development”.

Another strategic goal is the efficient management and implementation of regional cooperation programmes.

Also an important task is the full absorption of funding available from the Cohesion Fund (Regulation 1164/94) / the ISPA Programme of the European Union, and public investment implemented under projects funded through state investment loans.

This uses the administrative capacity of the Managing Authority responsible for the Cohesion Fund (Regulation 1164/94) to achieve active participation in Operational Programme “Environment”, Priority Axis 1, “Improvement and development of potable and waste water infrastructure in settlements with more than 2,000 population equivalents and in settlements with up to 2,000 population equivalents located in Water urban areas.

Efforts are also focused on the preparation of quality programming documents for the next programming period 2014-2020 and building the capacity of project beneficiaries and contractors.

The policy of maintaining, modernization and development of technical infrastructure related to improving transport accessibility and integrated water resource management

A strategic goal of this policy is the accelerated development of highways and the integration of the national road network with European transport infrastructure.

Benefits from the achievement of the goal include higher quality and efficiency of road transport services based on the use of modern road transport communications, improved transport access at the regional level and connectivity to main transport corridors, conditions for economic activity in peripheral and backward areas, inter-regional connections in the planning regions enabling the development of their specific economic potential, preservation and development of the national road transport infrastructure in line with modern road transport requirements.

Another goal of this policy is to ensure modern standards in water consumption with sparing use of scarce water resources, improve the efficiency of water supply and sewerage systems and the standards of water services by bringing up the quality of water supply and sewerage services and reaching the level of service of other countries in the European Union, create conditions for efficient management of water supply and sewerage, increase the interest of the central government, local regional authorities and municipalities in the improved functioning and management of

water supply and sewerage activities in the respective regions.

Public benefits will include provision of water supply in all settlements, with potable water meeting the requirements concerning quality, reduced water loss in the water transportation system, improved quality of water resources, reduced potential risk of ground water pollution, reduced risk of soil pollution, improved protection of river basin environment (flora, fauna) reduced risks to human health for the population in the areas serviced by water treatment plants; wastewater catchment and treatment in urban areas and improved quality of natural water resources.

Policy of development and implementation of a national programme for prevention and mitigation of landslide processes, erosion and abrasion

The goal of this policy is to prevent the emergence and spread of landslide and rockfall processes, water erosion and abrasion and recovery of damages caused to settlements and technical infrastructure. This will help increase security of living in settlements in landslide areas, increase the level of security of movement on roads located in the vicinity of landslide sections, protect fertile agricultural land from active sea abrasion, create new sandy beaches, prevent natural disasters, industrial averages and damages, help the recovery and protection of infrastructure and terrains along the Black Sea coast threatened or affected by landslides, and strengthen the terrains and protect infrastructure along the banks of the Danube river exposed to erosion, help damage recovery and prevent new damages due to landslides.

Policy of improving the living environment standards of Bulgarian citizens by improving the urban environment of settlements and better management and maintenance of the housing stock

This policy is aimed at improving the living environment standards in settlements and risk prevention by means of provision of reliable protection of the population against the adverse effects of water in settlements and by the development and modernization of communications and urban transportation systems in settlements.

The policy has also the objective to facilitate the improvement of the condition of the existing housing stock and set up a working mechanism for the provision of affordable housing by ensuring the safety of buildings and security of tenure, increasing energy efficiency of buildings and their market value.

Priorities include improvement of the management and disposal of real property in eminent domain, in accordance with the principles set in the Constitution and other legal acts by increased efficiency in real property management of assets held as public and private property of public institutions and optimization of central and municipal real property aimed at increasing the financial ability of municipalities to implement the sustainable development policy.

The policy considers a priority to promote social integration of people in a disadvantaged social position from the Roma community by improving their housing conditions and aims at uniting, providing guidance and coordination for the efforts of the various central and local government authorities involved, and land regulation and public works in urban areas with compact Roma population.

LABOUR AND SOCIAL POLICY

Policy in the area of employment

National goal 1: “Reaching employment rate of 76% among population aged 20-64 by 2020” set in the National Reform Programme of the Republic of Bulgaria (2011-2015) as part of the implementation of the Europe 2020 Strategy.

The main priorities include:

- Raise the employment rate by offering quick and efficient support to unemployed persons in finding a job both on the primary labour market and under special programmes and measures, including activation of inactive and discouraged persons;
- Improve labour force quality through acquisition of new skills and knowledge, improve the qualifications and skills of both employed and unemployed persons to ensure higher labour productivity, better match labour market requirements and increase the competitiveness of Bulgarian economy;
- Promote social dialogue.

Policy in the area of labour relations

This policy envisages:

- Ensure social protection of vulnerable groups of the population by better targeting of social assistance;
- Increase the efficiency of assistance programmes, apply a differentiated approach, improve the legal framework in the area of social assistance;
- Streamline institutional structure related to social protection for the lowest-income and high-risk groups of the population;
- Promote employment of supported persons in long unemployment at an labour-active age in order to reduce the number of passive consumers of social benefits and create opportunities to channel resources to those who need them most;
- Better coordination between the social assistance system and the system of active intervention programmes in the labour market to support social re-integration of social assistance recipients by providing better financing in the implementation of programmes and projects in the area of social assistance. The expected result of these steps will be a reduced dependency on social benefits;
- Administrative capacity building for central and local government authorities, the judiciary system, social partners and society at large, and strengthening the institutional mechanism;
- Increase public awareness and sensitivity to gender equality and anti-discrimination issues.

Policy concerning people with disabilities

The strategic goal is to integrate people with disabilities in all areas of public life by creating conditions and guarantees for equal treatment and full participation in all areas of public life, and for the

exercise of their rights by providing social and economic support to people with disabilities and their families and assist their integration in general and/or special working environments.

Policy of social inclusion

Work has begun on drafting a new legal framework in the area of child and family support, focusing this policy not only on children who are already at risk but also preventive policies and measures. The concept for this new legal framework envisages:

- Integration of all substantive matters relating to children and the family in a single legal act;
- Replacing institutional child care with care in a family environment or a community-based quasi-family environment. This is not limited exclusively to taking children out of institutions but aims also at preventing institutionalisation of children and creating new opportunities for children and families to receive support in the community. The financial support extended under this programme is part of efforts to prevent abandonment and promote re-integration by accommodating children in families of their relatives or close friends, or in foster families;
- Development of integrated social services aimed at resolving the risks of dropping out of the educational system, and risks for the healthy development of children.

Policy in the area of living standards, income and demographic development

The strategic goal of this policy is to maintain the living standards, income levels and social security of Bulgarian citizens in accordance with the economic situation and the public budget, and raise them gradually by strengthening the social economy sector and corporate social responsibility, to slow down the decline in population numbers, with a view of achieving stabilization in the long-term, and ensure a high quality of human capital which includes all people, with their health condition, education qualifications, abilities and skills.

Policy in the area of free movement of workers, migration and integration

This policy aims to provide guaranteed opportunities for all Bulgarian citizens to exercise their right of access to labour markets of the EU Member States and in the EEA labour markets during the time they reside in these countries.

DEFENCE

The Government's defence policy will continue to focus on the further development of the national defence system as a reliable and predictable ally in NATO and member of the European Union.

The Republic of Bulgaria will continue to take part in the decision-making process and the process of building NATO and EU military capabilities, and it will continue to contribute in the joint work and cooperation with EU countries in the framework of the European Defence Agency.

Defence capabilities policy

During the period 2012-2014, the main characteristics of the armed forces will involve: developing capabilities and their efficient combat use; maintaining a high level of readiness; preparation for action in joint and multinational environments; high usability and flexibility; modular principle in developing the armed forces.

A strategic goal of this policy is to build a unified complex of interoperable armed forces capable of implementing the full range of tasks posed by the trends of development in the geostrategic security environment, with a unified command and control system in peace time and in crises, with an organisation, size, armaments, technology and preparation adequate to their role, missions and tasks.

Alliance and international security policy

This policy deals with the implementation of the active defence policy of the Republic of Bulgaria within NATO, the European Union and other international and regional formats, and efficient participation in the collective defence system of the North Atlantic alliance, the Common Security and Defence Policy (CSDP) of the European Union and in the framework of other international and regional initiatives in support of world peace and stability.

The policy's main strategic goal is to ensure participation in NATO and EU security and defence policy-making and an adequate contribution in its implementation.

INTERNAL AFFAIRS

Policy of public order protection and counteracting crime

The main priorities in the framework of this policy are the following:

- Curb opportunities for organised crime to acquire and legalise large and particularly large amounts of financial assets of dubious or unproved origin;
- Prevent any terrorist acts on the territory of Bulgaria;
- Counteract crimes which directly affect the physical and mental health of young people such as drugs distribution, cybercrime, human trafficking, etc.;
- Combat corruption;
- Counteract white-collar crime, with a focus on fraud involving funds from the national budget and from the Structural and Cohesion Funds of the European Union;
- Protect public order and pro-actively counteract crime, focusing efforts on small settlements, resorts and tourist facilities, protection of agricultural assets, socially vulnerable and high-risk communities;
- Ensure public order and security during large-scale and mass events;
- Counteract serious crimes against the person, with a focus on counteracting murder, attempted murder, and rape;
- Pro-actively prevent crimes against property of citizens, with a focus on theft, robbery and larceny of motor vehicles;
- Increase the efficiency and further improve the investigation model in order to achieve speedy and high-quality pre-trial proceedings;

- Stop illegal trade in ferrous and non-ferrous metals; discontinue old established practices of insurers imposing the obligation to place “passive markers” such as signs, stickers or other markings on motor vehicles;
- Ensure external border security through efficient border control and adopt best Schengen practices;
- Maintain the downward trend in the number of casualties from traffic accidents and increase the efficiency of administrative legal activity, control and prevention in traffic safety.

Policy of providing state fire safety control, fire safety and rescue, protection in case of natural disasters and industrial accidents and early warning

The goals of this policy include:

- Increase capabilities to provide fire safety and protection of the population in case of fire, natural disasters and industrial accidents and emergency;
- Increase the level of protection of the population and critical infrastructure facilities from fire, natural disasters and industrial accidents, and other emergency situations by implementing efficient preventive measures, and develop capacity for efficient participation in crisis and natural disaster recovery missions within the EU and in assistance missions in other countries;
- Redirect emergency call numbers 150, 160 and 166 to SEECN 112, in accordance with CoM Decision 367/3.06.2010 and improve service quality.

NATIONAL SECURITY

Policy in the area of protection of national security

The primary goal of this policy is focused on counteracting any violations against national security relating to:

- Posing danger to the sovereignty and territorial integrity of the state and the unity of the nation;
- Anti-constitutional activity;
- Corruptive acts by high government officials;
- Danger to the economic and financial security of the country, including violations related to money laundering;
- International terrorism and extremism and their financing; detection, prevention and ceasing any attempts to set up terrorist and extremist organisations and engage in terrorist acts by international terrorist organisations on the territory of the Republic of Bulgaria;
- Any breach in the functioning of the national system for protection of classified information;
- Migration processes, illegal migration to and via Bulgaria, including the use of untrue Bulgarian ID documents for the purposes of human trafficking, and ceasing any attempts at wrongful acquisition of Bulgarian citizenship;

- Classic intelligence and unconventional risks and threats, including in the Ministry of Defence, the entities directly reporting to the Minister of Defence and the Bulgarian army;
- Threats to environmental security, the security of national strategic facilities and activities, and destructive influences on communication and information systems;
- International trade in arms and dual use products or technology, manufacturing, storage and distribution of dangerous devices.

JUSTICE

Policy in the area of justice

The priority goal is to ensure rule of law in Bulgaria, combat crime and corruption, and reform and improve the functioning of the judicial system for administering justice in society.

The vision in the area of this policy is related to the establishment of efficient and equitable judicial system and regaining public confidence in the judiciary. Another priority is to change legislation so as to provide safeguards for the rule of law in Bulgaria, combat crime and create conditions for curbing corruption at all levels of government.

The main tasks of the Ministry of Justice in terms of the judicial system involve:

- Improving the facilities and material conditions for the functioning of judicial authorities;
- Ensuring security of trial proceedings and protection of public order in courthouses;
- Provision of building stock, renovation and rehabilitation works in buildings of judicial authorities helps create a better working environment and increases the quality and speed of service provision;
- Protecting the health and safety of members of the judiciary and witnesses; ensuring timely cooperation with judicial authorities in serving summons, compulsory appearance and conveying;
- Ensuring protection of the rights and legal interest of citizens, thus guaranteeing equal access to justice for all citizens.

Policy in the area of execution of punishments

This policy is aimed at establishing a modern model of management and development of the penitentiary system, in line with internationally accepted minimum standards for detention facilities and the European rules for prisons, and is part of the responsibilities of the Ministry of Justice to ensure protection of society against offenders and ensure the rights and freedoms of people deprived of liberty and possibilities for their social rehabilitation.

A major task of the policy is the creation of legal guarantees for

improving living conditions in prisons and detention facilities with a view of gradually bringing penitentiary establishments up to international minimum standards for detention facilities and the European rules concerning prisons.

ECONOMY

Policy in the area of sustainable economic development and competitiveness

Consistent implementation of the economic recovery policy from the negative effects of the global financial crisis, and increasing the economic growth potential are based on investment and innovation, increased productivity and improved competitiveness.

Bulgaria needs a new economic growth model, aligned with the Europe 2020 Strategy of the EU, to promote linkages between employment, innovations, research and development, and industrial policies, to provide an impetus for growth in employment. Economic restructuring will be necessary also because of Bulgaria's loss of competitiveness in sectors with low value added and the need to increase its attractiveness as a centre for the development of high-tech products and services in the area of information technology, electronic components, machine-building, medical and optic equipment, etc.

In this regard, the main tasks to be addressed include also overcoming the dramatic decline in investment (particularly in innovation-based industries of the economy with a high export potential), an increase in the share of employed persons and improvement of their professional qualifications, particularly in the high-tech sectors of the economy.

The policy will include legislative initiatives at the primary and other levels, concrete measures and the implementation of Operational Programme "Development of the competitiveness of Bulgarian economy 2007-2013".

ENERGY

Policy in the area of sustainable and competitive energy development

In the mid-term, the global energy industry, including Bulgaria's energy industry, will face the challenges of having to depend on the import of resources and energy, growing energy prices and climate change. This determines the priority areas on which efforts will continue to focus, namely:

- Reduce external dependency on energy imports by diversifying energy supplies, energy conservation and promoting the use of local resources and RES;
- Liberalise the energy market with a view of ensuring affordable and secure energy for consumers;
- Mitigate the negative developments in climate change through the participation of Bulgarian energy facilities in the European greenhouse gas emissions trading scheme.

The main priorities of Bulgaria's energy policy in the next several

years are to increase the share of renewable energy in gross end consumption and improve energy efficiency. The goal is achieve cleaner and more efficient energy generation and consumption by promoting RES and more efficient use of fossil fuels and the energy generated from them.

TOURISM

Policy in the area of sustainable development of tourism and efficient international economic cooperation

The vision focuses on implementing an integrated policy of improving the external financial position of Bulgaria, and the condition of the balance of payments, respectively, and on achieving sustained economic growth based on export as a driver of growth and the tourism sector as a priority in the structure of the economy.

In the area of strengthening the contribution of export as a key factor for economic growth, an integrated package of measures will be implemented in support exporters and promote investment in export-oriented activities.

In the area of tourism, the institutional and legal framework of tourism governance will be further developed to match its importance for the national economy and adopt the European Commission guidelines for sustainable development of tourism and tourist destinations.

Actions will be taken to ensure sustainable development of tourism all the year round by diversification of the national tourist product, implementation of measures to increase quality and value added, and provide incentives for the development of specialized types of tourism. These measures will be supported by implementing a marketing and promotion policy concerning the national tourist product to improve its image and gain better position on the tourism market.

VI. MANAGEMENT OF FUNDING FROM EUROPEAN FUNDS AND PROGRAMMES

1. Projected Funding from EU Funds and Programmes

The main priority of the 2012 national budget, namely, a priority focus on sectors promoting economic growth (development of road, environmental and utility infrastructure, science and education) finds considerable financial support from operational programmes co-financed from the Structural and Cohesion Funds of the European Union.

In preparing projections for the 2012 absorption of EU funds, several key factors have been taken into account:

- The stage of implementation of each individual

programme (including pre-accession programmes);

- The nature of supported projects. Programmes co-funded by the European Union focus on sectors with various scale and pace of implementation.

Spending Side

The planned expenditure for 2012 under programmes co-financed by the EU totals BGN 3,834.9 million. In view of the weight of 2012 in the 2007-2013 programming period, and the Government's commitment concerning the absorption of EU funding, the following key factors have been taken into account in determining expenditure under the individual operational programmes:

- Stage of implementation of the respective programme.

The stage of development and implementation of the individual programmes is different. For programmes which are at a more advanced stage of implementation, a higher percentage of eligibility of forecasted expenditure is assumed. For bilateral transborder cooperation programmes implemented jointly with another partner country, where the element of bilateral coordination predetermines a slower pace of progress, a smaller percentage is applied.

- The nature of supported projects.

Programmes co-financed by the EU focus on sectors with various scale and pace of implementation.

Thus, for example, the *operational programmes "Transport" and "Environment"*, which focus on building a balanced and sustainable transport system by developing and modernizing the key transport infrastructure for connections of national, transborder and European importance, and on the development of environmental infrastructure and the improvement, protection and recovery of natural environment and biodiversity, respectively, include projects of larger scale of national importance, implementable in stages over time and requiring considerable resources to be implemented.

Similar implementation and, respectively, a relatively high amount of expenditure are also typical of *OP "Regional Development"* which focuses on improving regional, domestic and external connectivity, and on providing assistance to small municipalities with a lower technical and institutional capacity by promoting cooperation between municipalities to achieve integrated development.

A high level of spending is expected also under *OP "Human resource development"*. It focuses on promoting economic activity and development of the labour market, increase of productivity and adaptability of employed persons, and improving the standards of education and training in line with labour market requirements. Projects implemented under this operational programme are relatively faster to implement and have a faster absorption rate, respectively.

Pre-accession Programmes

In 2012, the implementation of the ISPA programme (Cohesion Fund Regulation 1164/94) continues to be a major priority for Bulgaria, in view of the social importance of infrastructure projects in the area of transport and environment.

Revenue Side

Revenue planned for 2012 under programmes co-financed by the EU amounts to BGN 3,318.1 million in total and is based on the indicative allocations for expenditure which is expected to be reimbursed by the European Commission in 2012, applying the following approach:

- The amount of expenditure under operational programmes corresponding to EU co-funding incurred in the fourth quarter of 2011;
- The amount of expenditure under operational programmes corresponding to EU co-funding incurred in the first, second and third quarters of 2012. This is also in compliance with the provision in Article 87, paragraph 1 of Regulation (EC) No. 1083/2006 of the Council from 11 July 2006 according to which payments can be made by the Commission in the current year only provided the payment request has been filed by 31 October.
- For pre-accession instruments, which are in their final stage of implementation, planning of expected revenue takes account of the specific terms and conditions for reimbursement of funds by the European Commission and the expected return of funds by the Bulgarian side in connection with unabsorbed funds and any ineligible expenditure.

It is extremely important to note that any slow-down in rate of making payments under the programmes co-financed with EU funds from the projections would result in a reduced amount of expenditure which can be certified to the European Commission, and ultimately, in lower proceeds for the Republic of Bulgaria for the respective years.

Common Agricultural Policy of the EU

The Common Agricultural Policy (CAP) is one of the main policies of the European Community (EC) through which it implements the goals set in the Treaty establishing the EC. It includes the establishment of common market organisations for the individual agricultural products, a policy of farmer income support, and a rural development policy.

The purpose of CAP is to ensure an acceptable standard of living for farmers, quality foodstuffs for consumers at affordable prices,

and to preserve the European heritage in rural areas and contribute to environmental protection.

The main CAP instruments are direct payments and market support for agricultural producers (first pillar of CAP) and the rural development policy (second pillar of CAP).

First Pillar of CAP

Through the European Agricultural Guarantee Fund (EAGF), the EU provides funding for assisting agricultural producers under direct payment and market support schemes.

Direct payment schemes. Under the Accession Treaty, direct payments in Bulgaria (in the form of single area payments) in 2012 will amount to 60% of the EU-15 level, with a 10% annual increase in direct payments thereafter, to reach 100% of the EU-15 average in 2016. With Bulgaria's accession to the European Union, Bulgarian farmers can receive additional national co-payments on top of the single area payment per hectare. National co-payments are allowable following consultations and the preliminary agreement of the European Commission. The purpose of national co-payments matching direct payments is to bring the level of support for Bulgarian agricultural producers closer to that in other Member States and increase their competitiveness.

Under the single area payment scheme (SAPS), it is envisaged to spend BGN 976.6 million in 2012 in direct payments to agricultural producers for the account of the European Union, and reimbursements from the EU for direct payments for the year are expected to amount to BGN 767.4 million.

Market support measures. Market support funding is provided through the following mechanisms:

- Interventions for the stabilization of the market in sectors such as grain crops, rice, meat, milk, fruit and vegetables;
- Export support subsidies to offset price differences between the EU and the world market;
- Assistance to raise the consumption of certain products;
- Support for organisations of fruit and vegetable producers;
- Market support for wine (restructuring of vineyards), meat, apiculture, sugar, etc.

Funding for market support for Bulgaria is not specified in the Treaty on the accession of Bulgaria to the EU since the amounts are determined on the basis of market measures specifically implemented in any given year. Funding for market support is appropriated depending on the market situation and upon a decision by the European Commission, and the necessary funds are disbursed from the national budget and are reimbursable from the EU budget.

Appropriations for market measures in 2012 amount to BGN 104 million, and it is expected that the amount will be

reimbursed by the EU within the same year.

Second Pillar of CAP

The **European Agricultural Fund for Rural Development** (EAFRD) provides funding for the development of rural areas in the following areas (axes):

- *Axis 1: Improving the competitiveness of the agricultural and forestry sector* – developing competitive agriculture, forestry and food processing sectors;
- *Axis 2: Improving the environment* – protecting natural resources, preserving biodiversity and protecting the environment in the countryside;
- *Axis 3: Quality of life in rural areas and diversification of the rural economy* – promoting employment opportunities and improving the quality of life in rural areas;
- *Axis 4: LEADER* – an instrument for decentralised management and integrated rural development.

In accordance with Article 5 of Regulation 1290/2005, EAFRD can be used to fund measures for preparation, monitoring, administration and technical assistance, evaluation, audit and control necessary in implementing CAP.

National co-funding complementing EAFRD funds amounts to 20 per cent, except for measures under Axis 2, where the percentage of co-funding is 18 per cent. EAFRD provides 7% of the agreed Bulgaria envelop as an advance payment, and the undisbursed portion of that is placed in a time deposit with BNB.

In 2012, the amount which Bulgaria plans to spend on rural development is BGN 595 million, of which BGN 478 million in EU funding, and BGN 117 million in national funding.

BGN 266.9 million, including BGN 53.3 million in national co-funding, is budgeted for projects of public beneficiaries under the Programme.

Funding envisaged for projects of non-public beneficiaries under the Rural Development Programme (RDP) amounts to BGN 324.5 million, including BGN 63 million in national co-funding.

In terms of technical assistance, in implementation of CMD No. 230 from 25 September 2009 concerning the appointment of additional staff for the needs and duration of implementing RDP for the period 2007-2013, the allocation for wages and related social security and health insurance contributions amounts to BGN 3.6 million, of which: BGN 3.1 million for salaries and other remuneration, including BGN 0.6 million in national co-funding, and BGN 0.5 million for social security and health insurance contributions, including BGN 0.1 million in national co-funding.

For funding expenditure for value added tax (VAT) payable by municipalities under assistance projects approved under RDP for

the period 2007-2013, the 2012 budget plan of SF “Agriculture” has envisaged BGN 35.2 million to be transferred from the state budget.

Common Fisheries Policy of the European Union

The EU Common Fisheries Policy is aimed at ensuring sustainable development in the sector through responsible fishing and conservation of fishery resources, long-term provision of supplies for the market and the processing industry with high-quality fish and fishery products at affordable consumer prices, and ensuring a decent standard of living for those employed in fishing activities.

On the basis of Regulation No. 1198/2006, the European Fisheries Fund (EFF) has provided 7 per cent of the agreed amount in advance, to cover the difference between the amount paid out and the reimbursed amount.

In 2012, the amount which our country plans to spend in implementing OPDFS is BGN 31.9 million, of which BGN 23.9 million in EU funding, and BGN 8 million in national funding.

For public beneficiaries under the programme, appropriations amount to BGN 1.5 million, including BGN 0.4 million in national co-funding. For non-public beneficiaries under the programme, appropriations budgeted amounted to BGN 30.4 million, including BGN 7.6 million in national co-funding.

Following the expiry of the deadline for making payments with European funds under the SAPARD Programme on 31.12.2009, any subsequent payments under outstanding projects in the framework of programme payable by SF “Agriculture”, after the completion of all audits by the competent authorities, including on the basis of court decisions, are to be paid out from the state budget. In this connection, BGN 25 million is planned in the budget plan of SF “Agriculture” for 2012, to make provisions for payments outstanding to beneficiaries of the SAPARD Programme.

2. Contribution to the EU General Budget

The forecast about Bulgaria’s 2012 contribution to the EU General Budget is estimated in accordance with the Council Decision of 7 June 2007 concerning the system of own resources in the European Communities (2007/436/EC, Euratom).

The amount of Bulgaria’s contribution to the EU General Budget for 2012 is projected at BGN 895.7 million. This amount is an estimate and a kind of guarantee for the payment of the national contribution in the EU budget. Its conditionality stems from: the probability that in the year of execution additional needs and/or contingencies may arise, which should be funded from the EU budget; periodic updates of VAT-based resources, GNI-based resources in connection with the latest information available in view of ensuring full accuracy.

it should also be recalled that despite projections concerning

revenue from customs duties and levies on the production of sugar and isoglucose, the Member States pay into the EU budget the actual amounts collected as traditional own resources.

VII. QUALITY OF PUBLIC FINANCE AND REFORM IN THE PUBLIC SECTOR

1. Fiscal rules and procedures to ensure long-term sustainability and quality of public finance

An important tool for improving the quality of public finance is to set up the relevant fiscal rules. By doing that, Bulgaria responded to the opinion of the European Council on Bulgaria's Convergence Programme (2011-2014) and to the requirements in the draft Council Directive concerning requirements to budget frameworks of the Member States, and the challenge of improved fiscal governance. The budget procedure for 2012 made significant steps in this regard:

- Moving forward and earlier adoption of the three-year budget forecast and the spending ceilings for first-level spending units as key documents supporting the drafting of the 2012 budget in order to achieve integration and alignment of this process with the European framework for enhanced preliminary coordination of economic policies, the European Semester;
- Participation in national budget peer reviews and preliminary policy coordination by meeting the commitments under the European Semester, and coordination of goals and priorities set in our national strategic documents with those required to implement the Stability and Growth Pact and the Europe 2020 Strategy, respectively – the Convergence Programme of the Republic of Bulgaria (2011-2014) and the National Reform Programme of the Republic of Bulgaria (2011-2015);
- Following up on the recommendations and assessments of EU institutions about Bulgaria's Convergence Programme (2011-2014) in the preparation of the 2012 Budget.

The budget framework for the period 2012-2014 takes account of the Government's intentions to change the current fiscal rules and strengthen the fiscal and budget discipline, which comes to how that the budget policy in the mid-term focuses on the exercise of enhanced control of expenditures and the size of the budget deficit, and on achieving a balanced budget in an environment of economic recovery by means of measures for implementing successful fiscal consolidation. Measures have been adopted to strengthen control over spending and commitments undertaken by

FLSUs (including municipalities) and companies with state participation.

One of the main budget policy goals is long-term balanced and sustainable budget system. The 2012 Budget parameters are directly linked to Bulgaria's long-term development goals set out in the Europe 2020 Strategy.

One of the most important fiscal objectives set by the Government is to ensure Bulgaria's macroeconomic and financial sustainability in the long-term. In implementing the measures agreed in the Financial Stability Pact proposed by the Government, the National Assembly amended the Organic State Budget Act (OSB Act) to define maximum levels for key fiscal indicators.

According to Article 12a of the OSB Act, the maximum amount of expenditures under CFP may not exceed 40 per cent of the projected GDP, which restricts the redistribution role of government and enables improved allocation of expenditures and implementing reforms to increase spending efficiency and effectiveness.

With the amendments in Article 20, paragraph 4 of the OSB Act, in cases where the budget balance under CFP is a deficit, it may not exceed 2 per cent of GDP, which is the maximum allowable level for a budget deficit on a cash basis.

The fiscal rules are a significant measure aimed at achieving an improved quality of public finance, while enabling flexible and dynamic management. The fiscal rules in the Financial Stability Pact will have a strong disciplining effect and will ensure the achievement of the Maastricht criteria on deficit and debt and will foster the achievement of a stable and predictable economic environment.

The 2012 Budget fully reflects the adopted mid-term fiscal targets and the measures set in the Financial Stability Pact by observing strictly the key elements instrumental in improving the fiscal framework – capping the budget deficit on a consolidated basis at 2% of GDP and limiting the size of government by setting an expenditure ceiling at 40% of GDP.

The effect of the introduction of these fiscal rules is expected to ensure the macroeconomic stability of Bulgaria, which will affect positively consumption and investment by all types of economic agents. Support for domestic demand will stimulate growth in the economy.

To achieve the fiscal and budget policy goals, efforts will continue to focus on improving procedures and the quality of public finance by practical implementation of programme budgeting and the introduction of a sectorial approach in funding for the public sector. It should be noted that the programme budgeting procedure needs to be further developed and improved, and include all participants in the budget process. The achievement of more feasible results in improving the quality of the individual sectorial policies and binding the latter with the budget will require wider use of indicators to assess their effects and perform systematic

cost/ benefit analyses of government programmes and policies as a basis for policy-making and governance decisions. This will result in better transparency, public awareness and civil participation in the governance process.

To improve fiscal management, the Government will continue to follow the current policy direction, which was evaluated as appropriate in the European Commission assessment and the decision of the Council. Also, the current fiscal policy is in line with the main action guidelines for the achievement of higher economic growth and competitiveness of the economy recommended by the World Bank report “Bulgaria: Public Spending for Growth and Competitiveness”.

2. Streamlining the Public Sector

Implementation of Measures to Optimize Public Administration

In the past two years, the administrative reform in Bulgaria has been very dynamic, and its main focus is to streamline public administration entities. The reform goal is to set up a modern structure of central administration meeting the requirements of citizens and the business. In this period, the Government closed down a number of inefficient entities and began a reorganisation of public administration in order to improve its effectiveness and the quality of public services.

From July 2009 till October 2011, a total of 29 administrative entities were closed down, which was supported by the implementation of several stages of the Plan concerning the implementation of measures for streamlining public administration (2010-2011) adopted under Decision No. 560 of the Council of Ministers of 29 July 2010. The implementation rate by early October was 55%.

The reforms consolidated and strengthened the entities, which resulted in reduced red tape, improved financial discipline and administrative efficiency in administering budget programmes.

Large-scale reforms have been undertaken within the Ministry of Agriculture and Food. The Bulgarian Food Safety Agency (BFSA) was established. It took over the functions of the National Service of Veterinary Medicine, the National Plant Protection Service (except for the Plant Protection Institute), and some of the functions of Regional Health Inspections, the National Grain and Feed Service and the Regional Directorates for Agriculture, which eliminated the overlap of functions. The National Food Safety Council was closed down. In this way, the state consolidated all core activities relating to food in a single authority, thus improving the overall policy in this area.

Large-scale structural changes were undertaken within the Ministry of Healthcare, consolidating Regional Healthcare Centres with Regional Inspections for Public Health Protection and

Control into Regional Healthcare Inspections. This reduced the number of second-level spending units reporting to the Minister of Healthcare by 28 entities, and businesses and citizens will be able to communicate with a single Ministry entity, which facilitates access to services. The National Centre for Public Health Protection and the National Health Information Centre were consolidated into a National Centre for Public Health and Analyses.

The Government continued to implement a consistent policy of streamlining the establishment plan of public administration. Since the beginning of the Government's term of office till October 2011, the number of staff by establishment in the central administration was reduced by 9,464, which is a decrease of 13.2% in comparison to July 2009. The staff level by establishment plan in the Ministry of Interior was reduced by 3,000, from 61,170 to 58,170.

For the period under consideration, the number of staff by establishment plan in the central administration and the Ministry of Interior is down by 12,464 jobs. This has been one of the most considerable downsizing efforts in the central administration in recent years.

In implementing CMD No. 217 of 6 April 2011, 721 labour/public service contracts with public administration employees were terminated due to pension entitlement for length of service and age, and 339 employees will retire by the end of 2011. Thus the total number of retired employees will exceed 1,000. This policy opens up opportunities for more young and energetic people to join public administration.

New Classification Plan of Job Positions in Public Administration, Staff Performance Evaluation System and Remuneration Model

Following an in-depth analysis and applying a methodology for evaluating job positions against 4 factors: (1) knowledge and skills; (2) discretionary powers; (3) impact of decisions and (4) people skills, the Council of Ministers approved the new Classification Plan for job positions in public administration, with an effective date of 1 January 2012. With the introduction of objective criteria, the new Classification Plan is fair and balanced. The number of grades has been reduced from 32 to 14, with a higher number of job positions in each grade. The new Classification Plan introduces matching management and expert grades, which enables experts to develop professionally, without having necessarily to take up managerial positions in order to advance in their career. The eligibility requirements in terms of grade and professional experience were reduced, enabling staff to progress in their career, and young people with shorter professional experience to apply for jobs in public administration. On the other hand, requirements for certain key positions were raised, to ensure better applicant selection.

Staffing levels of administrative units were increased in order to strengthen expert potential and reduce the number of managerial staff in public administration.

A new Ordinance on the terms and conditions for performance evaluation of public administration personnel has been drafted. One of the highlights is the possibility to assess the contribution of each staff member in the achievement of the goals of the respective administration. It introduces objective assessment criteria. These changes will improve the performance evaluation system as a whole and increase motivation among public service employees. The relevant pieces of secondary legislation are in the process of coordination and will then be proposed for adoption by the Council of Ministers.

A new remuneration model for the public service has been developed which will eliminate inconsistencies in the policy of the various administrations in setting individual basic monthly salaries and additional remuneration of staff. The model also aims to attract highly qualified and well educated staff to make a career in public administration, motivate staff to perform their duties better and links remuneration with performance.

The streamlining process will continue in 2012, with functional analyses leading to reform implementation. Thorough reviews and analyses will be conducted for the MoI system and the systems of NHIF and NSSI, and measures will be undertaken to streamline processes and administration structure. The introduction of the statute of public servants will continue in entities which have not yet implemented it.

3. Financial Decentralisation and Budget Relations with Municipalities

In 2012, work will continue in monitoring indicators for assessment and reporting on measures envisaged in Revised Decentralisation Strategy and the Programme for implementing the Revised Decentralisation Strategy for the period 2010-2013 (adopted under Decision No. 454 of the Council of Ministers of 2 July 2010). The goal of the measures included in the programme is to mobilise and stimulate action at the national and local levels, so that citizens can benefit from sound democratic local government through the constant improvement of the quality of local public services, and involve the population in public life and the implementation of policies corresponding to legitimate public expectations.

Policies reflected in the budget have as their goal to build capacity for sustainable and balanced development of municipalities with a view of providing more efficient and better quality services, and increase the living standards of citizens. In this aspect, central government transfers to municipalities are determined and carried out on the basis of clear rules, criteria and standards.

The appropriations set in the draft 2012 budget create conditions for sound governance at the local level in compliance with the principles of legality, appropriateness, efficiency and effectiveness.

In terms of tax policy and the revenue streams of local budgets, the trend towards more financial autonomy of municipalities is clearly manifested in relation to the full authority granted to municipalities to administer local taxes, and the powers to determine autonomously the rates of these taxes under the conditions and procedure, and within the range, set by the Local Taxes and Fees Act.

Projections concerning municipal spending in 2012 amount to BGN 3,696.0 million. By economic element, an increase from 2011 projections can be seen in appropriations for salaries – by BGN 51.8 million, social security and health benefit payments – by BGN 12.1 million, and other remuneration and payments - by BGN 5.2 million, and maintenance costs show an off-setting decrease of BGN 24.8 million, largely due to the change in in-kind indicators for budget function “Education”.

Projections for budget relations of municipalities in the draft 2012 budget show an off-set increase from the 2011 SBRBG Act of BGN 23.1 million, with in an increase of BGN 43.1 million in the subheading of the general subsidy for central government activities, and a decrease in the special subsidy for capital expenditure of BGN 20.0 million for environmental facilities, which is planned to be financed through EMEPA. In 2012, no increase is envisaged in the amounts of the general equalization subsidy, the transfer for winter maintenance and snow removal, and in the special subsidy for capital expenditure in accordance with the amounts of budget relations approved in Annex No. 5 of Decision No. 246 of the Council of Ministers of 15 April 2011 concerning the approval of budget projections for the period 2012-2014, adoption of spending ceilings for first-level spending units, excluding municipalities, for the period 2012-2014, and approval of the revision of the Sovereign Debt Management Strategy.

The draft 2012 budget plans BGN 1,834.7 million in appropriations for current expenditure under activities delegated by the state and funded through municipal budgets.

Projections for current expenditure of municipalities in 2012 for local activities amount to BGN 1,221.2 million. Envisaged expenditure for maintenance within local activities takes into account the forecast about own revenues and the amount of the equalization subsidy, with no increase planned for these spending items. Projections for those items reflects the expected developments in local activities and the provision of public services to the population by municipalities, including in the area of public works, maintenance of municipal infrastructure – roads, water supply and sewerage, street lighting, sanitation and maintaining green areas, etc.

The estimated capital expenditure of municipalities planned under

the consolidated programme for 2012 is BGN 640.1 million. This total amount is derived from the following sources of funds:

- BGN 70.2 million from special subsidies;
- BGN 569.9 million from own budget revenue, with an increase of BGN 1.9 million from the 2011 projection;

No funding for capital expenditure is planned to come from the source “Government-backed external loans”.

The envisaged capital expenditure provides for funding for activities delegated by the state and funded and for local activities. For activities delegated by the state, capital expenditure for 2012 amounts to BGN 17.0 million. For local activities, capital expenditure for 2012 amounts to BGN 623.1 million.

VIII. CONCLUSION

The parameters of the budget and the consolidated fiscal programme for 2012 presented in this report are a clear expression of the Government’s intentions to remain consistent in its policies and deal with challenges.

The 2012 Budget is not a vehicle of empty promises. It has been prepared in line with the vision of the Government that keeping focused on the set fiscal targets, building modern infrastructure and stressing on the development of regions, education and culture of the nation have a leading role in the creation of employment, economic growth and improving living standards.

The continuing financial and economic crisis increases the pressure on national budgets and requires adequate responses and decisions which sometimes are not met with unanimity by all. The global economy is undergoing considerable change in trade, investment, production, income levels and consumption which gradually become structural changes and will continue in the coming years as well.

In these times of dynamic change in the global and the European economy, Bulgaria needs firm resolve to follow the rules which have been institutionalized in the current fiscal year and the will to observe them strictly.

In the context of abiding by the fiscal rules, ensuring the successful and unhampered absorption of funding for the implementation of EU programmes is a particularly important instrument for economic development.

Pursuing a sustainable path of development of the various policies is a challenge which requires undertaking clear commitments and strong determination to achieve the desired results. The positive feedback of international financial institutions and observers confirm the assessment that the prudent fiscal policy direction taken by our country reduces financial risks, despite the high degree of uncertainty.

Performance results achieved in key macroeconomic and fiscal aggregates, and the surplus in the current account of the balance of payments, the limited levels of fiscal deficit and sovereign debt increase Bulgaria’s flexibility to market sensitivity. At the same time, the necessary measures are undertaken to create conditions for increasing productivity and speeding up convergence.

Through the 2012 Budget, the Government delivers on its commitment to push on with fiscal consolidation, maintaining the fiscal and budget aggregates at levels which make sure that the economy will steer clear of the vortex of the crisis, while maintaining the level of tax and social security burden and care for the most vulnerable social groups of the population.

Every budget is a vehicle for the collective morale, and it is hoped that its strength will remain, both during its discussion and adoption, and in the process of its execution. The 2012 Budget provides a real opportunity to achieve the goals and priorities coordinated with the European Commission, which are part of the documents of national importance adopted by the Government, through collective efforts and while retaining social justice.

IX. ANNEXES

1. Annex No. 1: The 2012 Budget, by responsibility
2. Annex No. 2a: Consolidated fiscal programme, by economic element
3. Annex No. 2b: Consolidated fiscal programme, expenditure by function
4. Annex No. 3: Draft budgets of the National Assembly, Council of Ministers, ministries and state agencies, first-level spending units, in programme format

PRIME MINISTER:

BOYKO BORISSOV