

MINISTRY OF FINANCE



Report on the Three-Year Budgetary Forecast for the Period 2007-2009

June 2006

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Introduction

This budget forecast for the period 2007 – 2009 encompasses the first years of Bulgaria's membership in the European Union. This is, also, the first medium-term budget forecast drawn up by the new coalition government. The level of fiscal parameters herein, as well as their structure, support the priorities outlined in the Government's Programme which envisages Bulgaria to become a country with a high standard of living based on a sustainable social and economic development. Expected EU funds give Bulgarian economy a good chance for a more rapid convergence of incomes and an increase of the potential for economic growth.

This report is drawn up in order to enable the members of the government to get familiar with the challenges to the medium-term budget policy at an earlier stage. The report aims to analyse and make a short review of the advisable measures and effects from the policy trends that are to be viewed in the light of existing challenges. Based on the approved macroeconomic and budget parameters, expenditure ceilings for first-level spending unit, including on a programme basis, as well as the annual state budget act will be developed during the next stage of the budget procedure.

The realisation of national priorities while maintaining a sustainable fiscal stance and preserving macroeconomic stability is the major challenge to the budget policy in the medium term. The implementation of programme budgeting will contribute to improving the effectiveness of budget expenditure whose level is limited to 40% of GDP. In parallel to that, there will be active work towards the development of economic mechanisms on sharing the responsibilities between the government and the private sector in the implementation of projects in the field of education, healthcare, development of IT society, road infrastructure, environment, etc.

The report starts with presenting the trends in the development of world and national economy. Part II is devoted to the budget framework for the period 2007 - 2009 by focusing on fiscal policy trends, challenges resulting from the country's accession to the EU, budget reform. The next part treats tax policy and budget revenues for the period 2007 – 2009. Part IV presents policy trends per expenditure item. Part V treats government debt and financing in the medium term.

I. ECONOMIC FRAMEWORK

1. Trends in the development of world economy

In 2004 world economy registered its highest growth since the early 1970s, thus consolidating its process of recovery. Growth rate exceeded 5%, and in 2005 world economy registered a growth of 4.8%, which was 0.5 percentage points higher than the forecasts. Some slow-down was observed in comparison to 2004 which was mainly due to the substantial increase of oil prices. For the period 2006-2009 world economy will be growing at relatively constant rates, i.e. an average 4.4% per annum. World trade dynamics is one of the major forces of growth with its volume increasing by 7.3% in 2005 compared to the expected 7% growth. In the following three years both world economy and world trade are expected to grow at slow speed and in 2009 will reach levels of 4.3% and 6.8% respectively. World economy growth slow-down in the period 2007- 2009 will be partly due to tightening the monetary policies in the main economic areas – the Euro area, the USA, Japan.

US economy slowed down its development in 2005. GDP growth diminished to 3.5% compared to 4.2% in 2004. One of the reasons therefore was the tightening of monetary policies in 2005 when the Federal Reserve increased the federal funds rate eight times in a row by 25 base points each. Thus, at the end of the year it reached 4.25%. In the period 2006-2009 GDP growth in the USA will continue slowing down by reaching 3.4% in 2009 both as a result of the slowing rates of domestic and external demand and as a result of the restrictive monetary policies that are expected to be pursued in the following years.

The economy of the Euro area also slowed down its development in 2005, with GDP growth dropping by 0.8 percentage points down to 1.3%, which was due to a decrease of private consumption and an increase of interest rates. In 2006 GDP growth of the Euro area is expected to accelerate to 2% and reach 2.3% in 2009.

In 2005 the growth of Japanese economy marked a trend towards stabilization by increasing by 2.7% compared to the expected 2% growth. Nevertheless, in the period 2006-2009 GDP will be slowing down its growth rates, with the figure for the period under consideration expected to reach 1.7%. This development will be mostly due to the sharper increase of the basic interest rates in the country as well as to an expected slow-down of the growth rate of private and public consumption.

Exchange rates, interest rates

The appreciation of the EUR compared to the USD, which started in 2002, slowed down. In 2005 1 EUR was exchanged for 1.2458 USD and its value increased by 0.2% only compared to 2004. Its slow rise compared the US currency was due to the political uncertainty in Europe after the vote of France and The Netherlands against the European Constitution. In 2006-2009 the EUR/USD exchange rate dynamics is expected to change its direction and at the end of the reviewed period 1 EUR is expected to be traded around 1.1890 USD.

In 2005 the European Central Bank (ECB) increased the level of the **basic interest rate** in the Euro area by 25 base points to 2.25%. The decision was aimed at adjustment of the monetary policy conducted to the existing risks for price stability. The substantial rise of oil prices led to an increase of the annual average inflation to 2.2% in 2005 which exceeded the targeted top limit of 2%. The decision of the ECB aimed to preserve the medium- and long-term inflation expectations in the Euro area at levels compatible with maintaining price stability. In March 2006 ECB increased the basic interest rate again – by 25 base points to 2.5%, since inflation

in the first quarter of the year had reached a level of about 2.3%, which was again incompatible with the price stability target. Inflation in the Euro area is expected to be within 1.6-2.6% in 2006 and within 1.4-2.6% in 2007 which, on its behalf, conditions the expectations for ECB to continue rising interest rates to levels of 2.8% in 2006, 3% in 2007, 3.2% in 2008 and 3.5% in 2009. Among the factors that might present a risk for price stability are the existing uncertainty in relation to oil prices, the transfer of a former rise of oil prices to consumers through the production chain, the possibility for secondary effects when setting up wages and indirect taxes, as well as further rise of administrative prices and indirect taxes. In addition, the expectations for depreciation of the European currency in the following four years is another reason for the forecasted increase of the basic interest rate in the Euro area.

In January, March and May 2006 the Federal Reserve raised again the federal funds rate to 5.0%. The decision was grounded by the still existing risks for pro-inflation pressures both due to the rise of oil prices and to the greater consumption of raw materials. Expectations are that the monetary policy of the Federal Reserve will continue to be restrictive, with interest rates being preserved around the current levels even in the period 2007-2009.

The gradual enhancement of the economic growth in Japan is expected to allow the Japanese Bank to start a smooth increase of the interest rates in the country which will reach to an average 0.9% in the period 2006-2009. These expectations are also based on the forecasts according to which after 2006 the deflation that has been witnessed in the country will ultimately turn into inflation.

Base raw materials and fuels

The prices of base raw materials in the last few years have risen as a result of the strong demand (those of metals mostly), as well as due to the irregular supplies. Their growth rate is expected to slow further down from 10.4% in 2005 to 3.2% in 2006, and in the period 2007-2009 they will be further decreasing. In 2005 metal prices rose by 26.4%, registering a slow-down of 9.7 percentage points compared to 2004. Their growth is expected to be positive in 2006 as well (7% on an annual basis) mostly due to the influence of the great demand on behalf of China as well as due to insufficient supplies. As early as end-2006 metal prices are expected to start falling down as a result of the greater loading of production capacities, the gradual accumulation of stocks and a slow-down of the demand growth by China. In the period 2007-2009, metal prices are expected to drop by an average 6.8%. For the same period, the prices of raw materials for food, wine and tobacco industries are expected to drop by an average annual 2.2%, while those of agricultural raw materials and materials by about 3.2%.

The **rise of oil prices**, which started at the beginning of 2005, continued throughout the whole year, with the price reaching USD 70/barrel in August and September. One of the reasons therefore was the insufficient extra processing capacity in order to meet demand in winter. This was further backed up by the uncertainty about oil product supply resulting from the Gulf war and the Katrina hurricane in the USA. The impact of the Katrina hurricane over crude oil prices was to a certain extent neutralized by releasing reserves as well as by the proposal of Saudi Arabia to increase production by 0.5 million barrels per day. In 2006 oil prices are expected to continue rising by 12.5% on an annual basis even at slowing rates and will remain at average levels of USD 60 per barrel, which will be mostly down to the problems in Nigeria, the expectations for imposing an embargo on and reduced supplies from Iran, as well as to reduced production by OPEC. In 2007 oil prices are expected to rise insignificantly by 1.3%, while in 2008-2009 their growth rates will be negative – an average 2.5%.

The trend of **natural gas** price development is similar. In 2005 prices grew by 42.4% on an annual basis, which was due to the changes in the pricing policy, and to Russia's supply policy respectively – Russia being major natural gas supplier to Europe. In 2006 prices are expected to continue rising, even though at slower rates (14.9%), while for the period 2007 – 2009 the development of oil prices will be valid for gas prices as well, i.e. an average reduction by 6.6%.

Fiscal policies of the leading economies

In 2004 the total budget deficit for EU member states improved by 0.4 percentage points compared to 2003 and reached 2.6% of GDP. The three-consecutive-year (2000-2003) trend of worsening for the Euro area countries slowed down and in 2004 budget deficit remained at the level of about 2.8% of GDP. Nevertheless, this indicator varies a lot per country. The table below presents data on the level of budget deficit/surplus and the government debt in selected EU member states taken from the EUROSTAT bulletin published in end-April.

	Budget deficit/surplus % of GDP				Government debt % of GDP			
	2002	2003	2004	2005	2002	2003	2004	2005
Germany	-3.7	-4.0	-3.7	-3.3	60.3	63.8	65.5	67.7
France	-3.2	-4.2	-3.7	-2.9	58.2	62.4	64.4	66.8
Italy	-2.9	-3.4	-3.4	-4.1	105.5	104.2	103.8	106.4
Greece	-4.9	-5.8	-6.9	-4.5	110.7	107.8	108.5	107.5
Great Britain	-1.6	-3.3	-3.3	-3.6	37.6	39.0	40.8	42.8
Austria	-0.5	-1.5	-1.1	-1.5	66.0	64.4	63.6	62.9
Ireland	-0.4	0.2	1.5	1.0	32.1	31.1	29.4	27.6
Slovenia	-2.7	-2.8	-2.3	-1.8	29.7	29.1	29.5	29.1
Hungary	-8.4	-6.4	-5.4	-6.1	55.0	56.7	57.1	58.4

At the beginning of 2006 Germany and Italy were still in excessive deficit procedure. Given the current policies are preserved, it will hardly drop below the advisable figure of 3% of GDP.

The total budget deficit in the Euro area is expected to grow in 2006, with the forecast being for around 2.7% of GDP (2.4% of GDP for 2005). The structural primary deficit, which is a fiscal policy trend indicator, remains stable – about 0.8% of GDP by 2007 inclusive.

From the EU member states that are outside the Euro area it was Great Britain and Hungary that were in excessive deficit procedure in 2005. At the beginning of 2006 only Great Britain was in excessive deficit procedure. Hungary expects its budget deficit to increase and in 2006 it might reach 7% of GDP. Unlike them, Cyprus, Slovakia and Malta are planning measures to improve their fiscal stance in the present year.

Labour output, investment and technology

In 2005 labour output in EU member states slowed its growth rate down to 0.8%. In the USA and Japan this indicator grew to 1.7 and 2.3% respectively. Comparison of the economic indicators of Europe with those of the USA and Japan shows that their production has been growing more rapidly and their investment in research and development is higher. Such a

trend in relation to labour output, investment and technology as percentage of GDP is expected to be preserved in the period 2006-2009 as well. According to the assessments in the Spring Forecast of the European Commission, labour output growth for EU member states will be 1.4 and 1.3% respectively in 2006 and 2007. The figures for the USA and Japan are expected to be 1.8 and 2.4% respectively for 2006, and 2.1 and 2.0% for 2007. Taking account of these unfavourable medium-term development trends, the European Commission adopted a revised Lisbon Strategy. It focuses on the fact that improvement of labour force qualifications, enhanced investment in research and development in both public and private sector, application of information and communication technology all over the economy, healthy competitive environment and finding the appropriate balance between regulation and competition are of utmost importance to production growth. According to the assessments of the European Commission, research and development costs in the EU will be growing in the next few years by 1% and will amount to 3% of GDP by 2010.

Table 1 Key macroeconomic indicators 2004-2007

	GDP Growth %				Inflation (HICP)				Current Account Deficit (% of GDP)			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
USA	4.2	3.5	3.4	3.3	2.7	3.4	3.2	2.5	-5.7	-6.4	-6.5	-6.5
Japan	2.3	2.7	2.8	2.1	—	-0.3	0.3	0.6	3.8	3.6	3.2	2.9
Euro area	2.1	1.3	2.0	1.9	2.1	2.2	2.1	2.2	0.8	—	-0.2	—
Baltic Republics												
Estonia	7.8	9.8	7.9	7.1	3.0	4.1	3.6	3.2	-12.7	-10.5	-10.1	-9.6
Latvia	8.5	10.2	9.0	7.0	6.3	6.7	6.4	5.5	-12.9	-12.5	-12.8	-12.0
Lithuania	7.0	7.3	6.5	6.0	1.2	2.6	3.2	2.7	-7.7	-7.5	-7.5	-7.3
Central Europe												
Czech Republic	4.7	6.0	5.5	4.5	2.8	1.8	2.8	3.0	-6.0	-2.1	-2.3	-2.3
Hungary	4.6	4.1	4.4	4.2	6.7	3.5	2.0	2.7	-8.8	-7.9	-8.2	-7.5
Poland	5.3	3.2	4.2	3.8	3.5	2.1	1.3	2.3	-4.1	-1.6	-2.5	-3.1
Slovakia	5.5	6.0	6.3	6.7	7.5	2.8	3.6	2.5	-3.5	-7.2	-6.4	-5.5
Slovenia	4.2	3.9	4.0	4.0	3.6	2.5	2.4	2.4	-2.1	-0.9	-0.3	0.1
South and South Eastern Europe												
Bulgaria ¹	5.7	5.5	5.3	5.8	6.2	5.0	7.7	4.4	-5.8	-11.8	-12.4	-11.8
Romania	8.4	4.1	5.2	5.6	11.9	9.0	7.9	4.8	-8.4	-8.7	-8.3	-8.1
Croatia	3.8	4.1	4.1	4.5	2.1	3.3	3.2	2.5	-5.6	-6.0	-5.9	-5.9
Malta	1.0	1.0	1.3	1.5	2.7	3.1	2.8	2.4	-10.4	-6.7	-6.5	-6.3

Source: IMF, World Economic Outlook, April 2006

¹ Data on Bulgaria has been updated by the Ministry of Finance.

2. Trends in the development of national economy

Economy development in 2006

The positive development witnessed in Bulgaria in recent years will be preserved in 2006 as well, with GDP growth expected to be around 5.3%. Unlike 2005, export dynamics is expected to be the base for growth. Investment in fixed capital is expected to grow by about 13% in 2006, while alteration of reserves will contribute negatively to investment growth following the substantial accumulation witnessed in 2005.

Household consumption is expected to slow down its growth to about 5% in 2006. The factors that will be exerting influence therefore are related to the measures taken by the BNB to restrict credit growth. The commitment to achieve budget surplus of 3% of GDP, partly through reduction of budget expenditure, will lead to a reduction of end-consumer expenses of the government in real terms. As a result of all these factors, end-consumption growth is expected to be a little over 5% in 2006.

In 2005 there was a relatively low rate of exporting goods and services mostly due to the weak third quarter. Its growth rate is expected to recover in 2006 due to an accelerated increase of tourism revenues and the increased export of base raw materials, as well as due to the high growth rate of investment commodities export. As a result of this, the exports of goods are expected to increase by 13.3% in real terms and those of services by 6.2%. This will lead to an improved contribution of net exports to GDP growth along with the slower import growth rate caused by the slower increase of domestic demand. The country's foreign trade dynamics will lead to deterioration of the current account deficit by 0.6% of GDP which is expected to be 12.4% of GDP for 2006.

A substantial increase of inflation is expected this year due to the higher excise duty rates for a number of products as well as due to the expected rise of electricity and heat prices.

In 2006 money supply will slow down its growth rate to 18.8% (23.9% in 2005). The main reasons for the slower growth of broad money are the expected reduction of the annual private sector credit growth to about 22.5% and the end-year budget surplus. Credit interest rates will remain around the levels reached in 2005, while they are expected to drop slightly in the following years. The reason for preserving those levels is the restricted lending, while the forthcoming drop will be due to the direct competition with foreign banks following the country's accession to the EU. As to deposit interest rates, no substantial changes are expected by the time of the country's joining the Euro area.

Economy development in 2007-2009

In the period 2007-2009 **GDP growth** is expected to increase and exceed 6% on an annual basis. The motivation behind such a scenario is based most of all on the effects of Bulgaria's accession to the EU in 2007.

Final **consumer costs** of households will continue growing at moderate rates, smaller than those of GDP. Factors therefore will be not only the higher incomes in economy but the direct payments under EU funds as well. The annual household consumption growth is forecasted at about 5%. Total consumption will slightly speed up its growth rate from 4.4% in 2007 to 5.5% in 2009. Investment is also expected to increase its share of GDP from 28.6% in 2006 to 31.0% in 2009.

For the period 2007-2009 the average annual **inflation** in the country is expected to drop to about 3-4%, since no significant adjustments of regulated prices are expected. Service prices are the ones expected to rise most on an annual basis. It should be noted that the price dynamics forecast for the period is made at the assumption that the Central Bank will maintain its monetary policy and there will not be increased liquidity in the economy as a result of reducing the mandatory reserves of commercial banks. Should they be changed according to EU requirements, for every 10% increase of the monetary M3 aggregate, inflation will go up by about 1.4 percentage points, according to expert assessments.

In 2007-2009 **enhanced exports** of goods and services are expected and this is grounded by the favourable development of the external environment, i.e. moderate rates of world economy and Bulgaria's joining the European Common Market, as well as by the improved competitiveness of Bulgarian economy due to the investment processes in the country and the funds of the Competitiveness Operational Programme and the Human Resource Development Operational Programme.

Increased aggregate demand caused by Bulgaria's accession to the EU will lead to higher imports of goods and services. Real import growth of goods and services is expected to be about 12% per annum. Trade deficit is expected to exceed 22% of GDP in 2009. Monies from EU funds will compensate part of this increase but will not improve the current account because of the different timing of incurring expenses and payments by the EU. Irrespective of this, the **current account** balance is expected to improve smoothly in the period under consideration and the deficit is expected to drop to 9.7% of GDP at the end of the period. These expectations are conditioned by both the import growth of services and the improved balance of the Services item. In the period 2007-2009 tourism revenues will be steadily increasing by an average annual 9-10% under the influence of the enhanced quality and variety of tourist services, as well as due to the stronger interest of European tourists in newly acceded countries.

Despite the fact that the current account deficit will remain relatively high during the period under consideration, it cannot be restricted by fiscal policy measures only. The budget exerts influence on the current account deficit through budget surpluses. Budget surplus increase by 1% of GDP leads to an improvement of the current account by about 0.5-0.6% of GDP. Having in mind the surpluses in 2004 and 2005, as well as the planned surplus of 3% in 2006, it is important that the stable fiscal stance be supported by the implementation of economic policy measures and the effect of structural reforms in a number of sectors as well. State and business are required to join their efforts to improve more substantially competitiveness of economy and labour output as a result of which export volumes will increase with trade

balance pressures eased. Structural reforms in public service sectors aim at greater effectiveness of budget expenditure and exploration of the means to optimize them.

There will be steady surpluses in the fiscal account in the period 2007-2009 which will cover entirely the current account deficit, with the coverage rate being around and over 1.4. In addition to foreign direct investment which forms the major part of current account financing, the inflow of capital also takes place in the form of increased lending for the private sector from abroad.

In 2005 **foreign direct investment** (FDI) reduced for the first time in the last three years (-34.4%). The main reason therefore was the lack of striking privatization deals with foreign participation. Unlike 2001, however, economic environment is currently more favourable for investment activities, which, together with the prospects of Bulgaria's forthcoming membership in the EU, will encourage foreign investment, including greenfield one. The 2006 forecast envisages a growth of non-privatisation revenues of 23% on an annual basis and an average 10% growth for the period 2007-2009. Since the privatization of enterprises key for the country has not yet ended, it is a potential source of additional inflow of foreign capital and has a stabilising function to this effect. Privatization revenues for 2006 are expected to amount to EUR 150 million.

As a result of the credit measures taken by the BNB in the previous year, **credit** growth rate is expected to slow down in 2006 to about 22.5% (32.4% in 2005), and in the next three years it will be rising smoothly up to 25% at the end of 2009. Expectations for higher credit growth in the period 2007-2009 are related to the greater competition commercial banks will face as well as to the easier access to free financial resources after the date of Bulgaria's accession to the EU.

Table 2 Key macroeconomic indicators 2004-2009

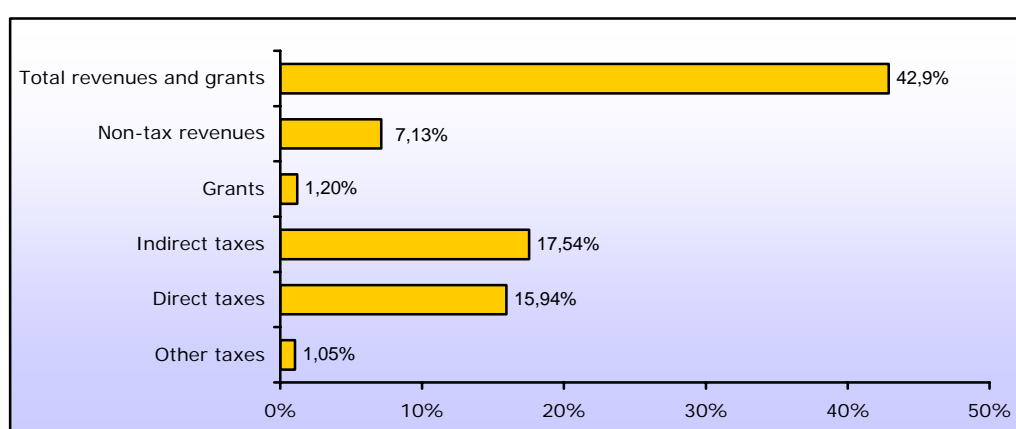
	2004 Report	2005 Report	2006 Expected	2007 Forecast	2008 Forecast	2009 Forecast
GDP – BGN M	38,275	41,948	46,620	51,043	55,565	60,567
- real growth (%)	5.7%	5.5%	5.3%	5.8%	6.2%	6.1%
Inflation (%)						
- end-year	4.0%	6.5%	6.9%	3.1%	2.8%	2.9%
- average for the period	6.2%	5.0%	7.7%	4.4%	2.8%	3.1%
Exchange rate (BGN/USD)	1.57	1.57	1.58	1.55	1.55	1.55
Current account						
- EUR M	- 1,131.4	- 2,530.6	-2,946.0	-3,066.9	-2,947.3	-3,003.5
- as % of GDP	-5.8%	-11.8%	-12.4%	-11.8%	-10.4%	-9.7%
Trade balance						
- EUR M	- 2,953.5	- 4,369.1	-5,084.2	- 5,725.1	- 6,261.6	- 6,900.0
- as % of GDP	-15.1%	-20.4%	-21.3%	-21.9%	-22.0%	-22.3%
Foreign direct investment (EUR M)						
- as % of GDP	2,727.5	1,789.0	2,350.5	2,708.6	3,009.5	3,097.4
	13.9%	8.3%	9.9%	10.4%	10.6%	10.0%

II. BUDGET FRAMEWORK

1. Budget execution in 2005

General government gross **revenues** collected in 2005 represent 42.9% of GDP. Last year there was significant overperformance of budget revenues mostly resulting from the high imports in the country and the sharp rise of oil prices, as well as from the improved collection of state receivables due to better operation of the customs and tax administration. Last year there were also substantial one-off revenues from sales of state and municipal property and state fees. Funding of budget expenditure was within the limits envisaged in the 2005 Republic of Bulgaria State Budget Act by taking account of the priority and periodicity of expenditure.

Chart 1 Structure of consolidated revenue for 2005 (as % of GDP)



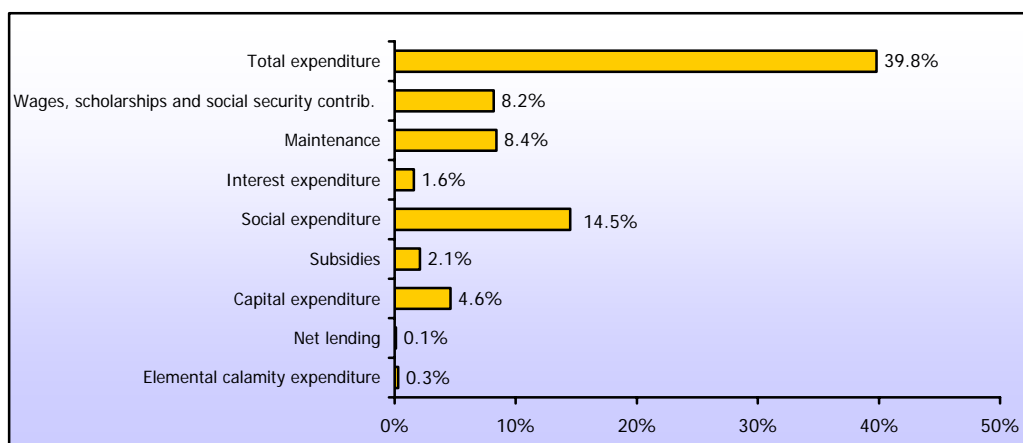
In recent years a large-scale tax reform has been launched aiming to achieve simplicity and sustainability of the tax system. The government strategy on providing incentives for the business and the private initiative has found expression in the consistent annual reduction of the main direct taxes and the transformation of the tax burden from direct to indirect taxes. Thus, in 2005 the business received a number of tax reliefs (the corporate tax was reduced from 19.5% to 15%, the tax on dividends dropped from 15% to 7%) aimed at stimulating investment and increasing incomes. The introduction of family taxation in Bulgaria was another step forward. There were also changes in the tax bracket of the personal income tax, with the non-taxable minimum being BGN 130 in 2005 and the tax rates for all income groups being reduced – by five points for the highest one, by four points for the monthly incomes from BGN 250 to BGN 600 and by two points for the remaining ones. In parallel to that, the amendments to the Excise Duty Act, oriented towards alignment of Bulgarian legislation with the acquis, provided for an increase of the excise duty for alcoholic beverages in 2005 as well as for a change in the structure of the excise duty rate for filter cigarettes.

The Consolidated Fiscal Programme **expenditure**² for 2005 represents 39.8% of GDP.

The basic groups of budget expenditure for 2005 as percentage of GDP are presented in the chart below.

² The Consolidated Fiscal Programme expenditure also includes net lending and acquisition of shares and stocks, as well as the expenditure of the Enterprise for Management of Environmental Protection Activities.

Chart 2 Structure of consolidated expenditure for 2005 (as % of GDP)



During the year, fiscal policy in relation to public expenditure was tight and flexible, taking account of the major risks to the country's macroeconomic stability which were mainly related to the current account deficit development. In this regard, in the second half of the year compensatory measures were taken to limit public expenditure, thus reducing the stimulating effect they had on final consumption. As a result of these measures and mostly through internal expenditure restructuring, the required resources for a number of priority and extraordinary spending for healthcare (to clear the greater part of the debt of hospitals), defence and security, education, overcoming the disastrous situation in the country after the floods, etc. were secured. Thus, a great part of budget revenue overperformance was saved, which led to a substantial budget surplus at the end of the year – 3.1%³ of GDP.

The consistent **external debt** management policy continued in 2005 as well by being reflected in the significant nominal reduction of its amount in the last two years on the one hand, and on the other, in the reduction of the costs related to debt service, i.e. interest payments dropped by 0.5 percentage points as a relative share of GDP compared to 2003. In parallel to that, a very high level of fiscal reserve was achieved providing stability for the economy and protection against potential risks for budget execution in the current year.

Fiscal reserve by 31.12.2005, calculated on the basis of programme exchange rates⁴, was BGN 4,511.6 million, thus guaranteeing stability for the economy and protection against potential risks for budget execution in the current year.

2. Fiscal policy – prerequisites and trends

2.1. 2006 Budget policy

During the first year of its term of office, the government incorporated into the budget policies that continue the implementation of the priorities for an accelerated progress of Bulgaria in the process of social and economic cohesion and integration of the country's economy into the European Common Market. The 2006 Budget meets the ambitions for an

³ For the purposes of the IMF programme, the surplus is adjusted as a result of a reclassification of the financing part on the expenditure side of net lending (excluding that to final beneficiaries under GIL) and the acquisition of shares and stocks, as well as by including the costs incurred by Public Investment Projects EAD and the net change of budget sector arrears, thus amounting to 2.3 % of GDP.

⁴The balance of foreign exchange accounts in BGN for 2005 is calculated on the basis of the exchange rates valid for 31.12.2004, the so-called programme exchange rates, in order to compare the data for the separate periods of the year.

economic development catching up with that of the European Union, an increase of incomes and cohesion of the quality of life with that of European citizens, with objective economic reality and opportunities for the state to provide financing for the budget sectors. These objectives are pursued by preserving the macroeconomic stability and fiscal sustainability and by striving to counteract the widening current account deficit.

The 2006 Budget reflects the continuity of the economic and budget policy carried out so far by laying emphasis on:

- ⇒ preserving macroeconomic stability and creating prerequisites for a sustainable economic growth;
- ⇒ preparing the country for EU membership;
- ⇒ increasing social responsibility;
- ⇒ overcoming the consequences from natural disasters in Bulgaria since the summer of 2005.

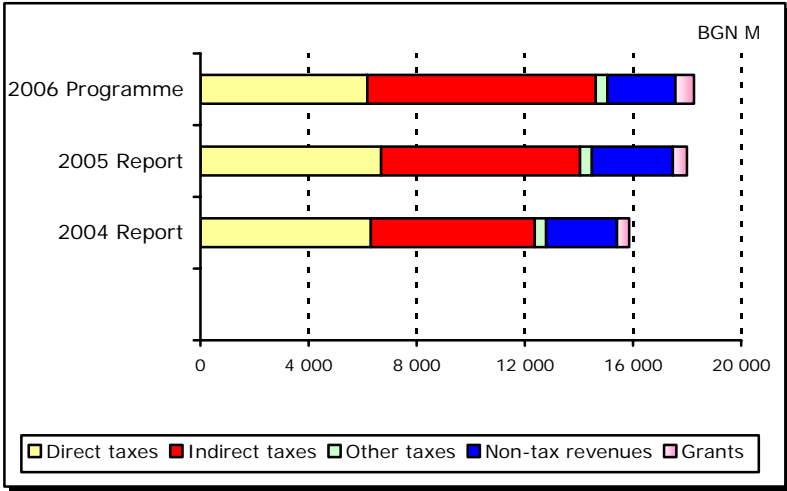
The programme measures and policies envisaged in the budget provide for Bulgaria's strengthening its position as an attractive place for foreign investment. The selected fiscal stance also helps maintain a stable and foreseeable macroeconomic environment. The 2006 Budget is the first budget since the start of transition which sets a zero budget deficit at the level of planning. The balanced budget is consistent with the record-high current account deficit, thus countering the trend of outstripping growth of domestic demand, helping to reduce the government debt level and enhancing financial discipline and stability of public finance.

The 2006 Budget envisages for real GDP growth in Bulgaria to reach 5.5%. The factors conditioning the relatively high growth of economy are investment and export growth. Investment is planned to grow quicker than GDP growth and its share of GDP is expected to reach 28.6% by 2006.

The main goal of tax policy for 2006 continues to be the achievement of a sustainable economic growth and stable economy, implementation of measures that stimulate the investment process and reduction of the direct tax and social security burden. The reduction of the social security burden by 6% since the start of the year from 29% to 23% follows this line as well. The ratio of employer/employee contributions has also been changed from 70/30 for 2005 to 65/35 for 2006 which, along with the reduced social security burden, is particularly favourable for Bulgarian business. Those more than BGN 600 million are a prerequisite for an increase of corporate investment, enhanced competitiveness of domestic production and services, further coming into light of remunerations and real increase of disposable incomes.

As to personal taxation for 2006, a new scale has been approved. The non-taxable minimum of BGN 130 in 2005 has been increased to BGN 180 for 2006 and in parallel to that, the scale has been reduced to a three-bracket one with maximum tax rate of 24%. As a result, about BGN 200 million less will be levied on household budgets.

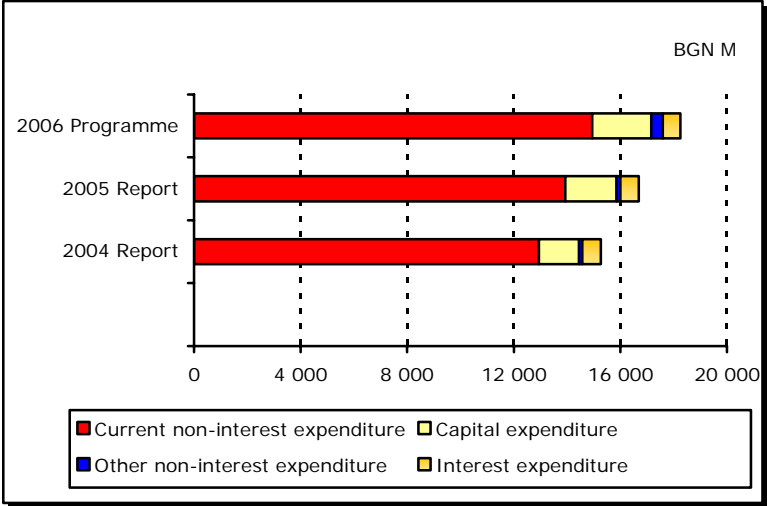
Chart 3 General government revenue for the period 2004-2006



Source: MoF

Expenditure policy is the main and substantial part of the economic policy of the government. This policy mainly aims at improving the systems for strategic planning and control of public expenditure, identification and binding thereof with specific programmes and results in order to improve economic benefits, effectiveness of expenditure and efficient management and allocation thereof. The leading principles are adherence to budget limitations by all public sector subjects and effective control of the targeted, expedient and economical spending of budget resources.

Chart 4 General government expenditure for the period 2004-2006



Source: MoF

In 2006 government expenditure will be structured depending on government priorities, with their overall level being limited to 40% of GDP. Substantial public funds will be allocated for financing activities related to European integration, overcoming the impact of floods and the social sphere.

Capital expenditure growth for 2006 compared to the 2005 programme will amount to BGN 542.6 million or almost 1.2% of GDP. Funds are allocated with the increased role of PHARE, ISPA and SAPARD funds. Large infrastructure projects such as Transit Roads III, the electrification of the Plovdiv-Svilengrad railway, the extension of Sofia Airport, Danube Bridge 2, regional depots for waste and waste water treatment plants will continue to be implemented in 2006. The amount of the funds our country will absorb from external investment credits under already concluded agreements has been increased

The 2006 Budget secures financially the continuation of reforms in the education and healthcare sectors by substantial nominal growth of budget expenditure for these sectors compared to 2005. Budget resources envisaged for healthcare amount to BGN 2,002.4 million for 2006 (4.4% of GDP), which is by BGN 223.5 million or 12.6% above those in the 2005 programme. An approach has been taken with the National Health Insurance Fund being the only source of funding hospitals, while the budget of the Ministry of Health will be funding national priority programmes, emergency health care, as well as all the remaining activities related to public healthcare.

Consolidated expenditure for education for 2006 amounts to BGN 1,907.8 million (4.2% of GDP), which is a growth of BGN 109.8 million or 6.1% more than the funds for education under the 2005 programme. These funds will be mostly targeted at improvement of equipment and optimization of structures in compliance with the economic and demographic factors of the country, as well as at enhancing the quality of education and facilitating the equal access to high schools and universities.

After the planned optimization of the public administration by up to 10 per cent, budget sector salaries will be raised by an average 6% as from 1 July 2006. An exception was made for the salaries of the people employed in the education sector which were increased by 4% as from 1 January and will be raised once more pursuant to § 93 of the 2006 Republic of Bulgaria State Budget Act.

Since the start of the year the minimum wage has been raised to BGN 160, and pensions have been updated by 5% at using a differentiated approach to the lower ones. A state investment fund is envisaged to be established in order to support financially the first pillar of the pension system.

An updated government debt management strategy is under way and is aimed at further reduction of the debt burden. Such management will contribute to reducing the risks for the budget when servicing debt. External financing adequate to priorities and needs has been ensured.

2.2. Long-term sustainability of public finance

Effective management and sustainability of public finance is a necessary condition for maintaining the country's macroeconomic stability. In order to provide a solid base of public finance, the long-term trends in government revenue and expenditure, transfers and funding are analysed and forecasted. It is only at a sound level of fiscal discipline that the government is able to direct its efforts towards effective allocation of resources that leads to growth and employment in the light of the Lisbon Strategy. The topic of sustainability and quality of public finance has found place in the latest Broad Economic Policy Guidelines for the period 2005-2008 as well as in the reviewed Stability and Growth Pact. The European Council has laid further emphasis by the Key Issues Paper, 2006.

2.2.1. Sustainability in response to demographic challenges

As to maintaining fiscal stability in the long run, demographic challenges exert strong pressure on the status of public finance, thus influencing the potential GDP growth. Potential economic growth is of crucial importance when making long-term analyses for it determines not only the average rate that may be maintained, without having inflation pressures caused by supply, but the possibilities for creation of employment, generating income and wealth as well. That is why, ensuring long-term stability of public finance through implementation of the reforms aimed at expenditure optimization and restructuring will remain among government priorities in the future as well.

It is a great challenge to make economic forecasts and take decisions thereon in the conditions of high total death-rate, sharply decreased birth-rate in recent years in our country, as well as long-term ageing of the population.

The critical demographic processes influence particularly the stability of the present social security and health insurance systems as well as labour market. Deteriorated demographic characteristics impose heavier social burden on maintaining pension-age population.

The key reason for the adverse impact over the social security and health insurance systems and market labour, however, is not the usual demographic pressure (elderly people/total population ratio), but rather the economic sustainability index, i.e. the elderly people/really employed ratio. It should be pointed out in this relation that the main feature of labour market is the relatively low level of employment and the short usage of potential labour force. This is a shortcoming and source of social expenditure in the short run but at the same time shows great potential for growth in the medium term, since labour force is a production factor as well. That is why, the need for long-term working on the achievement of an optimum population balance with emphasis on human capital comes to the fore in order to maintain sustainable public finance.

The ageing population trend in the country affects strongly the sustainability of public finance by exerting influence on the state budget through increasing the spending for pensions, healthcare and social care for ageing population. These assumptions have been made at preserving the existing policy. Analysis therefore shows that appropriate policy measures are urgently to be developed in order to address the challenges.

Budget consequences

It is extremely important to emphasize that budget consequences are related mostly to demographic pressures on the expenses for pensions and healthcare. According to the ageing population scenario elaborated by the EU for the period 2000-2050, it is assumed that public expenditure will not be increased by factors unrelated to age (for instance, the requirements for being eligible for such funds, level of compensation, amount-rising factors related to providing healthcare, etc) which have until recently caused almost 60% of this increase.

Pensions

In the absence of any corrective measures whatsoever, the age-related pressures on pension expenses will probably lead to progressive increase of government expenditure.

Pension system sustainability research has shown that while in 2005 NSSI's deficit to cover pension expenses was to the amount of 1-1.5 pensions for the system (for example, 12th pension), this deficit already amounts to 4 pensions in 2006 due to the drop of social security contributions. The possibility for NSSI to cover the expenses required for pensions by the

respective revenue collected should be considered here. This means that while in 2005 the pension system was relative sustainable, pressures on the budget are to be expected in the future, since more state transfers will be needed to cover the shortage.

Likewise, it is only the amendments to Article 100 of the Social Security Code⁴ (according to which the indexation percentage of pensions granted by 31 December of the previous year is updated annually as from 1 January by being equal to the sum total of 50 per cent of the growth of the social security income and 50 per cent of the consumer price index growth for the previous calendar year) and the additional impact factors that will lead to increasing pension spending for 2007 by over BGN 400 million. In this regard, the current budget forecast proposes an amendment to the Social Security Code in the part relating thereto as well as an update of pensions as from 1 June instead of 1 January of the respective year. For 2007 this will mean BGN 213 million more compared to 2006.

Social protection and care

Ageing of the population will affect social protection and care expenditure most of all. Although the total amount of this type of expenditure as a share of GDP is lower than that for healthcare, the real cost unit for rendering help or taking care of someone is extremely high.

Healthcare

The studied demographic changes would increase healthcare expenses by about 1-1.5% of GDP for the period until 2050. What has been valuable in this model is that it also includes non-demographic factors. Results show that these factors are as important as the demographic ones. The forecast demonstrates more precisely that changes in the health status of elderly citizens will influence significantly healthcare system expenditure. These results, however, are very sensitive to the variations of demand elasticity to incomes. They also show the importance of the factors related to providing health services such as better care, effective management and new technology. Rethinking of the healthcare model is required.

Education

Reduction of school-age population may lead to the conclusion that education expenses should gradually generate reserves in the long run, other things being equal.

The results from the research of these expenses in EU member states are extremely interesting. They show that, other things being equal, due to the demographic crisis, in almost all EU member states there will be a substantial drop of education spending and great opportunities for saving public funds in the next 50 years. Even in case of a possible pursuing of policies related to improving people's qualities and expertise, education expenditure will not be increasing by a rate comparable to that of pension and healthcare expenses.

Finally, in order to maintain sustainable public finance, it is necessary to outline and implement an overall strategic policy including comprehensive measures not only in the field of fiscal policies but in the field of economic and social policies as well. In this regard, the role of the state as coordinator and regulator by mostly using the tools of social, educational and health policies is of utmost importance. The results obtained show clearly that there is a limited yet quickly diminishing opportunity for undertaking adequate political actions to avoid the effects of the strongly deteriorated demographic trends. In the absence of **decisive**

⁴ State Gazette, issue 104 of 27.12.2005

balancing measures, the ageing population will stop potential economy growth as a whole and employment in particular, thus leading to increasing government expenditure in both medium term and long term as well.

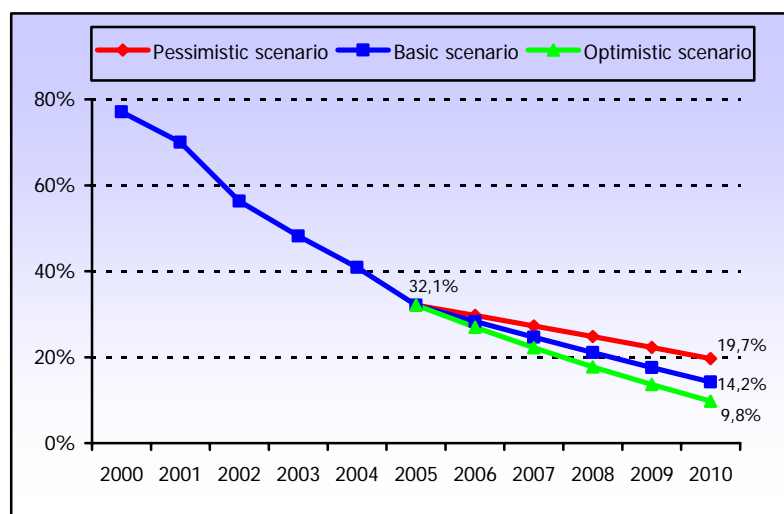
2.2.2. Sustainability of public finance and relation to government debt

Fiscal policy sustainability is linked to debt sustainability. The issue addressed by the debt sustainability analysis is whether the budget policy implemented would not worsen the government's capacity to service its debt (government paying capacity), with fiscal sustainability requiring that the "government paying capacity" be achieved at an unalterable fiscal policy. In this regard, analysis shows whether a change of budget policy is needed.

The sustainability analysis of the current fiscal policy in relation to debt is based on the average data of the indicators for the last 6 years used and includes:

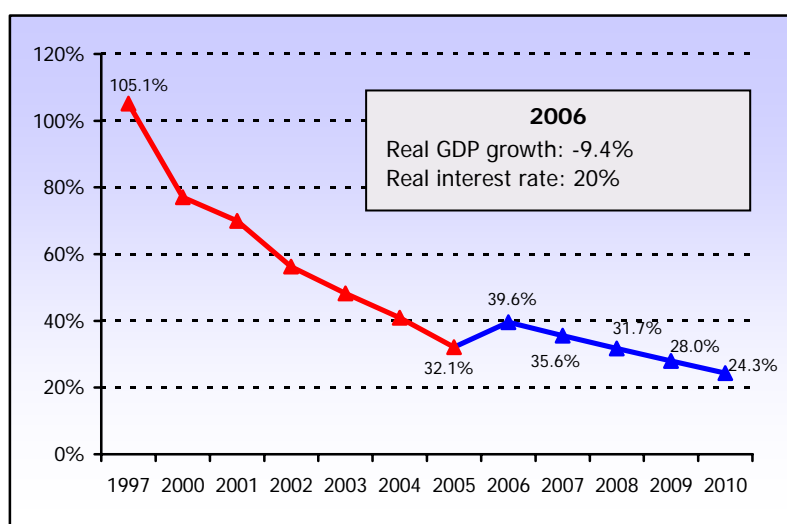
- ✓ assessment of the primary balance level needed to maintain debt at a permanent level. It has been found out that in order to maintain debt at the 2005 level, primary deficit should not exceed -0.9% of GDP;
- ✓ assessment of the primary balance level needed to achieve a targeted debt level (10 percentage points lower) in 2010. Analysis shows that primary surplus should not be lower than 1.2% of GDP during the period 2006-2010;
- ✓ assessment of the debt level at preserving the average level indicators for the last 6 years – **basic scenario**;
- ✓ assessment of the debt level by 2010 at improving macroeconomic indicators (+ 1.5 percentage points real GDP growth and a -3 percentage point reduction of the real interest rate) and preserving fiscal policies (primary surplus level) – **optimistic scenario**;
- ✓ assessment of the debt level upon worsening of macroeconomic indicators (a - 1.5 percentage point real GDP drop and a +3 percentage point increase of the real interest rate) and preserving fiscal policies (primary surplus level) – **pessimistic scenario**.
- ✓ stress test – analyzing debt sustainability in case of an economic crisis (assuming that the average level of primary balance for the last 6 years is preserved with a real GDP drop by 9.4% and a real interest rate of 20% in 2006, following which macroeconomic indicators reach again the average level of the last 6 years).

Chart 5 Government debt development scenarios for the period 2006-2010 as % of GDP



The results have shown that the fiscal policy carried out by Bulgaria since 1997, which has been aimed at fiscal sustainability and reaching budget balance and high primary surplus, has led to a more than 3-time reduction of government and government-guaranteed debt as well as to fiscal sustainability, i.e. Bulgaria may service both its domestic and external debt without any problems whatsoever. The stress test has shown that even in the case of an economic crisis, if Bulgaria continues the fiscal policy carried out thus far, it would not face difficulties in servicing its debt and up to 3 years after the crisis debt level would be recovered to the initial pre-crisis level and would continue dropping in the following years.

Chart 6 Stress test on government debt development as % of GDP



2.2.3. Sustainability of public finance in relation to the economic cycle

Fiscal policy influences economy by means of the budget balance level. The optimum use of this tool, however, is very difficult due to the inability to assess its qualitative effect accurately enough. Furthermore, the budget balance level is determined by political considerations as well which often collide with the economic situation. That is why, budget

balance is strictly monitored by the European Commission and according to the Maastricht criteria there may not be deficit higher than 3% of GDP. The Stability and Growth Pact recommends abiding by certain rules in carrying out fiscal policies to prevent a possible excessive deficit.

The gist of those rules is to maintain an counter-cycle fiscal policy characterized by restrictiveness in periods of economic growth so as not to stimulate economy too much, and vice-versa – expansiveness in periods of recession. The European Commission uses structural deficit as an indicator for the fiscal policy trend – restrictive or expansive. Structural deficit is an indicator that only takes account of the policy behind the budget balance generated by eliminating other economic factors that influence its level. Thus, for instance, in periods of economic growth income would rise by leading to relatively higher budget revenue than if the economy was in recession. From expenditure point of view, budget would save from unemployment benefits when an economy grows and new jobs positions are generated.

In general, in the absence of any government policy whatsoever, budget balance would vary again depending on the economic cycle stage – either expansion or recession. The economic cycle stage, on the other hand, is assessed on the basis of the difference between the GDP monitored and its theoretical potential level which depends on the accumulated capital and the labour force in economy, as well as on other factors such as technological development, labour force education, etc.

The methodology used to calculate the structural deficit divides the budget balance into a cyclical component, which takes account of economy impact, and a structural component that takes account of the policy pursued. Respectively, the change in the structural component (cyclically-adjusted budget balance) corresponds to the specific set of fiscal measures implemented by the government.

The requirement of the European Commission for non-admission of a pro-cyclical policy consists in raising the structural surplus (reducing the structural deficit respectively) in periods of economic expansion and vice-versa – reducing the structural surplus (raising the structural deficit respectively) in periods of recession.

Table 3 *Budget, cyclical and cyclically-adjusted budget balance for the period 2003-2009*

(% of GDP)	2003	2004	2005	2006	2007	2008	2009
Budget balance without variations	0.00%	2.10%	1.80%	3.02%	1.99%	1.50%	0.99%
Cyclical balance	-0.31%	-0.12%	0.08%	0.12%	0.04%	-0.04%	-0.08%
Cyclically-adjusted budget balance	0.31%	2.22%	1.72%	2.90%	1.95%	1.54%	1.07%

Estimates and projections for the period 2004-2009 show that the economy exceeds its potential in the period 2004-2006, by dropping below afterwards due to a high potential growth after the country's accession to the EU. This assessment of the cyclical stance of economy gives reasons to maintain a restrictive surplus under the 2006 consolidated programme in order to avoid a pro-cyclical fiscal policy that would worsen the imbalance between aggregate demand and supply in economy. The relative ease of expected overheating of the economy in 2007 and the drop of GDP level below the potential in 2008 and 2009 give a chance to carry out a relatively less yet restrictive budget policy. From this point of view, the expected relative deterioration of the fiscal stance (see table above) resulting from pressures on public finance after the country's accession to the EU as from the beginning of 2007 will not contradict the economy's cyclical development. Nevertheless, no deficit under

the consolidated budget programme should be allowed, since that would be a substantial adjustment compared to the surplus of 3.1% of GDP for 2005 and the expected surplus of 3% of GDP for 2006.

A significant ease of the fiscal stance in this period would give an excessive impetus to domestic demand and would exert inflation pressure in a time when the country would have to comply with the Maastricht inflation criteria so as to be able to apply for membership in the Euro area as from the start of 2009. Maintaining structural surplus is required from the point of view of the widening current account deficit. The reviews announced by the BNB show that this deficit has been increasing from 5.8% in 2004 to 11.8% in 2005 with new unfavourable trends at the start of 2006.

Everything mentioned thus far demonstrates that, with respect to the budget balance it is difficult to implement significant fiscal impulses or restrictions to the economy. In other words, budget surplus is to be maintained at levels of 1-3 % of GDP for the period 2006-2009.⁵ As a result, the short-term economic growth for the period 2006-2009 should remain as projected: 2006 – 5.3%, 2007 – 5.8%, 2008 – 6.2%, 2009 – 6.1%. The lack of change in the budget balance would mean a lack of change in the price level due to maintaining the aggregate demand. Therefore, changes in tax policy would result in reallocation of GDP between the public and the private sector. For instance, tax increase would lead to raising tax revenue, hence increasing expenditure, given the budget balance already established. As a result, public consumption and investment would increase at the expense of the share of private investment household consumption. Higher company taxation would lead to reduced private investment mostly, while higher household taxation would lead to reduced private consumption. The level of reduction would correspond to the size of tax changes chosen. Obviously, the possible reduction of taxes would change the effects in the opposite direction. The choice of tax policy is to be linked to the possible political implications of its implementation as well.

Maintaining fiscal discipline has proven its effectiveness in the past years and this will make it necessary to continue doing this in the future as well. Maintaining medium-term fiscal stability for the period 2007-2009 is based on the pursue of a policy aimed at a close-to-balance budget or surplus.

Sustainability of public finance to the challenges related to the country's accession to the EU, due to their significance, are reviewed in a separate chapter.

2.2.4. Challenges resulting from our EU accession⁶

Even though our EU membership is still threatened to be delayed by a year, the strategy on effective absorption of EU funds and restructuring of expenditure is one of the most important issues to budget policy. This three-year budget forecast takes account of financial flows under the Structural Funds and the Cohesion Fund as well as the Common Agricultural Policy funds.

Real convergence

Despite the high and sustainable economic growth marked in Bulgaria in recent years, real convergence of income and labour output are yet to occur, at that not in the short run.

⁵ Analysis excludes an appraisal of the general government balance as well as that of the BNB, which would require additional reserves due to the specifics of the currency board arrangement within the country.

⁶ Elaborates on information on the Three-Year Budget Forecast for the period 2006-2008 that is already published

Continuation of structural reforms, institutional building, improving the business climate and reducing the share of grey economy in the country in particular, becomes of crucial importance to this process. Maintaining the positive economic dynamics that will lead to real convergence inevitably includes high rate of investment, greater production and improving labour market conditions. One can also include here the commitments undertaken by the country to implement *acquis communautaire*. Bulgaria will apply EU standards in all areas of Community law, with transition periods being negotiated in some fields. Meeting the criteria in some areas like environment, for instance, requires solid investment in infrastructure, human capital and equipment, with national co-financing (private or public) needed to be added to the expected resources under the Structural Funds after 2007 in order to implement the projects successfully. On the other hand, some of the regulations affect the private sector directly through higher production standards.

Substantial improvement of the effectiveness of the judiciary, mostly through acceleration of procedures and implementation of existing legislation, is required for the development of the business environment in Bulgaria. The conditions for setting up business as well as falling out of market should also be improved in order to ensure operative market mechanisms. Reforms related to privatization and enhancing the effectiveness of energy and railway transport are a necessary condition for the participation of these sectors in the internal EU market.

Just like the other SEE countries, Bulgarian economy lags behind in the transition to knowledge-based economy. This raises the question as to how our economy will place itself on the internal Community market. Given the respective low levels of investment in research and development and information technology, it is probable that the economy falls behind in this process while productivity grows at unsatisfactory rates. In this sense, the promotion of high-technology greenfield FDI, which is not conditioned to such an extent by the current production structure as privatization-related investment, will speed up the transition to knowledge-based economy.

Structural reforms, whose implementation is facilitated by the continuing economic development, contribute to greater competitiveness and support the country's growth thus contributing to the improvement of the standard of living and the generation of new job positions.

Sound public finance is a prerequisite for sustainable growth. In this regard, improving the structure and efficiency of public finance should come to the fore. The recommendations of the European Commission in the Broad Economic Policy Guidelines will remain valid. The 2006 Key Issues Paper of the European Council lays emphasis on the fact that the increase of employment remains one of the major reform priorities followed by the measures targeted at establishment of favourable business environment, including SMEs, provision of proper incentives for innovation and pursuit of a consistent energy policy.

Box 1: Recommendations of the European Commission with regard to the Broad Economic Policy Guidelines for the period 2005-2008

The European Commission proposes the following Integrated guidelines for growth and jobs:

Macroeconomic guidelines:

1. To secure economic stability
2. To safeguard economic sustainability
3. To promote an efficient allocation of resources
4. To promote greater coherence between macroeconomic and structural policies
5. To ensure that wage developments contribute to macroeconomic stability and growth
6. To contribute to a dynamic and well-functioning EMU

Microeconomic guidelines:

1. To extend and deepen the internal market
2. To ensure open and competitive markets
3. To create a more attractive business environment
4. To promote a more entrepreneurial culture and create a supportive environment for SMEs
5. To expand and improve European infrastructure and complete agreed priority cross-border projects
6. To increase and improve investment in R&D
7. To facilitate innovation and the take-up of ICT
8. To encourage the sustainable use of resources and strengthen the synergies between environmental protection and growth
9. To contribute to a strong industrial base

Employment guidelines:

1. To implement employment policies aimed at achieving full employment, improving quality and productivity at work, and strengthening social and territorial cohesion
2. To promote a lifecycle approach to work
3. To ensure inclusive labour markets for job-seekers and disadvantaged people
4. To improve matching of labour market needs
5. To promote flexibility combined with employment security and reduce labour market segmentation
6. To ensure employment-friendly wage and other labour cost developments
7. To expand and improve investment in human capital
8. To adapt education and training systems in response to new competence requirements.

Impact on economy and budget⁷

According to the proposal of the European Commission of 2004, the total aid Bulgaria will receive for the first three years of its EU membership (2007-2009), compared to the size of the respective economy, is significantly greater than that for the ten new EU member states and is compatible to that for Romania as a whole. Given a relatively high and rational utilization of those funds, a tangible positive effect on the country's economic development is expected.

On the one hand, European Structural Funds, which aim to support the convergence of income, provide the government with a unique opportunity to improve the standard of living, if wisely utilized. On the other hand, the size of expected flows and the rational use thereof are a challenge in themselves.

First and foremost, two things should be considered from macroeconomic point of view. These new financial flows will generate greater demand on the internal market. In the long run, if invested with high rate of return in infrastructure and human capital, they will bring the potential for a serious contribution to the economic growth on behalf of the supply. On the other hand, however, experience has shown that if unwisely used, those resources might have

⁷ The World Bank Report on Public Finance Policy Review: Using EU Funds for Achieving Higher Productivity and Economic Growth (PFPR) has been cited.

a short-term positive effect on economy on behalf of the demand, while in the long run they could lead to real appreciation of currency and reduced competitiveness, aid-dependence and underestimation of the efforts towards management improvement. That is why, it is important to support the strategy on expenditure restructuring and public sector limiting to about 40% of GDP. It has been proved that funds are most effective when invested in sizeable and well-defined strategic programmes.

The inclusion of financial flows from/to the EU will influence the sustainability of the country's fiscal stance, with having to report a gradual increase of EU Structural Fund resources absorbed for the period after 2007. Structural Fund resources affect directly the economic activities in the country by exerting influence through the government sector. On the one hand, a significant grow of government expenses might be expected due to the fact that part of the funds spent under the operational programmes is classified as consumption as well as due to the assumption that co-financing of projects under the Structural Funds will not be at the expense of limiting final consumption of the government. This hypothesis in itself presupposes a deterioration of the budget balance by around 1% of GDP.

On the other hand, there is difference in the timing of incurring costs and receiving payments for activities funded by the EU Structural Funds. It should be considered that for the purposes of budget procedure real cash flows from the EU to the member state should be used and not funds eligible for contracting. Although according to EUROSTAT requirements the funds are classified as expenditure for the budget in the year of payments, these funds will be accounted in national accounts as ones for consumption and investment in the year of incurring them. For the period 2007-2009 these funds, along with budget balance deterioration due to project co-financing, will appear as fiscal expansion that will stimulate GDP growth.

It is important to direct financial flows towards areas where a long-term positive effect on productivity and economic growth could be achieved.

In order to absorb EU funds, **budget restructuring** has been selected. This means real structural measures on the reduction of expenditure in areas that do not receive EU funds totalling 1-2% of GDP. This option may be realized only through rationalization of expenditure on public administration, defence, internal affairs and security, healthcare, social assistance, real sector subsidies. On the other hand, there will be four main beneficiary sectors – accelerated capacity building of labour force (increasing labour productivity), agriculture, development of infrastructure and environment. This option takes account of the recommendations of the Ministry of Finance to introduce a strategic horizontal priority in order to reduce the current/capital expenditure ratio.

The revenue side should take account of two opposite effects. First, the excise duty rates will be gradually increased until they reach the minimum levels for EU member states, thus leading to an annual growth of indirect tax revenue. Similar effect has already been witnessed in recent years in Bulgaria. Another option is possible as well, where the new member states launch into competition to reduce the tax burden, especially of corporate taxation. It is more probable that the first option prevails and as a result of this tax revenue will increase.

Financial flows

The contributions Bulgaria will pay into the EU budget will be calculated on the basis of:

- ⇒ GNI data;
- ⇒ information on VAT and customs duty base and revenues;

- ⇒ projected data on revenue from sugar and glucose production fees;
- ⇒ working data by the European Commission on traditional own resources.

The forecast has been made on the basis of existing own resource acquis, by taking account of the required new VAT resource rate. It is possible to amend the Council Decision on the system of the European Communities' own resources which will become effective as from 1 January 2007. The European Union is to discuss the proposal for this amendment as well as that of the Commission's Draft document thereto on the calculation, financing, payment and accounting the budget inequality adjustment in favour of Great Britain into the budget.

Table 4 *Projected payment of the Republic of Bulgaria into the EU budget*

OR payments	2007		2008		2009	
	BGN M	EUR M	BGN M	EUR M	BGN M	EUR M
Total net TOR	132	67	149	76	170	87
VAT-based resource	33	17	23	12	16	8
GNI-based resource	420	215	469	240	479	245
Reserve	2	1	2	1	2	1
Adjustment Great Britain	41	21	51	26	65	33
Total OR	628	321	695	355	731	374
% of GDP	1.2%		1.3%		1.2%	
% of GNI	1.3%		1.3%		1.3%	

The funds we expect to receive are directed in four main areas:

- Agriculture
- Structural actions
- Internal policies and administration
- Budget compensations

The Community's financial framework differentiates between EU budget commitment appropriations and payment appropriations. The former represent a legal commitment of the Community the fulfilment of which may spread out in the next couple of years, while the latter may cover expenses related to commitments of the current or the previous years. From economic point of view, payments are more important to beneficiaries. That is why, projections of actual payments become of such crucial importance.

In the first years the strongest divergence is expected between the EU commitment appropriations to our country and the payment appropriations, which takes account of the gradual absorption of EU funds. This peculiarity, combined with fulfilling the conditions for full payment into the EU budget right from the first year of membership, will provide for budget difficulties and a slower positive effect of the membership. One should consider the fact, however, that in the first years after 2007 part of the pre-accession programmes will be still operating and further EU budget payments are to be expected respectively. The closure of pre-accession projects is expected to coincide with an increase of EU payment appropriations which will favour the smooth transition from pre-accession funding to absorbing monies from EU funds.

Table 5 *Financial package for Bulgaria for 2007-2009 (EUR M, 2004 prices)*

	2007	2008	2009	Total
Commitment appropriations				
Agriculture	315	573	673	1,562
Structural actions	539	759	1,002	2,300
Internal policies	168	166	164	498
Administration				
Budget compensation and supporting the implementation of the Schengen Agreement	122	59	59	240
Total	1,144	1,557	1,898	4,600

According to the approved financial package, our country may receive EUR 4.6 billion for three years after joining the EU from 2007 to 2009. The total EUR 2.3 billion is intended for structural reforms. EUR 1.562 billion is provided for agriculture. The key to successful allocation of these funds is to establish by 2007 a Paying and Intervention Agency (including the establishment of an Integrated Administration and Control System) to pay out the envisaged financial support for agriculture and ensure efficient mutual control between public agriculture administration and those using its services. The policies implemented in the respective sector as well as the envisaged target level of expenditure are considered below.

Agriculture

There is another reason that might lead to serious deterioration of the budget stance in the first year after accession. Direct payment expenditure related to the Common Agricultural Policy, according to effective regulations, is reimbursed by the EU budget in the year following that of payment, i.e. those funds are to be calculated in the budget for the respective year. As mentioned above, Bulgaria and Romania receive a most sizeable agricultural support as percentage of GDP, hence one-off difficulties for the 2007 Budget will be more tangible. In the following years the imbalance caused by delayed payments from the EU budget will be redressed to a great extent, for EU compensations paid out in the current year will be covering the larger part of direct payment expenditure incurred by the state budget. The envisaged equalization of direct payments with those of the fifteen member states will still mean that every year CAP expenditure will be higher than that for the previous year, hence EU compensations will fall behind budget financing for the respective year.

Taking account of fiscal framework possibilities, we propose that limits be set in order to absorb these resources:

Table 6 Resource absorption limits for the agriculture sector 2007-2009 (BGN M)

	Fixed direct payments by the EU	Market support	Rural development and fisheries ⁸	TOTAL
2007	385.0	258.2	104.8	748.0
2008	470.2	252.3	413.4	1,135.9
2009	549.6	248.4	637.5	1,435.5

Market support funds are part of budget “financing” and will not affect budget balance.

Market support includes:

- ‡ funds for intervention into sectors such as field crops, rice, meat, milk;
- ‡ export subsidies;
- ‡ aid for improving the consumption of certain products;
- ‡ aid for production of fresh fruit and vegetables to be processed;
- ‡ aid for producer organisations.

Market support funds are paid by the national budget and reimbursed by the EU budget within the same year. According to the financial framework, market support funds for 2007 amount to BGN 258.2 million, for 2008 – 252.3 million and for 2009 – 248.4 million.

In conformity with new draft EU regulations, rural development aid is separated from the Structural Funds and is transferred to the integrated European Agricultural Fund for Rural Development (EAFRD) including FEOGA funds under sections Guarantee and Orientation. The total amount of resources under the Structural Funds that will be transferred to EAFRD will be fixed at the historical percentage calculated for Bulgaria by the European Commission based on Objective 1 for the 10 new member states for the period 2004-2006. Expected percentage varies between 14 and 20%. The forecast assumes that the European Commission will decide to set aside 17% of the Structural Funds for rural development. Bulgarian co-financing will amount to about 20-25%.

When calculating the funds for rural development, 5% should be deducted for a reserve fund that is established to solve specific problems related to the deteriorated balance of some old member states with respect to the item under EAFRD.

According to negotiation agreements and the national ceiling set, direct payments for Bulgaria will amount to BGN 385.0 million for 2007, 470.2 million for 2008 and 549.6 million for 2009. Observing the same principle applied for the 10 newly acceded countries, those funds will in 2007 equal 25% of the level of direct payments for the 15 member states and 30% in 2008.

In addition, direct payments may be supplemented by national budget by another 30% of the EU-15 level, i.e. in 2007 direct payments (including both from the EU budget and from the national budget) may reach 55% of the EU-15 level and up to 60% in 2008. This option is applied by all newly acceded countries in order to compensate for the lower level of direct

⁸ Co-financing is included.

payments compared to the 15 old member states. Planned national extra payments amount to BGN 55 million for 2007. They may be partially funded by rural development funds for the period 2007-2009 (up to 20% of the annual rural development amount).

The Structural Funds support the following activities and fields:

- * transport investment;
- * energy, energy efficiency and development of renewable energy sources;
- * investment in education and healthcare and improvement of the education system;
- * research and technology development;
- * information society development;
- * investment in SMEs;
- * structural adaptation, growth and creation of job positions;
- * tourism;
- * environmental protection;
- * cross-border economic and social activities;
- * development of institutional capacity and efficiency of public administration.

According to the Treaty of Accession of the Republic of Bulgaria to the European Union, the country will have the right of the following maximum resources⁹ from aid under EU Structural Funds:

- 2007 – EUR 539 million (including EUR 180 million from the Cohesion Fund);
- 2008 – EUR 759 million (including EUR 253 million from the Cohesion Fund);
- 2009 – EUR 1,002 million (including EUR 334 million from the Cohesion Fund).

As to the Structural Funds and the Cohesion Fund of the EU, the realistic levels of absorption proposed by the National Fund to the Ministry of Finance, including the respective co-financing, are as follows:

Table 7 *Structural action limits (BGN M)*

Year	BGN M.
2007	300.9
2008	555.2
2009	1,093.1

The financing/gross investment ratio of the respective economy is an indicator for the importance of structural action support. It is namely in Bulgaria where structural activity expenses as share of gross investment are highest. Fixed capital formation is expected to grow by more than 15% in Bulgaria as a result of the Structural Funds. This data shows in parallel the great need for investment acknowledged by the EU as well as the great impact on economy.

Local and regional authorities play crucial role in absorbing EU Structural Funds. The process of fiscal decentralization in Bulgaria has direct positive effect on the absorption capacity of local authorities that are to use the funds.

⁹ Maximum available resources for commitments, 2004 prices

Fiscal decentralization will facilitate the accumulation of additional resources to co-finance EU-supported projects. To this end, however, it is necessary to attract local business and social partners thereto. Public-private partnerships could help accelerate local economic development, improve people's life and work for the prosperity of their regions.

Furthermore, delegating additional duties and rights to local authorities will cause the need for better planning of activities and local budgets that will provide funding of those activities. This, in its part, will improve the local medium-term planning capacity that appears to be a key issue of EU fund absorption. According to the Regional Development Act, Local Government Development Plans are devised for a period of seven years (2007 – 2013) and guarantee the development of the local government. This results in and preconditions the importance of local level planning since the period for which the plan is devised is linked with government policy cycles, on the one hand, and on the other, with the next EU programming period.

EU requirements to the human resources engaged in the Structural Funds bring forth the need for strengthening the capacity of local and regional administration that takes part in the absorption of EU funds. The European Commission recommends to the acceding countries to increase their efforts in preparing projects, including by using technical assistance, where needed, under the pre-accession funds.

The requirement for supplementing EU Structural Funds is most often connected with co-financing from the budget, which is expected to further burden the country's fiscal stance. However, it is possible that part of the investment budget expenditure funded by the budget prior to accession while at the same time being subject to EU structural policies, be reallocated for co-financing projects under the Structural Funds. Thus, the increase of budget expenditure will be prevented. To this end, significant flexibility is needed when planning and executing the budget taking account of co-financing needs.

Internal policies

Table 8 *Limit of absorbing funds under the Internal policies for Bulgaria 2007-2009 (BGN M)*

	2007	2008	2009	2007 - 2009
Existing policies	122.1	174.0	228.0	524.1
Institutional development (Transitional financial instrument)	19.6	13.7	5.9	39.2
Support for the implementation of the Schengen Agreement	87.3	73.7	73.7	234.7
Nuclear safety – outside-budget transfer	136.9	136.9	136.9	410.7

Notes:

1. *Budget commitments to the Transitional financial instrument for Bulgaria and Romania total EUR 82 million. Allocation of the amount for Bulgaria is based on the population ratio in both countries.*
2. *At least half of this amount will be used to support the Schengen Agreement*

The funds for implementation of EU internal policies for the period 2007-2009 amount to EUR 498 million, 2004 prices, and include:

- Aid to support the decommissioning of units 1-4 of Kozloduy NPP and the measures related to mitigate the consequences thereof. The total amount is EUR 210 million (2004 prices) in the form of budget commitments allocated at equal annual tranches of EUR 70 million each.
- Transitional Financial Instrument to develop and strengthen the administrative and judicial capacity for implementing the acquis.
- Support of existing policies mainly in the field of education, culture, social activities, energy, environment and scientific research.

In accordance with the Protocol to the Treaty of Accession of the Republic of Bulgaria to the European Union, both countries are obliged to implement the provisions of Schengen acquis as of the date of accession. In order to support this process, an Instrument facilitating budgetary cash flows and supporting the implementation of the Schengen Agreement is created.

The requirement is at least 50% of the allocated amount to be used for funding activities on enhancing the new external borders of the European Union.¹⁰ When taking account of the budgetary effect, payment schemes are to be considered. One twelfth of Bulgaria's annual contribution is to be paid on the first business day of each month of the respective year. The total amount of payments is used within three years after effecting the first payment.

2.3. Fiscal risk assessment

Fiscal risks to the budget for the period 2007-2009 are caused by the unfinished structural reforms and the unfavourable demographic structure of the population rather than by possible negative shocks to the economy.

Budget depends slightly on changes in **interest rate levels or the BGN/USD exchange rate**. Budget revenue and expenditure sensitivity analysis shows that an increase by 1 cent of the BGN/USD exchange rate would result in a 0.21% growth for the principal amounts due and in a 0.34% growth for the interest rates. These dependence ratios are further improved by the buy-back operations of SDR- and EUR-denominated debt to the IMF and the World Bank totalling EUR 490.5 million. At the same time, this same percentage of USD rise compared to the BGN leads to increasing VAT export revenue in the budget by 0.3%, thus compensating for the increased government debt service expenditure. The sensitivity of interest rate expenditure to an increase of the 6-month LIBOR in EUR and USD by 10 base points is 0.57% and 0.11% respectively. It should be noted that the substantial government debt reduction in recent years has significantly limited the share of interest rate expenditure in the overall budget expenditure, thus presupposing minimum pressure on the overall fiscal stance as a result of higher interest rate levels at the international financial markets. The parallel reduction of government guaranteed debt down to 2.4% of GDP and 7.5% of the overall government debt at the end of 2005 means that the potential realization of these guarantees will not influence substantially budget execution, since the possible increase of interest rate expenditure is assessed at BGN 50 million or 0.1% of GDP at worst.

When reviewing the risks to the budget forecast, **the negative effect for the budget revenue side** amounting to BGN 420 million should be considered, which will come as a result of aligning the Value Added Tax Act with EU directives (a one-off loss from the one-month

¹⁰ This means that the remaining part (50% of the total amount at most) may be used to neutralize a possible negative effect for the budget from the accession.

delay of VAT paid for intra-Community acquisitions, elimination of taxation for second-hand cars, expanding the scope of tax credit use, etc.), as well as the additional loss of revenue from customs duties due to trade liberalization. It is quite possible that the amount of revenue loss be doubled compared to the above assessment as a result of the changes in the VAT regime and the initial stage of administrative cooperation between our revenue administration and those of EU member states. That is why, the principle of prudent forecasting imposes a more conservative approach to planning the 2007 budget revenue side.

From the point of view of fiscal risks, **reforms in the healthcare and social security** sectors play a crucial role. Bad hospital management continued generating arrears that reached up to 0.1% of GDP by the end of 2005 despite the additional funds disbursed in the middle of the year. About BGN 150 million are still not covered. The possible solution is to postpone payments during this year and the next one as well, with creditors signing separate contracts with each hospital following a scheme that will cover old liabilities. Measures are taken to improve the spending of funds in this sector by replacing the management of a number of hospitals, as well as by transferring their funding entirely to the NHIF. This is expected to improve control over spending budget resources and introduce a strict fiscal discipline in the sector. Nevertheless, it should be taken into account that the measures being applied have not yet proved effective, which means that incurring arrears may continue along with the ensuing pressure on the state budget to provide additional resources for repayment thereof.

The pension system is another source of risk to the budget both in the short and in the long run, since it is still dependent on substantial amounts of subsidies and transfers from the central budget. First pillar budget balancing originally planned for 2007-2008 will not take place after it was shifted backward in time on several occasions due to some administrative measures such as the pension ceiling increase. The status of the pension fund of the public social insurance will further deteriorate this year due to the reduction of social security contributions by 6 points, which is expected to result in a loss of about BGN 600 million. By the end of the reviewed period, the reduction of social security contributions is expected to produce positive results for the revenue system by making part of the grey economy come into light and improving the insured persons/pensioners ratio. Nevertheless, pension system deficit will rise substantially and will become more dependent on funding by the central budget, which is not a sustainable trend in the long run.

Last but not least comes the need for sparing budget resources for funding **loss-making state-owned enterprises** like BDZ. The measures taken to rehabilitate the enterprise with the PAL of the World Bank led to eliminating the need for budget resources to cover its operational losses but still reduced their amount. BDZ subsidies reach 0.2% of GDP per annum and might be important taking account of the need to cut back expenses due to the surplus that is to be realized this year and the next one too, as well as due to the need for providing national co-financing of European projects after 2007. It is for the present intended to impose strict budget limitations to BDZ in order to introduce fiscal discipline. However, the suspension of budget subsidies for the enterprise may lead to arrears as to the payment of salaries and social security contributions to employees, i.e. these are again losses for the general government ultimately. That is why, putting these intentions into practice will require strong political will due to the social importance of BDZ as a big employer and the fact that it is still a state-owned enterprise and a government responsibility.

Enterprises from the energy and transport sectors, i.e. public utilities that provide services of common economic interest – heat supply, gas supply, railway transport services, etc., have sizeable liabilities and receivables. Meanwhile, some of these enterprises like BDZ EAD, Toplofikatsia Sofia AD and Toplofikatsia Pernik EAD are beneficiaries of government guaranteed loans. This fact creates certain risk and difficulties for accumulating enough own

working capital to service credit liabilities towards international credit institutions as well as a potential fiscal risk from government guarantee activation. In order to reduce that risk and enforce legislative provisions related to state aid and government financial support for the period 2007-2009, the need for appropriating budget resources in the form of subsidies for real sector non-financial enterprises is not suspended.

Despite the low budget sensitivity to short-term shocks, **reaction mechanisms** to such unfavourable impulses are envisaged by being concentrated in the expenditure side. These are the social reserve aimed to fund extraordinary expenses and structural reforms amounting to 0.6-0.7% of GDP and the provision according to which only 93% of the expenditure ceilings of first-level spending units may be appropriated. The latter provides for an additional cushion of about 3% of GDP that may be used to limit government consumption and compensate partially the pressure from private consumption growth on the current account deficit and the inflation.

2.4. Major budget policy trends

This part addresses all the above challenges, thus outlining budget policy trends. The underlying principles of budget policy are those related to maintaining stable public finance and promoting the effective allocation of resources through:

- Maintenance of a stable macroeconomic environment and implementation of the Maastricht criteria for joining the Euro area.
- Maintenance of medium-term fiscal stability based on strict financial discipline in the public sector.
- Optimum orientation of EU funds so as to produce a long-term positive effect on productivity and economic growth. Reduction of current budget expenditure on the account of capital expenditure.
- Implementation of a conservative and sufficiently flexible fiscal policy which allows to react timely and reliably to external and domestic risks that may destabilize the economy; maintenance of a certain targeted level of fiscal reserve.

The government has clearly outlined its political intentions in the adopted coalition Programme of government of European integration, economic growth and social responsibility. The major priorities therein are aimed at the solution of problems resulting from demographic trends, the structural challenges related to the overall economic development, i.e. real convergence of our economy to the average EU values, the strive after an overall improvement of the living environment of Bulgarian citizens.

These priorities encompass the major areas of the country's development and is important to target them in a balanced way in time mostly from the point of view of limited financial possibilities of the budget and the need to preserve a sustainable macroeconomic policy. It is extremely important to reach a consensus here, for the progress we will make and the quality of results will depend on the unification and the views of every member of the government.

As to **maintaining a sustainable fiscal stance and providing conditions for high economic growth**, the government has defined several major aspects of the macroeconomic framework to work upon.

With regard to tax policy, no sharp deviation from the conservative trend should be allowed mostly due to the pure macroeconomic effects witnessed in our country. The extremely deteriorated current account should not be underestimated.

It will be a great challenge to reach the targeted fiscal result levels next year and will require that a strong political resolve be taken with regard to several issues:

- As to tax policy, respective minimization of the loss of budget revenue. There are objective prerequisites for refraining from more substantial tax remissions in the conditions of greater uncertainty of budget forecasts in the first year of our effective Community membership.
- As to the flexibility of EU funds management and the corresponding co-financing.
- As to the readiness of the government to adapt the policies implemented thus far in the public sector to the new ones resulting from the accession to the European Community.

In view of responding to these tasks and aligning with European requirements, the following tax policy aspects have been proposed:

1. Preserving the VAT rate at the present level.
2. Reducing the tax rate under the Corporate Income Tax Act from 15% to 12%.
3. On-going alignment of excise duty rates with the European ones.
4. Preserving health insurance contributions at 6%. Increasing social security contributions paid by the state for under-aged children from 0.5% to 3%.

A real assessment of tax policy aspects can be made in the second half of the year when the effects from the substantial changes in the field at the start of 2006 are to be analysed (the start of the NRA, the reduced social security burden, the increased excise duty rates, etc.).

As a result, expected revenue for 2007 will amount to 41.4% of GDP, while expenditure is fixed at 40.7%, with budget surplus set at 0.8%. The contribution of Bulgaria to Community budget is included herein (it amounts to 1.2% of GDP). We consider that from economic point of view our country's contribution would not have direct and short-term influence on domestic demand, but at the same time, given these parameters, fiscal policy would not help mitigate the current account deficit.

The wage-determining mechanism is planned to be changed. The introduction of a decentralized model of payment will be possible if sectoral reforms and programme budgeting are launched. In case of preserving the traditional approach, we propose that the average annual growth be linked to labour output in economy in order to ensure a strong and competitive economy, high economic growth and stable macroeconomic environment on the one hand, and certain social expectations and government commitments on the other.

The major threat to preserving the expenditure ceilings in the coming years is linked to the EU budget contribution amounting to 1.2% of GDP as well as absorbing the additional 1-2% of GDP of EU funds that will be circulated in the budget on an annual basis, including the corresponding co-financing that will be required. These monies will be targeted at certain sectors, which will require to "draw off" from others that will not be receiving EU funds namely due to the overall expenditure ceiling limitation. Given the high level of public expenditure at the moment, it is of utmost importance that the government be able to replace existing expenditure by EU funds, i.e. to restructure the budget in the most effective way ad maximize the absorption of EU funds. The need for restructuring will become even more pressing in the light of increasing social expenditure related to the process of ageing of the

population and the relatively high unemployment rate. For 2007 BGN 1,074.3 million or 2.1% of GDP are envisaged for the absorption of new EU flows, including the respective supplementary and co-financing. The forecast is relatively conservative and complies with the country's capacity to absorb external financial resources.

Agriculture is the greatest beneficiary of funds. The capacity to absorb funds in this sector presents a great risk to the 2007 budget stability mostly due to the need for advance budget financing (which will be reimbursed in 2008) and provision of co-financing for some of the measures. Taking account of the opportunities of the fiscal framework, we propose that limits for the absorption of these resources be set to the amount of BGN 544.8 million for 2007 for direct payments and rural development. Market support funds are recorded "below the line" and amount to BGN 258.2 million for 2007.

As to the Structural Funds and the Cohesion Fund of the EU, the proposed realistic levels of absorption, including co-financing, amount to BGN 300.9 million, while internal policy funds amount to BGN 229 million for 2007.

As evident from the above challenges, **the balanced social policy taking account of the strongly deteriorated demographic characteristics of our population** is of utmost importance. Expenditure for social security, relief and care present almost 34% of the overall expenditure in the 2006 budget. It is obvious that problems in this field will not be solved until a long-term plan is devised to limit both increased payments and orientation to beneficiaries thereof. Active policy and relief schemes are to be entirely reviewed in order to enhance the effectiveness and efficiency of using funds thereunder.

One of the main instruments to improve this situation should be the active policy related to improving qualification and employment promotion. Generating new job positions requires that investment activities be promoted and incentives for SMEs be provided. We also propose that measures related to implementing more flexible forms of payment be considered through amendments to labour and social security legislation.

In practice, the Broad Economic Policy Guidelines for the period 2005-2008, recommended by the European Commission, define the common European aspirations regarding employment and it is recommendable to make use of this paper¹¹.

Quality of public finance, government expenditure restructuring, investment-oriented economic growth. In the context of budget discussions, the "quality of public finance" concept is to attain even greater importance; "quality" as a tool to guarantee effective and efficient utilization of resources within the overall budget limitation aimed at enhancing the potential for economy growth. The restructuring and management of public expenditure and revenue, which leads to enhanced growth and effectiveness, is the major political challenge with clearly outlined macro- and microeconomic impacts.

Based on the limitations set in the budget in the medium run, it is necessary to make a review of the sectors, update the policies and measures for development thereof, identify the need for restructuring, where necessary, and undertake the required steps towards reforms.

Decisions should be taken as to the size and priority of the respective sectors as well as the prioritization within the sectors themselves. One of the options to reduce expenditure when reviewing intra-sectoral priorities is to develop the partnership between the public and the

¹¹ See page 25

private sector. The state may decide to delegate to the private sector part of the services it renders, provide incentives for the business and receive its share of the total benefits. In this regard we suggest that ministries analyse the options therefore and propose projects to be implemented through public-private partnerships.

The quality of public finance is to be considered in several main aspects:

- The **education** model via transition from a resource-oriented to result-oriented model; binding the level of expenditure with the quality of the educational product; decentralization and autonomy of schools; optimization of the school network. These structural changes should also affect the field of higher education and science.
- Better transparency and effectiveness of the management of **healthcare** funds can be achieved by applying proper stimuli to the mechanism used for funding hospital care which is based on the principle of competition among the medical institutions by managing the expenditure and controlling their effectiveness respectively. The introduction of a guaranteed minimum package paid by the NHIF, the introduction of additional payment for hospital care and the guarantees of hospitals' financial autonomy can be positive measures to improve the disbursement of resources by hospitals. The reform in the hospital sector through optimizing, restructuring and privatising the hospital network should remain a priority.
- There is an option for restructuring the **defence, internal affairs and security expenditure**. The overall levels of those expenditure, which head the list in terms of amount among the CEE countries, should not be increased. Within the existing level, however, a number of steps should be considered to gradually increase the share of capital expenditure at the expense of current ones.
- As part of its preparation for accession to the EU, Bulgaria should pursue an **agricultural** policy and an institutional framework that are to be fully compatible with the Common Agricultural Policy of the EU. In this sense, the government is to take several strategic decisions related to the selection of measures aimed to support the income of farmers as well as a direct financial support scheme, possible additional payments based on the region, payment schemes, access criteria and transfers under the various schemes. When taking those decisions, the government is to consider the effectiveness factor as well, since in the long run it is only better effectiveness and competitiveness that may ensure further sustainable development and well-being of the agricultural sector.

Budget and administrative reforms that are to support the implementation of these measures in the public field are viewed in the next part.

2.5. Budget reform trends

The main objectives of budget reform are related to the attainment of an effectively operational medium-term framework of expenditure and consolidation of programme budgeting at all stages of the budgetary process, i.e. planning, drafting, adoption, execution, accounting and control, as well as progress of the processes related to fiscal decentralization.

Programme budgeting is an instrument that ensures flexibility through the implementation of a decentralized model regarding the identification of programmes and measures and the respective expenditure thereunder within the policies whose implementation is within the responsibility of the respective spending unit.

At present a total of nine ministries participate in the process of drafting and presenting programme budgets. These are the Ministry of Environment and Water (first pilot project in 2002), the Ministry of Transport and Communications (since 2005), the Ministry of Labour and Social Policy (since 2005), the Ministry of Education and Science (since 2005), the Ministry of Economy and Energy (since 2005), the Ministry of Regional Development and Public Works (since 2006), the Ministry of Culture (since 2006), the Ministry of Health (since 2006) and the Ministry of Agriculture and Forestry (since 2006). A programme budget was drafted by the Ministry of Youth and Sport in 2005 which, despite its transformation into a State Agency for Youth and Sport to the Council of Ministers, has preserved its status of first-level spending unit and will continue drafting its own programme budget. On the other hand, the already adopted Council of Ministers' Decision No 70 of 2006 on the 2007 budgetary procedure, as amended by CMD No 392 of 2006, regulates the inclusion of all ministries in the programme budgeting process, which means that the 2007 Republic of Bulgaria State Budget Bill will introduce the programme budgets of all ministries to the Council of Ministers.

This is the year of one of the most important steps in the programme budgeting reform, i.e. all ministries will draft three-year programme budgets by taking account of the policies in the general government sector. This will take place as early as the second intermediate stage of drafting the three-year budget forecast when preparing the expenditure ceilings. One of the requirements is that the 2006 approved budgets also be revised in a programming manner so as to serve as the basis for further planning.

The efforts to optimize the public sector, rationalise and improve the effectiveness of public expenditure and improve medium-term planning and fiscal stability continue. According to § 74 of the Transitional and Final Provisions of the 2006 State Budget Act, all ministries are obliged to review and introduce to the Council of Ministers optimized plans of the structure and number of staff of the institutions, including lower spending units thereto.

A step towards the implementation of the budget reform are the latest amendments to the Organic Budget Act as well. They respond to the recommendations and proposals for alignment of legislation in order to meet the criteria and improve and enhance the budgetary legal framework and the commitments taken by the Republic of Bulgaria in the negotiating process of accession to the European Union.

Budget reform is aimed to refine the budgetary process in order to attain a sustainable medium-term budget framework. This will help rationalize the fiscal policies implemented, for in their nature most of the projects and programmes cover a period longer than a year, therefore they should be planned in the medium run. Effective absorption of EU funds further strengthens the need for multi-annual expenditure planning. In order to attain those results, however, several preconditions are required. To start with, participants in the budgetary process are to be aware of the need to maintain a sustainable and foreseeable medium-term fiscal framework. The responsibilities and role of line ministries in preparing and executing the budgets will be increasing. This will cause the need for increasing the administrative capacity so as first-level spending units to be able to respond to the challenges related to new budget procedures. Along with the above measures, an overall review of budgetary legislation and an amendment to the legislative budget framework that is to define the amended functions and responsibilities in the budget sector are envisaged.

Fiscal decentralisation

Fiscal decentralization outlines the aspects of allocating powers and financial resources between the central and local level of governance aimed to provide more effective and qualitative public services to citizens.

Powers with respect to revenue include: own revenue and the possibilities for increasing the revenue through providing new sources of revenue; acquisition of financial resources from management and disposition of property; a possibility to organize, collect and use financial resources from the consumers/local community; planning and administration of own revenue; participation of local authorities in determining grant mechanisms and other transfers from the central government, i.e. amount and criteria for allocation thereof; extent to which they are free to use them; credit opportunities.

Powers with respect to expenditure provide for: expenditure planning, independent decisions on the use of saved funds and/or transitional residuals; availability of investment resources; delegation of funds to outside contractors; financial control over the usage of funds.

In conformity with their greater powers, local governments have adopted ordinances regulating the local fiscal policies carried out. A system for monitoring and assessment of fiscal decentralization has been developed, with the Council of Ministers adopting annual reports on the results from the implementation of the local government reform.

The changed relations between the central and local authorities have led to improving the financial status of local governments. The amount of their own revenue has increased. Government transfers have become more transparent, unbiased and foreseeable. There is an increase of own revenue as well as attracted funds that local governments direct for investment.

An important outcome of the reform is the enhanced participation of local authorities in the discussion and solution of financial and other problems between the authorities. A three-year (medium-term) programme on effective cooperation between the Ministry of Finance and the National Association of Municipalities in Bulgaria was signed for the first time in 2006.

III. TAX POLICY. BUDGET REVENUES FOR THE PERIOD 2007-2009

The forecast of the revenues for the reviewed period as shown in the table is made in compliance with the overall tax strategy of the government, the macro framework, the expected amendments to the tax legislation related to the future EU membership of the Republic of Bulgaria, and the trends in the budget receipts for the last reporting periods.

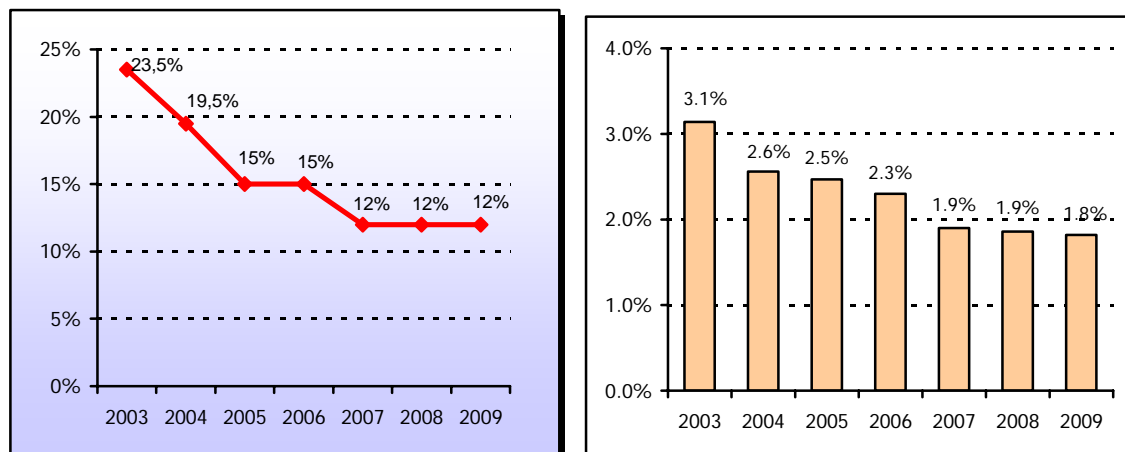
Table No.9 Revenues on consolidated basis for the period 2006-2009.

BGN million	2006		2007		2008		2009	
	program	%GDP	forecast	%GDP	forecast	%GDP	forecast	%GDP
TOTAL REVENUES	18 258.0	40.0	21 151.0	41.4	23 005.7	41.4	25 038.0	41.3
Tax revenues	15 049.0	33.0	16 956.2	33.2	18 047.6	32.5	19 233.1	31.8
<i>Direct taxes</i>	6 174.5	13.5	6 916.8	13.6	7 549.0	13.6	8 045.6	13.3
Corporate taxes	1 051.3	2.3	1 067.0	2.1	1 230.3	2.2	1 333.3	2.2
- non-financial enterprises	921.1	2.0	942.0	1.8	1 062.6	1.9	1 147.6	1.9
- financial sector	130.2	0.3	125.0	0.2	167.7	0.3	185.7	0.3
Personal income tax	1 040.0	2.3	1 139.4	2.2	1 286.5	2.3	1 335.5	2.2
Revenues of insurance funds	4 083.2	9.0	4 710.4	9.2	5 032.2	9.1	5 376.8	8.9
- PSS, PTU, UPF and FGRWE	3 043.2	6.7	3 495.2	6.8	3 663.2	6.6	3 905.2	6.4
- NHIF	1 040.0	2.3	1 215.2	2.4	1 369.0	2.5	1 471.6	2.4
<i>Indirect taxes</i>	8 449.4	18.5	9 538.7	18.7	9 996.6	18.0	10 671.5	17.6
VAT	5 509.5	12.1	6 243.0	12.2	6 478.3	11.7	6 844.2	11.3
Excise duties	2 582.2	5.7	3 041.7	6.0	3 225.3	5.8	3 518.3	5.8
Customs duties and charges	357.7	0.8	254.0	0.5	293.0	0.5	309.0	0.5
<i>Other taxes</i>	425.2	0.9	500.7	1.0	502.0	0.9	516.0	0.9
Non-tax revenues	2 521.0	5.5	3 155.7	6.2	3 350.3	6.0	3 686.3	6.1
<i>Transfers from BNB</i>	150.0	0.3	170.0	0.3	170.0	0.3	170.0	0.3
<i>Others</i>	2 371.0	5.2	2 985.7	5.8	3 180.3	5.7	3 516.3	5.8
Grants	687.9	1.5	1 039.1	2.0	1 607.8	2.9	2 118.6	3.5

1. Corporate taxes

The computation of projected revenues from corporate taxes is made on the basis of the reduced tax rates as approved in the Corporate Income Tax Act for 2007, i.e., from 15% to 12% for the 2007-2009 period which will leave funds to the amount of around BGN 140 million at the disposal of businesses.

Chart No.7 Rate and relative share of the corporate tax of GDP for the period 2003-2009.



The revenues from corporate taxes to the consolidated budget (including tax on dividends and income) by years for the 2007-2009 period are estimated respectively at: BGN 1 067 mln., BGN 1 230.3 mln. and BGN 1 333.3 mln.

Non-financial enterprises

The corporate tax from non-financial enterprises (incl. non-profit organizations and taxes on dividends and income) for 2007 is assessed at around BGN 942 mln, at BGN 1 062.6 mln for 2008, and at BGN 1 147.6 mln for 2009. When making the forecast, the following factors have been taken into consideration:

- ✓ Reduction of the corporate tax rate from 15% to 12%.
- ✓ Revenues in 2007 from the end-of-year settling of accounts for the fiscal year 2006 are expected to be higher than the ones in 2006, due to the improved collection on behalf of the tax administration and the legalization of a large number of companies from the gray economy, as a result of the low tax rate.
- ✓ Expected execution of the revenues from corporate taxes in the 2006 consolidated budget.
- ✓ Increase of the taxable profit with the projected growth of nominal GDP for the 2007 – 2009 period.
- ✓ Granting tax relief to companies investing in regions with high unemployment.
- ✓ As a result of the implementation of **EU directives** on corporate income taxation from 1 January 2007 the taxation regime of dividends and liquidation shares will change which will result in lower revenues from taxes on dividends and income.

Financial Institutions

The corporate tax from financial institutions (including corporate tax from insurance companies) for the 2007 – 2009 period is assessed respectively at BGN 125.0 mln for 2007, BGN 167.7 mln. for 2008 and BGN 185.7 mln. for 2009.

While developing the assessment a growth of the profits in the banking sector was taken into account, resulting from the credit expansion and the increased market shares of this sector.

Other taxes under LCIT

The revenues from other taxes come upon charging:

- tax on social expenses;
- tax on entertainment expenses;
- tax on donations and sponsorships;
- tax on the expenses on maintenance, repair and operation of vehicles.

2. Personal income taxes

As regards the policy of personal income taxation for the 2007-2009 period the trend of reducing the tax burden on all income groups has been kept. Apart from the reduction of the tax burden the purpose is also an attainment of higher nominal and real income for consumption of the population.

A new tax brackets for personal income taxation, that are simplified as compared to 2005 and eliminate the category from BGN 250 to BGN 600, have been proposed. With that new bracket the non-taxable minimum was raised from BGN 180 in 2006 to BGN 200 in 2007 and BGN 220 in 2008 and 2009. The rates are as follows: 20% for income in the range from the non-taxable minimum to BGN 600 and 24% for income above BGN 600. The amount and the ratios of the employer/ employee contributions are in compliance with the Social Security Code and are respectively: 60/40 in 2007, 55/45 in 2008 and 50/50 in 2009. The effect from that change is a decrease of budget revenues by BGN 90 million which are left at the disposal of the population.

In preparing the forecast on revenues from personal income taxes for the period 2007-2009, the following key factors have been considered:

- ⇒ the growth of the salaries for the country. For the budget sector, the income policy includes an 8% growth as of the middle of 2007, 2008 and 2009 each.
- ⇒ The number and type of activities subject to patent tax and the persons engaged in work without an employment contract;
- ⇒ The effect on the budget from the family income taxation, preserving the current amount of the deductions from the annual tax base depending on the number of children.

The following revenues are expected from taxes under LTINP in the reviewed period: BGN 1 139.4 mln, BGN 1 286.5 mln and BGN 1 335.5 mln, respectively. This forecast reflects the factors listed above, as well as the trend in the past few years of implementing measures in the sphere of the natural persons income taxation, directed at reducing the tax burden and increasing the real disposable income of employed persons.

3. Value added tax

The key factors which have influenced the development of the value added tax projections, are the gross domestic product and its structure in a breakdown by the elements of end consumption, foreign exchange rate and rate of inflation. The VAT revenues come from:

- imports from third countries non-EU member states;
- domestic transactions and intra-community acquisitions;
- ministries and agencies.

In connection with the forthcoming accession of the Republic of Bulgaria to the European Union and the need of aligning Bulgarian tax legislation with the requirements of the European directives in the field of indirect taxation two new terms are defined – intra-community supply, which substitutes the hitherto existing regime of export to Member States, and intra-community acquisition, which substitutes the hitherto existing regime of import from Member States. That is why in the draft for VAT revenues for 2007 the revenues from imports from EU Member States are transformed into revenues from intra-community acquisitions.

Table No.10 VAT revenues for 2006 and 2007, in BGN million.

	Base 2006	Project 2007*
VAT on imports	5 345.0	2 928.0
incl. from EU Member States	2 900.0	0.0
VAT on domestic transactions	300.0	3 285.0
incl. intra-community acquisitions*	0.0	2 950.0
VAT from ministries and agencies	35.0	30.0
VAT – consolidated budget	5 680.0	6 243.0

For 2007 the tax base for imports is projected at BGN 29 390 million and the VAT revenues (in total from imports from third countries and intra-community acquisitions from EU Member States) are expected to be BGN 5 878 million. Only 49.8% of those revenues will be collected by the customs administration as VAT on imports from non-EU Member States, which is BGN 2 928 million.

The projections have been assessed at an exchange rate of the US Dollar of 1.55 BGN for 1 USD and a price of crude oil of 60\$ per barrel. The negative effect on the budget to the amount of BGN 420 million as a result of the VAT Act alignment with the European directives (one-off loss from the one-month delay in paid VAT under intra-community acquisitions, dropping of the taxation of second-hand cars, extending the scope of tax credit use, etc.) is reflected.

Computation of the revenues from domestic transactions and intra-community acquisitions

The revenues under this item are strongly dependent on the amounts of the tax effectively paid in and the tax credit effectively refunded.

The VAT effectively paid in 2007 is projected to increase by 8.3% as compared to 2006 (with the final consumption growth). The reimbursements to exporters and others are made under that item, with the effectively reimbursed tax varying around 70% of the declared amounts for reimbursement. At the so made assumptions the cash receipts are expected to reach BGN 335 million. The growth as compared to 2006 is 11.2% because it also takes into account the 4.4% rise in goods' price. Additional BGN 2 950 million from intra-community acquisitions from EU Member States are also included and the revenues under that item are projected to reach BGN 3 285 million.

The projected revenues of BGN 6 243 million can be achieved in case of an effective collection of 92%. The expected effectiveness for 2006 is 91.5%.

Forecast of VAT revenues for 2008 and 2009.

The macro framework for that period envisages end consumption growth of around 5% and import growth of around 12%.

Based on those growing rates of the major components whereon VAT revenues depend, we can expect that in 2008 the revenues will reach BGN 6 478.3 million.

The conditions of collection and other international factors being kept the same for the whole reviewed period, the VAT revenues in 2009 are forecasted at BGN 6 844.2 million.

These calculations and projections reflect all effects and changes resulting from Bulgaria's forthcoming accession to the European Union and take into consideration the requirements of the European directives in the field of indirect taxation.

4. Excise duties

The amendments to the Excise Duty Act are aimed at aligning Bulgarian legislation with the EU acquis.

In 2007, in compliance with the schedule of changes to excise duty rates as agreed with the European Commission, the following changes to the rates for some types of fuels are projected:

- Increase of the excise duty on leaded petrol: from BGN 670 per 1000 litres to BGN 830 per 1000 litres;
- Increase of the excise duty on unleaded petrol: from BGN 530 per 1000 litres to BGN 585 per 1000 litres;
- Increase of the excise duty on gas oil: from BGN 430 per 1000 litres to BGN 485 per 1000 litres;
- Increase of the excise duty on kerosene: from BGN 430 per 1000 litres to BGN 485 per 1000 litres.

The existing legislation in the country does not provide for levying excise duty on electricity, coal and coke as the case is in EU Member States. The Republic of Bulgaria has taken the commitment to introduce excise duty on those goods in 2007, the rates being as follows:

- on electricity used for industrial purposes – BGN 0.001 per 1 kWh;
- on coal used for industrial purposes – BGN 0.30 per 1 GJ;
- on coal used by households - BGN 0.15 per 1 GJ;
- on coke used for industrial purposes – BGN 0.30 per 1 GJ;
- on coke used by households - BGN 0.15 per 1 GJ.

In calculating forecasted revenues from excise duties on domestic transactions, the assumptions have been based on the expected volumes of consumption of the major goods subject to excise duties - fuels and tobacco products, as well as on the amendments to the legislative framework and other factors. In 2007 the excise duty on cigarettes, beer and alcoholic beverages will not be increased which will lead to higher consumption of cigarettes,

beer and alcoholic beverages. Of special importance to revenues from excise duties is the business policy of the major taxpayers – Lukoil Neftochim – Bourgas AD and Bulgartabak-Holding AD.

The increase of the rates of the excise duties on petrol, gas oil and kerosene will lead to a positive effect for the budget evaluated at BGN 145 million.

The introduction of excise duty on electricity, coal and coke will lead to a positive effect for the budget evaluated at BGN 27,0 million.

The projected *revenues from excise duty on domestic transactions* are BGN 2 385.8 million.

The projected net *revenues from excise duty on imports* are BGN 655.9 million.

The dynamics of imports is a fundamental factor for the projected revenues from excise duties on imports. Throughout the entire year 2005 and the beginning of 2006, a growth of revenues from excise on imports has been observed with respect to all groups of goods and this trend is expected to be preserved in 2007.

The expected total amount of revenues from excise duties under the consolidated budget programme for 2007 is BGN 3 041.7 million.

In 2008, increase of the following excise duties is envisaged:

- Increase of the excise duty on unleaded petrol: from BGN 585 per 1000 litres to BGN 635 per 1000 litres;
- Increase of the excise duty on gas oil: from BGN 485 per 1000 litres to BGN 535 per 1000 litres;
- Increase of the excise duty on kerosene: from BGN 485 per 1000 litres to BGN 535 per 1000 litres;
- Increase of the excise duty on electricity used for industrial purposes – from BGN 0.001 per 1 kWh to BGN 0.0012 per 1 kWh;
- Increase of the excise duty on coal used for industrial purposes – from BGN 0.30 per 1 GJ to BGN 0.40 per 1 GJ;
- Increase of the excise duty on coal used by households - from BGN 0.15 per 1 GJ to BGN 0.20 per 1 GJ;
- Increase of the excise duty on coke used for industrial purposes – from BGN 0.30 per 1 GJ to BGN 0.40 per 1 GJ;
- Increase of the excise duty on coke used by households - from BGN 0.15 per 1 GJ to BGN 0.20 per 1 GJ.

The higher rates of the excise duties on petrol, gas oil and kerosene will lead to a positive effect for the budget estimated at BGN 139.2 million.

The higher rates of the excise duties on electricity, coal and coke will lead to a positive effect for the budget estimated at BGN 6 million.

In 2008 the excise duty on cigarettes, beer and alcoholic beverages will not be increased which is expected to lead to higher consumption of cigarettes, beer and alcoholic beverages.

The projected revenues from excise duty on domestic transactions are BGN 2 516.6 million.

The projected net revenues from excise duty on imports are BGN 708.7 million. The dynamics of revenues from excise duties on import as regards all groups of goods is expected to be preserved in 2008.

The expected total amount of revenues from excise duties under the consolidated budget program for 2008 is BGN 3 225,3 million.

In 2009, increase of the following excise duties is envisaged:

- Increase of the excise duty on unleaded petrol: from BGN 635 per 1000 litres to BGN 660 per 1000 litres;
- Increase of the excise duty on gas oil: from BGN 535 per 1000 litres to BGN 565 per 1000 litres;
- Increase of the excise duty on kerosene: from BGN 535 per 1000 litres to BGN 565 per 1000 litres;
- Increase of the excise duty on electricity used for industrial purposes – from BGN 0.0012 per 1 kWh to BGN 0.0014 per 1 kWh;
- Increase of the excise duty on coal used for industrial purposes – from BGN 0.40 per 1 GJ to BGN 0.50 per 1 GJ;
- Increase of the excise duty on coal used by households - from BGN 0.20 per 1 GJ to BGN 0.25 per 1 GJ;
- Increase of the excise duty on coke used for industrial purposes – from BGN 0.40 per 1 GJ to BGN 0.50 per 1 GJ;
- Increase of the excise duty on coke used by households - from BGN 0.20 per 1 GJ to BGN 0.25 per 1 GJ.

The increase of the rates of the excise duties on petrol, gas oil and kerosene will lead to a positive effect for the budget estimated at BGN 78,6 million.

The increase of the rates of the excise duties on electricity, coal and coke will lead to a positive effect for the budget estimated at BGN 7 million.

In 2009 the excise duty on cigarettes will not be increased but because of their impending increase in 2010 we expect around 10% growth of revenues from excise duty on cigarettes due to overstocking with cigarettes with old banderoles in the trade network.

The projected revenues from excise duty on domestic transactions are BGN 2 759.2 million.

The projected net revenues from excise duty on imports are BGN 759.1 million.

The projected total amount of revenues from excise duties under the consolidated budget program for 2009 is BGN 3 518.3 million.

5. Customs duties

Upon Republic of Bulgaria's accession to the EU on 1 January 2007 it should be taken into consideration that the customs duties on imports from EU Member States will be entirely dropped out and the Common Customs Tariff (CCT) will be applied where the rates of the customs duties are lower than the ones of the Customs Tariff of the Republic of Bulgaria (CTRB) wherefore the following adjustments need to be made:

- The revenues expected from customs duties on imports of all goods from EU Member States are to be excluded.
- The projected customs duties based on CTRB are to be recalculated in accordance with CCT rates.

The above adjustments are consistently made and are shown in the table below:

Indicators		2007	2008	2009	
<i>1. Projected revenues from customs duties, excluding those from EU</i>					
Total revenues from customs duties, incl. from:		416	473	538	
Agricultural goods		119	135	153	
Industrial goods		297	338	385	
<i>2. Recalculation of the revenues from customs duties in accordance with the rates of CCT of EU</i>					
Indicators	Average rate -%		2007	2008	2009
	of CT RB	of CCT			
Total revenues from customs duties, incl. from:			254	293	309
Agricultural goods		22,4	108	125	131
Industrial goods		10,6	146	168	178

Based on the analysis and the estimates and adjustments the following projection is made of the revenues from customs duties for the period 2007-2009 and of the amount of the contribution from customs duties to the EU:

BGN million	Total customs duties	Contribution to EU (75% of the customs duties)
2007	254	191
2008	293	220
2009	309	232

6. Social security and health insurance contributions

Health insurance contributions are key source of revenues to the health insurance system, paid by health insured persons. The amount of the mandatory health insurance contribution is determined in the annual NHIF Budget Act and according to the provisions of the Health Insurance Act it is calculated on an income basis and distributed between employers and employed persons at an initial ratio of 4:1 which will become 1:1 in 2009. Self-employed persons must also pay insurance contributions while the contributions of persons under the age of 18, full-time students, pensioners, indigent persons and some other categories and vulnerable groups are paid from the central and municipal budgets (i.e. the state budget pays

the contributions to NHIF in their favour). Unemployed persons must be registered as such in order to be released of the obligation to pay the contributions; the same refers to the persons who belong to the “vulnerable groups” – those register themselves at the territorial offices of the Social Assistance Agency. Taking into account all the groups, the state pays the contributions of around 4 million persons, which accounts for approximately 40% of the revenues from contributions of the health insurance fund.

Until 2006 the persons under the age of 18 and after attaining it until finishing their secondary education were insured from the Republican Budget to the amount of 0.5 percent of the minimum insurable income applicable for self-employed persons. The contribution for all other categories is 6 percent. Minimum monthly contributions are actually paid for this category of persons. The three-year budget projections suggest an increase, as from 2007, of the contribution from 0.5 to 3 percent of the minimum insurable income for the persons under the age of 18 and after attaining it until finishing their secondary education.

7. Non-tax revenues

The projected non-tax revenues for the period 2007 – 2009 by years are as follows: BGN 3 155.7 million, BGN 3 350.3 million and BGN 3 686.3 million.

These revenues include receipts and income from estates; state, municipal and court fees, fines, sanctions and penalty interest, concession revenues, dividends accruing to the state, etc.

The factors that determine the level of those revenues are as follows:

- In making the forecast for revenues from dividends accruing to the state, the fact has been taken into account that a large part of the state-owned property has already been privatized;
- Restructuring of Bulgargaz;
- Preservation of the level of interest revenues in view of the high level of the reserves;
- Preservation of the level of revenues from fines and sanctions;
- Projected concession revenues for the period 2007-2009 are around BGN 30-40 million, with the actual collection of those revenues in 2005 being taken into account. The expectations are that the payments under the existing contracts for concessions of mineral resources, sea beaches, mineral water, etc. will continue to be made;
- Revenues from state, court and municipal fees are an important item, amounting to approximately BGN 1.2-1.3 billion per year. Their amount depends on the changes to the licence regimes in view of eliminating the restrictions to businesses and on the introduction of a new, market-oriented principle of determining the amount of the fees on the basis of the services' cost (cost justifiable principle).

In making the forecast for the amount of non-tax revenues, the expected economic growth as well as the gross domestic product growth have also been taken into account.

8. Grants

After Bulgaria's accession to EU we expect flow of considerable financial resource in the form of grants. The main sources are the EU Structural Funds and Cohesion Fund. Moreover, the agriculture will receive considerable support under the Common Agricultural Policy.

Distinction should be made between net flows to the country and net flows to the budget. Net transfers to the budget are only a part of the net flow to the country. In planning the amount of grants for the next three years we are to take into consideration the actual payments which could be significantly below the grants ceilings according to the financial package for 2007-2009. The reason for this is that the implementation of the projects may cover more than one year and the capacity for funds absorption will gradually enhance in time.

The projected revenues from EU aid for the 2007-2009 period also include grants under the PHARE, ISPA and SAPARD pre-accession instruments.

If properly absorbed, EU grants will accelerate Bulgaria's convergence to the EU-25 Member States as regards the GDP per capita criterion, which is actually the primary goal of the grants. On the other hand, in terms of the budget those revenues do not lead to net improvement of the budget balance as those presume absorption of the grants under various programs (i.e. additional expenditures) as well as provision of national co-financing.

IV. POLICY ASPECTS BY MAIN EXPENDITURE CATEGORIES FOR THE PERIOD 2007–2009

1. Main policies incorporated in the expenditure part of the three-year budget forecast

Table No.11 Consolidated public expenditures by function (2006-2009)

BGN million	2006		2007		2008		2009	
	program	%GDP	forecast	%GDP	forecast	%GDP	forecast	%GDP
TOTAL EXPENDITURES AND CONTRIBUTION TO EU	18 258,0	40,0%	20 768,2	40,7%	22 621,3	40,7%	24 690,8	40,8%
Total expenditures	18 258,0	40,0%	20 140,3	39,5%	21 926,3	39,5%	23 959,8	39,6%
<i>Total non-interest expenditures</i>	<i>17 596,3</i>	<i>38,6%</i>	<i>19 399,6</i>	<i>38,0%</i>	<i>21 198,2</i>	<i>38,2%</i>	<i>23 222,2</i>	<i>38,3%</i>
<i>Current non-interest expenditures</i>	<i>14 942,0</i>	<i>32,8%</i>	<i>16 441,3</i>	<i>32,2%</i>	<i>17 991,5</i>	<i>32,4%</i>	<i>19 542,9</i>	<i>32,3%</i>
Salaries and scholarships	2 784,7	6,1%	3 000,1	5,9%	3 237,6	5,8%	3 494,2	5,8%
Salaries	2 738,8	6,0%	2 952,2	5,8%	3 188,4	5,7%	3 443,4	5,7%
Scholarships	45,9	0,1%	47,9	0,1%	49,2	0,1%	50,7	0,1%
Insurance contributions	871,7	1,9%	888,6	1,7%	902,3	1,6%	912,5	1,5%
Maintenance	3 777,6	8,3%	3 960,4	7,8%	4 262,9	7,7%	4 640,7	7,7%
Subsidies – total	592,4	1,3%	1 115,7	2,2%	1 568,8	2,8%	2 001,7	3,3%
Subsidies	450,8	1,0%	969,6	1,9%	1 413,5	2,5%	1 841,5	3,0%
Subsidies for healthcare activities	141,5	0,3%	146,1	0,3%	155,3	0,3%	160,2	0,3%
Social security and welfare	6 915,7	15,2%	7 476,4	14,6%	8 019,9	14,4%	8 493,7	14,0%
Pensions	4 073,1	8,9%	4 285,7	8,4%	4 606,2	8,3%	4 878,4	8,1%
Current transfers, compensations and assistance to households	1 340,6	2,9%	1 420,1	2,8%	1 484,0	2,7%	1 588,9	2,6%
Health insurance contributions	1 219,2	2,7%	1 357,3	2,7%	1 412,4	2,5%	1 494,1	2,5%
Other health insurance expenditures	282,8	0,6%	413,3	0,8%	517,3	0,9%	532,3	0,9%
Credits and temporary financial assistance (net)	100,0	0,2%	35,0	0,1%	35,0	0,1%	35,0	0,1%
Fixed assets	2 221,2	4,9%	2 603,2	5,1%	2 794,3	5,0%	3 261,5	5,4%
Contingency and structural expenditures reserve	333,1	0,7%	320,1	0,6%	377,5	0,7%	382,8	0,6%
- for structural reform and other	15,0	0,0%	45,0	0,1%	55,0	0,1%	60,0	0,1%
- budget	198,1	0,4%	197,1	0,4%	212,5	0,4%	222,8	0,4%
- for natural disasters	120,0	0,3%	78,0	0,2%	110,0	0,2%	100,0	0,2%
Interest payments	661,7	1,5%	740,8	1,5%	728,1	1,3%	737,6	1,2%
External interest payments	444,5	1,0%	542,7	1,1%	527,8	0,9%	537,7	0,9%
Domestic interest payments	217,2	0,5%	198,0	0,4%	200,2	0,4%	199,9	0,3%
Contributions to EU budget			627,8	1,2%	695,0	1,3%	731,0	1,2%

Public expenditures' planning and allocation is related to making a rational choice under the conditions of restrictions, which presumes effective and efficient use of the scarce resources for different and often equally desirable objectives.

Improvement of public finance quality

The European Commission (Lisbon, March 2000) puts the emphasis on the stability of public finance which contribute to accelerating economic growth and employment, in other words on the so-called "quality of public finance". Of special importance is the emphasis on the relation between the high quality of public finance and the economic growth.

The other challenge posed by the forthcoming membership to the European Union is the meeting of the Maastricht criteria and at the same time – achieving compatibility with European regulations and amount of budget expenditures for investments in the infrastructure, environment and other sectors.

In this context the quality of public finance depends on two key factors:

- structure of taxation, and
- public expenditures in terms of the high effectiveness of expenditure mechanisms.

The existing financial models of financing the sectors that produce and supply key public services and goods to citizens are insufficiently effective and efficient (they do not stimulate the improvement of the quality of those goods and services). This refers in the first place to educational and health services, public transport and infrastructure, protection of citizens' personal security and property.

Pursuant to the new theories of the endogenous growth model the investments /public expenditures/ in human and material capital provide a balanced growth effect and the changes to the government policy may result in constant growth of the gross product per capita. Technical progress and advance in knowledge are determined as key endogenous factors contributing to the acceleration of economic growth. The effectiveness of investments in the human capital of a given nation determines the potential of long-term increase of its prosperity.

Public expenditures for education, science, technologies and healthcare are productive as long as the financed concrete policy generates high public outcome. In view of that:

1. The educational policy needs to ensure equal access to quality education and free choice of educational services and high quality of input resources to the system /teachers, textbooks, curricula/ and restructuring of the system in view of the effective reallocation of expenditures. The financing model is a key component of the system and needs to be structured in such a way that it creates incentives for continuous improvement of educational service's quality, accessibility and effectiveness.
2. In the medium term an optimum balance needs to be struck between the public and the private sector in the financing of science and technologies with the purpose of enhancing the quality of scientific researches and new technologies.
3. The healthcare policy needs to be productive in terms of the quality of human capital. In this connection the **minimum** mandatory package of healthcare services purchased entirely by NHIF needs to be defined and the voluntary health insurance in private funds for a supplementary package of healthcare services to be encouraged. In addition, forms of shared payment (additional payment) in specialized and hospital care need to be introduced. The restructuring of hospitals and the optimization of their number will rationalize the use of the valuable financial resources.

Introduction of practices for assessment of budget expenditures' effectiveness, efficiency and outcome

In view of obtaining higher economic growth as a result of the budget expenditures significant improvement of public resource management is needed within the sectoral approach applied. For this goal to be attained actual actions need to be taken for assessment of the fulfilment of the budget objectives set out as well as for measurement of the effectiveness and efficiency of budget sources spent. The assessment of the budget expenditures outcome is a key element of every expenditure management system. Building and extending the capacity for assessment of

public expenditures effectiveness and efficiency is on the agenda of first-level spending units /FLSU/.

The intensive demographic changes necessitate development and implementation of programs for consolidation and optimization of infrastructure and staff in public services' sectors in view of the utilization of the considerable reserves for improvement of the effectiveness of public resources spent.

When making assessment of public expenditures outcome one should take into account that resources spent and public benefits obtained may not be equalized. The additional financial resources spent mainly on higher salaries do not automatically mean higher quality of public services.

On its part, the improvement of public services' effectiveness and efficiency will be induced through developing, reporting and controlling the values of certain target indicators providing information about the overall state and trend of development of the respective budget sector. The indicators are to be developed by FLSU in compliance with the overall objectives and priorities of their development.

The assessment of the **policies' effectiveness, efficiency and outcome** in FLSU activity is a system process carried out on some phases during the preparation of the three-year budget forecast by economic categories and policies and the preparation of the yearly budgets. The obtained values of the set effectiveness and efficiency indicators are assessed on the basis of the parameters obtained in budget execution.

The Ministries may assess the level of implementation of the policies in the respective sector and the individual sub-sectors by fixing the ratio of expenditures for implementation of the policy in the system and benefits generated for the public with the help of set target values of certain indicators.

It is advisable that based on the set target values of the indicators of expenditures effectiveness for the relevant period FLSU prepare a forecast **assessment of the benefits** from the improvement of expenditures effectiveness. They could assess the possibilities of reducing the volume of expenditures and obtaining the same volume and quality of a certain product/ improving the quantity and quality of a certain public service, with the volume of input resources being the same.

The directions of the expenditure policy are developed on the basis of those fundamental conditions:

1.1. Income policy

Emphasis in the government priorities in the years of Bulgaria's accession to the European Union is laid on ensuring a high standard of life, high quality of life to citizens, investments for development of the human capital.

In the medium-term, the implementation of active and targeted policy that is maximum specific and transparent and takes into account the social equilibrium in Bulgarian society is of key importance to the successful integration in the European Union. It should have two base points – high labour productivity and strong competitive economy. One of the most important components of this policy is the income policy significant part whereof is the income from salaries.

With program budgeting introduction in 2007, whose final objective is the “outcome achieved” the funds for salaries will be determined by a more effective mechanism which will ensure their more fair allocation to the individual salaries.

Stable values of the macroeconomic indicators are projected for the 2007-2009 period, which enables the preservation and development of the upward trend of income from salaries.

Of key importance is also measures to be taken for launching a procedure for determining a generally acceptable official threshold of poverty. This should be made with the active involvement of the social partners and the arrangements reached on the methods and frequency of its determining should be legislatively guaranteed. The poverty threshold is to serve as a basis for outlining the social protection system, including the minimum salary.

Taking into consideration the government priorities in the area of income in the medium term the projections are for stable 8% increase of budget salaries as from the middle of each year at a constant number of the persons employed in the budget sphere – 487 thousand. At this mechanism, the funds for salaries in 2007 are increased by 7.8% as compared to 2006, and in 2008 and 2009 – by 8% as compared to preceding year. The envisaged increase of the funds ensures the same growth of average budget salaries, too

1.2 Subsidies to non-financial enterprises

In execution of the Memorandum of Economic Policies and the arrangements with the IMF the government has taken the commitment to limit the areas of subsidizing non-financial enterprises from the real sector. The positive trend of reducing the subsidies and channelling those only in socially important areas while ensuring the rendering of mandatory public services of general economic interest continues.

Envisaged subsidies include subsidies for current activity to the railway transport (the subsidy is intended to compensate the difference between the income that would have been received from transport of passengers at prices determined by the carrier according to the commercial principles, and the actual income from transport services at the prices of the transport documents according to the existing tariff), subsidies for intra-city and inter-urban passenger transport (including to the Sofia Public Transport Company), subsidies to the Railway Infrastructure National Company and Bulgarian Posts EAD.

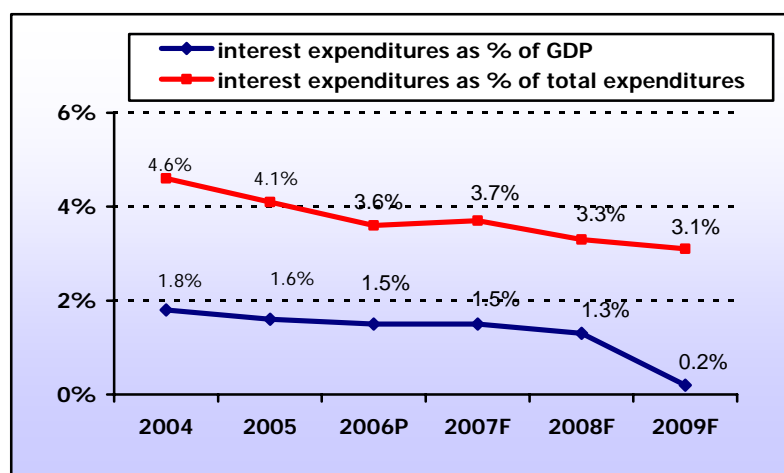
The transformation of activities from the public to the private sector which traditionally has higher value added in the gross production is an important factor for increasing the effectiveness in resources distribution in the economy and improving the productivity of labour.

The absorption of the EU funds for the agriculture as well as part of the resources under the Structural Funds is planned under this expenditure category. Taking into consideration the fiscal framework capacity, the limits (described above by sources and directions) for absorption of these resources regarding subsidies are to the amount of BGN 717,4 million in 2007, BGN 1 161 million in 2008 and BGN 1 581.7 in 2009. To these funds are added the decreasing resources which will be spent under the pre-accession programs and which are in the range from BGN 76 million in 2007 to BGN 28 million in 2009 for the three-year period.

1.3 Interest expenditures

The government debt interest expenditures in the next three years are expected not to exceed their amount for the last couple of years. Their level as compared to GDP will not exceed 1.5%. However, having in mind the debt structure one should take into account their sensitivity to any changes in international interest rates and the US dollar/ Euro ratio. The impact of these changes on budget expenditures will be significantly lower than in the past three-year period due to the much better debt parameters; however, those need to be further taken into account.

Chart No.8 Dynamics of the relative share of interest expenditures



Source: MoF

1.4 Capital expenditures

In the recent years public capital expenditures in Bulgaria have been increasing – in terms of both absolute value and as a percent of GDP. For 2006, their level is planned at 4.9% of GDP which is the highest level since 1998. In the previous years the public capital expenditures as well as the expenditures on operation and maintenance were the ones most influenced by budget restructuring and fiscal discipline tightening.

In view of the poor state of public infrastructure and public assets in Bulgaria the planning of an adequate level of public investment expenditures is of key importance to the economic development. It would reduce the negative effects to private investments which suffer from the shortcomings in the base infrastructure, especially in the transport network. Moreover, in order public capital expenditures to be efficient they should be supported by relevant operation and maintenance expenditures. The projects which receive government financing are to be well grounded as the cost of inefficient projects could be very high.

In the medium term considerable efforts will be targeted at developing the economic mechanisms for division of responsibilities between the government and the private sector in the implementation of large-scale projects in infrastructure and other spheres. The public capital expenditures, supplemented by financing from the private sector and the EU pre-accession funds, Structural Funds and Cohesion Fund, will be targeted at sectors and projects that generate high net benefits for the public. Four main areas in Bulgaria which will receive the major part of the European funds and will have a long-term positive effect on productivity and economic growth can be identified. Those areas are: upgrading the skills of the workforce, agriculture, roads and environmental protection.

Road infrastructure

The sharp drop of public investments in the period of the country's economic recovery and the lack of adequate maintenance and rehabilitation of the roads are among the main reasons for the poor quality and safety of the road infrastructure. The country is faced with the need to further build and maintain the base transport infrastructure in combination with the challenge to improve competitiveness. The intensifying connections and trade flows between Bulgaria

and the European market place new challenges to the road infrastructure and transport. The improvement of the road infrastructure is a prerequisite for Bulgaria's integration in the European transport network.

A significant portion of the national road network still needs to be modernized in conformity with European technical standards and safety standards irrespective of the ongoing "Transit Roads" program. Under that program are implemented projects for rehabilitation of road stretches from major European corridors. Around 2,000 kilometres of roads have been modernized or rehabilitated under Transit Roads I, II and III projects financed by the European Investment Bank. Another 340 kilometres of roads, mainly first class roads which are in poor condition or do not meet European standards, are subject to rehabilitation under Transit Roads IV project.

Bulgaria has taken the commitment to finish the rehabilitation and modernization of the major part of its road network in conformity with European standards by 2014, while part of the roads is to be improved by 2008.

The priorities for investments in the road sector include:

- Expansion and modernization of highways and first class roads included in European transport corridors;
- Expansion and modernization of supplementing corridors of national priority, which are connected to European transport corridors;
- Improvement of cross-border connections with neighbouring countries – development of the infrastructure of all existing border check points and construction of new border check points with the neighbouring countries;
- Maintenance and rehabilitation of the existing republican and municipal roads;
- Improvement of the transit crossing of populated urbanized territories (ring-roads).

After Bulgaria's accession to the EU in 2007 the financial needs of considerable investments in the transport sector for financing road infrastructure projects may potentially be secured through the possibilities of using European Funds resources.

The resources for capital expenditures intended for the railway infrastructure will be targeted mainly at the implementation of projects related to achieving and preserving the design parameters of the railway road and the facilities thereto, modernizing the signalization system, telecommunications, power supply system and energy system. The implementation of the "Doubling and electrification of railway line Karnobat-Sindel" and "Sofia railway station reconstruction" projects will continue. A number of projects for reconstruction of damaged railway facilities as a result of the floods in the spring and the summer of 2005 and 2006 will be implemented during this period. Depending on the available opportunities part of the resources are envisaged to be targeted at repairing the railway road and facilities in connection with the planned higher speed of trains on the railway lines.

The construction works under the "Sofia Airport Reconstruction, Development and Extension" are planned to conclude by end-2007.

2. Development of the main budget sectors in the coming years

This section makes a short overview of the main sectors for the period 2007-2009 taking into consideration the financial flows from EU and the respective co-financing under the PHARE, ISPA and SAPARD pre-accession programs, under the Operational Programs financed by the European Union Structural Funds and Cohesion Fund, as well as for financing the measures under the Common Agricultural Policy (CAP). The forecast is drawn at the assumption that Republic of Bulgaria will become full member of EU on 1 January 2007.

Table No.12 Consolidated public expenditures by function (2005 – 2009)

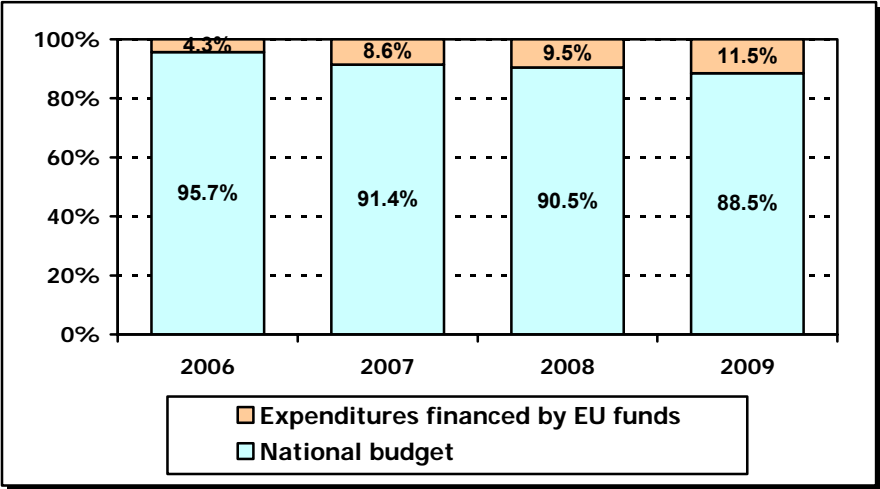
CONSOLIDATED STATE BUDGET BGN million	2005 report	2006 program	2007 forecast	2008 forecast	2009 forecast
DISTRIBUTION OF EXPENDITURES BY FUNCTION	16 691,5	18 257,9	20 140,3	21 926,3	23 959,8
Current expenditures	14 620,1	15 603,7	17 182,0	18 719,6	20 280,5
Capital expenditures	1 919,6	2 221,1	2 603,2	2 794,3	3 261,6
Credits and temporary financial assistance (net)	34,2	100,0	35,0	35,0	35,0
Reserve	117,6	333,1	320,1	377,5	382,8
% of GDP (Gross Domestic Product)	39,8%	40,0%	39,5%	39,5%	39,6%
% of total expenditures	100,0%	100,0%	100,0%	100,0%	100,0%
% of non-interest expenditures	104,3%	103,8%	103,8%	103,4%	103,2%
Total non-interest expenditures	16 005,9	17 596,2	19 399,6	21 198,3	23 222,2
Current expenditures	13 934,5	14 942,0	16 441,2	17 991,5	19 542,8
Capital expenditures	1 919,6	2 221,1	2 603,2	2 794,3	3 261,6
Credits and temporary financial assistance (net)	34,2	100,0	35,0	35,0	35,0
Reserve	117,6	333,1	320,1	377,5	382,8
% of GDP	38,2%	38,6%	38,0%	38,2%	38,3%
% of total expenditures	95,9%	96,4%	96,3%	96,7%	96,9%
% of non-interest expenditures	100,0%	100,0%	100,0%	100,0%	100,0%

According to the expenditure framework for 2007-2009, the most significant portion of the consolidated expenditures is envisaged for the following spheres: social security and care - 32-33% of the total expenditures; economic activities and services - 12.7-14.8%; defence and security - 12-13% of the total expenditures; education – 10-11%; and healthcare - 10.4%.

The major challenge to the Government in the reviewed three-year period is to ensure maximum absorption of the European funds as well as their optimum targeting so that a long-term positive effect on productivity and economic growth and approximation to EU standards of life is obtained. The funds are most effective when invested in large-scale and well defined strategic programs as well as when the financial flows are targeted at spheres where a long-term positive effect on productivity and economic growth could be obtained.

In compliance with the commitment for limiting the budget sector to 40% of GDP and achieving higher effectiveness of resources allocation, as laid down in the Government program and in connection with the need to absorb the additional European funds amounting to 1.5-2% of GDP which will be transmitted through the budget on an annual basis, including to ensure the needed co-financing, sectors need to be restructured in a way that the national financing be maximum substituted by financing from the European funds.

Chart No.9 Structure of the expenditures (expenditures financed with resources from the national budget and expenditures financed under EU pre-accession funds and European Funds /including the relevant co-financing and supplementary financing/)



In connection with the above, the indicative framework of consolidated expenditures by function proposed by the Ministry of Finance reflects the optimum allocation by sector of expenditures financed by the national budget, giving priority to those sectors that would lead to fast economic growth.

According to the National Strategic Reference Framework the main topical areas whereat the intervention of European Funds will be targeted are: enterprises and business environment; transport; environment; human resources; regional development; public administration; agriculture and rural areas development, fishery and aquacultures.

Chart No.10 Structure of the expenditures (by main sectors) financed with resources from the European Funds (including co-financing and national payments) for 2007

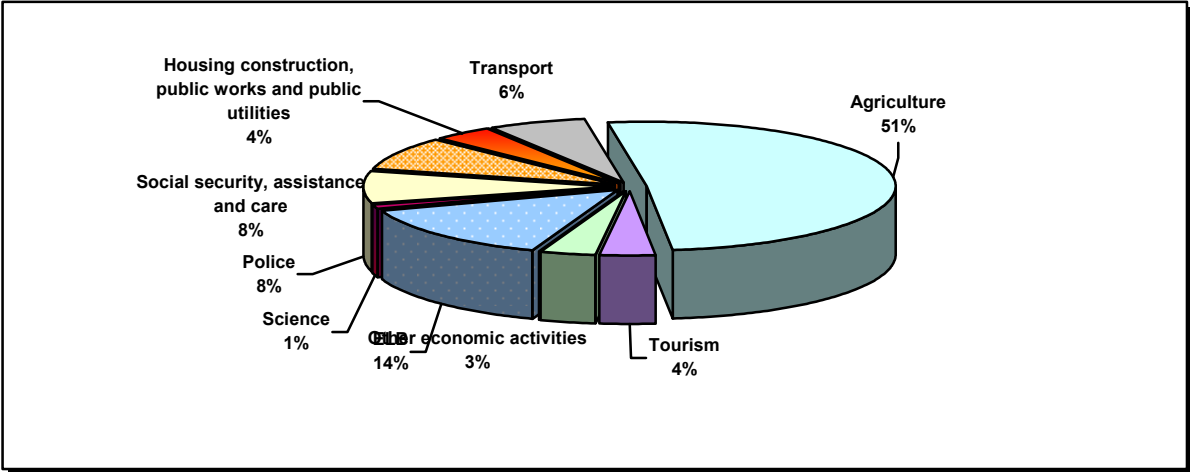


Chart No.11 Structure of the expenditures (by main sectors) financed with resources from the European Funds (including co-financing and national payments) for 2008

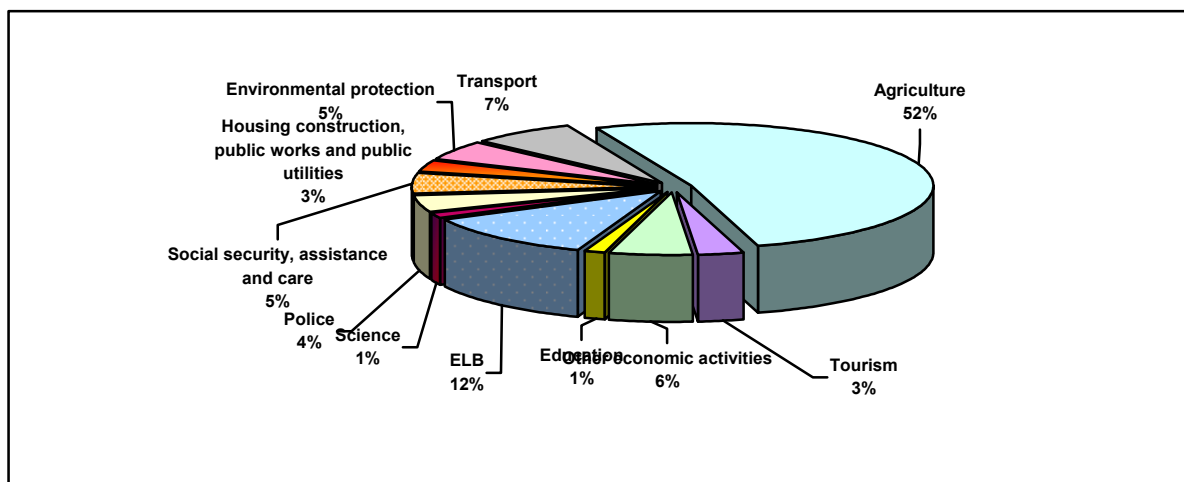
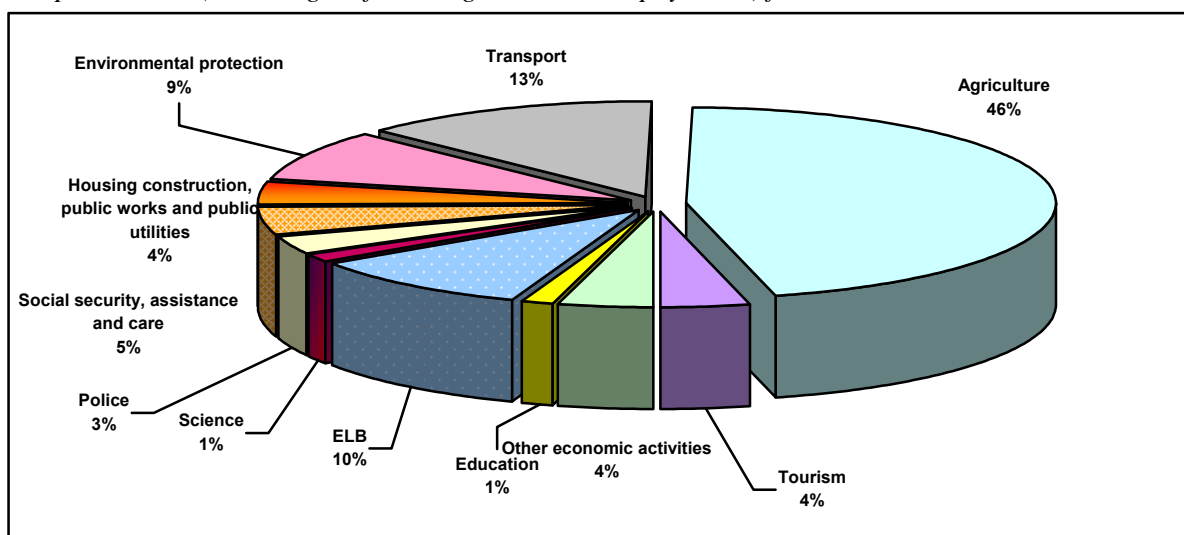


Chart No.12 Structure of the expenditures (by main sectors) financed with resources from the European Funds (including co-financing and national payments) for 2009



2.1. General public institutions

Table No.13 Distribution of expenditures for general public institutions (2005-2009)

CONSOLIDATED STATE BUDGET	2005	2006	2007	2008	2009
BGN million	report	program	forecast	forecast	forecast
I. GENERAL PUBLIC INSTITUTIONS - TOTAL (A+B+C)	1 268,3	1 546,5	1 701,9	1 869,2	2 010,9
Current expenditures	1 072,4	1 329,3	1 328,3	1 404,3	1 449,6
Capital expenditures	196,0	217,2	373,6	464,9	561,3
% of GDP	3,0%	3,4%	3,3%	3,4%	3,3%
% of total expenditures	7,6%	8,5%	8,5%	8,5%	8,4%
% of non-interest expenditures	7,9%	8,8%	8,8%	8,8%	8,7%
A. EXECUTIVE AND LEGISLATIVE BODIES	1 028,0	1 300,3	1 439,6	1 580,8	1 695,1
Current expenditures	845,9	1 092,8	1 077,1	1 129,0	1 149,7
Capital expenditures	182,1	207,5	362,5	451,8	545,4

% of GDP	2,5%	2,9%	2,8%	2,8%	2,8%
% of total expenditures	6,2%	7,1%	7,1%	7,2%	7,1%
% of non-interest expenditures	6,4%	7,4%	7,4%	7,5%	7,3%
B. GENERAL INSTITUTIONS	106,5	79,1	82,4	85,5	91,2
Current expenditures	100,7	74,4	77,5	80,5	84,7
Capital expenditures	5,8	4,7	5,0	5,0	6,5
% of GDP	0,3%	0,2%	0,2%	0,2%	0,2%
% of total expenditures	0,6%	0,4%	0,4%	0,4%	0,4%
% of non-interest expenditures	0,7%	0,4%	0,4%	0,4%	0,4%
C. SCIENCE	133,8	167,2	179,8	203,0	224,7
Current expenditures	125,8	162,1	173,7	194,9	215,2
Capital expenditures	8,0	5,1	6,1	8,1	9,4
% of GDP	0,3%	0,4%	0,4%	0,4%	0,4%
% of total expenditures	0,8%	0,9%	0,9%	0,9%	0,9%
% of non-interest expenditures	0,8%	1,0%	0,9%	1,0%	1,0%

The General Public Institutions function covers the financing of the public administration (central and local) and of science with both national budget resources and resources from the EU pre-accession funds and Community Funds.

The process of *modernizing the system*, increasing the effectiveness of administrative services, strengthening the administrative capacity for European integration processes, achieving higher level of satisfaction of the users of administrative services (citizens and companies), mitigating or eliminating some license, permission and registration regimes is a permanent objective of the government.

The quality and effectiveness of the administration is related to the achievement of better organized, effective and politically neutral administration, by improving the coordination in the administration activity and not by a higher number of people. In this connection a 10% optimization of administration structures and staff number has been envisaged for 2006, which will be mainly achieved through: merging structures where possible and expedient; closing structures that have out of date functions or merging institutions whose functions overlap; closing vacant or unnecessary job positions. The number of the public administration staff can be changed only with a decision of the Council for Public Administration Modernization and Council of Ministers (CoM).

The efforts of the government are targeted at developing human resources and upgrading the qualification of as many employees as possible through quality and timely training: language, computer and specialized training.

The quality of services rendered to citizens and businesses will be improved mainly through: eliminating or simplifying the license, permission and registration regimes; development of the “one-stop-shop” principle; transferring activities and services from the public administration to the private sector; development of the public-private partnership.

Science. Research and development activities, innovations and education are the engine of economic growth. The sector provides good opportunities for partnership between the private sector and the state and the aim is a more rational use of the various opportunities for science financing. The fundamental challenge is the attainment of the goal set up by the Lisbon Strategy, that is, to achieve a level of research and development expenditures equal to 3 percent of GDP. At present EC allocates around 2% of GDP, the lag being due mainly to the insufficient expenditures in the private sector, i.e. the mobilization of more investments in the private sector is crucial. Priority is given to the introduction of new technologies, in particular to information and communication technologies in both the private and the public sector

which are the backbone of the knowledge economy. Almost half of the productivity growth in the contemporary economy is due to them.

After our accession to EU good opportunities in support of regional innovation strategies are provided by EU regional and social funds and the state will ensure the needed support for the higher absorption of the Community funds.

The innovations are related to increasing the research potential and the quality of researches in higher education institutes so that they become more attractive and strengthen their links with real economy, as well as to improving research cooperation and transfer of technologies between higher education institutes and enterprises.

The good management, the prioritization of the spheres for scientific research work, the optimization of the system, the transformation of the financing model and its linking to the end results, the encouragement of the enterprises to invest more funds in research and development activities and the greater involvement of the private sector will contribute to the attainment of the main objectives of the government in the field of science and scientific research.

2.2. Defence and security

Table No.14 *Distribution of expenditures on defence and security (2005-2009)*

CONSOLIDATED STATE BUDGET BGN million	2005 report	2006 program	2007 forecast	2008 forecast	2009 forecast
II. DEFENCE AND SECURITY + RESERVE	2 078,2	2 345,7	2 595,6	2 760,2	3 000,1
% of GDP	5,0%	5,1%	5,1%	5,0%	5,0%
% of Total expenditures	12,5%	12,8%	12,9%	12,6%	12,5%
% of Non-interest expenditures	13,0%	13,3%	13,4%	13,0%	12,9%
II. DEFENCE AND SECURITY (A+B+C+D)	2 078,2	2 345,1	2 595,0	2 759,6	2 999,5
Current expenditures	1 829,1	2 026,6	2 156,0	2 308,9	2 476,8
Capital expenditures	249,1	318,5	438,9	450,7	522,7
% of GDP	5,0%	5,1%	5,1%	5,0%	5,0%
% of Total expenditures	12,5%	12,8%	12,9%	12,6%	12,5%
% of Non-interest expenditures	13,0%	13,3%	13,4%	13,0%	12,9%
A. DEFENCE	920,3	1 086,0	1 193,0	1 286,6	1 401,5
Current expenditures	722,5	821,4	891,4	961,6	1 026,6
Capital expenditures	197,8	264,7	301,7	325,0	375,0
% of GDP	2,2%	2,4%	2,3%	2,3%	2,3%
% of Total expenditures	5,5%	5,9%	5,9%	5,9%	5,8%
% of Non-interest expenditures	5,7%	6,2%	6,1%	6,1%	6,0%
B. POLICE, INTERNAL ORDER AND SECURITY	824,2	856,9	973,7	1 005,3	1 070,7
Current expenditures	799,7	832,3	866,4	910,6	969,0
Capital expenditures	24,5	24,7	107,3	94,7	101,7
% of GDP	2,0%	1,9%	1,9%	1,8%	1,8%
% of Total expenditures	4,9%	4,7%	4,8%	4,6%	4,5%
% of Non-interest expenditures	5,1%	4,9%	5,0%	4,7%	4,6%
C. JUDICIAL SYSTEM + RESERVE	265,9	327,7	350,2	382,5	428,6
% of GDP	0,6%	0,7%	0,7%	0,7%	0,7%
% of Total expenditures	1,6%	1,8%	1,7%	1,7%	1,8%
% of Non-interest expenditures	1,7%	1,9%	1,8%	1,8%	1,8%

D. JUDICIAL SYSTEM	265,9	327,1	349,6	381,9	428,0
Current expenditures	240,8	300,3	322,7	353,9	390,0
Capital expenditures	25,1	26,8	27,0	28,0	38,0
% of GDP	0,6%	0,7%	0,7%	0,7%	0,7%
% of Total expenditures	1,6%	1,8%	1,7%	1,7%	1,8%
% of Non-interest expenditures	1,7%	1,9%	1,8%	1,8%	1,8%
E. PRISON ADMINISTRATION	67,9	75,1	78,7	85,8	99,3
Current expenditures	66,2	72,6	75,6	82,7	91,3
Capital expenditures	1,7	2,4	3,0	3,0	8,0
% of GDP	0,2%	0,2%	0,2%	0,2%	0,2%
% of Total expenditures	0,4%	0,4%	0,4%	0,4%	0,4%
% of Non-interest expenditures	0,4%	0,4%	0,4%	0,4%	0,4%

Defence. Bulgaria will continue to pursue a defense policy whose essence is to shift the focus from defense against large-scale external threat of attack towards building a capacity for performance of a wide range of tasks to guarantee national security upon asymmetric threats. The development of the defense capacity will be in conformity with the membership of the Republic of Bulgaria in NATO as well as with the priorities of the now establishing European Security and Defense Policy as an integral part of the EU Common Foreign and Security Policy.

In the medium term the greatest challenges to national defense include the modernization and professionalisation of armed forces. The full professionalisation of armed forces is envisaged to complete by 2010. The purpose is to make the Bulgarian army a modern and trained army, capable to respond to the challenges placed before the national security and to take part in peace keeping operations in compliance with NATO requirements, if needed.

The state budget will allocate the resources for the modernization of our army but these resources should be considered as only one of the possibilities for attraction of resources. At the same time, the processes of armed forces modernization will be bound with the economic priorities of the government. Concrete off-set programs at both the direct and the indirect off-set will be contracted upon the conclusion of transactions for rearmament and modernization of the army. The government will strive to improve the parameters of the off-set programs and to establish better framework for the future transactions. Those measures will have positive effect on the economic development and GDP growth. The national policy on off-sets will be made compliant with the forming common European policy in the area of off-set agreements.

Further efforts should be targeted at increasing the transparency in planning and spending public resources intended for defense. Significant part of projected resources under this category fall under the restricting scope of the Classified Information Protection Act which hampers the evaluation of the defense activities' economic rationality and effectiveness. The effective and modern defense policy involves spending of allocated resources under the conditions of transparency, dialogue and use of the whole capacity of the civil society.

Police, internal order and security. The main measures taken by the government and the law enforcement and law protection authorities in the field of protection of public order and citizens security are targeted at improving the organization of police investigations in view of improving the rate of discovered crimes of high public danger. The work on improving the interaction among the bodies of the police, the investigation service and the prosecutor's office as well as on counteracting the so-called "new risks to security" – organized crime, corruption, terrorism, drug trafficking, etc., will continue.

Ensuring full EU membership of Bulgaria in the area of justice and judicial cooperation as well as effective accession of the country to the space of freedom, security and justice is one of the key priorities of the government. In this connection, the efforts will be targeted at:

- ♦ reducing corruption;
- ♦ reducing the rate of criminal offences in the country and limiting the action of organized criminal groups;
- ♦ strengthening the position of the Bulgarian police as a reliable partner of the European structures in counteracting cross-border organized crime;
- ♦ strengthening the interaction with foreign specialized and police services for exchange of information about concrete persons and terrorist organizations.
- ♦ strengthening the image of Bulgarian special and police services in the joint efforts for the EU policy strengthening in the region;
- ♦ improving the effectiveness in the work and capacity of MI individual structures for adequate response in counteracting criminal offences;
- ♦ limited illegal traffic of drug substances and precursors;
- ♦ improving the migration policy.

Judicial system. An important priority of the government is the continuation of the judicial reform with a view to achieving an effective, quick and accessible justice in view of the full membership of the Republic of Bulgaria in the European Union. The reform in this area is targeted at attaining: accessible and transparent judicial system capable to fully protect citizens' rights and freedoms; equal access to justice, European standards in the field of legal assistance; European standards for protection of the victims of crimes; European standards in the field of judicial execution and alternative solving of disputes; unification, standardization and centralization of the registers kept in view of the fast and quality registration; introduction and operation of the unified information system for counteracting crime; reliable security of court buildings, physical security of magistrates and of persons jeopardized in connection with any criminal proceedings.

In this connection the main priorities of the government related to the judicial system reform are as follows:

- ensuring full membership of Bulgaria in the European Union in the field of justice and judicial cooperation;
- harmonizing Bulgarian legislation with the international and European legislation in the area of child protection;
- strengthening the security of the judicial system;
- introduction of European standards for protection of the victims of crimes;
- improving the system of provision of legal assistance, alternative solving of disputes and increasing the effectiveness in the levy of judicial execution;
- computerization of the judicial system and establishing a single registration centre;
- strengthening the law enforcement capacity and improving the administrative activity of the judicial system.

In view of the high priority of the judicial reform carried out, the three-year budget forecast for the period 2007-2009 projects the share of judiciary expenditures as a percent of GDP to be preserved at the level for 2006.

The sustainability of the medium-term fiscal framework depends on the efforts that the spending units which administer their independent budgets exert for the observation of budget discipline and budget rules determined by the government depending on the budget policy pursued. In this connection we recommend the Supreme Judicial Council to spend more effectively, efficiently and economically the limited public resources.

2.3. Education

Table No.15 *Distribution of expenditures on education (2005-2009)*

CONSOLIDATED STATE BUDGET BGN million	2005	2006	2007	2008	2009
	report	program	forecast	forecast	forecast
III. EDUCATION	1 814,8	1 907,8	2 153,3	2 333,0	2 586,6
Current expenditures	1 637,5	1 779,7	1 965,2	2 116,9	2 396,5
Capital expenditures	177,4	128,1	188,1	216,1	190,1
% of GDP	4,3%	4,2%	4,2%	4,2%	4,3%
% of Total expenditures	10,9%	10,4%	10,7%	10,6%	10,8%
% of Non-interest expenditures	11,3%	10,8%	11,1%	11,0%	11,1%

The expenditures for education as a percent of GDP have been gradually growing in the past years. For the period 2007-2009 the expenditures for education are projected to grow by BGN 180-250 million on an annual basis. Accelerating investment in human resources will contribute to increasing economy productivity and competitiveness. In itself, the increase of public expenditures for education as a percent of GDP will not lead to improvement of the quality of our educational system if an overall reform in this sector is not carried out. The expenditures for education as a percent of GDP in Bulgaria (4.3 - 4.4% in the past three years) are at a level comparable to the one in many countries from Central and Eastern Europe and slightly below the average one for the EU-15 (5% of GDP); however, the indicators of Bulgarian students' results in the past years have been registering deterioration.

Greater effectiveness should be pursued within the available budget resources for the education sector. It presumes optimization and gradual consolidation of the large number of schools and higher education institutes at a reducing number of students with the purpose of increasing the students/teachers ratio. Keeping the unnecessary capacity in the educational system requires considerable resources for salaries and maintenance expenditures. The released funds could be used for modernization of the school base, higher salaries to teachers and upgrading of their skills and qualification, improvement of the curricula and introduction of modern training methods with the aim to improve the educational system results as a whole. The overall reforming of the educational system is also needed in view to stimulating human resource development and successfully training qualified staff meeting the contemporary needs of the labour market.

Precondition for the granting and effective absorption of resources under EU Funds as regards programs related to human resource development, is the successful implementation of planned reforms in the educational system. In principle, the EU policy on education is cautious, leaving the decision making powers in this sphere to the national authorities within the individual Member States. However, in the past years and especially since the objectives of the Lisbon strategy have been defined the European union put an emphasis on the

education policy. Education and training are recognized as fundamental factors for making Europe a competitive and dynamic knowledge economy on international level.

2.4. Healthcare

Table No.16 *Distribution of expenditures on healthcare (2005-2009)*

CONSOLIDATED STATE BUDGET BGN million	2005 report	2006 program	2007 forecast	2008 forecast	2009 forecast
IV. HEALTHCARE + RESERVE	2 009,8	2 002,4	2 221,3	2 420,8	2 641,9
% of GDP	4,8%	4,4%	4,4%	4,4%	4,4%
% of Total expenditures	12,0%	11,0%	11,0%	11,0%	11,0%
% of Non-interest expenditures	12,6%	11,4%	11,5%	11,4%	11,4%
IV. HEALTHCARE	2 009,8	1 879,9	2 099,8	2 283,9	2 494,7
Current expenditures	1 923,0	1 810,7	2 010,6	2 154,2	2 354,7
Capital expenditures	86,8	69,2	89,2	129,7	140,0
% of GDP	4,8%	4,1%	4,1%	4,1%	4,1%
% of Total expenditures	12,0%	10,3%	10,4%	10,4%	10,4%
% of Non-interest expenditures	12,6%	10,7%	10,8%	10,8%	10,7%

In the period 2007-2009 the expenditures on healthcare are projected to grow by BGN 200-220 million annually. However, more important is the attainment of greater effectiveness of those expenditures, better control and optimization of available resources and their targeting at improving the quality of work of doctors and hospitals.

The reform undertaken in the sector has not yet led to the expected results – improved financial position and functioning of the system, higher effectiveness of resources allocation, the universal and equal access to and scope of healthcare being preserved. All this necessitates acceleration of the reforms implemented in this sector, related to changes in the financing, organization and provision of health services.

The deteriorated demographic indicators in the country result in significant consequences to the healthcare system. The process of population ageing continues and it has negative effect in two aspects: the morbidity and invalidity rates become higher with ageing, and the increase in the number of persons at pension age as compared to working persons increases the burden of payments. The main challenges in the medium term to the establishment of an effective healthcare system are related to:

- Improving effectiveness while preserving the current levels of public expenditures on healthcare as a percent of GDP;
- Improving the quality of health services and hence – improving the health indicators;
- Improving the access to health services of those groups of the population which due to financial or other reasons give up benefiting of the needed medical care. Any potential changes to the system related to the introduction of additional payments could lead to additional revenues to the system but these should be made in combination with a strategy for protection of the vulnerable groups of the population;
- Improving the financial sustainability of the healthcare system related to:
 - ✓ improving the collection of health insurance contributions and first of all strict and strategic management of funds;

- ✓ control over expenses incurred and supervision over the behaviour of suppliers; limiting non-regulated payments; and providing consumers with the possibility to protect their own interests;
- ✓ continuing the process of optimization of hospital capacity (as existing structures and human resources). Hospitals consolidation should be accompanied by better coordination between their activity and the activity of outpatient medical care;
- ✓ analysis and improvement of current practices in administering the two largest items in the healthcare budget:
 - hospital care: the mechanisms of hospital care payment are to ensure incentives for the suppliers to limit the expenses while hospitals' actual operating costs are taken into consideration at the same time.
 - medicines: the growth of expenses on medicines needs to be put under control although this is a common phenomenon for most European countries.

The experience in other European countries shows that the regulation of medicines' prices in itself is not sufficient for the attainment of effective control over expenses on medicines (a lot of countries apply a combination of regulatory measures that comprise introduction of additional payment for medicines prescribed, limitation of the number of prescriptions per patient as well as the amounts under the prescriptions, laying down a ceiling of expenses on medicines, and the organizations of doctors bear responsibility for every excess expense).

In the medium term the private health insurance is expected to play limited role. The public sector will continue to be major source of health insurance services and adequate incentives need to be ensured so that the monopoly insurer NHIF strives to achieve economic effectiveness. The need of compromise between the competitive advantages of private health insurance and the possibility of preserving the health insurance system as a commonly accessible and covering a wide range of health services system needs to be analyzed.

The improvement of the quality of provided health services presumes adequate maintenance of existing capital assets at public health institutes. The closure of wards or of entire health institutes having unnecessary capacity as well as the merger of hospitals with the aim of reducing the total administrative costs will be hard and yet necessary decision. Thus, resources could be released for securing the pressing capital expenditures.

2.5. Social security, assistance and care

Table No.17 *Distribution of expenditures on social security, assistance and care (2005-2009)*

CONSOLIDATED STATE BUDGET	2005	2006	2007	2008	2009
BGN million	report	program	forecast	forecast	forecast
V. SOCIAL SECURITY + RESERVE	5 626,8	6 160,1	6 722,7	7 231,7	7 677,6
% of GDP	13,4%	13,5%	13,2%	13,0%	12,7%
% of Total expenditures	33,7%	33,7%	33,4%	33,0%	32,0%
% of Non-interest expenditures	35,2%	35,0%	34,7%	34,1%	33,1%
V. SOCIAL SECURITY, ASSISTANCE AND CARE (A+B+C)	5 626,8	6 100,1	6 662,7	7 171,7	7 617,6
Current expenditures	5 576,8	6 049,9	6 614,9	7 119,0	7 554,9
Capital expenditures	50,0	50,2	47,7	52,7	62,7
% of GDP	13,4%	13,4%	13,1%	12,9%	12,6%
% of Total expenditures	33,7%	33,4%	33,1%	32,7%	31,8%
% of Non-interest expenditures	35,2%	34,7%	34,3%	33,8%	32,8%
A. PENSIONS + RESERVE	3 803,3	4 168,4	4 382,5	4 705,0	4 979,5

% of GDP	9,1%	9,1%	8,6%	8,5%	8,2%
% of Total expenditures	22,8%	22,8%	21,8%	21,5%	20,8%
% of Non-interest expenditures	23,8%	23,7%	22,6%	22,2%	21,4%
A. PENSIONS	3 803,3	4 108,4	4 322,5	4 645,0	4 919,5
incl. support	28,0	35,4	36,8	38,8	41,1
% of GDP	9,1%	9,0%	8,5%	8,4%	8,1%
% of Total expenditures	22,8%	22,5%	21,5%	21,2%	20,5%
% of Non-interest expenditures	23,8%	23,3%	22,3%	21,9%	21,2%
B. SOCIAL ASSISTANCE AND INDEMNITIES + RESERVE	1 288,3	1 624,4	1 834,4	2 002,3	2 122,5
incl. maintenance	0,9	0,9	1,0	1,0	1,2
% of GDP	3,1%	3,6%	3,6%	3,6%	3,5%
% of Total expenditures	7,7%	8,9%	9,1%	9,1%	8,9%
% of Non-interest expenditures	8,0%	9,2%	9,5%	9,4%	9,1%
C. PROGRAMS, ACTIVITIES AND SERVICES RELATED TO					
SOCIAL SECURITY, ASSISTANCE AND EMPLOYMENT	535,3	367,3	505,8	524,4	575,7
Current expenditures	485,2	317,1	458,0	471,6	512,9
Capital expenditures	50,0	50,2	47,7	52,7	62,7
% of GDP	1,3%	0,8%	1,0%	0,9%	1,0%
% of Total expenditures	3,2%	2,0%	2,5%	2,4%	2,4%
% of Non-interest expenditures	3,3%	2,1%	2,6%	2,5%	2,5%

Employment, economic activity, unemployment

The expected high rates of economic growth in the period 2007-2009 ground the expectations the major indicators of the labour market to continue to improve. The stable economic growth in the past years created a good base for continuing the trends of higher employment and lower unemployment in the country. Nevertheless, the economic activity and employment of Bulgarian population are lower than the average level for EU.

In the three-year period the number of employed persons is expected to increase at slower rates mainly because of the projected lower effect of the government intervention in the labour market through the government employment programs. The employment growth will be mainly due to the higher activity of the private sector of the economy. This is projected to be also the main reason for continuing the trend of reduction of unemployment in the country. For Bulgaria the projections are the average annual unemployment to continue to decrease and to reach levels of below 10% in 2009.

The establishment of sustainable employment in the private sector of the economy would precondition the smooth increase of the rate of economic activity of population. Its average annual value in 2009 is projected to be by around 2 points¹² higher than in 2005.

The national plan for combating poverty and social exclusion in 2005-2006 is key government instrument in the social policy of the government of the Republic of Bulgaria for solving the existing problems in overcoming poverty and social exclusion in the process of the country's accession to EU by means of program target mechanisms. Combating poverty and social exclusion is a key component of the modernization of the European social model, its main characteristics being: competitiveness, social cohesion and control over inequality, and social solidarity. It is part of the global strategy of EU. The results from the implementation of the plan will be crucial for the preparedness of our country to meet the high standards and ambitious goals of the European project in social policy as regards persons, households and vulnerable groups that live in poverty or are threatened with poverty.

¹² Of the population at the age of 15 and older

As regards the expenditures on social security and care, curtailment of the funds for employment programs is proposed in view of the projected drop of the number of unemployed persons and the accession to EU.

Pensions

The government policy on the pension system is targeted at ensuring actual implementation of the principles of solidarity and social justice in Bulgarian legislation in view of making the system compliant with EU sound practices and standards. When implemented this policy will result in attainment of the objectives of the EU Growth and Jobs Strategy related to adequacy of pensions, financial sustainability of the pension system and its modernization in line with the economic growth, increasing employment and income of people. Together with NSSI and the social partners the government will work for the more fair and adequate consideration of persons' insurance contribution, the reduction of the inequality of the individual persons working under different labour conditions. A demographic investment fund – Silver fund, is being established in view of the improvement of the financial sustainability of the pension system.

The projections of the pension expenditures have been made taking into account the introduction of new indexation mechanism as from 2007 – indexation as of 1 June each year with a coefficient obtained by 50% of the inflation rise and 50% of the increase of the average insurable income, which is 7.7% for 2007.

2.6. Housing construction, public works, public utilities and environmental protection

Table No.18 *Distribution of expenditures on housing construction, public works, public utilities and environmental protection (2005-2009)*

CONSOLIDATED STATE BUDGET	2005	2006	2007	2008	2009
BGN million	report	program	forecast	forecast	forecast
VI. HOUSING CONSTRUCTION, PUBLIC WORKS, PUBLIC UTILITIES AND ENVIRONMENTAL PROTECTION (A+B)	725,8	975,9	1 011,9	1 040,0	1 228,5
Current expenditures	374,2	423,8	510,6	526,3	595,4
Capital expenditures	351,6	552,1	501,3	513,7	633,1
% of GDP	1,7%	2,1%	2,0%	1,9%	2,0%
% of Total expenditures	4,3%	5,3%	5,0%	4,7%	5,1%
% of Non-interest expenditures	4,5%	5,5%	5,2%	4,9%	5,3%
A. HOUSING CONSTRUCTION, PUBLIC WORKS, PUBLIC UTILITIES					
PUBLIC UTILITIES	233,6	257,4	397,9	400,7	435,3
Current expenditures	95,6	121,8	196,3	198,3	234,0
Capital expenditures	137,9	135,5	201,6	202,4	201,3
% of GDP	0,6%	0,6%	0,8%	0,7%	0,7%
% of Total expenditures	1,4%	1,4%	2,0%	1,8%	1,8%
% of Non-interest expenditures	1,5%	1,5%	2,1%	1,9%	1,9%
B. ENVIRONMENTAL PROTECTION	492,2	718,5	614,0	639,3	793,2
Current expenditures	278,5	301,9	314,3	328,0	361,4
Capital expenditures	213,7	416,6	299,7	311,3	431,8
% of GDP	1,2%	1,6%	1,2%	1,2%	1,3%
% of Total expenditures	2,9%	3,9%	3,0%	2,9%	3,3%
% of Non-interest expenditures	3,1%	4,1%	3,2%	3,0%	3,4%

Priority of the **housing policy** in this period will be the improvement of the state of the existing housing buildings and the establishment of a working mechanism for provision of accessible dwellings (for purchase or lease).

The policies in the area of **public works** include: averting and limiting landslides, erosion and abrasion processes; geodetic activity and cadastre; ensuring and maintaining spatial development and public works systems in settlements; regulating and exercising control on design and construction.

The planned improvement of the state of the water and sewerage infrastructure and the management of the water supply and sewerage system is targeted at attaining the following main objectives: eliminating the water consumption restrictions; supplying to all settlements drinking water that meets the quality requirements; reducing the amount of water lost from the water distribution system; removing and treating the waste water from urbanized territories and improving the quality of natural water.

The three-year budget forecast for the period 2007-2009 envisages around 2.9-3.3% of consolidated expenditures to be intended for **environmental protection** on an annual basis. The fulfilment of the European requirements on environmental protection ensuing from EU directives in this area presumes increase of budget resources for this sphere in the long term. A significant change is pending as regards the target of public expenditures in the area of environmental protection: the current expenditures will decrease on the account of the capital ones.

The financial resources needed in the area of environmental protection are significantly higher than the current level of expenditures of around 1% of GDP. Such level of expenditures for that area is comparable to the one in other countries from Central and Eastern Europe and EU-15. The expenditures for environmental protection in EU-15 total around 2% of GDP but approximately half of them are financed by the private sector, i.e. the public expenditures are around 1% of GDP. In new EU Member States the part that comes from the private sector is significantly lower. In Bulgaria the public sector will be major source of financing for environment investments. In the medium term we do not project considerable private sector involvement in addition to the resources from the EU Funds, the state budget and the municipal budgets.

According to the projected data the needs of public financing after 2006 for management and development of the water sector and management of waste related activities are significantly higher than the envisaged total amount of capital expenditures for investments in environmental projects. Difficulties may arise also in relation to the needed financing for environmental protection projects (projects for drinking and waste water and solid waste) by municipalities. The water supply and sewerage system which has not been adequately maintained in the past 15 years need to be rehabilitated and further built in a number of municipalities. At the same time, due to the delayed process of financial decentralization most of the municipalities are still not able to generate considerable resources unless a reform is implemented granting more powers to local authorities in terms of revenues collection.

2.7. Recreation, culture and religious activities

Table No.19 *Distribution of expenditures on recreation, culture, sports and religious activities (2005-2009)*

CONSOLIDATED STATE BUDGET BGN million	2005	2006	2007	2008	2009
	report	program	forecast	forecast	forecast
VII. RECREATION, CULTURE, RELIGIOUS ACTIVITIES	339,5	319,6	332,8	353,8	394,2
Current expenditures	289,8	281,1	292,6	307,9	335,3
Capital expenditures	49,7	38,5	40,2	45,9	58,9
% of GDP	0,8%	0,7%	0,7%	0,6%	0,7%
% of Total expenditures	2,0%	1,8%	1,7%	1,6%	1,6%
% of Non-interest expenditures	2,1%	1,8%	1,7%	1,7%	1,7%
A. RECREATION	7,4	7,0	7,2	8,1	9,3
Current expenditures	6,9	6,7	7,0	7,2	7,4
Capital expenditures	0,5	0,3	0,3	1,0	2,0
% of GDP	0,0%	0,0%	0,0%	0,0%	0,0%
% of Total expenditures	0,0%	0,0%	0,0%	0,0%	0,0%
% of Non-interest expenditures	0,0%	0,0%	0,0%	0,0%	0,0%
B. PHYSICAL CULTURE AND SPORTS	41,4	17,8	18,5	20,1	23,4
Current expenditures	37,9	17,8	18,5	20,1	23,4
Capital expenditures	3,5				
% of GDP	0,1%	0,0%	0,0%	0,0%	0,0%
% of Total expenditures	0,2%	0,1%	0,1%	0,1%	0,1%
% of Non-interest expenditures	0,3%	0,1%	0,1%	0,1%	0,1%
C. CULTURE	287,5	291,5	303,5	320,9	356,5
Current expenditures	241,8	253,2	263,6	276,0	299,5
Capital expenditures	45,7	38,3	40,0	45,0	57,0
% of GDP	0,7%	0,6%	0,6%	0,6%	0,6%
% of Total expenditures	1,7%	1,6%	1,5%	1,5%	1,5%
% of Non-interest expenditures	1,8%	1,7%	1,6%	1,5%	1,5%
D. RELIGIOUS ACTIVITIES	3,2	3,4	3,5	4,6	5,0
Current expenditures	3,2	3,4	3,5	4,6	5,0
Capital expenditures					
% of GDP	0,0%	0,01%	0,01%	0,01%	0,01%
% of Total expenditures	0,0%	0,02%	0,02%	0,02%	0,02%
% of Non-interest expenditures	0,0%	0,02%	0,02%	0,02%	0,02%

The national policy in the area of **culture** is targeted at:

- safeguarding the cultural and historical heritage – movable and immovable, ensuring the access of a wide range of citizens thereto, establishing a system for its promotion in both the country and abroad as part of the positive historical image of Bulgaria;
- supporting the creation and dissemination of the various genres of art and cultural products and services;
- promoting our culture in both the country and abroad, disclosing the contribution of the cultural heritage and modern cultural phenomena to the development of the European and world culture;
- ensuring quality training in art and culture and better realization of qualified artists, respectively. This is connected with deepening the process of interrelation of curricula and specific tasks in cultural institutes, and strengthening new forms of supporting creative innovations and initiatives.

The forms of active involvement of public authorities and non-governmental organizations in forming the policy on culture is projected to extend. In addition, the participation of local government representatives in the management bodies is projected to extend by means of decentralization of financing and de-concentration of cultural process actors.

The main orientations in the policy on **physical culture and sports** are as follows:

- preserving and developing of and investing in youth as the social capital of the country;
- extending the scope of students who regularly practice physical drills and sports, and strengthening the physical education and sports as a means of healthy way of life;
- creating conditions and opportunities for increasing the number of people practicing physical drills and sports as a means of prophylaxis, maintaining and preserving the health and physical ability of the population;
- supporting the socially useful activity of sport organizations and creating conditions so that sportsmen attain high sports results in international competitions, European and world championships and Olympic games;
- construction, reconstruction and modernization of sporting sites and facilities in compliance with the requirements of the respective international standards and creation of conditions for access of disabled people thereto;
- effective and rational management and absorption of European and budget resources in view of the building of modern youth and sports sphere in the Republic of Bulgaria.

The State assists and encourages the registered **religious denominations** in the country in the exercise of their religious, social, educational and curative activities.

2.8. Economic activities and services

Table No.20 *Distribution of expenditures on economic activities and services (2005-2009)*

CONSOLIDATED STATE BUDGET	2005	2006	2007	2008	2009
BGN million	report	program	forecast	forecast	forecast
VIII. ECONOMIC ACTIVITIES AND SERVICES + RESERVE	1 990.9	2 118.3	2 547.1	3 044.6	3 547.4
% of GDP	4.7%	4.6%	5.0%	5.5%	5.9%
% of Total expenditures	11.9%	11.6%	12.6%	13.9%	14.8%
% of Non-interest expenditures	12.4%	12.0%	13.1%	14.4%	15.3%
VIII. ECONOMIC ACTIVITIES AND SERVICES	1 990.9	2 088.3	2 487.1	2 974.6	3 472.4
Current expenditures	1 231.9	1 241.0	1 562.9	2 054.1	2 379.6
Capital expenditures	759.0	847.2	924.2	920.6	1 092.8
% of GDP	4.7%	4.6%	4.9%	5.4%	5.7%
% of Total expenditures	11.9%	11.4%	12.3%	13.6%	14.5%
% of Non-interest expenditures	12.4%	11.9%	12.8%	14.0%	15.0%
A. MINING, FUELS AND ENERGY	17,2	25,7	17,9	18,7	23,5
Current expenditures	15,1	14,9	15,5	15,9	19,5
Capital expenditures	2,1	10,8	2,4	2,8	4,0
% of GDP	0,0%	0,1%	0,0%	0,0%	0,0%
% of Total expenditures	0,1%	0,1%	0,1%	0,1%	0,1%
% of Non-interest expenditures	0,1%	0,1%	0,1%	0,1%	0,1%
B. AGRICULTURE, FORESTRY, HUNTING AND FISHERY	462.0	654.0	908.3	1 232.3	1 415.9

Current expenditures	400.5	497.3	783.7	1 134.6	1 371.2
Capital expenditures	61.5	156.8	124.6	97.7	44.7
% of GDP	1.1%	1.4%	1.8%	2.2%	2.3%
% of Total expenditures	2.8%	3.6%	4.5%	5.6%	5.9%
% of Non-interest expenditures	2.9%	3.7%	4.7%	5.8%	6.1%
C. TRANSPORT AND COMMUNICATIONS	816.9	1 080.8	1 144.7	1 234.8	1 483.7
Current expenditures	505.1	412.7	396.5	457.9	486.0
Capital expenditures	311.8	668.2	748.2	776.9	997.7
% of GDP	1.9%	2.4%	2.2%	2.2%	2.4%
% of Total expenditures	4.9%	5.9%	5.7%	5.6%	6.2%
% of Non-interest expenditures	5.1%	6.1%	5.9%	5.8%	6.4%
D. INDUSTRY AND CONSTRUCTION	8.0	11.2	11.7	12.2	13.9
Current expenditures	7.9	11.1	11.5	11.9	13.2
Capital expenditures	0.1	0.2	0.2	0.4	0.7
% of GDP	0.0%	0.0%	0.0%	0.0%	0.0%
% of Total expenditures	0.0%	0.1%	0.1%	0.1%	0.1%
% of Non-interest expenditures	0.0%	0.1%	0.1%	0.1%	0.1%
E. TOURISM	7.8	13.6	55.1	66.0	115.2
Current expenditures	7.0	13.4	45.3	53.5	91.0
Capital expenditures	0.8	0.2	9.7	12.5	24.2
% of GDP	0.0%	0.0%	0.1%	0.1%	0.2%
% of Total expenditures	0.0%	0.1%	0.3%	0.3%	0.5%
% of Non-interest expenditures	0.0%	0.1%	0.3%	0.3%	0.5%
F. OTHER ECONOMIC ACTIVITIES	679.2	302.9	349.5	410.6	420.3
Current expenditures	296.4	291.7	310.4	380.3	398.7
Capital expenditures	382.8	11.2	39.1	30.3	21.5
% of GDP	1.6%	0.7%	0.7%	0.7%	0.7%
% of Total expenditures	4.1%	1.7%	1.7%	1.9%	1.8%
% of Non-interest expenditures	4.2%	1.7%	1.8%	1.9%	1.8%

Road infrastructure. The country is faced with the need to further build and maintain the base transport infrastructure in combination with the challenge to improve competitiveness. The intensifying connections and trade flows between Bulgaria and the European market place new challenges to the road infrastructure and transport. The improvement of the road infrastructure is a prerequisite for Bulgaria's integration in the European transport network. Bulgaria has taken the commitment to finish the rehabilitation and modernization of major part of its road network in conformity with European standards by 2014, while part of the roads is to be improved by 2008.

After Bulgaria's accession to EU in 2007 the financial needs of considerable investments in the transport sector for financing road infrastructure projects may potentially be secured through the possibilities of using European Funds resources (under the Cohesion Fund as well as under the European Regional Development Fund for financing road investments in second and third class roads that are outside the major European corridors).

Non-financial enterprises. The trend of changes in the structure of the non-financial public and municipal sector will continue in the reviewed period because of the expected privatization of companies in the following sectors:

- "Supply of electricity and heating, gaseous fuels and water" – the district heating companies - Varna, Bobov Dol and Rousse, the expected restructuring of Bulgargaz EAD, the water supply and sewerage companies.

- “Transport, storage and communications” – the privatization of “BMF” EAD, “BRP” AD and “Bulgaria Air” EAD.

- deregulation of the natural monopolies in the sectors of energy, railway transport, water supply and sewerage companies, etc., aimed at enhancing competition in those markets.

- “Production of foodstuffs, beverages and tobacco products” – the companies from the system of “Bulgartabak”;

- Continuing restructuring of the industrial sector and the service sector – faster development of productions with relatively high added value (especially in export oriented sectors).

The already started process of liquidation of ineffective productions, mostly in the mining industry, will complete during this period.

In the period 2007-2009, as a result of the continuation of the processes of privatization, granting under concession, development of public-private partnership the competitiveness of the Bulgarian economy and the production sector will improve based on viable enterprises. The share of small and medium sized enterprises and their role as a factor in the economic and social development of the country will increase.

Agriculture. After the expected accession of Bulgaria to EU the country will be able to apply for considerable financial support. It seems that the agriculture will receive the greatest portion of the EU funds in the form of financial support under Pillar 1 and Pillar 2 within the Common Agricultural Policy. Pillar 1 is used for financing direct payments and market actions in support of agricultural producers, and Pillar 2 – for financing measures for rural development.

The resources allocated under Pillar 1 within the Common Agricultural Policy are not linked to co-financing from the national budget unlike the resources allocated under Pillar 2 which require 20% co-financing. At the same time, the direct payments in support of agricultural producers under Pillar 1 necessitate pre-financing with resources from the national budget. Funds will be subsequently transferred by EU to cover the financial resources already disbursed as direct payments to Bulgarian agricultural producers. Thus the direct payments could lead to deterioration of the budget position. Provided the direct payments system starts functioning without any problems, the first disbursement of direct payments from the national budget will be made in the period from 1 December 2007 to 30 June 2008. The EU will reimburse those funds after a certain period of time (within few months), i.e. at the beginning of 2008 at the earliest, which will exert pressure on the 2007 budget.

Schemes of direct payments are already in place in Bulgaria but those are not made compliant with the requirements of the Common Agricultural Policy. The introduction of the principles of the Common Agricultural Policy will lead to substitution of the now applied schemes of direct support to Bulgarian agricultural producers. The current level of budget expenditures for the agriculture, forestry, hunting and fishery sector is around 1.1-1.4% of GDP, including the Agriculture State Fund and the Tobacco Fund which are the two major sources of agricultural subsidies. The total amount of those subsidies can be covered by EU funds within the Common Agricultural Policy in the period 2007-2009. Substituting the subsidies granted to those two funds with EU funds will release resources for the needed co-financing of rural development activities under Pillar 2.

Within certain amounts Bulgaria will be able to complement the direct payments from EU with the so-called Compensatory National Direct Payments usually referred to as “top-up”

payments. Those payments are part of a compromise solution reached with all new EU Member States, including with regard to Bulgaria and Romania, the effect of the ten-year period of gradual introduction for direct payments to be compensated.

Direct payments may be complemented in two ways – entirely with own resources (from the national budget) or via partial use of up to 20% of the funds that can be disbursed under Pillar 2. Under the second approach, relevant co-financing with national resources should be ensured for those funds under Pillar 2 that are reallocated for complementing the direct payments. Thus, resources will be again taken for covering direct payments instead of being used to finance activities that could have greater effect for the improvement of Bulgarian agriculture competitiveness. In addition, the measures for direct support can not compensate the need of increasing productivity and improving competitiveness of Bulgarian agriculture. Direct payments decrease the incentives for agricultural producers to undertake restructuring, consolidation and modernization of their activity as their receipt guarantees minimum income from the agricultural activity.

Only the framework of the overall package of financial commitments under Pillar 1 and Pillar 2 of the Common Agricultural Policy has been defined in the negotiations with EU on agriculture. The strategic decisions and key aspects regarding the implementation of the Common Agricultural Policy in Bulgaria are still to be made and evaluated by the Bulgarian government. A number of aspects related to the implementation of the Common Agricultural Policy are to be clarified – selection of an appropriate scheme of payment and determining the selection criteria for direct payments; budget possibilities for complementing the direct payments and potential reallocation of the resources under the individual pillars within the Common Agricultural Policy.

Energy. The main priorities in the sector are related to:

- opening the energy market and deregulating the trade in electricity and natural gas aimed at creating actual competition in the energy market;
- continuing the privatization process in the energy sector and withdrawal of the state from the energy sector;
- improving the method of pricing in the energy sector and attaining fair prices for businesses and end consumers;
- not admitting decapitalisation of the companies in the energy sector;
- encouraging the introduction of renewable energy sources in the energy balance of the country and protecting the environment by means of reducing harmful emissions;
- fulfilling the country's obligations under international conventions, national security and independence as regards nuclear safety and radiation protection;
- absorbing effectively the resources under the EU Structural Funds.

Tourism is one of the sectors on which we rely to contribute to the high and sustainable growth of our economy in the coming years.

The national policy in the area of tourism is targeted at:

- improving the quality of tourist services and setting up a better system for quality improvement via training the staff in the tourism sector;

- better and more effective presentation of Bulgaria abroad as a tourist destination not only for less solvent tourists;
- establishing mechanisms for public-private partnerships in the sector;
- using effectively the opportunities provided by the EU Structural Funds with a view to improving the quality of tourist products and developing new products and services.

The tourist business should contribute with funds to the greater advertisement of Bulgaria abroad, thus attaining a unified advertisement and vision of the country. The efforts in the advertising activity need to be focused not only on summer and winter tourism but also on the other types of tourism – cultural, cultural-historical, congress, balneological, alternative.

2.9. Expenditures not classified under the other functions

Table No.21 *Distribution of the expenditures that have not been classified under the other functions (2005-2009)*

CONSOLIDATED STATE BUDGET	2005	2006	2007	2008	2009
BGN million	report	program	forecast	forecast	forecast
IX. EXPENDITURES NOT CLASSIFIED UNDER THE OTHER FUNCTIONS	837.4	1 094.8	1 095.9	1 140.6	1 155.4
Current expenditures	685.6	661.7	740.8	728.1	737.6
Capital expenditures					
Credits and temporary financial assistance (net)	34.2	100.0	35.0	35.0	35.0
Reserve	117.6	333.1	320.1	377.5	382.8
% of GDP	2.0%	2.4%	2.1%	2.1%	1.9%
% of Total expenditures	5.0%	6.0%	5.4%	5.2%	4.8%
% of Non-interest expenditures	5.2%	6.2%	5.6%	5.4%	5.0%

The items planned under this function include interest expenditures, targeted credits granted by the Agriculture State Fund to agricultural producers, and the contingency reserve which guarantees stability in the course of budget execution and ensures funds for the prevention and elimination of the consequences of natural disasters and major industrial accidents.

V. DEBT AND FINANCING

1. Government debt

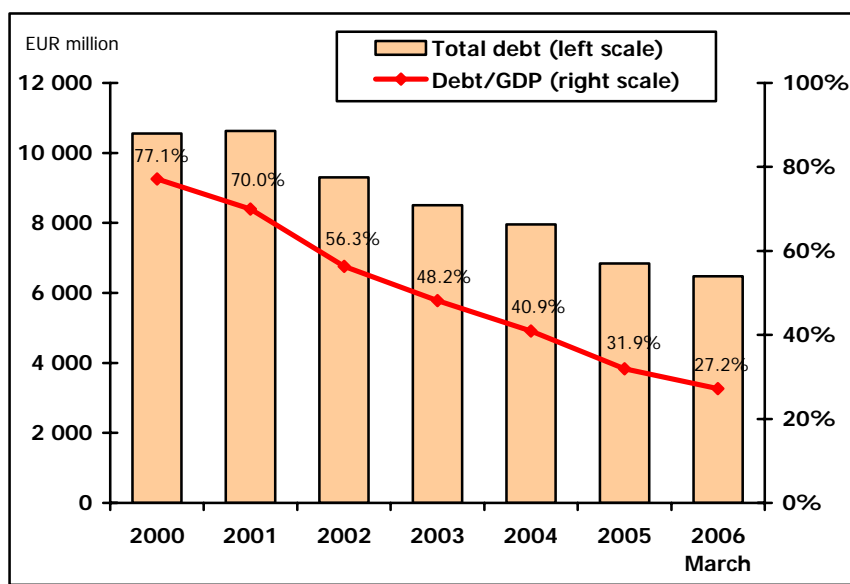
As of the end of 2005 the nominal amount of the government and government-guaranteed debt totalled BGN 13 386.5 million, including external debt to the amount of BGN 10 543.8 million and domestic debt of BGN 2 842.7 million. The government debt amounted to BGN 12 380.9 million. The debt to GDP ratio for the same period is 32.4 percent, while in respect of external debt exclusively this ratio is 25.5 percent. Compared to the end of 2004 and in absolute terms, the debt amount has decreased by BGN 2 172.5 million, while its relative proportion to GDP has shrunk by 8.5 percentage points.

A number of transactions for external debt early repayment were conducted in 2005, the major of them being the early prepayment of the Brady Interest Arrears Bonds (IAB) and the Front Loaded Interest Reduction Bonds (FLIRB) totalling around USD 1.5 billion, the debt to the Italian Export Credit Insurance Agency SACE amounting to Euro 53.8 million, and three tranches under the Three-Year Extended Arrangement with the International Monetary Fund amounting to Euro 147.4 million. Due to the early debt repayment transactions the funds spent on external debt payments considerably exceeded the amount envisaged by law for 2005.

The interest structure was also subject to positive changes in 2005 – the relative share of debt with floating interest rate out of the total debt amount was reduced to 45.8 percent from 58.8 percent at end-2004. Those transactions have mainly led to changes in the indicative parameters of the external debt which reached 25.5% as compared to GDP as at end-2005, representing a reduction of 8.4 percentage points in comparison with end-2004 (33.8%). An improvement is also being witnessed in the external debt currency structure, since the share of debt in U.S. dollars dropped down to 29.5 percent at the end of December 2005, which represents a reduction of around 10 percentage points as compared to the end of 2004. The reduction in the U.S. dollar component is fundamentally due to the increase of the debt in Euro from 44.4 percent up to 55.7 percent, respectively, within the same period of time. In 2005 the funds for debt service spent under the central budget amounted to BGN 4 714.1 million, including BGN 3 432.5 million under the external debt, and BGN 1 281.6 million – under the domestic debt.

The level of the domestic debt projected for the end of 2006 is approximately BGN 3.5 billion, while that of the external debt is BGN 10 billion. The projected amount of payments under the external debt on a consolidated basis is around BGN 1.3 billion, out of which principal amounting to around BGN 800 million and interest in the amount of around BGN 460 million. Payments under the domestic debt are projected to be approximately BGN 1.1 billion (including payments to the Bulgarian National Bank), out of which principal amounting to BGN 930 million and interest in the amount of BGN 200 million. Having in mind the present state of debt, the payments on the government debt under the consolidated budget in the next three years are expected to be within the range from BGN 2 300.0 million in 2007 to BGN 1 800.0 million in 2009. The greatest impact on these parameters will be exercised by the international interest rate levels, as well as by the rates of exchange of the U.S. dollar against the main currencies.

Chart No.13 Dynamics of the government and government-guaranteed debt for the period 2000 - 2006¹³.



Source: MoF

2. Financing

Under the expected macro environment and projected budget policy the debt financing will be mainly targeted at ensuring resources to cover the due debt payments and maintain an adequate fiscal reserve level. **External loans** will be taken mainly to support significant public projects and the expertise of the international financial institutions will be used. In the **domestic market**, the efforts for secondary market development through implementation of positive net issuance of government securities will continue. The volume of the issues as well as their characteristics will be determined depending on the current market environment and on the requirements imposed by our country's accession to the single European market.

A number of important privatization deals are expected to be finalized in 2007, namely Parahodstvo Bulgarski Morski Flot EAD, Bobov Dol District heating company EAD, Bulgaria Air EAD, etc. The proceeds expected from privatization in 2007 amount to BGN 200 million, including 10 percent for replenishment of the Privatization Expense Recovery Fund /PERF/ to the Privatization Agency.

For 2008 the projections are that mainly residual minority packages of shares/interests will be sold, the expected proceeds from privatization being to the amount of BGN 100 million, including 10 percent for replenishment of the PERF to the Privatization Agency.

In 2009 the proceeds are projected at the amount of BGN 5 million, those being solely from the rescheduled payment transactions concluded by the Post-privatization Control Agency as we expect the privatization resource from company packages/interests to be exhausted at that time. The proceeds from privatization for 2009 would be higher upon eventual exclusion of companies from the list under Annex 1 to Article 3, paragraph 1 of the Privatization and Post-Privatization Control Act.

¹³ The computations have been made on the basis of updated GDP forecast for 2005 – BGN 41 948 million, and GDP forecast for 2006 – BGN 46 620 million.

Conclusion

The present budget forecast for the period 2007-2009 has been developed on the assumption that our country will become full EU member on 1 January 2007. The forecast is compliant with both the management priorities of the new coalition government and the total financial assistance we expect to receive under the European Structural Funds during the first three years of EU membership. The pursuit of high and rational utilization of those funds is expected to have tangible positive effect on the economic development of the country.

The three-year budget forecast for the period 2007-2009 has been developed at minimum levels of surplus which will ensure the maintenance of the macroeconomic stability, the unproblematic financing of the budget sectors and the successful absorption of EU funds. The counter-cyclical fiscal policy that our country implements is one of the key recommendations of the European Commission for long-term stability of public finance.

The expectations are that in the next three years the GDP growth will remain high - 5.8% in 2007, 6.2% in 2008 and 6.1% in 2009. Continuing the structural reforms, improving the business environment and reducing the share of grey economy in the country are important for the maintenance of positive economic dynamics.

In view of the EU funds absorption we have chosen to restructure the budget. This means that in order to meet the expenditures ceiling certain budget spheres that do not receive resources under the European Funds need to be optimized on the account of other spheres which will absorb the additional European funds amounting to 1-2% of GDP. For this purpose we have proposed a review to be made of the expenditures in a number of budget sectors such as public administration, defense, subsidies, social assistance, etc. The efforts of local and regional authorities will be crucial for the absorption of the resources from the EU Structural Funds

The measures in the area of taxes during this period will be made subordinate to the main objectives of the fiscal policy, namely – economic growth by means of stimulating the economic activity and maintaining the stability of public finance. The implementation of the commitments to EU with regard to the unification of the tax legislation in compliance with the European legislation will continue.

In the medium term we will exert considerable efforts to develop the economic mechanisms for division of responsibilities between the government and the private sector in the implementation of large-scale projects in infrastructure and other spheres. The public capital expenditures replenished with financing from the private sector and the EU pre-accession, Structural Funds and Cohesion Fund will be targeted at sectors and projects that generate high net benefits for the public.

Three-year budgetary forecast for the period 2007-2009

Table: Consolidated fiscal program 2006-2009 (in BGN million)

CONSOLIDATED STATE BUDGET BGN million	2006	2006	2006	2007	2007	2007	2007	2008	2008	2008	2008	2009	2009	2009	2009
	national budget	pre- accession	total program	national budget	pre- accession	EU	total forecast	national budget	pre- accession	EU	total forecast	national budget	pre- accession	EU	total forecast
Total revenues	17 598.0	660.0	18 258.0	20 153.4	476.1	521.5	21 151.0	21 438.4	255.2	1 312.1	23 005.7	22 962.0	130.6	1 945.5	25 038.0
Tax revenues	15 049.0		15 049.0	16 956.2			16 956.2	18 047.6			18 047.6	19 233.1			19 233.1
Direct taxes	6 174.5		6 174.5	6 916.8			6 916.8	7 549.0			7 549.0	8 045.6			8 045.6
Corporate taxes	1 051.3		1 051.3	1 067.0			1 067.0	1 230.3			1 230.3	1 333.3			1 333.3
non-financial enterprises	921.1		921.1	942.0			942.0	1 062.6			1 062.6	1 147.6			1 147.6
financial institutions	130.2		130.2	125.0			125.0	167.7			167.7	185.7			185.7
Personal income tax	1 040.0		1 040.0	1 139.4			1 139.4	1 286.5			1 286.5	1 335.5			1 335.5
Revenues of public security and health insurance systems	4 083.2		4 083.2	4 710.4			4 710.4	5 032.2			5 032.2	5 376.8			5 376.8
Security contributions	3 043.2		3 043.2	3 495.2			3 495.2	3 663.2			3 663.2	3 905.2			3 905.2
Health insurance contributions	1 040.0		1 040.0	1 215.2			1 215.2	1 369.0			1 369.0	1 471.6			1 471.6
Indirect taxes	8 449.4		8 449.4	9 538.7			9 538.7	9 996.6			9 996.6	10 671.5			10 671.5
VAT	5 509.5		5 509.5	6 243.0			6 243.0	6 478.3			6 478.3	6 844.2			6 844.2
Excise duties - total	2 582.2		2 582.2	3 041.7			3 041.7	3 225.3			3 225.3	3 518.3			3 518.3
Customs duties and charges	357.7		357.7	254.0			254.0	293.0			293.0	309.0			309.0
Other taxes	425.2		425.2	500.7			500.7	502.0			502.0	516.0			516.0
Non-tax revenues	2 521.0		2 521.0	3 155.7			3 155.7	3 350.3			3 350.3	3 686.3			3 686.3
Transfers from BNB	150.0		150.0	170.0			170.0	170.0			170.0	170.0			170.0
Others	2 371.0		2 371.0	2 985.7			2 985.7	3 180.3			3 180.3	3 516.3			3 516.3
Grants	27.9	660.0	687.9	41.5	476.1	521.5	1 039.1	40.5	255.2	1 312.1	1 607.8	42.6	130.6	1 945.5	2 118.6
external grants	15.5	660.0	675.5	20.0	476.1	521.5	1 017.6	21.0	255.2	1 312.1	1 588.3	22.6	130.6	1 945.5	2 098.6
domestic grants	12.4		12.4	21.5			21.5	19.5			19.5	20.0			20.0

CONSOLIDATED STATE BUDGET BGN million	2006	2006	2006	2007	2007	2007	2007	2008	2008	2008	2008	2009	2009	2009	2009
	national budget	pre- accession	total program	national budget	pre- accession	EU	total forecast	national budget	pre- accession	EU	total forecast	national budget	pre- accession	EU	total forecast
Total expenditures and contribution to EU	17 472.5	785.5	18 258.0	18 413.7	652.3	1 702.1	20 768.2	19 842.6	383.6	2 395.2	22 621.3	21 210.5	161.3	3 318.9	24 690.8
Total expenditures	17 472.5	785.5	18 258.0	18 413.7	652.3	1 074.3	20 140.3	19 842.6	383.6	1 700.2	21 926.3	21 210.5	161.3	2 587.9	23 959.8
Total non-interest expenditures	16 810.8	785.5	17 596.3	17 673.0	652.3	1 074.3	19 399.6	19 114.5	383.6	1 700.2	21 198.2	20 472.9	161.3	2 587.9	23 222.2
Current non-interest expenditures	14 709.3	232.7	14 942.0	15 531.3	152.9	757.1	16 441.3	16 655.4	123.3	1 212.8	17 991.5	17 823.5	46.9	1 672.4	19 542.9
Salaries and scholarships	2 784.7		2 784.7	3 000.1			3 000.1	3 237.6			3 237.6	3 494.2			3 494.2
Salaries	2 738.8		2 738.8	2 952.2			2 952.2	3 188.4			3 188.4	3 443.4			3 443.4
Scholarships	45.9		45.9	47.9			47.9	49.2			49.2	50.7			50.7
Insurance contributions	871.7		871.7	888.6			888.6	902.3			902.3	912.5			912.5
Maintenance	3 619.5	158.1	3 777.6	3 844.0	76.7	39.7	3 960.4	4 150.2	60.9	51.7	4 262.9	4 530.5	19.5	90.7	4 640.7
Subsidies - total	517.8	74.6	592.4	322.1	76.2	717.4	1 115.7	345.3	62.3	1 161.1	1 568.8	392.6	27.4	1 581.7	2 001.7
Subsidies	376.2	74.6	450.8	176.0	76.2	717.4	969.6	190.0	62.3	1 161.1	1 413.5	232.4	27.4	1 581.7	1 841.5
Subsidies for healthcare activities	141.5		141.5	146.1			146.1	155.3			155.3	160.2			160.2
Social security and welfare	6 915.7		6 915.7	7 476.4			7 476.4	8 019.9			8 019.9	8 493.7			8 493.7
Pensions	4 073.1		4 073.1	4 285.7			4 285.7	4 606.2			4 606.2	4 878.4			4 878.4
Current transfers, compensations and assistance to households	1 340.6		1 340.6	1 420.1			1 420.1	1 484.0			1 484.0	1 588.9			1 588.9
Health insurance payments	1 219.2		1 219.2	1 357.3			1 357.3	1 412.4			1 412.4	1 494.1			1 494.1
Other health insurance expenditures	282.8		282.8	413.3			413.3	517.3			517.3	532.3			532.3
Credits and temporary financial assistance (net)	100.0		100.0	35.0			35.0	35.0			35.0	35.0			35.0
Fixed assets	1 668.4	552.8	2 221.2	1 786.6	499.4	317.2	2 603.2	2 046.6	260.3	487.4	2 794.3	2 231.6	114.4	915.5	3 261.5
Contingency and structural expenditures reserve	333.1		333.1	320.1			320.1	377.5			377.5	382.8			382.8
- for structural reform and other	15.0		15.0	45.0			45.0	55.0			55.0	60.0			60.0
- budget	198.1		198.1	197.1			197.1	212.5			212.5	222.8			222.8
- for natural disasters	120.0		120.0	78.0			78.0	110.0			110.0	100.0			100.0
Interest payments	661.7		661.7	740.8			740.8	728.1			728.1	737.6			737.6
External interest payments	444.5		444.5	542.7			542.7	527.8			527.8	537.7			537.7
Domestic interest payments	217.2		217.2	198.0			198.0	200.2			200.2	199.9			199.9
Contributions to EU budget						627.8	627.8			695.0	695.0			731.0	731.0
Balance	125.5	-125.5	0.0	1 739.7	-176.2	-1 180.6	382.8	1 595.8	-128.4	-1 083.1	384.4	1 751.5	-30.8	-1 373.4	347.3

NOTE: The “pre-accession” and “EU” columns comprise the financial flows under the EU pre-accession funds and under the EU Funds, respectively, including the national co-financing ensured.

Table: Consolidated fiscal program 2006-2009 (% of GDP)

CONSOLIDATED STATE BUDGET as % of GDP	2006	2006	2006	2007	2007	2007	2007	2008	2008	2008	2008	2009	2009	2009	2009
	national budget	pre- accession	total program	national budget	pre- accession	EU	total forecast	national budget	pre- accession	EU	total forecast	national budget	pre- accession	EU	total forecast
Total revenues	38.6%	1.4%	40.0%	39.5%	0.9%	1.0%	41.4%	38.6%	0.5%	2.4%	41.4%	37.9%	0.2%	3.2%	41.3%
Tax revenues	33.0%		33.0%	33.2%			33.2%	32.5%			32.5%	31.8%			31.8%
Direct taxes	13.5%		13.5%	13.6%			13.6%	13.6%			13.6%	13.3%			13.3%
Corporate taxes	2.3%		2.3%	2.1%			2.1%	2.2%			2.2%	2.2%			2.2%
non-financial enterprises	2.0%		2.0%	1.8%			1.8%	1.9%			1.9%	1.9%			1.9%
financial institutions	0.3%		0.3%	0.2%			0.2%	0.3%			0.3%	0.3%			0.3%
Personal income tax	2.3%		2.3%	2.2%			2.2%	2.3%			2.3%	2.2%			2.2%
Revenues of public security and health insurance systems	9.0%		9.0%	9.2%			9.2%	9.1%			9.1%	8.9%			8.9%
Security contributions	6.7%		6.7%	6.8%			6.8%	6.6%			6.6%	6.4%			6.4%
Health insurance contributions	2.3%		2.3%	2.4%			2.4%	2.5%			2.5%	2.4%			2.4%
Indirect taxes	18.5%		18.5%	18.7%			18.7%	18.0%			18.0%	17.6%			17.6%
VAT	12.1%		12.1%	12.2%			12.2%	11.7%			11.7%	11.3%			11.3%
Excise duties - total	5.7%		5.7%	6.0%			6.0%	5.8%			5.8%	5.8%			5.8%
Customs duties and charges	0.8%		0.8%	0.5%			0.5%	0.5%			0.5%	0.5%			0.5%
Other taxes	0.9%		0.9%	1.0%			1.0%	0.9%			0.9%	0.9%			0.9%
Non-tax revenues	5.5%		5.5%	6.2%			6.2%	6.0%			6.0%	6.1%			6.1%
Transfers from BNB	0.3%		0.3%	0.3%			0.3%	0.3%			0.3%	0.3%			0.3%
Others	5.2%		5.2%	5.8%			5.8%	5.7%			5.7%	5.8%			5.8%
Grants	0.1%	1.4%	1.5%	0.1%	0.9%	1.0%	2.0%	0.1%	0.5%	2.4%	2.9%	0.1%	0.2%	3.2%	3.5%
external grants	0.0%	1.4%	1.5%	0.0%	0.9%	1.0%	2.0%	0.0%	0.5%	2.4%	2.9%	0.0%	0.2%	3.2%	3.5%
domestic grants	0.0%		0.0%	0.0%			0.0%	0.0%			0.0%	0.0%			0.0%
Total expenditures and contribution to EU	38.3%	1.7%	40.0%	36.1%	1.3%	3.3%	40.7%	35.7%	0.7%	4.3%	40.7%	35.0%	0.3%	5.5%	40.8%
Total expenditures	38.3%	1.7%	40.0%	36.1%	1.3%	2.1%	39.5%	35.7%	0.7%	3.1%	39.5%	35.0%	0.3%	4.3%	39.6%
Total non-interest expenditures	36.9%	1.7%	38.6%	34.6%	1.3%	2.1%	38.0%	34.4%	0.7%	3.1%	38.2%	33.8%	0.3%	4.3%	38.3%
Current non-interest expenditures	32.2%	0.5%	32.8%	30.4%	0.3%	1.5%	32.2%	30.0%	0.2%	2.2%	32.4%	29.4%	0.1%	2.8%	32.3%
Salaries and scholarships	6.1%		6.1%	5.9%			5.9%	5.8%			5.8%	5.8%			5.8%
Salaries	6.0%		6.0%	5.8%			5.8%	5.7%			5.7%	5.7%			5.7%
Scholarships	0.1%		0.1%	0.1%			0.1%	0.1%			0.1%	0.1%			0.1%
Insurance contributions	1.9%		1.9%	1.7%			1.7%	1.6%			1.6%	1.5%			1.5%
Maintenance	7.9%	0.3%	8.3%	7.5%	0.2%	0.1%	7.8%	7.5%	0.1%	0.1%	7.7%	7.5%	0.0%	0.1%	7.7%

CONSOLIDATED STATE BUDGET as % of GDP	2006	2006	2006	2007	2007	2007	2007	2008	2008	2008	2008	2009	2009	2009	2009
	national budget	pre- accession	total program	national budget	pre- accession	EU	total forecast	national budget	pre- accession	EU	total forecast	national budget	pre- accession	EU	total forecast
Subsidies - total	1.1%	0.2%	1.3%	0.6%	0.1%	1.4%	2.2%	0.6%	0.1%	2.1%	2.8%	0.6%	0.0%	2.6%	3.3%
Subsidies	0.8%	0.2%	1.0%	0.3%	0.1%	1.4%	1.9%	0.3%	0.1%	2.1%	2.5%	0.4%	0.0%	2.6%	3.0%
Subsidies for healthcare activities	0.3%		0.3%	0.3%			0.3%	0.3%			0.3%	0.3%			0.3%
Social security and welfare	15.2%		15.2%	14.6%			14.6%	14.4%			14.4%	14.0%			14.0%
Pensions	8.9%		8.9%	8.4%			8.4%	8.3%			8.3%	8.1%			8.1%
Current transfers, compensations and assistance to households	2.9%		2.9%	2.8%			2.8%	2.7%			2.7%	2.6%			2.6%
Health insurance payments	2.7%		2.7%	2.7%			2.7%	2.5%			2.5%	2.5%			2.5%
Other health insurance expenditures	0.6%		0.6%	0.8%			0.8%	0.9%			0.9%	0.9%			0.9%
Credits and temporary financial assistance (net)	0.2%		0.2%	0.1%			0.1%	0.1%			0.1%	0.1%			0.1%
Fixed assets	3.7%	1.2%	4.9%	3.5%	1.0%	0.6%	5.1%	3.7%	0.5%	0.9%	5.0%	3.7%	0.2%	1.5%	5.4%
Contingency and structural expenditures reserve	0.7%		0.7%	0.6%			0.6%	0.7%			0.7%	0.6%			0.6%
- for structural reform and other	0.0%		0.0%	0.1%			0.1%	0.1%			0.1%	0.1%			0.1%
- budget	0.4%		0.4%	0.4%			0.4%	0.4%			0.4%	0.4%			0.4%
- for natural disasters	0.3%		0.3%	0.2%			0.2%	0.2%			0.2%	0.2%			0.2%
Interest payments	1.5%		1.5%	1.5%			1.5%	1.3%			1.3%	1.2%			1.2%
External interest payments	1.0%		1.0%	1.1%			1.1%	0.9%			0.9%	0.9%			0.9%
Domestic interest payments	0.5%		0.5%	0.4%			0.4%	0.4%			0.4%	0.3%			0.3%
Contributions to EU budget							1.2%	1.2%			1.3%	1.3%			1.2%
Balance	0.3%	-0.3%	0.0%	3.4%	-0.3%	-2.3%	0.8%	2.9%	-0.2%	-1.9%	0.7%	2.9%	-0.1%	-2.3%	0.6%
GDP	45 615.4	45 615.4	45 615.4	51 043.1	51 043.1	51 043.1	51 043.1	55 564.8	55 564.8	55 564.8	55 564.8	60 567.4	60 567.4	60 567.4	60 567.4