REPUBLIC OF BULGARIA
Ministry of Finance

CONVERGENCE PROGRAMME

(2017–2020)

2017
Sofia, Bulgaria

CONVERGENCE PROGRAMME

OF THE REPUBLIC OF BULGARIA 2017–2020

Sofia, 2017
Ministry of Finance

Table of Contents

List of Abbreviations

AF	Armed Forces
ATR	Annual tax return
AQR	Asset Quality Review
BNB	Bulgarian National Bank
CEB	Council of Europe Development Bank
CITL	Corporate Income Tax Law
CP	Convergence Programme
EC	European Commission
ECB	European Central Bank
EIB	European Investment Bank
ESA 2010	European System of Accounts 2010
EU	European Union
EUR	euro
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GS	Government securities
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
HIL	Health Insurance Law
IMF	International Monetary Fund
ITC	International Trade Centre
LFS	Labour Force Survey
LIBOR	London Inter-Bank Offered Rate
MF	Ministry of Finance
MoI	Ministry of Interior
MRR	Minimum reserve requirements
MTO	Medium-term budgetary objective
NCA	National Customs Agency
NHIF	National Health Insurance Fund
NRA	National Revenue Agency
NRIC	National Railway Infrastructure Company
NSI	National Statistical Institute
NSSI	National Social Security Institute
OPAC	Operational Programme Administrative Capacity
O-SIIs	Other Systematically Important Institutions
PFL	Public Finance Law
PIC	Personal Identification Code
PITL	Personal Income Tax Law
pp	Percentage points
PSS	Public Social Security scheme
R&D	Research and Development
RA	Registry agency
REER	Real effective exchange rate
RRCIIFA	Recovery and Resolution of Credit Institutions and Investment Firms Act
SBA	Republic of Bulgaria's State Budget Act
SGP	Stability and Growth Pact
SSC	Social Security Code
ULC	Unit Labour Costs
USD	U.S. dollar
VAT	Value Added Tax
WB	World Bank
WTO	World Trade Organisation

1. OVERALL POLICY FRAMEWORK AND OBJECTIVES

Bulgaria's Convergence Programme (2017-2020) outlines the key policy priorities in support of macroeconomic and fiscal stability in order to create conditions for economic growth.

The key objectives in managing public finances are maintaining fiscal sustainability, overcoming the macroeconomic imbalances and conducting a consistent, transparent and predictable fiscal policy aimed at improving the business environment, promoting investment and stimulating labour market development.

Positive implications on the Bulgaria's economic growth perspectives are expected from the implementation of policies geared towards increasing the productivity and competitiveness of the economy by ensuring a better match between the demand and the supply side of the labour market, improving the quality of public goods and services, and increasing the funding of certain areas such as education, healthcare, R&D and infrastructure investment. To achieve balanced growth, sustainable convergence and higher living standards in the country, the Bulgarian authorities will persist in their efforts to improve the efficiency and effectiveness of public administration, ensure transparent absorption of EU funds, eliminate barriers to private sector investment, including as part of the efforts within the third pillar of the Investment Plan for Europe (the so-called "Juncker Plan").

In the medium term, fiscal policy focuses on maintaining the sustainability of the budgetary framework in the context of Bulgaria's commitments under the Stability and Growth Pact, as well as those arising from its status of a Contracting Party under Title III of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. In this regard, the fiscal policy clearly defines the observance of strict budgetary discipline as a fundamental commitment of the government. The fiscal parameters have been prepared on the basis of realistic projections for the key macroeconomic indicators, conservative revenue estimates and a more austere planning of public expenditure.

Maintaining the medium- and long-term sustainability of public finances continues to be a priority policy aspect, including in terms of strengthening credibility and creating a predictable investment and business environment. In this update of the Convergence Programme, Bulgaria maintains its medium-term objective of -1% of GDP for the structural budget balance on an annual basis.

Bulgaria's tax policy remains predictable, while at the same time oriented towards promoting business development and investment activity. The government will continue its policies aimed at improving tax collection and curbing the informal economy and undeclared work.

In the context of preserving its macroeconomic stability, Bulgaria guarantees to maintain the currency board arrangement at the current fixed exchange rate of BGN 1.95583 to the EUR until the country joins the Euro area.

This Convergence Programme covers the period 2017-2020 and comprises seven chapters.

The first chapter contains the overall framework of the economic policies and objectives of the government.

Chapter two presents an analysis of the country's economic development in terms of the key macroeconomic indicators, and provides a forecast for their development in the medium term.

The third chapter makes an overview of the strategic fiscal policy objectives in terms of the budget balance and government debt. It outlines the current budgetary position and the expected developments during the reference period, with emphasis on the structural balance. It presents the outlook for the development of the debt position during the programme period. The main policy aspects are also covered, together with the specific measures on their application, as well as the estimates of the expected quantitative effects from the concrete measures implementation.

Chapter four presents a sensitivity analysis of the forecast parameters, presenting an alternative scenario for the economic development of the country in the medium term. It also assesses the impact of the alternative scenario materialization on the budgetary parameters. An analysis is also provided for the impact over the government debt of changing the assumptions underlying the baseline macroeconomic scenario.

Chapter five is dedicated to the sustainability of public finances. The main focus here is on the long-term budgetary outlook, examining the implication of ageing population.

Chapter six deals with the quality of public finances. It presents the government policy strategy in that area, the composition of expenditure, and the structure and efficiency of revenue systems.

Chapter seven provides an overview of the institutional features of public finances in Bulgaria – budgetary procedures and national fiscal rules. That part of the Programme highlights also the key legislative changes relevant to public finances.

The current Convergence Programme presents developments and measures addressing the first two of the four Council Recommendations of 12 July 2016 on the 2016 National Reform Programme of the Republic of Bulgaria, containing the Council Assessment of Bulgaria's 2016 Convergence Programme[1], namely:

- **Specific Recommendation 1:** Achieve an annual fiscal adjustment of 0.5 % of GDP towards the medium-term budgetary objective in 2016 and in 2017. Further improve tax collection and take measures to reduce the extent of the informal economy, including undeclared work.
- **Specific Recommendation 2:** By the end of 2016, finalise the asset quality review and stress test of the banks. By the end of 2016, complete the balance-sheet review and stress test of the insurance companies and the review of private pension funds' assets. Take, as necessary, follow-up actions in all three sectors and continue to improve banking and non-banking supervision. ▼

[1] OJ C 299/32, 18.08.2016

2. ECONOMIC OUTLOOK

2.1 Assumptions concerning the World Economy

This Convergence Programme is based on the macroeconomic forecast for the period 2017-2020, made with the medium-term macroeconomic model of the Ministry of Finance under the assumptions for the key indicators for the external environment as of mid-March 2017 provided by the International Monetary Fund, the World Bank, the European Commission and the Bulgarian Ministry of Finance.

Table 2-1: Assumptions on key macroeconomic indicators

	2017	2018	2019	2020
Global economy (real growth, %)	3.4	3.6	3.7	3.7
EU GDP (real growth, %)	1.8	1.8	1.8	1.8
Exchange rate USD/EUR, annual average	1.06	1.06	1.06	1.06
International commodity prices (in USD, %)				
Crude Oil Brent (per barrel)	27.7	0.9	2.4	2.4
Non-energy goods	8.6	1.6	1.4	1.4
Food	3.0	1.2	1.2	1.2
Beverages	-1.3	0.2	0.2	0.2
Agricultural raw materials	2.2	1.6	1.6	1.7
Metals	23.5	2.4	1.8	1.9
6-month LIBOR on USD-denominated deposits	1.65	2.77	3.63	3.68
6-month LIBOR on EUR-denominated deposits	-0.29	-0.22	-0.09	0.09

Source: EC, IMF, WB, MF

The global economy is expected to accelerate its growth in 2017 and 2018 driven by stronger economic activity in developing countries and in the U.S. The rise in commodity prices and the higher demand from developed economies will translate into accelerated GDP growth in developing markets, while the fiscal incentives planned by the U.S. administration will boost the U.S. economy. The contribution of developing countries to the global economic growth will continue to increase in 2019-2020, while the U.S. economy will slow down. At the same time, the growth of the European economy will remain subdued. Higher commodity prices will limit the real disposable income of households and the increase in private consumption, respectively. The growing uncertainty stemming from geopolitical tensions, the migration flow toward EU countries and the forthcoming Brexit are also expected to affect negatively economic activity in the region.

2.2 Economic Outlook and Cyclical Developments

2.2.1 Economic Growth

In 2016 Bulgaria's Gross Domestic Product increased by 3.4% in real terms. The growth was balanced, with a contribution both from domestic demand (1.6 pp), and from net exports (1.8 pp). The slow-down from the 3.6% growth reported in 2015 was due to the smaller increase in consumption and investment.

Final consumption increased by 1.8% against 3.8% in 2015. The increase in government consumption was constrained to 0.6%, while private consumption reached 2.1%. The private consumption trend followed that of disposable household income. Its growth slowed down compared to the 2015 level, since the decrease in prices could not fully offset the weaker increase in nominal income levels, notably in compensation of employees.

Total investment went up 0.9%, which was due entirely to the change in inventories. Fixed capital investment was down 4% due to shrinking government capital expenditure. Private investment[2] in the economy saw an increase for the first time since 2012, and was accompanied by improvements in the overall business climate in Bulgaria. Increased capacity utilisation in manufacturing in 2014 and 2015 resulted in an increase in investment in expanding the production capacity in 2016. Considering that credit activity is still weak, investment projects in 2016 were most probably financed from company profits earned in 2015 when the gross operating surplus in manufacturing went up 13.5%.

In 2016 exports of goods and services grew at 5.7%, the same rate as in 2015. At the same time, weaker domestic demand resulted in a more moderate increase in imports of goods and services (2.8%). As a result, net exports for the year registered a positive contribution to GDP growth.

In 2016 gross value added grew 2.9% against 3% in 2015. A positive contribution to growth was reported for all economic sectors except construction. The increase in value added generated in manufacturing and services stood at 2.8% and 3.1%, respectively, while agriculture reported a growth of 4.3%.

2.2.2 Cyclical Developments[3]

According to Ministry of Finance estimates, the growth in the potential GDP reached 3% in 2016. The same growth is expected also in 2017 and 2018. In the period 2019-2020, growth will accelerate slightly to 3.1%. Total factor productivity accounts for the largest contribution in potential growth. The gradual decline in the NAWRU along with the increase in the activity rate will compensate the drop in the working-age population and will lead to a positive contribution of labour as a factor to potential growth during the forecast period. The projected acceleration in the growth of investment in the economy will increase the contribution of capital stock to potential growth.

In 2017, expectations are for a negative output gap, which is close to its 2016 level of – 0.3%. The output gap will gradually decrease and is expected to close in 2020.

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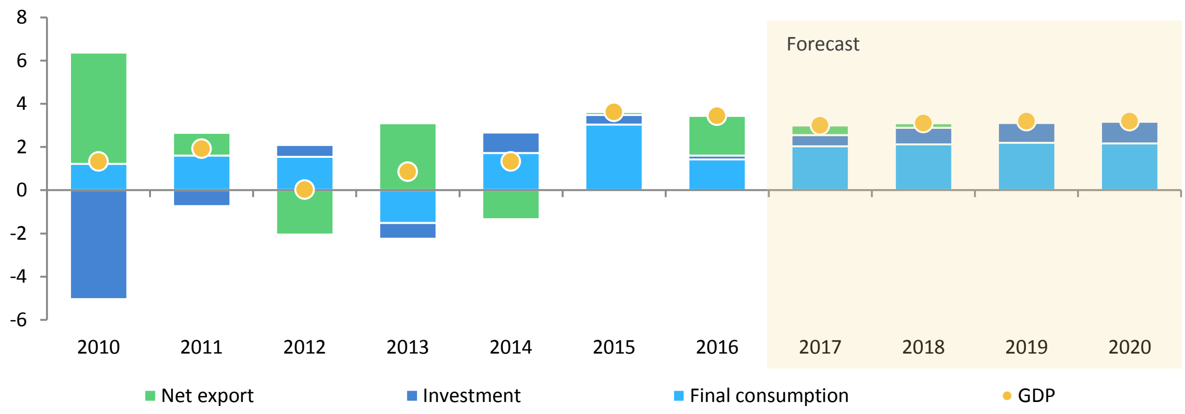
[2] Private investment is measured as the difference between fixed capital investment for the overall economy and investment in the General Government sector.

[3] Cyclical development of the economy is measured by the output gap indicator. It is calculated as a ratio between the difference between the actual and the potential output in GDP terms over the potential GDP. The potential GDP of the Bulgarian economy is calculated using a production function on a methodology developed by the EC: Karel Havik & Kieran Mc Morrow & Fabrice Orlandi & Christophe Planas & Rafal Raciborski & Werner Roeger & Alessandro Rossi & Anna Thum-Thysen & Valerie Vandermeulen, 2014. The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, European Economy – Economic Papers 535

2.3 Medium-Term Scenario

In 2017 the growth of the Bulgarian economy is expected to be 3%, driven by domestic demand, and primarily by private consumption. The positive developments on the labour market and improved consumer confidence will translate into private consumption growth of 2.3%, while the planned increase in public capital expenditure, which is associated with the absorption of EU funds, will generate a positive contribution to the 2.8% growth in fixed capital investment. At the same time, private investment development in 2017 is affected by the presence of a high base in 2016, when reported growth exceeded 10%. Higher domestic demand will result in an accelerated increase in imports. At the same time, exports are expected to slow down slightly, both due to the weaker external demand from Bulgaria's main trade partners and because of the high 2016 base. As a result, the positive contribution of net exports to GDP growth will decline from 1.8 pp in 2016 to 0.4 pp in 2017.

Figure 2-1: Contribution to GDP growth, by component (in pp)



Source: NSI, MF

Economic growth will accelerate slightly to 3.1% in 2018, as a result of the upward trend in private consumption and investment. Private consumption will increase by 3%, supported by the increase in real disposable income of households and the continuing positive development on the labour market, while the growth in investment will accelerate to 3.8%. Private investment will have a major contribution to the expected development. Despite the slight acceleration in the increase of exports, the positive contribution of net exports will drop to 0.2 pp, since stronger domestic demand will result in a faster increase in imports.

GDP growth will reach 3.2% at the end of the forecast period. Domestic demand will be a leading factor both in terms of consumption and in terms of investment. At the same time, the contribution of net exports will continue its gradual decline over the coming years and is expected to drop down to zero in 2020.

2.4 Sectoral Balances

2.4.1 Labour Market, Incomes and Productivity

In 2016 the labour market continued its positive development manifested in an increase in employment and a decrease in unemployment. The rebound in employed was accompanied by an increase in the labour productivity and a slow-down in the rate of increase in the compensation per employee, which translated into an improvement of the cost competitiveness of the economy.

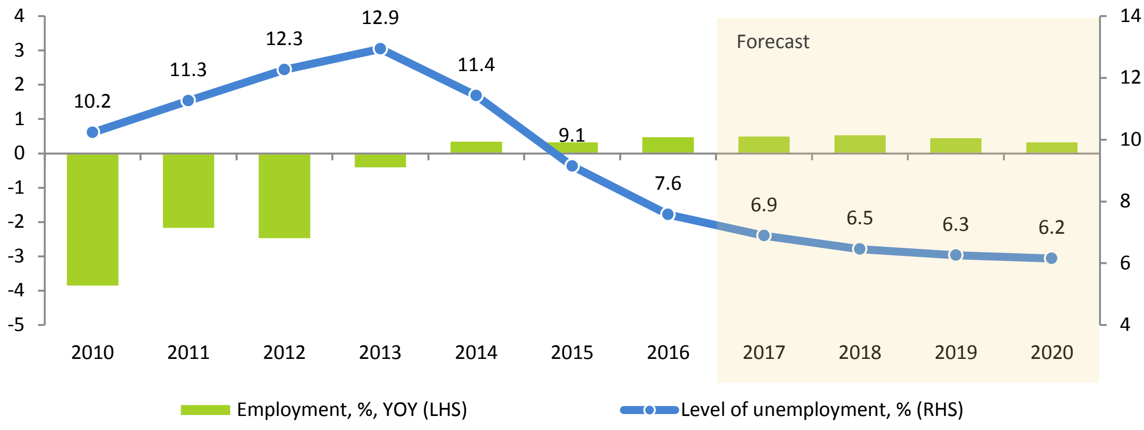
The average number of employed (according to ESA 2010) went up 0.5% against 2015, supported by the positive developments in services and industry. The real growth of 3.1% in the value added in services remained close to its 2015 level (3.3%) and contributed to the accelerated increase in employment by 2.2%, against 0.6% in the previous year. All sub-activities in services registered a higher labour demand on annual basis, with ”public administration, education and healthcare” as the only sector to have retained the number of employed persons in the proximity of its 2015 level. The higher job turnover in 2016 was evidenced also by the sustainable increase in labour demand in the manufacturing industries producing mostly for the foreign markets. Unlike services and industry, agriculture and construction played a constraining role to the increase in total employment in 2016. Although the real value added in agriculture went up, the number of employed persons registered a decrease, due to the high proportion of self-employed and their general downward trend. Following the increase in job creation in construction registered in 2015, 2016 saw a decline in employment in the sector as the previous programming period for financing projects from European funds expired and as a result of the decline in construction.

The unemployment rate went down for a third year in a row, yet the negative demographic developments affected labour supply more tangibly. In 2016, the unemployment rate stood at 7.6% (LFS[4]) of the labour force, against 9.1% in 2015, while the participation rate of the population (aged 15-64) for the first time since 2012 decreased in comparison to the previous year 2015 by 0.6 pp to 68.7%. In response to the challenges arising from demographic developments, the current reform to raise the retirement age aim to keep working-age people on the labour market for longer. According to NSSI data, in 2016, the number of newly-retired people with personal pension entitlements for required length of service and age recorded a 4.0% decrease compared to 2015.

In the first two months of 2017, the private sector expectations concerning staff turnover improved in all of the activities surveyed by the short-term business statistics, while the survey among consumers in January reported expectations for a decline in unemployment over the next twelve months. These expectations were also supported by the data on registered unemployment, which amounted to 8.2% during the first two months of 2017 and remained 1.9 pp lower than in the corresponding period of 2016. The developments in short-term indicators since the beginning of the year support expectations that the labour market progress will persist throughout 2017 as well, within the context of relatively high GDP growth and domestic demand recovery. The average number of employed (according to ESA 2010) is expected to rise by another 0.5%, primarily as a result of the expected positive developments in services, but also due to the job creation in industry supported by the expected increase in exports. The unemployment rate will further decrease to an annual average value of 6.9%, and its slower rate of decline compared to the previous year will be due to the limited decrease in labour force, as a result of the measures to increase the required retirement age and length of service, and the longer participation in the labour market. The pension reform is expected to strengthen gradually its effect on the economic activity of the population over the years covered by the forecast, due to the smooth increase in the required retirement age and length of covered service. In addition, structural reforms in the labour market will also support the expected increase in the participation of the population in the labour force. Over the period 2018-2020, the unemployment rate is expected to decrease to 6.2% in 2020, while the medium-term employment growth is projected at about 0.5% per year.

[4] Labour Force Survey (LFS).

Figure 2-2: Employment dynamics and unemployment rates, %

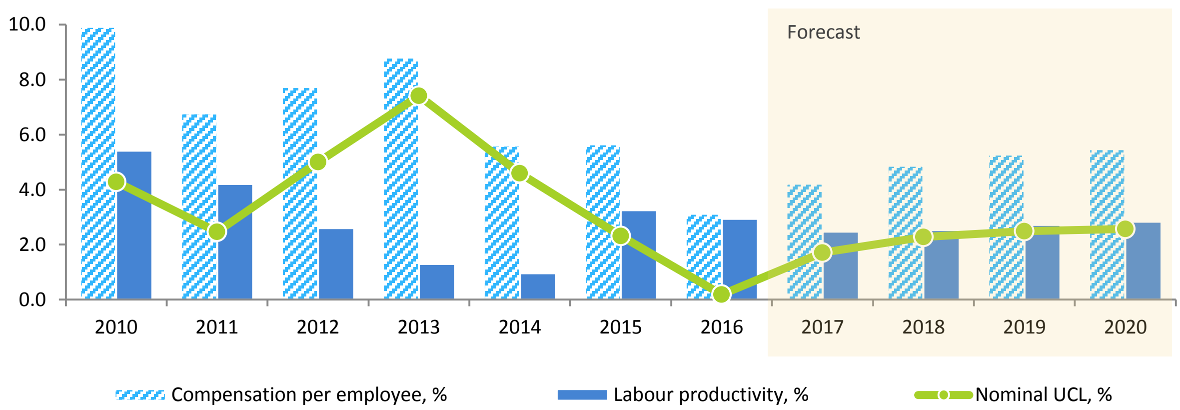


Source: NSI, MF

The employment recovery in 2016 was accompanied by a real increase in labour productivity[5] of 2.9%. The indicator slightly decelerated against the reported growth of 3.3% during the previous year which was associated with the weaker pace of increase in services. The growth in productivity in industry was supported by the positive development in manufacturing of 2%, and by the improvement of 1.5% reported in construction, which was due to the stronger fall in employment compared to the sector's drop in value added in real terms. Agriculture reported a considerable increase of 8.3% in labour productivity in 2016, as the increase in newly produced output was accompanied by a continuing downward trend in self-employed.

Along with the labour productivity increase, the growth in compensation per employee in 2016 slowed down to 3.1% in nominal terms. Thus the increase in productivity almost offset the increase in incomes and nominal unit labour costs (ULC) decelerated their rate of increase to 0.2% against the previous year. The improvement in the cost competitiveness of the Bulgarian economy was achieved mainly in terms of services, where a large part of the economic activities marked a decrease in the compensation per employee on an annual basis. The increase in incomes in manufacturing continued at a double-digit rate of 11.6%, driven by the economic activity in the sector, improved productivity and labour demand, but the increase in ULC did not have a negative effect on the competitive positions of export-oriented activities, which was confirmed by the sustainable real growth in industrial output and in exports of goods.

Figure 2-3: Nominal ULC and break-down by component



Source: NSI, MF

[5] Calculated as a ratio between GDP in 2010 prices and the number of employees in accordance with ESA 2010.

Influenced by the expected increase in labour productivity, labour demand and the positive changes in prices over 2017, the rate of increase in compensation per employee is expected to accelerate to 4.2%. This acceleration will occur mainly in services, both as a result of a rising domestic demand and due to a base effect from the reported decrease in the compensation per employee in services in 2016. The further increase in labour productivity, labour demand and inflation will determine an upward trend in income levels over the whole forecast period, with their nominal rate of change expected to range between 5 and 5.5%. Over the period 2017-2020, real growth in labour productivity will amount to an annual average of 2.6%, which, along with the expected developments in incomes, will translate into a moderate increase in the nominal unit labour costs, at an average rate of about 2.3% per year.

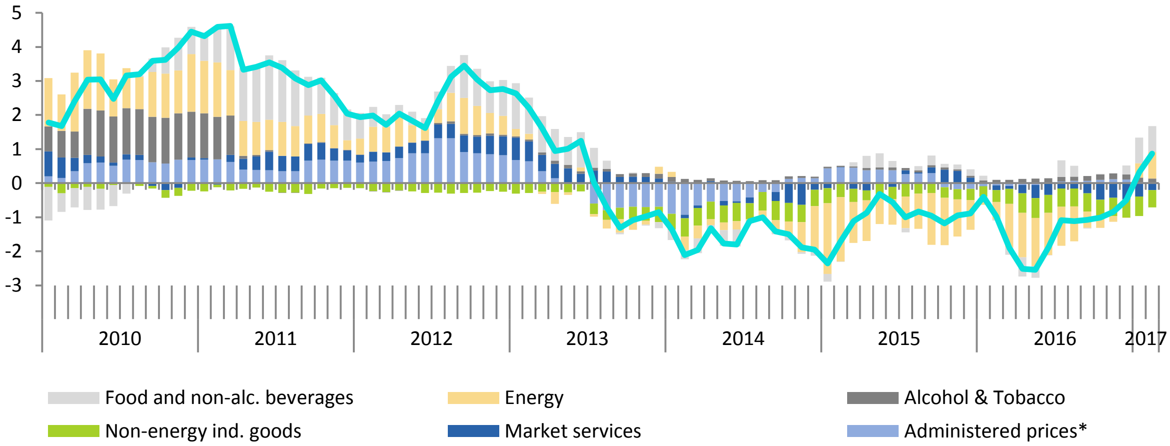
2.4.2 Inflation

The change in consumer prices, according to the HICP, remained negative throughout 2016, with the annual deflation rate slowing down to -0.5% yoy in December. The annual average inflation rate was -1.3%.

The largest contribution to the negative inflation rate in Bulgaria during most of 2016 came from the decrease in fuel prices, which followed the developments in international crude oil prices. The entry of a new player on the retail market and the gradual expansion of its operations over the year also influenced the situation in the sector. In the second half of the year there was a significant slow-down in the fall in motor vehicle fuel prices, to -0.4% on an annual basis in December.

The global market situation and the specific weather conditions are usually among the key drivers of domestic food prices. The rate of increase in the prices of processed food products stabilised during the second half of the year, whereas prices of unprocessed food exhibited the typically higher volatility associated with seasonal fluctuations and the impact of weather conditions on fruit and vegetables crops. Inflation of food and non-alcoholic beverages as of December on average was 1.3% yoy.

Figure 2-4: Inflation rate (%) and contributions by key HICP components (pp), compared to the corresponding month of the previous year



* The index of administered prices is calculated as a weighted average of the relevant elementary aggregates in the consumer basket.

Source: NSI, MF

The deflation was also affected by the acceleration in the negative rates of core inflation[6]. Market services prices (except for items with administered prices) began to register declines on an annual basis in February, with the downward trend deepening over the year, and as of December they decreased by 1.9%. The factors accounting for that development include not only the reduction in roaming tariffs for the whole EU at the end of April but also the fall in prices of internet access services, and international airfares under the influence of steeper competition among the (low-cost) airline companies. As regards the road transport, there was no significant effect related to the cheaper transport fuels. Prices of the other major component of core inflation, i.e. non-food products (except energy goods and administered price items), continued to report a decline on an annual basis for a seventh consecutive year, which amounted to -2.3% yoy in December.

Changes to the excise duty rates on tobacco products since the beginning of 2016 led to an increase in their prices which, as in December, was 3.9% yoy. To prevent possibilities for excise fraud or avoidance, a single excise duty rate was adopted for gas oil for heating and for motor fuel at the beginning of 2016. Due to its relatively low weight in the consumer basket, however, the effect from this measure on fuel prices in Bulgaria was not significant.

Goods and services with regulated prices reported an annual increase of 0.7% at the end of 2016. Because of declining international prices of energy goods and primarily oil prices, the prices of natural gas and heat energy were reduced several times during the year, with price reductions as of December of 19.1% and 7.8% yoy, respectively. Their negative contribution, however, was offset primarily by the 47.4% price increase on vignette stickers at the beginning of the year, and that of the single ticket for the public transport system in Sofia by 60% in June.

In January 2017, the annual inflation rate reported a positive value for the first time since mid-2013, while in February it accelerated to 0.9% yoy. The continuing recovery in international oil prices resulted in a rise in automotive fuel prices on the domestic market by 13.3% on an annual basis, while their contribution to the change in the headline index is estimated at 0.8 pp.

The annual average inflation rate in 2017 is expected to be positive, at 1.2%, and the end-of-period increase in the headline rate is expected to reach 1.3%. The expected increase in international prices, aided by the depreciation of the euro against the U.S. dollar, will translate into higher domestic prices of energy and food. These will have a major positive contribution to the inflation rate at the end of the year. Services prices are expected to go up slightly, supported by the stronger domestic demand, whereas prices of non-food products (excluding energy goods) will continue to register decreases, although at a slower rate.

The annual average increase in the HICP in 2018 is expected to be 1.3%, and the inflation rate will accelerate to 1.7% in 2019 and 1.8% in 2020, under the assumption for higher international prices of crude oil and the major non-energy commodities, and an increase in domestic demand.

Table 2-2: HICP Forecast for the 2017–2020 – period

	2017	2018	2019	2020
Annual average inflation (in per cent)	1.2	1.3	1.7	1.8
End-of-year Inflation (in per cent)	1.3	1.6	1.8	1.9

6 The price changes of energy goods and non-processed food products have been excluded from the headline index.

The contribution of the planned increase in the excise duty rates on cigarettes to the increase in the headline price index is estimated at 0.1 pp as at the end of the year, for 2017 and 2018, respectively.

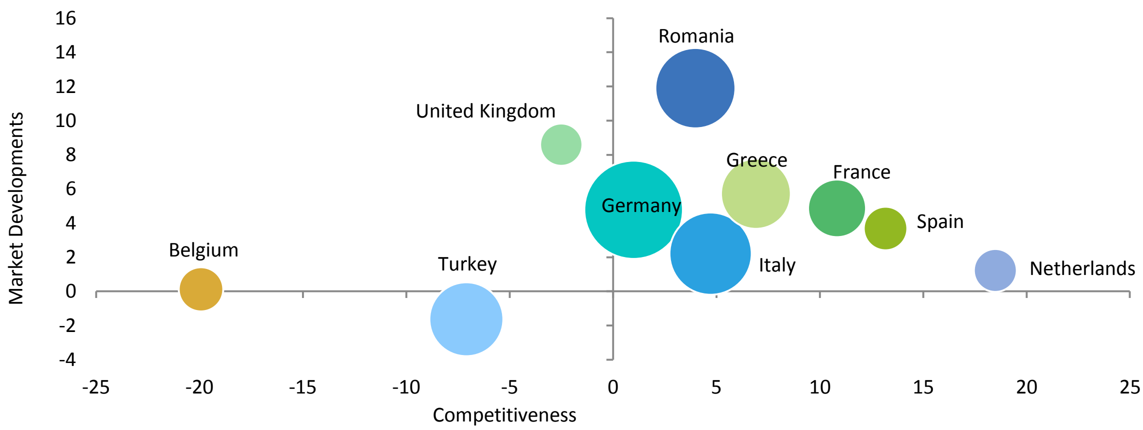
The main risks to the inflation forecast are mainly related to the expectations concerning international prices. Considering the specific conditions on the global market for crude oil to-date, the risks that the expectations would fail to materialise, are significant, both on the upside and the downside, especially regarding the supply. At the same time, adverse weather might lead to a more tangible rise in prices for certain foods on international markets. Domestic risks to the inflation outlook are associated primarily with the announced increases in administered prices, which would have not only a direct effect through the relevant goods or services, but would also have some secondary pro-inflationary effects on the rest of the HICP components related to increased production costs.

2.4.3 External Sector[7]

In 2016, net financial inflows were reported in all three accounts of the balance of payments of the country: current, capital and financial account. The balance in the current account recorded a surplus of EUR 1.8 billion (3.8% of GDP) against a balance of EUR 172 million (0.4% of GDP) in 2015.

That development was driven primarily by the increase in the surplus in Goods and Services, and the shrinking of the deficit in Primary Income. The increase in the surplus in services was due to the accelerated increase in the export of services associated with travel in Bulgaria by non-residents. The improvement in the trade balance reflected the 3.3% rise in the export of goods against a decrease in imports by 0.4%. The decrease in international prices during the greater part of the year translated into negative deflators which limited the increase in nominal terms, despite the larger volumes traded. The increase in imports was driven by the demand for raw materials in export-oriented industries and the increase in domestic demand, while export developments were affected by a relatively stable external demand, as well as by improved competitiveness.

Figure 2-5: Export competitiveness vis-à-vis Bulgaria's top 10 trade partners[8] (pp)



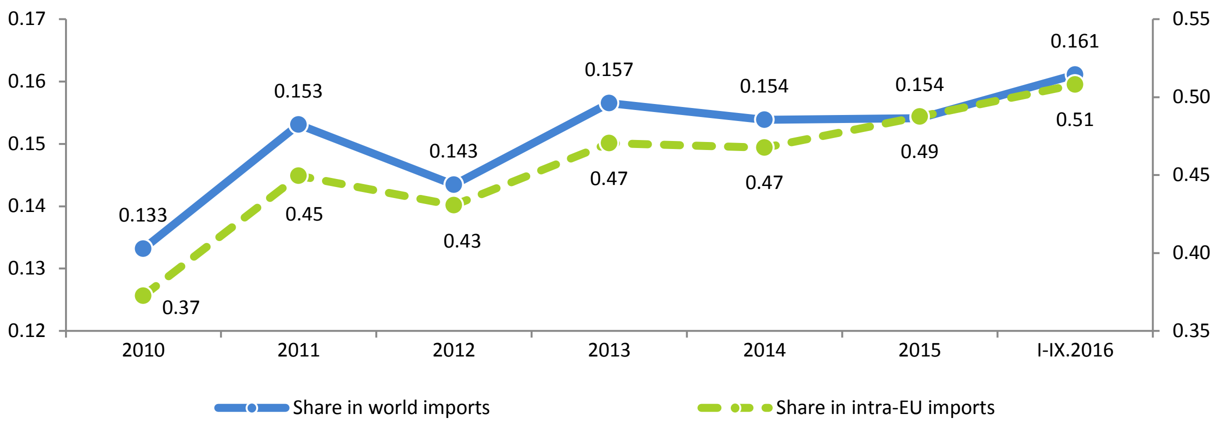
Source: ITC, WTO, MF

[7] The analysis and projections of the external sector were prepared with statistical data available as of 17 March 2017.

[8] The size of each bubble reflects the country's share in Bulgaria's exports over the period January-September 2016. Market dynamism is calculated as the difference between the annual growth rates of imports into the respective country and the growth in global imports for the period January-September 2016. A positive value indicates favourable developments in imports on the respective market compared to the global average. Competitiveness is the difference between the increase in the annual export of Bulgaria to a given country and the total increase in imports into that country for the period January-September 2016. A positive value indicates that the increase in Bulgaria's exports to that country was larger than the average increase in its imports.

Export developments translated into improved market positions for Bulgaria. On the average for the period January-September 2016, Bulgarian exports increased their respective shares as a percentage of global imports, as well as in terms of intra-EU imports.

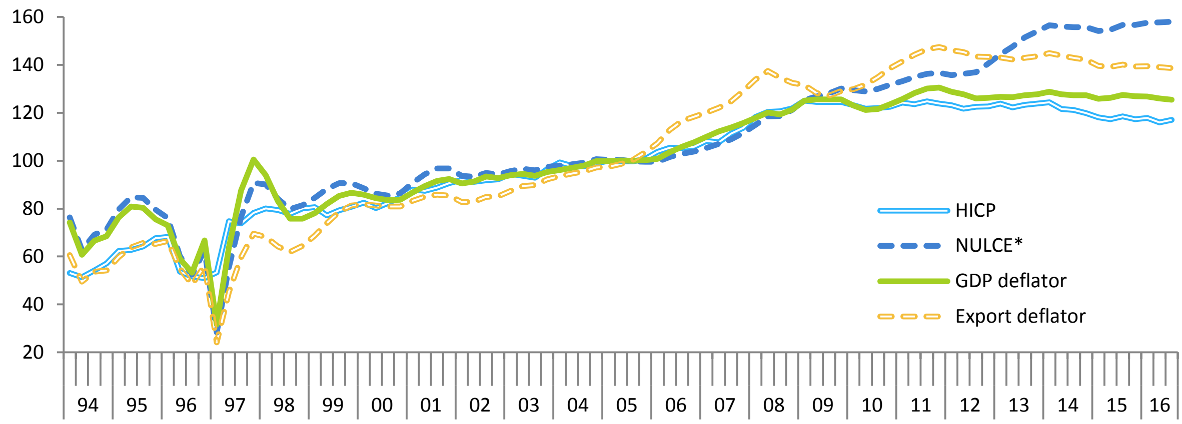
Figure 2-6: Bulgaria's share in international trade (%)



Source: MF estimates based on WTO and Eurostat data

Figure 2-7: REER, Bulgaria vis-à-vis 36 industrial countries, 2005=100

(Quarterly data, until Q3 2016)



* Nominal unit labour costs, total economy

Source: EC, MF

The development of the real effective exchange rate (REER) based on different deflators indicated that the indicator has considerably slowed down its rate of increase in the post-crisis years and has even registered periods of negative growth in yoy terms in certain quarters. Due to the deflation observed in Bulgaria from mid-2013 to the end of 2016, the accumulated change, from the last quarter of 2009 onwards, in the REER based on HICP is -6.0%[9]. REER with the GDP deflator showed a marginal adjustment for the period (-0.1%). Only the REER based on the nominal unit labour costs in the total economy reported a more accelerated increase, particularly in 2013 and the first half of 2014, primarily as a result of the increase in the unit labour costs. An influence, although less significant, came also from the observed appreciation of the euro and the related increase in the

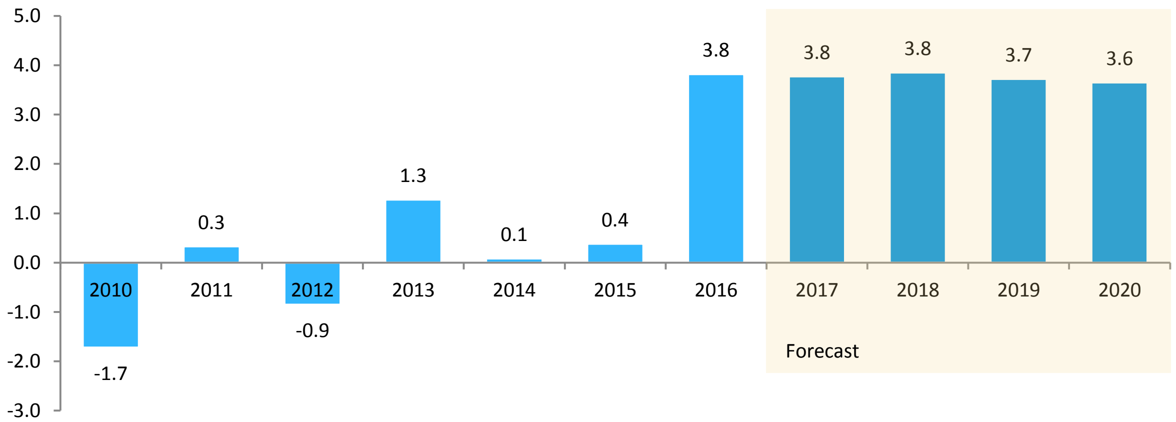
[9] Calculated using data until Q3 2016.

nominal effective exchange rate. During the first two quarters of 2015, however, there was an adjustment, after which the increase in the REER with that deflator slowed down significantly.

The expected increase in international prices and the depreciation of the euro against the dollar in 2017 will have a positive effect on the nominal growth rates in the trade in goods, and the increase in prices for imports is expected to be larger than that in the export prices. In terms of real growth rates, the increase in the exports of goods is expected to continue, although at a more moderate rate. Acceleration in domestic demand and in the demand for raw materials for export-oriented industries will support the increase in the imports of goods. Import and export rates will tend to converge, but exports will retain their lead. Positive net exports, despite the deteriorating terms of trade, will result in a shrinking trade deficit in 2017 as well. Following the considerable increase in travel services export registered in 2016, expectations are for a decline in the growth of the export of services, which will translate into a lower Services surplus, in GDP terms. Payments to foreign investors and the still limited transfers from the EU funds under the operational programmes within the 2014-2020 programming period will result in a minor deterioration in the ratio of Primary and Secondary Income balances to GDP. The improvement in the trade deficit will fully offset the developments in the rest of the articles and the current account balance in 2017 will remain at the level of 3.8% of GDP.

The increase in traded volumes will be a determining factor for the nominal increase in the imports and export of goods over the period 2018–2020. Following the significant increase in the price of crude oil in 2017, the expected price developments in the main commodity groups during the coming years will result in lower positive deflators of foreign trade. There will be a faster increase in the export deflator compared to the import one, and positive terms of trade. As a result of the price changes and the positive, yet decreasing, net export, trade deficit will improve in 2018, and is expected to increase gradually afterwards. The negative trade balance will be fully offset by the surplus in Services, which, over the entire forecast period, will be close to 7% of GDP, supported by a moderate increase in revenue from tourism and acceleration in other services trade. There will be a gradual increase in the surplus on Secondary Income, mostly from transfers from the EU. After an initial improvement, the current account balance will deteriorate slightly, to 3.6% of GDP in 2020.

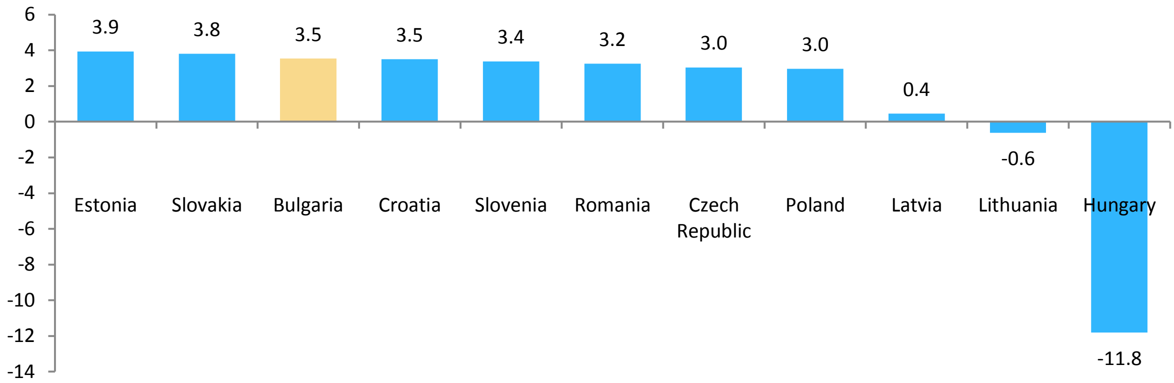
Figure 2-8: Current account (% of GDP)



Source: BNB, NSI, MF

In 2016, under the financial account[10] of Bulgaria's Balance of payments were recorded net inflows of EUR 368.7 million. The main inflows were associated with Eurobond transaction issued in March, and from Foreign Direct Investments (FDIs). FDI inflows amounted to EUR 1.1 billion, or 2.3% of GDP, mainly in the form of reinvested earnings by parent companies in local entities.

Figure 2-9: FDI flows per country, EU-11 (% of GDP, Jan-Sept, 2016)



Source: Eurostat data; MF calculations

The expectations are for FDIs in Bulgaria to increase over the 2017–2020 period. Due to the relatively high liquidity maintained by the banks, no financial inflows are expected to occur in the sector in the medium-term period, either. The contribution from the net position on the Portfolio Investments line item to the financial account will be determined by the issuance of new government debt, and by principal payments on the Eurobonds maturing in 2017.

2.4.4 Monetary Sector and Financial Sector

The main objective of the monetary policy of Bulgaria is to maintain price stability by ensuring the stability of the national currency. This objective is achieved by means of the Currency Board and a fixed exchange rate of the national currency to the euro. Together with the analyses of the 2016 developments and trends, information is also provided herein regarding the concrete measures implemented during the year aimed at addressing the specific recommendation 2 of the Council from July 12, 2016, concerning the banking sector. A description of the measures related to the insurance companies and pension funds is given in the 2017 actualization of the National Reform Program.

As of December 2016, the market value of Bulgaria's international foreign exchange reserves, i.e. the assets on the balance sheet of the Issue Department[11] of the Bulgarian National Bank (BNB), amounted to EUR 23.9 billion, registering an increase of EUR 3.6 billion yoy. Foreign exchange reserves provided a cover of 10 months of imports of goods and non-factor services, while the reserves-to-short-term external debt ratio of the country reached 298.1%.

As of February 2017, international foreign exchange reserves amounted to EUR 23.8 billion, posting an increase of EUR 4.1 billion yoy. In accordance with the principles of operation of the Currency Board, the increase in international foreign exchange reserves corresponded to the increase in the Issue department balance sheet liabilities. The main contribution to developments on the liability side came from the increase in liabilities to the government and budget organisations, mainly as a result of the two new benchmark issues, of a total volume of EUR 1 994 million, placed on

[10] Analytical presentation of the balance of payments

[11] The market value of international foreign exchange reserves includes adjustments from transactions, exchange rate differences and price revaluations.

international capital markets on 14 March 2016 and of the cash surplus generated for the period January 2016–February 2017, amounting to BGN 2 297 million.[12] To a lesser extent, the growth in foreign exchange reserves was due to the increase in currency in circulation and liabilities to banks.

Developments in monetary aggregates in 2016 were driven by the continuing considerable inflow of deposits from residents into the banking system. During the year, broad money increased at a relatively high pace and as of December their annual growth amounted to 7.6%. The increase in overnight deposits made by the non-financial non-government sector continued to determine the leading role of these resources in the annual growth of broad money, whereas the contributions of money outside MFIs and deposits with an agreed maturity were considerably lower. In the context of low interest rates during the year, both households and enterprises preferred to keep their savings mainly in overnight deposits, while in terms of the currency structure, the predominant type of deposits were those denominated in BGN. At the end of 2016, the total growth in deposits held by the non-government sector stood at 7.0% on an annual basis. The main contribution to these developments came from deposits of households which amounted to BGN 45.4 billion as of December, registering an annual growth of 6.6%. The annual rate of increase in deposits held by non-financial corporations followed a decelerating trend in 2016, reaching 6.3% in December, while their amount totalled BGN 19.4 billion. In January 2017, broad money went up 7.6% on an annual basis, while the annual growth in deposits held by the non-government sector was 6.7%.

Concerning loans to non-financial corporations and households, in 2016 a gradual deceleration in the downward trend was observed and as of December a low positive growth of 1.0% was reported (-1.6% as at the end of 2015). The annual rate of change in loans to non-financial corporations, which remained negative over most of 2016, as of December amounted to 0.3% (-1.7% at the end of 2015). Concerning lending to households, an acceleration in the annual growth was observed as from the second half of the year, reaching 2.0% in December (- 1.3% at the end of 2015), with the main contribution coming from housing and other loans to households. The increase in other loans was driven mainly by loans made under the National Programme for Energy Efficiency in Multifamily Residential Buildings. As of January 2017, the annual growth in loans to non-financial corporations and households accelerated to 2.5%.

On 4 January 2016, a new Ordinance No 21 on the Minimum Required Reserves (MRR) Maintained with the Bulgarian National Bank by Banks came into force. It introduced a definition for "excess reserves"[13] of banks held with the BNB. In accordance with the Ordinance, the BNB applies the ECB deposit facility interest rate to the excess reserves of banks, when that rate is negative. The BNB applies a zero interest rate to the excess reserves, when the ECB deposit facility interest rate is positive or zero. In line with these changes, on 4 January, the BNB applied the ECB deposit facility interest rate of -0.30%, and as from 16 March, of -0.40%, to the excess reserves of banks held with the BNB. In the first quarter of 2016, there was a decline in the excess reserves of banks, whereas in the rest of the year the percentage of exceeding the MRR remained relatively stable and stood at 89.8% in December (127.8% as of December 2015). The 2016 daily average of the resources held by the banks in accounts with the BNB by way of complying with the requirements in Ordinance No 21 exceeded the minimum reserve requirement by 92.0% against an excess of 93.4% in 2015. As of February 2017, the amount of bank funds held with the BNB in excess of the required minimum in reserve assets amounted to 115.5% of the MRR.

The changes introduced at the beginning of 2016 by means of the new Ordinance No 21 enhanced the transmission of the effects of the ECB monetary policy onto the rates quoted on the interbank

[12] Based on MF preliminary data and estimates. The surplus accumulated in 2016 amounts to BGN 1 465 million.

[13] According to Article 5 (1) of the new Ordinance No 21, "excess reserves" refers to holdings in reserve assets exceeding by more than 5% the minimum reserve requirement.

money market in Bulgaria. In 2016, the interbank market rates went down significantly, mainly under the influence of applying the negative ECB deposit facility interest rate to the excess reserves of banks. Interest rates on the interbank market continued to decline until April 2016, after which, over the period May – December, they did not display any significant change.

In the context of high liquidity in the banking system and limited investment opportunities for the available funds of banks, interest rates on deposits continued to follow a downward trend throughout 2016. As of January 2017, the weighted average interest rate on new[14] time deposits[15], presented as a weighted average on a 12-month basis, was 0.7%, showing a decrease of 52 b.p. against the same period in the previous year. A more significant decline in interest rates occurred in new time deposits of households, and a weaker one in deposits of enterprises. The increasing volume and the falling price of deposit resources in the context of high liquidity within the banking system contributed to maintaining the downward trend in interest rates on newly extended loans in 2016. As of January 2017, the weighted average interest rate on new loans[16], presented as a weighted average on a 12-month basis, went down by 1.2 pp against the same month in the previous year and stood at 5.6%. In the same period, average interest rates on new bank loans to households and enterprises went down by 1.1 and 1.4 pp, respectively, reaching 7.4% and 4.8%, respectively.

The BNB regulates and oversees the operations of the rest of the banks in Bulgaria in order to maintain the stability of the banking system and protect the interest of depositors. During the first half of 2016, an asset quality review (AQR) was carried out in all the 22 banks licensed by the BNB (with the exception of the 6 branches of foreign banks operating in Bulgaria). The BNB conducted the AQR in cooperation with an independent external consultant selected in a public procurement tender procedure, and with independent consultants and appraisers hired by the banks after a uniform selection procedure approved by the BNB. Over 900 BNB experts and the independent external experts took part in the AQR. The European Commission and the European Banking Authority were kept informed and their opinion was sought at all stages of the process.

The asset quality review examined assets of a total value of BGN 84.2 billion as of 31 December 2015, or 96% of all assets in the banking system. Over 3 400 separate credit files were reviewed, equivalent to a total of BGN 23.2 billion, or 71% of the corporate portfolios of banks and the large loans to small and medium-sized enterprises. As a result of the AQR, adjustment assessments were prepared, at a total value of BGN 665 million, or 1.3% of risk-weighted assets, which need to be reported in the 2016 financial statements of the banks.

As a result of the AQR, the adjusted capital ratio for Common Equity Tier 1 capital for the banking system as of 31 December 2015 is 18.9%. Although results vary among the banks, after the AQR, the capital adequacy ratio of all banks remains above the mandatory regulatory minimum. That is why the expected corrections to capital in the individual banks involve only the capital buffers above the regulatory minimum for capital adequacy ratio. To maintain the existing capital buffers or restore their cover, the relevant follow-up measures have been specified.

In July 2016, a stress test was also conducted in the 22 banks, in order to assess the resilience of each bank in absorbing shocks caused by hypothetical negative financial and macroeconomic developments. According to the stress test results, the capital positions of banks remain sound and

[14] The terms “new” deposits and “new” loans refer to the statistical category of “new business”.

[15] The weighted average interest rates on time deposits of the sectors of households and non-financial corporations, weighted in terms of currency and term.

[16] The weighted average interest rates on loans in the sectors of households and non-financial corporations, weighted in terms of currency and term.

demonstrate resilience to withstand the tested shocks, although results vary among the individual banks. On 13 August 2016, the BNB published the results from the AQR and the stress test.

In October 2016, in the framework of a joint mission of the International Monetary Fund (IMF) and the World Bank (WB) to evaluate the Bulgarian financial sector, the overall activity of the BNB was examined, with a special focus on the way in which the BNB performs banking supervision, including for compliance of the BNB supervision practices with the Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision. The IMF and WB Mission also conducted a comprehensive review of the process, documentation, approach and results from the recent AQR and stress test.

As part of the implementation of the Plan on Reforms and Development of Banking Supervision, an update of the On-Site Inspections Manual was launched, with the aim to further improve existing audit procedures and techniques for on-site inspections, and develop additional guidelines on assessing banking risks in the framework of supervisory review and assessment, which will help improve the quality and efficiency of supervision inspections and the overall supervision of credit institutions.

Within its current supervisory activity, the BNB analyses the financial condition of credit institutions and makes assessments of the risks assumed by the banks, risks for their capital and liquidity, by applying the tools of macro-prudential supervision, remote supervision, on-site inspections and specific supervisory activities. In 2016, the Bulgarian banking sector continued to report stable financial indicators showing growth in balance-sheet assets and in deposits, maintaining its high levels of capital adequacy ratios and increasing its liquidity position and profitability ratios.[17]

Total capital adequacy of the banking system remained high, at the level of 22.15% as of December 2016, with Tier 1 capital adequacy at 20.88%. The amount of capital in excess of the minimum capital adequacy requirement of 8% continued to rise and at the end of 2016 stood at BGN 7.1 billion. Profit generated in 2016 in the banking sector was BGN 1 263 million (or BGN 416 million, i.e. 49.1%, higher than the figure reported for 2015). End-of-the-year indicators for the return on assets (ROA) and return on equity (ROE) in the system were 1.37% (against 0.97% in 2015) and 10.41% (against 7.35% in 2015), respectively.

In 2016, the amount of gross non-performing exposures in the banking system showed a decrease, while their coverage, with impairment, remained above 50%. During the period, a downward trend was reported also in terms of the share of gross non-performing loans and debt securities in the total gross amount of all exposures within the banking system and, at the end of 2016, it was 11.2% (against 13.1% a year earlier). There was a decrease also in net non-performing exposures[18], with their amount (BGN 5 billion) remaining fully covered by capital, which exceeded the minimum regulatory requirement of 8% (BGN 7.1 billion).

As of the end of December 2016, the liquid assets ratio of the banking system, calculated according to BNB Ordinance No 11 reached 38.24% (36.71% at the end of 2015). In January 2017, the liquidity position of the banking system continued to provide a high level of cover of liabilities, and as of the end of the month, the liquid assets ratio was 37.88%.

[17] The assessment of the state of the banking system is made on the basis of data from the supervision reports by individual bank as of the end of December 2016 received by 24 February 2017, and as of the end of December 2015, received by 18 April 2016.

[18] Net non-performing exposures are calculated by reducing the gross amount of exposures with their inherent impairment accrued.

In accordance with its mandate, the BNB implements macro-prudential supervision of banks in order to maintain the stability of the banking system. In 2016, expert analysis and assessment activities continued, for the purposes of regular calibration of the countercyclical capital buffer[19]. The buffer is designed to serve as a macro-prudential tool to protect the banking system against potential losses caused by the accumulation of cyclical systemic risk in periods of excessive credit growth. In 2016, no accumulation of cyclical systemic risk in the economy was reported, and hence, the level of the countercyclical buffer applicable to credit risk exposures in Bulgaria in 2016 was 0%.[20]

At the end of 2016, the buffer for other systemically important institutions (O-SII)[21] was also introduced as a tool for the macro-prudential policy of reducing risk associated with the activity of systemically important credit institutions. The purpose of that buffer is to strengthen the capacity of O-SIIs to take losses, thus limiting the transfer of risks from a potential stress situation in a systemically important bank into other credit institutions or the banking system as a whole. The BNB follows the Guidelines of the European Banking Authority in identifying banks in Bulgaria as O-SIIs.

In accordance with the Law on the Recovery and Resolution of Credit Institutions and Investment Firms (LRRCIIF), effective as of 14 August 2015, the BNB is the authority responsible for the restructuring of banks. In performing this function, in 2016 activities at the operational level were geared towards building a framework for information and data exchange between the BNB and credit institutions in connection to gathering, review and assessment of the quality of information for the purposes of identifying critical functions and designing bank resolution plans. In accordance with the LRRCIIF requirements, in March, the BNB Governing Council set the amount of the annual contribution of the banking system to the Bank Resolution Fund for 2016 at BGN 95 687 thousand, and all banks have paid up their contributions on time.

In December 2016, following a proposal by the Bulgarian Deposit Insurance Fund, the BNB Governing Council adopted a new Ordinance on the Terms and Procedure of Reimbursing Deposits up to the Coverage Level, which has the objective to align the reimbursement procedure to ensure compliance with the Bank Deposit Guarantee Law, effective as from 14 August 2015, which introduced the requirements in Directive 2014/49/EU of the European Parliament and of the Council from 16 April 2014 on deposit guarantee schemes into Bulgarian law.

According to the MF projections for 2017, the growth rate of money supply will reach 8.1%, against 7.6% at the end of 2016. This is based on the expectations for a continuing increase in the foreign exchange reserves of the country, and in deposits held by residents with the banking system. At the end of 2018, growth in broad money will go up to 8.4% and will continue to accelerate slightly over the forecast period to 8.9% at the end of 2020. The rate of increase in deposits will remain close to that of the broad monetary aggregate M3. Overnight deposits will retain their leading role in that development but their contribution will shrink, while deposits with an agreed maturity and deposits redeemable at notice, which will gradually pace up their growth until the end of the forecast period.

During the period 2017–2020, private credit will continue to gather momentum in line with the expected private consumption growth, improved economic activity, accelerated growth of imports of goods and private investment in 2018. At the end of 2017, the annual growth rate of claims on the private sector will be 3.9%, driven mainly by the claims on households. The acceleration over 2016

[19] Capital buffers: countercyclical capital buffer. http://bnb.bg/BankSupervision/BSCapitalBuffers/index.htm

[20] Along with the capital conservation buffer and the systemic risk buffer, which were introduced in 2014, this is the third buffer which all banks must maintain in excess of the minimum regulatory requirement of 8%.

[21] Capital buffer for Other - Systemically Important Institution (O-SII). http://bnb.bg/BankSupervision/BSCapitalBuffers/index.htm

will be due to a stronger demand for loans, as well as to the continuing intensification in bank activities after completing the AQR and stress tests in the banking system. The annual growth rate of claims on the private sector is expected to reach 5.1% at the end of 2018 and 6.6% at the end of 2020, driven largely by the claims on non-financial corporations. Claims on households will also follow a trend of smooth acceleration. A positive contribution will come from the increase in households' consumption, in line with developments in the labour market and forecasted growth of compensations per employee, which will slightly accelerate after 2017. ▼

3. Government Balance and Debt

3.1 Policy Strategy

The main priority of fiscal policy in the current year and in the coming years is to maintain the sustainability of public finances, while providing for the relevant measures to stimulate economic activity in Bulgaria. At the end of 2016, the medium-term budgetary objective for the country was achieved, and it will be maintained in the medium-term period. For the period 2018–2020, the parameters for the General Government sector have been planned conservatively and ensure that the structural budget balance will be maintained at a level above the medium-term budgetary objective. The latter provides a certain degree of flexibility in case of performance deviation from the expectations for the development of the national and global economy in the medium term. The government debt to GDP ratio is expected to decrease significantly in 2017, mainly due to the upcoming payment on the maturing 2012 Eurobonds, the resources for which are already available in the fiscal reserve. In the medium-term, it is envisaged to keep additional resources available in the fiscal reserve over and above the statutory minimum required, which provides a buffer against possible liquidity risks.

In the medium term, no changes in tax rates are envisaged, except for the planned increase in the excise duty rate on cigarettes. A major priority in the tax policy area is maintaining the structure of the tax system and ensuring transparency and predictability in terms of the tax obligations of economic operators. The emphasis is placed, again, on the measures to dismantle the informal economy and combat the concealment of income, which produced a positive budgetary effect over the previous two years. The revenue projections for the General Government sector take account of the positive trends in the development of the national economy which are already confirmed by reality. An additional positive fiscal effect is expected to come from implementing the discretionary revenue measures during the years under consideration as well. With regard to expenditure, the main objective is to cap its annual increase at the level of increase in the potential GDP, thus ensuring compliance with the SGP requirements in terms of structural budget balance and the expenditure benchmark. Efforts to optimise budget-funded organisations and increase the efficiency of their spending and improve the provision of public products and services in the individual sectors continue, including by conducting a review of public expenditure in cooperation with the WB.

The work on the elaboration of the budgetary forecast has started during the term of office of a caretaker government[22], with the initial projections and estimates being prepared under the assumption of maintaining the existing policies, and afterwards supplemented by the assessment of the effects corresponding to the implementation of the new government policy priorities, which are presented in its Program for the 2017-2021 period. While accounting for the policy developments planned until 2020 and the expectations for the major indicators' trends according to the spring macroeconomic forecast, the budgetary targets remained unchanged, which shall ensure the

[22] A caretaker government was appointed by the President of the Republic of Bulgaria on January 27, 2017. The parliamentary elections were performed on March 26, 2017. After the elections a new parliamentary majority was formed, which subsequently nominated and elected a new government on the 4th of May 2017.

macroeconomic and financial stability in the country. In practice, the latter ensures maintaining the stability of the budgetary framework and a realistic forecast of its parameters, with the set fiscal targets being a continuation of the predictable, consistent and sustainable fiscal policy pursued in recent years. Bulgaria continues in its positive development towards achieving a balanced budget by gradually narrowing the actual deficit in its General Government sector, against the backdrop of a continuing trend of smooth acceleration of economic growth. The planned reduction in deficit and the current macroeconomic forecast reflect the progress achieved so far and the positive expectations in the medium term, as well as the potential risks in the forecast.

Over the coming years, government debt management will remain the overarching consideration in determining the status and level of consolidated General Government debt in view of Central Government subsector debt dominant share of over 98% within the structure of consolidated debt. Taking into account the dynamics and condition of the main macroeconomic parameters and the market environment, the debt management policy will be implemented in strict compliance with the planned reference values for debt and monitoring of its current profile, including the debt service expenditures. The sovereign debt management policy will be implemented following the main objective of debt management, aimed providing the necessary resources for refinancing the debt outstanding, as well as, if necessary financing of the state budget, and ensuring the stability of the fiscal reserve at an optimal possible price and an acceptable level of risk.

Assuming of new government debt will be focused on securing the access of the government to financial resources by means of free-market-oriented borrowing both on the local, as well as on international markets, by maintaining the possibility to raise financing through the established Global Medium-term Note Programme of the Republic of Bulgaria for issuing government securities on international capital markets. For the review period, it is envisaged to secure debt financing mainly by issuing government securities on the domestic market.

The planning and implementation of the issuance policy for offering market-based debt instruments will be tailored to the needs to provide financing for the budgetary flows, as well as to the measures already put into place to promote the secondary market by offering highly liquid debt instruments positioned in a range of maturity segments. The use of a secondary market trading venue (an MTF electronic trading platform and a regulated market) will contribute to the development and modernization of the government securities market in Bulgaria, and will ensure compliance with the regulatory reforms at the EU level: MiFIDII/MiFIR, CRR/CRDIV.

3.2 Medium-Term Objectives

Following the series of steps in the fiscal policy area, setting the medium-term objectives in terms of the deficit in the General Government sector for the 2018–2020 period is bound to the results achieved and the expectations in the area of fiscal governance, taking account of the influence of the economy and the fiscal effects from the discretionary measures of the government. For the period 2018–2020, the forecast concerning the balance in the General Government sector (under ESA 2010) is to achieve a near-balance budgetary position with a deficit of 0.5% of GDP in 2018 and a surplus of 0.1 % of GDP in 2019 and in 2020. With these values for the budget balance on accrual basis, the structural balance is estimated at – 0.4%, 0.1% and 0.1% of GDP for 2018, 2019 and 2020, respectively. These targets for the balance in the General Government sector are compliant with the fiscal rules and restrictions set in the Public Finance Law and in the Stability and Growth Pact.

In the medium term, total revenue and expenditure in the General Government sector as a share of GDP, are expected to be maintained at sustainable levels, close to the current ones. The improvement in the budget balance during the planning period is expected to be achieved through the outlined tendency of a slight decrease of the expenditure to GDP ratio in the range of 36.6-35.1%, while on the revenue side the ratio varies from 36.1% in 2018 to 35.3% in 2020.

Nominal revenue growth in each of those years comes as a result of increased proceeds from all the main types of taxes: VAT, excise duties, personal income tax and corporate tax. The revenue from social security contributions is also planned to grow, at a most pronounced rate in 2018.

In the General Government sector expenditure, the highest growth in the medium term is projected to occur in compensation of employees and social payments. At the same time during the period 2018-2020 as a percentage of GDP these expenditures remain at levels close to the levels of 2017 and vary accordingly to 9.1-9.0% and 14.2-14.0% as a share of GDP. The medium-term forecast envisages the nominal amount of expenditure for personnel in the sector to grow annually by over BGN 0.4 bn.

The improved budgetary position achieved in 2016 and the expected positive macroeconomic development imply a considerable adjustment to the budget balance targets and, respectively, targets for a deficit of 0.5% of GDP for 2018, a surplus of 0.1% of GDP for 2019, and 0.1% of GDP for 2020, from the previous Convergence Programme update (2016–2019), where deficit was planned at -1.9% of GDP for 2016, -0.8% of GDP for 2017, -0.4% of GDP for 2018 and -0.2% of GDP for 2019. Those adjustments require aligning the fiscal policy to the estimates for potential growth and the relatively low value of the output gap, while at the same time focusing on activities geared towards implementing the structural reforms, the effect of which should have a positive impact on the potential of the Bulgarian economy for growth and the level of convergence with the rest of the EU countries.

3.3 Actual Balances and Updated Budgetary Plans for the Current Year

In 2016, fiscal development was favourable in terms of the budgetary position and enabled the achievement of a fiscal consolidation step larger than the one planned in the previous Convergence Programme. The 2016 Programme adopted the General Government deficit target not to exceed 1.9% of GDP on accrual basis. According to the April 2017 EDP Notification Tables for Bulgaria, the General Government fiscal position is broadly balanced, with a minimal surplus of BGN 29.9 million (0.03% of GDP). Thus, Bulgaria has achieved a larger than the required annual adjustment in its structural budget balance.

The main contribution for this development lies on the expenditure side, as the shrinking of spending from the EU funds, after their peak in 2015, including the lower amount of resources allocated to national co-financing for projects in 2016, and the discretionary measures undertaken in terms of spending, helped for the significant decrease of total expenditures in the General Government sector in comparison with the previous year. There were also a number of other contributing factors, both internal and external, which affected the developments along the revenue and expenditure indicators in 2016.

On the revenue side, a positive development was observed mainly in tax and social security revenues, whereas due to a slower absorption rate of funds under the Operational Programmes and the EU funds, the EU grants remained lower than planned. Larger proceeds from taxes and social security and health insurance contributions were the result of the continued positive development under the key macroeconomic indicators, as well as the active efforts by revenue agencies in implementing the measures aimed at increasing budget revenue collection, combating the informal economy and tax evasion, including through joint operations with the Ministry of Interior, SANS and the Prosecution Office, active measures to bring out of the shadows the cash flows from the grey sector of the economy by means of strengthening fiscal control, measures to strengthen controls in the trade of excisable goods, countering any attempted tax violations and fraud, and other such steps.

Outperforming against the projections was recorded for most of the key macroeconomic indicators, with the real increase in GDP reaching 3.4%, against a growth rate target of 2.1% planned in the previous Convergence Programme. The 2016 tax proceeds were affected positively by the increase in domestic demand which made a considerable contribution to the GDP growth. The increase in the economic activity rate over the year was manifested in increasing the utilisation of production facilities, an increase in employment, increased income levels of employees. Favourable external environment also played a positive role, as the economies of Bulgaria's main trade partners registered growth, which translated into rise of exports. Prices of imported energy resources remained low, which supported Bulgarian customers and consumers. Producers and merchants showed a keener interest and registered a stronger presence on export markets. The positive outcomes from the quality assessment of bank assets gave an additional boost to the confidence in the banking system and supported the normal functioning of the sector in 2016.

On the expenditure side, implementation in 2016 reported lower than the planned spending, which was due to the above-mentioned slow-down in the absorption rate for some of the projects co-financed from the EU Structural and Cohesion Funds, the Rural Development Programme, etc. In comparison to the projection made in the previous Convergence Programme, total expenditure in the General Government sector in GDP terms was 3.0 pp lower, which is associated mainly with the lower implementation of the planned investment expenditure in the accounts for resources from the EU, due mainly to the delay in launching calls for applications and project implementation within the new programming period 2014–2020, administrative difficulties and other. It should be noted, however, that compared to the parameters of project contracting and payments to project at the same implementation stage under operational programmes in the previous programming period (2007–2013), the current parameters for contracting and the rate of absorption of EU funds in the new programming period are performing considerably better.

3.3.1 Budgetary Developments in 2016

The overview of revenue parameters and a comparison to the previous year indicate growth in the revenues under the national budget, mainly in the proceeds from taxes and social security and health insurance contributions, whereas the EU grants are decreasing, due to a pronounced base effect in 2015. The deadlines for completing the projects within the previous programming period (2007–2013) placed the peak of payments for the whole programming period in the previous year, which reflected into a base effect in the budget indicators of the revenue and expenditure items under which the transactions relating to the EU programmes and funds are reported. Due to that, total revenues of the General Government for 2016, which, in GDP terms, amount to 35.5%, show a decrease of 3.6 pp from their 2015 level. This is explained primarily by the shrinking amounts of the EU grants, where the received capital transfers and other current revenue in 2016 is considerably lower in terms of its relative proportion to GDP than its 2015 level, down by 4.1 pp. However, it should be noted that if the revenues net of the flows associated with EU programmes and funds between the two years are compared, proceeds to the national budget on a comparative basis would show an increase.

Compared to the forecast in the previous Convergence Programme, the General Government revenues, as a share in GDP, decrease by 1.1 pp, which is due to the overly ambitious initial projections for 2016 concerning the absorption of funds under the EU operational programmes.

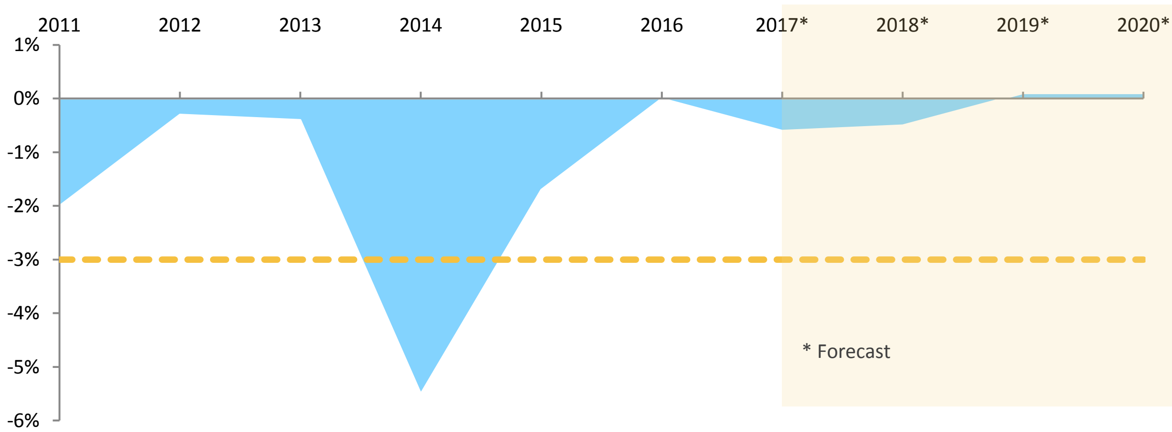
Reported data show underperformance in payments and in grants received under projects co-financed by the EU, respectively, due to the early stage of implementation in the current programming period 2014–2020.

Tax revenue on accrual basis (net of social security and health insurance contributions) increased compared to 2015, by 0.4 pp in GDP terms, and by over BGN 1.2 billion in nominal terms. The main groups of taxes show an increase in GDP terms against 2015. Taxes on output and imports report an increase of 0.2 pp, the main contributions coming from VAT and excise duty revenues, positively affected by the growth in domestic consumption, intensified activity of economic agents and the positive effect from actions undertaken by the revenue administrations to improve the revenue collection rate and fight the informal economy and tax evasion.

In the taxation of income the increase compared to 2015, in GDP terms, is 0.1 pp which, in nominal terms, exceeds BGN 330 million. The main factors behind the increased proceeds for personal income tax are the increase in employment, and the considerable increase in income levels in the economy. For taxes on capital, the level remained unchanged in GDP terms, with a nominal increase of BGN 20 million, which is due mainly to higher positive financial results both in non-financial and financial corporations, which, in its turn, is an expression of the continuing acceleration in business activity, increased demand for their products in Bulgaria and abroad, and a growing business confidence among the economic agents.

As a proportion of GDP, the revenue from social security and health insurance contributions increased by 0.1 pp against the previous year, which is due to the above-mentioned factors affecting personal income tax revenue, higher employment (decrease in the unemployment rate), the increase in the minimum social security and health insurance thresholds, etc.

Figure 3-1: Budget balance (ESA 2010, % of GDP)



Source: Eurostat, MF

Total General Government expenditure for 2016 amounts to 35.5% of GDP, which is 5.2 pp less than the figure reported in 2015. The decrease is due mainly to the above-mentioned effects associated with the EU programmes, including the lower expenditure on national co-financing, and to the effects of the discretionary measures on the expenditure side of the budget. Due to those factors, the most significant decrease against the previous year was reported in gross fixed capital formation, which as a share in GDP shrank by 3.7 pp. Apart from the base effect of the previous year, the amount of that expenditure item in 2016 was influenced also by the absorption rate, which was lower than expected, and the slow-down at the starting stage of implementation in a number of infrastructure projects in the programming period 2014-2020. The slow-down is also reflected into deterring the spending to subsequent periods, which has been taken into account in the three-year budgetary forecast.

The expenditure for compensation to employees decreased by 0.4 pp in GDP terms, in comparison to the previous year, and that decrease is associated with the expenditure ceilings planned in the Annual Budget law and the base effect in the 2015 expenditure. In addition to the expenditure for compensation to employees, a decrease against the previous year was reported in the expenditure for subsidies, by 0.8 pp, in maintenance costs, by 0.2 pp, and in interest expense, by 0.2 pp.

The amount of social transfers in GDP terms decreased slightly by 0.1 pp. However, a differentiation needs to be made among the various types of social payments. The efforts made to repay the arrears in the healthcare area resulted in an increase in social transfer in-kind payments via market producers. Despite the slight decrease in GDP terms, the rest of the social transfers, which include also expenditure for pensions, reported a nominal increase of BGN 394 million, mostly due to the indexation of pensions under the Swiss Rule, which was planned in the Programme for the year and the one-off payments on top of the April and December pensions.

3.3.2 2017 Budget Highlights

According to the Medium-term Budget forecast the deficit in the General Government sector is planned at 0.6 per cent of GDP. This target takes into account the current economic conditions and the requirements laid down in the national fiscal rules.

The revenue policy remains consistent with the one pursued over the past several years and is pointed towards supporting the economic growth, improving the business environment, curbing tax fraud and enhancing macroeconomic and fiscal sustainability in the long term. The Programme for the year provides for maintaining the tax burden at the present levels for the basic taxes, with the exception of the rates in excise duties on tobacco products. A more tangible increase is planned in proceeds from social security and health insurance contributions, which is result of the changes in social security and health insurance policy in 2017. The revenue framework is again planned in a moderately conservative way, attaching importance to the measures for improving the tax collection rate.

The public expenditure policy is aimed at ensuring the normal functioning of the budgetary systems, securing funding for the priority policies and increasing the efficiency of expenditure in the various sectors in order to enhance their contribution to strengthening economic growth.

– Priorities on the Revenue Side

In their work, revenue administrations will continue to focus on reducing the share of the informal economy and improving revenue collection, reducing the administrative burden and the cost of compliance for businesses and private individuals, fighting tax fraud and tax evasion, promoting investment activity and employment, implementing measures to collect overdue liabilities and measures to improve the conditions for doing business and attract investors.

The main legal provisions and changes in tax laws and regulations include:

- Retaining the low tax rates in corporate taxation, personal income tax and VAT unchanged, as an important incentive for investment, economic growth and employment.
- Measures to improve collection of overdue payments of taxes and social security and health insurance contributions from big debtors. The expected positive revenue effect of this measure is BGN 40 million (0.04 % of the forecast GDP).

- Increase in the excise duty on tobacco products. This is a step planned in the time schedule for a step-by-step increase in excise duty rates to bring them up to the minimum EU taxation levels, and the process of gradual increase will continue next year as well. The expected positive effect on the tax revenue from excise duties and VAT is BGN 56 million (0.06 % of GDP).
- Restricting the scope of tax-deductible income from cash and in-kind winnings obtained from gaming, with expected effect of BGN 1.5 million (0.002 % of the forecast GDP).
- Introduction of a local tax on passenger taxi services in towns and villages. Implementing this measure is expected to generate a positive effect on the revenue in the amount of BGN 9 million (0.01 % of GDP).
- Modification to the parameters set in the dividend policy for profit distributions in companies with majority state ownership; the expected positive revenue effect is BGN 20.2 million.

Social security policy has the following parameters on the revenue side:

- The ratios of the social security contributions to the Public Social Security (PSS) funds and the health insurance contribution remain unchanged in 2017.
- The amount of the social security contribution to the PSS Pensions Fund is increased by 1 pp, to 18.8 % for people born before 1 January 1960, and to 13.8 % for people born after 31 December 1959, respectively. The purpose of this measure is to reduce the shortfall of funds in the PSS budget and reduce the amount of the state budget subsidy. The expected positive effect on the revenue is BGN 186.7 million (0.19 % of GDP).
- As from 1 January 2017, the social security contribution to the SSC Pensions for Persons under Article 69 Fund is increased by 20 pp. For people born after 1959, the social security contribution becomes 55.8 %, while for people born before 1960, it is 60.8 %, respectively. The increased revenue from social security contributions made by that category of insured persons will cover the cost of pensions to the current retired military personnel, in accordance with the principles of pay-as-you-go pension schemes.
- In 2017, the differentiated minimum insurance income for self-employed is increased, depending on their taxable income, to BGN 460, BGN 500, BGN 550 and BGN 600, respectively. The effect on the revenue is expected to be BGN 23.1 million (0.02 % of GDP).
- The maximum insurance income in 2017 remains unchanged for all insured persons, at the level of BGN 2 600, and the minimum monthly amount of insurance income for registered farmers and tobacco producers remains unchanged as well, in the amount of BGN 300.
- The minimum insurance income levels for the main economic activities and occupational groups increase, on the average, by 2.6 % in 2017 in comparison to 2016. The effect on the revenue side is estimated as an increase by about BGN 24.3 million (0.02 % of GDP). That change is associated with the modified amount of minimum monthly wages, which is BGN 460 as from 1 January 2017.
- Revenues from social security contributions increase as a result of switching from a private social security fund to the NSSI by BGN 12 million. (0.01 % of GDP).

– Priorities on the Expenditure Side

The implementation of expenditure policies is linked to carrying out structural reforms in certain sectors. Measures to improve the efficiency of public expenditure are envisaged, including by enhancing the role of market-based mechanisms and compliance with the budget ceilings and restrictions.

Measures in the Area of Education

The 2017 priorities in the area of education are geared towards addressing the main challenges and facilitating the implementation of the key policies in the sector. To implement those priorities, integrated measures and activities have been put into place to ensure equal access to quality education and vocational training and growth based on knowledge and science, and the development of young people. Last year, the Law on Pre-School and School Education came into force and more than 15 implementing rules and regulations were adopted, becoming the basis for changes in all segments of the secondary education system.

The policy in the area of pre-school and school education is focused on the following priorities:

- Enable physical access to educational institutions by designating protected kindergartens and expanding the scope of eligibility to free-of-charge transport to include schoolchildren until they complete their secondary education. Additional funding of BGN 7.1 million has been allocated to the implementation of these measures.
- Implement the inclusive education concept paper. Additional funding of BGN 6.0 million has been budgeted.
- Implement the Strategy for the deployment of modern information and communication technologies in schools by adopting educational content for the purposes of e-learning. Additional funding of BGN 3.0 million has been allocated to the implementation of this measure.
- Differentiate the cost standards for financing kindergartens to cover the shortfall of funds for the institutions within the pre-school educational system in small and medium-sized municipalities. Additional funding of BGN 11.0 million has been allocated to the implementation of this measure.
- Introduction of the new educational structure and make provisions to ensure the free-of-charge use of new textbooks and school sets for schoolchildren in grades I, II, V and VI. The budget allocation amounts to BGN 10.3 million.
- Refund the expenditure incurred by educational institutions in covering the increased amount of employee benefits in case of termination of employment. Additional funding of BGN 9.0 million has been secured for the implementation of this measure.
- Increase state support for the preservation of the Bulgarian ethnic and cultural area and the national and cultural identity of Bulgarian citizens residing abroad by financing the learning the Bulgarian language, literature, history and geography in Sunday schools abroad. Additional funding of BGN 1.5 million has been secured for the implementation of this measure.
- Additional funding in the amount of BGN 4.0 million has been secured for raising the cost standards for technical vocational training areas in vocational secondary schools. Those are the vocational training areas with both the largest decrease in the number of school students and the highest labour market demand. The declining number of school students will result in a deficit and inability to cover the maintenance costs of classes specialising in technical areas in many vocational training areas.

- An additional amount of BGN 3.5 million has been secured for funding full-day organisation of the school day for school students in Grades I through VII, including in focal point schools.
  - Ensuring access to educational institutions for children and school students from small towns and villages by designating protected kindergartens and expanding the eligibility scope for free-of-charge transport for school students until the completion of their secondary school education, and to cover the maintenance cost of school buses provided to schools;
  - Providing support to children and school students with special educational needs in kindergartens and schools by special resource teams;
- In the higher education area, the budgetary policy is aimed at supporting the implementation of the on-going reforms in the sector. The additional funding in the system budgeted for 2017 is directed towards:
  - Increasing the weight of the comprehensive evaluation of the quality of education and its relevance to labour market needs in determining the amount of the allocation for covering the maintenance cost of education in state tertiary schools. Additional resources allocated to funding this objective amount to BGN 7.9 million;
  - Supporting and promoting the consolidation and optimisation process in the system of higher education. Additional resources allocated to funding this objective amount to BGN 1.0 million;
  - Promoting education in priority professional training areas and providing support for the maintenance costs of certain protected areas of specialisation;
  - Increasing the resources made available from the state budget for student scholarships. The additional funding made available amounts to BGN 3.0 million.

Funding has been allocated to providing free-of-charge transport to children and school students in support of equal access, in compliance with the Law on Pre-School and School Education, which is linked to the efforts to optimise the school network and provide support for children and school students commuting to focal point schools.

National financing for education will further be complemented by funding from the EU Structural Funds. The resources are targeted primarily at the development of learning skills and the creativity of school students and increasing learning motivation, teacher training, practical training and internships for school students, enhancement of practical skills of students in tertiary schools and increasing the labour market success rate of young people.

In terms of the policy in the area of science, efforts in 2017 are geared towards achieving the targets laid down in the Operational Plan for the period 2017–2020 and the Indicative Investment Plan for the period 2017–2020in implementing the National Research Development Strategy 2025.

Measures in the Area of Healthcare

The main emphasis in healthcare policy in 2017 is placed on improving the functioning of the system on the basis of the latest amendments to the Health Insurance Law and the Law on Healthcare Institutions. The provisions laid down in the HIL remain in force, as regards the adoption of a step-by-step increase in the minimum insurance income on the basis of which the health insurance contributions are determined for people obtaining health insurance cover at the expense of the state budget, from 55 % in 2016 to 60 % of the minimum insurance income for self-employed persons as from 1 January 2017, with an incremental annual step of increase of 5 pp until the minimum insurance income applicable to self-employed is reached. The effect on revenue and expenditure is neutral.

⦿ Measures in the Area of Defence

Defence policy is associated with maintaining modern and combat-ready armed forces (AF). The main priorities are: continuity and sustainability in the development of AF by conducting a realistic defence policy which is adequate to national security threats, our commitments as a NATO ally and an EU member state and the available financial resources; maintain the existing defence capabilities and gradually develop new ones; gradually phasing out all dependencies in the Bulgarian defence capabilities potentially leading to instability along the external border of the Euro-Atlantic community; develop defence capabilities within the Programme for the Development of the Defence Capabilities of Bulgaria's Armed Forces 2020. In order to implement these priorities in line with the NATO Defence Planning Process and the EU defence capability development process, efficient and effective defence planning is maintained and developed, aimed at building, developing, maintaining and using the necessary AF capabilities to fulfil national defence tasks, Bulgaria's commitments within the collective security and defence system and to contribute to national security in peacetime.

In 2017, for the purposes of maintaining the existing defence capabilities and gradually develop new ones, additional expenditure of BGN 402 million (0.41% of projected GDP) in total has been allocated to: ensuring the airworthiness of MiG-29 aircraft, acquisition of a new type of fighter jet and acquisition of a multi-functional modular off-shore patrol vessel for the navy.

⦿ Measures Concerning Pensions and Social Assistance:

- From 1 January 2017 onwards, there is a gradual increase in the weight assigned to one year of covered service in the pension formula by a percentage equal to or higher than the percentage specified in the rule laid down in Article 100 of the Social Security Code (SSC). According to Article 70 (1) of the SSC, the percentage for each year of covered service is to be set annually in the Law on the PSS Budget for the respective year on the basis of estimates of the increase in social security income and of the consumer price index.
- As from 1 January 2017, in the pension formula, the percentage for each year of covered service is increased from 1.1 to 1.126 (by 2.4 %). From 1 July 2017 onwards, labour pensions granted up to 31 December 2016 will not be indexed under Article 100 of SSC but will be recalculated applying the new percentage per year of covered service. The effect of the recalculation on the pension expenditure is BGN 106 million (0.11% of the forecast GDP).
- When paid for a whole year, the pensions updated as from 1 July 2016 and the supplementing allowances attached to them will translate into an increase of the pension expenditure by BGN 110 million. Respectively, the increase in the weight of the length of covered service for newly-granted pensions will have an effect equal to BGN 7 million. The recalculation of pensions already granted to persons who have exercised the early retirement option in the security sector due to switching from Pillar Two to Pillar One resulted in an estimated increase of another BGN 17 million. The total expenditure effect amounts to 0.14 % of GDP.
- The maximum amount per person of one or more pensions he/she can receive remains unchanged at BGN 910.
- From 1 January 2017 onwards, the required retirement age and length of covered service are raised for all categories of labour. That is reflected into a decrease of pension expenditure by about BGN 15 million. (0.02% of GDP).
- To support pensioners receiving the lowest pensions, Council of Ministers Decision No 47 from 8 March 2017 adopted an additional transfer, in the amount of BGN 51.5 million (0.05 % of GDP), to the PSS budget to be used for one-off additional benefit payment of BGN 40

to supplement the April 2017 pensions. The additional supplement will be paid to all pensioners whose pension, or sum of pensions, along with any supplementing allowances attached to them, amounts to up to BGN 314. In the area of social benefits and family allowances, the parameters specified in the effective legislation remain unchanged in 2017, including the eligible length of time for payment of cash benefits for pregnancy and maternity and the amount of the childcare benefit for raising a child between one and two years of age; the arrangements for granting the benefit for temporary disability; the time period on the basis of which short-term benefits in cases of temporary disability and unemployment, pregnancy and birth are calculated; the size of the lump-sum support benefit in case of death; the maximum amount of guaranteed claims of workers and employees from the Guaranteed Claims of Workers and Employees Fund for unpaid wages in the event of bankruptcy of the enterprise; the minimum and the maximum amount of unemployment benefits.

- With the goal of improving the adequacy of the lowest receivable pensions, in the new governments' priorities an increase of the minimum pension, for covered years of service and age, to BGN 180 from 1 July 2018 and to BGN 200 from the 1 October 2017 is envisaged. The effect from this measure is about additional BGN 100 million. Expenditures, which are forecasted to be provided by the overachieving of PSS revenue (0.1% of forecast GDP).
- The priority of the policy in support of families with children is to improve the effectiveness and focus of family assistance for raising children in a family environment. Following these principles, the Family Child Benefits Act and the Integration of People with Disabilities Act were amended, with the aim to regulate a new type of monthly allowance for children with long-term disabilities. The amendments provide that allowances for all children with long-term disabilities are to be provided for the purposes of meeting their basic needs, and their specific needs relating to their disability. Allowances for children with determined disability type and a disability degree of 90 or over 90 per cent, or a degree of long-term reduced ability to work, who are raised by their birth parents/adoptive parents, are to be determined in a higher amount, so that those children can be provided with care and support in their home and family environment. On the basis of the defined criteria for determining the size of the allowance depending on the degree of disability or the degree of reduced ability to work, and in line with the intended purpose of such allowance, the size of the allowance is differentiated, whereby children with determined disability type and a disability degree of 90 or over 90 per cent are eligible for the highest amount of that allowance (BGN 930), while for children with determined disability degree between 50 and 70 per cent, the amount is the lowest (BGN 350). The high amount of the allowance for children with the most serious disabilities takes into consideration the fact that their parents need to meet much more serious costs and needs, in comparison to other families. They have more serious commitments in providing childcare, which very often makes it impossible for them to have a job and earn income from gainful employment. Differentiated amounts will provide more fairness and better targeting of the support for children with long-term disabilities. The expenditure effect of introducing the allowance and adopting a differentiated approach in determining its amount is BGN 55 million (0.06% of GDP).

◉ Income Policy

- From 1 January 2017 onwards, the national minimum wage (MW) has been raised from BGN 420 to BGN 460, with a neutral net effect from the measure on the budget balance, since the expected higher expenditure resulting from the increased minimum wage of the budget sector employees will be offset to a large extent by the expected revenues from taxes and social security and health insurance contributions applied to the increased pay to all employees in the other sectors of the economy whose remuneration is equal to the MW. Increasing the MW amount is aimed at achieving an increase in nominal terms in the income levels of the lowest income groups in the labour market. The current income policy facilitates the achievement of social cohesion and provides equal opportunities for a full-blooded social and work life for all social groups in the population, which is in line with the established practices in EU Member States for protecting the income and living standard of the low-paid workers and the "working poor", and for implementing the minimum standards to ensure a decent standard of living.
- Within the secondary education system, an increase of the cost standards for funding educational activities is envisaged, which opens up an opportunity to raise the salaries of teaching and non-teaching personnel in the system. The increase in remuneration in the sector is a key prerequisite for attracting young people to the teaching profession and a major factor in improving the quality of education in the long term. Additional funding in the amount of BGN 100 million has been allocated to the increase in the remuneration of pedagogical specialists. Besides them the implementation of a new system for the gradual increase of teachers' salaries is envisaged, as the first step of this process will be made in September 2017. The funding needed for this measure amounts to BGN 80 million for 2017, which will be provided for in the approved annual expenditure ceilings. To implement the commitments undertaken in the collective labour bargaining process for the system of pre-school and school education, the allocation is BGN 12 million. To compensate the increase in the MW and the PSS contribution, the additional funds allocated are in the amount of BGN 26.2 million. The expenditure effect amounts to 0.22% of GDP.

3.4 Medium-Term Perspectives, Including Description and Quantification of the Strategic Policy Impact

The strategy for the policy being conducted is detailed in the Medium-Term Budgetary Forecast, the National Reform Programme and the Three-Year Action Plan for implementation of the National Development Programme: Bulgaria 2020 for the period 2017 – 2019. The latter provides for the implementation of a wide range of measures grouped into several key priority areas which are expected to lead to a more balanced regional development, enhanced quality of human capital, promotion of innovation, improved infrastructure quality and an increase in the competitiveness of the economy, as well as employment and income levels. The relevant funding will be secured primarily from the EU funds which complement the expenditure from the national budget.

3.4.1 Improved access to and quality of education and training and qualitative features of the labour force: allocations in the amount of BGN 3 billion

The policy is focused on the formation of human capital and enhancing its quality in all dimensions. It is primarily aimed at modernisation, improving access to the educational system and introducing mechanisms for better quality management. Activities in that area include measures to improve access to education, as well as gearing education towards creativity and innovation which lead to personal development, and reducing the rate of early school leavers. In order to improve quality in education, more efficient financing models will be developed. The introduction of a system of course credits, which will improve the qualifications of teaching staff, strengthen the use of information and communication technology and improve interaction with business, is also planned. The enhanced qualitative features of the labour force should be ensured via measures aimed at adapting policies in the area of lifelong learning to the needs of the labour market, including by promoting on-site training in priority sectors of the economy, such as knowledge-based sectors, high-tech and ICT, etc. These measures include: improving mobility, introduction of a system of course credits, strengthening links with the business sector and promoting the adoption of up-to-date forms of work organisation in enterprises.

Additionally, increasing the social role and relevance of research, developing scientific potential through integration into the European Research Area, as well as bolstering research and development through programme financing via competitive procedures, are envisaged. Measures ensuring national access to European and global infrastructure facilities, digital infrastructure and databases of key importance for the development of science in Bulgaria will be financed. In terms of improving the quality of healthcare, envisaged measures include developing innovative solutions for a sustainable and efficient healthcare system, as well as improving the quality of health services and ensuring comprehensive citizen access.

3.4.2 Poverty reduction and promoting social inclusion: allocations in the amount of BGN 1.8 billion

Emphasis is placed on guaranteeing the adequate participation of vulnerable groups in all areas of public life through a set of comprehensive measures, covering areas such as the provision of opportunities for training and employment, and for starting one's own business, improving the quality of social services, deinstitutionalisation of care for children, the elderly and people with disabilities, as well as a number of legislative changes. Planned activities include improving the qualifications of the unemployed, enhancing the quality of intermediary services in the area of employment to ensure that they better match the needs of the labour force, as well as measures to ensure more flexible employment, so as to improve the possibilities for reconciling private and work life.

3.4.3 Achieving sustainable integrated regional development and utilisation of local potential: allocations in the amount of BGN 6.5 billion

Regional development in Bulgaria is geared towards developing the potential of the Bulgarian regions, reducing interregional disparities and improving the attractiveness of all regions as places for living and doing business. The key areas of government intervention are: strategic planning and regional governance through enhanced capacity of the local authorities; promoting the development of towns and improving the integration of Bulgarian regions through integrated sustainable urban development and strengthening of the functions of the polycentric network of cities; improving urban labour mobility; developing and improving access to cultural services and sports in the regions and the building of broadband infrastructure; support for effective and sustainable utilisation of tourism potential in the regions through development of the infrastructure for specialised forms of tourism and through marketing of the tourism regions and development of regional tourism products; support for the development of underdeveloped regions and improving the quality of life in rural areas; creating conditions for environmental protection in the regions by improving the quality and efficiency of water supply services for businesses and citizens and building and upgrading sewage and waste water treatment systems for sustainable water resource management; as well as enhancing territorial cohesion through the development of cross-border, interregional and transnational cooperation.

3.4.4 Support for innovation and investment activities to enhance the competitiveness of the economy: allocations in the amount of BGN 0.5 billion

The key priority areas in the three-year period will be the building of innovation and scientific infrastructure to improve the connections between business, science and education, and the implementation of measures under the Investment Promotion Act. There will be comprehensive measures for promoting investments in manufacturing and in high-tech industries and services, such as support for infrastructural projects, education, job creation and financing innovation projects. Concrete steps will also be taken to improve the quality of services in the tourism sector. Pro-active marketing will help support the attraction of targeted investment to the economy and the promotion of the country as a tourist destination. The sector of small and medium-sized enterprises will be supported by measures aimed at improving the conditions for starting up business and implementing good practices, including wider use of ICT and support for R&D projects. EU funds will be used to finance the building and completion of innovation and scientific infrastructure in Bulgaria, while national financing will be used to support the participation of Bulgarian enterprises in EU programmes such as Horizon 2020 and Eureka.

3.4.5 Strengthening the institutional environment for greater efficiency of public services for citizens and businesses: allocations in the amount of BGN 0.2 billion

In the period until 2019, the main focus of government work will be on the introduction and mainstreaming of integrated administrative services and the review of all regulatory regimes set up by means of special legislative act, with the aim of reducing the regulatory burden and preventing its subsequent increase, as well as ensuring better coordination among the territorial units of the central government administration which provide services. The emphasis of government policy will be on developing e-government and ensuring the interconnectivity and interoperability of the information systems in the public administration. Insolvency procedures will be streamlined and the use of the tacit agreement principle will be expanded. Improved cooperation among the various units within the structures of the judicial system and the wider implementation of ICT are expected to improve its effectiveness. Measures to enhance law enforcement and unregulated and corrupt practices will be implemented. To make the administration more effective, the system for assessing and planning the need for experts will be improved and a wider choice of up skilling options will be offered. Measures to modernise selection methods and improve mobility options are also envisaged. Work to improve the dialogue with the public on policy-making and monitoring government policies will continue by developing the capacity of the private sector in that field and improving access to information.

3.4.6 Energy security and improving resources efficiency: allocations in the amount of BGN 0.2 billion

Government efforts will be geared towards enhancing energy security, independence and efficiency in the economy, as well as towards improving the environment. To ensure Bulgaria’s energy security, conditions will be provided enabling diversification of sources and routes for the supply of natural gas by building gas interconnections with the neighbouring countries and supporting the construction of gas pipelines along the main European gas corridors, as well as by promoting the maintenance of a reasonable balance between the energy resources available in Bulgaria and the EU clean energy targets. Reducing the use of electricity in households by replacing it with natural gas will result in a more efficient use of resources, lower costs and a higher quality, healthier environment. In terms of resource efficiency, actions will be undertaken to promote the introduction of low-carbon, energy-efficient and clean technologies, and increase the proportion of waste recycling and reuse. As regards the provision of an integrated internal energy market, the efforts will be geared towards full transposition of the Third Energy Liberalisation Package of the EU with the aim of achieving full liberalisation of the market for electricity.

3.4.7 Improving transport connectivity and access to markets: allocations in the amount of BGN 6.8 billion

During the period until 2019, the key focus of the policies aimed at creating optimal conditions for the development of the economy, improving access to markets and limiting environmental pollution will be on efficient maintenance, upgrading and developing transport infrastructure, sustainable development of public transport and reforming the railway transport system. A number of projects along the trans-European corridors which cross national territory are planned. The largest projects include the completion of the Struma motorway, upgrading the Sofia-Plovdiv railway line, rehabilitation of the Plovdiv – Burgas railway line, development of the Sofia railway junction and completion of the Plovdiv – Svilengrad railway line. With a view to ensuring sustainable development of mass public transport, efforts are focused primarily on the construction and development of smart networks and services. The extension of the subway in Sofia is of paramount importance in this respect. As regards the reform in the railway transport system, the main efforts will focus on improving the management of the railway sector, as well as on restructuring BDZ Holding EAD and the National Railway Infrastructure Company (NKZI).

3.4.8 Ex-ante impact assessment

The table below presents the expected effects from the implementation of the measures planned. The SIBILA (Simulation model of Bulgaria's Investment in Long-term Advance) model has been used for this purpose. The assessment covers the effects[23], defined as changes in the levels of key macroeconomic indicators.

The interventions planned are expected to result in a positive change in employment (an increase of 3.6% against the baseline scenario) and in the unemployment rate (a decrease of 1.4 pp) at the end of 2019. This is due both to direct effects from the inflow of the funds into the economy (job creation) and to indirect effects (expressed in improved quality of employees and the labour force as a whole).

Table 3-1: Effects from the implementation of the measures planned

Macroeconomic indicator	Effect as of 2019
GDP	8.6%
Export of goods and services	1.8%
Current account balance, % of GDP	-5.2 pp
Employment rate (aged 15-64), in thousands	3.6%
Unemployment rate (aged 15-64)	-1.4 pp
HICP Inflation	3.5 pp
Budget balance (% of GDP)	-1.4 pp

Source: MF, SIBILA.

According to the analysis, the country's fiscal stance will deteriorate in the short term and, as of the end of 2019, the net effect from the implementation of the planned measures on the budget balance will reach minus 1.4 pp of GDP. As a whole, the overall effect is a combination of several factors

[23] The overall effects for the economy from the implementation of measures are calculated as the difference between two scenarios: a baseline scenario (scenario 0), which simulates the development of the economy without the Action Plan interventions, and a hypothetical alternative scenario (scenario 1), which takes account of the implementation of the measures within the deadlines set in the Action Plan and with the resources planned for this purpose.

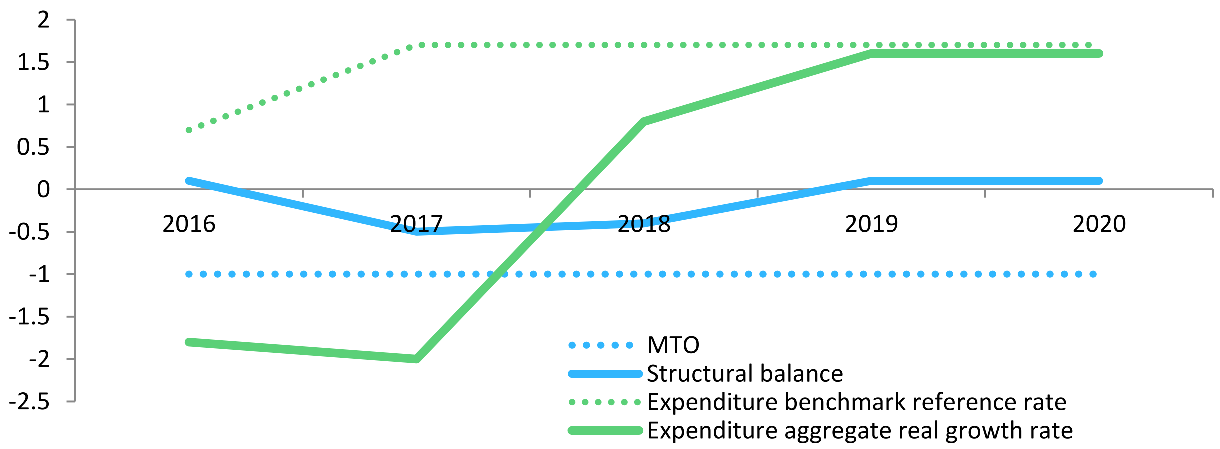
acting in opposite directions: increasing government spending, and higher income levels and a favourable economic situation, which leads to increasing budget revenue. In the medium term, the interventions will contribute positively to the budget balance as a result of the improved economic situation, the increase in output and increased consumption.

Over the period considered, Bulgaria's output and production will be increasing smoothly, enabling a gradual convergence with the EU in real terms. The implementation of the planned measures would play a significant role in that, and simulations indicate that, as of 2019, their effect on GDP would be 8.6% above the baseline scenario without EU funding. The inflation rate will accelerate by 3.5 pp against the baseline scenario. The export of goods and non-factor services will also increase faster against the baseline scenario (1.8%) as a result of the planned interventions.

3.5 Structural balance (cyclical components of the balance, one-off and temporary measures) and fiscal stance, including in terms of the government expenditure benchmark

The structural budget balance is estimated at 0.1% of GDP at the end of 2016. Against the previous year, the adjustment achieved was about 1.6 pp, which considerably exceeds the recommended structural effort of 0.5% of GDP. Therefore, the average adjustment over the two-year period 2015-2016 is in the range of 1 pp. Thus, the medium-term objective (MTO) of the country in terms of a structural deficit of 1% of GDP has been achieved and exceeded already in 2016. In 2017, when no change in the negative output gap is expected against the previous year (-0.3% in 2016 and 2017), the General Government sector is planned to generate a deficit that corresponds to a structural budget balance of -0.5% of GDP. The latter remains above the country-specific MTO, thus complying with the requirements of the Stability and Growth Pact, and is associated with the need to strike an appropriate balance between the need for short-term stimulation of the economy and maintaining the sustainability of public finances in the long term. Although the MTO remains unchanged at a level of -1% of GDP, in the coming years, when a smooth decrease and, hence, closing of the negative output gap is expected, an improvement in the structural balance is planned, to -0.4% of GDP in 2018 and 0.1% of GDP in both 2019 and 2020.

Figure 3-2: Compliance with the requirements of the preventive arm of SGP



Source: MF

Compliance with the PFL and SGP fiscal rules is confirmed also by the estimates of the growth in expenditure calculated using the common methodology for the so-called expenditure benchmark, when accounting for the differences in the financing of public investment expenditures (gross fixed capital formation under ESA 2010) between national resources and EU funds The change, in real terms, in the expenditure aggregate used for fiscal surveillance purposes in the EU (corrected government expenditure net of discretionary revenue measures), is estimated at -1.8% in 2016, -2.0%) in 2017, 0.8% in 2018, 1.6% in 2019 and 1.6% in 2020. Those estimates are based on outturn data and forecasts for the budgetary parameters presented under the ESA 2010 methodology, and on the GDP deflator for the particular year according to the current macroeconomic forecast of MF. The dynamics of net expenditure corresponds to the determined by EC reference rate of the potential growth (decreased by the convergence margin for the years when the MTO is not respected), which are set at 0.7% for 2016 and 1.7% in 2017.

3.6 Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments

In 2016, the government debt management policy took account of the planned medium-term economic outlook and the main priorities in the budgetary framework, and the measures geared towards the timely securing of sources for efficient borrowing, maintaining the stability of the indicative debt parameters and monitoring of statutory debt restrictions.

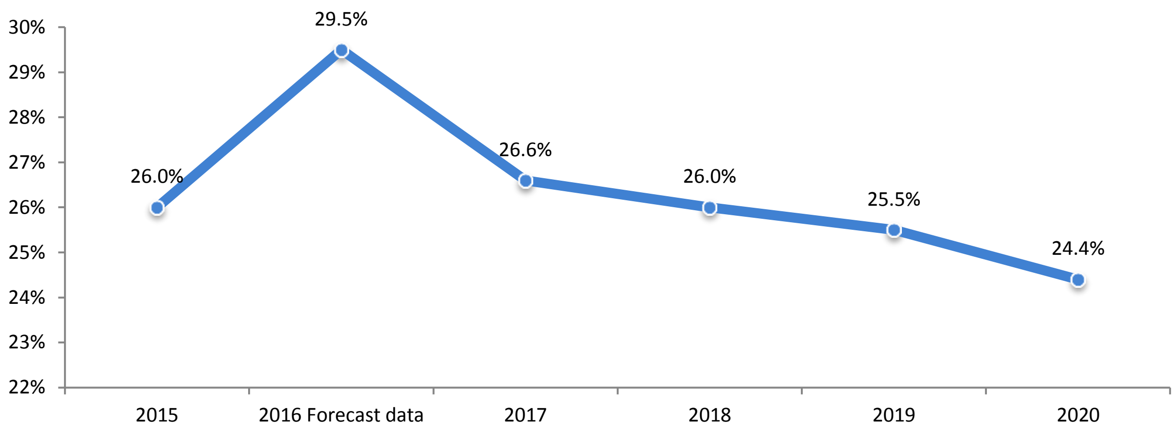
As a result of the strict implementation of a tight fiscal policy and a reliable approach in managing sovereign debt, as well as the need to have a fiscal buffer in 2016, serving as a potential insurance for maintaining the stability of the banking system, the consolidated General Government debt increased significantly as at the end of 2016 against its level at the end of the previous year, both in nominal terms and as a share of GDP. According to preliminary MF data, the size of the debt increased by BGN 4 296.5 million, amounting to BGN 27 320.8 million. The ratio of the consolidated General Government debt to Gross Domestic Product registered an increase of about 3.5 pp, reaching a level of about 29.5%.

Just as the contributions by the three subsectors within the General Government sector, the Central Government subsector continues to have a major share, at about 98.0%. In 2016, the debt increase is due mainly to the second Eurobond issue transaction on international capital markets executed in March 2016 within the Global Medium-term Note Programme of the Republic of Bulgaria for issuing government securities on international capital markets, as well as to the disbursement of funds under loans of the Bank Deposit Insurance Fund and to new units included in the scope of the Central Government subsector.

In 2016, the main source of debt financing, accounting for about 99% of total debt, remain the issues of government securities, the dominant portion of which have been placed on international capital markets. The use of the Global Medium-term Note Programme enabled the adoption of a flexible approach to the placement of government securities on international capital markets in March 2016. The availability of a benchmark curve and the positive investor response to the previous transaction executed in March 2015 enabled Bulgaria to issue, for the first time, bonds on international markets without conducting market test meetings with investors, which in its turn enabled the issuer to maximise on the favourable market conditions. The new benchmark Eurobonds issued in March amount to a total of EUR 1.994 billion. The transaction includes a EUR 1.144 billion tranche of 7-year bonds with a coupon of 1.875% and a EUR 850 million tranche of 12-year bonds with a coupon of 3.000%. The remaining 1% is disbursements from loans from international financial institutions. In 2016, the portion of external financing amounted to about 88.7% of the total amount of the new borrowing, while domestic borrowing was about 11.3%, respectively. The fiscal buffer set up by the government in 2016 is intended to cover payments due on maturing external debt, thus eliminating the need to refinance it by new debt assuming in 2017.

In the context of budgetary policy, projections for a moderate GDP growth rate, the need to refinance outstanding government debt, the level of the consolidated debt of the General Government sector is expected to range between 23.8–26.4% of GDP in the period 2017–2020. The one-off debt increase in 2016 is projected to be partially neutralised by the upcoming repayment, due in July 2017, of the maturing 2012 issue of 5-year Eurobonds, after which the debt amount is expected to stabilise around BGN 26 billion over the period 2018–2020. Debt level estimates remain considerably below the maximum reference value of the Maastricht convergence criterion of 60%, which will ensure that the level of state indebtedness remains within sustainable range; hence, Bulgaria's lead position among the 28 EU Member states in terms of debt burden.

Figure 3-3: Consolidated Government Debt-to-GDP Ratio



Source: Eurostat, MF

In support of the efforts to control the level of government debt and maintain it within a low-risk range, the following debt ceilings have been set in the 2017 State Budget Act:

- The maximum amount of government debt as of the end of 2017 shall not exceed BGN 23.9 billion (12.2 billion EUR);
- The maximum amount of new government debt that may be assumed in accordance with the State Debt Act procedure shall be BGN 1.2 billion (0.6 billion EUR).

The approach of setting debt limits in annually State Budget Act applied contributes to the task of controlling the increase in debt and to maintaining its sustainability. In addition, in circumstances that could lead to a risk of breaching the 60% threshold for the consolidated general government debt to GDP ratio, there is a statutory possibility to set additional restrictions on the assumption of debt by municipalities and the social security funds in the State Budget Act for the respective year. Such a restriction makes it possible to prevent any significant negative effects from an excessive increase in the size of the debt.

The debt in the Local Government subsector is not expected to change notably in the review period. A major factor to that effect is the setting of limits according to the Public Finance Law and the Municipal Debt Act. They stipulate that the annual sum of municipal debt payments for any municipality in any given year may not exceed 15 per cent of the annual average amount of its own revenue and general balancing subsidy for the past three years calculated on the basis of data from the annual reports on the implementation of the budget of that municipality, and that, within the current budget year, municipalities may assume new debt to finance long-term energy performance contracts (ESCO contracting) in an amount up to 15 per cent of the annual average amount of their reported capital expenditure in the past four years in the respective municipal budget. Preliminary 2016 data indicate that the restrictions regulated in the law, along with the expected flexible municipal financing schemes during the new programming period, will keep it in the range of 1% of GDP over the whole review period from 2017 till 2020.

The debt in the subsector of Social Security Funds has been fully repaid in June 2016. The accumulated financial assets in the form of government securities issued by the Central Government subsector amounted to about BGN 641 million in 2016, which is a factor determining the influence of that subsector on the debt in the General Government sector in the period 2017–2020 as well, bringing the debt down, in compliance with the principle of debt consolidation.

Estimates for the debt in the Local Government and Social Security Fund subsectors in measuring state indebtedness show that the downward trend in their contribution is continuing.

Table 3-2: Central budget revenue from privatisation and post-privatisation control

(in thousand BGN)

Reported 2016	SBA 2017	Forecast 2018	Forecast 2019	Forecast 2020
6 167	13 700	10 980	43 900	2 050

The values shown in the table are based on projections for the revenue generated from privatisation sales and post-privatisation control for the period 2018–2020 estimated in January 2017 by the Privatisation and Post-Privatisation Control Agency, as a result of an evaluation of the residual privatisation resources.

The main revenue, in the respective year, is expected to be earned from divestiture from the following companies:

- 2017: Bulgarian Stock Exchange – Sofia AD, Central Depository AD, Voenno Izdatelstvo EOOD (Military Publishing House), Plod i Zelenchuk EOOD (Fruit and Vegetables), Burgas Free Zone AD;
- 2018: Varna Transit Trade Zone AD, VMT Orbita AD, Rousalka EOOD, Pazar za plodove i zelenchutsi AD (Fruit and Vegetables Market), the Marketing Institute EAD;
- 2019: Nauchni Izsledvania po Geodezia i Photogrammetria EOOD (Surveying and Photogrammetry Research), Slanchev Bryag AD (Sunny Beach), Sortovi Semena Elit EAD (seed bank), SAPI EOOD (Agri-Market Information System).
- 2020: GUSV EAD, Plovdivproject OOD.

Proceeds are also expected from the sale of state-owned real estate held in the private law domain and minority stockholdings, and from post-privatisation control.

3.7 Budgetary Implications of Major Structural Reforms

Estimates for the revenue and expenditure in the Public Social Security scheme for the period 2018–2020 were prepared on the basis of Decision No 37 of the Council of Ministers from 19 January 2017 concerning the 2018 budgetary procedure and Guidelines BU No 1/8.02.2016 of the Ministry of Finance (MF) concerning the preparation and presentation of budgetary estimates by the Government of the Republic of Bulgaria for the period 2018 –2020.

3.7.1 Implications for the Expenditure Side of the Budget

– Changes in the Pension System

The pension reform undertaken over the recent years aims to ensure revenue stability in the pension and social security system, and improve the adequacy of pensions in view to the demographic challenges the country is facing. The further increase in the retirement age will be geared towards increased stability in the pension system in the long term, maintaining solidarity among generations and reducing poverty risk for elderly pensioners.

The pension expenditure forecast for the period 2018–2020 takes into account the provisions laid down in the SSC and the assumptions in the medium-term fiscal framework of the government, including:

1. The eligible age requirement for acquiring pension entitlements for employees under Labour Category 3 is raised by 2 months for women and by 1 month for men. The required length of covered service for acquiring pension entitlements for both men and women continues to rise by 2 months each year so as to reach 35 years and 10 months for women and 38 years and 10 months for men in 2020. The eligibility requirements for retirement in the period 2017–2020 are shown in the table below.

Table 3-3: Conditions for retirement under Article 68 (1) and-(2) of the SSC, 2017–2020

	WOMEN		MEN	
Year	**Age**	**Length of service**	**Age**	**Length of service**
2017	61	35 years and 4 months	64 years	38 years and 4 months
2018	61 years and 2 months	35 years and 6 months	64 years and 1 months	38 years and 6 months
2019	61 years and 4 months	35 years and 8 months	64 years and 2 months	38 years and 8 months
2020	61 years and 6 months	35 years and 10 months	64 years and 3 months	38 years and 10 months

2. The minimum retirement age for persons employed in the Security sector continues to rise by 2 months until it reaches 53 years and 6 months in 2020.
3. The minimum retirement age for persons who have been employed under Labour Categories 1 and 2 who do not meet the retirement requirements for an occupational pension fund laid down in Article 168 of the SSC or have opted for a switch in their social security scheme under Article 4c of the SSC continues to rise by 4 months for women and 2 months for men until it reaches 49 years and 4 months for women and 53 years and 6 months for men for Category 1, and 54 years and 4 months for women and 58 years and 6 months for men for Labour Category 2.

The expected financial effect from the above changes reduces pension expenditure accordingly by BGN 11.0 million in 2018, BGN 12.0 million in 2019, and BGN 13.0 million in 2020.

4. Over the 2018 – 2020 period, the percentage for each year of covered service in the pension formula continues to rise by percentage points equal to or higher than the percentage specified in Article 100 of the SSC. Over the 2018–2020 period, the labour pensions, granted up to 31 December of the previous year will be recalculated as from 1 July of the respective year at the new percentage rate for each year of covered service as specified for the respective calendar year. The recalculation using the new weight per year of covered service in the pension formula will replace the indexation under Article 100 of the SSC.
5.

The expected effect on the expenditure for pensions is as follows:

- In 2018: at a percentage per year of covered service of 1.169 (an increase by 3.8%);
- In 2019: at a percentage per year of covered service of 1.213 (an increase by 3.8%);
- In 2020: at a percentage per year of covered service of 1.258 (an increase by 3.7%).

6. The maximum sum per person of one or more pensions he/she can receive in 2018 remains unchanged at BGN 910.00, while as from 1 July 2019, it becomes BGN 1040 (40% of the maximum insurance income amount). The maximum sum per person of one or more pensions he/she can receive will not apply for pensions granted with an effective date after 31 December 2018.

The expected increase in pension expenditure is about BGN 36 million in 2019.

In the reference medium-term programme, the expenditure for pensions and supplementing allowances remains in the range of 9.2% to 9.4% of GDP.

Table 3-4: Pension expenditure estimates[24]

Year	Pension Expenditure	
	in BGN million	% of GDP
2017	8935.0	9.2
2018	9570.4	9.4
2019	10018.0	9.3
2020	10487.0	9.2

Source: NSSI

– Education and Science

Budget resources allocated to the system of pre-school and school education are geared towards supporting reforms and implementing the measures laid down in the Law on Pre-School and School Education; addressing the main challenge faced by the system in the medium and the long term, i.e. staffing the system with good teachers; ensuring an equal start for all children by improving the conditions for early childhood development; improving education quality in all schools and levels within the system.

In the higher education system, a Development Strategy for Higher Education was adopted and the Higher Education Act was amended, triggering sector reforms to encourage specialisation in state tertiary schools and the optimisation of academic profiles in the system, provide financial incentives for the quality of education and research, and cooperation with the labour market, restructuring and optimisation of state-funded admissions in line with labour market demands and focusing financing on the basis of the quality assessment provided by the market and academia.

The principal objective for the period 2017–2020in the science area in Bulgaria is to provide support and turn the science sector into a key driver in the development of an economy, based on knowledge and innovation.

[24] Data until 2020 based on the updated forecast for revenue and expenditure in the consolidated PSS budget for the period 2018-2020 from March 2017.

The policy is orientated towards the implementation of the National Strategy for Research Development 2025 and the National Science Infrastructure Roadmap, and in particular, the policy for restructuring and modernisation of science infrastructure. For the period 2017–2019, the resources from the EU Structural Funds under Operational Programme Science and Education for Smart Growth 2014-2020 (OPSESG) will be focused primarily on investment in new and unique types of science infrastructure, such as excellence centres, competence centres and regional science centres.

Top priorities in the 2017–2020 programming period in the area of science and research include:

- Modernize research organisations and develop human potential engaged in research, promote education in science and entrepreneurship and training in interdisciplinary skills to foster the next generation of researchers;
- Provide incentives for cooperation with the Bulgarian science and research community abroad and make Bulgaria a more attractive place for R&D and career development;
- Develop a competitive national R&D infrastructure, as part of the Common European R&D Area in favour of the economic and social development of regions in Bulgaria;
- Enhance the efficiency and effectiveness of the R&D system in Bulgaria, adopt new financial models and instruments enabling more efficient, results-oriented financing of science, by balancing institutional, programme and competition-based financing of research;
- Enhance the synergy among the elements of the “knowledge triangle” – education, research and innovation by implementing the measures planned in the OPSESG, Operational Programme Innovation and Competitiveness 2014-2020, the EU framework programme for research and innovation Horizon 2020, and participating in joint EU programme initiatives and in international cooperation in the area of scientific research;
- Develop policies associated with Bulgaria’s EU membership such as Open Science and Open Innovation.

– Healthcare

The reform efforts in the sector are aimed at improving access to integrated medical activities, increasing the satisfaction of Bulgarian citizens with the quality of the medical services offered, adequate financing and achieving financial sustainability in the sector in the medium term. The main priorities in the area of healthcare are the following: improving diagnostics, quality of and access to integrated medical treatment; priority development of emergency care through investments in its resource, technical, logistic and staff development; introduction of information and communication technologies to ensure information, accountability, fairness, equal treatment and objective control of procedures in the health system; design a hospital healthcare model that is based on predictability of financial resources to ensure quality and accessibility of treatment; improvement of the requirements and criteria for medical and financial oversight of the operations of medical care providers and pharmacies; stabilisation of the health insurance model and enhancement of the financial autonomy in the health sector.

3.7.2 Implications for the Revenue Side of the Budget

– I. Legislative Changes in the Tax Policy Area

Table 3-5: Estimated budgetary effect from discretionary revenue measures

Discretionary measure	2017	2018	2019	2020
Change in the social security contribution to the PSS Pensions fund	186.7	244.2		
Step-by-step change in the excise duty rate levied on cigarettes until it reaches the minimum excise duty rate of BGN 177 per 1000 pieces as of 1 Jan 2018	46.7	92.4		
Positive effect on VAT revenue from increased excise duty rates for cigarettes.	9.3	18.5		
Change in the minimum insurance income	23.1	79.1	79.1	79.1
Revenue from PSS Pensions funds and social contributions from the increase in salaries of pedagogical staff in the area of pre-school and school education		78.8	78.8	78.8
Revenue from PSS Pensions funds and social contributions from the MW change		14.5	17.6	19.2
Ongoing monitoring of debtors with overdue liabilities in excess of BGN 100 000 (BGN 200 000 for the Sofia City Territorial Office) for taxes and mandatory social security and health insurance contributions	40.0	30.0	20.0	10.0
Implementation of an approved plan for scheduled telephone campaigns	3.0	2.0	2.0	
Revenue from social security choice	12.0	12.0	12.0	12.0
Revenue from raising the retirement requirement for length of covered service by 2 months	0.3	0.3	0.3	0.3
Change in the social security contribution to the PSS Pensions fund resulting in a decrease in revenue from personal income tax	-7.5	-9.5		
Tax allowance for cashless payments	-0.6			
Elimination of VAT on donated food close to best-before date	-4.2			
Modification to the parameters set in the dividend policy	20.2			
Narrowing the scope of tax-deductible income from cash and in-kind winnings obtained from gaming with the exception of gambling	1.5			
Tax on passenger taxi services	9.0			
Revenue from the 20 pp increase in the social security contribution to the Pension Fund for Persons Under Article 69 of the SSC	215.7			
Total	**555.2**	**562.3**	**209.8**	**199.4**

◉ Corporate Taxes

The forecast for corporate tax revenue (including taxes on dividends, liquidation quotas and income of resident and non-resident legal persons) is based on retaining the basic tax rate of 10 per cent, the projected macroeconomic indicators, data about losses from previous years that are subject to deduction in subsequent reporting periods declared by taxable persons in their annual tax returns, the amount of the tax prepayments made by taxable persons who have realised taxable profit in the previous year and the respective amount of their balancing payment under their annual tax return (ATR) for certain legal entities, the amount of tax refunds, and on the changes in the regulatory basis.

To simplify the mechanism for correcting errors, the CITL was amended so that taxable persons can themselves make a correction to their taxable financial result, in accordance with the requirements in the effective legislation, by a one-off resubmission of a tax return containing the corrected data by 30 September of the year in which the relevant tax return was filed.

As from 1 January 2018, it is mandatory to file tax returns electronically, using a standard template provided in the CITL, and an electronic signature. In this connection, the existing tax deduction for electronic submissions has been repealed since that date.

The CITL and PITL have been amended (Act Amending the CITL, published in the State Gazette No 75 from 2016, effective as of 1 January 2016), thus introducing the option to apply a tax on the in-kind expenditure when taxing costs associated with assets that are own, hired and/or made available for use, and have been made available for personal use and/or associated with the use of personnel, to workers, staff and persons hired under management and control contracts (employees), and to persons engaging in personal labour in the meaning of paragraph (1) (26) (i) from the additional provisions section of the Personal Income Tax Law. In case the employer chooses not to take that new option, that cost item of the enterprise will continue to be taxed by personal income tax payable by the individual in whose favour such expenditure is incurred.

Personal Income Taxation

The forecast concerning revenue under the PITL for the period 2017-2020 has been made while preserving the flat tax rate of 10% (with no tax-exempt minimum amount) for all taxpayer income, with the exception of income from economic activities of sole traders, for which the tax rate is 15%. It also takes into account forecast growth of compensations for employed persons, the projected number of employed persons, the statutory tax relief, the expected better collection rate of PITL taxes, as well as certain legislative amendments. The effect of the planned changes to the minimum wage and the contribution to the Pensions Fund has also been taken into consideration. Personal income tax revenues also include patent tax proceeds in the municipal budgets.

The latest amendments involve the formation of taxable income relating to subsequent sale of shareholdings or equity participation obtained in exchange of a non-cash contribution into commercial companies (on which no tax is calculated), as well as concerning the equalisation of the sale of property by a partner/shareholder to a decrease in the company’s capital resulting from the sale of such in-kind contribution into the capital. Those amendments are made in order to prevent possible tax avoidance cases.

New regulations include the requirement for annual declaration and payment of final taxes on income earned by resident individuals from sources abroad. This change considerably decreases taxpayer compliance costs regarding final tax, since up to 2016, these taxes were to be declared on a quarterly, as well as on an annual basis, and the tax was payable also quarterly, depending on the time when the income was acquired. As a result of that change, the revenue from final taxes of resident individuals for income from sources abroad will be deferred in time and will actually be paid in 2018.

An amendment to the law introduces a ceiling for the use of the 5-per cent tax deduction from the final tax instalment payable under the annual tax return for 2016 (payable in 2017), limiting the amount of the tax deduction to BGN 1000.

The scope of tax-exempt income under the law has been narrowed by means of an amendment which treats as tax-exempt income only prizes from low-value-prize machines as defined in the Gambling Act or in accordance with the legislation of another EU Member State, and not the winnings from participation in all games that are not considered gambling in the meaning of the Gambling Act and where the winning is determined randomly. At the same time, the amendment to Article 13 (1) (22) of the PITL adds to the tax-exemption list prizes awarded to school students (in competitions in school subjects, sports and other such contests), which used to be taxable under the law prior to those amendments.

Similarly to the CITL, there is now the option for a one-off correction to the annual tax return at the initiative of the taxpayer after the statutory deadline for filing tax returns has expired.

A tax allowance was introduced for individuals who make cashless payments when covering their expenses. The tax allowance is equal to 1 per cent of the tax payable for the relevant year assessed on the total annual tax basis but cannot exceed BGN 500, provided that during that year the person has made cashless payments amounting to 80 or more per cent of the income, which should be received entirely by means of bank transfers. The purpose of this measure is to encourage individuals to use cashless payments, and the direct effect from the tax preference on the budget revenue is a loss, in 2018, estimated at BGN -0.6 million.

⦿ Value Added Tax (VAT)

The forecast of VAT revenues includes the assumption that the current proportion of VAT proceeds to consumption will be maintained. It takes account of both the projections for the macroeconomic indicators, and the positive effect from the measures adopted in 2014 concerning fiscal control on the movement of goods involving high fiscal risk on the territory of Bulgaria and the VAT reverse charge mechanism for the supplies of cereals and technical crops. The effectiveness of fiscal control was enhanced in 2016 by setting up additional fiscal points inland and expanding the scope of goods subject to fiscal control. In estimating the VAT revenue, the amendments to the tax law have also been taken into account.

According to the amendments adopted in connection with the further harmonisation with the rules in Directive 2006/112/EC on the common system of value added tax, in cases of joint use of fixed assets, and in cases of independent economic activity, as well as activities outside the independent economic activity, entities registered under the VATL have the right to deduct tax credit in proportion to the degree of use of the goods for the purposes of conducting such independent economic activity.

A non-compliance with EU legislation was removed and national law was harmonised as regards the scope of exemptions for supplies associated with international transport, as provided in Article 148 of Directive 2006/112/EC (EU Pilot 8324/16/TAXU).

To eliminate non-compliance with EU rules in the area of VAT, the provisions concerning the levying of VAT on supplies of goods and services where a taxable person acts in his own name but on behalf of another person (EU Pilot 7884/15/TAXU) were amended.

In relation to a Court of Justice ruling on case C-209/14, amendments were made to the criteria determining the actual transfer of goods under a financial lease agreement as a supply of goods.

In order to provide clarification concerning certain provisions, the amendments made regulate that there is no supply of goods or services for the purposes of the VATL when a good or service is contributed by a partner in order to achieve a common objective under a memorandum of association creating an unincorporated company. All rights and obligations under the VATL in relation to their use by the unincorporated company, including the right of deduction and the obligation to make adjustments to the deductions made, will be vested with the partner who makes such contribution to the achievement of the common objective. The law now requires mandatory registration of any unincorporated company into which goods or services have been contributed by a partner that is a person registered for the purposes of the VATL.

The law determines the date when the tax on an intra-community acquisition of a new vehicle becomes chargeable in the absence of an issued invoice since the supplier is a non-taxable person, e.g. a natural person established in another Member State, while the recipient of the supply is a person not registered for the purposes of the VATL. The VAT becomes chargeable on the date of the document evidencing the acquisition of the new vehicle, when such document has been issued before the 15th day of the month following the month in which the tax event occurred.

There is an option to set off the assessed tax refund, in cases of the so-called accelerated refund (within 30 days of submitting the VAT return) against any public claims outstanding that have arisen prior to the date of issue of the tax assessment or the statement of set-off or refund.

There are amendments to the provisions relating to actions by heirs in the case of death of a natural person registered for the purposes of the VATL who is, or is not, a sole trader, as the case may be.

The range of circumstances where the coercive administrative measure of sealing off a facility for a period of up to one month is enforced was extended by adding cases where the persons fail to observe the procedure and method for documenting the changes in the cash in hand available at a facility, other than the cases when sales have occurred. The period for imposing the coercive administrative measure has been reduced to 15 days, with the exception of cases of repeated violation, in which case the measure is enforced for a period of 30 days.

With a view of addressing the risks associated with the subsequent sale of energy products in Bulgaria or in other Member States, the VATL was amended in 2016 (published in the State Gazette, No 60 from 02 August 2016) so as to include a requirement to set up collateral to secure the payable VAT amount in the case of supplies of liquid fuels.

Estimates for the 2017 VAT proceeds take into account the expected positive budgetary effect of BGN 9.3 as a result of the scheduled increase, pursuant to the Excise Duties and Tax Warehouses Act(EDTWA), of the excise duty rates for cigarettes. The expected positive budgetary effect in 2018 is estimated at BGN 18.5 million.

⦿ Excise Duties

The forecast of excise duty revenue takes into account, in addition to the macroeconomic indicators, also the positive effect from improving control over trading in excisable goods. The legislative changes from January 2017 relating to the increased excise duty rate for cigarettes have also been taken into account.

Effective as of 1 January 2017, the excise duty rates for cigarettes are as follows:

1. specific excise duty: BGN 101 per 1000 pieces;
2. proportional excise duty:
    - 27 per cent of the selling price, as from 1 January 2017;
    - 28 per cent of the selling price, as from 1 January 2018.

The amount of the excise duty should not be lower than:

- BGN 168 per 1000 pieces as from 1 January 2017;
- BGN 177 per 1000 pieces as from 1 January 2018.

The positive effect on budget revenue from the increase in the excise duty rate for cigarettes is estimated at BGN 46.7 million in 2017 and BGN 92.4 million in 2018 in increased proceeds from excise duties.

The following amendments to the law were adopted with the aim of streamlining control activities and improving the collection of excise duties.

- A ban on attaching, holding, carrying on self or transporting by transportation vehicles, including affixed onto excisable goods, of used excise labels.
- More detailed requirements in Article 90b of the EDTWA specifying the procedure for registration of identification data of transport vehicles in the permit to trade in tobacco products, in cases of doorstep sales or unsolicited sales of tobacco products.
- More detailed text in Article 93 of the EDTWA regulating the obligation for owners or users of transport vehicles and transport vessels to use the global positioning system and the measuring and control equipment for its intended purposes within their scope of operation, while ensuring and monitoring their good technical condition, proper use and uninterrupted data transmission to a GPS service provider. Where a violation is established, the vessels certificate of approval is to be cancelled immediately as from the date of the inspection by the relevant customs authorities.
- Introduction of a new provision regulating the conditions and the procedure for using technical devices for the purposes of control under the EDTWA.
- The law designates the body which is to provide the relevant tax information associated with EDTWL implementation, following the requirements in the Tax and Social Insurance Procedure Code.
- Introduction of a legal possibility, by adding a new provision to the EDTWA, enabling search and seizure actions as regulated in the Criminal Procedure Code to be carried out by customs authorities as well, when performed for the purposes of tax control, in the cases specified in Articles 42 and 43 of the Tax and Social Insurance Procedure Code.
- Customs laboratories are to be consulted, and are designated a being the only body which is competent to make judgements as to the samples taken for the purposes of control of excisable goods, and as a body entitled to set the indicators and other features of relevance for applying excise duties.

The special procedure for reimbursement of amounts under the state aid scheme as regards the refund of excise duty on purchases of gas oil used in primary agricultural production was amended. The new arrangement provides that the National Customs Agency is to refund the portion of the particular excise duty amount which corresponds to the respective state aid amount as specified in Chapter Four “a” of the Agricultural Producers Assistance Act by remitting the amounts to be paid back to farmers to the State Fund Agriculture. The refund will be executed on the basis of the order and notification by the Minister of Agriculture and Food as regulated in Article 47b (5) of the Agricultural Producers Assistance Act.

To reduce the administrative burden involved in licensing and registration regimes, persons will no longer have the administrative obligation to submit certification letters for the presence or absence of tax liabilities and liabilities in terms of mandatory insurance contributions in dealing with the customs administration. That information will be obtained officially from the National Revenue Agency.

– II. Measures to Improve Revenue Collection

The measures undertaken by the NRA to improve the revenue collection rate are discussed in detail in Section 6.3 of the Convergence Programme (2017–2020).

National Customs Agency

In 2016, the National Customs Agency implemented a number of projects for the development and improvement of integrated information systems. New components were added to the systems and existing components thereof were enhanced. As a result, the quality of the services, provided to citizens and businesses, was improved through the addition of new e-services, improvements to processes for shifting to a paperless environment, changes in the legislation and/or new functional obligations of the administration, enhancing control, increased horizontal interaction and provision of automated inter-institutional exchange of data and information.

The following information systems, components and functionalities were upgraded in 2016:

- BIMIS, Bulgarian Integrated Customs Information System, (English acronym: BICIS);
- BACIS, Bulgarian Excise Centralised Information System (English acronym: BECIS);
- ITMS, Upgrading the functionality of the Calculation Module of ITMS (Integrated Tariff Management System);
- PTRR, Road Charges and Permits Module (English acronym: RCPM);
- MIS3A, System for provision of information from customs documents for management purposes (MIS3A);
- eCustoms.bg, the National Customs Agency e-portal.

In 2016, Commission Delegated Regulation (EU) 2016/341 of 17 December 2015 supplementing regulation (EU) No. 952/2013 of the European Parliament and of the Council as regards transitional rules for certain provisions of the Union Customs Code where the relevant electronic systems are not yet operational and amending Delegated Regulation (EU) 2015/2446 was analysed and the relevant changes were implemented.

A uniform digital signature and time stamp component (DS & TS) was rolled out for the information systems of the National Customs Agency.

The deployment of the Microsoft Active Directory Service, which considerably facilitates the centralised administration of users and their workstations and thus enhances security, continued in 2016 as well.

The following system enhancements are scheduled for 2017:

- BIMIS, Bulgarian Integrated Customs Information System, (English acronym: BICIS);
- PTRR -Road Charges and Permits Module (English acronym: RCPM);
- BACIS, Bulgarian Excise Centralised Information System (English acronym: BECIS);
- MIS3A
- REZMA, Register of Liabilities towards the Customs Administration (RLCA).

The E-Customs 2020 Sectoral Strategy and the Roadmap for the implementation of process automation measures and of the National E-Governance Strategy 2016 – 2020 were updated. In 2016, an agreement to provide for the financing of measures in the area the customs legislation using the instruments in the new Operational Programme Good Governance was signed. Implementation of the first project activity within the BIMIS 2020 – Stage 1 project financed within Operational Programme Good Governance commenced.

In 2016, the development of the Road Charges and Permits Module (PTRR) of BIMIS continued through the addition of new functionalities aimed at improving the collection rate of road charges and vignette fees and optimising controls. As a result, the control of high-risk and excisable goods has been strengthened. The functionality enabling repeated use of data from the driver's ID card and passport, etc. was provided for. The PTRR module method of data storage was modified to a three-cell format, viz. road vehicle licence plate, country of registration and road vehicle owner. It is now possible to determine with full certainty whether the data in these data cells has been entered manually by the customs officer or automatically, using an ID reader, and whether automatic reader data has been manually tempered with.

The implementation a system for administrative cooperation (SAC) which will serve as a main tool in the management of messages within the National Customs Agency is pending.

In accordance with the Overall National Strategy for Increasing Revenue Collection Rates, Combatting the Informal Economy and Reducing Compliance Costs 2015–2017 adopted by the Bulgarian government, and in accordance with the National Reform Programme (Europe 2020), the National Customs Agency is envisaged to be widely represented in the various processes of national fiscal policy implementation, and in the measures to improve the tax collection rate and eliminate the informal economy.

The measures associated with the work of the National Customs Agency focus primarily on countering excise duty avoidance. Over the past year, there is a tendency for enhancing the joint controls with the National Revenue Agency (NRA) to counter tax violations and crimes by persons registered for the purposes of the Value Added Tax Act (VATA). In response to the 2016 priority tasks with regard to the end-use distribution of fuels, the National Customs Agency took part in joint operations concerning the control of companies trading in motor fuels conducted with the Ministry of Interior (MoI), the State Agency for National Security (SANS), the State Agency for Metrological and Technical Surveillance (SAMTS) and the NRA. As a result, the proportion of legal sales of fuels has increased considerably and more realistic end prices per litre of fuel have been achieved. Such joint control exercises are carried out on an ongoing basis, and the leadership and coordination of such specialised operations is provided by the Interagency Coordination Centre for Countering Contraband and Controlling the Movement of High-Risk Goods and Cargo at the General Directorate for Combatting Organised Crime within the Ministry of Interior (MoI GD COC).

Since the summer of 2016, action was undertaken to coordinate interagency control of goods released into free circulation under customs clearance under procedure 42. The data concerning goods being cleared under procedure 42 are presented to the Interagency Coordination Centre for Countering Contraband and Controlling the Movement of High-Risk Goods and Cargo at the MoI GD COC. On the basis of information analysis, concrete decisions are taken as to the application of NRA fiscal control technical means. The NRA has reported a positive result, an increase in taxable turnover volumes of monitored companies, and improved tax behaviour on their part. Provisional precautionary measures have been imposed with respect to outstanding VAT liabilities.

The administrative burden has been reduced by eliminating the requirement to submit a certificate issued by the NRA for the presence or absence of unpaid outstanding public liabilities, and the check will be made by the customs authorities using official channels. ▼

4. Sensitivity Analysis and Comparison with the Previous Update

4.1 Alternative Scenario: Rise in International Crude Oil Prices

The alternative scenario assumes that oil prices on international markets will stabilise at a higher level during the forecast period. That risk could occur due to a more limited supply on a global scale, related to a stricter observance of the agreement among the major oil producers.

Table 4-1: Comparison between baseline and alternative scenario assumptions

	2017		2018	
	Alternative scenario (percentage change)	Difference from the baseline scenario (pp)	Alternative scenario (percentage change)	Difference from the baseline scenario (pp)
Crude Oil Brent Price, in USD/barrel	37.7	10.0	0.9	0.0
Annual average inflation (HICP), %	1.8	0.6	1.7	0.4

Source: MF

In this scenario, the international price of crude oil in 2017 is expected to increase by 10 pp above the assumption in the baseline scenario, up to 60.8 USD/barrel. In the following years, the price of crude oil will increase at the same rate as in the baseline scenario, to reach 64.4 USD/barrel at the end of the forecasting period.

The accelerated increase in international oil prices will result in higher inflation than the baseline scenario, driven both by the higher prices of energy goods, and the secondary effects on the rest of the HICP components through higher production costs. Therefore, the annual average inflation would go up by 0.6 pp in 2017 and 0.4 pp in 2018 as compared to the baseline forecast. Afterwards, no change against the baseline scenario is expected.

Higher inflation will limit the growth in the real disposable income of households and hence, household consumption. Final consumption will decline by 0.2 pp in 2017 and 0.1 pp in 2018, with no changes against the baseline scenario expected after that period. The price increase and the deceleration in private consumption growth are expected to have a slight negative influence on investment activity in Bulgaria, as a result of which the growth of fixed capital investment is 0.1 pp less in 2018. Weaker domestic demand will also lead to a slight slow-down in GDP growth in 2017 and 2018, by 0.1 pp.

The above-mentioned change in the external environment is not expected to affect directly the growth rates of imports and exports in real terms. At the same time, restricted consumption will translate into a lower domestic demand for imported goods. As a result, the real increase in imports under the alternative scenario will be lower, while the contribution of net exports will go slightly in 2017. Real growth rates of exports and imports will remain unchanged against the baseline scenario over the following years of the forecast period.

The assumption for a more accelerated increase in the price of crude oil in 2017 will have a direct effect on international trade prices. Deflators of exports and imports of goods are expected to go up, with the increase in imports being more tangible, and translating into an additional deterioration in terms of trade.

The upward price developments will support the nominal growth rates of imports and exports in 2017. Expectations are that the accelerated increase in the import deflator will offset the slow-down in real imports, resulting in nominal growth of imports converging towards the growth in exports. The surplus in the trade in goods and services and, hence, in the current account, will decline by 0.1 pp.

Under the alternative scenario, the annual change in the price of crude oil over the period 2018–2020 remains unchanged against the baseline scenario. That implies no change in the import deflator. The export deflator will go up slightly in 2018 as a result of the impact of the higher domestic inflation rate on certain export services. Unlike the baseline scenario, where the current account-to-GDP ratio remains unchanged in 2017 and 2018, under the alternative one, with a slight increase in the export deflator in 2018, the current account surplus is expected to rise 0.1 pp against 2017. The deflators and the current account are not expected to experience any impact over the rest of the years in the forecast period.

The expected slight dips in the real GDP growth rates in 2017 and 2018 do not have any significant implications for the key labour market indicators. Employment estimates indicate a lower rate of increase, by 0.03 pp, over the two years, with a more pronounced effect occurring in 2018 and corresponding to the lower growth in investment. The higher inflation in the alternative scenario is expected to have a more tangible influence on income levels, where growth in real terms is expected to be more modest in comparison with the baseline scenario and to contribute to a slower rate of increase in private consumption.

Table 4-2: Effects on the key macroeconomic indicators

Growth rates in real terms	**2017**		**2018**	
	Alternative scenario (%)	**Difference from baseline scenario (pp)**	**Alternative scenario (%)**	**Difference from baseline scenario (pp)**
GDP	2.9	-0.1	3.0	-0.1
Final consumption	2.4	-0.2	2.7	-0.1
Fixed capital investment	2.8	0.0	3.7	-0.1
Export of goods and services	5.2	0.0	5.4	0.0
Imports of goods and services	4.6	-0.1	5.3	0.0
Current account (% of GDP)	3.7	-0.1	3.8	0.0

Source: MF

4.2 Sensitivity of Budgetary Projections to Various Scenarios

4.2.1 Sensitivity of Budgetary Projections to the Alternative Scenario

The oil price level in international markets is an exogenous factor which influences budget proceeds from indirect taxation. Other things being equal, the assumption for a higher oil price translates into higher proceeds from import VAT, excise duties and customs duties. The alternative scenario is based on the assumption that oil prices will recover to a level above the one assumed under the baseline scenario, reaching up to 60.8 USD/barrel, against 56.4 USD/barrel in the baseline scenario. A faster recovery pace in the price of crude oil would result in about BGN 110 million more VAT revenue in comparison to the baseline scenario. The aggregate effect from higher proceeds from indirect taxation would amount to approximately BGN 150 million.

Changes to price levels in the alternative scenario lead also to higher nominal values of the tax bases for direct taxation. As a result, proceeds from income taxes and social security and health insurance contributions would also be higher than under the baseline scenario.

The aggregate effect from the price risk described above on the revenue side of the budget is positive and is estimated at about BGN 245 million more from taxes, social security and health insurance revenues in 2017.

Under the assumption of keeping budgetary expenditure at the same level as in the baseline scenario, and as a result of the higher proceeds on the revenue side, in the alternative scenario, the 2017 budget deficit is expected to close by 0.3 pp of GDP. However, it should be taken into account that the higher inflation compared to the baseline scenario could exert pressure on current non-interest expenditure, thus offsetting the positive effect on the revenue side. As a result, the budget balance could remain close to its baseline scenario level.

4.2.2 Debt Sensitivity to Changes in Exchange and Interest Rates on International Markets

Risk-neutral currencies (BGN and EUR) and fixed-interest coupons continue to dominate in the currency and interest structure of the consolidated debt in the General Government sector in 2016 as well. The portion of the BGN- and EUR-denominated debt reaches the level of 99.3%, while the percentage of fixed-interest rate liabilities is about 91%. According to projections for the period 2017–2020, the share of debt denominated in currencies other than the BGN and the EUR is expected to be below the 1 % range. The portion of floating-rate debt, respectively, is also expected to remain relatively low, ranging between 2.3% and 9.4%.

The current currency and interest rate composition of the consolidated debt in the General Government debt, as well as the expectations for its change in the upcoming medium-term period, are a prerequisite for assumptions for a possible change in the levels of the main market variables (exchange rates and interest rates), the nominal value of debt and the relevant amount necessary to service it would not be significantly affected.

4.3 Comparison with the Previous Programme

In 2016, the Bulgarian economy grew at 3.4%, against an expected growth of 2.1% envisaged in the previous Convergence Programme. Contributions to the reported growth by both exports and domestic demand were higher than projected.

The differences in terms of the two projections are mainly due to the revision of data concerning the GDP and its components for the period 2000–2015 which was made in October 2016. The figure for the 2015 economic growth was adjusted upwards from 3% to 3.6%, while the difference in the various components was even larger. Domestic demand emerged as the main growth driver, while the lead contributor prior to the revision was net exports. As a result, the base level for 2016 also changed. Thus, although the expectations of international institutions concerning the development of the European and the global economy went down slightly, the contribution of net exports in 2016 was higher than projected in the previous Programme due to the lower 2015 base. The growth rates of both consumption and investment were higher than expected, yet in investment, the favourable developments were due entirely to the increase in inventories.

Revised reported data for the Bulgarian economy and revised projections of international institutions for GDP growth in the EU, the U.S. and globally, and the changed assumptions for the developments in international prices and exchange rates required an adjustment to the medium-term macroeconomic forecast of the Ministry of Finance.

In this Convergence Programme, a higher economic growth is expected over the whole forecast period. As in the previous Programme, GDP growth will be driven by domestic demand. A more significant increase is projected in 2017 investment, mainly as a result of the planned increase in public capital expenditure. At the same time, the contribution of net exports is set slightly lower, due to a less favourable external environment.

As regards inflation rate, the annual average decline in HICP in 2016 was larger than the one expected in the previous CP update. That applied to all key components of the index, with the exception of foodstuffs and fuels. The largest contribution to the difference came from the decline in prices in the headline of services, while prices had been expected to rise, which in attributed primarily to the stiffer competition in the sector as described in the section on inflation, and to the adjustment to roaming rates. The expected increase in the overall level of consumer prices in 2017 and 2018 is 0.1 pp higher than in the previous Programme, coming primarily from the more accelerated increase in international food and oil prices and their impact on domestic consumer prices.

A comparison with the previous Programme scenario for the developments in the labour market indicates that the main differences are in the lower rates of unemployment against those expected in the 2016 CP, due to the lower reported values in 2016 and the larger than expected decrease in labour supply. That translates into lower unemployment rates and a lower participation rate of the population during the whole forecast horizon. The October 2016 revisions of the GDP data using the income approach produced a higher rate of increase in the compensation per employee in 2015 of 5.6%, against a preliminary growth rate of 1.8%, and a slow-down in the pace of increase to 3.1% in 2016. Until the end of the forecast period, expectations for a gradual acceleration in the increase of incomes remain, with developments in the compensation per employee being more dynamic than projected in the previous Programme, as a result of the expected higher economic growth and the larger increase in labour productivity. The latter is reflected also in a slightly higher growth in nominal unit labour costs over the period 2018–2020, at an annual average of 2.4%, against 1.8% in the previous Programme.

Table 4-3: Key macroeconomic indicators

Real growth rates	2016			2017			2018		
	2017 CP	2016 CP	Difference, pp	2017 CP	2016 CP	Difference, pp	2017 CP	2016 CP	Difference, pp
GDP	3.4%	2.1%	1.3	3.0%	2.5%	0.5	3.1%	2.7%	0.4
Final consumption	1.8%	1.5%	0.3	2.6%	2.2%	0.4	2.8%	2.5%	0.3
Investment	0.9%	-1.8%	2.7	2.6%	-0.1%	2.7	3.8%	2.7%	1.1
Export of goods and services	5.7%	4.5%	1.2	5.2%	4.7%	0.6	5.4%	4.9%	0.5
Imports of goods and services	2.8%	2.6%	0.2	4.8%	3.6%	1.1	5.3%	4.7%	0.6
Annual average inflation (HICP)	-1.3%	-0.8%	-0.6	1.2%	1.1%	0.1	1.3%	1.2%	0.1
Unemployment rate	7.6%	8.6%	-1.0	6.9%	7.9%	-1.1	6.5%	7.4%	-0.9

Source: MF

5. SUSTAINABILITY OF PUBLIC FINANCE

5.1 Policy Strategy

This chapter is analysing the fiscal position by evaluating the current status of public finance by taking into account the future increase in age-related public expenditures. For this purpose, the sustainability indicators S1 and S2 are used calculated under the methodology elaborated by the Commission[25]. The medium term fiscal sustainability indicator (S1) shows the necessary adjustment to the primary structural budget balance, which is needed to sustain the level of government debt of up to 60% of GDP in 2030. The long-term fiscal sustainability indicator (S2) shows the adjustment to the current primary balance required to fulfil the inter-temporal budget constraint (the discounted value of the future primary structural balances should cover the current debt level) over infinite horizon including additional age-related costs. The positive value of the indicators means a presence of medium or high risk and imposes a need for fiscal consolidation or structural reforms to reduce the burden of the ageing population on public finance.

Table 5-1: Comparison between sustainability indicators under the old and the new Programme scenario

	Programme scenario 2016		Programme scenario 2017[26]	
	S1	S2	S1	S2
Value,	-2.9%	2%	-4.5%	1.1%
of which:				
Initial budgetary position	0.1%	1.3%	-1.2%	0.3%
Debt requirement	-2.1%		-2.6%	
Future changes in the budgetary position[27]	-0.9%	0.7%	-0.7%	0.8%

Source: MF

[25] Annex 2 of Fiscal Sustainability Report 2015.

[26] The assessment of fiscal sustainability is strongly dependent on the prospects for long-term development of the economy. The basic parameters used in this scenario are shown on Table 7 of Annex A. They have been developed by the Ministry of Finance on the basis of the long-term assumptions and methodology set in the 2015 Ageing Report (The 2015 Ageing Report http://ec.europa.eu/economy_finance/publications/europeaneconomy/2014/pdf/ee8_en.pdf). The forecast used for the population is Europop 2013. The differences between the long-term macroeconomic scenario released in the Report and in the present Convergence Programme is justified by the different medium term forecasts used to start calculations. The MF scenario is based on the forecast in this Convergence Programme (2017-2020), while the one in the Report is based on the Commission's 2014 Spring Forecast.

[27] Future changes in the budgetary position are related mostly to the pension, healthcare and education costs. The calculation of this position in the resent Convergence Programe use a forecast for costs for pensions submitted by the National Social Security Institute and forecasts for the healthcare and education costs obtained from the long-term model of the MF on the basis of the methodology described in the 2015 Ageing Report.

The estimates of the Ministry of Finance show that the value of the S1 indicator for 2017 is negative, which according to the Commission's reference values[28] means low fiscal sustainability risk in the medium term and presupposes maintenance of the debt level below 60% of the GDP. The S2 value of 1.1% also corresponds to a low fiscal sustainability risk but shows that an adjustment to both the initial budgetary position (0.3 pp) and to the ageing expenditure component (0.8 pp) is required. Item 5.2 addresses in detail the increase in the expenditure caused by the demographic changes.

The conclusions of the European Commission from the Monitoring[29] report on the debt sustainability of EU member states published in January 2017 coincide with the stated analysis. According to the European Commission there are no forecasted risks for the sustainability in a mid-term plan due to the low initial level of debt to GDP. In the long term, the risks facing the fiscal sustainability of Bulgaria are also low.

5.1 Long-term budgetary prospects, including the implications of ageing populations

5.1.1 Social security

The long-term budgetary forecast for the development of the pension system is based on the current (2017) pension legislation and on the provisions of the Social Security Code. For the preparation of the pension expenditure forecast in the period 2017–2060, the Eurostat demographic projections EUROPOP 2013 and an updated macroeconomic forecast prepared by the Ministry of Finance were used. The NSSI Actuarial model for long-term forecasting of PSS funds was used as a tool.

The forecast does not take into account the link between the retirement age and the changes in the average life expectancy after year 2037 since the legislation has still not determined the precise mechanism of this linkage. As regards the opportunity provided in 2016 to transfer to social security rights only in PSS, there are different proposals on the percentage of persons born after 1959 who chose to be insured only in pillar I[30].

Figure 5-1 shows the estimated results in terms of the public pension expenditures as a share of GDP for the period 2017–2060.

The results obtained on the basis of the current pension legislation, show a certain reduction of pension expenditure as a share of GDP in the beginning of the forecasting period, reaching its lowest levels in the period 2021–2025.

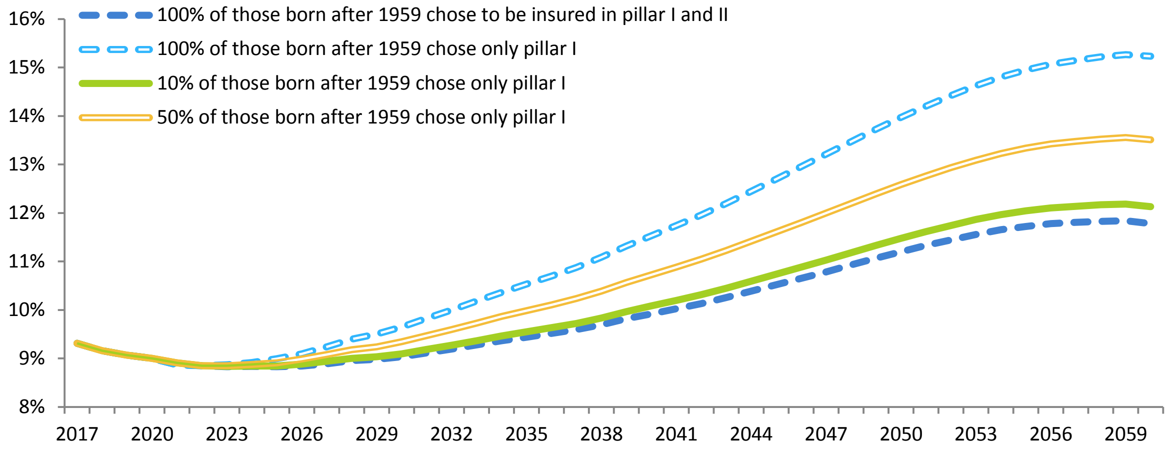
[28] S1<0 – low risk; 0<S1<2.5 – medium risk; S1>2.5 – high risk;

28 S2<2 – low risk; 2<S2<6 – medium risk; S2>6 – high risk.

[29] Debt Sustainability Monitor 2016, EC, January 2017, http://ec.europa.eu/info/sites/info/files/ip047_en.pdf

[30] By the end of 2016 9585 secured persons submitted applications to the National Revenue Agency for the transfer of their social security rights from a universal pension fund to PSS, which makes 0,4% of the insured persons born after 1959.

Figure 5-1: Pension expenditures as % of GDP, 2017 – 2060



Source: National Social Security Institute

As a result of the ageing population and the increasing average life expectancy in Bulgaria, the fiscal pressure on the pension system will increase considerably in the long run. Assuming that 100% of those born after 1959 choosing to continue insurance in both pillars, pension expenditure as a share of GDP is expected to exceed 11% by 2060. This is the variant with the lowest expenditures because PSS pensions of all persons born after 1959 will be reduced proportionally to the social security contribution, which is transferred to pillar II. The reduction applies to the person's social insurance income upon calculation of the pension for the periods with social contributions in pillar II and by 2060 the reduction reaches 25%. The scenario where 100% of those born after 1959 choose to be insured in pillar I only, implies the highest expenditure due to the fact that all persons will receive pensions in full amount. In this case the pension expenditure will reach 15.2% of GDP in 2060. Thus, at the end of the period for each 10% of those who transferred to pillar I, there will be an increase in pension expenditure of approximately 0.34% of GDP. The possibility to transfer social security rights fully to the first pillar will also lead to an increase in the PSS incomes because the insurance contribution for the Pension fund of those who choose to insure only in the first pillar will be 5 per cent points higher. Upon retirement the funds from the individual accounts of these persons will also be received as an income to the PSS budget. The results show an increase of PSS revenue of around 0.15% of GDP for every 10 % of persons transferring to insurance in the first pillar only.

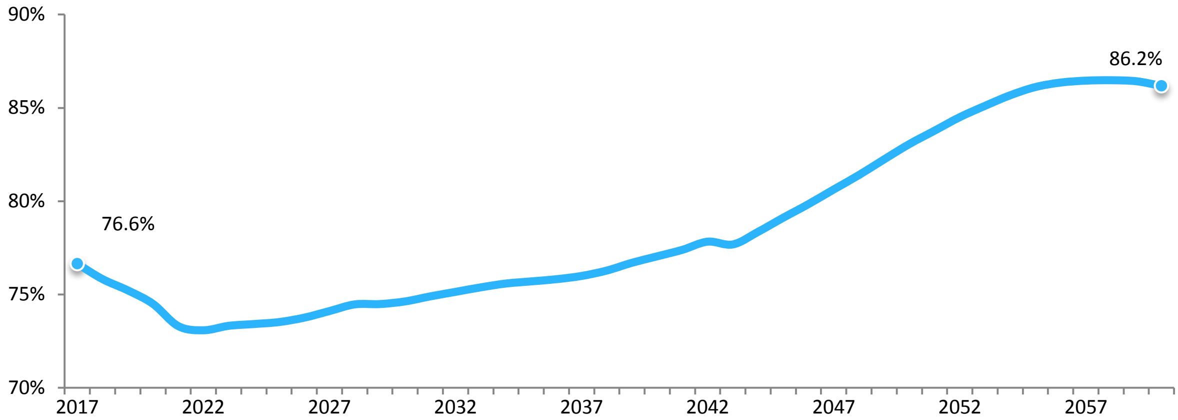
The main factors having an impact on pension expenditures are the dependency ratio[31] and the replacement rate[32]. The ageing population and the increasing life expectancy, on the one hand, and the decreasing number of working age population, on the other hand, significantly affect the public social security system in the long term. According to preliminary data, in 2016 a hundred social insured individuals corresponded to 77 pensioners with pensions for labour activity. In the period until 2037, when the retirement age for women and men will become equal at the level of 65 years of age, the dependency ratio remains at levels below 77% due to the increase in the retirement age and in the required insurance length of service, the limitation of early retirement, as well as due to the existence of incentives for longer presence of older workers on the labour market. There is an upward trend of the dependency ratio after 2037 due to the ageing population, the increasing average life expectancy and the decreasing number of employed persons, with 86 pensioners with pensions for labour activity expected to correspond to 100 insured persons in 2060.

[31] The ratio between the number of labour activity pensioners and the number of social insured persons

[32] The ratio between the average pension and the average contributory income for the country

The upward trend of the dependency ratio is accompanied by an upward trend of the replacement rate, mainly due to the higher values of the pensions, as a result from the gradual increase in the percentage for each year of insured length of service in the pension formula from 1.1 to 1.5 in the period 2017–2026. The most recent amendments in the pension legislation stipulate that from 2017 the percentage for one year of length of insurance service, referred to also as weight of one year of length of insurance, will increase by a percentage larger than or equal to the one calculated from the sum of 50% of the increase of the insurance income and 50% of the consumer price index in the preceding year. For new pensioners the new percentage will apply upon determination of the amount of their pensions, and as regards already granted pensions there will be a recalculation of the amounts performed from 1 July of the respective year, which will replace the annual indexation in the period of achievement of a weight of 1.5%. The increase of the percentage for each year of length of service will have a considerable positive effect on the adequacy of pensions, fully making up for the decrease of the PSS pension for persons who have been insured in the second pillar too. The amount of this decrease depends on the period of insurance in the two pillars and on the amount of the social security contribution, which is redirected from the first to the second pillar.

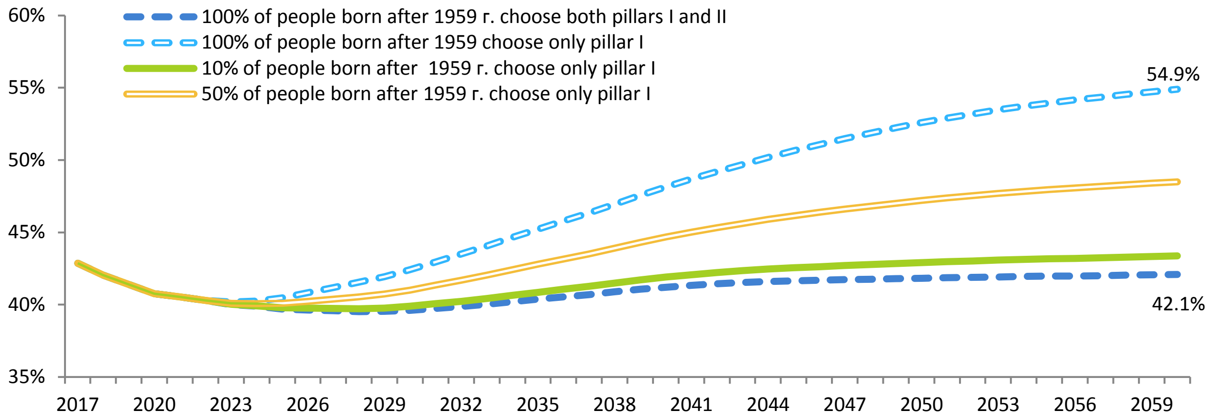
Figure 5-2: Number of pensioners to number of socially insured individuals (dependency ratio) 2017–2060



Source: National Social Security Institute

Considerable impact on the replacement rate from the first pillar will also be caused by the possibility, provided in the legislature, to transfer social security rights from the first and second pillars to the first pillar only. The next figure shows the values of the average gross replacement ratio from the first pillar of the pension system depending on the percentage of insured persons born after 1959 who will choose to be insured in PSS only. The possibility to transfer social security rights entirely to PSS has a favourable influence on the replacement rate of the first pillar in the long run, as in the case when 100% of the insured persons born after 1959 choose to pay contributions in pillar I only, the average gross replacement ratio exceeds 54% in 2060, compared to values of about 42% in case when 100% of the persons born after 1959 are insured in both pillars.

Figure 5-3: Average labour activity pension to average social insurance income (replacement rate), 2017–2060



Source: National Social Security Institute

5.1.2 Healthcare

In the long term population aging would have a considerable impact on the budgetary expenditure and revenue for several reasons. On the one hand, the expenditures for old age pensions and those for health and long-term care will, in the context of increasing life expectancy and decreasing growth rate, increase. Although healthcare is directed to various age groups of the society, the expenditures per capita, expressed as a percentage of GDP, are expected to increase as the age increases and in particular from 55 for men and from 60+ for women. The combination between sharp decrease of the working age population and the expected increase of the demand for health care by the aged population predetermine the increasing financial burden for those who work as well as an increase in the total amount of the healthcare expenditure. This determines also the trend that the goods and services offered in the sector are mostly addressed to aged people. In many EU member states public healthcare is largely financed out of the social insurance contributions of the working age population. Ageing results in an increase of the age dependency ratio, i.e. less participants in the social security system. The age dependency ratio is expected to increase from 27.8% in 2014 to 50.1% in 2060[33]

The forecast for the dynamics of long-term healthcare expenditures is only based on the population dynamics. Such a scenario is very restrictive. It does not presuppose a change in the policy of public expenditure on healthcare in the context of expansion of the healthcare services funded out of the budget. Likewise, according to a number of econometric surveys, the technological progress and other non-demographic factors are among the main reasons for the increase in the expenditure on healthcare in developed countries.

The newly developed methods for early diagnosis and treatment greatly contribute to the increase of the expenses but certain medical innovations may also bring about a decrease of the expenses in the long term. Investments in prevention and in healthcare technologies allow the population to remain in good health and to be productive for a longer period of time. Besides, the development of treatments for less known pathologies provides opportunities for employment and growth. These possibilities are not included in the present forecast.

[33] Data of EUROPOP2013.

Table 5-2: Healthcare expenditure

	2020	2030	2040	2050	2060
Share of the healthcare expenditure, % of GDP	4.9%	5.8%	6.0%	6.1%	5.9%
Share of the healthcare expenditure of the total expenditure, 65+	40.7%	43.6%	46.2%	50.6%	53.1%
Share of the population 65+	21.6%	24.3%	27.1%	30.2%	31.9%

As shown in Table 5-2 the increase of the healthcare expenditure is due to an aggravation of the demographic structure of the population. The share of people aged more than 65 increases considerably, by about 10 percentage points until the end of the period. Bearing in mind that in most of the cases the main healthcare expenditure of an individual are made in the years immediately before his death, the ageing of population logically results in an increase of the healthcare expenditure for the aged population compared to the total expenditure. In the end of the period under review they are expected to exceed 50% of the total expenditure. The total healthcare expenditure is expected to increase from 5.5%[34] of GDP in 2015 to 6.1% in 2050 and then to slightly decrease to 5.9%.

5.1.3 Education

The forecast for the educational public expenditure is based on the long-term demographic forecast and on the assumption that the expenses will be indexed by the increase of the nominal labour productivity. In the period after 2040 the stabilization of the demographic dynamics of the population aged up to 18 is expected to bring about a gradual increase of the total educational expenditure, which will cause certain pressure on the budget.

The impact of ageing on public expenditure for education remains indefinite and in contrast to other main expenditure items, such as pensions and health, where the effect is expected to be negative. On the one hand the expected decrease in the number of young people is likely to bring about budgetary economies, but on the other hand the trends of higher and higher levels of enrolment, the longer periods spent in education and the constantly increasing higher education expenditure may cause pressure on the total education expenditure.

5.2 Contingent Liabilities

The general government guaranteed debt as of end-2016 was 0.5% of GDP remaining at the same level as the one reported in the end of 2015.

The sector of “Energy” preserves a dominating share of 55.4% in the guarantees structure by sectors. As regards the currency composition of the guaranteed debt of the general government sector the prevailing part of the loans in BGN and euro is preserved – 71.9% followed by the one in Japanese yens – 27.1%. The USD obligations are about 1%. A guarantee agreement was ratified in the year between the Council of Europe Development Bank (CEB) and the Republic of Bulgaria in relation to the lending of a loan by CEB to the Bulgarian Development Bank for financing of the National Energy Efficiency Programme in the amount of EUR 150 million. As at 31 December 2016 funds in the amount of EUR 45 million are disbursed under this loan.

For 2017 the State Budget Act provides for the possibility of the issuing of government guarantees for financing the “Gas Interconnection Greece-Bulgaria” project, for the benefit of the Bulgarian Development Bank, under the Student and Doctoral-Candidate Law, as well as in the form of

[34] Data from General government expenditure by function (COFOG)

guarantee deposits for covering the financial shortage of beneficiaries from the public sector of projects under Operational Programmes “Transport and Transport Infrastructure”, “Environment” and “Regions in Growth”. In case of assumptions for issuance of the mentioned government guarantees, resp. disbursement of loan funds under them and under already agreed government guaranteed loans it is expected to have a considerable impact both on the nominal amount of the government guaranteed debt, and on its ratio to GDP. As a result, in 2017 the “Guaranteed debt of the State Government sector to GDP” ratio is expected to increase to around 1.2%.

The approach to issuing of new government guarantees on debt financing and within the forthcoming mid-term time period will remain strictly regulated, subordinated to certain criteria and linked to the risk for the budget. ▼

6. QUALITY OF PUBLIC FINANCES

6.1 Policy Strategy

The policy strategy in the area of the quality of public finances follows the consistent acts for institutional, legal and methodological changes towards improvement of the public finance management. New opportunities and mechanisms are sought for closer interaction between the institutions engaged in the implementation of the budgetary process, the development and implementation of the fiscal policy, the monitoring of the observance of the fiscal rules, etc. The improvement of the legal framework in the budgetary area is accompanied by monitoring and analysis of the application of the budgetary legislation and of the budgetary practices, as well as for the observance of the fiscal rules. Requirements determining the quality of the budget documents and the procedures for their preparation are formed annually in the budgetary procedure and by acts of the minister of finance.

The effective cooperation with the Fiscal Council appears to be a factor for the improvement of the quality of the budget documents and for orientation concerning the fiscal policy conducted by the government, for the adherence to the fiscal rules and for the potential risks for the budget. The opinions and the recommendations of the Council are an element of the conciliation procedure in the preparation of the basic budget documents.

As a result from the EC's review of the transposition of Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, the scope and quality of the information for the budgetary framework was expanded in the national budget documents. A comparison is included of the forecast of the Ministry of Finance to the forecast of the European Commission with respect to the indicators of the General government sector, the discretionary measures of the government and fiscal effects of an accrued basis and evaluation of the structured budgetary balance and annual rate of expenditure compared to the reference growth of the potential GDP.

The increased efficiency of public expenditures in the different sectors remains to be among the priorities of the government, as the measures are not limited to the implementation of structural reform programmes only, but are also focused on the nature and orientation of expenditures in the relevant sector in order to strengthen their contribution to the increase of the economic growth, mostly through investments.

The making of a review of the expenditure appears to be an effective instrument for identification of the necessary reforms in the various sectors, as the Ministry of Finance implements a joint project in cooperation with the World Bank, for which a more detailed description is set out in part 7.3 "Other institutional developments in relation to public finances".

Another important element in this aspect is also the process of implementation of programme and result-oriented budgeting on the part of the budget organizations responsible for the conduction and execution of policies in the public sphere. The achievement of a maximum degree of connection between the targets and the priorities set by budget organizations, the activities performed for their implementation and the products/services provided within this process to the achieved results (measured through objectively defined performance indicators) and ensuring an adequate level of funding in accordance with the degree of achievement of the target values set, is a major tool for improvement of the public sector expenditure quality.

In order to improve the processes of strategic planning and development of the national policies in line with the government priorities and the possibilities for their funding, a legal requirement was set for establishment of a sustainable classification of expenditures by policy areas and budget programmes. The first-level spending units that apply programme budgeting prepared their budgetary forecasts for the period 2018-2020 on the basis of the classifier, approved by the Council of Ministers, of expenditures by policy areas and budget programmes within the competence and under the responsibility of the relevant first-level spending unit, thus ensuring continuity and consistency of the policies and budget programmes implemented by them.

6.2 Composition, efficiency and effectiveness of expenditure – COFOG

Table 6-1: Budget expenditure by function

	% of GDP		% of the total budget expenditure	
	2015	**2020**	**2015**	**2020**
1. General public services	3.2	3.2	7.8	9.1
2. Defence	1.4	1.7	3.4	4.9
3. Public order and safety	2.8	2.1	6.8	6.0
4. Economic affairs	6.1	4.5	14.9	12.9
5. Environmental protection	0.8	1.0	1.9	2.8
6. Housing and community amenities	2.1	0.8	5.2	2.3
7. Health care	5.5	4.9	13.4	14.0
8. Recreation, culture and religion	1.7	0.6	4.2	1.7
9. Education	4.0	4.3	9.8	12.4
10. Social protection	13.3	12.0	32.6	34.1
11. Total expenditure	**40.7**	**35.1**	**100.0**	**100.0**

The expenditures under the **"General public services"** function **preserve their share of 3.2% of GDP in 2020.** The increase of their share in the total expenses is contributed to by the nominal increase of the contribution of Bulgaria to the general budget of the European Union, which is reported under this function.

The expenditures for the **"Defence"** function increase as a share of GDP from 1.4% to 1.7% and as a share of the total expenditures from 3.4% to 4.9% due to the action taken for modernization of the equipment of the Bulgarian Army. It is intended to acquire aviation equipment and multifunctional modular patrol ships for the Navy Forces.

The expenditures for the **"Economic activities"** function decrease from 6.1% of GDP in 2015 to 4.5% of GDP in 2020. The function includes the state-owned enterprises which form part of the general government sector and excludes the expenditures covered by EU funds which, according to ESA 2010 methodology, do not have any impact on revenues and expenditures in the general government sector.

The expenditures for the **"Environmental Protection"** function increase from 0.8% of GDP in 2015 to 1% of GDP in 2020. The expenditures for the function include measures for continuing the accelerated construction of an ecological infrastructure in the country and the Natura 2000 ecological network, which will support the improvement of the life quality of the population and the protection of the ecosystems, as well as the meeting of the country's commitments to the EU.

The expenditures for the **"Healthcare"** function decrease from 5.5% of GDP in 2015 to 4.9% of GDP in 2020. This is connected to the measures for optimizing the activities and improving the control over the expenditures in the healthcare system, which aims at stabilizing the health insurance model and increasing the financial independence of the health sector as a whole.

The expenditures for the **"Education"** function will increase from 4.0% of GDP in 2015 to 4.3% of GDP in 2020 as a result of the envisaged salary increase of pedagogical staff. This function includes measures directed towards the achievement of higher transparency and efficiency of the spending of public funds in the educational system, optimization of the structures in the school network system and more comprehensive covering of students within the system.

The reduction of the expenditures for the **"Social protection" function** from 13.3% of GDP in 2015 to 12% of GDP in 2020 reflects the decrease of the social security and social assistance benefits due to an improvement of the economic environment and the lower level of unemployment. The pension reform continues in the medium term, as an increase is envisaged both of the insurance contributions and of the age and length of insurance service required to obtain an entitlement to pension. This brings about a decrease of the pension expenditures as a share of GDP as at the end of the period.

6.3 Structure and Efficiency of Revenue Systems

6.3.1 Institutional Changes and Legislative Amendments Related to Public Finances and Improving the Collection Rate of Tax Revenues, Tackling the Shadow Economy, Reducing the Compliance Costs, which Address Specific Recommendation 1 in the Part Concerning Tax Revenues

– Tax Policy and Legislation

The tax and social security policy in the Republic of Bulgaria is oriented towards supporting the economic growth, improving the business environment, and increasing the fiscal sustainability in the long run. In an international aspect, the tax policy is oriented to support the functioning of the single marked of the European Union and to meet the challenges of globalization and digitalization of economy. It is intended to preserve the low rates of corporate taxes and personal income tax, as an important incentive for investments, economic growth and employment. In the period 2017–2020 Bulgaria will achieve the minimum levels of excise duty rates in the EU, in accordance with the agreed transitional period.

Subject to adherence to the principles of justice and effectiveness, the tax system must develop in a way that favours growth and ensures an increase of the budget revenues. Considering this, the main objective in the period is the pursuing of a policy oriented towards an increase of the collection rate of revenues and decrease of the share of the shadow economy. This objective corresponds to the specific recommendations issued by the Council to Bulgaria in the last three years (2014-2016). The achievement of the objective to achieve the budget revenues is related to the maintaining a sustainable level of revenues subject to preservation of the weight of the taxation and an expected positive effect from the intensified acts upon revenue administration. In this respect an important factor are the measures taken for restricting the tax frauds, for preventing tax evasion and for coping with the shadow economy. The main tools for minimizing the losses from uncollected tax revenues in the budget include, inter alia, the strengthening of the interaction of the institutions and the exchange of information both on national and international scales, as well as the decrease of the administrative burden and the costs for doing business and costs for the citizens.

The amendments to the tax legislation in 2016 are related to the implementation of measures on the tax policy priorities, and namely:

- measures for increasing the collection rate of budget revenue through prevention of the possibilities to hide and not to pay taxes and evade taxation, as well as through measures in the field of collection of obligations overdue;
- measures for reducing the administrative burden and costs for doing business and costs for the citizens;
- measures for stimulating the economic development, investments and employment;
- introduction in the national legislation of European Directives in the field of taxes, as well as for setting of the national legal framework in conformity with the case-law of the EU Court of Justice.

⦿ Measures for increasing the collection rate of budget revenue through prevention of the possibilities to hide and not pay taxes and evade taxation, as well as through measures in the field of collection of obligations overdue

– ***Extension of the deadline for application of the VAT reverse charge mechanism upon supplies of cereals and technical crops***

Council Directive 2013/43/EU of 22 July 2013 amending Directive 2006/112/EC on the common system of value added tax, as regards an optional and temporary application of the reverse charge mechanism in relation to supplies of certain goods and services susceptible to fraud introduces amendments to article 199a(1) of Directive 2006/112/EC, according to which the member states may by 31 December 2018 and for a minimum period of two years provide that the person liable for payment of VAT is the taxable person to whom certain supplies are made, as the scope of the supplies is extended and it includes supplies of cereals and industrial crops, including oil seeds and sugar beet, that are not normally used in the unaltered state for final consumption (article 199a(1)(i) of the Directive). In this regard the term for application of the VAT reverse charge mechanism upon supplies of cereals and technical crops is extended in the maximum admissible temporal scope in accordance with the provision of article 199a of the VAT Directive – 31 December 2018.

The introduced VAT reverse charge mechanism is on the one hand an effective tool for prevention of the organized VAT frauds involving cereals and technical crops with the participation of non-existing economic operators (missing traders), and on other hand it causes a decrease of the unfair competition by restricting the possibility for unfair economic operators to obtain tax advantage from hiding and not paying VAT. The mechanism is also a safeguard for fair economic operators against accidental transactions with unfair suppliers participating in tax fraud schemes.

The experience so far has proven that the VAT reverse charge mechanism is an effective tool for counteraction to and fight against VAT frauds for certain categories of goods. After the introduction of the VAT reverse charge mechanism a considerable and permanent decrease of the level of VAT frauds is reported in the short term in the supplies of cereals and technical crops.

– ***Improvement of the control of the supplies and movement of liquid fuels***

An amendment was made to the Value Added Tax Law (amended, State Gazette, No.58 of 2016, supplemented, No.60 of 2016) directed towards prevention of possibilities of tax frauds with fuels. A new mechanism is adopted for trading in liquid fuels, according to which persons performing taxable supplies or intra-community acquisitions of liquid fuels with a tax base exceeding BGN 25 thousand are required to submit a security in cash, government securities or in the form of an unconditional and irrevocable bank guarantee for a period of one year before the competent territorial directorate of the National Revenue Agency. The amount of the security is 20 per cent of the tax base of the taxable supplies, the acquisitions or the value of the received liquid fuels, released for consumption for the preceding tax period, but no less than BGN 50 thousand.

When the person did not make taxable supplies, intra-community acquisition or did not release liquid fuels for consumption within the meaning of the Excise Duties and Tax Warehouses Law (ZADS) having a total value in excess of BGN 25 thousand in the previous tax period, the amount of the security is to be determined with respect to the forecast average monthly tax base of the taxable supplies or the acquisitions of liquid fuels or the value of the liquid fuels released for consumption, calculated on the basis of 12 months, but no less than BGN 50 thousand.

The National Revenue Agency creates and maintains an electronic public register, part of the register under Article 80, paragraph 1 of the Tax and Social Security Procedure Code (TSSPC), in which the identification data is specified – for the persons who have provided a security, the amount of the security and the term of validity of the security, the date of registration and the date of deregistration.

– ***Regulation of doorstep sales or sales of tobacco products without a prior order***

A new provision is introduced to the Excise Duties and Tax Warehouses Law, pursuant to which the identification date of the transport vehicles must be registered in the license for trading in tobacco products, in case of doorstep sales or sale of tobacco products without a prior order. The change is related to the already established practice of traders (mostly wholesale ones) to distribute tobacco products through means of transport, from which actual sale is performed (a fiscal device is put into operation in them).

– ***Strengthening of the control over means of transport and transportation vessels***

A supplementation to the Excise Duties and Tax Warehouses Law is made, whereby it is provided for that those who are owners or users of the means of transport and the transportation vessels are bound to use the global positioning system and the measuring and control devices in accordance with their intended use in their operational scope, as they must ensure and monitor their good working order, proper use and constant transmission of data to a provider of GPS services. The purpose of the provision is to create legal certainty and prevention with respect to the persons transporting energy products by the use of transportation vessels mandatorily equipped with a GPS device. In case of failure to comply with the requirements the certificate of an approved transportation vessel shall be terminated on the date, on which the customs authorities established the respective facts and circumstances.

– ***Optimization of the control activity and improvement of the collection rate of excise duties***

A prohibition is introduced on the placement, keeping, carriage or transportation, including on excise goods, of used excise duty labels, in relation to the more and more frequent cases – established by the customs authorities – of keeping of used excise duty labels by natural persons and legal entities, intended for subsequent use.

A legal possibility is created in the cases of Art.42 and 43 of the Tax and Social Security Procedure Code for the performance of the search and seizure under the procedure of the Code of Criminal Procedure by the customs authorities too, for the purposes of fiscal supervision.

The customs laboratories are constituted as the only unit competent to rule on the samples taken for the purposes of the supervision of excise duty goods, as well as a unit having the right to determine the indicators and the other features having importance for the levying of excise duty.

– ***Restriction of the possibilities to evade taxation upon making of in-kind contributions to business companies***

In view of the prevention of possible cases of tax evasion in the cases of making of in-kind contributions to business companies (for which no tax is assessed as at the date of registration of the in-kind contribution) changes are adopted with respect to the formation of the taxable revenue upon subsequent sale of the shares or units of interest, received against the contribution, as well as for the treatment of sale of property by the shareholder as equal to a performed decreased of the capital of the company as a result from a sale of the contributed property. In both hypotheses the tax treatment is conformed to whether as at the time of making of the in-kind contribution the income from a possible sale of the property would be taxable or non-taxable within the meaning of the Personal Income Tax Law (PITL).

– ***Restriction of the tax discount under the Personal Income Tax Law for those who file the annual tax return for 2016 by 31 March 2017 electronically***

The discount is limited to BGN 1000. The lack of maximum threshold for the amount of the discount provides an opportunity for a certain circle of taxable persons to decrease considerable amounts from the tax due.

– ***Changes related to the award and prize incomes exempted from taxation***

For the purpose of remedial of the problems in the practice of implementation of an effective provision of the Personal Income Tax Law and for precise specification of the scope of the exemption from taxation, an amendment is adopted, according to which the only non-taxable income remains the prizes from entertainment machines within the meaning of the Gambling Law or in accordance with the legislation of another member state, and not the prizes from participation in all games that are not gambling within the meaning of the Gambling Law, and in which the prize is determined on a random basis. By the supplementation to another provision of the Personal Income Tax Law an amendment was adopted whereby students' awards (from Olympiads and other similar contests and competitions) were exempted from taxation, which according to the law in force before the amendments were subject to taxation.

– ***Introduction of a tax exemption for cashless payments made***

Amendments to the Personal Income Tax Law introduce a relief for natural persons who use, upon the incurrence of their costs cashless payments. The tax relief is in the amount of 1 per cent of the tax due for the year over the total annual tax base, but no more than BGN 500, when the person has made in the year cashless payments in the amount of 80 or more than 80 per cent of the amount of the incomes that must be fully received by bank.

The aim of this measure is to stimulate natural persons to use cashless payments, which will in turn help increase the reporting of the turnovers of the traders, at whom the costs are incurred by natural persons.

– ***Participation of the Republic of Bulgaria in initiatives of the Organization for Economic Cooperation and Development (OECD) in the field of taxes and administrative cooperation***

Bulgaria signed and ratified the Convention on Mutual Administrative Assistance in Tax Matters (Ratification Law adopted by the National Assembly and promulgated, State Gazette, No.14 of 2016) and the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (Ratification Law adopted by the National Assembly and promulgated в State Gazette, No.14 of 2016), effective from 01 July 2016. The country joined the Global Forum on Transparency and Exchange of Information for Tax Purposes at OECD in 2015. This will allow the country to receive information — automatically and upon request, from a large number of jurisdictions all over the world.

In 2016 the Republic of Bulgaria joined the inclusive framework for introduction of tax measures against base erosion and profit shifting (Base Erosion and Profit Shifting – BEPS) – official Resolution of the Council of Ministers No.23 of 8 June 2016. The country was given the opportunity to take part in the activities related to the establishment of standards in the field of tax treaties and transfer pricing, as well as to the process of development of monitoring in relation to the introduction of the four minimum standards already agreed with OECD and other elements of the BEPS package of measures. By joining the Inclusive Framework, Bulgaria assumed a commitment for introduction of the four minimum standards for a fight against base erosion and profit shifting (BEPS), as well as for participation in partnership inspections. At this stage, the introduction of the minimum standards is also related to the fulfilment of Bulgaria's commitments as an EU member-state, i.e. the introduction of the EU legislation in the national tax legislation. In this relation the Ministry of Finance has drawn up a draft law amending and supplementing the Tax and Social Security Procedure Code, which shall introduce the legal framework for exchange of information about Country by country reporting. The draft law creates also a legal ground for the creation of a regulatory legal framework for the performance of spontaneous exchange of tax opinions in accordance with the OECD rules. The draft law is approved by the Council of Ministers (Resolution No.876 of 18 October 2016 of the Council of Ministers) and is put forward for hearing to the National Assembly. The proposed amendments introduce into the Bulgarian legislation two directives amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation (Council Directive (EU) 2015/2376 of 8 December 2015 and Council Directive (EU) 2016/881 of 25 May 2016), as well as provisions for linking the rules for provision of mutual assistance upon the collection of public receivables in accordance with concluded international agreements, to which the Republic of Bulgaria is a party (incl. the Convention on Mutual Administrative Assistance in Tax Matters), to the proceedings referred to in the Tax and Social Security Procedure Code.

⦿ Measures in the field of collection of obligations overdue

Current on-going monitoring of taxable persons continues through determination of collection actions and a selective approach to the debtors on the basis of the amount of their debt, the risk for the collection of the obligation and their behaviour concerning the compliance with the obligation for registration, declaration and payment of tax and social security liabilities and other public state receivables.

Techniques for stimulation and observance of the voluntary fulfilment of the obligations depending on the group to which the taxable persons belong apply: notices, reminder letters, clarification of the possibilities of securing and repaying the obligations of persons in temporary financial difficulty, possibility to enter into agreements with the revenue administration.

In this relation, the performance of the following measures will continue:

– ***Performance of constant monitoring of debtors with debts overdue exceeding BGN 100 thousand (BGN 200 thousand for the Sofia City Territorial Directorate of the National Revenues Agency) for taxes and mandatory social security contributions, categorized as collectible and partly collectible, incl. conduction of personal meetings on the part of the***

directors of National Revenue Agency territorial directorates all over the country with persons having unpaid public obligations in particularly large amounts

The measure is constant in nature and the aim of its implementation is to assume explicit commitments for the provision of securities and/or performance of complete or partial payments of delayed debts, effective monitoring of the commitments assumed by the debtors and timely control of the treatment thereof on the part of the competent authorities – up-to-date evaluation of the economic status of the taxable person, timely imposition of security measures, issue of permits for urgent payments, deferment/postponing, sale of the property, performance of audits and inspections if need arises, etc.

- ***A mechanism is applied for repayment of public obligations of persons having receivables against municipalities, against other departments or state enterprises under public procurement contracts and contracts awarded in pursuance of EU operational programmes, through directing of the enforcement against third obligated parties, such as the specified ones***

The Council of Ministers adopted a Resolution on the Conditions and Procedure for Payments to Spending Units under Contracts (Resolution No.593 of 2016 of the Council of Ministers), which is drawn up in pursuance of one of the major government priorities for increasing the collectability of budgetary revenues. The adopted resolution develops the measure for implementation of effective protection of the fiscal position and optimizes the process of collection of the budget revenues from customs duties, taxes, mandatory social security contributions and other public receivables collected by the two revenue agencies – the National Revenue Agency (NRA) and the National Customs Agency (NCA), implemented so far by Resolution No.788 of 2014 of the Council of Ministers, which was repealed.

Resolution No.593 of 2016 of the Council of Ministers introduces a requirement for all spending units, except for those under the budget of the National Assembly and of the judicial branch, to mandatorily notify the National Revenue Agency and the National Customs Agency before making payments under contracts, the value of which is no less than BGN 30 000. Such a notice shall also be made when the sum to be paid under the contracts amounts to less than BGN 30 000 but is not less than BGN 100, when it is a part of a monetary consideration under a contract, the value of which is not less than BGN 30 000.

The exchange of information between spending units and the revenue administrations takes place by the use of an information system, subject to a certain procedure and deadlines. Payments under contracts by spending units may only be made after a confirmation from the National Revenue Agency and the National Customs Agency that the person – counterparty under the contract, does not have tax liabilities overdue, mandatory social security contributions overdue and other public obligations overdue in a total amount of more than BGN 100. When the persons have obligations, the revenue administrations must send confirmation within 7 days that a distraint is imposed, for the respective public obligations, over the debtor's receivables against a bank or spending unit in its capacity of a third obligated party, or that they are secured by money, irrevocable and unconditional bank guarantee or government securities. When for the securing of the public obligations overdue the National Revenue Agency has imposed a distraint on the amount to be paid, after receipt of an enforcement order, the payment owed by the spending unit is to be made to the revenue administration up to the amount specified in the order.

The adopted resolutions has the following objectives: to increase the collectability of the public receivables; to decrease the expenditures for collecting the public receivables, through electronic exchange of information; to effectively use the existing information technologies and resources in the institutions; to ensure better reporting and transparency for the activity of the public sector, in accordance with the principles, provisions and best practices of the EU; to restrict the corruption practices and to strengthen the inter-institutional cooperation and coordination at a national level in the process of collection of the budget revenues.

- **Measures for reducing the administrative burden and costs for doing business and costs for the citizens**

  – ***Reducing the administrative burden and costs for compliance with the Corporate Income Tax Law (CITL)***

For the purpose of mitigation of the process of filling-in and filing of the returns on the part of the taxable persons, as well as decreasing of the information processing costs for the revenue administration, an amendment is adopted that introduces mandatory electronic filing of the return forms under the Corporate Income Tax Law, by the use of an electronic signature. According to the adopted transitional provision, electronic filing shall be mandatory for return forms, in respect of which the filing obligation arises after 31 December 2017.

Upon electronic filing of tax returns an automatic link is created to internal information databases of the National Revenue Agency, and the filled-in data is inspected and verified. In the presence of any inaccuracy a list is mistakes is visualized, which allows easy and fast filling-in of the return, and the tax due is calculated free of arithmetic errors.

  – ***Change in the procedure for correcting accounting and other errors related to the obligations under the Corporate Income Tax Law and the Personal Income Tax Law***

For the purpose of mitigation of the mechanism for correcting accounting and other errors and for the purpose of facilitating the application of the reliefs set forth in the Corporate Income Tax Law, the Personal Income Tax Law and the Double Taxation Agreements (DTAs) an amendment is adopted, which provides for that taxable persons themselves carry out the correction of the declared data by a one-off filing of a new return by 30 September. The change in the correction mechanism refers only to correction of errors established after the expiration of the deadline for filing of the annual tax return for the respective preceding year, which is filed in the relevant current year.

  – ***Decrease of the administrative burden and costs for persons in relation to incomes subject to final tax under the Personal Income Tax Law***

By the amendment made to the Personal Income Tax Law, incomes gained by individual residents from sources abroad are subject to tax and declaring only on an annual basis, as the tax due must be determined in the annual tax return and must be paid by 30 April of the next year. The purpose of the adopted amendment is to considerably decrease the administrative burden and the costs of the persons related to the process of declaring and payment of the tax due for these incomes and encouragement of the voluntary payment of the final tax.

  – ***Mitigation and optimization of the process of declaring of the selected procedure for taxation by farmers***

In order to avoid any possibility of non-taxation of incomes of farmers who switch from taxation under the procedure for traders to taxation under the general procedure of the Personal Income Tax Law, a provision is set out for inclusion in the taxable income of incomes obtained in preceding tax years when the person was taxed as a trader but they were not reported as income for the same or for previous years, in view of the rules of the accounting legislation.

The process of declaring of the selected taxation procedure by farmers is mitigated and optimized with respect to the term of application and in the cases of newly registered farmers.

– ***Changes related to the tax relief for children with disabilities***

The provision of the Personal Income Tax Law regulating the tax relief for children with disabilities sets out that the reduction applies both for the year of birth and for the year, in which the child attains full age. The adopted amendment creates legal certainty for the persons using the tax relief for children with disabilities.

– ***Amendments and supplementations to the provisions of the VAT Law affecting the acts of heirs in case of death of a natural person registered under the VAT Law, who is (respectively is not) a sole proprietor***

Amendments and supplementations are made to the provisions of the VAT Law that affect the acts heirs in case of death of a natural person registered under the VAT Law, who is (respectively is not) a sole proprietor. A possibility is set forth for an heir who intends to continue the independent economic activity of the ancestor and is not a person registered under the VAT Law to be able to register within 7 months from the date of the ancestor's death. For this purpose the heir must submit an application for registration under the VAT Law within 14 days from accepting the inheritance. In this relation, for the sake of greater clarity, an amendment is introduced also in the provisions regulating the scope of the goods and services, for which no tax is due upon deregistration of the ancestor. In any case not tax shall be due in case of a death of a natural person when the available goods and/or services, for which tax credit has been used in full, in part or pro-rata to the extent of use for an independent economic activity, have a total value of up to BGN 25 000, incl. The procedure and deadline for filing by the heirs of a tax return and reporting registers for the last tax period in relation to the mandatory deregistration of the deceased person are regulated.

– ***Decrease of the administrative burden for compliance with the Excise Duties and Tax Warehouses Law***

For the purpose of decreasing the administrative burden upon the licensing and registration regimes a provision is adopted for the elimination of the administrative obligations of persons to submit to the customs administration certificates of the presence or absence of tax and mandatory social security liabilities. This information will be obtained ex officio by the National Revenue Agency.

– ***Performance of a permanent analysis of the legal regimes and procedures for the purpose of optimizing and simplifying them***

The measure is permanent and is related to optimizing and simplifying the legal regimes and procedures, development and deployment of new electronic services by the revenue administrations for provision of integrated information to the obligated persons and to other institutions, increase of the tax and social security returns filed electronically, etc. The objective of the measure is to improve the investment and business environment and to improve the competitive advantages of Bulgaria in an international aspect.

⦿ Measures for stimulating the economic development, investments and employment

– ***Tax relief for farmers***

The tax relief referred to in art.189b of the Corporate Income Tax Law, which is state aid for farmers, may apply to the tax periods until the end of 2020. The essence of the aid is to support through tax relieves enterprises engaged in activities of production of unprocessed plant and animal production and to encourage the investments of farmers in new buildings and new agricultural equipment. A possibility will be thus created in addition for an increase in the investment activity in this field.

– ***Optimization of the special procedure for recovery of excise duty in respect of purchased gas oil used in primary farming production***

Changes are made in the procedure for recovery of the amounts under state aid scheme with respect to the special procedure for recovery of excise duty in respect of purchased gas oil used in primary farming production. The new Art.45 (e), paragraph 1 of the Excise Duties and Tax Warehouses Law provides for that the National Customs Agency must recover the part of the value of the excise duty representing the individual amounts of the state aid determined in accordance with chapter four "a" of Agricultural Producers Support Law by transferring to the State Fund Agriculture the funds to be paid to farmers. The recovery shall be carried out on the basis of the order and notice of the Minister of Agriculture and Food under Art.47b, paragraph 5 of the Agricultural Producers Support Law.

- **Introduction in the national legislation of European Directives in the field of taxes, as well as for setting of the national legal framework in conformity with the case-law of the EU Court of Justice.**

– ***Changes related to Directive 2006/112/EC on the common system of value added tax and as a result from established discrepancies with the EU law and harmonization of the national legislation with the European legislation, for the purpose of uniform application, upon observance of the case-law of the EU Court of Justice***

Amendments are adopted in the VAT Law, for the achievement of compliance with Directive 2006/112/EC with respect to the determination of the amount of the charged tax with the right of deduction in relation to the acquisition and construction of real estates that are or would be long-term assets within the meaning of the Corporate Income Tax Law, which are intended by the persons registered under the VAT Law to be included in their economic assets and to be used both for performance for independent economic activity, and for purposes other than their independent economic activity (incl. for personal purposes). It is provided for that in such cases registered persons will have the right to deduct tax prorate the extent of use of the respective real estate for the performance of an independent economic activity. The regime of this so called "proportional deduction" is provided for in the provision of article 168a of Directive 2006/112/EC. In the cases of proportional deduction the persons will also apply the ratio of partial deduction of tax to the amount of the tax charged with the right of deduction, if their independent economic activity consists both of supplies, for which the right of deduction is present, and of supplies or activities, for which this right is not present (e.g. in cases of performance of an exempt supply of a building or confiscation of a real estate for the benefit of the state).

In relation to judgments of the EU Court of Justice it is held that the term "traveller" should be given a wider meaning than that of final consumer, highlighting that the approach based on the concept of a customer may best achieve the specified two purposes by allowing tour agents (in the sense of tour operators) to use the simplified rules, regardless of the type of customers, to whom they provide their services and a contribution is thus made for the uniform allocation of the revenues among the member states. In its judgments the EU Court of Justice has held that the provisions of the VAT Directive should be interpreted upon observance of the approached based on the concept of a client. In this respect and in view of the increasing of the competitive powers of the Bulgarian tour operators it was adopted in the law that the regime would apply to the supplies of a general tour service by a tour operator to any person, incl. to another tour operator or to a tour agent, when they act on their own behalf and on their own account.

Provisions are adopted that govern the levying of VAT on the activity of unincorporated partnerships. According to the amendments made, the import of a commodity or a service by a partner for the achievement of the common objective under a contract for the establishment of an unincorporated partnership is not to be considered an import of a commodity or service for the purposes of the VAT Law. A mandatory registration is also provided for in respect of an unincorporated partnership, to which goods or services are contributed by a partner who is a person registered under the VAT Law.

– ***Changes related to harmonization with the effective legislation in the area of trade in natural gas and the liberalization of the electricity market***

Rules are introduced that explicitly determine the status of the traders within the meaning of the legislation of another member state or a state, which is a party to the Agreement on the European Economic Area, that can perform an activity as persons registered under the Excise Duties and Tax Warehouses Law. A possibility is given to the persons to perform an activity on the territory of the country through a branch in the Republic of Bulgaria or through a local legal entity – an accredited representative in accordance with Art.133 – 135 of the Value Added Tax Law.

Implementation of the Single national strategy for improving the tax collection, tackling the shadow economy and reducing the compliance costs 2015-2017 (UNS), adopted by Resolution No.806 of 2015 of the Council of Ministers and preparation of annual reports on the implementation of the SNS:

The implementation of the measures from the Action Plan to the SNS continues. In April 2016 the first Report with an Evaluation of the Implementation of the SNS for 2015 was drawn up (approved by the Council of Ministers by Minutes No.17 of 27 April 2016), which reports the achieved results and reports the progress in the implementation of the measures in 2015. The second annual Report with an Evaluation of the Implementation of the SNS, which includes information about the implementation of the measures and activities in 2016, is approved by the government by Minutes No.13.18 on 22 March 2017. The reports are published on the webpage of the Ministry of Finance in the column "The Tax Policy in Numbers".

In relation to measure 1.4 of the Action Plan to UNS 2015-2017, which is related to the improvement of the legal framework and improvement of the effectiveness of the control with respect to the hiding of sales, a draft Law on the registration and reporting of the sales in trade outlets is developed, which is to replace Ordinance No.H-18 of 2006 on the Registration and Reporting of Sales in Trade Outlets though Fiscal Devices.

In relation to the implementation of measure 1.3. of the Action Plan to UNS with respect to the expansion of the scope and improvement of the mechanism for performance of fiscal control with respect to the movement of high fiscal risk goods, there has been drawn up an Ordinance Amending Ordinance No.H-2 of 2014 on the Conditions and Procedure for Exerting of Fiscal Control over the Movement of High Fiscal Risk Goods on the Territory of the Republic of Bulgaria and the Requirements to Fiscal Check Points (State Gazette, No.13 of 2016).

– National Customs Agency

The amendments to the Excise Duties and Tax Warehouses Act (EDTWA) adopted in 2016 are aimed at improving the tax legislation and rendering more precise the provisions of the law for the purpose of eliminating any vagueness and facilitating its practical application, as well as ensuring compliance with EU Court of Justice case-law.

In accordance with Article 72, paragraph 2, subparagraph 3 of the Tax and Social-Insurance Security Procedure Code (TSIPC), the aim is to facilitate the procedure for spontaneous exchange of tax information between the National Revenue Agency and the National Customs Agency – as a prerequisite for the improvement of the interaction between the two administrations and the effectiveness of the fiscal supervision implemented in accordance with their relevant competences.

Following the amendments to the EDTWA, effective as of 2016, the regulatory legal framework was rendered more precise.

The requirements for the information, contained in the material accounting of end consumers exempted from excise duty in relation to the control of the used excise goods were expanded. The contents of the register of issued authorizations for trade in tobacco products, kept by the National Customs Agency, were also regulated.

In 2016, Ordinance H-7 on 19 September 2016 on the Determination of a Procedure, Manner and Format for Sending Measurement and Control Devices Data under Article 103a, paragraph 1 of EDTWA was promulgated. The ordinance regulates the procedure, manner and format for sending of the data from the measurement and control devices for excise goods in the cases of electronic communication to the automated system for accounting of the persons and to the National Customs Agency information system.

All changes in the excise duty legislation are expected to result in additional revenues in the state budget and to have a financial impact on the taxable persons under the EDTWA and the consumers of excise goods.

The Union customs legislation is directly applicable in the Republic of Bulgaria. The amendments to the Customs Act achieve the objective to set the national legislation in conformity with the Union customs legislation and making provisions more precise for facilitating their practical application.

The new provisions highlight the new role and mission of the customs authorities in relation to the building of the internal market and reducing of the barriers to the international trade and the increased need to guarantee the security and safety of the external borders of the Union:

- Protection of the financial interests of the Union and its member states;
- Protecting the Union from unfair and illicit trade, while supporting legitimate business activity;
- Ensuring the security and safety of the Union;
- Maintaining an appropriate balance between the customs control and facilitation of the legitimate trade.

Within the European Union the role of customs in areas related to the security and safety – expands in directions other than the collection of revenues from indirect taxes such as customs duties, excise duties and VAT. This includes tasks ensuing from the Union legislation in specific areas related to the product safety – health protection of people, animals and plants, environmental protection, cultural heritage, etc. For instance, the provisions of Regulation (EU) No.765/2008, Regulation (EEC) No.338/97, Regulation (EC) No.116/2009. These are aimed at highlighting the function and tasks of the Bulgarian customs administration in the application of a number of legal instruments from specific control areas as a result of the implementation of policies ensuing from the membership of the Republic of Bulgaria in the EU.

Amendments are made to the provisions concerning customs representation to provide for mandatory notary certification of signatures only when a natural person represents another natural person before the customs authorities. The aim is to facilitate the activity of economic operators and decrease the administrative burden.

The competence of the customs authorities regarding the issuance of decisions is explicitly specified. This is in accordance with the interests of both economic operators and customs authorities as clearly appointed competent administration for submitting an application to and issuance of decisions. This leads to procedural economy and improved efficiency gains.

A possibility to serve decisions electronically is introduced too to account for the European customs legislation provisions.

The Law Amending and Supplementing the Customs Act also introduces respective amendments to the EDTWA aimed at adopting national level measures necessary for the implementation and application of acts of the European Union. In the respective amendments to the EDTWA, as pertaining to the application of the customs legislation, are suggested the relevant changes for ensuring the compliance with the provisions of Regulation (EO) No.952/2013.

In relation to transitional measures for the periods required by the Member States to develop or adapt the customs electronic systems and ensure, not later than by 31 December 2020, the necessary required level for exchange of information between the customs administrations and the economic operators, as well as between the customs administrations of the member states and the European Commission, transitional provisions are set out in the Customs Act to lay down that paper forms and the existing national systems shall be used for the processing of applications permits for the management of a temporary storage facility, as well as the submittal and processing of the declaration for temporary storage. The transitional rules are applicable as of 1 May 2016 until an improved state is reached or the respective electronic system is introduced (until the date of entry into operation of the national system for “Arrival Notification, Presentation Notification and Temporary Storage” and until the date of entry into operation of the “Customs Decisions” – Management system). Furthermore, a transitional provision is set forth to provide for that the Director of the National Customs Agency is competent to issue decisions for the use of a Union transit procedure on the basis of paper documents for goods carried by rail, air or sea, and the use of a Union transit procedure on the basis of an electronic manifest for goods carried by air or sea only until the dates of achieved improvement of the new computerized transit system specified in the annex of Commission Implementing Decision establishing the Work Programme for the Union Customs Code (2016/578/EU).

In the beginning of 2016, the National Customs Agency underwent structural reorganization. In view of the changes in the legislation, the activity, structure and functional competences of the customs houses and the directorates in the Central Customs Directorate were optimized. The changes are aimed at strengthening the expert analytical assessment capabilities in forming concepts on the Agency’s operation and elaborating planning, programme and reporting documents within the framework of drafting and summarizing analyses and forecasts for the agency’s activity.

As a result from Order No. PFL-1257/14 December 2015 of the Minister of Finance and the legal requirements in the Rules of Organization of the National Customs Agency, amended and supplemented by State Gazette, No.2 of 08 January 2016, effective as of 11 January 2016, the structure of the Svilengrad customs house (having a total number of 330 employees) was reorganized/restructured, as the customs offices to the Svilengrad customs were closed down and new customs offices with the same territorial competence were created within the Burgas and Plovdiv customs houses that assumed on a centralized basis the functions of the closed customs office within the Svilengrad customs, thus resulting in the extended scope of the activity of the customs officers.

The approved staff number of the National Customs Agency remains unchanged, viz. 3362 employees. The functions of officers, stationed at the Svilengrad customs house, as relating to the main activity of the customs administration are preserved, adding new functions related to X-ray systems.

– National Revenue Agency (NRA)

In order to decrease the shadow economy, to improve the collection of tax and social security liabilities and to reduce the administrative burden the National Revenue Agency continues implementing and plans the improvement of the following measures:

Provision of the quality service and facilitation of the customers in the performance of the obligations:

- Maintenance and improvement of the existing e-services and deployment of new e-services.
- Renovation of the website and e-service portal of the National Revenue Agency for facilitation of the customers of the National Revenue Agency. Maintenance of a customer-oriented site and e-services.
- Implementation of constant and purposeful communication and conduction of explanatory campaigns to specific customer groups, incl. an education programme for start-ups.
- Provision of access to electronic administrative services for the customers of the National Revenue Agency through the use of electronic identification.
- Optimization of the process of registration/deregistration under the VAT Law and relieving of the customers of the National Revenue Agency. This includes also the joint action that started in January 2017 between the National Revenue Agency and the Registry Agency (RA) for securing a possibility or the taxable persons to state upon an initial registration in the Registry Agency by the same application that they wish to register voluntarily under the VAT Law, as the information is to be sent ex-officio to the National Revenue Agency for starting a check for a registration under the VAT Law.
- Mitigation of the administrative procedures and requirements of the customers of the National Revenue Agency. E.g., since the beginning of March 2017 a simplified procedure applies for recovery of overpaid income tax declared by an annual tax return under art.50 of the Personal Income Tax Law, by the performance of an automated evaluation of the cases on the basis of certain criteria without an inspection being made by a revenue authority. In practice, the term for recovery is made ten times shorter, as the person is not required to visit an office of the National Revenue Agency, to submit additional documents, as well as to sign new ones.
- Application of specific measures for improving the voluntary fulfilment of the obligations on the part of customers, in respect of which an analysis of the declared data has shown that they have made mistakes in the fulfilment of tax and social security liabilities.

Effective and efficient collection of obligations overdue

- Upgrade of the National Revenue Agency information system securing the activities of collection of public receivables for the purpose of automated processing of data, speed in the issue of documents, additional options for control over the process.

- Improvement of communication, incl. electronic communication, with debtors, public execution creditors and interested parties for early treatment of the new debt, incl. for the purpose of avoiding the need to apply coercive actions. The measures include notices, reminder letters, clarification of the possibilities for securing and repayment of the obligations of persons who are in a temporary financial difficulty, possibility to enter into agreements with the revenue administration, as well as conduction of campaigns by outgoing telephone calls from the Information Centre of the National Revenue Agency to obligated persons for the purpose of repayment of obligations overdue.
- On-going operational monitoring of the obligated persons and application of approaches for collection of public obligations overdue on the basis of the debtor's profile, incl. the amount of the debt, the risk for the collection thereof, behaviour with respect to the obligations for registration, declaration and payment of the debts.
- Performance of constant monitoring of debtors with obligations overdue in an amount of more than BGN 100 thousand (BGN 200 thousand for the Sofia City Territorial Directorate of the National Revenue Agency) for taxes and mandatory social security contributions, categorized as collectable and partly collectable, incl. conduction of personal meetings between the debtors and the directors of the Territorial Directorate of the National Revenue Agency.
- Implementation of a mechanism for repayment of public obligations of persons with receivables against municipalities, against other institutions or state enterprises under public procurement contracts and contracts awarded in pursuance of EU operational programmes, through an enforcement against these persons.

Focussing of the control activity of the National Revenue Agency on significant risks of non-compliance with the obligations and strengthened institutional cooperation for counteracting tax and social security frauds

- Active interaction of the National Revenue Agency with the National Customs Agency and other structures within interdepartmental coordination centres that have been set up.
- Set up of specialized computer investigation teams (IT-Forensic) and provision of technical equipment and software for securing of evidence in an electronic form.
- Development of the electronic audit in the control activity and of the control with respect to persons performing commercial activity in Internet. For this purpose a Contract for the development of the control over electronic trade is developed in the National Revenue Agency. The preparation of specific legislative changes, which are to be proposed for discussion, is forthcoming.
- Improvement of the organization of work of performance of fiscal control. Introduction of an identification code for tracking the movement of high fiscal risk goods.
- Constant monitoring and communication with obligated persons forming a significant share of the economy in the country in view of protecting good-faith taxpayers from being involved in tax-fraud and tax-evasion schemes.
- Application of a simplified procedure for recovery of VAT for fair taxpayers.
- Optimization of the use of the information obtained through the network for early warning about VAT frauds – EUROFISC.
- Development of specific approaches for branch-based control, which are distinguished for a high frequency of tax frauds with a considerable fiscal effect.

- Control campaigns in summer and winter tourist resorts have proven to be among the most efficient means of control of the turnovers in the tourist sector.
- Implementation of the engagements and implementation of the possibilities in relation on the accession of Bulgaria to the Global Forum on Transparency and Exchange of Information for Tax Purposes at OECD.
- Participation of Bulgaria in the activities related to the establishment of standards in the area of taxation agreements and transfer pricing in relation to the introduction of tax measures against the base erosion and the profit shifting (Base Erosion and Profit Shifting – BEPS).

Development of system for management of the risk of failure to comply with the tax and social security legislation

- The National Revenue Agency applies a "Model for management of the risk of failure to comply with the tax-and-social security legislation" as a main instrument. Within the risk management model, the National Revenue Agency examines on a regular basis all economic sectors and tax risks in each of them, measures quantitatively the damages for the budget, determines the number of risky persons. On the basis of this analysis the National Revenue Agency prepares and performance a biannual "Programme for observance of the legislation and decrease of the risk levels", the purpose of which is to decrease the grey economy and profit concealing. What come next is the implementation of the measures laid down in the Programme for observance of the legislation and decreasing of the risk levels for the period 2016-2017, as risks are treated both by control and sanction measures and by "soft" measures, incl. letters, telephone calls, meetings, information campaigns, observations and reporting of the achieved effect.
- Determination of the priority risks for treatment in the next programme period and development of a Programme for observance of the legislation and decreasing of the risk levels for the period 2018-2019.
- Starting of the activities under the "Undeclared labour" project, incl. activities within the European Commission Risk Management Platform, as well as with the participation of established experts and university lecturers in Europe, working in the area of the subject under review.

In 2015 – 2016 the National Revenue Agency made considerable efforts to outline all new challenges and the approaches necessary for the resolution thereof, which will be implemented by it in the period until 2020, as for this purpose it updated its strategic documents:

- **Charter of the National Revenue Agency Client**. The new charter is developed in 2015 and is focussed on encouraging the voluntary fulfilment of the obligations for payment of taxes and social security contributions, as it assumes a commitment to the citizens and the companies for fair and honest attitude and also describes the fundamental rights and responsibilities of clients.
- **Strategic plan of the National Revenue Agency 2016-2020**. The fourth strategic plan of the National Revenue Agency in a row is governed by the logic that voluntary compliance with of the tax and social security liabilities contributed to more than 96% of the received revenues and the focus is therefore on encouraging the observance of the obligations. The control and coercive action of the National Revenue Agency will be based on a systemic analysis and selection that are based on the risk, whereby the National Revenue Agency continues limiting the administrative burden for taxpayers and for the society as a whole. In all of its plans, the

National Revenue Agency is guided by the approach that is mostly based on help and support for more purposeful control actions, mainly on the organized schemes for tax avoidance.

- Strategy for human resource development in the National Revenue Agency 2016 – 2020
- Strategy for information technology development in the National Revenue Agency 2016 – 2020
- Concept for strengthening of the leadership in the National Revenue Agency and its image in the public 2016–2020
- In 2016 the National Revenue Agency took action related to the implementation of the **Concept for visual corporate identity of the Agency**
- Concept for development of the processes and activities of collection of public receivables 2016 – 2020
- Manuals under the Tax and Social Security Procedure Code, under the VAT Law, the Corporate Income Tax Law, the Personal Income Tax Law and social security legislation are updated and published for clients and employees, as well as the constantly updated column “Questions – Answers” and a number of other information campaigns and forms of feedback for the obliged persons. ▼

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

7.1 National budgetary rules

With the adoption of the Public Finance Law (PFL) and Fiscal Council and Automatic Corrective Mechanisms Law, Bulgaria has introduced the European requirements for enhancing economic governance in the European Union. The presence of a legal framework that determines budgetary rules, restrictions and procedures for action upon any deviations from the targets set for a certain indicator, is a precondition for increasing the predictability of the fiscal policy and compliance with the budgetary and financial discipline, and ensuring public finance sustainability.

The fiscal rules set in the Public Finance Law aim at defining clear and transparent restrictions on the fiscal policy in the long run, expressed in the imposition of numerical restrictions on main budgetary aggregates. The rules were developed in accordance with the internationally adopted definitions and criteria, as well as with the requirements for coordination of the national fiscal planning with the preventive and corrective arm of the Stability and Growth Pact.

The concentration of fiscal rules and their permanent regulation within the Public Finance Law have a positive effect as they guarantee long-term sustainability, link the elaboration of the fiscal policy to the making of a complex evaluation for their application and create preconditions for preserving budgetary discipline at all levels of governance of public finance.

The fiscal rules and restrictions comprise indicators under the national methodology – for the budget balance and the expenditures under the consolidated fiscal programme (on a cash basis) and for the state debt, as well as indicators of the General Government sector (for some rules as well as for its relevant subsectors) – for the medium term budgetary objective for the structural deficit, the budget balance and the consolidated debt of the General Government sector. The construction of three groups of fiscal rules – balance, debt and expenditure ones helps reflect the impact of the policies on the parameters of key budget indicators relevant to the General Government sector and to its relevant subsectors, as well as to the consolidated fiscal programme, incl. to a local level (municipalities/municipal budgets). The rules are further developed with the inclusion of specific provisions for cases of deviation from the target/restriction and the respective correction mechanisms and measures for returning to the target or the limit determined by the rule.

The presence of fiscal rules and restrictions that indicate the state of public finances is a mechanism for prevention from adverse fiscal trends and for taking prompt and adequate decisions, based also on the opinions and recommendations of the Fiscal Council, which after being constituted in the end of 2015 has joined by its expertise also in the coordination of the main budget documents within the budgetary procedure for 2017.

Based on a performed review of the application of the PFL and after a thorough analysis and an identified need for regulation of social relations in order to guarantee the sustainability of municipal finances, the National Assembly adopted an amendment to the Public Finance Law (promulgated, State Gazette, No.43 of 2016). The amendment aims to resolve a number of issues related to the need of taking action to set the budget position of municipalities in accordance to the requirements of the national fiscal rules, applicable to municipalities pursuant to the PFL. Issues concerning the identification of municipalities in financial difficulty, the introduction of procedures for their recovery and the implementation of a financial recovery plan are provided for.

In line with the implementation of the amendments to the PFL, methodical guidelines were drawn up and criteria were approved for determination of municipalities with financial difficulties. Quarterly analyses are performed and the data for the financial condition of municipalities and for municipalities in a financial recovery procedure is published, while an evaluation of the indicators for financial independence is made; indicators for financial sustainability and efficiency; other indicators, such as the observance of fiscal rules; the availability at the end of the year of expenditure obligations under the municipal budget, which exceed 15 per cent the average annual amount of the reported expenditure for the last 4 years; the availability at the end of the year of commitments undertaken for expenditures under the municipal budget exceeding 50 per cent the average annual amount of the reported expenditures for the last four years; the availability at the end of the year of obligations overdue under the municipal budget that exceed 5 per cent the expenditures of the municipality reported for the last year; a negative budget balance under the budget of the municipality for each of the last three years; an average level of collection rate of the real estate tax vehicle tax, which is under the average collection rate of the two taxes for all municipalities, reported for the last year.

As a result from the application of the amendment in the PFL, municipalities have improved the collection rate of local revenues and their financial indicators. In 2016 there is a decrease of the number of municipalities meeting the requirements for financial recovery compared to 2015. There is a relatively uniform structure of the expenditures under economic elements, but trends are also observed of better management of the budgetary funds on the part of a number of municipalities – a greater number in 2016 than in 2015.

The amendments to the Public Finance Law related to the implementation and making of changes of the indicators under the respective budgets not only provided a permanent regulation of these mechanisms but also contributed to a larger clarity in their application.

The amendments to the Public Finance Law established a permanent regulation of the relations connected to the determination of the elements of the structure of the programme budgets through regulation of a classification in the policy areas/ functional areas and budget programmes, the aim being to create preconditions for a sustainable framework of the conducted policies and budget programmes.

7.2 Budgetary procedures

One of the elements of sound public finance governance is the successful first step and the start of the process of planning and drawing up of budget documents. The first document in this process is a well-structured budget procedure conformed to the Public Finance Law, synchronized with the European requirements and engaging all responsible institutions – both budget organizations and legal entities that though not being a part of the consolidated fiscal programme are within the scope of the General Government sector.

The budgetary procedure for 2018 is approved by Resolution No.37 of the Council of Ministers of 19 January 2017 and is conformed to the deadlines for the application of the mechanisms and measures laid down in the main stages of the European Semester for Economic Policies Coordination in 2017 for the purpose of closer coordination and management of the economic policies in the European Union, strengthening of the economic governance and overcoming of macroeconomic imbalances. It was drawn up in accordance with the rule and requirements of the Public Finance Law, as its preparation reflected the requirements set for the structure and contents of the key budget documents and the deadlines for their adoption.

The launch and implementation of the first stage of the budgetary procedure for 2018 coincided with the mandate of the caretaker government appointed by the president of the Republic of Bulgaria. The Minister of Finance gave instructions for the preparation and presentation of the budgetary forecasts of the first-level spending units for the period 2018–2020, as given the limited functions and mandate of the caretaker government the guidelines for the development were to prepare the forecasts under assumptions of unchanged policies.

The first stage of the budget procedure for 2018 should have concluded with the adoption of a Decision of the Council of Ministers for an approval of the mid-term budgetary forecast for the period 2018–2020, in accordance to the deadline set in the PFL and the schedule in the Council of Ministers Decision №37 from 19.01.2017 for the 2018 budget procedure, and in accordance with the schedule of the Convergence programme and the National Reform Programme. The delay in the deadlines for the preparation and the approval of these documents of the Council of Ministers was validated with the need of further specifying the policies in the medium-term, taking into account the new parliamentary elections and the formation of the new government. The priorities of the new government were taken into account, as well as the fiscal effects from the envisaged policy changes, and the final steps of the first stage of the 2018 budget procedure were taken.

The second stage of the procedure covers the preparation, consideration and approval by the Council of Ministers of the 2018 Budget and of the updated Medium-term budgetary forecast as motives to the Budget and the subsequent steps for reflection of the final budget parameters approved by the National Assembly. The successful implementation of the second stage implies achievement of coordination of the fiscal policy with the sectorial policies of the government being conducted in the period 2018–2020, subject both to the fiscal rules of the Public Finance Law and to the latest values of macroeconomic parameters and the expectations for the development of the national and world economy.

Within his powers and in accordance with the deadlines defined in the procedure the Minister of Finance must issue instructions and guidelines for the second stage of the budgetary procedure for 2018 in order to support the processes of planning and preparation of the budgetary forecasts and the draft budgets of the budget organizations, including those that apply programme budgeting. The guidelines to the spending units concern not only the budgetary parameters of their forecast but also the increase of the quality of the budgetary documents prepared by them.

At the first stage of the budgetary procedure the first-level spending units applying a programme budget drew up and submitted to the Ministry of Finance their budgetary forecasts on the basis of the last approved classification of the expenditures under areas of policies and budgetary programmes for the period 2016-2018, as this period corresponds to the mandate of the last regular government. In line with the priorities set out in the new government’s governance programme, it is likely that possible changes in the defined policy areas and budget programmes, are applied.

Pursuant to the Public Finance Law amendments and supplementations to the Classification can be made in case of organizational or legal modifications affecting the activity of the budgetary organizations and aim at improving the processes of strategic planning and formulation of the national policies in accordance with the priorities of the government.

The procedure creates good organization and provides the required coordination upon the drawing-up of the mid-term budgetary forecast, its updating and elaboration of the draft state budget act, subject to the main participants in the budgetary process, stages, deadlines, and requirements for the structure of the budgetary documents.

7.3 Other institutional developments in relation to public finances

– Fiscal Council

Since the beginning of 2016 a Fiscal Council functions in Bulgaria, which performs the functions of an independent fiscal supervision authority within the meaning of Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States. The objectives of the Council are maintaining sustainable public finances, increasing the quality of the official macroeconomic and budgetary forecasts, and strengthening the public awareness with respect to the fiscal governance of the country.

The Fiscal Council has so far published a number of opinions and recommendations, as an Opinion on Convergence Programme 2016-2019, Opinion on the implementation of the state budget of the Republic of Bulgaria for 2015, Opinion on a Draft Law on the State Budget of the Republic of Bulgaria for 2017, Opinion on a Draft Law on the Budget of the National Health Insurance Fund for 2017, etc. The recommendations given by the council in these opinions have been taken into account by the government.

On the basis of a memorandum, good cooperation has been established between the Ministry of Finance and the Fiscal Council for exchange of opinions and information, which is also recognized by the European Commission in the Annual Report on Bulgaria for 2017.

— Review of the public expenditures in Bulgaria

In the beginning of October 2016 a review of the public expenditures in Bulgaria started. The review is carried out by the World Bank and is a result from a request made by the Ministry of Finance for the performance of an analysis of the effectiveness and efficiency of the public expenditures, for the purpose of identification of options for savings and redistribution of funds to more effective activities in the public sector.

According to the action plan for the performance of the review, the World Bank will, with the assistance of the Ministry of Finance, perform a review of two types of expenditures – maintenance and staff expenditures – in seven ministries and second-level spending units to them, as well as in 21 municipalities, a representative sample of all municipalities, i.e. municipalities with and without financial difficulties. The aim of this analysis is to identify potential ineffective expenditures, as well as expenditures that considerably exceed the same expenditures in other ministries/municipalities or countries having a GDP similar to ours.

The political body that directs the review of the public expenditures in Bulgaria is a Steering Committee including deputy ministers from all ministries being inspected and chaired by a deputy Minister of Finance. Such representation is supposed to ensure the strong political commitment to the recommendations made in the course of the review of the expenditures, and to their addressing in a subsequent budgetary procedure.

On the basis of the results from the initial analysis, which is expected to be drawn up in the spring of 2017, the Steering Committee must propose two areas/programmes for the performance of further thorough evaluation. The results from the thorough review will serve as a basis for the preparation of proposals for reforms directed towards an increase of the effectiveness and efficiency of the expenditures in these two areas/programmes.

The review of the public finances is intended to be finally completed in March 2018, as in addition to a report on the results from the analysis and recommendations for further action, a manual will also be drawn up for the conduction of future reviews of the expenditures by the Bulgarian administration. ▼

8. ANNEX A

Table 1a: Macroeconomic prospects

	ESA 2010 code	2016 Level MBGN	2016 Rate of change	2017 Rate of change	2018 Rate of change	2019 Rate of change	2020 Rate of change
Real GDP (at previous year prices)	B1*g	91 620	3.4	3.0	3.1	3.2	3.2
Nominal GDP	B1*g	92 635	4.6	4.9	5.0	5.3	5.3
Components of real GDP							
Private consumption expenditure	P.3	56 558	2.1	2.3	3.0	3.5	3.6
Government consumption expenditure	P.3	14 373	0.6	3.9	1.8	0.4	0.1
Gross fixed capital formation	P.51	17 876	-4.0	2.8	3.8	4.6	4.9
Change in inventories and net acquisition of valuables (% of GDP)	P.52+ P.53	1 056	1.2	1.2	1.2	1.2	1.2
Export of goods and services	P.6	59 996	5.7	5.2	5.4	5.4	5.6
Import of goods and services	P.7	58 238	2.8	4.8	5.3	5.6	5.9
Contributions to real GDP growth (In percentage points)							
Final domestic demand		-	0.6	2.6	2.9	3.1	3.1
Change in inventories and net acquisition of valuables	P.52+P.5 3	-	1.0	0.0	0.0	0.0	0.0
External balance of goods and services	B.11	-	1.8	0.4	0.2	0.1	0.0

Table 1b: Price developments

	ESA 2010 code	2016 Level	2016 Rate of change[35]	2017 Rate of change	2018 Rate of change	2019 Rate of change	2020 Rate of change
GDP deflator		100	1.1	1.8	1.8	2.0	2.0
Private consumption deflator		100	-0.4	1.1	1.4	1.7	1.8
HICP[36]		100	-1.3	1.2	1.3	1.7	1.8
Public consumption deflator		100	2.1	5.4	1.6	1.6	1.6
Investments deflator		100	-0.6	2.0	2.4	2.7	2.8
Export price deflator (goods and services)		100	-1.9	2.4	1.7	1.7	1.7
Import price deflator (goods and services)		100	-3.8	2.7	1.3	1.5	1.7

[35] Percentage change as compared to the previous year.

[36] Optional for Stability Programmes.

Table 1c: Labour market developments

	ESA 2010 code	2016	2016	2017	2018	2019	2020
		Level	Rate of change	Rate of change	Rate of change	Rate of change	Rate of change
Employment (thousand persons)[37]		3 463.3	0.5	0.5	0.6	0.5	0.4
Employment (millions of hours worked)[38]		5 692.2	0.4	0.5	0.5	0.4	0.3
Unemployment rate[39]		7.6	7.6	6.9	6.5	6.3	6.2
Labour productivity (BGN per person employed)[40]		26 454.3	2.9	2.5	2.5	2.7	2.8
Labour Productivity (BGN per hour worked)[41]		16.1	3.0	2.5	2.6	2.7	2.9
Compensation of employees (MBGN)[42]	D.1	38 386.9	5.0	5.5	5.7	5.9	5.9
Compensation per employee		14 901.3	3.1	4.2	4.9	5.3	5.5

Table 1d: Sectorial balances

% of GDP	ESA 2010 code	2016	2017	2018	2019	2020
Net lending/borrowing vis-à-vis the rest of the world	B.9	6.1	5.9	6.1	6.0	5.8
of which: –balance of goods and services		3.3	3.5	3.7	3.7	3.6
–balance of primary incomes and transfers		0.5	0.3	0.2	0.0	0.1
–capital account		2.3	2.1	2.3	2.2	2.1
Net lending/borrowing of the private sector	B.9	6.1	6.5	6.6	5.9	5.7
Net lending/borrowing of the general government	EDP B.9	0.0	-0.6	-0.5	0.1	0.1
Statistical discrepancy						

37 Occupied population, national accounts definition.

38 National accounts definition.

39 Harmonised definition, Eurostat; levels.

40 Real GDP per one person employed.

41 Real GDP per one hour worked.

42 In MBGN.

Table 2a: General government budgetary prospects

	ESA 2010	2016 Level	2016 % of GDP	2017 % of GDP	2018 % of GDP	2019 % of GDP	2020 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	29.9	0.0	-0.6	-0.5	0.1	0.1
2. Central government	S.1311	-43.9	0.0	-0.7	-0.6	0.0	-0.1
3. State government	S.1312		0.0	0.0	0.0	0.0	0.0
4. Local government	S.1313	52.5	0.1	0.1	0.1	0.1	0.2
5. Social security funds	S.1314	21.3	0.0	0.0	0.0	0.0	0.0
General government (S13)							
6. Total revenue	TR	32 877.3	35.5	35.5	36.1	35.7	35.3
7. Total expenditure	TE	32 847.5	35.5	36.1	36.6	35.5	35.1
8. Net lending / borrowing	EDP B.9	29.9	0.0	-0.6	-0.5	0.1	0.1
9. Interest expenditure	EDP D.41	708.1	0.8	0.8	0.7	0.7	0.7
10. Primary balance		738.0	0.8	0.2	0.2	0.8	0.8
11. One-off and other temporary measures							
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		19 826.0	21.4	21.5	21.6	21.5	21.2
12a. Taxes on production and import	D.2	14 478.3	15.6	15.5	15.5	15.3	15.1
12b. Current taxes on income, wealth, etc.	D.5	5 094.1	5.5	5.7	5.8	5.9	5.9
12c. Capital taxes	D.91	253.6	0.3	0.3	0.3	0.3	0.3
13. Social contributions	D.61	7 369.5	8.0	8.4	8.7	8.7	8.7
14. Property income	D.4	792.4	0.9	0.8	0.6	0.6	0.6
15. Other		4 889.4	5.3	4.8	5.2	4.9	4.8
16=6. Total revenue	TR	32 877.3	35.5	35.5	36.1	35.7	35.3
Tax burden (D.2+D.5+D.61+D.91-D.995)		27 195.5	29.4	29.9	30.3	30.2	29.9
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	13 037.7	14.1	14.2	14.3	14.1	13.8
17a. Compensation of employees	D.1	8 352.3	9.0	8.9	9.1	9.1	9.0
17b. Intermediate consumption	P.2	4 685.5	5.1	5.2	5.2	5.0	4.8
18. Total social transfers (18=18a+18b)		12 931.7	14.0	14.1	14.2	14.1	14.0
of which Unemployment benefits	D.621, D.624	390.0	0.4	0.4	0.4	0.4	0.3
18a. Social transfers in kind	D.6311. D.63121. D.63131	1 923.5	2.1	2.3	2.5	2.5	2.6
18b. Social transfers other than in kind	D.62	11 008.2	11.9	11.8	11.8	11.6	11.4
19=9. Interest expenditure	EDP D.41	708.1	0.8	0.8	0.7	0.7	0.7
20. Subsidies	D.3	939.8	1.0	1.0	1.0	1.0	1.0
21. Gross fixed capital formation	P.51	2 622.1	2.8	4.2	4.7	3.9	4.0
22. Capital transfers	D.9	1 359.4	1.5	0.5	0.4	0.4	0.4
23. Other		1 248.6	1.3	1.3	1.2	1.3	1.3
24=7. Total expenditure	TE1	32 847.5	35.5	36.1	36.6	35.5	35.1
Government consumption (nominal)	P.3	14 672.1	15.8	16.5	16.3	15.8	15.3

Table 2b: No-policy change projections

	2016	2016	2017	2018	2019	2020
	Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Total revenue at unchanged policies	32 877.3	35.49	34.89	35.58	35.48	35.27
2. Total expenditure at unchanged policies	32 847.5	35.46	35.69	35.54	34.75	34.13

Table 2c: Amounts to be excluded from the expenditure benchmark

	2016	2016	2017	2018	2019	2020
	Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	977.9	1.1	1.8	1.4	1.4	1.5
1a. Investments fully matched by EU funds revenue	560.7	0.6	1.3	0.8	0.9	0.9
2. Cyclical unemployment benefit expenditure	-36.7	-0.04	-0.02	0.0	0.01	0.02
3. Effect of discretionary revenue measures	244.3	0.3	0.6	0.6	0.2	0.2
4. Revenue increases mandated by law	0.00	0.0	0.0	0.0	0.0	0.0

Table 3: General government expenditure by function

% of GDP	ESA 2010 code	2015	2020
1. General public services	1	3.2	3.2
2. Defence	2	1.4	1.7
3. Public order and safety	3	2.8	2.1
4. Economic affairs	4	6.1	4.5
5. Environmental protection	5	0.8	1.0
6. Housing and community amenities	6	2.1	0.8
7. Health	7	5.5	4.9
8. Recreation, culture and religion	8	1.7	0.6
9. Education	9	4.0	4.3
10. Social protection	10	13.3	12.0
11. Total expenditure (=item 7=24 in Table 2)	TE1	40.7	35.1

Table 4: General government debt developments

% of GDP	ESA Code	2016	2017	2018	2019	2020
1. Gross deb[43]		29.5	26.4	25.6	25.1	23.8
2. Change in gross debt level		3.5	-3.1	-0.7	-0.6	-1.2
Contributions to changes in the gross debt to GDP ratio						
3. Primary balance[44]						
4. Interest expenditure[45]	EDP D.4	0.8	0.8	0.7	0.7	0.7
5. Stock-flow adjustment						
of which:						
Differences between cash and accruals[46]						
Net accumulation of financial assets[47]						
of which: privatisation proceeds						
Valuation effects and other[48]						
Implicit interest rate on debt[49]		3.3	2.7	2.8	2.9	2.9
Other relevant variables						
6. Liquid financial assets[50]						
7. Net financial debt (7=1-6)						
8. Debt amortization since the end of the previous year		6.8	11.9	6.4	4.8	5.1
9. Percentage of debt denominated in foreign currency		80.5	79.2	76.3	72.8	71.6
10. Average maturity		7.8	7.9	7.4	6.7	6.4

43 As defined in Regulation 479/2009 (not an ESA concept).

44 Cf. item 10 in Table 2.

45 Cf. item 9 in Table 2.

46 The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

47 Including liquid assets, government securities, assets in third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

48 Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant or in case the debt-to-GDP ratio is above the reference value.

49 Peroxided by interest expenditure divided by the debt level of the previous year.

50 AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5: Cyclical developments

% of GDP	ESA 2010 code	2016	2017	2018	2019	2020
1. GDP growth (%)		3.4	3.0	3.1	3.2	3.2
2. Net lending of general government	EDP B.9	0.0	-0.6	-0.5	0.1	0.1
3. Interest expenditure	EDP D.41	0.8	0.8	0.7	0.7	0.7
4. One-off and other temporary measures		0.0	0.0	0.0	0.0	0.0
5. Potential GDP growth (%)		3.0	3.0	3.0	3.1	3.1
Contributions:						
labour		0.4	0.3	0.3	0.3	0.2
capital		1.1	1.1	1.1	1.2	1.2
total factor productivity		1.5	1.6	1.6	1.7	1.7
6. Output gap		-0.3	-0.3	-0.2	-0.1	0.1
7. Cyclical budgetary component		-0.1	-0.1	-0.1	0.0	0.0
8. Cyclically-adjusted balance (2-7)		0.1	-0.5	-0.4	0.1	0.1
9. Cyclically-adjusted primary balance (8+3)		0.9	0.2	0.3	0.9	0.8
10. Structural balance (8-4)		0.1	-0.5	-0.4	0.1	0.1

Table 6: Divergence from previous update

	ESA 2010 code	2016	2017	2018	2019	2020
Real GDP growth (%)						
Previous update		2.1	2.5	2.7	2.7	
Current update		3.4	3.0	3.1	3.2	3.2
Difference (pp.)		1.3	0.5	0.4	0.5	
General government net lending (% of GDP)	EDP B.9					
Previous update		-1.9	-0.8	-0.4	-0.2	
Current update		0.0	-0.6	-0.5	0.1	0.1
Difference (pp.)		1.9	0.2	-0.1	0.3	
General government gross debt (% of GDP)						
Previous update		31.7	31.2	31.8	30.8	
Current update		29.5	26.4	25.6	25.1	23.8
Difference (pp.)		-2.2	-4.8	-6.2	-5.7	

Table 7: Long-term sustainability of public finances

% of GDP	2007	2010	2020	2030	2040	2050	2060
Total expenditure	37.6	35.9	33.8	35.2	36.3	38.0	38.7
Of which: age-related expenditures	15.1	17.8	17.6	18.9	20.0	21.7	22.4
Pension expenditures	7.4	9.3	8.8	8.8	9.7	10.9	11.4
Social security pension	7.1	9.1	8.5	8.5	9.3	10.5	11.0
Old-age and early pensions	5.6	7.5	6.6	6.2	6.7	7.9	8.7
Other pensions (disability, survivors)	1.5	1.6	2.0	2.2	2.6	2.6	2.2
Occupational pensions (if in general government)							
Health care	4.0	4.4	4.9	5.8	6.0	6.1	5.9
Long-term care							
Education expenditure	3.6	3.6	3.6	4.1	4.1	4.5	4.7
Other age-related expenditures	0.1	0.4	0.3	0.3	0.3	0.3	0.3
Interest expenditure	1.1	0.7	0.7	0.5	0.6	1.0	1.7
Total revenue							
Of which: property income	38.7	32.8	34.3				
Of which: from pensions contributions (or social contributions if appropriate)	1.3	1.2					
Pension reserve fund assets							
Of which: consolidated public pension fund assets (assets other than government bonds)							
Social contributions diverted to mandatory additional pension scheme[51]	0.7	1.0					
Pension expenditure paid by mandatory additional pension scheme[52]	0.0	0.0					
Labour productivity growth	2.6	8.0	3.2	2.5	2.3	2.0	1.5
Real GDP growth	7.3	1.3	3.2	1.4	1.2	0.9	1.4
Participation rate males (aged 20-64)	78.3	76.8	78.7	78.6	77.7	78.0	79.2
Participation rate females (aged 20-64)	68.4	67.0	69.6	69.2	67.5	67.6	69.8
Total participation rate (aged 20-64)	73.3	71.9	74.2	74.0	72.7	72.9	74.6
Unemployment rate (%. 15-64)	6.9	10.3	6.2	6.8	7.3	7.3	7.3
Population aged 65+ over total population	17.3	17.5	21.6	24.3	27.1	30.2	31.9

51 Revenue from social security contributions or other revenue for the mandatory additional pension insurance, with which the accounts payable can be covered..

52 Pension expenditure or other social benefits paid by the mandatory additional pension insurance.

Table 7a: Contingent Liabilities

% of GDP	2016	2017
Government guaranteed debt	0.5	1.2
Of which: linked to the financial sector	0.1	0.8

Table 8: Basic assumptions

	2016	2017	2018	2019	2020
Short-term interest rate (annual average) 6-month LIBOR in EUR, %	-0.28	-0.29	-0.22	-0.09	0.09
Short-term interest rate (annual average) 6-month LIBOR in USD, %	1.06	1.65	2.77	3.63	3.68
Long-term interest rate (annual average), %	2.27	2.67	2.72	2.95	3.15
USD/EUR exchange rate (annual average)	1.11	1.06	1.06	1.06	1.06
Nominal effective exchange rate. percentage change. previous year = 100[53]					
EUR/BGN exchange rate (annual average)	1.95583	1.95583	1.95583	1.95583	1.95583
World economy (excluding EU). GDP growth, %	3.1	3.4	3.6	3.7	3.7
EU GDP growth, %	1.9	1.8	1.8	1.8	1.8
Growth of relevant foreign markets. %					
World import volumes, excluding EU, %					
Oil Brent (USD/barrel)	44.2	56.4	56.9	58.3	59.7
International prices of non-energy goods, %	-1.7	8.6	1.6	1.4	1.4
International prices of food products, %	1.6	3.0	1.2	1.2	1.2
International prices of agricultural raw materials, %	-3.6	2.2	1.6	1.6	1.7
International prices of metals, %	-5.4	23.5	2.4	1.8	1.9

[53] The positive values reflect appreciation, the negative – depreciation.