



## **Bulgaria: Staff Concluding Statement of the 2020 Article IV Mission**

February 14, 2020

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or ‘mission’), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under [Article IV](#) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

*An International Monetary Fund (IMF) mission, led by Mr. Jaewoo Lee, visited Sofia during February 4-14 to conduct the 2020 Article IV consultation.*

*With macroeconomic stability well established, Bulgaria's economic policy challenge now is to reinvigorate inclusive growth and sustained income convergence. This calls for supporting growth-friendly reforms and investment in people. Stronger institutions and better provision of public services are the key, which, in turn, would boost broader investment and productivity growth.*

Bulgaria's economy had robust growth in 2019 and unemployment fell to a record low. The fiscal position is strong. The fiscal account is projected to move back from a one-off deficit in 2019 to balance this year and over the medium term. The external position remains strong as well, with the current account recording a large surplus. Another robust economic performance is widely expected for 2020, albeit with softer growth and subject to downside external risks. If such risks materialize, automatic fiscal stabilizers should be allowed to play freely and public spending that supports investment could be raised.

The main economic policy challenges concern the medium term. The strong economic performance of recent years has supported a healthy pace of income convergence. But the distance to the high incomes elsewhere in the EU remains a long one. Also, Bulgaria's income inequality is high and society and the economy are facing important demographic headwinds. Against this backdrop, achieving more inclusive growth and faster income convergence requires reforms on all structural fronts, including to improve governance, loosen labor

shortages, strengthen education, and alleviate inequality. Ongoing preparations for joining ERM II and the banking union have helped strengthen institutions and policy frameworks.

Successful reforms could bring about appreciable efficiency gains and catalyze higher investment. Higher, more efficient investment is a necessity for sustaining faster growth and convergence. It will also help moderate Bulgaria's current account surplus, which now appears high for an economy that should invest more for a faster income catch-up. By the same token, more and better spending on government services could also moderate savings and the current account surplus.

### *Improving public services and governance*

Bulgaria's strong fiscal and external positions provide room to increase the level of fiscal spending. Efficiently executed spending measures could support structural reforms on all fronts. There is scope for greater revenue mobilization to maintain a balanced budget over the medium term, which is an appropriate objective. That said, small deficits that serve to support growth-enhancing spending measures would also be appropriate, provided public debt remains around its present low level.

- Improving public investment management would increase the investment efficiency and set the stage for increasing the level of public investment. We welcome the forthcoming nation-wide application of the e-procurement system and encourage developing standard guidelines for project appraisal and improving multi-year budgeting.
- The absorption rate of the EU funds has improved over that of the previous cycle. Better planning for future EU funds would further reduce the backloading of projects and support more efficient investment.
- More effective revenue collection would increase usable resources for the government, as well as improving the efficiency and transparency of the public sector. Options include reducing the sizable VAT compliance gap and increasing the property tax. A diagnostic based on the IMF's framework, Tax Administration and Diagnostic Assessment Tool, could help assess the administrative capacity of the revenue authorities and identify key areas for improvement.

We look forward to further progress in strengthening the judiciary and implementing the framework for state-owned enterprise (SOE) governance. Following the favorable recognition in the European Commission's Cooperation and Verification Mechanism, the government plans to operationalize a post-monitoring council, which will help ensure reform continuity. The legislation on SOE governance has been aligned with the OECD guidelines (a commitment for ERM II), and strong implementation should follow, including for ownership policy, financial oversight and board qualification.

### *Investing in people*

Better designed social protection spending could reduce poverty and inequality. Bulgaria's already high inequality has been rising in recent years, as social protection spending (as a share of GDP) and the effectiveness of fiscal redistribution have been falling. We recommend a review of the level, targeting, and composition of social protection spending, after which such spending could be increased to better cover broader social risks. Without necessarily revisiting the social contract around the flat income tax, the redistributive role of taxation could be increased, for example, by increasing the maximum insurable income.

While endorsing ongoing policies to reduce labor shortages, we would recommend strengthening active labor market policies (ALMPs). The government has fruitfully undertaken many initiatives to address labor and skill shortages: worker importation agreements, efforts to bring back overseas Bulgarians, and training programs for skills anticipated to be in high demand. Another way to address labor shortages is to reduce long-term unemployment (LTU), which has remained high as a share of total unemployment in Bulgaria. At the same time, spending on ALMPs is low relative to other EU countries. The spending on ALMPs could be increased, in particular for training, start-up incentives, and private sector employment programs, which have been effective in reducing LTU in many countries. Improving the job matching efficiency would also help reduce LTU and raise the allocative efficiency of the tight labor market.

Strengthening education would help build human capital and improve economic opportunities for individuals and society. We see room to increase the public spending on education that remains low among EU countries, while ensuring its efficiency. Higher spending could further strengthen the teaching of digital skills and the modernization of the education system, as well as supporting other ongoing initiatives. They include assisting the NEET (not in education, employment or training) and early school leavers, promoting equal access to quality education, and raising teacher salaries. Greater involvement of business could help better align university curricula with evolving labor market needs, and teacher wage hikes should be complemented by measures to attract and retain high-performance teachers.

### *Strengthening the financial sector*

The Bulgarian National Bank (BNB) continues to uphold a conservative approach to financial supervision with emphasis on capital buffers. Effective supervision is a necessary condition to ensure the resilience of the financial system. A resilient and well-functioning financial sector in turn improves the allocation of resources and expands opportunities. The BNB has been raising the countercyclical capital buffer gradually to safeguard the banking system against the vulnerabilities that could cumulate under a protracted period of low interest rates. More narrowly targeted macro-prudential measures, e.g. borrower-based ones, could also be deployed, in case a risk of excessive growth were to emerge in certain credit segments.

We encourage renewed efforts to reduce non-performing loans (NPLs), as the strong economy and financial sector conditions make the current juncture a propitious time to do so. After declining rapidly since 2015, NPL reduction slowed in 2019, with the NPL ratio still well above the EU average. We welcome the BNB's adoption of the European Banking Authority's NPL guidelines, which could help ensure that banks with high NPLs take corresponding actions to address them. Reforms in improving the insolvency framework, another ERM II commitment, could also help reduce NPLs.

Joining the European banking union would further strengthen the financial system resilience. This awaits the satisfactory recapitalization of two banks identified under the ECB's comprehensive review, a pending requirement. Upon joining the banking union (as a non-euro area country), significant institutions will fall under the direct supervision of the ECB, as Bulgaria joins both the Single Supervisory Mechanism and Single Resolution Mechanism. In preparing for the entry into ERM II and the banking union, other welcome financial sector reforms have progressed, including strengthening the anti-money laundering framework and the supervision of the non-bank financial sector.

*The mission would like to thank the authorities and other counterparts for the constructive dialogue and kind hospitality.*