Republic of Bulgaria

EXPLANATORY NOTE TO CONVERGENCE PROGRAMME OF THE REPUBLIC OF BULGARIA 2006-2009

Agency for Economic Analysis and Forecasting

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2006 Fiscal outcomes

Budget revenues

The total amount of the revenues received in the Central budget and the Local budgets as of end-November 2006 is 6.2 EUR bln. (100.7% of the annual plan). It was 5.1 EUR bln. for the same period of the previous year (89.6% of the annual receipts).
Tax revenues are 5.5 EUR bln. as of end-November 2006 (98.7% of the annual plan) and 4.6 EUR mln. for the same period of the previous year.
The non-tax revenues are 670.3 EUR mln. (536.1 EUR mln. for the same period of 2005)

Corporate income tax

Corporate taxes revenues are 639.7 EUR mln. as of end-November 2006 (121.4% of the annual plan), whereas the performance was 93.4% for the same period of the previous year. There is overperformance in comparison with the planned amount for the reviewed period because of the four main reasons:

- Receipts from tax paid under annual tax return amounted to 229.1 EUR mln by November, which is 51.1 EUR mln more compared to the same period of 2005;
- Receipts from advance payments by November are 354.1 EUR mln, which is 99.2 EUR mln more compared to 2005;
- Tax audit acts 14 EUR mln;
- Taxable profit growth generated by non-financial and financial enterprises is 49% in 2005 compared to 2004.

Personal income tax

The personal income tax revenues as of end-November 2006 are 597.1 EUR mln. (112.5% compared to the annual plan). For the same period in 2005 this amount was 567.8 EUR mln (89.1%).
In *labour contracts* the revenues are 444.6 EUR mln. and 433.9 EUR mln. for the same period of the previous year. The overperformance is 13.8 EUR mln. as of end-November 2006. The main factors for the overperformance are:

- The entire effect of the family taxation hasn't occurred yet. In preparing the budget for 2006 the estimated loss of family taxation was announced to be 40.3 EUR mln., the expected loss is 25.6 EUR mln.
- Increase by 4% in the teachers' wages with total effect of 20.5 EUR mln.

In *extra-labour arrangements* (free lance, civil arrangements etc.) tax revenues are 129.6 EUR mln. as of end-November 2006 (110.9 EUR mln. for the same period of the previous year). The overperformance is 21.9 EUR mln. in November, compared to the plan. There is increase in the number of the submitted tax returns and in the number of registered sole proprietor in 2005 compared to 2004 and that affects the revenues from the annual tax returns. The advance tax paid by extra-labour arrangements and the civil arrangements is also higher.
In *final annual tax* (Patent tax) the revenues are 22.9 EUR mln. as of end-November 2006

VAT

The VAT revenues are 2 652.2 EUR mln. as of end-November 2006, (94% of the annual plan) and the amount is higher by 21% compared to November 2005. There is expected overperformance by 3.3% compared to the plan which is mainly due to the higher receipts from customs.
The plan for the revenues from domestic transactions is not met, and the growth of the receipts in comparison with the previous year is insignificant. The main reason is the decrease

of the payment on fuels and oil trade by 68 EUR mln., as a result of reduction of the domestic production because of an increase of import of finished petroleum products.
The budget assumption is for 11% of import growth for the year but the higher price of the crude (price index 119.7%) and non-ferrous metal, together with the increase in the imported volume of the fuels, led to a steeper rise of the imports.

Excise taxes

The legislation changes in excises for 2006 were orientated to harmonization of the Bulgarian legislation with the EU. In 2006 there was an increase in the excise duties of alcohol and beverages and the excise structure of tobaccos has been changed. Meanwhile, the companies that organize gambling and the companies producing gambling machines and casino machines do not pay excise duties but are taxable according to the Corporate Income Tax Act.
The excise receipts are 1 153.7 EUR million as of end-November 2006 (87.4% of the annual plan), whereas the performance is 976.9 EUR mln. for the same period of previous year (87.3% of the annual receipts). Collection of excise duties missed the plan for the period by 23.7 EUR mln.
The receipts in the Republic budget as of end-November 2006 are shown in the table below:

Excise tax revenues (EUR mln)	Report 30 November 2005	Report 2005	% of annual revenues	Plan 2006	Plan 30 November 2006	Report 30 November 2006	% of annual plan	% for the period
Domestic transactions	781.7	891.4	87.7%	1 067.1	954.0	913.8	85.6%	95.8%
Import	195.2	227.2	85.9%	253.2	223.4	239.9	94.7%	107.4%
Excise tax revenues in the republic budget	**976.9**	**1 118.6**	**87.3%**	**1 320.3**	**1 117.4**	**1 153.7**	**87.4%**	**98.0%**

Stocking up of excise goods and particularly fuels in December 2005 (ahead of the planned excise tax rate hike from the beginning of 2006) led to stronger excise tax revenues for 2005 but correspondingly to lower revenues for 2006. The effect of this process is estimated at a roughly 33.2 EUR mln revenues loss for the budget during 2006.
The excise duties from imported fuels amount to 193.7 EUR mln. compared to 170.9 EUR mln for the previous year. This is a result of the increase in the volume of fuels import.
The excise duties revenues from domestic transactions with tobacco products are 468.6 EUR mln as of end-November 2006, while the relative amount for the previous year is 306.5 EUR mln. The main reason for the higher receipts from domestic transactions is the increase in the tax rate. Simultaneously the produced tobacco quantities by “Bulgartabak” have significantly decreased.
The receipts from excise duties from Bulgarian excise labels for imported goods are 16.7 EUR mln.
Excise revenues from other goods – beer, beverages, alcohol containing raw materials, coffee, etc., are 70.8 EUR mln. from domestic transactions and 31.1 EUR mln. from import. The respective amounts for the same period of the previous year are 79.6 EUR mln. and 26.5 EUR mln. Total excise tax revenues are expected to fall by 3.4% from the target for 2006 as a whole.

Custom duties

The customs duties collected as of end-November 2006 amount to 209.1 EUR million (114.4% of the annual plan). The collected customs duties have increased by 37.6 EUR mln.

or 21.9% in comparison with the same period of 2005. The import volume for the ten months of the year amounts to 1 801 EUR mln. There is increase by 23.9% in comparison with the same period of the previous year.

Non-tax revenues

The non-tax revenues in the central budget amount to 669.8 EUR million as of end-November 2006 (121.1% above the plan). The receipts are 536.1 EUR mln. for the same period of the previous year.
The increase in non-tax revenues tendency continues in 2006 as in 2005. Receipts from dividends are 65.3 EUR mln as of en-November 2006 against 35.1 EUR mln. for the same period of the previous year. The receipts from fines and forfeits are higher (73 EUR mln.) There is significant increase in the revenues from property sales, which amount to 97.6 EUR mln.

Social security contributions

The revenues from social security contributions are 1 997.5 EUR mln. as of end-November 2006 (94.3% of the plan). The main factors behind the collection of social security contributions are:

- Decrease in the social insurance payment for fund “Pension” by 6%;
- The agreed higher thresholds for economic professions;
- Increase in the insurance income and increase in the insured persons, which is due to in a large extent to a lower share of the grey economy, induced by the cut in pension contribution rate from the beginning of the year and not taken into account in the budget forecast
- Increase in the maximum insurance income in 2005 from EUR 664.7 to EUR 715.8;

The reported receipts from health insurance contributions as of end-November are 472.9 EUR mln. (88.9% compared to the annual plan). They are 430.8 EUR mln. for the same period of the previous year.

Budget expenditures

The convergence program expects the expenditures for the year to fall short of the annual target by 1%. This is due to the activation of the “93%” clause of the budget for saving current primary spending of the primary budgetary units. Wages and salaries spending was subsequently a key source of savings for the budget as it would miss the target by around 3.8% due to lower than expected employment. The implied employment level in the budget sector in the budget program was a little lower than 500,000 people while average employment for the year should be around 450,000 people. Realized savings on this item allowed payment of bonuses for the employed in the budget sector at the end of the year and still remaining below the spending plan. The interest expenditures on the other hand should register savings of approximately EUR 25 mln. as a result of the pro-active debt management policy and the early repayment of IMF and World Bank debt in the end of 2005 and the beginning of 2006. Capital outlays are also expected to be roughly below the program which should be due to lower utilization of funds from the EU pre-accession instruments rather than discretionary saving.

2007 Targets

Updated 2007 surplus target

The medium-term fiscal framework is outlined in Part 5 "Quality of Public Finance" of the Convergence Program (CP). **The Ministry of Finance underlines its commitment to work for achieving a 2% of GDP surplus in 2007 (3.2%, excluding the contribution to the EU budget).** Payments to the EU budget (1.2% of GDP) represent money outflows and do not affect the GDP growth in a pro-cyclical way. The government acknowledges the risks for the macroeconomic stability, arising from the possible overheating and the imbalance in the current account of the balance of payments. Accordingly, fiscal targets were appropriately revised in comparison to the PEP 2005-2008, which projected a deficit for both 2007 and 2008 of respectively 0.2% and 0.7% of GDP. Tellingly, the 2007 budget is the first budget, which projects a surplus fiscal target, from the start. This serves to emphasize the firm commitment of the government to maintain strict fiscal discipline (reflected in a "surplus bias" with only three years of budget deficits during a ten-year period) and fiscal policy flexibility in order to react to potential economic shocks. In this sense the 2% of GDP surplus target for 2007 adequately addresses the projected economic development and in particular, the significant deceleration of the consumer inflation.

The revision of the fiscal target for 2007 should be considered in the light of the deliberate policy for not setting overly ambitious objectives in advance as to allow for a more conservative and flexible fiscal policy. Budget execution consequently has a good track record of overperforming its targets and achievement of the updated fiscal target for 2007 is feasible. This should be viewed in the context of a solid string of surpluses, recorded during the last several years.

The CP explains that the spending part of the budget contains sufficient buffers as to realize adequate savings in the course of the year in order to reach the surplus objective from the initial fiscal plan. These are the structural reserve and the so-called "90%" rule, which is explicitly laid down in the budget law. The size of this buffer was increased in comparison to 2006 when it was a "93%" rule, underlining strict adherence to fiscal discipline. This rule relates only to current primary spending of budgetary units and therefore, maintenance expenditures are most likely to be the source for savings and possible subsidies as well. Attainment of the stricter fiscal target in 2007 would be also supported by a more favorable economic environment than originally projects. New GDP data on economic growth for Q3 of 2006 was published after the preparation of the CP and it suggested that 2006 growth in the CP might be underestimated. This should reflect in an underestimation of the nominal GDP for 2007 as well, providing an additional cushion for the budget as the revenue elasticity with respect to GDP is significantly higher than the expenditure elasticity and moreover, spending ceilings are defined in nominal terms in the budget law.

Transition from 2006 to 2007 fiscal target

As evident from Table 2, the sources of the fiscal expansion would be entirely on the spending part of the budget and specifically on the "Others" item, which under initial plans increases to 4.5% of GDP in 2007 (the increase will be less under the revised fiscal target as explained above). It includes re-classification of the National Fund spending from the "Gross Fixed Capital Formation" item to "Others". In its nature the expenditures of the National Fund are investments into projects, financed by the EU structural and Cohesion funds. Taking this into account, the planned increase in the budget spending in 2007 as a share in GDP would be a result of higher capital outlays, including also national co-financing for EU-financed projects. The other factors behind the higher expenditures would be the contribution to the EU budget (also in "Others") as well as the envisaged hike in the subsidies. The latter would be on account of planned agricultural subsidies under the Common Agricultural Policy (CAP), amounting to EUR 278.6mn in 2007 or 0.5% of GDP.

The planned growth of the budget expenditures should be mainly covered by a reduction of the budget surplus but to some extent it would be also financed by a corresponding increase of the revenues or the tax revenues in particular. Specific policy measures to this end would be the increase in the excise tax rates on fuels, electricity and coke from the beginning of 2007. In this respect, parliamentary amendments to the budget draft, approved after the drafting of the CP, included implementing a steeper excise tax rate hike on fuels than initially planned. This measure should bring around EUR 25 mln to the budget above the projected revenues in the CP with no impact on the budget surplus as the additional resources were distributed among various spending items. The original raise of the excise tax rates, however, would be sufficient to induce an increase in the revenues from excise taxes by 0.3 percentage points of GDP. A similar increase in the VAT revenues for 2007 is forecast despite the estimated loss, stemming from the change in the tax treatment of trade flows with EU Member States. It would be offset by an increased compliance ratio, as mentioned in the CP, as well as a projected higher share of the consumption in GDP and expected higher oil prices on the international markets. The hike in the excise tax rates should also contribute for collecting higher VAT. At the same time, direct tax revenues are projected to rise slightly even under reduced tax rates. The justification for this lies entirely with improved compliance but it has a two-sided effect. On the one side, an improvement of the efficiency of the tax administration is assumed as a continued result from the establishment of the National Revenue Agency (NRA) in 2006 and the accumulation of experience after one year in operation. On the other side, voluntary compliance would be also stimulated with the reduction of the corporate income tax rate and as a lagged effect from the cuts in the social security contributions from 2006. In addition, EU accession is expected to positively impact the revenues from grants with providing access to structural and Cohesion funding. Grants are projected to rise by 0.5 percentage points on an annual basis to 2% of GDP in 2007 or EUR 531.3 mln.

Justification of 2007 surplus target

It should be noted that the 2007 fiscal stance should not be considered as pro-cyclical policy as it would not add to the consumption growth. Collective consumption growth lags behind GDP growth and actually declines to 9% of GDP in 2007. Moreover, as discussed above, the spending increase of 2.8 percentage points of GDP for the year could be broken down roughly as follows: investments – 1.3 percentage points of GDP, contribution to EU budget – 1.2 percentage points of GDP and subsidies – 0.4 percentage points of GDP. To put it in other way, the planned expansion in 2007 is mainly for capital outlays and serve to improve the existing infrastructure and contribute for higher potential output growth. Payments to the EU budget represent money outflow and do not affect the GDP growth in a pro-cyclical way.

The uncertainty of the economic overheating during the year is also an argument against pro-cyclical criticism of the 2007 fiscal stance. Applying alternative methodologies for the output gap calculations yield different results and as indicated in the CP, actual overheating might be quite close to zero in 2007 and non-existent in 2008.

The fiscal easing in 2007 is a direct result of the EU accession, which requires a restructuring of the expenditure side. Increased revenues from grants would be matched by corresponding spending on financed projects with no positive effect for the budget balance. On the other hand, the obligation to contribute to the EU budget would not be met with additional revenues and would definitely require cuts of other expenditures in order to be accommodated in a unchanged spending framework. The same holds true for resources, necessary for national co-financing of EU-financed projects. As outlined in the Pre-accession Economic Program (PEP) 2005-2008 and PEP 2004-2007, the combined effect would amount to around 1% of GDP. The PEP estimation, however, did not take into account the expected loss of VAT revenues as a result of the EU accession, amounting to 0.9% of GDP. Together these fiscal effects of the accession account for the larger part of the fiscal easing in 2007.

MTO

The long-term MTO of a balanced budget on a cyclically-adjusted basis remains unchanged. The timing of arriving at the MTO is outside the programming period of the current CP and of the medium-term fiscal framework. Consequently, there is no firm commitment of achieving the MTO in 2011 in particular. 2011 was chosen as an **indicative** date since current output gap projections suggest that at that time the economy would return to its potential. The government reserves the right to revise the timing of reaching the MTO on the basis of updated projections on the output gap as to avoid running a pro-cyclical fiscal policy.

Outlook for 2008-2009

The revenue projection for 2008-2009 does not include any new policy measures with the exception of the planned excise tax rates hikes, according to the adopted schedule for aligning the rates with the minimum levels in the EU. Implicit assumptions are basic indexation of the wages in the budget sector with the inflation rate and the compliance ratio. Its potential to boost indirect tax revenues is largely exhausted but limited gains are expected in the direct tax revenues and the social security contributions due to the operations of the NRA. Changes in the revenue structure reflect these two factors together with changes in the GDP structure and expected growth of the revenues from grants.

On the expenditure side, the transition from a 2% of GDP surplus in 2007 to a 1.5% surplus in 2008 and 2009 would reflect increased investment spending due to the pick-up of EU funds utilization as well as higher agricultural subsidies under the CAP. They would be accompanied by offsetting cuts in administrative expenditures due to the ongoing process of improving the efficiency of the public sector. This concerns current spending of budgetary units, not classified as collective consumption, and the reduction should amount to 0.5% of GDP. The policy of increasing capital outlays and agricultural subsidies would be extended in 2009 as well and the specific spending forecasts reflect the expected utilization of EU funds and expected EU transfers on agriculture. The contributions to the EU budget (around 1.2% of GDP) for 2008 and 2008 represent money outflows and do not affect the GDP growth in a pro-cyclical way. The policy of containing the deficit of the pension system is expected to yield results in 2009 with the start of a gradual reduction in the pension payments as a share in GDP. This reflects actuarial forecasts on a reduction in the number of pensioners with the increase of the retirement age and elimination of retirement privileges for certain types of labour, which should dominate the effect of pension indexation and pension ceiling increases. Further, more strict control would be exercised over the growth of the number of disability pensions, which should also translate into a slower growth of the pension spending.