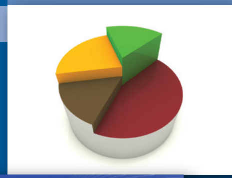
ECONOMIC
POLICY
ANALYSES






Fiscal Policy and Management of the Fiscal Deficit

Implications and Conclusions for Bulgaria

Kalin Marinov

- The paper elaborates on some basic aspects of fiscal policy and the origins of fiscal deficits, as well as the threats to its management caused by internal or external crisis. It explores the background on how the economic crisis evolved into a fiscal one in the countries of Central and Eastern Europe and looks into the instruments and approaches of the Bulgarian crisis management.

- On the basis of the budget proposed for Bulgaria 2011 three possible scenarios are analysed. Despite chances for a moderate economic revival a growing threat of running into a period of constantly high fiscal deficit remains.

- In the long-term the focus of the fiscal policy should remain on preserving social welfare and additional efforts should be made to strengthen the long-tem planning rather than on balancing the budget.

- Future outlines of the Bulgarian fiscal policy strongly depend on the indispensable reforms in the pension and healthcare systems. Any further delay in their implementation increase the risk for dampening recovery and growth.

November 2010

FRIEDRICH EBERT STIFTUNG

Институт за икономическа политика
Economic Policy Institute

Published by: Friedrich Ebert Foundation, Office Bulgaria
Final Editing: Maria Petrova
Graphic design and printed by: Grafimax 02 Ltd.

Table of Contents

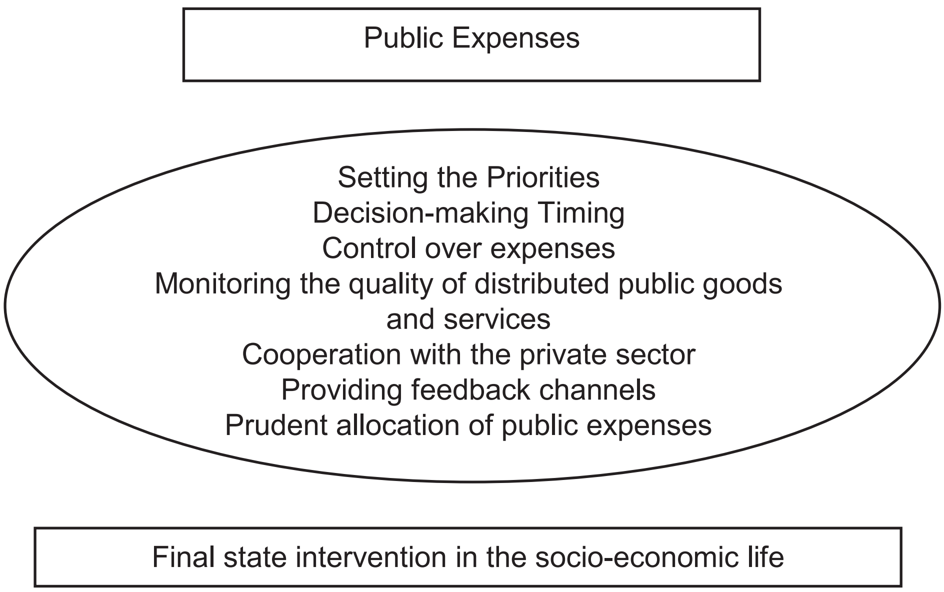
Abbreviations

EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
IMF	International Monetary Fund
FDI	Foreign Direct Investments
WB	World Bank
CEE	Central and Eastern Europe
GDP	Gross Domestic Product

1. Introduction

Debates over the fiscal policy are inevitably related to the views to what extent the state is engaged in the socio-economic life of the country. The most common indicator used for measuring the scale of state institutions intervention in socio-economic life is the correlation between public expenses and the amount of the Gross Domestic Product. However, this index in no way could be applied to measure the efficiency of those expenses and the scale of state commitment. Even the comparison made between particular countries on the basis of this correlation should be interpreted in a deeper sense. The missing element in order for the public expenses-to-the-GDP proportion to be applied as trustworthy measurement for state intervention is the reached final state engagement (both quantity and quality of distributed public goods and services) with the provided financing and it is nothing else but the so-called efficiency of the expenses. When it comes to the efficiency of public expenses, one has to take into consideration that this indicator is comprehensive and provides space for speculation. We will try to minimize the scale of this speculation and for the purposes of this discussion paper we suggest the following interpretation of the efficiency of public expenses (Figure 1)

Figure 1: Concept proposition on the efficiency of the spending of public expenses



Source: Economic Policy Institute

There are seven factors for the efficiency of public expenses that have direct impact on the eventual advent of budget deficit and they could be defined as follows:

1. Setting the priorities - priorities must be set and the available budget means must be taken into account. Long-term vision, consistency and precise analysis are crucial for identifying the areas of most pressing needs. Policy that is targeted at eliminating a large amount of fundamental problems could hardly be implemented.
2. Decision-making timing – a factor that has long been acknowledged as crucial on a corporate level but is already transforming into a competitiveness indicator on national level as

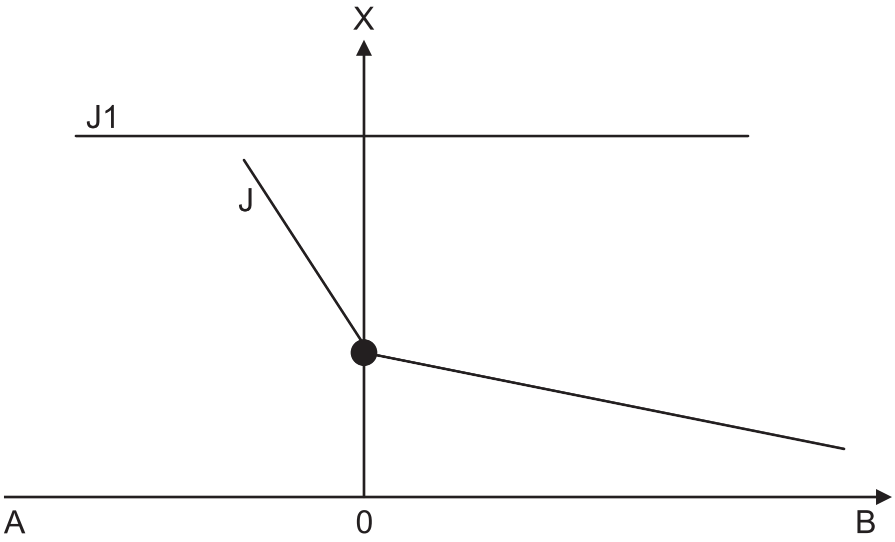
well. If this factor is at low levels, one cannot expect successful management of the budget deficit in a short-term perspective.

3. Control over expenses – analysis of the expenses on activity basis is required. Before leaving some activities to the private sector, it is necessary to ensure competitive conditions through clear rules and regulations. State withdrawal from one sphere could itself be even more dangerous than not-so-efficient state engagement because of possibly emerging discrimination practices for business organizations and the society. The next step following the adoption of a legal framework is its timely application in accordance with the law[1].
4. Monitoring the quality of public goods and services – to create working control mechanisms when delegating the provision of public goods and services to private contractors (public procurement).
5. Cooperation with the private sector – a clear self-awareness must exist when the state institutions play the role of regulators and when the one of equal partner.
6. Providing feedback channels – creating mechanisms for intensive public dialogue with stakeholders; clear definitions of goals and expected results from those debates.
7. Prudent allocation of public expenses – it is a key issue when it comes to social expenses. Their accurate allocation could help avoiding their uncontrolled increase and ensure their delivery to those in real need. This factor is especially topical in the present situation in Bulgaria as well as in other countries from Central and East Europe because social expenses are expanding due to the worsened situation on the labour market and the pressure on the pension system.

Quite often the successful implementation of a fiscal policy based on a balanced budget is dependent but not solely on reaching efficiency of spending the public expenses. However, the listed seven factors that are directly related to efficiency do not have the ability to change with the same rates as those of the economic environment on national and global level. This became evident in the countries all over Europe in the months of economic downfall in the period 2008 – 2010 when many were forced to strive for efficiency increase in a situation of fiscal policy with budget deficit. Precisely in times of recession, when tax revenues decrease and social transfers increase, the factors defining the efficiency of public expenses are called upon to be the system which has to decide how to meet as much social needs as possible with the declining amounts of resources. This system of efficiency must undergo constant optimization even when the national economy is on the upswing and there are more resources available for public expenses. All else being equal, the correlation between the efficiency in spending public expenses and the budget balance could be portrayed graphically as follows (Graph. 1)

[1] Law application should be in view of its gist and not just formally abiding by its provisions.

Graph 1: Budget balance and efficiency of budget expenses



Source: Economic Policy Institute

We assume that the values of the budget balance lie on AB axis while OX axis represents the efficiency of spending public expenses. All else being equal, the fiscal policy should be devoted to constant maintenance of high efficiency that does not decrease in the presence of budget surplus. This ideal condition could be illustrated with J1 straight line. Thus, the authorities should aspire to optimizing the efficiency of the expenses sliding J to its ideal J1 position.

Fiscal Policy and Fiscal Deficit

The main function of fiscal policy is to provide national economies with stability. The sole focus on that stabilizing role was gradually expanded and the two dimensions of income redistribution and resource relocation were added. The state of the national economy is logically reflected in a budget balance or a budget deficit therefore the latter should not be used as indicator of fiscal policy adequacy.

Origins of the Fiscal Deficit

Budget deficit occurs in case aggregated expenditures exceed aggregated revenues within the state budget. What is important to be underlined are the three types of deficit theoretically existing – structural, cyclical and cumulative. The concept of structural deficit defines its occurrence as determined by the governmental tax policy and the state supported investment projects. Such types of deficit are more easily controlled and to some extend even manageable. The structural budget deficit may occur even in a stable economic environment with GDP growth.

The second type of deficit, which is cyclical, is determined by the economic environment. The cyclical deficit occurs when the expenditures exceed revenues due to reasons related to functioning under the economy's potential level, e.g. factors resulting in GDP drop. Those factors may consist of decrease of the domestic consumption, exports decline, suspension or restriction of raw materials supplies.

There also exists a third type of budget deficit which is cumulative. It can be observed when governmental policy for economic growth allows for a structural deficit while at the same time the above described cyclical deficit is also occurring. In general it is prudent if fiscal policy is aiming at a balanced budget without critical deficits or high surpluses. In order to avoid a cumulative deficit the best policy would include allowing structure deficit for a year or two at the most followed by returning to a balanced policy with surpluses. Thus, it becomes possible to abstract benefits from the structural deficit. However, the analyses are controversial precisely on the issue whether fiscal policy is manageable in such short term.

Based on existing analyses the reasons for occurrence of fiscal deficits related to revenues and expenditures could be separated as follows:

Revenues related:

- Profit of local enterprises is decreasing which translates into a shortage of corporate tax revenues and a decline of income tax revenues as well.
- Unemployment increases resulting in a decrease of revenues due to lower income taxes and higher social payments.
- While the overall available resources decrease banks are tightening their loan policy, thus private consumption is shrinking in parallel and this again has a direct negative impact on indirect tax revenues.
- Foreign direct investments (FDI) inflows and remittances are among the most important factors influencing consumption especially in the countries of Central and Eastern Europe (CEE). Bearing in mind the dramatic economic downturn that Western Europe and the USA had to face FDI flows to the region have also shrunk. Bulgaria did not make an exception;
- Usually when a significant decrease of the overall revenues is observed, the tax collection rate declines as well. A trend of improving their collection might be expected as a result of activation of national control mechanisms.

Expenditures related:

- When the number of unemployed increases expenditures for unemployment compensations grow higher.
- The number of people receiving pensions is also increasing.
- State debt that was accumulated in previous periods and which could not be served is extended to future periods.
- Ongoing project might need to be frozen and this would lead to loss of investments already made or otherwise almost the same amount will need to be paid both as liability fees and costs for maintaining the project in its current state;
- Low levels of control over the public funds spending.

What are the Threats of the Budget Deficit?

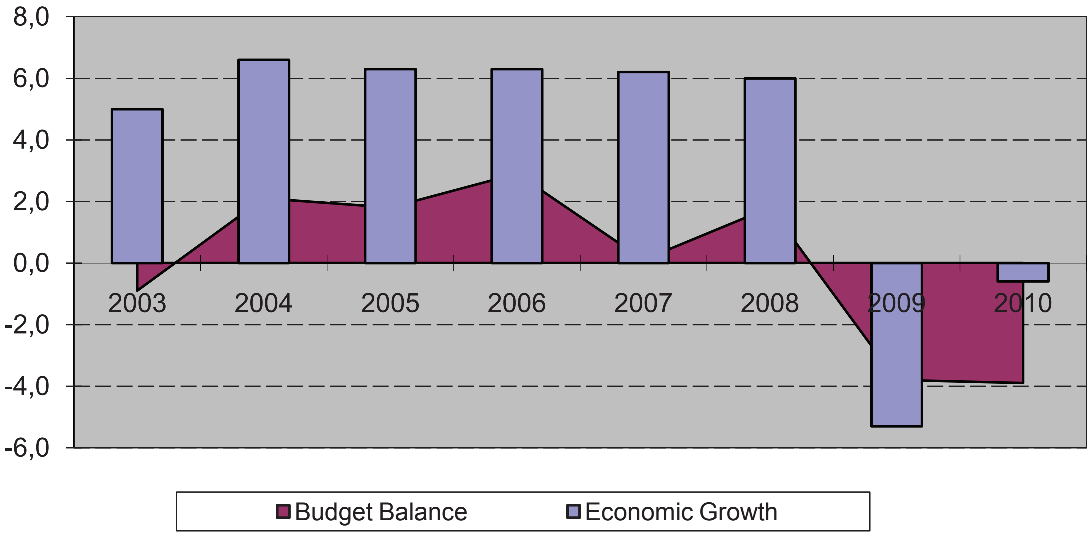
A budget deficit might even worsen in case the deficit turns out to be chronic for a couple of years as a result not only of the economic environment in the country.

- Even if a tax rate increase is avoided within the given year and the budget deficit does not show a trend of decrease then it is very likely such an increase to be implemented in the next budget period. In this regard the state reserve is the buffer allowing the financial authorities to adjust their policies to the given economic environment condition. Additional financing might be provided by an increase of governmental debt though if the budget deficit persists then the state authorities will have to offer worse conditions under which to attract potential external sources of financing.

- AN increase of internal government debt might occur as well that would lead to additional complications for the business sector resulting in a lack of liquidity, which is crucial for the functioning of companies in times of economic crisis.
- Accumulating extra governmental debt as a result of budget deficits for a long period will necessarily turn into an obstacle for fiscal policy in a following period of economic growth. Thus a current budget deficit reflects the negative impacts on national healthcare and social policies in the future. Therefore, even if sustaining a budget deficit is unavoidable its financing through issuing debt must be prevented. More prudent are options for financing the deficit through fiscal reserves and privatization or sale of tangible fixed assets that might be restored in periods of economic growth and higher revenues.
- Serving of government debt limits the options for lowering tax burden and eventual processes of outsourcing activities to the private sector (e.g. cutting expenditures).

The period in which Bulgaria enjoyed budget surpluses (2004-2006) allowed the introduction of low taxes both on corporate and individual level at the rate of 10%. That policy led to an additional stimulus for attracting foreign direct investments that gave impetus both to the economy and to GDP growth in the country. However, postponing the implementation of some key infrastructure projects was the price to be paid for preserving budget surpluses for five consecutive years (*See Graph 2*) but they allowed accumulating fiscal reserves of over BGN 8 billion until 2009. The lack of appropriate infrastructure resulting in certain loss of profits provided Bulgaria with short term stability in months of economic downturn. However, the latter source of stability will be exhausted for the next planning period since the revised budget framework for 2010 includes cutting it to BGN 4.5 billion. Afterwards additional restriction of expenditures will be necessary in case the economy do not return to its previous condition of economic growth and higher revenues, respectively. The budget deficit in 2009 and its growth in 2010 must not be considered dramatic in case that this trend is overcome in 2011-2012. However, if that scenario does not happen and in the next budget period deficit growth continues and if the fiscal reserve shrunk to beneath BGN 3.2 billion, then it is very likely that the Currency Board functioning to be seriously threatened.

*Graph 2: Budget balance (% of GDP) and economic growth of Bulgaria (%), 2003-2010**

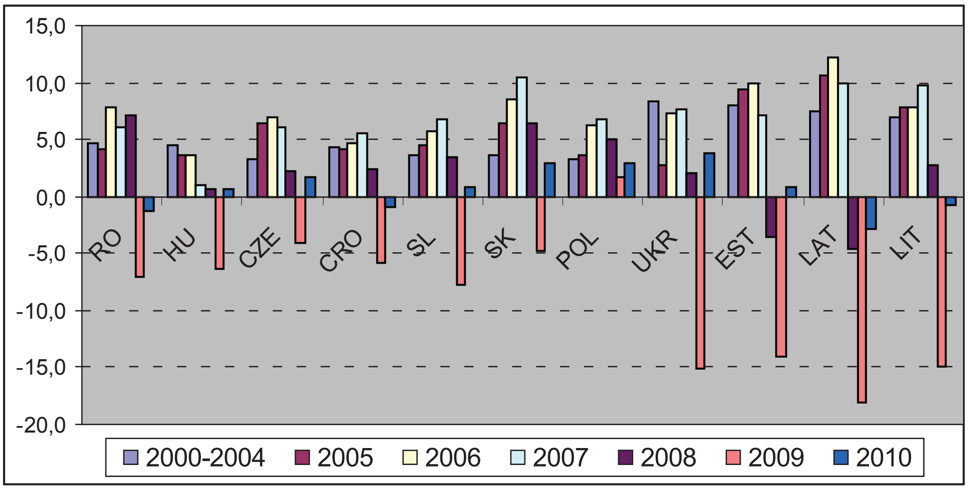


Source: Bulgarian National Bank (BNB)

** Budget balance data for 2010 are based on the prognosis from the Budget Amendment 2010*

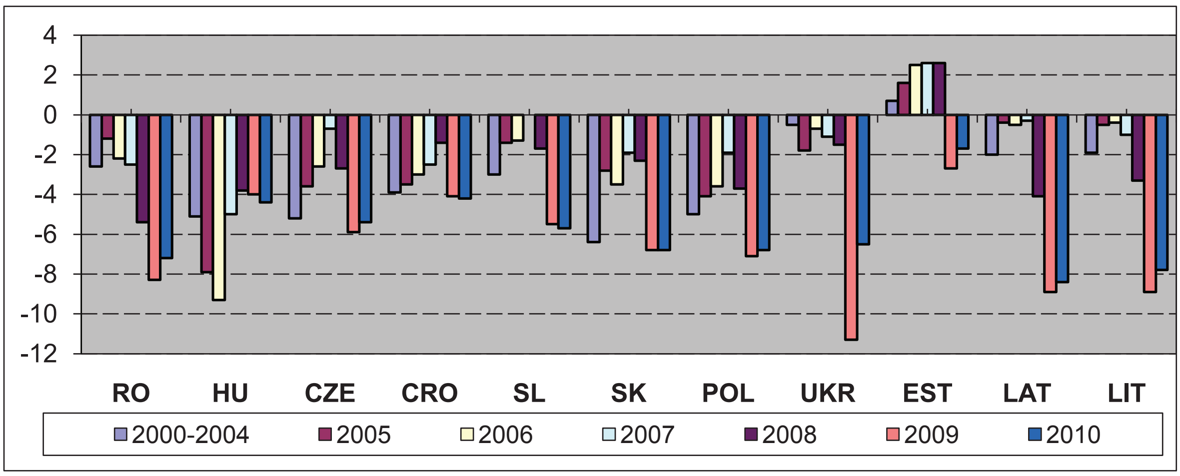
The figures of fiscal indicators for the countries from CEE do not differ very much, with the exception of Estonia which is the only one from the 11 countries included in the comparison that registers surpluses in the years of economic growth (See Graphs 3 and 4). Many governments of these CEE countries were not concerned about the registered budget deficit rates and did implement tax reductions to give additional impetus to the economy and to stimulate domestic demand through more disposable incomes. Among the main positive results following sustaining structural deficits was not only reaching accelerated economic growth but even more important was achieving higher convergence with Western European countries in regards to the living standards and the average level of disposal incomes. An increase in private consumption in CEE countries could be taken as a clear proof of the above statement. However, the economic downturn counterbalanced the positive trend related to their budgets in 2006 and 2007 and pushed them to even higher levels of deficit. A cumulated deficit is evident in their economies during 2009.

Graph 3: Economic growth in the Central and Eastern Europe (CEE) countries (2000-2010)*



Source: National Statistical Institutes and Agencies in the given countries
** 2010 data are based on prognoses from the FocusEconomics bulletins*

Graph 4: Budget balance in the CEE countries, % of GDP (2000-2010)*



Source: National Statistical Institutes and Agencies in the given countries
** 2010 data are based on prognoses from the Focus Economics bulletins*

Graphs 2, 3 and 4 show that it is hardly possible to identify a correlation between budget deficits or surpluses and economic growth rates. It is also impossible to conclude which policy will lead to easier and quicker recovery after the crucial 2009. Possible differences might be found in regards to the period needed for economic revival. Of course, foreign direct investments are another fundamental factor for economic growth and in most cases the FDI per capita for Bulgaria exceeds those in the other countries observed. Though, if one isolates this factor it will apparently turn out that a structural deficit results in higher economic growth. Elaborating on such hypothesis is not a subject of the current discussion paper though it could be proofed through further and more detailed research.

2. Socio-economic Life under Fiscal Deficit

Fiscal Deficit and Economic Growth

There is no lack of theories on fiscal policies with budget deficits created on purpose. Fiscal authorities may decide in favour of fiscal policy based on budget deficit even when the opportunity for balanced budget or budget surplus exists. The arguments behind such decision could be summarized in the following two points.

- Public expenses could stimulate economic growth. For example, if resources for capital investments in infrastructure are provided, this could result in a long-term favourable economic effect. In this context, additional expenses on education and healthcare could lead to increase in labour productivity and improvements in the functioning of the labour market.
- Public expenses could also be considered as an accelerator of aggregated demand because in times of economic downfall and increasing unemployment it naturally declines. Numerous governments in Europe turned to this mechanism in the period of economic turmoil in 2008-2010. The argument behind such policy is that the state should try to preserve production close to the maximum potential of the economy in order to avoid major collapses on the labour market.

If this approach for economic growth stimulation with a structural budget deficit is connected to a massive increase in public expenses, it may bring about considerable additional inflation. In a state of already high inflation rates the authorities should be very cautious with increases in public expenses.

Fiscal Crisis and Social Challenges

What are the social aspects of fiscal policy and especially those aspects that distinguish it from the financial policy of an enterprise which is generally interested in income increase, cost decrease and eventual profit maximization?

Public interest and social welfare are difficult to define, at least unambiguously. They follow interrelated objectives that vary for different countries. They depend on the diversity of citizens, regions, ethnic groups and demographic factors. Quite often, authorities try to give priority to one of the objectives through their programmes as they assume this will help to better achieve the main goal – namely, the general improvement of well-being.

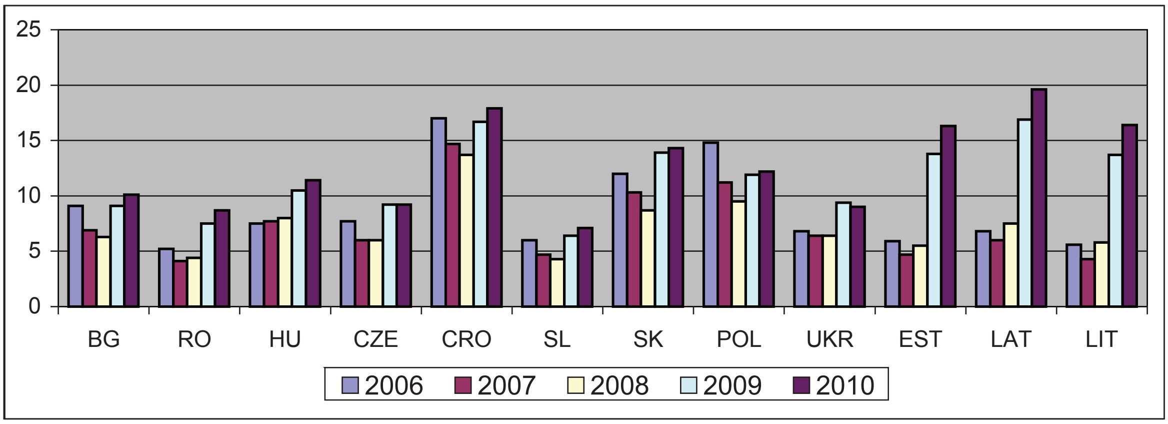
The only verified assumption with regard to defining the real dimensions of the term public interest is that the more homogeneous a society is, the fewer goals are diversified which makes them easier to address. A sign of homogeneity within the society could be the presence of large middle class and the lack of significant margin in standard of living for the various strata.

Does implementing a fiscal policy of budget deficit imply per se the advancement of fiscal crisis? One could state a fiscal crisis when even the main state policies are actually blocked or frozen due to lack of financial resources. The chances of such consequences turning into reality rise with an increase in the number of consecutive periods with budget deficit, especially when the economy is facing prolonged recession.

In practice, the boost of expenses in the social sphere often is an indicator for economic crisis, particularly when it is related to so-called automatic stabilizers such as unemployment compensation. The amount of resources redistributed by the state on that scheme grows in the budgets of all countries scathed by the crisis manifestations and they vary according to the established order in the socio-economic life. Here, the importance of one of the verified factors for efficiency of the public expenses becomes evident – namely, the prudent allocation or more precisely stated, their direction to those groups of individuals who are most needy. A brief review of the economies in Central and Eastern Europe (CEE) for the last four years shows that the unemployment surge is a common phenomenon and it is not typical only for Bulgaria (Graph 5). The increase of this indicator is obvious for 2009 and in some countries it will continue at least in 2010.

Actually, in the case of unemployment one can see a double effect on state expenses in the following years. On one side, the accumulated budget deficit at present covered by debt creation will have to be paid in the future. On the other side the unemployment rate very quickly follows the negative trend in the economy but during the recovery a minimum time lag of one or two years might be necessary in order to reverse the decline in the index. However well targeted employment policies might fasten the recovery as the often cited "German model" of active employment policy proves. However, this fact should be considered when setting the parameters for future fiscal programmes. Even if the number of newcomers in the unemployment group declines, their total number might not fluctuate much because finding a job will still remain difficult. In the first years of economic growth, it is only natural for the business establishments to stress the raising of labour productivity before regaining the confidence to employ new staff.

Graph 5: Unemployment rates at the yearend in the countries of Central and Eastern Europe (2006 – 2010)*



Source: National Statistical Institutes and Agencies in the selected countries
** 2010 data are based on prognoses from the Focus Economics bulletins*

The existing social networks will continue to put aside resources for the registered unemployed in conformity with the established national mechanisms for stimulating active job-seeking and employment. So, if in the years of economic growth the mechanisms were revised precisely for this reason, in order to fight long-term unemployment, now in crisis the temptation is great for authorities to seek a decrease in expenses through downgrading these mechanisms. Such reforms might argue for a reduction of the number of months for receiving unemployment benefits or the reducing of the benefit percentage towards the received wage. Instead of demolishing the social security walls against impoverishment of its citizens, a better option might be seen in many of the reviewed countries where controls were straightened and additional sanctions introduced for employers who force their workers to enrol as unemployed.

A problem that is common for almost all countries from Central and Eastern Europe is the state of pension systems which also face enormous strains as a result of the economic slump and the fiscal restrictions that followed. The most frequently adopted measure for alleviating state expenses in this respect is the increase in the retirement age. But this approach has already been exploited in previous crisis years and the chances for its implementation are considerably limited even if one would leave aside the negative public opinion towards such policy. The pressure on the pension systems was additionally aggravated by the intentions of many employed in pre-retirement or retirement age to seek protection from unemployment through this system. As well, one should not forget the influence of the overall aging of the population in Europe in the following decades. To a large extent, this factor enquires a re-thinking of some postulates about fiscal policy, enforced in recent decades directed towards the indication and acknowledgement of the increased burden of the means necessary to support those social networks.

3. Fiscal Policy and Management of The Fiscal Deficit

Objectives of Fiscal Policy

An important question which arises when looking closely into the details around budget deficits is whether the objectives of fiscal policy do not fade away and entirely fall subject to curbing the negative budget balance. In this way, improvement in efficiency is required but the long-term vision about priorities and programmes might get lost.

Should Fiscal Policy be Subject to Curbing the Fiscal Deficit?

Fiscal policy could be subject to an objective such as achieving a balanced budget if this is part of the long-term vision for the future of the country, e.g. membership in the Euro-Zone with all forthcoming pros and cons or concurrence with the budget policy norms set in accordance with the EU membership[2]. In such a case, the country should act as a reliable partner that is committed to make all possible efforts in order not to cause any additional stresses to the other member states.[3]

When taking into account such norms, each country faces the reality that in the short term a budget deficit cannot be substantially reduced and that it is more related to the existing economic realities. When one chooses to follow a policy wholly committed to limiting the budget deficit it is necessary to

[2] In September 2010 the idea for introducing the so-called "European semester" was adopted. According to the new mechanism, the 27 EU member states will have to send their budget plans and assessments for 2012 to Brussels. If necessary, the responsible EC bodies will issue a statement and come up with recommendations on the implemented policies. The ultimate goal is to guarantee better coordination of the national policies on EU level. The documents will be returned to the governments in the summer of 2011 so that the suggestions could be voluntarily taken into consideration in the national budget frameworks for 2012 before their official adoption. Still, there are no clearly stated sanctions to be imposed on a state which does not conform with the recommendations and does not provide sufficient arguments against accepting them.

[3] Bulgaria has such commitment related to the membership in the EU. In July 2010 the Council on economic and social affairs in Brussels started penalty procedures for excessive budget deficit against Bulgaria, Denmark, Cyprus and Finland. For Bulgaria, in particular, the reason for the procedure is the going beyond the referent value of 3 % budget deficit in 2009. The recommendations of the European Commission for the country are to manage to limit the deficit to 2.7 – 2.8% in 2011.

conduct an analysis whether its values in a short-term period of one year should be left behind in order to define its framework for the next 2-3 years. Of course, such policy seems politically luring in the search of favourable signals in the present but it also holds the danger of bringing some negative impacts:

- Potential investors could hardly be persuaded in the future macroeconomic stability of a particular state if it registers a high budget deficit even in comparison with the region. Declaring cuts in fiscal expenses for a deficit decrease will not have a reassuring effect. It might even be taken as a sign for probable tax increases or suspension of infrastructural projects in the following period aimed at reducing the negative budget balance and such measures by no means could be viewed favourable by business.
- A fiscal policy under budget deficit could lead to its avalanche-like increase if it is not supported by economic growth which to a large extent is related to external factors, especially for the CEE countries due to their size. Such an approach might be implemented more successfully by the leading economies in a global perspective.
- Even sustaining a budget deficit for one or two years could create preconditions for debt accumulation and thus lead to a certain loss of sovereignty in conducting fiscal policy.

Approaches to Fiscal Deficit Management

The approaches for managing fiscal deficit could be divided in two main streams with regard to the economic situation in which they occur.

a.) In a state of stable economy and economic growth the fiscal deficit is easier to predict and manage. Many governments prefer to conduct fiscal policies with deficits hoping to promote an accelerated economic development. However, such aggressive means deprive them of the opportunity to accumulate reserves that could be used in times of a *compulsive* state of budget deficit. As already mentioned, there is a significant difference in the policies implemented by Bulgaria and by the other 11 countries from CEE that are subject to the present research.

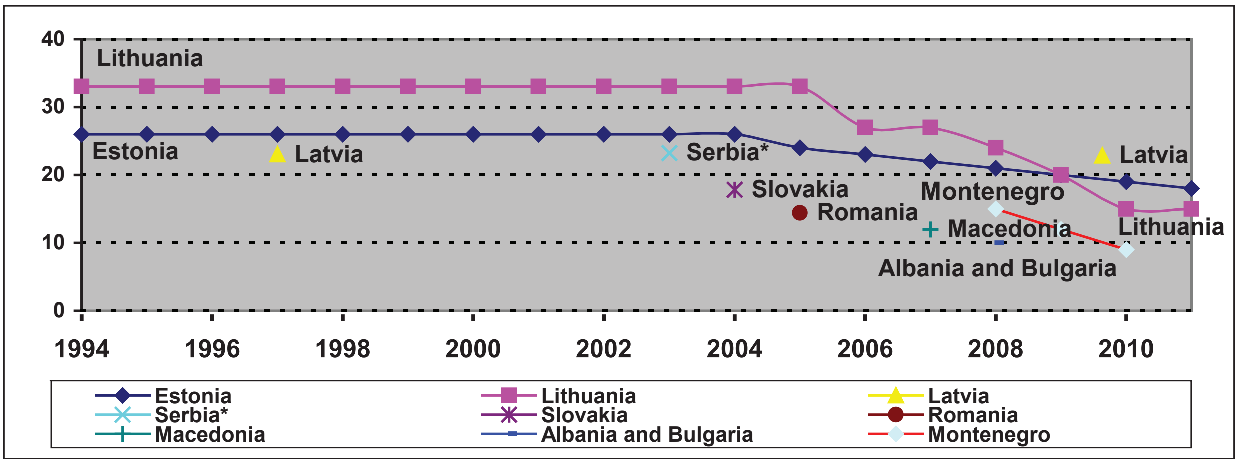
The positive and negative features of maintaining a structural deficit could roughly be summarized in the following aspects.

Dangers coming from the structural deficit:

- Inability to accumulate reserves which could be used in crisis years;
- Although to a smaller extent, structural deficit also leads to incurring state debt;
- In a situation of economic crisis, the figures of a structural deficit are added to those of the cyclical one, resulting in a combined "cumulative deficit" (see above). However, those two could hardly be distinguished as their boundaries are blurred and the cumulative or aggregated deficit gradually tends to be treated as entirely cyclical.
- A larger total deficit requires more substantial financial inflows into the state budget to compensate for it.
- Potential signals that the fiscal policy prior to the beginning of the crisis was not adjusted well enough may be seen as a result of low taxes. In this case, an increase in taxes might be sought as a way out of the deepening of the fiscal crisis;
- Vice versa the structural deficit is sometimes taken as an argument for cuts in taxes, particularly if it is assumed that revenues will increase due to the coming into the light of the hidden economy. Graph 6 traces the tendency for corporate tax cuts in a selected group of

CEE countries. These reforms were aimed at attracting larger volumes of FDI. Nevertheless, the graphic also shows that the simultaneous decrease once again stimulated competition and that the individual effect for a single country was much smaller than the one it could have achieved if only a sole country adopted lower taxations.

Graph 6: Review of corporate taxation in the CEE countries (1994 – 2010)



Source: National statistical institutes and Agencies in the selected countries

It is still too soon to draw conclusions and make comparisons regarding the indicators of the larger group of countries and Bulgaria in terms of experiencing more severely the effects of the crisis or their faster overcoming.

Positive premises determined by the structural deficit:

- The basis of all assumptions for a positive impact of a structural deficit is the statement that the government resorts to it in order to provide additional impetus for the national economy and thus to achieve a higher level of economic convergence and an increase of public welfare.
- Precisely, leaving more resources available for spending in the hands of the population can boost the economy. Such is the case of Poland where the large domestic market with almost unscathed purchase power contributes to the preservation of positive economic growth. Once again this is a proof that for larger economies it may be prudent to increase expenses and the structural deficit at least in a short-term perspective.
- In some cases, when the structural deficit is used to finance long-term goals (infrastructure, education, etc.) this could be defended in certain limits with the return and value added in a future period. However, for those goals to be validated, a detailed revision of the efficiency of public expenses is required.

b.) In case of economic downturn the fiscal deficit together with the increase in unemployment rates is one of the most certain indicators for evaluating the depth of the turbulence. In this case the term "management of the fiscal deficit" to a large extent overlaps with the more commonly used "crisis management". Overcoming recession by own resources of the country is directly linked to the size of the national economy and its sustainability. "Crisis management" varies from setting trends globally by the most powerful economies to enhancing or mitigating these trends by small economies. The rate of reduction in tax revenue is a direct indicator of the sustainability of the national economy and the level of its development, while at the same time a fundamental precondition for the emergence of the deficit.

In times of economic downturn priorities of fiscal policy gradually disappear and are replaced by attempts to limit and reduce the budget deficit. In practice, almost every economic recession leads to a negative budget balance. This correlation can be avoided only by countries which are exporters of natural resources and are able to increase the percentage of their revenue from exports, which is put in the public sector.

In the beginning of the current economic crisis, following the domino effect, the initial reaction of any government was to undertake programmes aimed at increasing the expenses towards business applying measures implemented by the large economies. However, their protective powers were not sufficient and the resonances affected severely the social sphere, consecutively deepening the budget deficits.

In such situations long-term objectives disappear and measures are taken "on an emergency basis", i.e. insufficient funds are allocated only to the most pressing problems.

Practically, the advices that can be derived for fiscal policies under the economic crisis and budget deficit are the following:

- In case of available fiscal reserves it is better to use it to cover the deficit but one has to clearly indicate to what extent this could work. For Bulgaria their excessive contraction might cause problems for the functioning of the Currency Board;
- Direct money transfers to businesses without tying the funding to long-term goals should be avoided. Instead, measures to maintain employment through direct subsidies to companies that declare difficulties might have a positive impact, albeit with a short-term nature. Again the "German model" shows that this can work. The main benefits of similar instruments are related to the provision of additional reaction time for businesses. However, they do not solve their problems and the positive effect does not justify such money transfers for a longer period of time.
- Attempts to seek revenue increase by raising tax rates might backfire. For instance, a rise of the most common tax, the VAT should be used only when all other mechanisms have been exhausted. Its increase, apart from further reducing final consumption, could cause a significant inflation impulse.
- Instead, attempts should be made to increase tax revenue collection and to make further efforts to end possible abuses.
- Freezing salaries and pensions might be prudent, at least until the overcome of the economic contraction, even if this reduces the consumptive purchasing power and thus internal demand.
- The labour market should be considered a priority, so that even the very few existing opportunities for employment creation can be exploited.
- In cases when a country is a EU member and additional funding from the Community programmes is available, it must be used, even at the cost of necessary co-financing as this type of "investment" actually carries an immediate positive impact when implemented. When co-financing of 25% is required, in practice the direct effect is multiplied three times by the use of European funds and in the future period even additional benefits can be extracted. Priority should be given to projects that create employment and in particular those that envisage maintenance of those job places in one way or another after the end of the project timeframe. A typical example of such an instrument is the Operational Programme "Competitiveness of the Bulgarian economy".

4. Fiscal Policy of Bulgaria

Future Short-Term Scenarios

During the years of economic growth Bulgaria implemented a prudent fiscal policy that did not run into budget deficit and managed to accumulate a reserve. However this seemingly successful fiscal policy is criticized on two main points. On the one hand several infrastructural projects were delayed or postponed and on the other hand the absorption of EU funds was unsatisfactory. Actually the accumulated fiscal surplus is thought to be a missed opportunity to ensure future benefits for both the society and the business entities. However, the critics` arguments were mostly limited to the demands for a balanced budget and not going further to a structural deficit as was the approach in many of the countries in CEE.

For 2009 and 2010 the stabilizing role of the fiscal reserve cannot be neglected and it should be mentioned that in fact it is the pillar that is keeping the fiscal deficit on a still bearable level having in mind the downturn in the Bulgarian economy. And it is protecting the government from the necessity to go into negotiations with the IMF for a Stand-by agreement, as was the case in many neighbouring countries. However, the accumulated deficit at the level of -3.9% of GDP in 2009 forced Bulgaria to abandon its plans to join the Euro-Zone.

Looking into the future and challenges standing before the national financial authorities in the following three short-term scenarios of fiscal policies correlated with dimensions of the national and global economy are presented. The basis of our analysis is the framework of the National Budget for 2011 which was still under consideration at the time when this research has been prepared.

Features of the National Budget 2011

The National Budget 2011 is planned to be implemented along with recovery of the economy and economic growth of 3.6%. The revival is expected to be driven by the external demand and an increase of the Bulgarian export. Additionally, the volume of the FDI is expected to rebound from the low levels registered in 2010 by 20 to 30% which will have also favourable impacts on the indicator.

Table 2: Vision for the Bulgarian economy in 2011

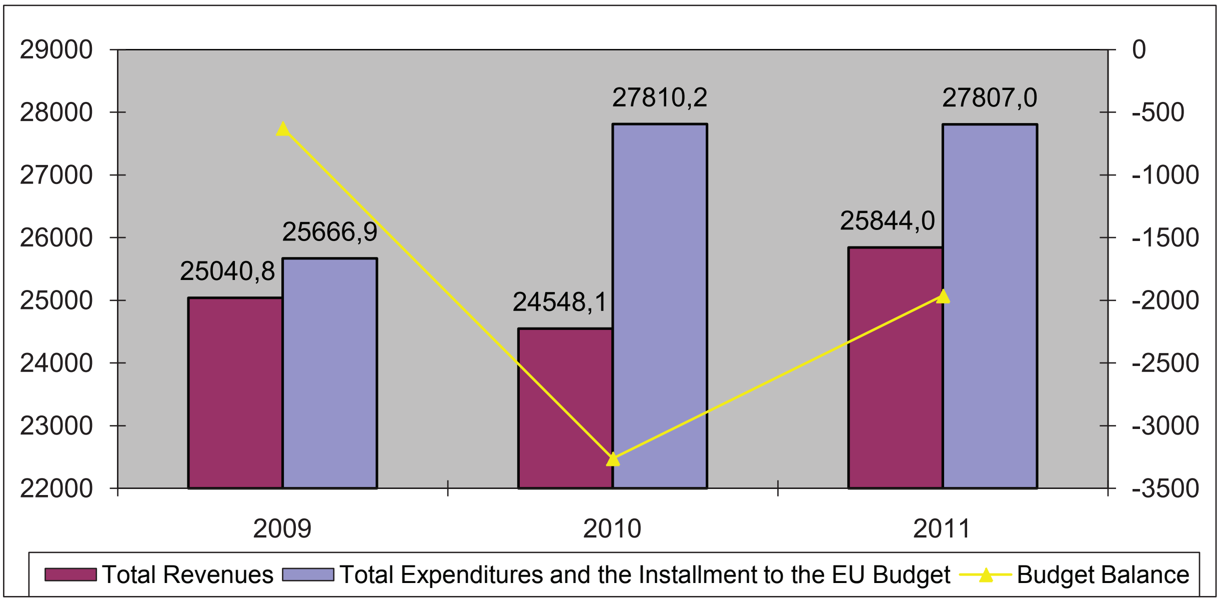
Macroeconomic framework	2009	2010 est.	2011 forecasts
GDP (million BGN)	**68,537.2**	**71,726.4**	**77,076.7**
Growth rate	-4.9%	0.7%	3.6%
CPI			
End of period	1.6%	4.5%	2.6%
Average for the period	2.5%	3.2%	3.7%
FDI (million EUR)	**3,281.9**	**1,500.0**	**1,980.0**
% of GDP	9.4%	4.1%	5.0%

Source: Ministry of Finance of the Republic of Bulgaria

Public expenditures are set to remain at their level of 2010 and below the threshold of 40% of GDP. Revenues are expected to have a nominal increase of BGN 1,295.9 million, while the share of public revenues to the GDP which are relocated via the National Budget is expected to decline by 0.8%. The forecasts of the Bulgarian Ministry of Finance are setting the budget deficit at a level of BGN 1,963 million or approximately 2.5% of the predicted GDP volume. In the amendment of the

Law for the National Budget 2010 it is planned to be -3.8% on annual basis and some forecasts are even giving figures of -4.0 to -4.2%. With the implementation of several additional measures the forecasts for 2011 are brighter. The IMF has the benchmark at -2.8% for the next year, the Bulgarian Ministry of Finance has even braver expectations to cut it to -2.2%.

Graph 7: Total revenues and expenditures in the national budget in the period 2009-2011

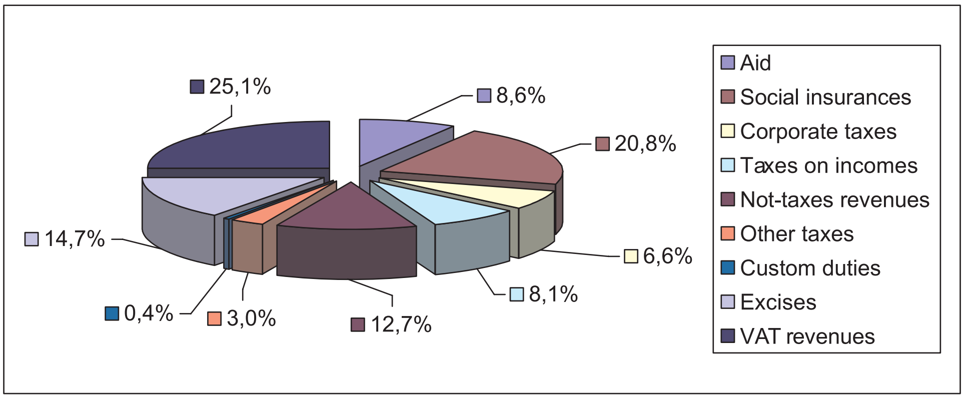


Source: Ministry of Finance of the Republic of Bulgaria

The forecasts show a nominal increase in the volume of revenues from corporate taxes, excises and VAT. The most considerable is expected to be the expansion of the VAT revenues (BGN 300-350 million) followed by an increase by BGN 250-300 million in revenues from corporate taxes. However, the drop of the proceeds from Social insurance is expected to prevail by approximately 20% the accumulated higher total revenues from the other sources. Very indicative for the fiscal framework for 2011 are the revenues from international aid and no-taxes incomes. These two items include the proceeds in the ministries and municipalities as well as the sources which are related with further expansion of the emission of new debt instruments. Additionally, the government will be able to take advantage of the fiscal reserve to finance short-term issues.

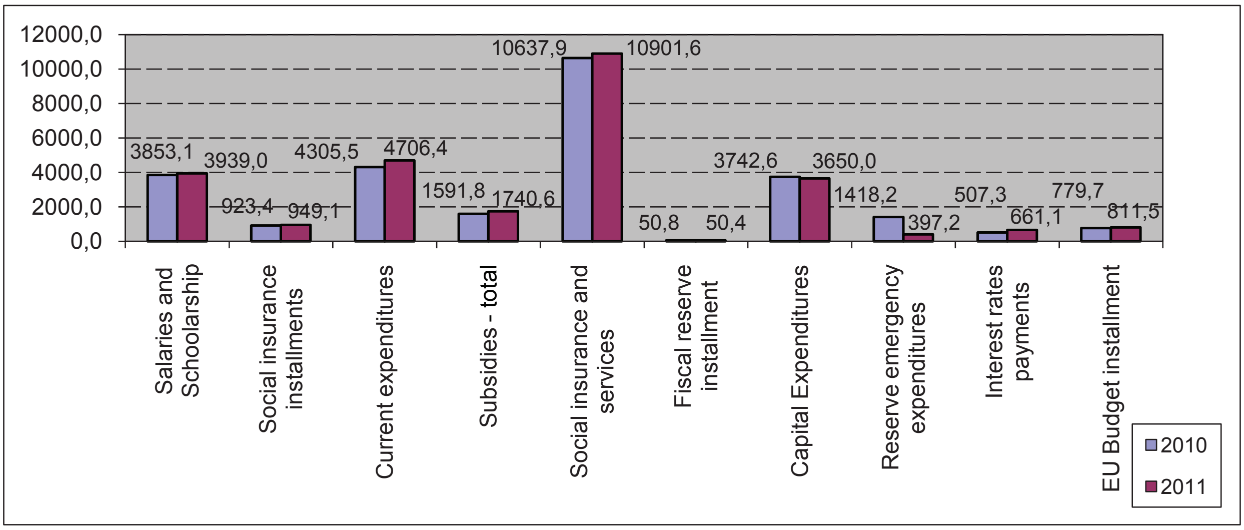
The total volume of public expenditures is expected to remain unchanged. However, some relocation between the different institutions will take please. The funds for capital expenditures will be further reduced in order to ensure free space in the public finance framework for current expenses throughout the year and especially for the estimated increase in social expenditures.

Graph 8: Expected structure of public revenues in 2011



Source: Ministry of Finance of the Republic of Bulgaria

Graph 9: Expected structure of the public expenditures in 2011



Source: Ministry of Finance of the Republic of Bulgaria

Taking these data as basis for calculating alternative models the following three scenarios will be discussed, all scenarios maintain the following general assumptions:

- Inflation rate: up to 4-5% (for 2011 and 2012)
- Freezing of salaries in the public sector and pensions
- Further reduction of the fiscal reserve, not to be contracted to beneath the threshold of BGN 3 million as this will threat the stable functioning of the currency board.
- Keeping the VAT rate, the corporative tax rate and the individual incomes tax rate unchanged.

The scenarios change specific assumptions on the growth of GDP and FDI, respectively as well as explicit changing factors. These assumptions lead in consequence to specific impacts on the budget balance.

First Scenario: Further Fall of the Domestic Consumption and Worsening of Social Indicators

Specific assumptions:

- GDP growth rate: 3-4% (for 2011 and 2012)
- FDI growth rate: up to 30% (for 2011 and 2012)

Changing factor:

- Household consumption: negative growth rate for third consecutive year

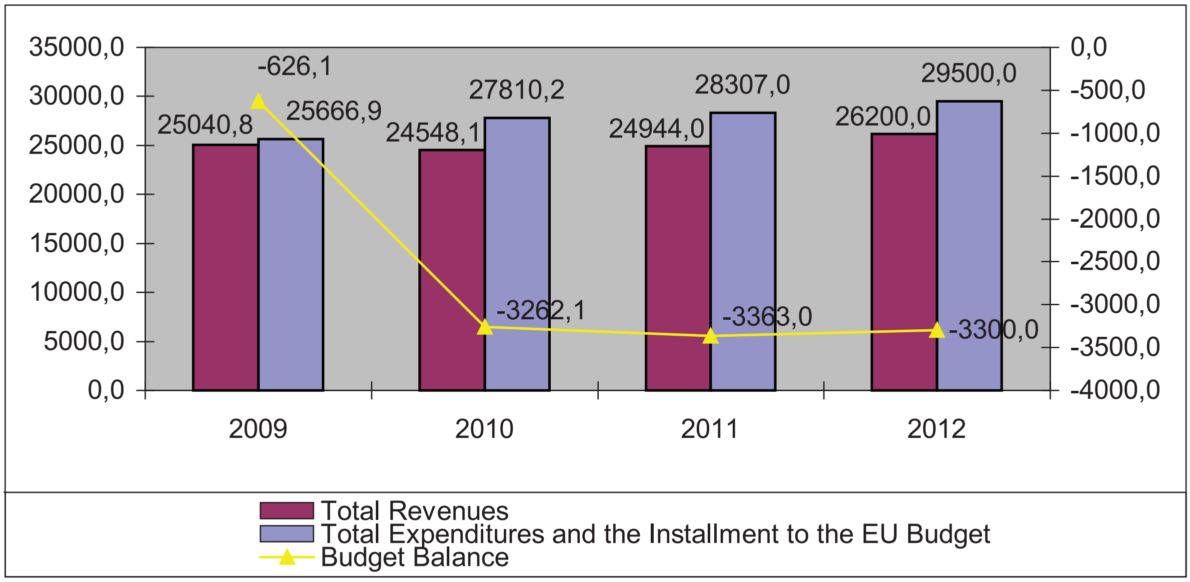
Impacts on the budget balance:

- Lower volume of the revenues: BGN 700-900 million (2011 in comparison with National Budget Program)
- Higher volume of the expenditures: BGN 500-800 million (2011 in comparison with National Budget Program)

In this scenario we assume that the decrease in revenues from indirect taxes such as VAT and excises will decrease even further in 2011 as well as the proceeds from income taxes since the perceived growth of the economy (3.0-4.0%) would not be able to compensate the increased unemployment and the declining of the average incomes level in the country in one year-term. First signs for a recovery of employment and the growth of the incomes level have a certain time lag after the returning of the whole economy to growth. This trend is visible in the division of average incomes of households in the first half of 2010. The share of incomes from salaries is decreasing as the shares of incomes from pensions and social insurance payments are increasing. For example the share of salaries drops from 52.8% to 50.3% in the second quarter of 2010 in comparison with same period of the previous year. Additionally, there is a decrease of approximately 1% in the total incomes level for one household. Thus it could be expected that domestic demand will be able to register recovery in the fourth quarter of 2011 at earliest and only if the national economy maintain the predicted growth rate of above 3%.

Furthermore since the mid of 2010 there is a certain decrease in the level of the average individual income which is used as a basis for the calculation of payments for social insurances. Of course, one could assume that the reason is a moderate increase of the employment rate due to seasonal factors predominantly for low-skilled labour which is usually registered at lower salaries. However, if this trend remains in the last quarter of 2010 along with again increasing unemployment it would be a reliable sign that in 2011 even lower revenues from social insurances instalments can be expected. The expectations for slower recovery of the employment rate and average income levels lead to the conclusion that after two years of such sharp downfall even an environment of economic growth between 3.0-4.0% would not lead to an increase of tax revenues of more than BGN 400-600 million. And the bulk of this increase would be accumulated from proceeds from corporate tax. Only if the export sector becomes the engine of the economic growth this might be a way to positively affect the volume of the revenues. On the other hand if the current framework of the government expenditures remains unreformed financial authorities would not be able to maintain their volume at the level of 2010. The pressure coming from the pension and health care systems will cause an increase of at least additional BGN 500 million in 2011 and additional BGN 1,200 million in 2012.

Graph 10: Total revenues and expenditures in the national budget in the period 2009-2012 (First Scenario)



Source: Economic Policy Institute

This scenario is based on the assumption that the growth of the economy at 3.0-4.0% for 2011 alone would not be able to restore domestic consumption and the volume of household incomes to levels that would generate substantial tax revenues. One should have in mind that the economic growth of the country in pre-crisis years was to a large extent fed by domestic demand along with a large volume of FDI. This functioning and organization of the Bulgarian economy is somehow programmed in it in short-term and it would take time to be set in a new direction. Furthermore, the pressure onto the social safety nets will remain high due to the lack of reforms in pension and health care systems and the ineffective way the funds are used. Having in mind these conclusions it could be expected that the budget deficit will increase in nominal terms in 2011 unless some radical reform measures are implemented. If these reforms are further postponed, the country deficit will become even more disturbing and cyclical in long-term.

Second Scenario: Moderate Increase of Exports and Moderate Growth

Specific assumptions:

- GDP growth rate: 0.5-3% (for 2011 and 2012)
- FDI growth rate: up to 10% (for 2011 and 2012)

Changing factor:

- Lower economic growth and lower increase of exports

Impacts on the Budget Balance:

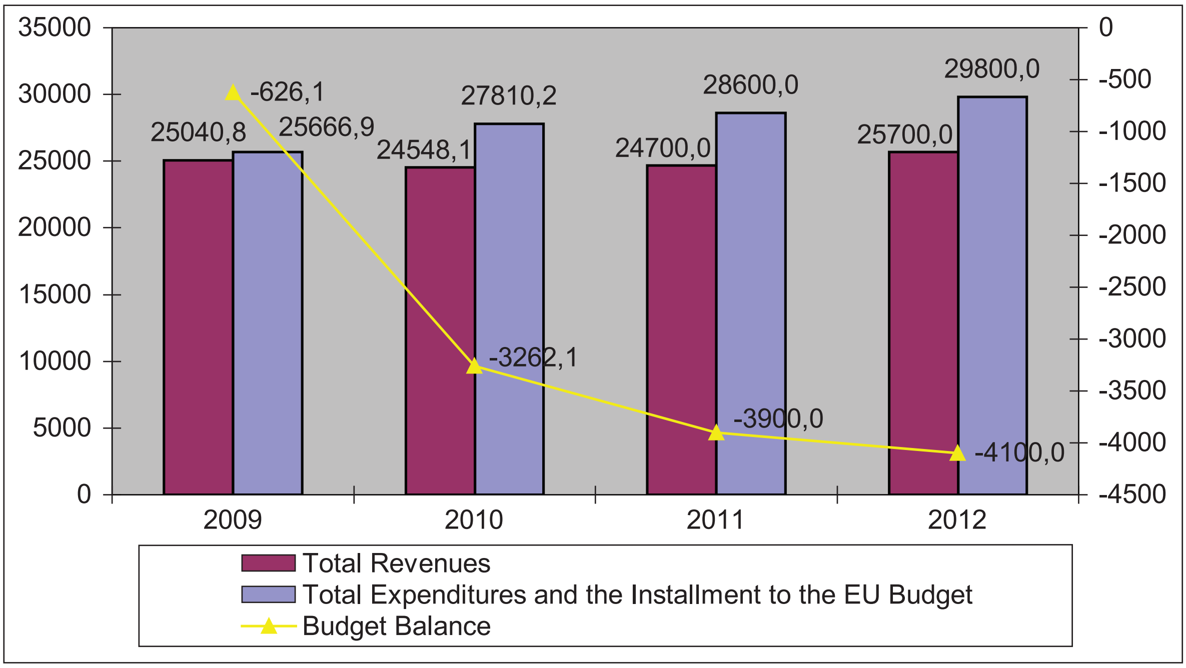
- Lower volume of the revenues: BGN 1100-1300 million (2011 in comparison with National Budget Program)
- Higher volume of the expenditures: BGN 800-1000 million (2011 in comparison with National Budget Program)

In this scenario the expected rapid growth of export is slowed down by companies in other client countries of our export partners which are also recovering from the crisis and gradually becoming more competitive. Thus Bulgarian companies will face strong competition abroad and at the same time will face low domestic demand. In this second scenario the household consumption growth rate would be negative for a third consecutive year. Only the revenues from corporate tax could be expected to show a moderate increase. As a result of low economic activity the unemployment rate would remain unchanged thus augmenting pressure on social safety nets. The government will need to register emissions of new external and internal debt in order to meet the need of additional funding. The majority of shares in government bonds issued in 2009 and in 2010 were with a maturity of two and a half years. This means that in each of the three scenarios one should have in mind also that the debt should be financed in the end of 2012 as well as in 2013.

A favourable fact is that since 2011 the share of national top-ups within the Common Agricultural Policy and more precisely Single Area Payment Scheme will begin to decrease according to the signed agreement for the Financial Framework 2007-2013 of the EU Budget. Gradually, this will free more public funds to be reallocated for other purposes. At the same time the volume of payments provided by the EU will increase by 10% until reaching the levels of member states representing EU15. It should also be emphasized that a large share of the national top-us is paid through funds available for the Rural Development Programme and not through the budget. The agricultural sector is still one of the considerable employers and if it is left without additional support as it is in other member states it will lose its price competitiveness especially to the products coming from neighbouring countries.

Although, the decrease of national top-ups will have a favourable effect on fiscal expenditures the negative impact of increasing payments through the social and pension system will lead to a fiscal deficit which will grow at least until 2012.

Graph 11: Total revenues and expenditures in the national budget in the period 2009-2012 (Second Scenario)



Source: Economic Policy Institute

Third Scenario: High Economic Growth and High FDI

Specific assumptions:

- GDP growth rate: 6-9% (for 2011 and 2012)
- FDI growth rate: up to 40% (for 2011 and 2012)

Changing factor:

- Higher economic growth and higher FDI inflows

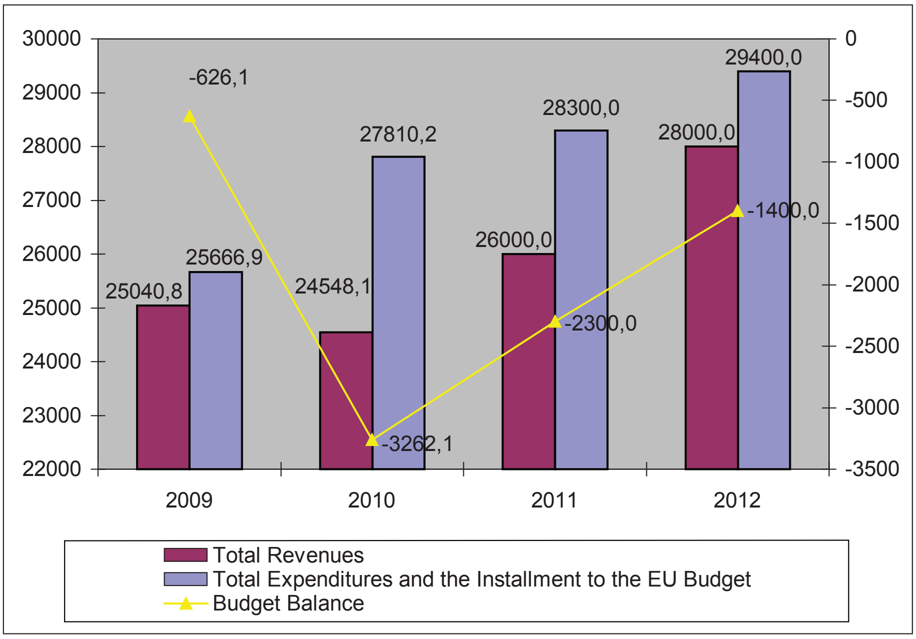
Impacts on the Budget Balance:

- Higher volume of the revenues: BGN 200-400 million (2011 in comparison with National Budget Program
- Higher volume of the expenditures: BGN 400-600 million (2011 in comparison with National Budget Program)

The third scenario assumes that the economic growth will be as in the pre-crisis period and FDI inflows will increase rapidly. No doubt, this return to the pre-crisis growth model is a very optimistic and hence quite unrealistic scenario. But it might as well suit the Bulgarian economy. It could be easily predicted that in years of higher economic growth it would be easier for the government to achieve a balanced or surplus budget but the needed radical reforms should not be neglected. Such high economic growth is very fragile especially for small economies and the government should try to avoid longer periods of structural deficits.

In this scenario we are observing a rapid decrease of the budget deficit in 2011 and 2012 but in longer term we will need higher and higher economic growth to compensate the shortages in the social, healthcare and pension systems. The decrease of the budget deficit in this scenario is ensured by higher tax revenues and lower expenditure for preventing unemployment or for the payment of unemployment benefits. However, the expenditures on pension system and healthcare services will further increase as the government would have larger fiscal space to finance discrepancies in these systems as was the case in the pre-crisis period.

Graph 12: Total revenues and expenditures in the national budget in the period 2009-2012 (Third Scenario)



Source: Economic Policy Institute

Conclusions and Reform Proposals

All the three scenarios above are elaborated in the absence of major reforms in the three most neuralgic fields, i.e. the healthcare, social and pension systems. Postponing the reforms in these three key spheres will prevent Bulgaria from having a balanced budget no matter what budget reductions are made. Even if the cuts are made for 2011 and we achieve budget balance with low or no deficit the problem will appear again in two or three years time and then further reductions would not be possible without ceasing basic state functions. Thus threats of running into a fiscal deficit for at least four or five years are absolutely real and on the political agenda. To prove this hypothesis all the three scenarios for the period 2011-2012 included setting a certain positive growth rate for the Bulgarian economy. But even in the third scenario, assuming higher economic growth it would only give more time for the government to implement the proposed reforms but not substitute them.

Even after the reforms are made Bulgaria would run into a fiscal deficit but depending on the accurateness of the reforms the period of maintaining the fiscal deficit could be reduced. On top of this, the emergence of a fiscal deficit in the case of small open economies as the Bulgarian one can be caused by external factors whose effects the government's fiscal policies could only mitigate but not eliminate.

Concrete reforms should include the following elements

Social Welfare

- Better targeting since very often people that are in real need remain aside or are not fully covered by government programmes. The control of the evaluation process of registered people with disabilities should be strengthened.
- Improving the quality of the social services and at the same time raising the effectiveness of the government programmes and policies. A clear example for social welfare systems that should be reformed are the government programmes towards orphan children. The existing system of permanent accommodation of the children in institutional buildings should be phased out. The children should remain closer to the community which will make their social inclusion easier.

Pension System

- Ensuring a more direct connection between the level of the individual incomes through the years and the pension volume. This will provide stimuli for the employees to insist with their employers on the registration of the full amount of their salaries.
- Reducing the possibilities for early retirement in some labour categories. However, these options should remain but on voluntary basis and not assured by the government system. Each employee should have clear information on the size of its pension during the years of his/her employment which would enable him/her to decided individually when to retire.

Healthcare Services

- There are needs to be a minimum of obligatory health insurance, guaranteed by the state budget, destined for the coverage of basic health services for all citizens. Introducing private health insurance funds also for the coverage of these general, public health services would increase efficiency of the service providers (hospitals doctors etc.). However, this step should be ensured by the state with the implementation of clear legislation which guarantees the equality and competitiveness among these funds. Additional private insurance for specific or better services should remain in the optional decision of each individual.

- Strict procedures of evaluation of hospitals and services they are providing. Bulgaria remains one of the countries with the largest number of hospital beds per capita of the population but at the same time has one of the lowest qualities in health care services in the region.
- Allowing for more public-private partnerships (PPP) in this field, including FDI; especially including external professional management of hospitals and clinics.

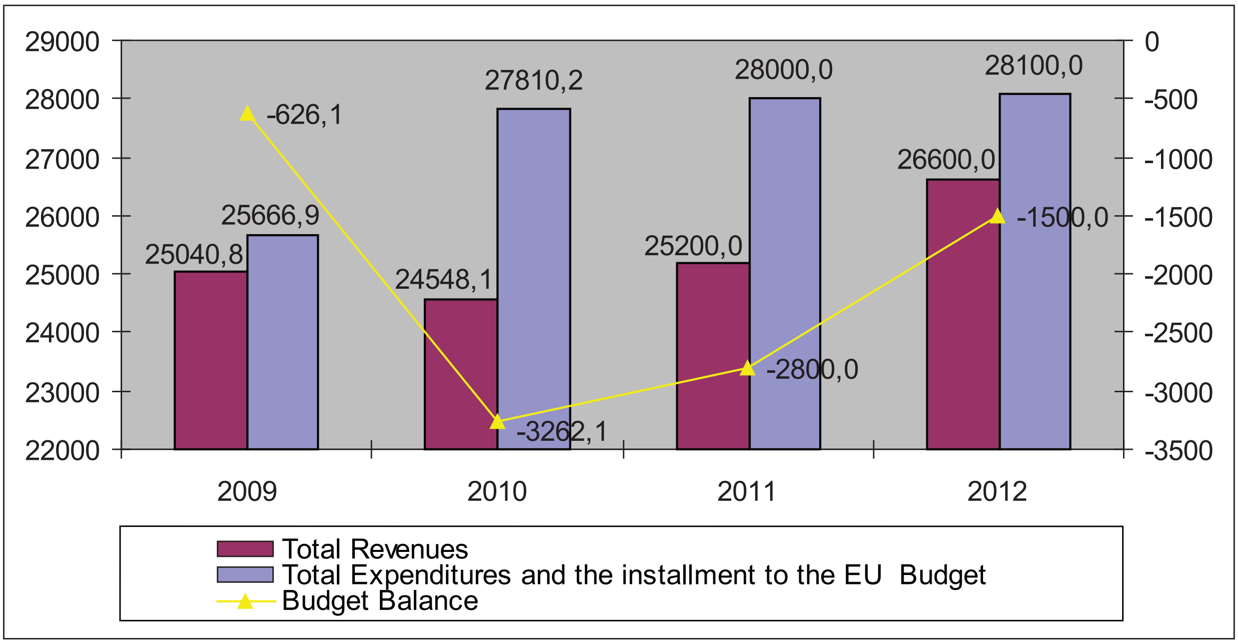
Reducing Grey Economy

- Implementation of a maximum threshold for payments that are made in cash both by individuals and legal entities.
- Increasing the control of the state authorities especially on the labour market.

The estimated impacts of the proposed reforms on the total public expenditures and revenues in the period 2011-2012 in accordance with the three scenarios implemented above would look like given in the following graphs.

- First scenario: Immediate slow decrease of the budget deficit in 2011

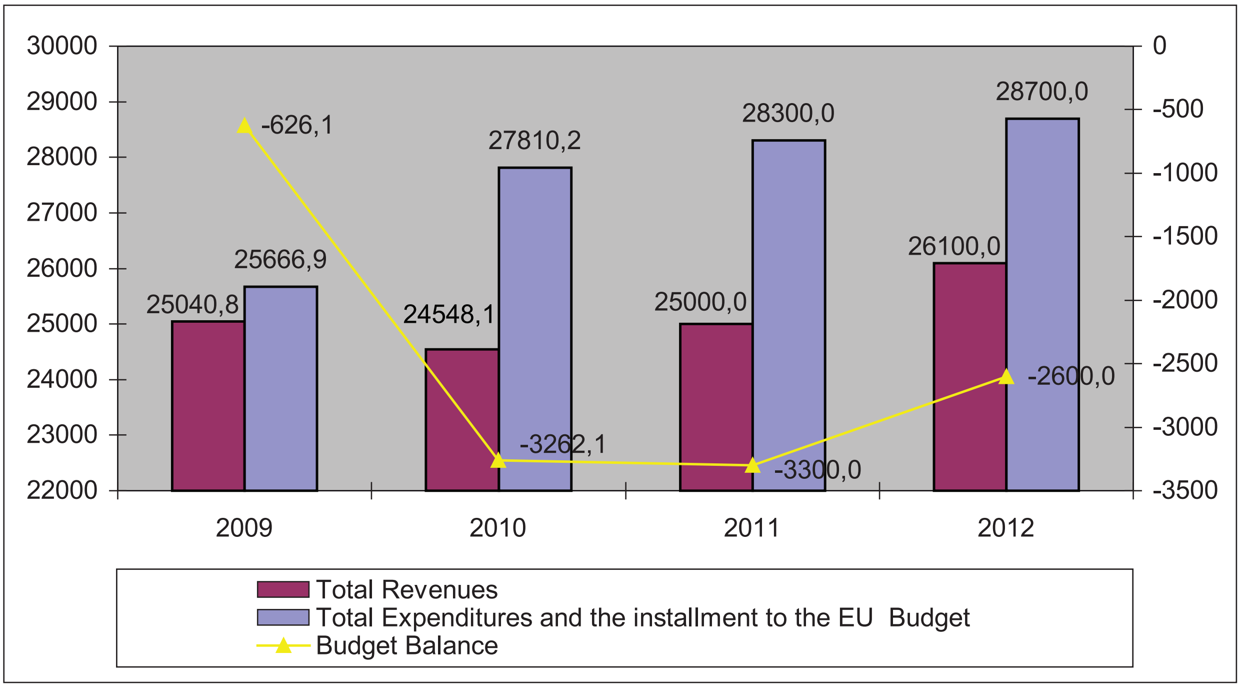
Graph 13: First Scenario after reforms



Source: Economic Policy Institute

- Second scenario: Overcoming the increase of the fiscal deficit, avoiding cyclical dimensions and slow decline in the next annual fiscal framework.

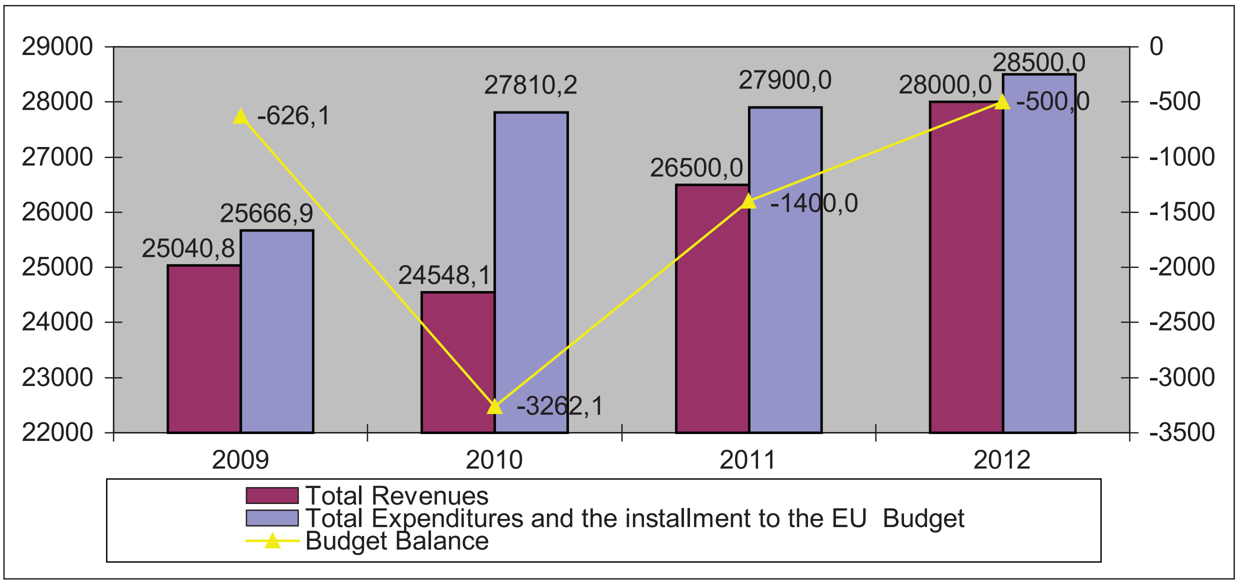
Graph 14: Second Scenario after reforms



Source: Economic Policy Institute

- Third scenario: Immediate rapid decrease of the fiscal deficit, economic growth, increase of tax revenues plus limitation of expenditures due to the implemented reforms.

Graph 15: Third Scenario after the Reforms



Source: Economic Policy Institute

General Comments of the Current Government Policies

Major reforms in the pension, social and healthcare systems are needed in order to avoid running into a fiscal deficit for a longer period and it is obvious that government authorities are acknowledging this necessity. However, these reforms keep being postponed as the fiscal policies in all CEE countries are primarily aimed at balancing the budget. But solving the fiscal dilemma in longer term requires radical reforms now. In order to avoid a Greek or Romanian scenario Bulgaria should start implementation of these reforms immediately. The priorities of the fiscal policies set in the framework of the National Budget for 2011 are raising some doubts that this will happened.

A promising tendency in the policy of the Bulgarian government in 2009 and 2010 is the commencement of some important infrastructural projects which will bring profits to the economy in the longer term. It is even more encouraging that these initiatives are financially supported through the programmes of the EU.

The eventual increase of the tourist tax rate up to 9% seems to be reasonable as this is the sector of the Bulgaria economy which has recovered most rapidly in 2010 after the downturn in 2009 and it is closer to the external demand more than any other. However, the real increase of the budget incomes from this tax for 2011 could be expected for the second quarter at earliest when the international tourist companies will sign the first contracts with the Bulgarian entities.

The increase of the fuels` excises was a measure well anticipated by the Bulgarian business as it had been planned for further in future but only pushed sooner. With no doubt it will cause moderate inflation but currently the real challenge is how to manage the fiscal deficit and how to decrease it.

Any overall increase of general tax rates should be avoided, especially an increase of the VAT rate should be laid last in the government's agenda as this would additionally reduce the individual consumption which is currently experiencing a considerable drawback due to the increasing unemployment rate and decreasing average level of incomes. However, introducing taxes or excises on luxury goods and properties and/or very high incomes would be socially acceptable and might generate additional revenues that could then be specifically destined to support reforms in the social policy area.

The most important point to be maintained in the policies implemented in 2011 is to generate an upward trend in the absorption of EU funds. Through some of the programmes funding for capital investments could be ensured which is one of the areas that are suffering the most from restrictive fiscal policy.

About the Author:
Kalin Marinov is an economist and presently Executive director of the Economic Policy Institute in Sofia. Holder of a Bachelor degree in Economics and Master degree in International Economic Relations with specialization on Project Management both obtained at the University of National and World Economy, Sofia.

Imprint
Friedrich Ebert Foundation
Office Bulgaria
P.O.Box 958
97, Knjaz Boris I St.
1000 Sofia
Bulgaria

Orders
Economic
Policy Institute
Kalin Marinov

e-mail: epi@epi-bg.org
Fax: (+359 2) 9520847

All texts are available online
www.fes.bg