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**ECONOMIC DEVELOPMENT AND
POLICIES IN BULGARIA:
EVALUATIONS AND
EXPECTATIONS**

Focus:

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Analysis and Evaluations”**

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MAIN CONCLUSIONS, MIDDLE-TERM DEVELOPMENT PERSPECTIVES, AND IMPACT POLICIES

Analysis of the economic development of Bulgaria in 2012 in the context of the carried out economic policy allows drawing of the following conclusions:

Conclusions

1. Economic environment in Bulgaria in 2012 is characterized by uncertainty and lack of clear priorities in the carried out economic policy. In 2012 there are no substantial changes in the policy. The latter continues to be rather passive towards what is happening in Europe and globally. 2012, as the previous two years, is a period of economic stagnation, and survival is the main task of most firms and households.
2. In 2012 economic growth substantially slows. Two counteracting factors contribute to this. First, the export, which has been practically the main engine of economic growth in Bulgaria in 2011, is not strong in this role in 2012. Second, while in 2011 the domestic demand in Bulgaria has remained suppressed in 2012 it shows visible signs of restoration by both components – end consumption and gross investments. These changes can be considered the first signs of real stabilization after the beginning of the economic crisis in 2009. If the domestic demand has also develops favorably, the end result concerning the economic growth for the last year could actually reach the growth, foreseen in Report 2012 (1.3%).
3. The government role for the economic development of the country in 2011 cannot be determined one-sidedly. In the whole mix of policies, measures, decisions and real actions, there has been some with strong positive impact, as well as others with arguable idea and end effect. The first group consists of all elements, contributed to the fast assimilation of the European fund.
4. It would be quite unreasonable if the government would emit a debt, which would be used for example to increase its consumption (more expenditures for state administration, including for salaries of employees) or for expenditures for pensions. Practice concerning such measures shows that since this type of expenditures are not flexible, in possible worsening of the economic environment they lead to a substantial damaging of the budget position as well due to inability the expenditures to be reduced in reasonable terms.
5. However, the total passiveness in 2012 concerning the reforming of key areas of the public policies – education, health care, pension system – can be determined as a certain disadvantage of the policy.
6. Since decades the goods structure of the export remains typical for a developing economy with predominant share of resources and materials (especially primary goods and metals), i.e. production with low degree of processing and respectively low share of added value. *In long-term plan such type of structure cannot generate a sustainable economic growth, since it is strongly dependable on the changes in the prices on the international markets, which have strong pro-cyclic character.* The shrunk markets and economic crisis in Europe have lead to some changes in the goods structure of the trade, which generally can be determined as positive, for instance the increasing share of the consumer goods in the export.
7. In the import the most substantial changes concern overcoming the tendency towards a drop of the share of investment goods. Most increased is the import of machines and spare parts for the equipment, but there is growth in the other two goods groups as well – electrical machines and transport means.
8. The changes in the dynamics of the payment balance in 2012 reflect slowing of the growth of the export and at the same time slow restoring of the domestic demand and growth of

the import. This has led to increase of the deficit on the annual trade balance, stronger in the first half of the year.

9. Worsened trade conditions since the beginning of 2012 has also contributed to expansion of the trade deficit. As a result in the first half of the year the current account reported deficit, while in the second half it had again a surplus. For the whole year the current account has remained in deficit with a realized surplus in 2011. The financial account has reported a surplus for 2012. Main contribution for this has the positive inflow of FDI and the emission on the international capital markets of the euro bonds with nominal value of 950 million euro.
10. In the first half of 2012 banks have continued to pay their foreign obligations and increase their foreign assets. In the second half the tendency towards decrease of the foreign liabilities has remained, while the foreign assets of the banks have shrunk.
11. The dynamics of the gross foreign debt has generally followed the model of economic development based on a strong dependency on foreign financing. Noticeable is the fast increase of crediting of domestic firm, which is over 40% of the total size of the foreign debt.
12. Tracing the dynamics of the foreign debt shows that the conditions of the foreign financing of the Bulgarian economy have slightly improved. The average weighted maturity on the debt of the country continues to increase, the share of the short-term debt in the total gross foreign debt remains low, and the interest percentages on new credits are lower.
13. The fiscal sector, a successful guarantee of the financial stability so far, suffers enormous pressure by the population (for increasing the salaries, pensions and benefits), as well as by the business (for reducing the tax-insurance burden and timely payments on programmes and state orders), as well as by the European Union (for meeting the contracts and maintaining financial stability). To a great extent the near future of the economy and society in Bulgaria depends on overcoming these multi-directional challenges.
14. The increased expenditures of the state since the end of 2009, as well as the followed expenditures for covering the budget deficits in 2010 and 2011, have effectively reduced the level of fiscal reserve. The latter decreases after the record 12 billion BGN (October 2008), and in 2011 is sustainably striving to the "sanitary" minimum of 4.5 billion BGN. Sometimes it partially goes under it, and sometimes it exceeds it (which serves as a temporary depot of a newly issued state debt).
15. The negative tendencies in the dynamics of the budget balance and the fiscal reserve, partially compensating the economic consequences of the financial crisis in Bulgaria, are accompanied by a tendency towards increase of the state debt.
16. Although its level is still far under the limit of 60% of GDP, the tendency is evaluated as unfavorable, since this obligation is not accompanied by clear GDP growth or by creating a structural and capital potential guaranteeing more significant growth in the future.
17. In the structure of the expenditures of the consolidated fiscal programme for 2011 outlined is their large share for social insurance and cares (43%), which has increased compared with the one in 2007 by the significant 8 percentage points. In 2012 these expenditures are higher than the ones for salaries in the state by more than 2 times, and exceed the expenditures for care by more than 2.5 times. Disturbing is the drop of the share of capital expenditures (-4 percentage points under its level in pre-crisis 2007). In 2012 they are only 13% of the total state expenditures.
18. Maintaining low level in 2012 of the share of subsidies (4%) and interests (2%) is a positive

fact.

19. In 2012 government contributes to the total state incomes by almost 65%, municipalities – only 6%, insurance – little less than 21%, EU – less than 9%.
20. In 2012 government realizes only 40% of the state expenditures, i.e. way under half, although it declares a national policy towards increasing the prosperity of the people.
21. In the structure of tax incomes in 2012 the share of indirect taxes (VAT and excises) is about 70%, while the income taxes (on incomes and profits) are about 24%. For the duties and all other taxes (including local taxes) remain 7%. This structure is considerably sustainable for the period after 2007.
22. The bank system maintains its stability; the capital base remains unchanged, and in the end of the year it is 9.15 billion BGN. The change of the capital adequacy is weak.
23. The main problem of the bank system in the country is the low norm of profitability. In 2012 it has decreased by 5.7%, despite the many actions undertaken to stabilize the reported result. While the banks have had the opportunities to compensate the lower incomes by respective corrections of the interest stakes on the attracted resource. The decreasing rate of new deposits however shows that this year it will not be possible.
24. At the same time the stronger competition between banks leads to decrease of the stakes on credits for attracting reliable clients. Banks are not inclined to compromise with the credit risk, and already for a third year most of them strengthen the standards for crediting and increase the requirements for reliability to the candidates for credits.
25. The profile of Bulgaria among the other EU-27 countries is of a country, which transferred the shock of the crisis on the labor market; and mostly as a shock on employment and in a much smaller degree as a shock on real labour incomes. Possible influence for this have had some government measures (minimal insurance thresholds), fixed exchange rate of BGN to EUR, low inflation in the country, as well as the fact that Bulgaria is late compared with EU-27 mostly concerning the level of payment and less concerning the level of employment and unemployment.
26. The unfavorable dynamics of the labor market and the increase of unemployment level have made the question of the necessary measures on the labor market especially current. The increase of the range of measures and programmes carried out by the Employment Agency (EA) is significant for a temporary decrease of the sharpness of the problem, but it would hardly have a significant long-term effect.
27. Municipalities are the most affected public institution in the period 2009-2012. Main reasons are economic crisis and the carried out state financial policy in this period.
28. Public institutions at central and local level did not read correctly the first signs of the crisis in 2008 and did not react adequately to the worsened economic environment.
29. In the system of local finances, the mechanism of distribution of state transfers places municipalities in uneven situation – some municipalities get privileges on the account of others.

Perspectives

1. Economic perspectives for the country for this and the next two years are **relatively unfavorable**. The reasons of external character come from the openness of the Bulgarian economy and the strong dependence on foreign demand and foreign financing. Having in

mind the European orientation of the foreign trade flows, the country can hardly depend on the export as a significant factor of growth, at least not as much as in 2010 and 2011. The foreign financing in the form of FDI is also far below the levels reached in the years before the global financial crisis. Having in mind both factors, it is easy to conclude that as far as there is any growth in the future, in short-term as well as middle-term plan it will remain low and unstable.

2. In best case (if the financial crisis does not get stronger) the growth of real GDP can increase at the end of 2013, and improve slightly in 2014. However, the restoration will be most probably delayed by the carried out in many branches restructuring of the balances and the unfavorable conditions of financing in many countries of the Eurozone. At the same time the restoration is expected to be supported by increase of demand in global scale and by favorable for the real incomes decrease of inflation of the prices of energy carriers and foods, as well as by the positive impact of the too low short-term interest rates and the measures for restoring the functioning of the financial system on the domestic demand.
3. We expect the rate of increase of the gross investments in the economy to delay substantially – mostly concerning change of reserves, while the rate of increase of investments in main capital is still expected to slightly increase (having in mind the low base and too small percentage of increase from the last year). The government (both the expert and possible future government) is not expected to make significant fiscal stimuli to the real economy, foreseen is the policy to limit in the frames of the approved Law on public finances, namely budget deficit to 2% of GDP. At the same time it is not expected to have a substantial change in the trust of the public towards the institutions, which in most general plan would not contribute to a change of the total sense of cautiousness and pessimism among the households and firms. The described developments are expected to have 0.6% increase of GDP in 2013.
4. The restoration of the domestic demand, which in the previous report was foreseen to happen in 2013, in forecast is delayed for 2014. In this year the export of goods and services is expected to accelerate its rate of increase to about 3%, and in 2015 – to about 7.5%. The foreseen percentages of increase of the consumption in the next two years are respectively 2.2 and 2.6%, and of investments – 5.3 and 6.5%. These positive changes of the components of domestic demand, and of the export, suggest also increase of import of goods and services – by 4.4% in 2014 and 6.7% in 2015. The foreseen rate of economic growth in 2014 is 2.1% and in 2015 – 2.9%.
5. Generally the expected dynamics of GDP in the three years of the forecast can be determined as considerably weak to average restoration. It suggests maintaining the model of growth, set in the years after the crisis – a model where macroeconomic balances (like considerably high inflation, high deficit on current account of the payment balance, etc.) have been gradually eliminated. In other words, in the frames of the forecast horizon a repetition of the increase from few years before the economic recession in the country is not foreseen in 2009.
6. Worth noting is that the forecast of the development of the Bulgarian economy till 2015 is established on the basis of the assumption that after the elections in May 2012 the Parliament will be able to elect a stable government, which will start an effective work on the problems. If such government cannot be elected, and there will be another row of Parliament elections in the year, there will be a negative pressure on the rate of economic growth in the current as well as possibly next year.
7. If the newly elected government, supported by the Parliament, takes a course towards more loose fiscal policy, consisting of higher budget deficits for stimulating the incomes, respectively more active emitting of public debt, in short-term plan it could give a certain push (limited in size) to the economic growth, and would change the context of the forecast. However, with such development of the policy in middle-term plan in the

Bulgarian economy there will be negatives, coming from the structure of the budget expenditures and debt burden, which would give erosion to the long-term growth potential.

8. In middle-term plan substantial changes in the structure of the gross foreign debt are not foreseen, neither concerning its term, nor concerning the institutional sectors. The decision of the government to emit new state debt, with which to cover the coming payment date of global bonds in the beginning of next year, will not influence the total size of the debt. The only unknown things for now are the characteristics of the new emission, which would directly influence the service.
9. The experience on the development of the Bulgarian economy in the last 15 years shows that the financial stability is necessary but not enough condition for achieving economic growth and prosperity for the people. The fact that the country has fallen in the speculative "balloon" of the global economy, led to financial crisis and painful economic consequences from it, does not mean that economic growth is achieved as easy as it looked so far, without undertaking difficult and purposeful structural reforms. The financial stability at notably low levels of income taxes is not the reason for poverty of people in Bulgaria, but the fact that the painfully achieved stability has not been followed by the mandatory structural reforms, which would create a favorable environment for business and life.
10. The demands for "dipping into the pocket" of the state in view of the poor Bulgarians are fair, but at the same time they are disastrous for the economy and society, because the fact that the "pocket" of the state has exhausted its potential. The comparisons with the far richer European countries are good for populist goals, but in essence they are not serious. In practice the fiscal sector is not on the first step of the Greek "escalator" leading to a system growth of the state debt.
11. At the end of 2012, after legalizing the tax on the interest for fixed deposits, many banks started offering attractive stakes on the products without a fixed maturity for providing opportunity to avoid taxing on this category for physical entities. In a situation of liquidity, the balances on the payment accounts remain at considerably constant level and the banks in practice receive a long-term resource. However, this will change with a future change of the attitudes of the depositors. For the depositors in different banks these attitudes can change after comparing their financial results. Totally for the depositors in the bank system the change will happen when the economy revives and the inclination towards consumption and investments is restored. Then the worsened maturity structure will force the banks to react with a visible increase of the interest stakes on the deposits and again will influence on their financial result. However, such situation can hardly be expected this year, since the foreseen rates of restoration are close to the reported ones in 2012.
12. In 2013 the employment will continue to decrease and the unemployment level will increase and vary at about 13%. The expected rate of the economy is not high enough to generate enough new working places, which would compensate the cut working places due to the continuing process of restructuring the economy. The high unemployment and weak activity on the labour market will be main factors to limit the rate of nominal wage in 2013, as well as in 2014. An additional factor in this direction will be also the expected low inflation.
13. In 2014 due to increasing the growth, we foresee the trend in the dynamics of the employment to break at last, and the unemployment level in the country will decrease at first minimal, and in 2015 more seriously. We suggest that in this and next year the funds on programmes for temporary and subsidized employment will increase, which would contribute to a certain easing of the unemployment problem. Still, we hope this increase of the range of the employment programmes to be temporary and the state to withdraw from its increased influence through them on the labour market; and a main factor determining its dynamics to be the restoration of the activity of the economic agents in the country.

Policy Recommendations

1. Counting the fact that for more than 15 years Bulgaria functions under Monetary Board, which stability requires a reasonable fiscal policy like limiting the budget deficits to the possible minimum in times of crisis and generating surpluses in times of growth, we can state that the conservative management of the budget incomes and expenditures and restraining from unnecessary indebteding of the country is a necessary condition for generating the entire macroeconomic stability. In this sense it is recommended the future governments to keep the line of behaviour followed more or less by all their predecessors since 1997. However, this by itself cannot lead to solving the problems of growth.
2. For achieving real effects from the budget policies, it is necessary to undertake a set of measures, directed towards a drastic increase of the effectiveness of the government expenditures, focusing mostly on the forgotten in the last few years introduction of the principles of programme budgeting – financing against achieving a concrete preliminary set results. This requires complete reforming of the state administration, including decreasing its number on the account of introducing the components of the electronic government, undertaking reforms in financing the education and health care, gradual solving the problems of the pension system (for example change in the schemes for early retirement so the pension will reflect more realistically the contribution of the person to the system).
3. Required is clear defining of the priorities of the country, respectively reform in the budget structure, i.e. redirecting more funds to these desired areas of impact (for example concerning forming special classes of human capital – specialists with engineer education, specialists in exact sciences, etc.) and the country gradually leaving activities, which do not generate enough added value to the society but only require financing (for example administrating the registration and licence regimes for certain activities can be transferred to the relevant branch and professional associations).
4. A key factor for restoring the growth is improving the productivity and competitiveness through introduction of modern technologies and innovations. Besides the traditional instruments (FDI, transfer of technologies and know-how), the state should play a decisive role in encouraging R&D activity. The final goal of such policy and ending the many years of practice of exporting labour-intensive goods with low degree of added value in favour of capital-intensive production, has a dominating share in the foreign trade of EU.
5. Softening and the followed overcoming the problem of low competitiveness of the Bulgarian products, especially the agricultural ones. Achieving this goal requires gradual but sustainable increase of the assimilated funds from the European funds and applying a purposeful policy of developing the rural areas.
6. Easing the access of the Bulgarian firms to the common EU market through increased participation in the system of mutual recognition of the certificates and certifying procedures. This will reduce significantly the expenditures on the export, especially in the branches of milk processing, meat producing and meat processing industry, which have acknowledged huge potential.
7. Identifying the firms with potential for entering and competitive behaviour on the common European market. These firms should be supported with purposeful programmes and projects, including establishing partnerships with leading foreign firms.
8. Encouraging the use of tools for public-private partnership when realizing projects financed by EU funds.
9. Stimulating initiatives and proactive behaviour of the Bulgarian firms for finding suitable contractors, their inclusion in highly technological chains and in establishing and functioning of industrial clusters and entrepreneurship networks.

10. In short-term plan the fiscal policy needs a firm keeping of the course for maintaining the fiscal stability of the state.
11. European funds and programmes give a chance for creating a potential for economic growth, maintaining the balances in the public finances. Although their significant assimilation needs a joint political will and mobilization of the general administrative capacity of the state, the fiscal policy should more effectively and actively coordinate, direct and control this process. A significant experience in their assimilation is already accumulated. The declarations and successes in negotiations should be replaced by their real assimilation.
12. An unpopular reform of the system of social insurance and cares should be carried out, as well as limiting its deficits. This will free resources for implementing structural reforms by the government.
13. The financing of the municipal sector should be reconsidered and strengthened with more solid own sources, respectively reducing the financial engagement of the government to it. For the depth of this process much needed is a national consensus, which should be sustainable in a long-term perspective.
14. A real political will should be mobilized for implementing an uncompromising policy for increasing the tax collecting in order to include all liable by them people in carrying their burden.
15. Structure and economic effects of the income taxes should improve with keeping their sizes and incomes for stimulating the real investments and business.
16. There should be a mobilization of a political will for continuing the reform in the state administration, including ending the political assignments, for achieving lower costs and increasing its effectiveness.
17. Introducing a progressive income tax with not taxed minimum around the minimum wage (MW); maintaining the current level of taxing for a large category of employed people, determined on the basis of data from National Income Agency (NIA) about the declared incomes; introducing one (minimum two) additional income nests, which would concern incomes exceeding the lower limit of the last decil. In other words, the introduced higher tax stake will concern incomes exceeding the limit formed by not more than 10% of the employed people.
18. It is important that in the next years a study of the opportunities for introducing a family income taxing should start, as well as the conditions for its application.
19. Developing rules (methods) for actualization of MW.
20. Improving the work of the legal system concerning all systems in it. "Supremacy of the law" in highest possible degree.
21. For a stable decrease of unemployment and creation of new stable working places, there should be created favourable conditions for running a business and encouraging the investment activity. This concerns the constantly repeated necessity of improving the business climate in the country, simplifying the administrative procedures, optimizing the number and content of permit and registration regimes in the country, introducing electronic government.
22. Very important for improving the functioning of the labour market is the measure, which comes from the range of the economic policy, and concerns the functioning of the whole society – ensuring an effective functioning legal system. The supremacy of the law and the

effective administration are one of the main comparative advantages of each society that wishes to attract foreign investors, as well as to encourage the domestic investment effectiveness.

23. Our suggestions for changes in the financial relations of the state with the municipalities envision the necessity to improve the system of local finances. This means not to allow balancing of the state budget on account of the municipal budgets. The latter are part of the public finances of the country and transferring the problems from central to local level does not mean they are solved.
24. The state should adopt and implement a programme of decentralization. It should have concrete goals for achieving, which bring Bulgaria to the average EU level by the following macro indicators: share of municipal incomes in GDP; share of municipal expenditures in the expenditures in the Consolidated Fiscal Programme (CFP); share of municipal investments in the public investments; share of tax incomes in the municipal budgets in all tax incomes in the public sector; share of own incomes in all incomes of the municipal budgets; share of municipal investments in all expenditures of the municipal budgets.
25. To present new sources of own incomes, which should decrease the dependency of the municipalities on the state financial support. In this case suitable are the taxes from incomes of physical entities (through redistribution of the amounts in favour of the municipalities) and from land ownership through introducing a tax on the agricultural land and forests.
26. The state should create financial mechanisms for compensation of those municipal incomes that are reduced as a result of factors outside the municipalities.
27. To regulate in a sustainable legislation the size and way of distribution of the state transfers; to stop the unregulated "giving away" of municipal funds.
28. The size of concessions should be added to the local taxes in determining the subsidy.