

MOTIVES

to the Bill amending the 2014 Law on the State Budget of the Republic of Bulgaria

The need to draft a Bill amending the 2014 Law on the State Budget of the Republic of Bulgaria (the "Bill") arises from the impossibility the fiscal targets provided for in the 2014 State Budget to be achieved. The reasons behind this are, on the one hand, considerable digression from the assumptions for key indicators in the macro framework and the overestimated forecasts of the revenues in the state budget, and on the other, the need to provide additional expenditure in certain budget systems.

An update of the macroeconomic forecasts has been made in September that reflects the current developments in the national economy and the changed assumptions for the international environment by the end of 2014 and in 2015.

The started in 2013 drop in international non-energy raw material prices continues in the current year. Further factor restricting nominal growth not only in Bulgaria was the stronger than expected rise of the Euro to the US Dollar. Inflation in the EU is at historically low levels, the trend being this to continue longer than expected a year before. The updated forecasts for Bulgaria envisage negative consumer price inflation of 1.1%, while in the previous forecast the figure is positive – 1.8%. The GDP deflator is also forecasted to be negative – 0.1% (the previous forecast was a positive figure – 1.5%), reflecting the changed inflation forecast. The political uncertainty in Bulgaria and the following resignation of the previous government, as well as the calling of early elections at the beginning of October caused the economic expectations of businesses and households to worsen which had given grounds to revise the economic growth forecast for 2014 downward. **The revised 2014 forecasts envisage a real GDP growth of around 1.5% year on year**, which is a slightly more pessimistic scenario compared to the one provided for in the macro framework to the 2014 budget – 1.8%.

➤ *Underperformance of state budget revenues*

The analysis of the fulfilment of the revenue parameters shows a serious underperformance on an annual basis compared to the ones planned in the 2014 State Budget Law. The reasons behind the non-fulfilment of revenues are complex – macroeconomic, administrative, regulatory, etc. The forecast for the economic situation is overestimated and the impact of a number of unfavourable

external factors is underestimated. Unrealistic assumptions for key macroeconomic indicators at the planning stage, the yet weak influence of domestic demand recovery on indirect tax revenues, intensification of the deflationary processes in the economy, overestimated effects of the measures to improve revenue collection, etc. can be pointed out among the main factors.

Despite the slight change in the growth forecast for 2014 the updated macroeconomic forecasts revise **the nominal GDP figure for 2014 downward by more than BGN 2.4 billion** (from BGN 81,582 million to BGN 79,178 million). Other things being equal, the lower nominal GDP means lowering the forecast for the economy's ability to generate higher tax revenues. This relates to risks for budget revenue performance not only in 2014, but also in the medium term and requires a conservative approach to revenue planning in the national budget.

The estimates made for the state budget revenue parameters reflect the net effects in tax and non-tax revenues of the forecasted non-fulfilment, exceeding of the plan respectively, in respect of some indicators, and assessment of the effects of the measures to improve revenue collection. The key taxes where the forecast is for lower than the planned in the 2014 State Budget Law revenues are VAT on imports, excise duties, corporation taxes, etc.

Reported data as of the end of August show serious slowdown of revenues from VAT on imports that form a substantial part of tax revenues in the budget.

The revenues from VAT on imports for the first eight months of the year amount to BGN 2,389.3 million; compared to the same period of last year a drop by BGN 107.7 million (4,3%) is reported. Compared to the annual plan, revenues from VAT on imports constitute only 54.8%. The main factors having a negative impact on the revenues from VAT on imports are:

- drop in imports from third countries (according to the most recent NSI data for the first seven months of 2014 this drop is 6.4%);
- decline of the stock-market prices (in US Dollars) of raw materials which constitute the main part of the imports from third countries; aluminium (-3,9%), iron (-21,0%), copper (-6,3%), lead (-1,3%). The effect of the lower prices of this group of commodities in nominal terms is almost BGN 33.0 million less revenues from VAT on imports; the increase of quantities not compensating this decline;
- consistently decreasing imports of crude oil, the effect on the revenues from VAT on imports being by BGN 173.9 million less revenues compared to January—August 2013.

- growing intra-Community acquisition of goods (according to NSI data the growth is 2.3% for the period January-July). Part of the economic operators redirects their imports from third countries to intra-Community acquisition of goods.

The estimates of the expected proceeds of VAT on imports in 2014 show a non-performance of the estimates under the 2014 State Budget Law by around BGN 670 million.

Apart from the revenues from VAT on imports, there will be a significant lagging behind of revenues from excise duties. Excise duty revenues in the first eight months of 2014 amount to BGN 2,569.7 million, or 58.7 % of those planned for 2014 under the State Budget Law. Compared to the same period of 2013, excise duty revenues are by BGN 20.0 million less. Apart from the overestimated forecasts at the stage of budget planning, the analysis shows that a number of regressive legislative amendments have been made in the last year that result in a deterioration of the control functions of the Customs Agency, i.e. repeal of the requirement for mandatory mounting of measuring equipment in the manufacturing of and trading in excisable goods, which enormously impedes the control of these goods of high fiscal risk. In order to strengthen the control functions, it is planned to propose the relevant legislative amendments to regulate the process, and, in the short run by the end of the year, to strengthen the physical control along the entire chain of manufacturers and/or importers of excisable goods, warehouses of excisable goods, transport and trading in goods of high fiscal risk. Another factor that exerts negative influence on the excise duty proceeds in 2014 is the possibility for refunding of the excise duty on fuels used by farmers through vouchers, with the budget loss estimated at around BGN 50 million. The estimates show a non-performance of the excise duty revenues from the annual estimates for 2014 by around BGN 318 million.

There is also an overestimation of the corporate tax proceeds. The 2014 State Budget Law sets a growth of 2% of the corporate tax declared for the year whereas, based on the returns filed, the declared tax has decreased by 3.4 per cent. The forecasts show that corporate tax revenues will remain by around BGN 79 million less than the plan year-on-year.

The estimates of the 2014 state budget revenue plan a underperformance of revenue of BGN 1,061.8 million (1.3 % of the estimated GDP) for the whole year, reflecting the anticipated effects of the measures taken to increase revenue collection by the end of the year.

➤ *Pressure of expenditures in a number of budget systems*

One of the first steps of the Caretaker Government was to appoint a parallel comprehensive audit by teams of the Public Financial Inspection Agency and by the internal audit units of the ministries to find out the real status of budget execution in the relevant budget systems, to assess the expenditure obligations by the end of the year, the commitments taken, including the arrears, and to identify the budget risks. Based on the audits made and on the summary report, some problems have been identified showing a shortage of financing of expenditure commitments already taken in a number of budget spending units. Some of the budget systems are put in a situation where they cannot perform their functions and responsibilities after their expenditure ceilings for the last four months of the year were reduced. The Ministry of the Interior, for instance, where over 80 per cent of the expenditure is formed by staff costs, faces the impossibility to secure the performance of its vested functions and responsibilities with the year budget. The problem within this ministry is further aggravated by the amendments to the Ministry of Interior Law which plan an increase in the costs for remuneration and social security of staff as from 01.07.2014. The resources needed for this purpose, however, have not been planned in the budget of the ministry for 2014.

A shortage in the financing of social payments under the budget of the Ministry of Labour and Social Policy is also expected due to the increased number of beneficiaries in the provision of social protection for the most vulnerable groups of the population as well as to ensure support to children and family.

The Ministry of Health experiences difficulties to secure the requisite financing of psychiatric hospitals, kidney dialysis, treatment of HIV/AIDS, emergency care financing as well as the financial assistance to hospitals in remote or inaccessible areas where the lack of health units poses a serious threat on the population.

The budget of Agriculture State Fund also shows a shortage of funds for the national animal co-payments to farmers due to imbalance payment of subsidies in the agriculture for this year.

There is a shortage of funds in the budget of the Ministry of Regional Development for winter maintenance of the republican road network, as well as for expropriation of property and payment of activities under priority infrastructure projects.

There are no funds planned in the budget of the Ministry of Transport and Information Technologies for the payment of amounts due under the construction contract under the project "Construction of a new combined (road and railway) border bridge on the Danube River between Bulgaria and Romania at Vidin-Kalafat".

There will also be a shortage in the expenditures for overcoming the disaster consequences, etc.

In order to secure the expenditure commitments taken in the estimates under the Law amending the State Budget of the Republic of Bulgaria Law for 2014, resources for structural and additional fiscal measures of **BGN 448.5 million (0.6 % of the estimated GDP)** are planned in the contingency reserve.

In the context of the Bill amending the State Budget of the Republic of Bulgaria Law for 2014, *the state budget balance is planned to deteriorate by BGN 1,510.3 million (1.9 % of the estimated GDP) against the estimates under the State Budget Law for 2014, which results in a state budget deficit for 2014 of BGN 2,846.5 million (3.6 % of the planned GDP).*

An in-depth review has been made of the implementation of the Growth and Sustainable Regional Development Public Investment Programme so as to seek possibilities for targeted savings in expenditures. Based on this review of project implementation, Council of Ministers' Decree No 288 of 2014 suspends the financing of projects whereunder there are no contracts signed with contractors as of 17 September 2014. The effects expected from this measure in the months remaining by the end of the year is to make *savings in the state budget totalling BGN 130 million (0.2% of the planned GDP), which are expected to improve the budget balance in the course of the implementation.*

In addition to the state budget, there are some serious tensions in other budget systems, which further deteriorate the forecast of the CFP deficit for 2014. Budget balance deterioration against the parameters set in the State Budget Law for 2014 is expected mostly in the accounts for EU funds of the National Fund and the NHIF budget. The problems identified in these budget systems may be summarised as follows:

➤ *Shortage of financing for expenditures under EU Programmes and Funds and potential risks of losing funds*

The major problem was the suspension of payments under the temporarily frozen Operational Programme “Environment” and subsequently under two axes of Operational Programme “Regional Development”. On the one hand, the suspension of the payments under these Programmes had a negative effect on the economic environment throughout the “contractors – suppliers – subcontractors” chain which multiplied many times in the economic cycle. On the other hand, with the entering of the implementation of the projects into their final stage the risk of losing EU funding is extremely high. The artificial containment of expenditures has led to underestimation of the actual budget deficit until the end of July.

In this connection active actions have been taken to restore the payments to beneficiaries and contractors under the Operational Programmes for which the reimbursement of certified expenditures was suspended by the European Commission, with the purpose being to make maximum efforts after payments' unfreezing the funds to be reimbursed by the end of 2014. Considering these assumptions we expect a higher than planned deficit under the National Fund's account for EU funds to the amount of around BGN 200 million (0.3 % of forecasted GDP).

It should be born in mind that there is a certain risk of delayed reimbursement of funds in the course of 2014, which may lead to an increase in the deficit under CFP. There is a risk of higher deficit also for the accounts for EU funds of beneficiaries which are budget organizations due to projects' entering into an advanced stage.

➤ **Shortage of financing for health insurance payments under NHIF's budget**

As back as at the beginning of 2014 there was a considerable imbalance of the reported expenditures for medical activities compared to the ones planned in the NHIFBL for 2014. No timely actions have been taken for fulfilment of the envisaged measures for strengthening of the system, which were to ensure better control on the expenditures and the management of the financial resources, and as a result the pressure on the NHIF's budget continued to deepen. The deficit refers to the expenditures for activities in the part of hospital care, medicinal products for outpatient treatment and dietary foods for special medical purposes, medicinal products and drug treatment for malignant diseases. The shortage of financing for health insurance payments under the NHIF's budget for 2014 is grave and according to estimates of the Supervisory Board of NHIF from July 2014 the additional deficit in the system amounted to around BGN 400 million. The amendments to the NHIFBL for 2014 adopted by the 42nd National Assembly ensured only partial resources to the amount of BGN 225 million.

The prepared second update of the NHIFBL for 2014 provides for approval of additional expenditures for health insurance payments in the amount of BGN 100 million (0,1% of forecasted GDP). The additional financing of the remaining part of the shortage may be at the expense of the expected overperformance of revenues under the budget of NHIF.

Based on the above and taking into account the effects of the taken revenue measures as well as the expected effects of the expenditure savings by the end of the year the expectations are for a ***deterioration of the annual forecast for the deficit on a cash basis under CFP to 4,0% of the forecasted GDP (BGN***

3 152,3 million). Additional debt financing is also needed for the financing of the emerging higher deficit. Based on these estimates, the deficit of the “general government” sector assessed under the methodology of the European System of National and Regional Accounts in the Community is estimated at around 3,6% of the forecasted GDP for 2014.

In the context of the proposed increase in the deficit and the provision of a reliable cushion for liquidity support there is a necessity of assuming new government debt, respectively of changing the envisaged debt caps for 2014 which are to allow securing additional debt financing of up to BGN 4.5 billion in the course of the year. The envisaged new debt includes the possibility of debt financing in view to providing liquidity support in the framework of the state aid approved by the European Commission to the amount of up to BGN 2.9 billion or assuming, within the same limits, new government debt to extend a loan to the Bulgarian Deposit Insurance Fund to the amount of BGN 700 million. These circumstances require an increase in the maximum permissible amount of government debt at the end of the year up to BGN 22.5 billion (28.4% of the forecasted GDP).

The maximum amount of the new government guarantees that may be issued in the course of the year has been increased by BGN 2.0 billion in connection with the envisaged possibility of issuing government guarantees in favour of the Bulgarian Deposit Insurance Fund.

It is evident from the above that the budgetary stance for 2014 cannot be stabilized in the short run with the revenue and expenditure measures because the possible corrective actions can meet only partially the negative effects on the budget balance from the revenue underperformance and the unsecured expenditure commitments for 2014. In the medium run we need a strategy for consistent fiscal consolidation.

PRIME MINISTER:

/GEORGI BLIZNASHKI/