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Advantages and Disadvantages of Fiscal Discipline in Bulgaria in Times of Crisis

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The global economic crisis of 2008 has posed serious challenges to the Bulgarian economy and was reflected in worsened macroeconomic indicators. The subsequent sovereign debt crisis in Europe further aggravated the situation and blocked its path to recovery. In line with the overall sentiment in the European Union (the EU), Bulgaria made maintaining fiscal stability a priority that it set out to accomplish by following a policy of austerity. The country managed to achieve the desired effect relatively quickly. It became one of the best performers in terms of budget deficit and government debt as a share of GDP (which are among the lowest in the EU). These accomplishments underlie international institutions’ greater confidence in Bulgaria, which has led to an increase in its credit rating. Nevertheless, the state has not managed to reap the maximum benefits that this type of policy offers. Fiscal sustainability was accomplished at the expense of economic growth, the slow pace of which was accompanied by impoverishment of the population, high unemployment, restricted consumption, and operational difficulties faced by real-sector companies. These problems fueled doubts about the adequacy of strict budget discipline, especially in times of crisis. They provoked the author to examine in greater depth the benefits and the drawbacks that such a policy ultimately offers to Bulgaria. The results show that the strict fiscal measures have put additional pressure on the already fragile economic growth and have a high social cost as well. All this justifies the need for the government to take on a new course to achieve economic recovery by means of more active state support that would stimulate a pickup in consumption and production activity.

Introduction

The public debt crisis and the deterioration in the budget deficits of some EU Member States in 2010, especially in the Eurozone, have made the issue of fiscal stability extremely relevant. As a part of the EU, Bulgaria has not been immune. The country chose to follow the austerity policy advocated by the EU to maintain fiscal stability, which is considered the foundation on which a predictable economic environment is created.

The author has decided to examine this subject matter due to the controversial effects of fiscal consolidation and the fact that this topic is not widely covered in Bulgarian economic literature. The aim is to study the positive and negative implications of restrictive policy for the country not only from an economic perspective, but also in a social context. This is performed to assess whether the implementation of such a policy is justified and supports
economic development in the current situation in Bulgaria.

Background to the Problem

The global economic turmoil of 2008 inflicted severe damage on economic development in the EU. The significant decline in production and investment activity, as well as the mounting unemployment, gave rise to the need for more government support. Many Member States have turned away from the principles of neoliberalism and shifted towards active government intervention to cope with economic difficulties. According to Razin (2012), the initial response of strong Eurozone members was to treat the disorder as a liquidity problem occasioned by the shock of the American financial crisis. The expansionary fiscal policy, however, worsened the high budget deficits and public debts that most European economies maintained before 2008. Thus, in 2010 the EU entered into a debt crisis that forced Member States to once again take decisive action. This time around, stimulus was replaced by the adoption of numerous fiscal limitations to rein in high debt. Their effect was different from what was expected – the European economy slowed down substantially until it fell back into recession at the beginning of 2013. Fiscal consolidation contributed to the rise in unemployment, income inequality, poverty, and social isolation, which were more pronounced in some Member States. These problems raised the question whether austerity policies were adequate and appropriate in the current economic environment. Even the International Monetary Fund, an advocate of such restrictive policy, admitted that its implementation is not always efficient. In its report ‘Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement’ (International Monetary Fund [IMF], 2013), the IMF states that spending cuts imposed by Greece have deepened the crisis.

The openness of the Bulgarian economy has undoubtedly created favorable conditions for a spillover of the external economic shocks of 2008 that turned the country into a real victim of the global economic crisis. The ensuing sovereign debt crisis in the EU put additional pressure on economic development and impacted the decision of governments to embrace austerity. Bulgaria has always considered maintaining a balanced budget a priority, as evident from the surplus that it consistently registered (usually over 1% of GDP). The country is among the best performers in the EU by fiscal stability indicators, ranking at the highest positions along with the Scandinavian countries, Estonia, Luxembourg, and Sweden. However, the global economic turmoil inevitably had a negative influence on this trend and logically led to deterioration in Bulgaria’s fiscal stance.

The Road to Strict Fiscal Discipline

The recession of 2009 put a heavy burden on Bulgaria’s budget balance. The surplus, which was 1.7% of GDP in 2008, turned into a deficit of as much as 4.3% of GDP. This deterioration was caused mainly by the dynamics of budget revenue, which fell by 8.7%. Total proceeds from taxes and social contributions contracted by 11.1%, with VAT receipts shrinking the most (by 18.3%). The unfavorable international market environment, the dire straits of Bulgarian companies, the decreasing purchasing power of the population, and restricted consumption have resulted in a drastic downturn in import volume, which in turn, triggered a fall in VAT revenue. The recession in Bulgaria was the reason behind the deterioration in the financial state of enterprises operating in the country, which is also obvious in the drop in the money collected from taxes on the income or profits of corporations in 2009 (by 20.7%) that continued at the same pace in the next year as well (20.5%). In addition to shrinking revenue, public expenditure also slowed down considerably (to 6.4%) compared with the prior two years (it grew by 32.5% in 2007 and 12.8% in 2008).

In 2009 the level of Bulgaria’s budget deficit as a percentage of GDP seemed relatively good compared with the other EU countries (in some of them it reached double-digit values). Nevertheless, the pace of its deterioration (by 6.0 percentage points), which was faster than in Greece (by 5.8 percentage points – from -9.8% to -15.6% of GDP), was a cause for worry. This situation certainly called for preventive measures against further widening of the negative budget balance of the country and justified the adoption of a fiscal consolidation policy. It was what made it possible for Bulgaria to contain expansion of the deficit and even slash it to -0.8% in 2012. This progress stemmed mainly from the improvement in budget revenue and the more moderate rise in expenditure over the last two years.
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In 2010, the actions of the Bulgarian government were fully in line with the aim of achieving fiscal stability that resulted in a contraction of budget expenditure by 6.8% compared with the crisis year of 2009. These steps were in sharp contrast to the general trend in the EU where public expenses increased by 3.6%. The majority of the Member States followed this trend, and only five countries (besides Bulgaria) curbed their government spending in 2010: Greece (-8.3%), Estonia (-6.9%), Latvia (-3.3%), Lithuania (-2.1%), and Italy (-0.8%). In the EU as a whole, all elements of budget expenditure registered growth, which was most pronounced in the field of social protection and economic affairs. Thus, both the private sector and European citizens received support. Bulgaria, unlike the EU, slashed a large part of its budget expenditure, especially spending on general public services (by EUR 1,316.4 million or 50.6%), education (by EUR 140 million or 9.3%), environmental protection (EUR 139.5 million or 35.4%), housing and community amenities (EUR 114.3 million or 23.9%), and public order and safety (EUR 90 million or 8.6%). As observed in Chart 2, after 2009 budget expenses (as a share of GDP) contracted much more sharply and significantly in Bulgaria than in the EU. The state’s involvement in the economy has declined gradually, payments to businesses have been delayed, the actions taken to address escalating unemployment have been insufficient, and a number of structural reforms were postponed.

These factors have had a detrimental impact on Bulgarian economic growth and raised the question whether austerity measures are the right option for the country and whether they might be too much for the economy to endure, putting an additional burden on economic development. It was these concerns that provoked the author to outline the positive and negative aspects of fiscal consolidation in Bulgaria to assess its ultimate effects on the economy.

Positive Aspects of Fiscal Discipline

While Bulgaria has not managed to reap the maximum benefits from strict fiscal discipline, its positive sides should not be neglected. The country has established itself as an example of financial stability thanks to the fourth lowest deficit in the EU (after Germany, Estonia, and Sweden) and second lowest general government gross debt (after Estonia) in 2012. Bulgaria’s position is also solidified by the higher level of confidence of international institutions, the increase in its credit rating by Moody’s Investors Service from Baa3 to Baa2 with a stable outlook in 2011, and the fact that other similar credit rating agencies confirmed their positive expectations about Bulgaria’s economic development and the European Commission terminated the excessive deficit procedure. The successful containment of the deficit in 2011 and 2012 allowed Bulgaria to maintain favorable tax rates at a level of 10% for both corporate and personal income taxes (which are among the lowest in the EU) instead of being forced to raise taxes to secure more budget revenues, as was the case in many Member States. Additionally, the country has managed to keep the financial environment stable even in the face of escalating uncertainty on European capital markets, which provided a foundation for constant improvement.
in the government’s cost of financing. In the second quarter of 2013, for instance, the yield on the country’s long-term government bonds (used to calculate one of the Maastricht convergence criteria) reached 3.41%. In this regard, Bulgaria outperformed many Member States from Central and Eastern Europe such as Poland (3.58%), Lithuania (3.68%), Romania (5.37%), and Hungary (5.58%). Additionally, the narrowing trend in the spreads between Bulgarian government securities and the benchmark German bonds has become more pronounced. In addition, the values of the credit default swap (CDS) indicator have placed Bulgaria close to the Baltic States, and the country has surpassed economies such as Brazil, Russia, and Turkey, where the risk of bankruptcy is estimated to be higher.

Negative Aspects of Fiscal Discipline

Fiscal consolidation is a good decision when the stability of public finances brings sustainable economic growth and a more predictable economic environment. The desire to follow such a policy is justified until the moment it becomes overemphasized and turns into an end in itself, thus leading to a situation in which fiscal stability is achieved at the expense of economic growth. However, this is exactly what happened in Bulgaria in recent years. As a result, all participants in the economic processes in the country have faced serious headwinds. The economy has been increasingly plagued by problems such as impoverishment of the population, high unemployment, low production and investment activity, and the unfavorable financial condition of companies.

The crisis of 2009 highlighted the issue of population impoverishment and income differentiation. Rising 2.1% in 2011 and 11.7% in 2012, household income grew at a much slower pace than expenditure – by 4.3% and 13.2% in the two years, respectively. People spent their income primarily on products and services that satisfy basic necessities such as food and utilities. A study made by the World Bank and the Open Society Institute (2011) shows that poverty in Bulgaria is extremely high compared to the EU levels and in 2011 reached 21%. At the same time, according to Eurostat data, the share of people at risk of poverty or social exclusion in the total population of Bulgaria rose steadily to 46.2% in 2009 and to 49.2% in 2010, respectively. The difficulties faced by the poorer strata of the population are serious and require the support of the social system. In this regard, any further tightening of the fiscal discipline would only decrease their purchasing power. Measures that will produce immediate results but at the same time will have a constant impact need to be adopted to alleviate the burden on household budgets. Specific steps in that direction include the following: restoring the non-taxable minimum income that will support the people with the lowest income; expanding the coverage of energy benefits; increasing maternity allowances (from BGN 240 to BGN 310); and raising the one-off aid for children enrolled in first grade (from BGN 150 to BGN 250). The last three measures were actually implemented by the government, but the first measure was postponed indefinitely. Such actions could have positive social implications and will contribute to resolving the prob-
lem of impoverishment in the country. The adoption of these measures will not trigger a serious widening of the budget gap and at the same time will lead to a rise in consumption, which against the background of weak export growth, will provide a significant boost to economic activity in the country.

Another pressing social issue that Bulgaria faces since 2009 is persistently increasing unemployment. The government has not taken sufficient action to address it. Economic woes led to the loss of 431,900 jobs from the second quarter of 2008 until the corresponding period of 2013. Within the same time frame, the unemployment rate more than doubled – from 5.8% to 12.9%. It is particularly high among the youth, reaching 28.7% in the second quarter of 2013. The opportunities provided by OP Human Resources Development might give some support in resolving this issue. Unfortunately, at this stage its implementation is still too low – only 43.9% at the end of June 2013. At the same time, an incentive measure was introduced, according to which the state budget will cover part of the expenses for social security contributions made by investors in their capacity as employers for a certain period of time. It will boost job creation and thus lead to an increase in consumption. In the long term, this process will reflect in budget revenue growth, which will compensate significantly for the initial expenses made to implement this measure.

Continuously rising unemployment is the consequence of another serious problem that the Bulgarian economy faces – the dire state of real-sector companies, which is the reason why their managers resorted to dismissing workers as a precautionary measure against default. The crisis reflected in stagnation of Bulgarian companies’ revenue, a significant slowdown in their production activity, rising indebtedness, and a lack of favorable prospects for development given the frail demand on the domestic market and in the country’s major European partners. Led by the desire to maintain strict fiscal discipline, the government provided insufficient support to businesses in times of escalating uncertainty. This can be observed in the contraction of gross fixed capital formation expenditure in the budget by 34.6% (EUR 683.4 million) in 2008-2012. In comparison, the pace of decline in the same budget element in the EU was much slower – 12.9%. Capital expenditure is the budget item that serves as a buffer when implementation of revenue measures, which are most easily modified, fails. In 2012 and at the beginning of 2013, this trend was broken, and expenses on gross fixed capital formation edged up slightly thanks to national co-funding of large-scale projects under EU programs in the sphere of infrastructure and public works. This pickup impacted positively on engineering construction, where production activity was falling a year earlier. Despite the high levels of contracted EU funds that Bulgaria managed to achieve in recent years, the significant gap in their absorption remains an acute problem. The country is at the bottom of the EU by this indicator. The funds contracted under EU operational programs and agricultural funds stood at EUR 11.2 billion (98.6%) at the end of June 2013, while the money actually paid was less than half that amount – EUR 4.9 billion (43.0%), which is an example of the disappointing performance of the country. One of the main reasons behind this is the large number of companies that give up the projects because they are burdened by problems with finding sources for their share of the financing. This situation puts the country under the real threat of losing European money. The Joint European Resources for Micro to Medium Enterprises (JEREMIE) initiative, which aims to improve access to financing for SMEs, provides another possible solution in addition to EU funds. The state might provide support by giving funds, at least, to the municipalities whose projects have been approved. Furthermore, ways to support private companies should also be sought because finding the funds required for project implementation is the last serious obstacle to absorption that businesses usually face. In this regard, the government might consider securing the necessary financial resources by a bond issuance through a special state fund and thus transfer liquidity to the real sector.

In addition to limited demand, consumption, and investment, Bulgarian companies suffer also from the lack of timely repayment of the government’s obligations to business. Delays in debt repayment to the real sector should never be tolerated only to maintain a balanced budget, as these delays restrict firms’ working capital and might be devastating to smaller enterprises for which all financial resources are crucial. Thus, the state risks becoming a factor for job cuts or missed business opportunities. To address these problems,
the EC adopted a directive that provides certain reliefs for SMEs. Public authorities are obliged to pay for the goods and services that they procure from such companies within 30 days or, in very exceptional circumstances, within 60 days. The Summary of the Ministry of Finance of the Republic of Bulgaria (2011) is indicative of the challenges facing the national budget and of the inability to meet the EC’s requirements – the outstanding obligations of the central and local governments totaled BGN 376.5 million, while the government owed business BGN 316.8 million in the form of unpaid VAT refunds. According to the Ministry of Finance of the Republic of Bulgaria (2013a), the amount of VAT that had not been refunded on time by June 2013 was also large – BGN 314 million. By delaying its payments to businesses, the country contributes to intercompany indebtedness and hampers value added creation and company growth. According to a study made by the Bulgarian Chamber of Commerce (2013), intercompany obligations amounted to BGN 107.7 billion at the end of 2011. This problem faced by real-sector enterprises is nothing new and its seriousness should not be underestimated. It should be quickly and efficiently resolved. A possible solution might be issuing bonds and using the raised funds to pay back state debts to business. Thus, Bulgaria will be able to benefit from the low interest rates its government securities have registered in the last few years as well as from the strong domestic demand, especially from the banking sector, which stands out with its high stability. The repayment of obligations to private companies will allow them to use the money for a timely payment of salaries, which in turn, will contribute to higher consumption. Later, all of these processes will reflect in improvements on the revenue side of the budget as a result of higher proceeds from taxes and social security contributions. The payment of BGN 800 million to Bulgarian farmers was a successful approach to boosting business activity because the money was raised precisely by a bond issuance.

If the government does not take the initiative to improve the state of Bulgarian companies through direct stimulus, it should offset this lack of support, at least partially, by measures to ease their operation. A possible solution is an efficiently functioning electronic government. It will not only improve administrative efficiency by optimizing the time and resources spent on its operations, but will also ease doing business in the country by reducing red tape, limiting corruption, and providing more security (limiting cybercrime risks through automatic validation and verification). In this regard, the Ministry of Transport, Information Technology, and Communications (2010) has adopted a concept of electronic governance in Bulgaria for the 2010-2015 period. The country should use the opportunities for support in this area provided by EU Structural Funds. According to the EU Structural Funds Single Information Web Portal (2013), as of 31 September 2013 the funds contracted under OP Administrative Capacity stand at EUR 161.3 million (89.24%), while the absorbed money is EUR 92.1 million (50.96%). The bulk of money was allocated to the sub-priority axis Quality administrative services and development of the electronic government. Despite the fairly large amount of European funds allocated to the development of electronic services in Bulgaria and the fact that some actions were taken in this direction, progress has been insignificant, so far, and the results cannot be considered satisfactory.

The crisis has certainly highlighted a number of unsolved problems in the Bulgarian economy that have obviously hampered its development. However, instead of taking steps to gradually and consistently resolve the issues, in recent years, governments have followed an inactive policy involving no attempts to make serious and long-term changes. A consistent policy is necessary, which has to be followed unconditionally – a clear vision with specific priorities and measures targeted at improving economic conditions in Bulgaria. Whatever positive changes the government tries to make to revive the economy, it will not achieve the maximum and long-lasting results that a number of structural reforms could bring. Reforms in the sphere of health, education, the pension system, and energy, among others, have been postponed repeatedly. Without reform implementation, simply pouring money into the economy would be pointless. Health and education should be a priority, and the state should allocate the necessary time and resources to these spheres. The cumbersome healthcare system is in need of a thorough change and a new strategy to guarantee higher quality and more affordable health services to stop medical workers from leaving the country (mainly because of low pay) and to solve the
problems with drug prices. Bulgaria ranks in 24th place among EU Member States by healthcare budget expenditure — only 4.6% of GDP. In comparison, Germany and the United Kingdom spend almost twice as much on health — 7% and 8% of their GDP, respectively. The two countries stand out with constantly rising employment and high remuneration levels in the sphere of human health and social work activities. These factors make them attractive destinations for Bulgarian medical workers. Bulgaria can follow the successful example of certain European countries, such as the Netherlands, and learn from their good practices in this area. After implementing reforms in this sphere, the Netherlands became the country with the best healthcare system in the EU.

The low quality of education in Bulgaria at all levels, the gap between universities and businesses, and the consequent mismatch between supply and demand for labor undermine the economic potential of the country. An attempt to overcome this pressing issue might be made by linking a part of every university’s financing with the availability and the quality of its career development and entrepreneurship centers. Compared with the other EU Member States, Bulgaria lags significantly behind in funds allocated to education system support and usually ranks last. According to Eurostat data, public education spending fell in 2010 and 2011, when it reached 3.6% of GDP. Given the long-term positive effects of high quality education and research and development activities and the potential they hold for economic development, the country should spare no resources for their financing, especially considering the strong need for such investment at this point.

**Change of the Budget Restrictions Course**

Despite the aforementioned advantages of the fiscal discipline, which Bulgaria has maintained strictly, the disadvantages seem to outweigh the advantages. The negatives forced the current government (in office since May 2013) to revisit the policy of budget restrictions that the previous government had followed and to undertake some partial changes. This also reflected in the proposal for adjustments to the budget, which according to the government, was prompted by the lack of effective policy for growth and by the overestimated revenues set in The State Budget Act of Republic Bulgaria for 2013. Thus, the budget revision is already a reality in the second half of 2013 (National Assembly of the Republic of Bulgaria, 2013) and has become one of the most widely discussed topics among economists in the country. The government now anticipates a rise in the deficit by BGN 493.4 million, up to 2% of the projected GDP. At the same time, it is expected that the government debt ceiling for 2013 will be raised, and a new loan (BGN 1 billion) will be taken. Budget revenues and grants have been revised down (by approximately 1%) and are now BGN 18.2 billion, while the projected expenditure (including net transfers and the contribution to the EU budget) has increased (by 1.5%) and now amounts to BGN 19.5 billion. According to the government in office, this budget spending is urgent, and a priority is placed on using the money primarily to pay off state debt to business and support the vulnerable groups. The additional BGN 160.4 million (0.2% of the projected GDP) have been allocated primarily to repaying overdue state debt to real-sector companies that has been accumulating mainly in the systems of the Ministry of Defense, the Ministry of Interior, and the Ministry of Justice. Another BGN 8 million has been set aside for urgent reconstruction of health establishments in the country, and BGN 15 million have been transferred to State Fund Agriculture to support tobacco, fruit, and vegetable producers. According to the Ministry of Finance of the Republic of Bulgaria (2013b) the revised budget also reflects the government’s social commitment, as BGN 40 million will be used to raise the expenses of the Ministry of Labor and Social Policy, primarily to the benefit of disabled people. A significant part of the increased spending (BGN 85.62 million) will go to the energy sector, mainly in the form of state energy benefits, which will reduce the burden of electricity bills on Bulgarian households.

Budget updates are not very common and are usually used as a last resort because in most of the cases, they are related to uncertainty, deterioration of the financial and economic situation, and send bad signals for the development of the economy. Still, in this particular case, a budget revision can be considered justified. Undoubtedly, the government's desire to repay its obligations to business more rapidly and, in time, provide support to Bulgarian residents is in the right direction because these measures will boost consumption. Thus,
the reforms will bring about the desired effect of economic growth and will also increase budget revenues from taxes. Furthermore, the concerns that spread in public space that these reforms will hinder the financial and fiscal stability of the country are groundless. In this regard, a comparison between the fiscal stability and economic growth indicators of Bulgaria and the other Member States from Central and Eastern Europe can very well be used as proof (Table 1). As already mentioned, the country is among the best performers in terms of maintaining low budget deficits and low levels of government debt. The credit rating agencies’ evaluations are also positive and, despite the tense political climate in the country, have not been revised down. However, business activity in Bulgaria has developed in a different direction, and in the past year, it did not manage to reach even 1%. In contrast, some of its EU peers from the CEE successfully maintained moderate debt levels and considerably larger economic growth. For example, Standard & Poor’s (2013) has given the same credit rating and outlook to Bulgaria and Lithuania. Yet, Bulgaria’s sovereign debt and budget deficit are several times smaller, and the government’s cost of financing is lower. At the same time, the level of economic activity is considerably higher in Lithuania, with growth rates of 3.7%, which can be considered a success against the backdrop of the uncertainty hovering over the EU economy. The situation in Latvia, Poland, and Slovakia is quite similar. These countries have a significantly larger negative balance and public indebtedness as well as a higher yield on long-term government bonds, yet their growth is considerably faster than that of Bulgaria.

All things considered and given the current levels of its budget deficit and government debt, Bulgaria can afford to update the budget without lingering worries over the health of its finances. Nevertheless, in the future, Bulgaria should also consider the much-delayed reforms in health care and education and take measures to boost employment that will have a long-term

<table>
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<th>Budget Balance to GDP (%)</th>
<th>Public Debt to GDP (%)</th>
<th>10-year Government Bond Yield (%)</th>
<th>GDP Growth Rate (%)</th>
<th>Sovereign Credit Rating, Foreign Currency (S&amp;P) (LT/Outlook/ST)</th>
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and much stronger impact. The government should not become indebted to businesses and neglect investments in innovations and spheres that can make the country more competitive.

**Conclusion**

The analysis shows that the controversial character of austerity policy is obvious not only in most EU members, but also in Bulgaria. The country is among the Member States with the lowest budget deficit and public debt and has earned the high trust of international institutions, which can also be observed in the favorable cost of financing of the government – indisputable evidence of fiscal stability. Fiscal stability provides the foundations for creating a predictable economic environment in Bulgaria and is a prerequisite for significant growth. Nevertheless, the country remained plagued by subdued production and consumption activity, anemic demand at home and abroad, disturbingly high unemployment, and impoverishment of the population, all of which are an apparent hindrance to economic development. In the end, it turns out that strict fiscal discipline contributes to deterioration in the economic and social environment, as the implementation of a restrictive policy to maintain a balanced budget in times of crisis caused by limited demand is not the right approach. To overcome these difficulties, the government should focus its efforts on improving the business environment and reducing the administrative burden even at the expense of a moderate and reasonable increase in the public debt and the budget deficit. These are steps that the government can afford without worrying about the stability of the fiscal system.

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