PUBLIC EXPENDITURE MANAGEMENT IN AN INDEBTED COUNTRY – IS FISCAL CONSOLIDATION VIABLE? (THE EXPERIENCE OF BULGARIA IN 1991-2004)

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1. Setting the scene – The debt burden

Ever since 1991, when the transition to a market economy reforms had been launched in Bulgaria, the economic development of the country has been marked by the debt burden, accumulated in the second half of the Eighties. Although in the early Eighties the debt-to-GDP ratio was around 20-23 per cent, since 1986 the speed of debt accumulation accelerated and brought the ratio up to double in 1988-89. The combination of high debt accumulation rate and short-term maturity of newly acquired debt jeopardised the financial position of the government and questioned its ability to service the debt. The severe administrative measures, introduced in order to curb the debt growth rate, had a negligible effect on the debt growth rate but adversely affected the economic growth.[1] The overall economic activity started to cool down.[2] Ineffective in its measures to stabilise the debt ratio and opting for refinancing debt payments by short term borrowing the government was shortly pressed to announce a moratorium on debt payments in March 1990. The debt-to-GDP ratio at that time had barely hit 50 per cent (Figure 1).

The immediate response of the international financial markets to the moratorium was to renounce the country as a borrower and to cut off its access to foreign financing. The sudden disruption in external inflows exerted a severe blow on the economy. Another shock followed – the collapse of the socialist system and its common market. As a consequence, in 1991 the GDP in dollar terms plummeted to 37.4 per cent of its respective level as of 1989.

The fiscal position of the government sharply weakened in 1991 when the ratio of budget revenues to GDP fell down from 57.9 in 1989 to 39.6 per cent in 1991 largely due to the output loss and the vast deterioration of the state-owned companies' finances. Under the socialist regime budget revenues were channelled entirely through the enterprises. They paid profit contributions at a specific differentiated rate; they paid all social security contributions and transferred automatically to the budget the personal income tax accrued on their employees' wages. The profound control over the state-owned enterprises and the state of literary full employment allowed the government to collect resources at about 60 per cent of GDP. It enjoyed the irrevocable authority to accumulate as much resources

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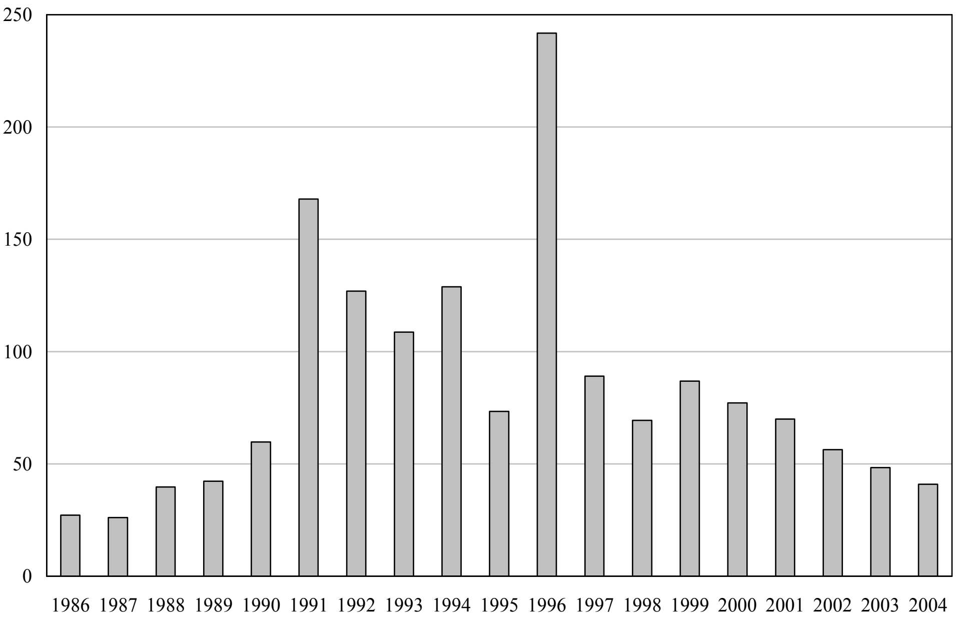
[1] The measures had been targeted at administrative reallocation of the scarce foreign currency (predominantly US dollars) inflow among a great number of net importers. All requests for foreign currency had been checked by the administration and either approved or rejected.

[2] The GDP in US dollar terms fell down by 25 per cent in 1988-89 (the exchange rate being stable).

Figure 1

Bulgaria: Total Government Debt-to-GDP Ratio

(percent)



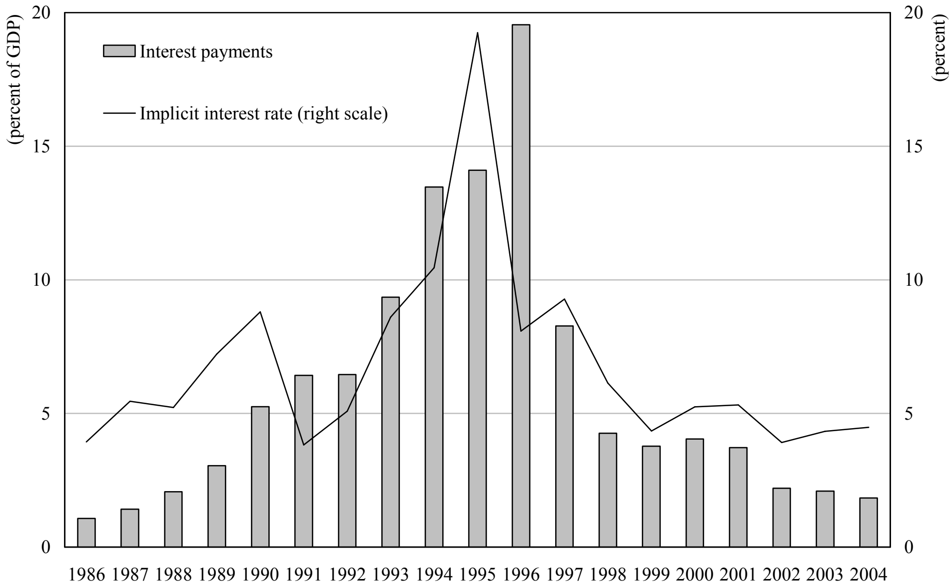
Source: Ministry of Finance.

as necessary to fulfil its expenditure programmes by discretionary changing the regulations of taxation. But even that in place it needed to resort to central bank financing and foreign borrowing.

The transition to a market economy reform, launched in February 1991, not only caused a substantial loss in output but also initiated a change in the principles of taxation and the taxpayers' behaviour that adversely affected the budget revenues. The incidence of taxation and the size of the tax base shrank abruptly in 1990-91. First, due to rising unemployment the numbers of employed decreased sharply. Second, early retirement schemes introduced in 1990 and the high emigration wave, following the change of the political regime, both reduced the number of tax payers. Next, the financial status of the already overburdened by debt state-owned enterprises further deteriorated. The liberalisation of prices – an important component of the reform package, allowed enterprises to raise output prices but they were not able to benefit from a higher profit margin. They got trapped in-between private firms which overtook all operations of input supply and output sale, thus re-shifting profits from the state-owned enterprises to the private sector – a phenomenon, which further exacerbating the financial position of the state sector (Beleva, Jackman and Nenova, 1995).

Figure 2

Bulgaria: Interest on Government Debt



Source: Ministry of Finance.

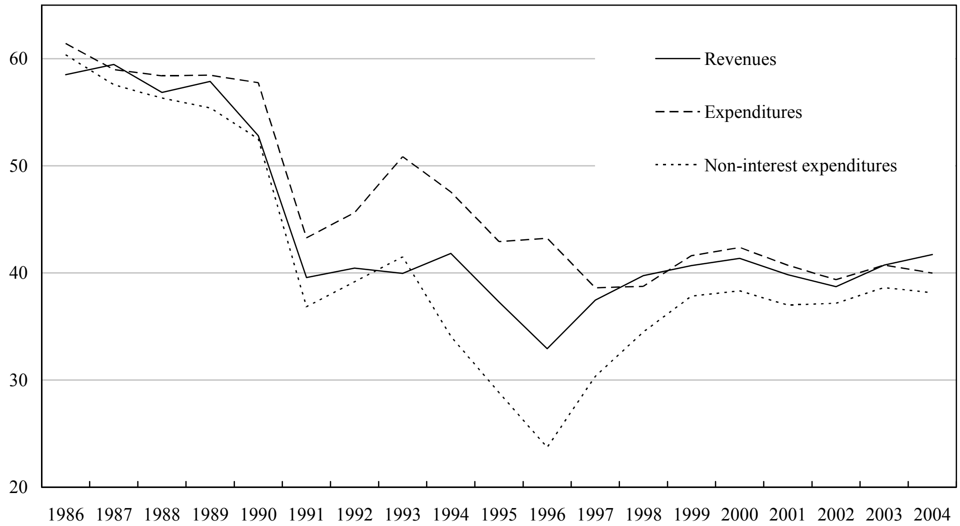
The negative impact of the reform package on the tax revenue would have been softened if significant and fast legislative and institutional changes had been undertaken and enforced in 1991. Privatisation would have helped to eliminate the problem of profit sharing, too. Instead, the obsolete tax laws and rules were subjected to continuous repair based on unclear principles. The incidence and timing of tax payments became ambiguous keeping market participants in the dark about possible short-term changes in legislation and rules. Tax rate differentiation remained dominant and the preferential tax regime for certain types of tax payers continued to exist. As a result, the distortionary tax legislation was preserved thus impeding the transition process and inspiring tax evasion (Nenova, 1994a).[3]

Financially constrained by both external and domestic factors, the government was expected to reform radically the principles of budgetary expenditures management and shortly to achieve a significant consolidation of public finances. Although the primary balance was on a surplus in the years following 1990 (with the only exception of 1993), it was not sufficiently high to cover the interest payments on government debt (Figures 3 and 4). Moreover, additional financial resources were needed for payments on principal. In 1991 only

[3] Radical changes in the tax laws took place only after 1997.

Figure 3

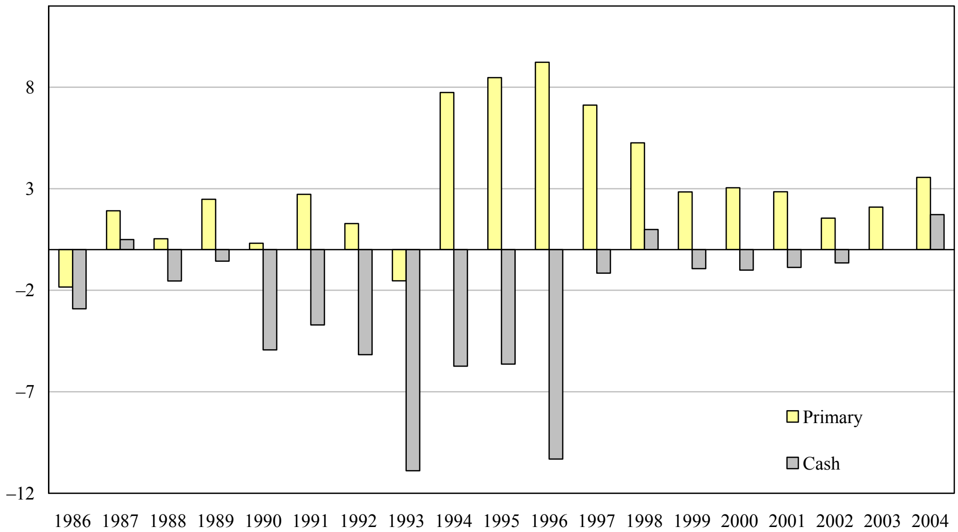
Bulgaria: Total Budget Revenues and Expenditures
(percent of GDP)



Source: Ministry of Finance.

Figure 4

Bulgaria: Consolidated Budget Balances
(percent of GDP)



Source: Ministry of Finance.

the IMF and the World Bank extended loans to the government but those were quite insufficient to cover all the expenses at the prevailing fiscal policy. As the government (the country) had no access to international financing it resorted to domestic resources, ultimately linked to money issue.

Data suggests that the initial 1991 slump of budget revenues brought them down to a level, which was maintained on average during all subsequent years until nowadays (Figure 3). So, from a retrospective point of view, it had been recommendable to quickly adjust public expenditures to the new level of revenues. As it did not happen and a growing share of budgetary expenditures had been financed by money issue the economy developed on an unsustainable path with high inflation, volatile exchange rate and high nominal interest rates. Although the lack of radical structural reforms like privatization or effectively applied bankruptcy procedures for indebted companies had been the fundamental factors destabilising the economy it was the lack of fiscal expenditures adjustment generating the crisis outbursts of 1994 and 1996-97.

The GDP loss caused by the crisis of 1996-97 was about 16 per cent. High inflation (climbing up to hyperinflation in February 2005) reduced real wages and personal income, and wiped out the real value of the domestic government debt. The year 1997 marked the launch of the transition to a market economy in Bulgaria, this time brought to completion, with a starting point of public finances being almost at balance.

The paper will describe the ups and downs of the fiscal expenditures adjustment process since 1991 and will search for evidence to justify a conclusion that public finances have been in a sustainable position since 1999. The first section comments on the very initial change in public expenditures – the reduction of production subsidies and capital expenses. The role of income policy for government expenditures adjustments is the topic of the second section. The third section presents the structural reforms in the social security system as a major factor for achieving stability. The fourth section reviews the structural reforms in progress in the health care system and education – two sectors which like the public social security system determine to a great extent the sustainability of fiscal policy. The last section concludes with an assessment of the sustainability achieved up to now.

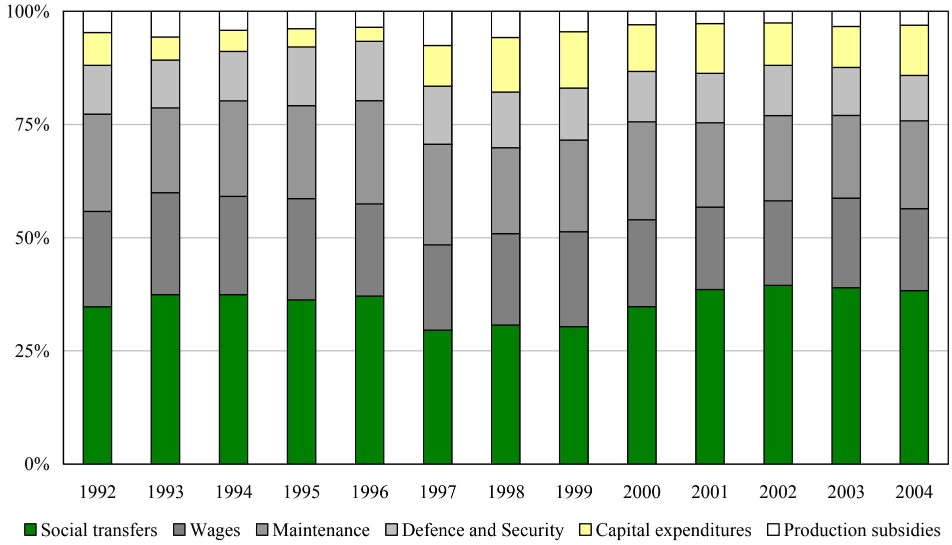
2. The adjustment process

2.1 The initial response – reduction of production subsidies

Budget expenditures plummeted in 1991 and underwent substantial structural change compared to their breakdown during the socialist period (Figure 5). Production subsidies had been cut down not only in nominal terms, but also in percent of GDP and as a share of non-interest expenditures. Their GDP ratio fell down in 1991 by 11.4 percentage points in comparison to 1989 (Figure 6).

Figure 5

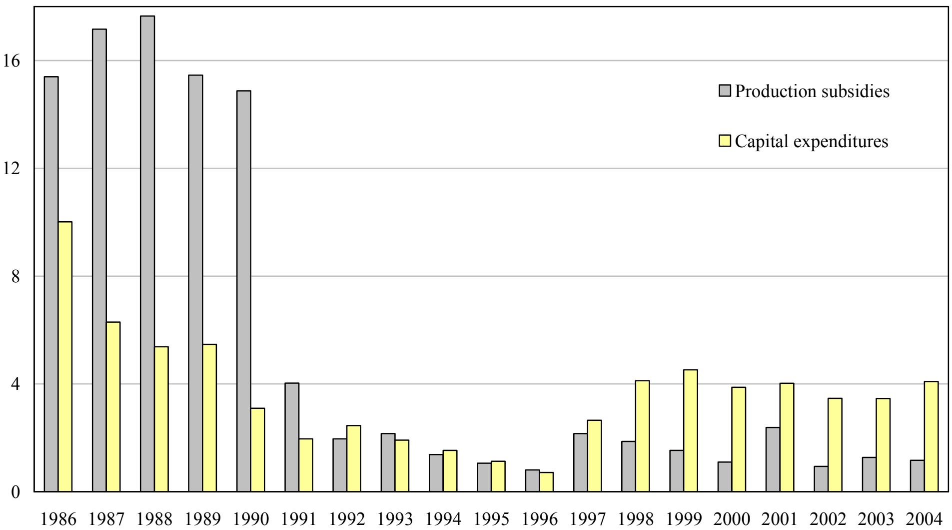
Bulgaria: Structure of Non-interest Expenditures
(percent)



Source: Ministry of Finance.

Figure 6

Bulgaria: Production Subsidies and Capital Expenditures
(percent of GDP)



Source: Ministry of Finance.

The liberalization of prices was an inextricable component of the reform programme of 1991. The centralised determination of prices was abolished and the government preserved its control over a small number of goods and services with a weight in the consumer basket of about 10 per cent. The scope of subsidised production was restricted to the sectors of electricity distribution, central district heating, and public transport (intra-city and railway transport).

In the years to follow up to 1996, the range of administered prices was gradually widened as an instrument to curb the persistently high inflation (closely related to the money finance of budget deficits). In April 1997 the weight of controlled prices in the consumer basket had already reached 52 per cent. The price control depressed inflation by slowing down the adjustment or in some cases even freezing the level of administered prices. However, this type of measures aimed at lowering the inflation rate was not matched by a corresponding extension of subsidies to the companies, adversely affected by the cap on their output prices. Those enterprises that were able to run profits now turned into loss-makers, contributing to the overall destabilisation of the economy.

The resumption of the reform efforts in 1997 initiated a new wave of price liberalisation. At the end of the year the weight of goods and services with controlled prices diminished to 12.8 per cent. The adjustments of administered prices, undertaken in the next years up to 2004, were facilitated by the overall macroeconomic stability. Quite successfully the costs of providing certain goods and services were transferred to the final consumer leading to a steep rise of households' expenditures on utilities (Figure 7).

Capital expenditure was the other item considerably lowered in 1991 to 2.2-2.5 per cent of GDP from 5.8 per cent in 1989. Only the sustained macroeconomic stability and the improved public finances management after 1997 allowed for an increase in capital expenditures to around 4 per cent of GDP, highly related also to the major task to prepare the country for EU accession.

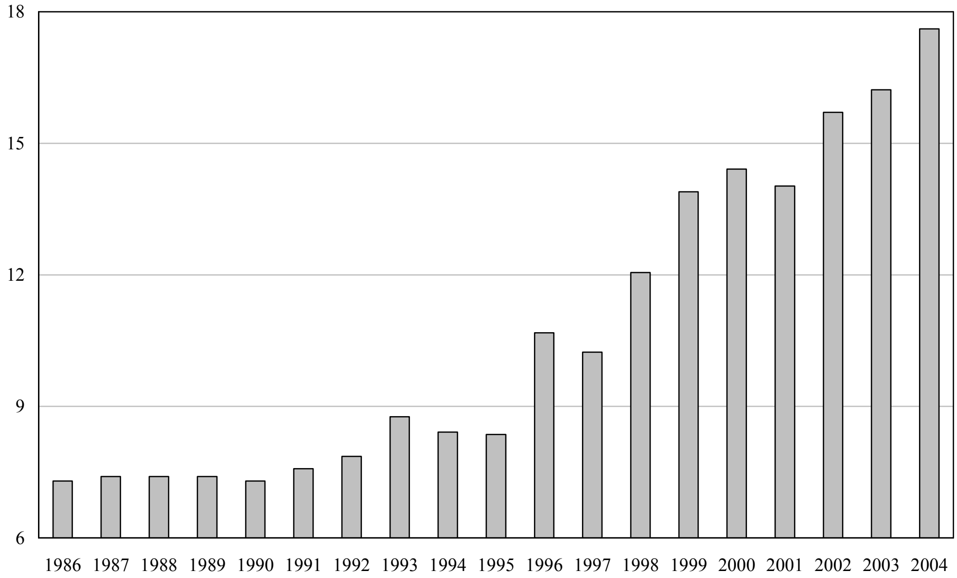
2.2 Income policy and the flexibility of fiscal policy

Going back to 1991, a restrictive income policy had to be implemented in support of the macroeconomic stabilisation programme launched at the beginning of the year, according to the Bulgaria-IMF stand-by agreement. The restrictive income policy pursued during the first months of 1991 was aided by the then-existing rigid wages tariff system with built-in limits on nominal wages linked to workers' education, qualification and job position. While the system had been created to operate under non-inflationary environment and total control over wages increase it proved beneficial in 1991 for the enforcement of a centralised approach to inflationary indexation of wages (Nenova, 1993).

The size of wages inflationary compensation was decided upon in a Tri-partite Commission, established at the beginning of 1991 and represented by government officials and trade unions, as well as members of the Union of

Figure 7

Bulgaria: Expenditure on Utilities and Housing in Total Household Expenditures
(percent)



Source: National Statistical Institute.

Employers. The initial indexation scheme envisaged an invariable nominal amount of compensation. As inflation in the first months of 1991 exceeded the forecast the schedule underwent subsequent changes in the form of a series of compensation increases matching the actual rate of inflation. Yet the state control over wages rise helped to depress inflation from the sky-rocketing 123 in February and 50 in March to 2.5 in April and 0.8 per cent in May.

Although extremely appropriate from income policy point of view, the outdated wages tariff system was abolished in November 1991 as part of the reforms. It was replaced by the system of collective wages bargaining at a firm level. The government preserved the control over salaries of government employees and had the right to enforce regulations over wages increases in state-owned enterprises after negotiations in the Tri-partite Commission.

As a result of the introduction of the collective bargaining system wages rocketed at the end of 1991. To outweigh the possible stimulus on domestic demand the government imposed further restrictions on government employees' wages and social transfers (pensions, unemployment benefits and social aid).

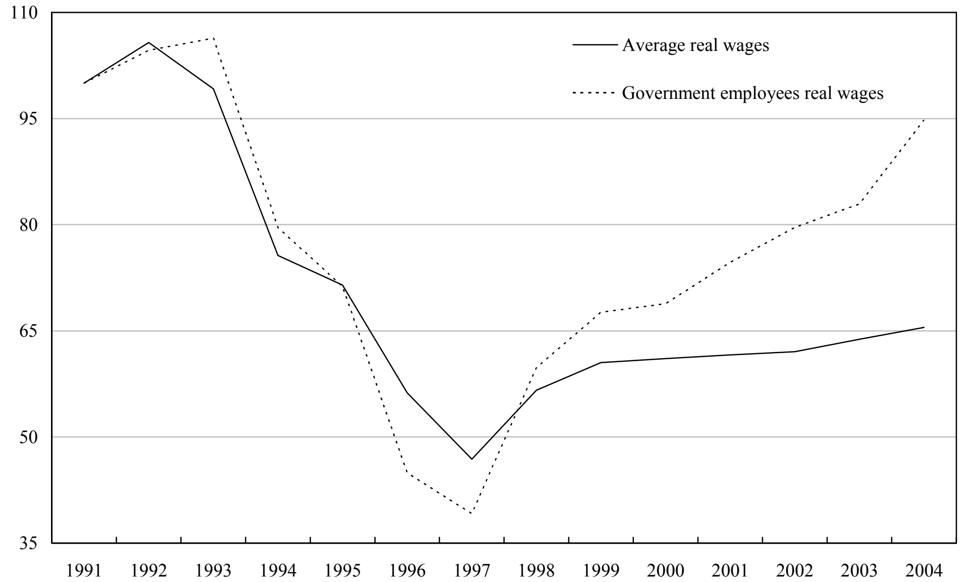
By mid-1992 government employees' wages, the minimum wages as well as pensions and social benefits steadied at their late 1991 level while wages in the non-government sector followed the rates of inflation. The rising social discontent brought the government of 1992 down and it was replaced by a coalition government. One of the first measures of the new government was to grant a 26 per cent rise of wages in the government sector (Nenova, 1994b).

In 1993 a mechanism of automatic indexation had been introduced. According to the regulation wages in budget organizations were subjected to automatic indexation of 90 per cent of the reported inflation rate. The same principle applied to the level of the minimum wages, the pensions, social insurance and unemployment benefits. The minimum wages was increased four times in the course of the year. As a consequence, though the average real wages was on a downturn trend, real wages of government employees as well as the real pension and all social benefits went up. Ultimately, the share of budget expenditures on wages and social transfers increased in 1993 (Figures 8-10). The primary balance turned negative, while the cash deficit rocketed to almost 10 per cent of GDP (Figure 4), financed by domestic resources and money printing.

Not surprisingly the first quarter of 1994 was marked by an exchange rate crisis and the negotiations with the IMF had been resumed urgently. The crisis enforced the government to adopt a restrictive income policy. Though the

Figure 8

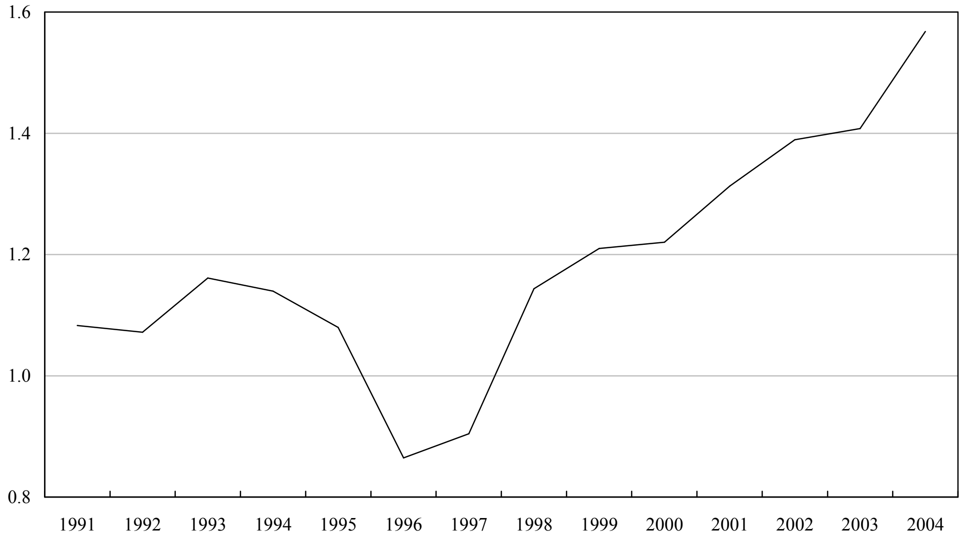
Bulgaria: Real Wages
(1991 = 100)



Source: National Statistical Institute.

Figure 9

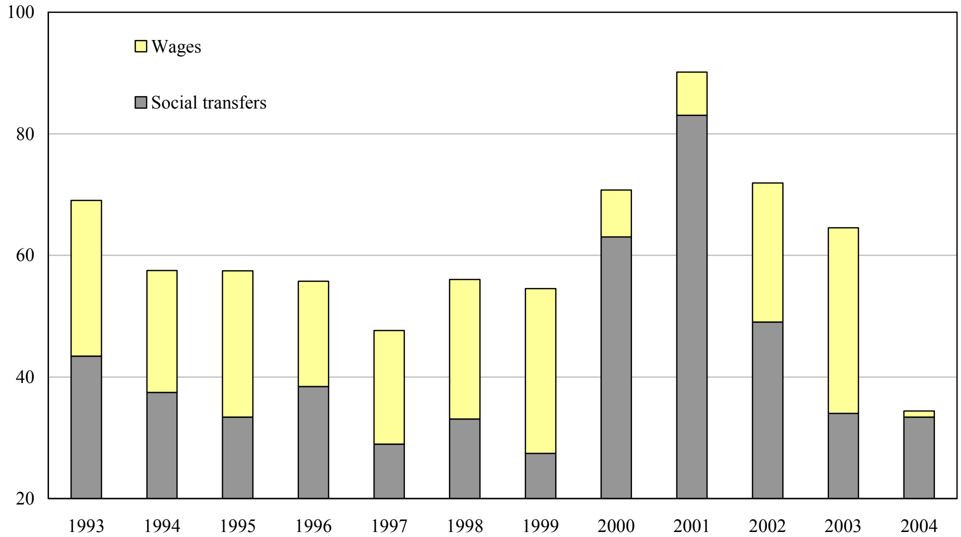
Bulgaria: Relative Wages of Government Employees
(relative to the national average wages)



Source: National Statistical Institute.

Figure 10

Bulgaria: Share in the Nominal Growth of Non-interest Budget Expenditures
(percent)



Source: Ministry of Finance.

mechanism of wages indexation remained similar to the one introduced in 1993, the rate of indexation was linked now to forecasted and not to the reported inflation. The actual inflation was thrice higher than the forecasted but no steps had been undertaken to increase the rate of compensation rate.

The crisis of 1994 denoted the beginning of a downward trend in real income of government employees, retirees, recipients of social aid, ruthlessly imposed by the growing government expenditures on interest and principal debt payments. In 1994 Bulgaria had to make the first payment on its external debt after the conclusion of agreement with the London Club creditors. But since the domestic debt had been on an increase ever since 1991 it was the domestic debt interest and principal payments imposing rigid constraints on fiscal policy. Moreover, a law, adopted at the end of 1993, transferred the debts of the state-owned enterprises into a government debt. The first two payments on this newly accepted debt were due also in 1994.

In 1995 the primary surplus amounted to 7 per cent of GDP. The restrictive stance of wages policy was preserved. But other errors in macroeconomic policy initiated a fast reduction in international reserves at the end of the year and unleashed the crisis of 1996-early 1997.

In 1996 the crisis developed at a very fast speed. Efforts had been made to increase tax rates, to further curtail wages of government employees and social transfers and pensions. In real terms, non-interest budget expenditures decreased twice compared to the previous year. A political crisis at the end of 1996 led to a change in government and enforced early parliamentary elections.

In the period of mid-1996 to early 1997, income lost a lot of purchasing power. The February 1997 decline was more than two fold relative to December 1996. After February 1997, the government adopted a cautious approach to the upward adjustment of wages so as to avoid cost-push and demand-pull inflation, as well as inflation caused by the monetisation of government debt. March 1997 witnessed the first adjustment of wages. In May the average real wages gradually recovered to its December 1996 level and it remained practically at a freeze afterwards.

The practice of inflationary compensation of wages was completely abolished in 1998. The process of privatization of state-owned enterprises was accelerated and the restructuring of the newly privatized enterprises gradually took momentum. Eliminating labour redundancies was a first priority and the unemployment rate started to grow up and reached a maximum in 2000. Employers in the private sector regulate the average wages growth rate in accordance with labour productivity and their profit targets.

Since 1998 the government employees' salaries are determined quite as a residual in dependence with the forecasted budget revenues and other expenditures and constrained by the target of achieving a balanced budget.[4] A coefficient of wages indexation, corresponding to the restrictions, is calculated and presented to the Tri-partite Commission for approval. The acidity of discussions on wages indexation in the Tri-partite Commission is diluted by a provision that if in the course of the budget implementation revenues exceed the forecast it is possible by a discretionary decision of the government to grant bonuses equal to one but not more than two monthly wages at the end of the year. The applied principle allowed for a fast recovery of government employees' average real wages (Figures 8-9).

In summary, income policy played a major role in destabilising (and stabilising) public finances. The approaches applied since 1991 range within the extreme cases of automatic inflation indexation, when the respective governments dared to ignore the priority of debt payments, to wages freeze at times, when ignoring the highest priority of debt service generated depletion of foreign reserves and brought the economy on the verge of a crisis. The recently selected approach of tightly relating income policy to budget programme implementation allows for attaining real increase in income and grants flexibility to the management of budget expenditures.

2.3 The pension system

A severe structural imbalance, generated in 1991 by a number of factors like the absolute decline in population, the growth of the unemployment rate, the introduction of an early retirement scheme and the rising number of pensioners, overwhelmed the pension system. The dependency ratio, calculated as a ratio of the pensioners to employees sharply increased (Figure 11).[5]

After the slow down of the average pension nominal growth rate in 1992 since 1993 onwards pensions were subjected to the same mechanism of automatic indexation to inflation which was applied to wages. However, it was almost impossible to preserve the replacement ratio and it plummeted in the years to follow. Since 1997 the regulation of the annual update of pensions has been changed and consequently the replacement ratio has been kept quite stable at around 40 per cent in 2000-04 (Figure 13).

It is a difficult task to strike a financial balance in a system with persistent structural imbalance. In mid-1997 amendments to the Law on Pensions had been adopted. In line with the overall cautious income policy of 1997 the amendments allowed for regular annual indexation of pensions based on the growth rate of the average monthly gross salary, announced by the National Statistical Institute (NSI)

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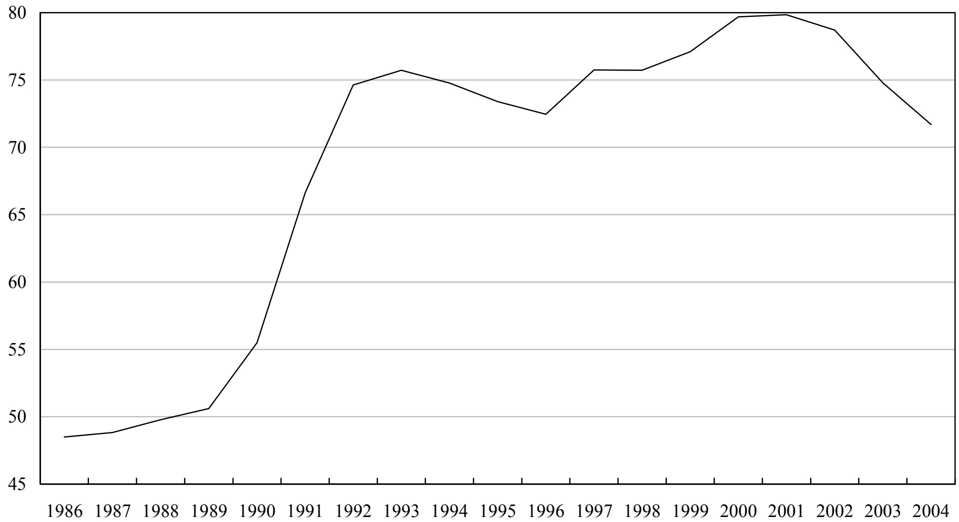
4 The consolidated budget balance target in recent years was for a deficit of less than 1 per cent and balancing the budget in 2006. However, due to a better tax revenue collection it was possible both to reduce some tax rates and to achieve a cash surplus. In 2004 the cash surplus amounts to 1.7 per cent of GDP.

5 In 1990 a provision of early retirement enabled women to retire at 53 instead of 55, and men at 57 instead at 60, which raised the absolute number of retirees (Figure 12).

Figure 11

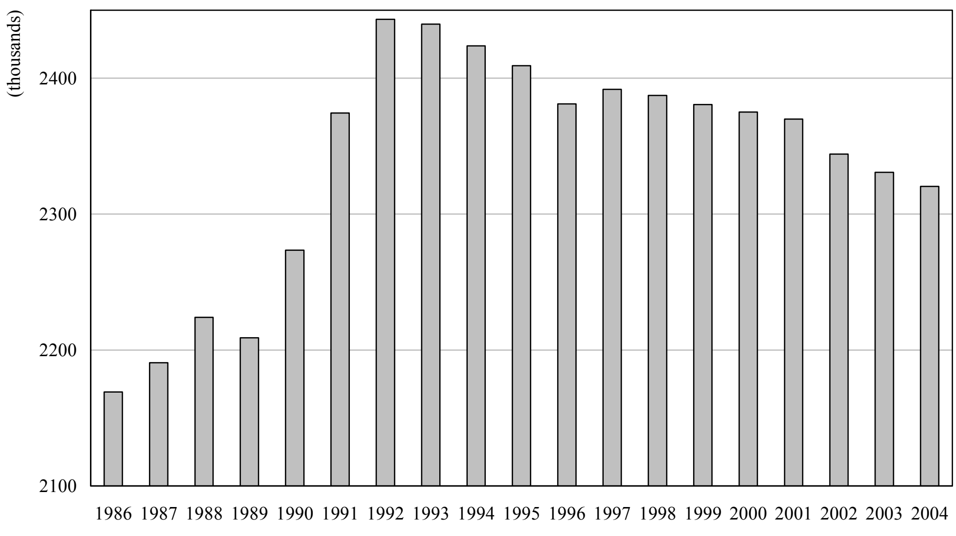
Bulgaria: Dependency Ratio



Note: The dependency ratio is calculated as the ratio of the number of pensioners to the number of employees.
Source: National Social Security Institute.

Figure 12

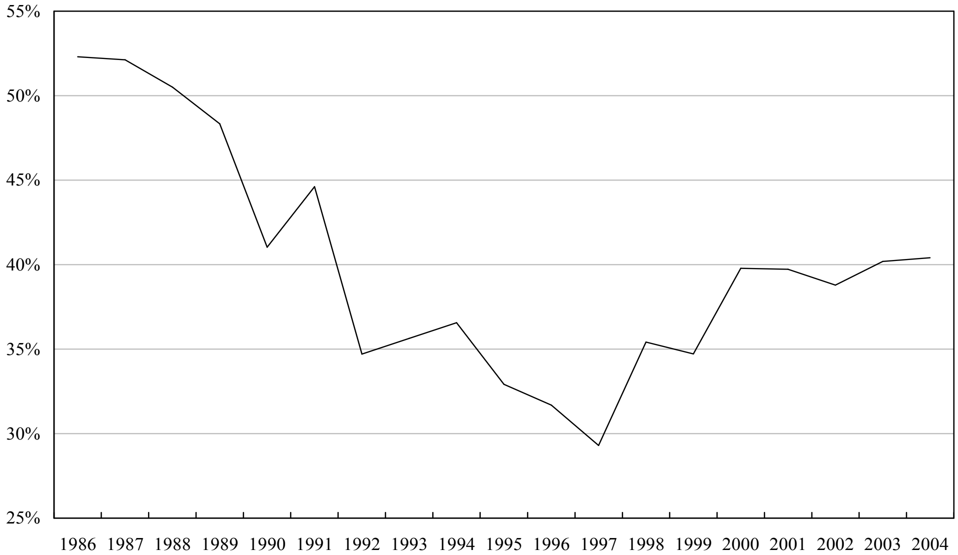
Bulgaria: Number of Pensioners
(thousands)



Source: National Statistical Institute.

Figure 13

Bulgaria: Replacement Ratio



Note: The replacement ratio is calculated as a ratio of the average pension to the average gross wages.
Source: National Social Security Institute.

in the calendar year preceding the year of adjustment. As an exception the 1997 adjustment of pensions had to be based on the average salary of the first quarter of 1997. Even with this revision, the basis for the calculation of pensions remained twice lower than the average working salary in the second quarter of 1997. The maximum pension was limited to three times the amount of the social pension but so restrictive were the conditions that only few retirees were eligible to receive it.

The radical reform of the public social security system started in January 2000 with the adoption of a new Social Code. Three public insurance funds were established, namely the Pension Fund, the Work Injury and Occupational Sickness Fund and the General Sickness and Maternity Fund, each fund financed through a specific contribution rate, determined on an assessment of the risks it covers. The objective of the reform was to draw a clear-cut line between short-term and long-term type of insurance. The Social Code states a provision that the rate of each contribution is determined on an annual basis in relation to forecasted expenditures.

In July 1999 a new institution was established, independent from the government, namely the National Health Insurance Fund (NHIF) – responsible for financing of the public health care sector.[6]

[6] The issue of health care reform is discussed in the next section of the paper.

Table 1

Average Social Security Contribution Rates
(percent)

	Before 1991	1991-96	1996-99	2000	2001-04
Pension Fund	30	35	37	32.0	29.0
Work Injury and Occupational Sickness Fund				0.7	0.7
General Sickness and Maternity Fund				3.0	3.0
Unemployment Fund (the different rates correspond to changes in the rates within the period)	0	3.75 5.0 7.0	5.0 4.5 4.0	4.0	4.0
National Health Insurance Fund	0	0	0	6.0	6.0
Overall	30.0	40.2	41.5	45.7	42.7

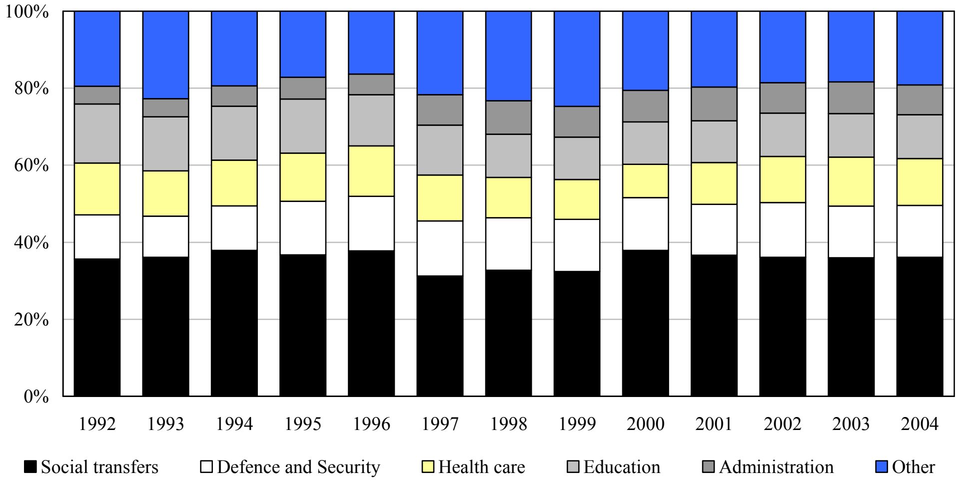
Source: National Social Security Institute.

The amendments of the pension system introduced in 2000 have been targeted at strengthening the public Pay As You Go (PAYG) pension system. The retirement age of men and women is going to be raised to 63 and 60, respectively, in a gradual way until 2010. The eligibility for a public pension is granted based on the following criterion: a minimum number of points representing the sum of the age and the length of participation in the system. The retirement eligibility requirements did influence the number of pensioners, which started to decline since 2001 (Figure 12). A compulsory fully funded system for people born after 1960 had been introduced, too.

According to the Social Code provisions the annual indexation of individual pensions is implemented once a year (in June). The rate of indexation is decided upon by the Supervisory Board of the National Social Security Institute (NSSI) and it may reflect the changes of the insurance income and inflation in the preceding calendar year. The discretionary determination of indexation contributes to the flexibility of the pension system and leaves room for manoeuvre. The restriction on the maximum pension is still valid but the ceiling has been lifted up recently.

Figure 14

Bulgaria: Structure of Non-interest Expenditures by Major Budgetary Sectors
(percent)



Source: Ministry of Finance.

An important provision in the Social Code regulates the split of contribution payments between employer and employee.[7] According to the time table, stated in the Social Code, the burden will be equally distributed between employers and employees in 2008. In the meantime the employees' share is gradually to be raised. This provision, on one hand, alleviates the social security contribution burden of the employers and, on the other hand, increases the awareness of workers to the actual payment of the contribution and their importance. Both are expected to improve the collection rate.

All changes in the social security legislation have been targeted at achieving long-term sustainability of the system. Although the reduction of the unemployment rate since 2001 and the growing employment relieve the tension of the structural imbalance over the pension system the dependency ratio remains still very high.

2.4 Education and health care

Social transfers (pensions, unemployment contributions, social aid) represent the highest share in the structure of budget expenditures by sectors. Next in importance come education and health care expenses (Figure 14).

7 Until the adoption of the Social Code in 2000, employers were responsible for the payment of the social security contributions of their employees.

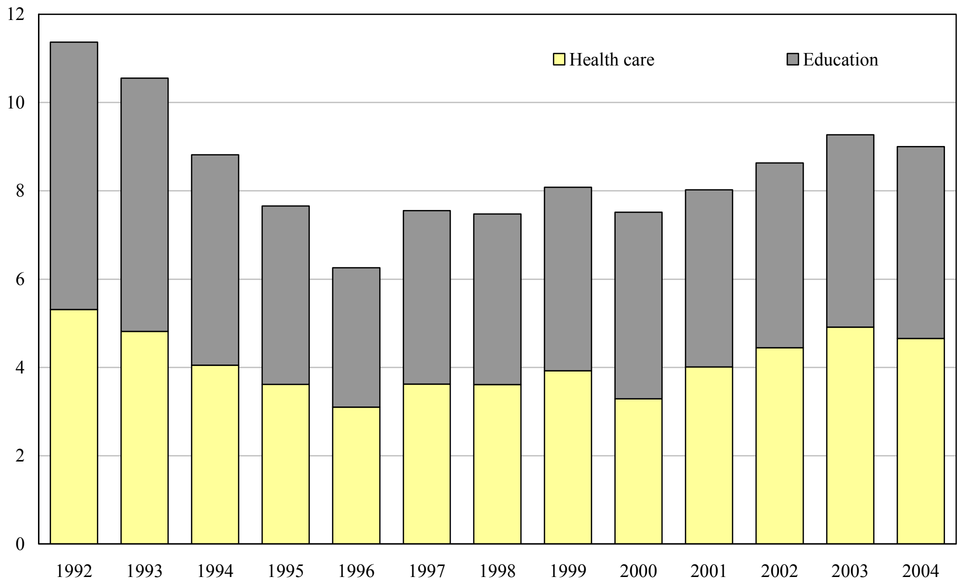
The macro stabilisation programme of 1991 focused on fiscal and monetary policies but not on structural reforms. As a consequence the reform package did not envisage any radical fiscal expenditures adjustments apart from reducing subsidies and implementing restrictive income policy. No changes, either legislative or institutional, were perceived related to the incidence of government services provision. Any attempts to introduce market driven supply of services in the sectors of health care or education were doomed to fail because of the well established notion (stated also in the Constitution) that basic services should be provided for free. The behavioural problems inherited from socialism stepped on long cultivated beliefs that:

- government will shelter job security and support the existing standard of living (identical for most of the citizens). This type of belief nurtured expectations for centralised inflationary compensations;
- the centralised provision of education and health care services will continue at the prevailing insignificant prices or free of charge.

To break with the habitual behaviour was a task no politician put forward in 1991. Due to insufficient financial resources, however, the quality of services provided by the health care system and education declined abruptly and households were forced to resort to private providers (Figures 15 and 16).

Figure 15

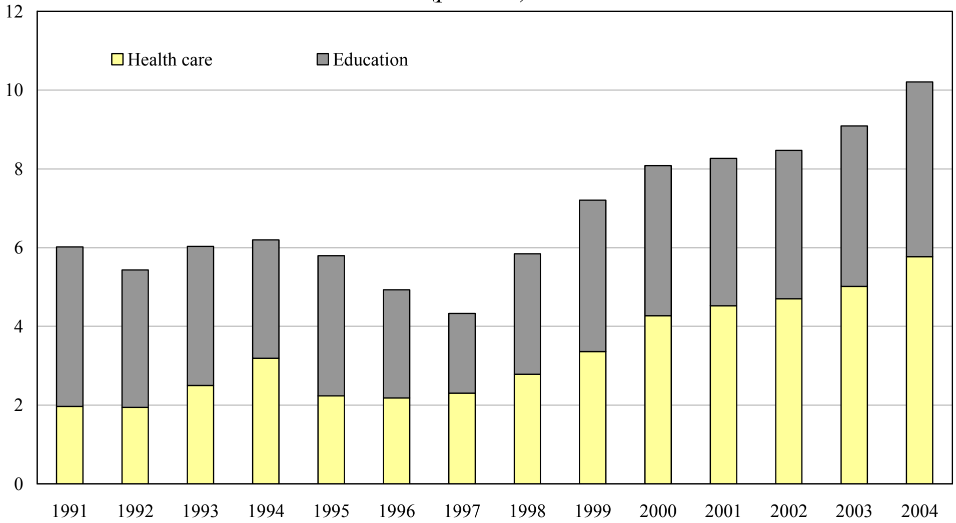
Bulgaria: Budget Expenditures on Health Care and Education
(percent of GDP)



Source: Ministry of Finance.

Figure 16

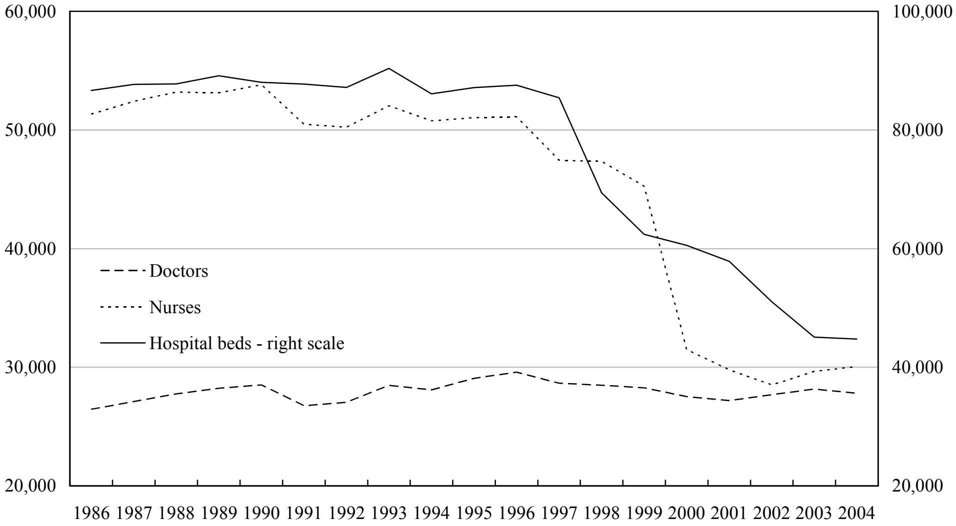
Bulgaria: Expenditures on Health Care and Educational Services in Total Household Expenditures
(percent)



Source: National Statistical Institute.

Figure 17

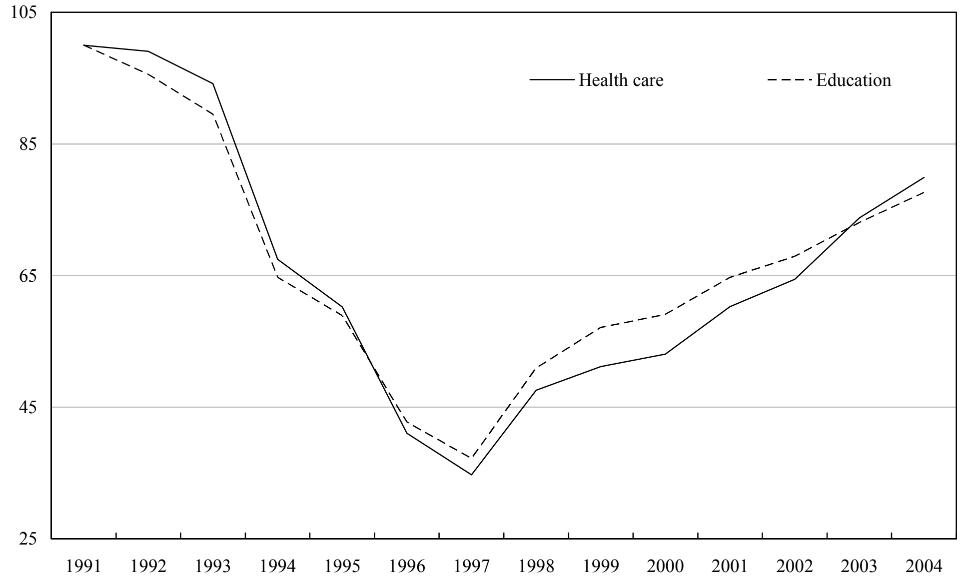
Bulgaria: Employees in the Health Care Sector
(numbers)



Source: National Social Security Institute.

Figure 18

Bulgaria: Real Average Wages in Health Care and Education
(1991 = 100)



Source: National Statistical Institute.

The health care sector remained practically intact until 1999 (Figure 17). There was no reduction in the number of medical staff or hospital beds, whereas the fixed costs of maintaining the system remained relatively high. The reduction in expenditures in percent of GDP was achieved by keeping wages low and slowly transferring costs to patients (Figures 18-19).

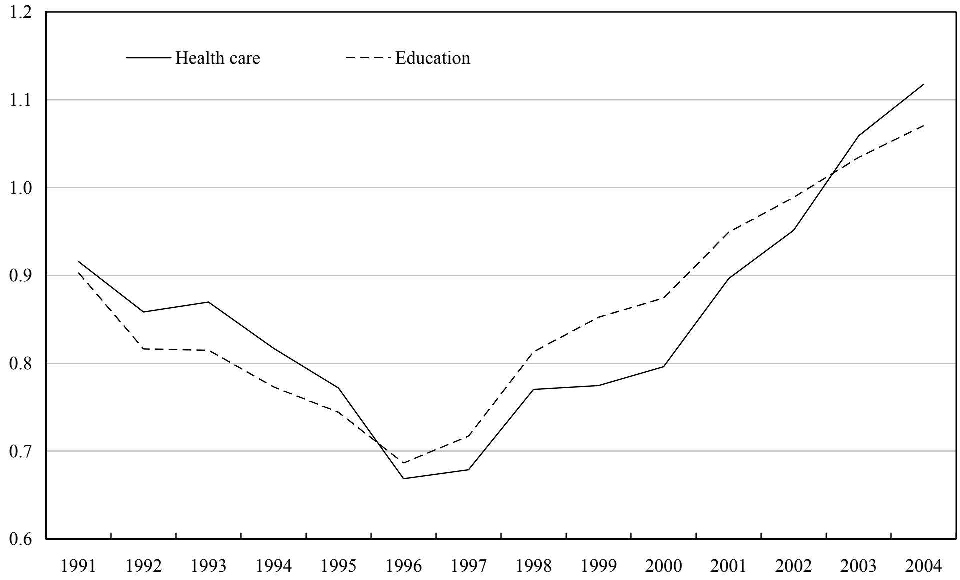
The reform in public health care was launched in July 1999 with the establishment of the National Health Insurance Fund (NHIF). A new contribution was imposed at the amount of 6 per cent of wages and the contribution is equally shared by employers and employees. During the first year of its establishment the Fund only accumulated resources while the financing of health care still remained within the responsibility of the government budget.[8] In July 2000 the NHIF started its operation by opening the financing of primary health care. Since 2001 a step by step process of transferring hospital health care financing from the budget to the NHIF is in progress.

The health care reform initiated in 1999-2000 was targeted at improving the link between the actual provision of services and their financing. The reform was

[8] Accumulated resources are still available on the Fund's account at the central bank.

Figure 19

Bulgaria: Relative Wages in Health Care and Education
(relative to the national average wages)



Source: National Statistical Institute.

Table 2

The Share of the NHIF in Health Care Financing

	2000	2001	2002	2003
Share of NHIF in overall financing of health care	13.0%	36.0%	41.0%	46.0%
Share of NHIF in the hospital health care financing	0.0%	3.0%	15.0%	36.0%

Source: Ministry of Health Care (2004), National Health Insurance Fund (2004).

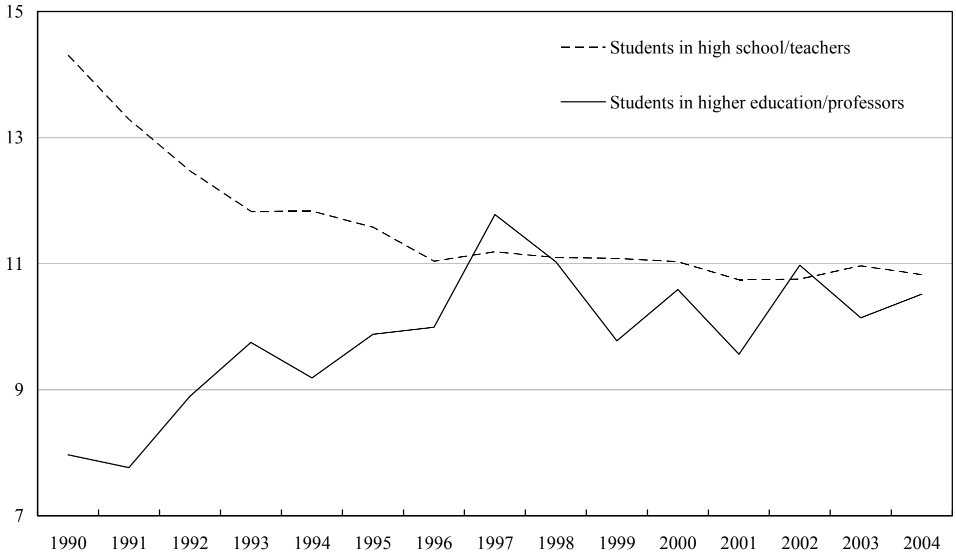
also supported by a process of granting licenses to hospitals as a result of which a substantial decrease in the number of hospital beds was achieved. One consequence of the applied structural measures was the sharp decline in medical staff, particularly nurses (Figure 17). Although public expenditures on health care are growing recently the households' costs on health care services are also on the increase. In practice the public health care is financed from three sources – the government budget, the NHIF and the households.

In terms of sustainability of health care financing it may be presumed that equilibrium may be achieved if the contribution rate of 6 per cent is raised in accordance with the process of shifting financing of hospital health care from the budget to the NHIF. The restructuring of the sector is still undergoing and may improve the efficiency in service provision. The amount of financing supplied by the NHIF is negotiated every year so that to reach a balance between expected revenues and expenditures. By law the NHIF is not allowed to run a deficit and to accumulate debt. The private supply of services is thriving but it closely depends on income growth rate and the quality of services.

The ongoing reform in education does not follow the clear-cut path of the health care reform. The demographic changes influence developments in education, too. The number of students enrolled in primary and secondary education decreases and the ratio of students per one teacher diminishes (Figure 20). Closing down schools due to a reduction in students creates high social tension in the regions affected. Although social discontent may slow down the speed of restructuring it can not stop the process because of its purely demographic nature. On the other hand, the demand for higher education is high and keeps the ratio of students to a professor relatively stable (Figure 20). Since 1991, financing of higher education is mixed. One part is funded through the government budget based on negotiations between the higher schools and the government. The remaining part is covered by tuition fees, determined independently by every higher school.

Figure 20

Bulgaria: Ratio of Students to Teachers



Source: National Social Security Institute.

The structural reforms in the health care system and education are far from completed. The aging of the population will put pressure on the health care system, while the absolute decline in the number of the young population should be matched by a respective reduction of schools and dismissal of teachers, very sensitive issues representing a potential source of social tension.

3. Sustainability of the achievements

Confidence in the current and the future fiscal policy represents the most important building block of fiscal sustainability. Rising support to the economic policy implemented reduces the discount rate used for assessing the inter-temporal budget constraint and in the evaluation of the sustainable fiscal position of the government (Nenova and Kaloyanchev, 2004). In Bulgaria, the two consecutive governments that have taken office since July 1997 maintained a restrictive stance of fiscal policy (Figure 4). The continuity and coherence of the economic policy put into practice was appreciated highly by the international financial markets and the credit rating agencies. The spread on the Bulgarian government securities declined and also in 2004, after seven years of macroeconomic stability and prudent fiscal policy, Bulgaria has been granted an investment credit rating.

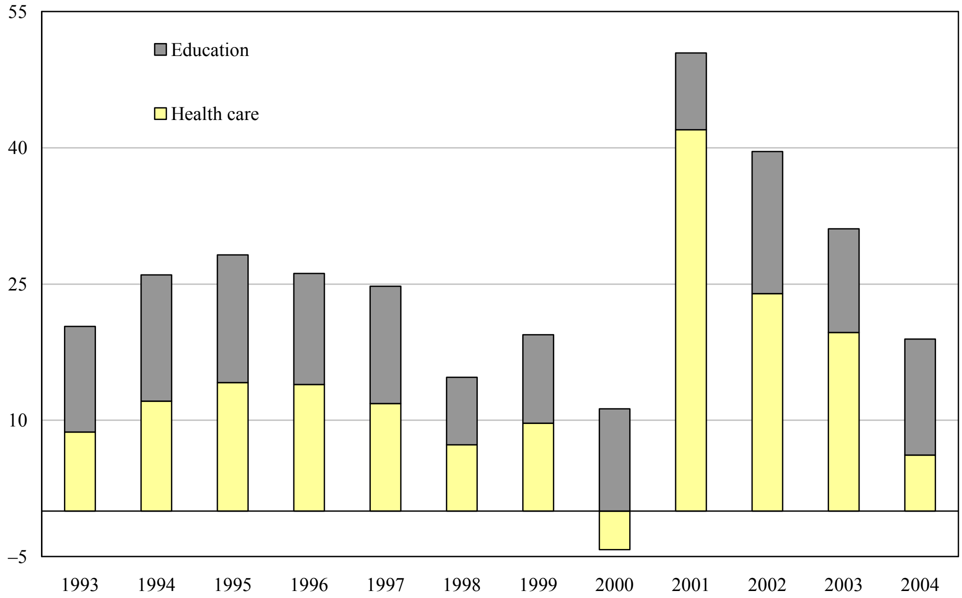
In addition to the positive track record, two documents, related to the Bulgaria's preparation for the EU membership, had been published in 2004, namely the Strategy of the Bulgarian National Bank for the period of 2004-09 and an Agreement between the Government of Bulgaria and the Bulgarian National Bank (BNB) on the policy and commitments to be followed in the process of introducing the Euro in the Republic of Bulgaria in the period until 2009-10. They reveal the commitment of both the Government and the central bank to apply for ERM II entry as early as the country becomes an EU member and to fulfil the criteria for entry into the third phase of EMU at the earliest possible time (end of 2009-beginning of 2010). The documents aim at strengthening the confidence in the implemented economic policy on the eve of the country's EU membership. The signing of the accession treaty in April 2005 contributed to the positive assessment of the medium-term perspectives of the economy.

It should be noted that the falling international interest rates in 2002-03 had been crucial for the maintenance of a balanced budget (even running a surplus) and allowed for the progress in the reforms performed in the fiscal sector. On the other hand, the governments did take the opportunity of the favourable international environment and through a series of debt net payments and buy backs succeeded in reducing twice the nominal government debt in the period 1999-July 2005. The ratio of the total government debt to GDP diminished to about 30 per cent in July 2005 from 86.8 per cent in 1999, a pre-requisite for the future sustainability of public finances.

The wages policy set by the Government and negotiated in the Tri-partite Commission concerns only the minimum wages and the government employees'

Figure 21

Bulgaria: Share in the Nominal Growth of Non-interest Expenditures
(percent)



Source: Ministry of Finance.

salaries, which now cover a small share of overall employment. The approach to wages determination for sectors financed by the budget is quite flexible as it contains two components – a rule, stating that the coefficient of wages increase depends on the target of maintaining a close to balance fiscal policy; and discretion allowing for end of year bonuses in case of budget revenues out-performance. Although the average wages in the government sector, health care and education is permanently on the increase in the last few years the share of wages expenses in non-interest budget expenditures is quite stable (Figures 5, 8 and 18-19).[9]

The privatization in 2004-2005 of utilities like distribution of electricity to final consumers and the fixed telephone lines will further advance the process of price liberalization as the new owners will set their prices under the monitoring and with the approval of independent regulatory bodies. If expectations for future increases in personal income, revealed in the consumer confidence surveys, come true then households will be better positioned to absorb possible rises in utilities prices.

[9] There is a process of faster growth of wages in the sectors but in real terms they are still far below the 1991 level (Figures 18-19).

The structural imbalance in the pension system will remain, but it will be alleviated by the gradual reduction in the dependency ratio as a result of the reforms in the system, launched in 2000 and envisaged for completion in 2010. The medium term forecasts perceive relatively high real growth rates of GDP and growing employment in Bulgaria. Based on the forecasts and adjusting for the higher retirement age it might be expected that the dependency ratio will further improve while the built-in procedure in the Social Code for pension calculation and indexation will keep the replacement ratio within affordable limits of around the current level of 40 per cent of the average wages. These are all factors easing the pressure on the public pension system and support the view that the new system of public social security as a whole supplemented by the mandatory fully funded pension scheme will operate in a sustainable way in the future. As of today the national social security system is not burdened by debt and its deficit of about 5 per cent of GDP in 2002 has been reduced to 3.9 per cent in 2004 and it is financed by a transfer from the central government budget.

The financial soundness of the health care and education sectors has been achieved in the last few years by significant reduction of hospital beds, closures of schools in depopulated regions, staff dismissals, and a poor quality of the services provided. The last factor – the very low quality of services provided by the public providers, urged the households to resort to services supplied by the private sector. However, the balance of today is extremely fragile and the structure of financing creates a high degree of social discontent. A priority for the fiscal policy of the coming years is to continue with the reforms in the two sectors that will improve the overall quality of services and sustain the balance in their financing.

The experience of Bulgaria in the period 1991-2004 exemplifies the challenges faced by governments in managing public finances under a heavy debt burden. But it also points out that it is not an impossible task to undertake successful fiscal restructuring and gain a gradual reduction of the debt burden to a sustainable level.

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