Analysis on Public Debt

Bulgaria

CSOs as equal partners in monitoring public finances

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BALKAN MONITORING PUBLIC FINANCES
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CREDITS

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This document has been produced as a part of the project "CSOs as equal partners in the monitoring of public finance" which started beginning of 2016 and is implemented by a consortium of 10 organizations from 7 countries and will last for four years.

The aim of the project is to improve the transparency and accountability of policy and decision making in the area of public finances through strengthening the role and voice of NGOs in monitoring the institutions that operate in the area of public finances. In this way, the project will strengthen CSO knowledge of public finance and IFIs and improve CSO capacities for monitoring. Additionally, it will help advocate for transparency, accountability and effectiveness from public institutions in public finance. Moreover, this project will build know-how in advocating for sustainability, transparency and accountability of public finance and IFIs. This project will also increase networking and cooperation of CSOs on monitoring of public finance at regional and EU level. Lastly, it will increase the understanding of the media and wider public of the challenges in public finance and the impacts of IFIs.

Key project activities are research and monitoring, advocacy, capacity building and transfer of knowledge/practices and networking in the field of the 4 specific topics: public debt, public-private partnerships, tax justice and public infrastructure.

More information about the project can be found on http://wings-of-hope.ba/balkan-monitoring-public-finance/ and on the Facebook Page Balkan Monitoring Public Finances

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CONTENT

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INTRODUCTION

Despite the growth from the past years, the national debt of Bulgaria is still relatively low. Compared to other Member States of the EU, this increase is not the result of more social expenses but due to the support of the banking sector after the bankruptcy of the fourth largest bank in Bulgaria. The issuing of more state bonds can be explained with the need to guarantee liquidity in case of future financial shocks as well as with the favorable market interest rate. However, no source of paying off the debt are indicated. There are also no plans for significant public investments, which could eventually turn into a source of income that would repay the debt. The conservative approach of the Bulgarian governments creates an illusory vision of stability, which cannot guarantee real sustainability of the Bulgarian economy and the society.

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1. LEGAL FRAMEWORK ON PUBLIC DEBT

The government debt is regulated in two main legal instruments- the 2002 Government Debt Act and the Public Finances Act. Article 2 of the former stipulates that all financial obligations, undertaken on behalf and for the account of the government in compliance with the Constitution, shall constitute government debt, and shall represent a liability of the government.[1] The law also contains another category called government-guaranteed debt, which includes all financial obligations, for which the Council of Ministers has issued guarantees on behalf and for the account of the government in compliance with the requirements of the Constitution.[2] The Public Finances Act complements the definition of government debt by adding that it shall also include other forms of debt pursuant to Council Regulation (EC) No. 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit, annexed to the Treaty establishing the European Community, which is assumed and repaid from the central state budget and from the persons whose budgets are part of the state budget, including through their accounts for EU funds.[3]

The Government Debt Act outlines several cases when the State can borrow money on the international financial markets:

- To finance budget deficit
- To finance investment projects and specific programs, where approved by the National Assembly
- To refinance the government debt outstanding on or before the maturity date
- To meet payment under government guarantees that have become due
- To support the balance of payments of Bulgaria
- To finance projects through financial instruments as set out in art. 2, point 11 of Regulation 1303/2013[4]

The borrowing itself is executed by the Minister of Finance who signs on behalf of the government loan agreements on the basis of a Council of Ministers decision according to the procedure established by the International Treaties of the Republic of Bulgaria Act. The Minister also prepares an annual report on the state of the government debt, which is discussed by the Council of Ministers and presented before the National Assembly together with the report on the implementation of the state budget for the relevant

[1] Government debt act art.2.
[2] Government debt act art.18
[3] Public Finances Act § 1, it. 15 of the Supplementary Provisions
[4] Government debt act art.5

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year. To ensure transparency the Ministry of Finance maintains an official register of the government and government-guaranteed debt.[5]

The Stability and Growth Pact agreement binds all EU member states to maintain a sound fiscal policy and coordination by setting a budgetary target also known as the medium-term budgetary objective (MTO), which aims at sustainable debt levels. To this end, the Ministry of Finance develops a **government debt management strategy** for the respective medium term period of three years, which has to be approved by the Council of Ministers.[6] It contains information about the status of the government debt and the government guaranteed debt, economic prospects for the period and analysis of the risks, ending with goals to be achieved.[7] Every year the State Budget Act sets a limit on the maximum amount of new government debt, which may be assumed during the year.[8] Municipal debt is not guaranteed by the state and is not an obligation of the government except in cases when a government guarantee is issued.[9]

[5] Government debt act art.38
[6] Government debt act art.16
[7] Government Debt Management Strategy 2017-2019
[8] Public Finances Act art.37 (1) point.1.
[9] Municipal Debt Act art.7.

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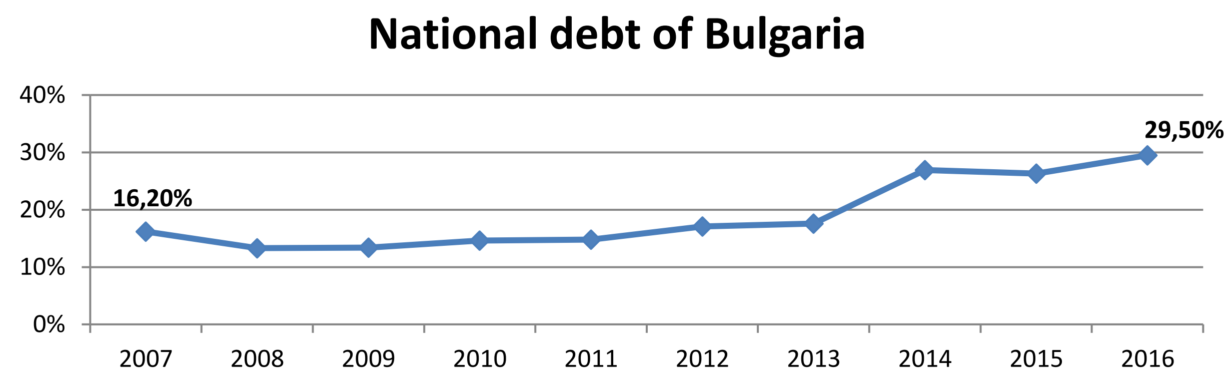
2. PUBLIC DEBT

For six years (2008-2013) Bulgaria had the lowest national debt to GDP ratio in the EU second only to Estonia.[10] In 2014 the debt ratio increased significantly by 7 per cent and reached a level of 26,9% by the end of the year. Since then it has continued to rise with more steady steps peaking at 29,5% at the end of 2016. Although it is still among the lowest in the EU, the government's unwillingness to invest in key project, the moderate economic growth and the high share of grey economy pose the question about the sustainability of the Bulgarian national debt. The indebtedness of countries like Germany for example is much higher (68,3%), but the economic and social structure of countries like these presupposes better capacity to repay the loan compared to Bulgaria, which makes their debt more sustainable.



Sources: „Review of the national debt" by the Ministry of finance[11] and data of the National bank[12]

The latest increase of the debt is due mainly to the necessity of guaranteeing the liquidity of the banks. A full independent audit of the banking system was planned after the bankruptcy of one of the largest banks. Awaiting to uncover new weak spots, which would require a guaranteed liquidity of the banks, the government proposed a mid-term program of state loans, which would allow for an additional 8 billion euro debt.[13] The stress tests revealed the necessity of extra liquidity, which prompted the assets to be kept in the fiscal reserve. At the end of May 2017 there is 6 855 million euro in it[14]- significantly

[10] General government gross debt - annual data, Eurostat http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=teina225
[11] http://www.minfin.bg/bg/statistics/2
[12] http://www.bnb.bg/Statistics/StMacroeconomicIndicators/index.htm
[13] Law for ratification of the Contract for dealing and issuing of bonds worth 8 billion eurohttp://parliament.bg/bills/43/502-02-3.pdf
[14] Fiscal Reserve Account (FRA) by months as on 31.05.2017https://www.minfin.bg/document/20072:2

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above the minimum required by law. There is no plan for the spending of this reserve either. There is no doubt that in a period of extremely low interest rates it is lucrative to take a loan. What is disturbing is the absence of information about the government's plans about how to spend these assets for which interest is paid.

In Bulgaria there is the so-called government-guaranteed debt. These are guarantees, which might or might not be triggered and are therefore, called conditional debt. The last issued guarantees in September 2016 were three: two for 300 million euro in connection with the Project for stabilizing the guarantee of deposits and one for 150 million euro for the partial financing of the National program for energy efficiency of multifamily buildings. At the end of 2016 the government-guaranteed debt amounted to 1,8% of the GDP.[15]

The biggest challenge are the state companies in the energy sector. One such example is the project for the Belene Nuclear power plant. After taking the decision to terminate the project, the state was sentenced to pay 601 million euro. There is also the "hidden" guaranteed debt. A recent example are the two foreign-owned coal power plants, which are protected by the contractual obligation of Bulgaria to pay 1.5 billion euro in case of pre-term termination of the contract. [16] According to a provision in the contact the National electric company has to purchase the produced energy in these power plants on preferential non-market prices. The American companies voluntarily lowered the prices only after extensive negotiations. At the signing of the agreement the US ambassador was also present but the National electric company was still obliged to take a loan and pay 535 million euro of accumulated debt.[17] Although not officially guaranteed by the state, these funds were taken from a national company with the assistance of the Ministry of energy. This means that in times of need, the company will most probably be supported by the state budget, which makes it a state loan.

The biggest part of the national debt is owed to foreign investors. The most part of it is taken through emissions of bonds, the rest are credits from international financial institutions (EIB and the World Bank).

[15] Central Government Debt and Guarantees Monthly bulletin May 2017https://www.minfin.bg/document/20066:2
[16] Response of the Minister of energy http://www.dnevnik.bg/biznes/2017/06/16/2990380_neustoiki_ot_3_mlrd_lv_sa_zalojeni_v_dogovorite_s/
[17] Response of the Minister of Energy in a parliamentary hearing https://www.me.government.bg/bg/themes/vapros-otnosno-dogovor-za-mostovi-zaem-v-razmer-na-535-mln-evro-1708-0.html

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Structure	Million euro	% of GDP
Domestic national debt	3507,7	7,4%
Foreign national debt	10273,7	21,7%
Government-guaranteed debt	855,5	1,8%

The interest rate of the emissions of state bonds in circulation over the last fiscal year floats between 0,5% and 6%. Due to the general collapse of interest rates the last emitted bonds in 2017 have a 0,3% interest and profitability of only 0,14%. The annual expenditure on interest in the past fiscal year amount to 375 million euro or 0,8% of GDP.[18]

According to the Strategy for management of the national debt 2017-2019[19] the debt will increase but in light of the expected growth of GDP the overall forecast is for the debt to reach the level of 25,1% at the end of the mid-term period.

2.1. Availability of information and transparency of data

The Bulgarian Ministry of Finance publishes a monthly bulletin of the national debt and an annual review. On the website of the ministry there is information about the government-guaranteed debt, the fiscal reserve and the overdue payments (published every three months). Despite this, it is difficult to make an analysis of the dynamics because the main data is in pdf form. The only files with data from previous years which can be analyzed are those about the government-guaranteed debt and the Consolidated fiscal program, with the latter containing only the interest expenditure. Another difficulty is posed by the different data about the GDP and the national debt published on the website of the Ministry of Finance and the Bulgarian national bank.

The website of the National association of the municipalities in the Republic of Bulgaria, which includes all municipalities and is their legitimate representative, contains statistics about the revenues and expenditures of the local power. However, it is not regularly published (the last one dates from 2015) and contains information only about the temporary no-interest loans of the municipalities.

[18] Expenditures by Function 1998-2016https://www.minfin.bg/document/3044:20
[19] https://www.minfin.bg/document/19352:1

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It is difficult to find information about concrete expenditure on single projects financed with debt as well as government-guaranteed debt for different spheres. Very often for the purposes of an analysis what can be used are only the statements of ministries and experts from state institutions.

2.2. Consistency of official data with fiscal framework policies

The official data about the debt in Bulgaria overlaps with the governmental fiscal policy. The only uncertainties are about the means and objectives for which the latest debt will be used. For now the funds are in the fiscal reserve.

The strategy for the management of debt 2017-2019 and the annual report of the European Commission point towards sustainability of the debt. Unlike them the reports of the IMF reveal some challenges to the financial system such as the high rate of non-performing loans. They also underline the need for stricter control on the deals between connected persons and credit concentration. According to the IMF in case of a new bank crisis it will be difficult to provide quick liquidity in sufficient amounts, which would in turn require restructuring and supporting concrete banks.[20]

2.3. Key milestones for the increase of the public debt

The first drastic increase of the national debt was in 2014. Although from initial low levels, the debt rose by about 50% and reached 26,9% of GDP. The funds from the emitted bonds were used to finance the deficit in the state budget, to pay off bonds with maturity in January 2015, to give a loan to the Fund for guaranteed bank deposits (FGBD) and to secure liquidity of the bank sector.

The biggest part was used to guarantee the bank deposits because the Corporate Trade Bank went bankrupt in 2014 and the funds were inadequate. The bank crisis also affected another bank- First Investment bank, which received a loan.

[20] IMF Executive Board Approves Bulgaria's 2017 Financial System Stability Assessmenthttp://www.imf.org/en/News/Articles/2017/05/24/PR17190-Bulgaria-IMF-Executive-Board-Approves-2017-Financial-System-Stability-Assessment

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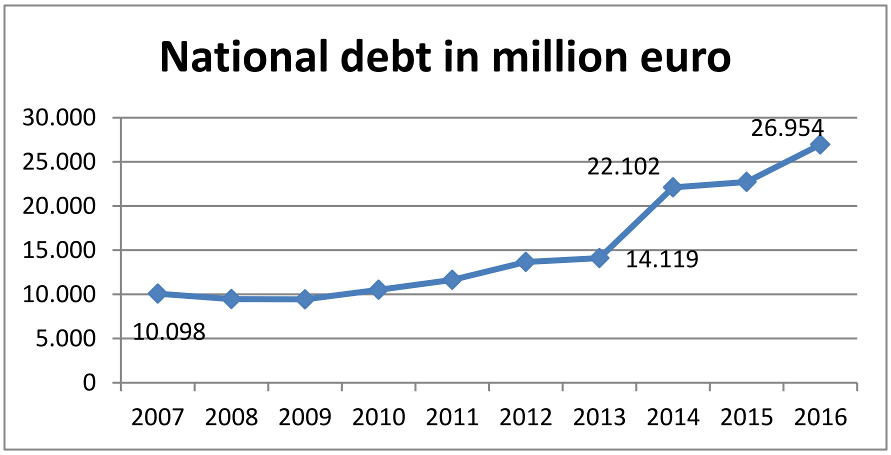
In 2015 the parliament adopted the decision to take an additional 8 billion euro debt over the next three years. It must be noted that the motives of the bill contain inadmissible objectives such as the increase of the fiscal reserve.[21] The decision of the parliament was disputed by the opposition before the Constitutional court with the motive that there was no time for debate between the two readings in parliament and hence, no amendments could be proposed. The claim was rejected.

When taking the last installment of the approved debt the government acknowledged that the idea is to guarantee the sustainability of the bank system in connection with the audit of the Bulgarian banks in 2016. Since there were no further shocks, the funds from the debt were directed towards the fiscal reserve, which is significantly above the required minimum at the moment. To this day not all envisaged bonds have been emitted, the government does not plan to take the full approved debt of8 billion euro.

The following graphs show the dynamics of the national debt in the past 10 years, as well as the paid interest.



Source of data: Ministry of Finance

[21] Law for ratification of the Contract for dealing and issuing of bonds worth 8 billion eurohttp://parliament.bg/bills/43/502-02-3.pdf

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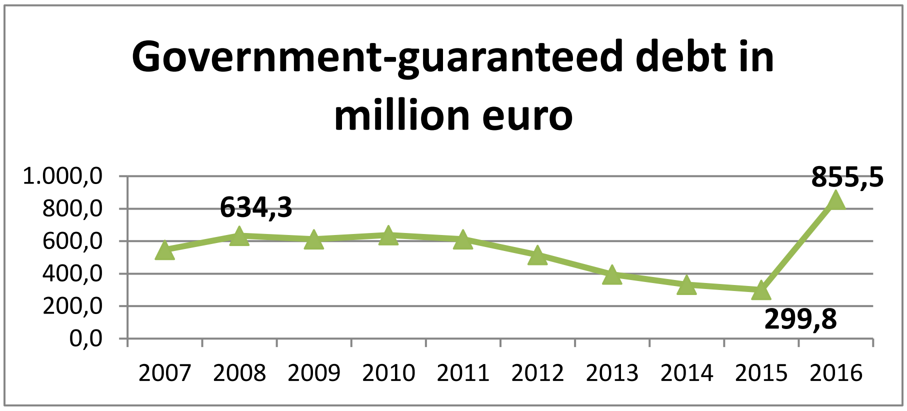
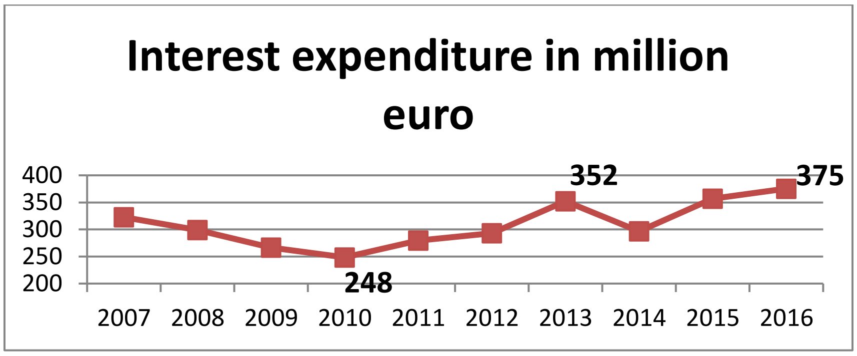


Source of data: Ministry of Finance



Source of data: Ministry of Finance

In the last year the government-guaranteed debt has evidently increased.

The private pension companies pose a particular interest since they invest in state issued bonds. The so-called second pillar of the pension system in Bulgaria is supplementary, but obligatory. This means that in addition to the solidarity pillar every worker is required to ensure themselves in a private pension fund as well. Two years ago the possibility to transfer the whole accumulated amount into the National Social Security Institute was introduced but to the complexity of the rules and the financial results of the private funds, not many persons have taken advantage of this.

In essence the insured persons finance the state budget through their contributions in the private funds and thus the state is able to pay a great deal of the pensions today. In exchange for that the state pays interest, which it would not owe had these social security contributions been paid directly to the National

The state bonds in the hands of private pension funds amounts to 325 million euro in 2016

Social Security Institute- the solidarity pillar. This mechanism would have some financial meaning if at least the workers received a higher income after retiring. Analyses of a parliamentary commission prove that for a ten year period (2004-2014) the real profitability of the private funds is negative. The situation today is improving but nobody can guarantee final positive profitability of the accumulated contributions after the end of the work life of the insured person. What is guaranteed are only the interest expenditures from the budget on the state bonds.

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3. INDEPENDENT REGULATORY AND OVERSIGHT BODIES/ ACCOUNTABILITY

The National Audit Office (hereinafter NAO) is the body that exercises control over the implementation of the budget and other public resources. Its main task is to oversee the reliability and accuracy of the financial statements of budget organizations and the lawful, effective, efficient and economical management of the public finances. It is independent when exercising these functions and reports the results to the National Assembly. The objects of audit are the state budget, the budget of the public social security scheme, the budget of the National Health Insurance Fund, the budgets of municipalities, accounts for the EU funds. The NAO also audits the origin and management of the government debt, the government guaranteed debt, the municipal debt, and the utilization of debt instruments.

The NAO compiles a report and recommendations to be followed by the audited organization, which is obliged to take measures for implementation of the recommendations. Since the NAO does not have sanctioning powers itself, in the event of noncompliance it sends a report with suggestions for penalties to the National Assembly, the Council of Ministers or the Municipal Council.

Until 2005 the internal audit and financial inspection of the public sector was centralized in the hands of the Agency for state internal financial control. After a reform inspired by European practices the two functions were separated and now the internal audit is done by a unit in each organization while the ex post inspection is conducted by the Public Financial Inspection agency under the auspices of the Ministry of Finance. Its main objective is to protect the public financial interests and unlike the NAO it has the legal authority to impose administrative and financial sanctions in the case of a violation.[22]

In 2013 Bulgaria ratified the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, the fiscal component of which is the Fiscal Compact. This treaty postulates that the fiscal discipline has to be scrutinized by an independent national institution. To this end in 2015 the Parliament enacted the law on Fiscal Council and automatic corrective mechanisms. The main aim of this council is to identify deviations from the mid-term budget objective and to ensure the state goes back on track within 2 years. The Council prepares opinions on the spring and autumn macroeconomic forecasts of the Minister of finance and on his suggested law on the state budget.

[22] Public Financial Inspection Act art.2

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4. PUBLIC DEBT MANAGEMENT

Until 2011 the annual review of the debt had a separate part of its servicing. The following reviews contain it in their whole texts but the strategy for its repayment is not distinguishable. The strategy for the management of the national debt shows the size, legal restrictions, eventual sanctions for non-published information, economic expectations, risks, but even there the sources for the repayment of the debt are not indicated. The prognoses show gradual reduction of the national debt to 25,15% of GDP by 2019. If we look at them in absolute amounts, however, the loans are expected to be reduced significantly in the current year of 2017 and then to rise steadily again. Actually, the reduced debt to GDP ratio is expected to be the result mainly of the increased GDP- 2,7% in 2018-2019. Foreign direct investments are also expected to return.

Reason for optimism comes from the data about the budget balance from the end of 2016. From the first time since 2008 the budget ended with a surplus of 750 million euro. This is, however, due to frozen social spending and the chronic underfinancing of the public systems.

The Strategy envisages new loans to be taken only in case of necessity to refinance the debt, to cover liquidity needs of the budget and depending on the current state of the fiscal reserve. In addition to these factors, the two clearly indicated objectives of the national debt are- financing the National program on energy efficiency of multifamily buildings and co-financing projects under the European Cohesion policy. This conservative approach is explained with the need of “market oriented debt financing”. The strategy resembles a plan to develop a market finance company and not a state. The stability is founded primarily on the lower activity as well as on the fact that with a currency board the possibility of conducting any monetary policy is significantly curtailed.

The challenges posed by this approach include:

- High share of grey economy- various research shows that the size of the non-formal sector is 30-35%. According to the latest research it is going down but in view of the different methodology the results among the different analysis are incomparable. The grey economy includes unregistered business activity and non-contractual labour- practices, which are beyond the control of the state and from which no taxes are collected.
- Tax evasion- several practices for tax evasion were revealed in the past few years. The big multinational companies with multibillion revenues report accounting losses, which is why they are tax exempt. Paying huge sums for consultancy services, transfers to the mother companies

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under taxes for the usage of the brand name and others are among the mostly utilized by the big firms.

- Fragile tax system- the main revenue to the budget is from indirect tax. On the one side, this reflects on the sustainability of the state treasury as lower consumption leads to lower revenues. On the other hand, the flat tax for the natural persons without non-taxable minimum income puts disproportionate pressure on the most vulnerable households. Until recently the corporate tax in Bulgaria was the lowest in all EU. Lowering the tax was framed as the most-efficient way of bringing the economy to the light and attracting foreign investors. None of the two objectives was achieved but nevertheless, it weakened the revenues to the state budget and deficits had to be covered by taking debt.

The sustainability of the national debt can be guaranteed by a real economic revival and not by maintaining low levels. This includes public investments in important public projects. The only one such project at the moment is the energy efficiency program for the multifamily buildings, which might save energy but it will not translate into a motor for growth. The remaining necessary steps include introducing control over unaccounted economic activities, reconsidering the tax system since the data proved that tax dumping does not lead to economic boost, real sanctions for hidden social and tax payments. The most secure way towards sustainability of the debt is sustainable growth of the budget revenues.

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CONCLUSIONS AND RECOMMENDATIONS

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REFERENCES

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