Bulgaria’s Fiscal Sustainability and Policy Response to the COVID-19 Outbreak

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Abstract: The analysis of the present study on the effects of the fiscal policy response of Bulgaria to the COVID-19 outbreak illustrates that the European Union (EU) additional fiscal rules introduced after the 2008 global economic and financial crisis help build buffers for the period of a new sudden macroeconomic shock. The new legislative initiatives to reform the coordination, monitoring and macroeconomic risk management in the EU taught lessons about fiscal framework from Maastricht, which inevitably has had an impact on national fiscal policies of the EU member states before COVID-19 pandemic. The assessment of Bulgaria’s fiscal sustainability indicates that the government followed a strong fiscal discipline since early 2000s, which helped the country during both recent crises. Prior to the EU accession Bulgaria experienced strong economic growth above its potential provoked by the attractiveness of the country to foreign investors. The fiscal policy has been countercyclical, which contributed to the macroeconomic stability of Bulgaria as a country in the currency board arrangements. During the good periods when the output gap was positive the government created stable buffers with positive structural fiscal balance, which was above the medium-term budgetary objective (MTO) of 1% of GDP. Thus, in the emergency COVID-19 epidemic situation Bulgaria has had fiscal space for additional public spending and debt issuance. The assessment of the study shows that Bulgaria should return to its MTO with a gradual fiscal consolidation over the following years.

Key-Words: Fiscal policy, Public Economics, Public Finance.
JEL Classification Numbers: H3, E62

1. Introduction

During COVID-19 pandemic the governments across the world have implemented extraordinary fiscal actions to support households and businesses. Conventional and unconventional measures have been prompted by central banks to support the flow of credit and to prevent financial market disruptions (IMF, October 2020). To overcome the challenges of COVID-19 pandemic while also fighting with climate changes, the European Union (EU) has envisaged €1.8trillion EU Budget for supporting the EU economies through the Multiannual Financial Framework (MFF) for 2021-2027 (European Commission 2020). How did Bulgaria follow the fiscal rules in the EU before COVID-19 and how will the response to COVID pandemic cope with them in medium term for its fiscal sustainability?

To respond to that, this paper will focus its analysis on: (i) assessment of fiscal policy sustainability in Bulgaria for the period 2003-2019; and (ii) fiscal performance of Bulgaria and selected EU countries and Bulgaria’s fiscal policy response to COVID-19 and future perspectives.

2. Assessment of Fiscal Policy Sustainability of Bulgaria (2003 – 2023)

The EU legislative initiative for coordination and monitoring of public finances through additional fiscal rules of the Growth and Stability Pact (GSP) with the adoption of Fiscal Pact and five directives “Six pacts” (European Parliament 2011) during the period 2011-2013 created buffers and taught lessons about fiscal framework from Maastricht, which inevitably has had an impact on national fiscal policies of the EU member states after the 2008 global economic and financial crisis. Before COVID-19 complexity had become the major problem of the EU fiscal rules for policymakers (Darvas et al., 2018). The EU fiscal rules system of the GSP became nearly unmanageable due to its complexity and the constant addition of exceptions, escape clauses and

other factors (Wieser, 2018). Additionally, the EU faces new challenges after Brexit, COVID-19 and transition towards green and digital economy, which may lead to amendments to the EU fiscal rules for the way forward.
One of the consequences of the COVID-19 outbreak has been that the EU relaxed temporary existing fiscal rules for general government fiscal deficit of 3% and government debt of 60%. The new Recovery Plan for Europe called Next Generation Europe (NGEU), being a part of the MFF for 2021-2027, aims to support of EU economies for sustainable recovery from COVID-19 pandemic, returning to fiscal and debt targets, and for effective movement towards environmental, digital and sustainable economy (European Commission 2020).

The rational for the EU fiscal policy rules is macroeconomic stability. Their developments point to a twofold task: first, making a credible reduction in the fiscal deficit within a range that will stabilize the debt ratio at a prudent level and, then, containing the debt ratio over the medium to long term. To maintain macroeconomic stability the EU regulations set up medium term objectives (MTOs) for the Member States in structural terms. The EU Regulation 1466/97 specifies that the MTOs should be pursued to achieve a structural fiscal deficit of at least 1% of GDP for countries in the euro area and in the EU Exchange Rate Mechanism II. Member countries, which are signatories to the Treaty on Stability, Coordination and Governance in the European Monetary Union, have even more ambitious commitment to achieve at least 0.5% structural fiscal deficit.

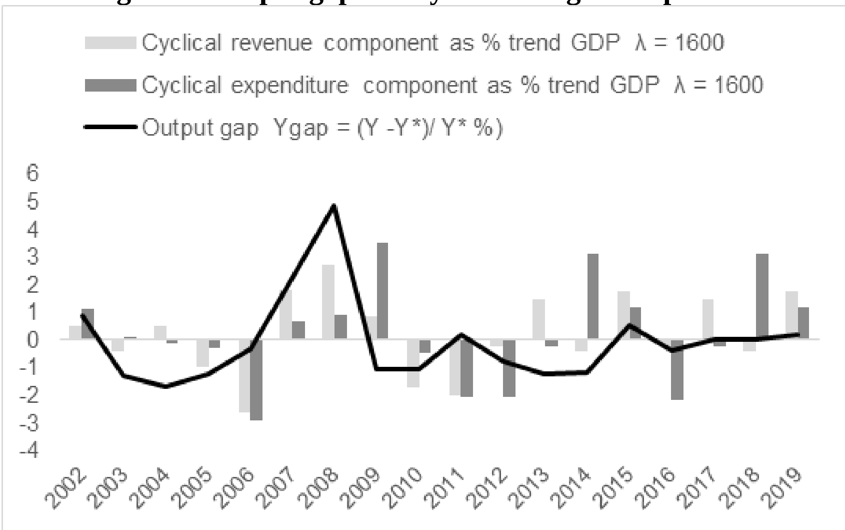
From theoretical point of view a structural deficit occurs when a country (or state, municipality, etc) posts a deficit even when the economy is operating at its full potential. This is the opposite of a cyclical deficit in that a cyclical deficit only occurs when an economy is not performing to its full potential (for example, if an economy is currently struggling through a recession

Conceptually, the most basic reason to be concerned about the structural deficit is that it is projected to grow faster than the economy. On the other hand, fiscal policy can contribute to economic recovery when it is countercyclical in the medium term and this is when changes in structural balance and output gap as deviations of actual GDP from potential GDP (Ygap) move in one direction. The reason is that the improved structural fiscal balance shows fiscal interventions in a restrictive direction, which is positive for business activity when the economy is growing above potential. In the opposite case, when the Ygap indicator is negative (i.e. the economy is growing below its potential), it is believed that an improved structural fiscal balance would further exacerbate fluctuations in economic activity.

To assess Bulgaria's fiscal policy, the methodology of the International Monetary Fund (IMF) was applied by measuring the change in the primary structural fiscal balance against potential GDP; the trend of the structural components of the budget parameters relative to the potential GDP, and the endogenous response of the budget parameters to the changes in the business activity.
A quantitative measurement was applied. First, structural components of budget parameters were performed by clearing the cyclical elements of net budget revenues and expenditures at constant prices. Second, the change in the structural (cyclically adjusted) fiscal balance was defined as the difference between cyclically adjusted budget revenues and fixed expenditures.

For the calculation of structural components, the seasonally adjusted series for net budget revenues and expenditures on a quarterly basis at constant prices in Bulgaria (Q1 2002-Q4 2019) were filtered by HP filter (Hodrick and Prescott 1997) with a smoothing parameter λ = 1600 and calculated as a share of GDP. Simulations were made at λ = 500 and 1000 to ignore the subjectivity of the conclusions, and they did not substantially change the conclusions about cyclically adjusted budget parameters.
The cyclical components of the budget parameters were calculated as the difference between the budget parameters and their structural components on a quarterly basis, aggregated on an annual basis and expressed as a percentage of the potential (trend) GDP. The estimates for Bulgaria for cyclical items compared to the deviation of the actual GDP outturn confirmed their effect as an automatic fiscal stabilizer (Figure 1).

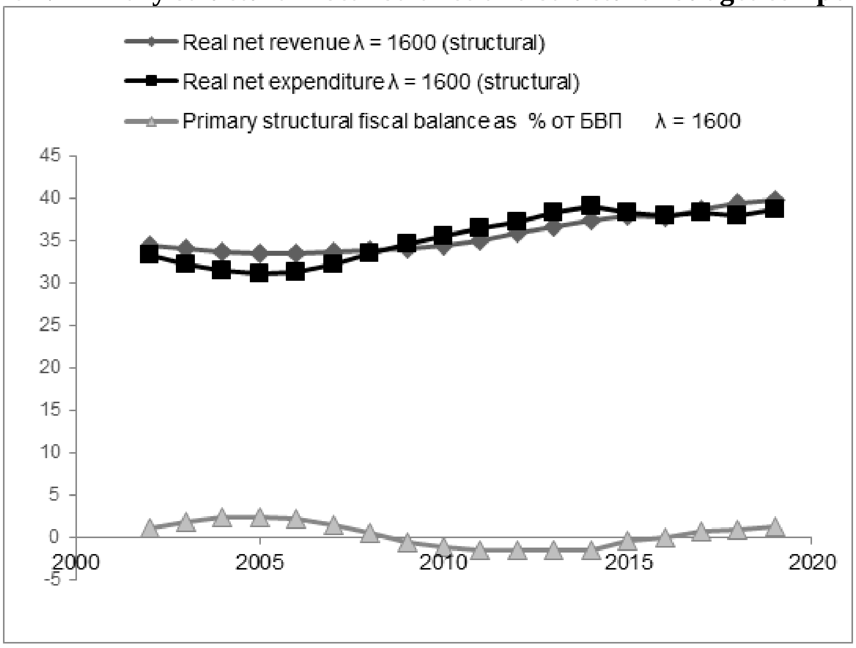
Figure 1. Output gap and cyclical budget components



Source: Own calculations, Eurostat (2020)

The econometric assessments of the structural components of the budget parameters and the primary structural balance, respectively, reflecting the medium-term intentions of the government and their trend show that their trend is most years aligned with the changes in output gap (Figure 2).

Figure 2. Primary structural fiscal balance and structural budget components



Source: Own calculations, Eurostat

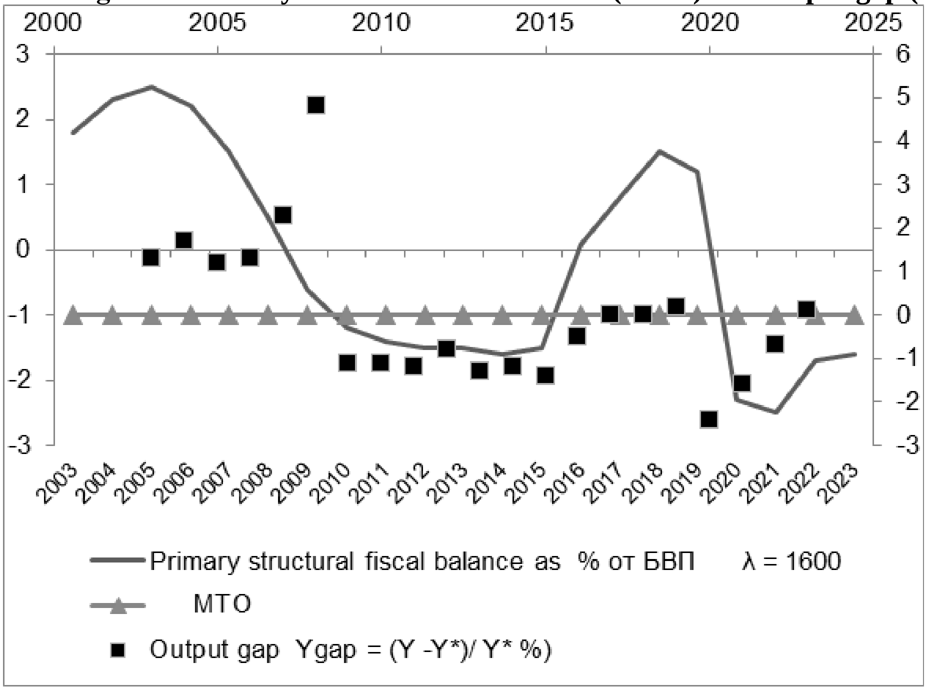
The limitations of the applied approach are linked to HP-filter, which has several disadvantages. The most important in this context being that it is known for its revisions inherent to this procedure. This means that the estimated trend and cycle for the entire series will always be revised as new observations are added to the time series every month or quarter.

The assessment shows that the output was positive before the country's accession in the EU in 2007, peaking to 4.8% in 2008, and the structural fiscal balance moved in the same direction. Thus, the fiscal policy was countercyclical before the 2008 global economic crisis, which created buffers to cope with the consequences of the crisis.

Since 2009 the output gap and structural fiscal balance had turned to negative until 2016. The government achieved fiscal consolidation and created stable buffers during the period 2016-2019 when the output gap was positive again.

As a result of the COVID-19 pandemic the output gap and the structural fiscal balance for 2020 turned to negative again, but the projections showed a gradual improvement by 2023 (European Commission, 2020). The assessment of the study shows that since early 2000s the fiscal policy of Bulgaria has been countercyclical. The country has kept the structural balance aligned with the output gap and above the MTO for a structural deficit of 1% several years before COVID-19 pandemic (Figure 3).

Figure 3. Bulgaria's Primary structural fiscal balance (PSFB) and output gap (Ygap)

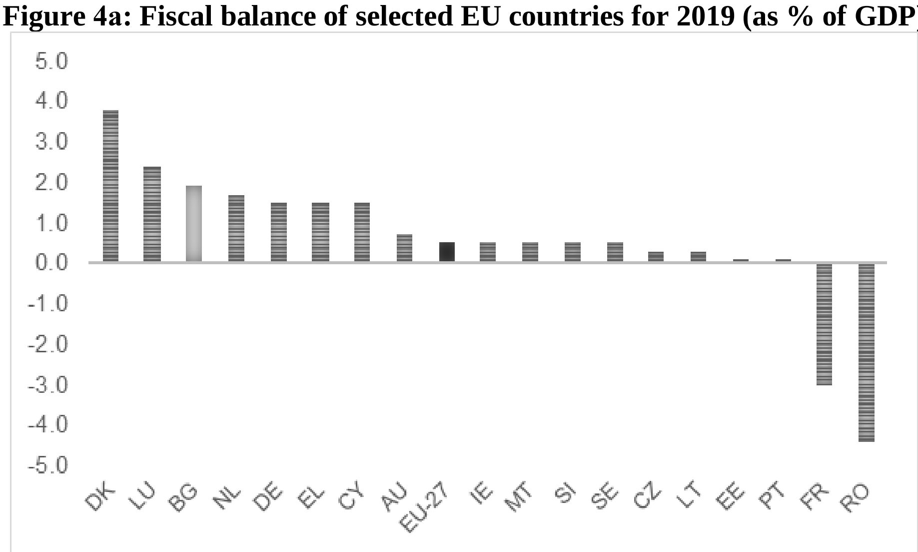


Source: Own calculations, Bulgarian Ministry of Finance (2020)

3. Bulgaria's Fiscal Policy Response to COVID-19 pandemic and Future Challenges

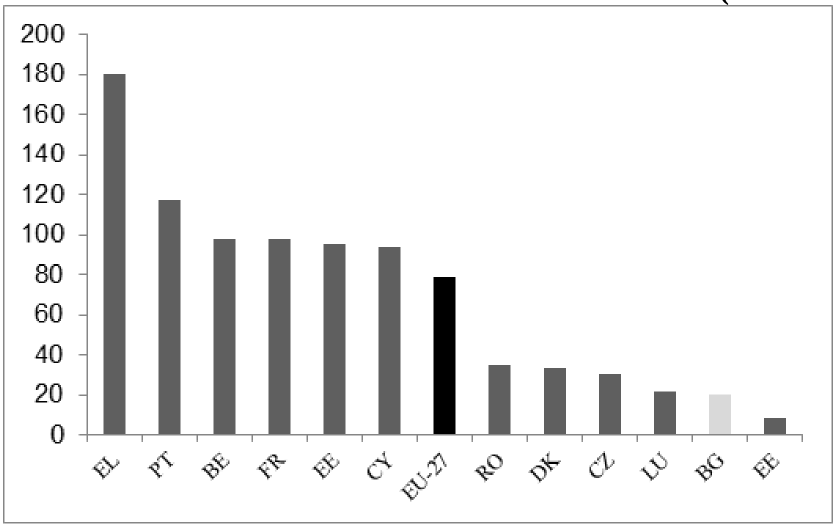
Before COVID-19 outbreak Bulgaria together with many other EU countries followed strict fiscal discipline with a budget surplus and lower government debt of GDP. In 2019 only France and Romania had a budget deficit above 3% of GDP, while more Member States had government debt ratios higher than 60% of GDP, breaching fiscal rules (Figures 4a and 4b).

Figure 4a: Fiscal balance of selected EU countries for 2019 (as % of GDP)



Source: Eurostat (2020)

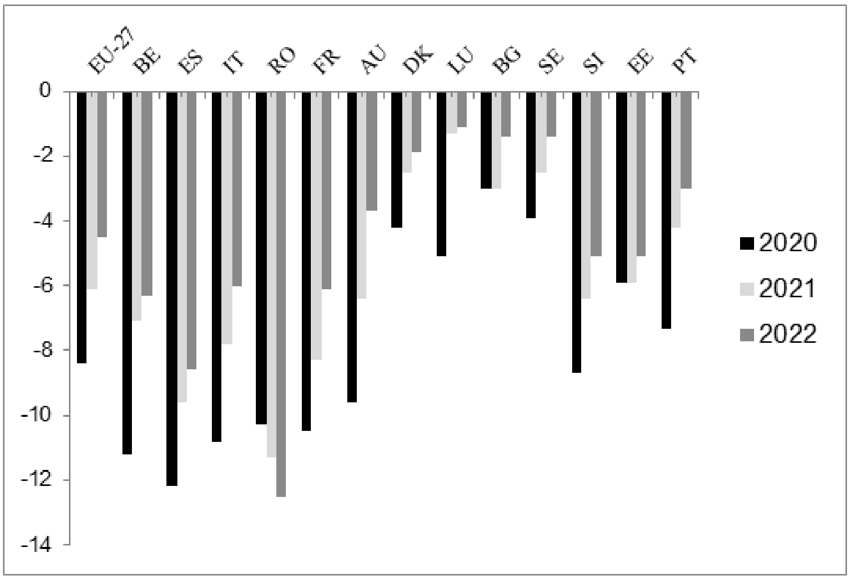
Figure 4b: Government debt of selected EU countries for 2019 (as % of GDP)



Source: Eurostat (2020).

Preliminary data about the COVID-19 outbreak suggest a significant economic impact from the pandemic in 2020 on fiscal deficits and government debt in the EU member states. The projected increases in general government deficits are expected to be much higher than those observed during the global financial crisis (European Commission, 2020). The large number of the announced COVID-related government policy measures will lead to significant annual deficits in medium term. All member States except Bulgaria are set to show deficits of over 3% of GDP in 2020 (Figure 5). Belgium, Spain, France, Italy and Romania forecast to exceed deficits of 10% in 2020 (European Commission, 2020).

Figure 5: Fiscal balance of selected EU countries for 2020 – 2022 (% of GDP)



Source: European Commission (2020)

Bulgaria is facing the COVID-19 pandemic from a strong fiscal position and the government has put in place measures such as support for businesses, higher remuneration for medical and security staff, subsidies and social support schemes (Bulgarian Ministry of Finance, 2020). The key anti-COVID-19 fiscal measures include:

- revenue measures for 0.3% of GDP for households with children, VAT reduction for restaurant services, books and baby food to 9 percent (from 20 percent) until end-2021;

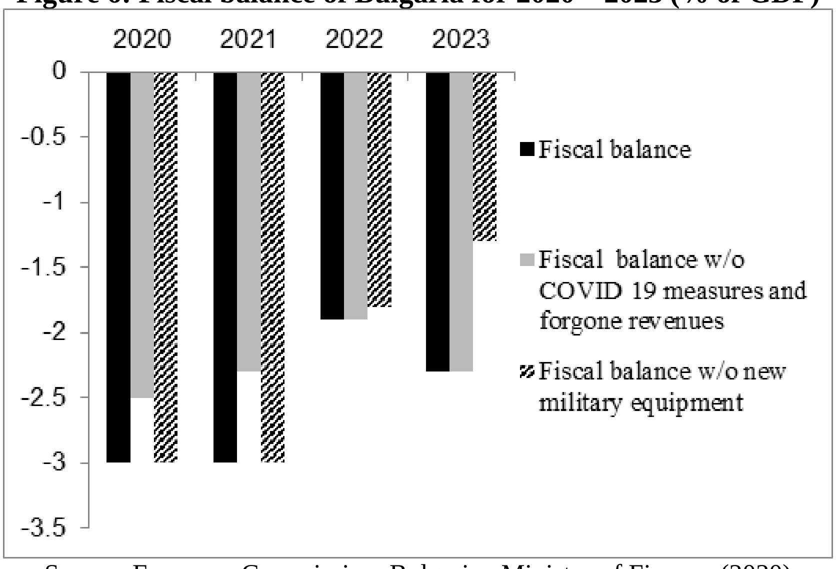
-support for various vulnerable groups of 1.3% of GDP, including pensioners (1% of GDP), parental support (0.2% of GDP) and freelancers in the area of culture.
-support for businesses 1.1% of GDP for 2020 through coverage of 60% of the wages of the employees in affected sectors that would have been otherwise laid off, including the social security contributions due by the employers. The support included reallocation of BGN173MM and 200 mn (0,3% of GDP) from the EU funds, respectively to support SMEs and larger companies that experienced at least 20 percent loss in revenues due to the pandemic; a minimum wage subsidy for the duration of three months to companies that hire an unemployed person; starting July 1, 2020 a monthly subsidy of a minimum wage (up to six months) for each job preserved, in tourism, hospitality and transportation sectors.
-additional remunerations in the ministries of health, interior and defense; bonus payments to medical and social services staff and expansion of social patronage services, but without impact on the expenditure ceilings of the budget.

The amendments to the 2020 budget act increased the amount of state guarantees that might be undertaken in order to cover Bulgaria's contribution to the EU Recovery Fund and its new instrument so-called temporary "Support to mitigate the Unemployment Risk in an Emergency" (SURE) programs(European Council 2020) . The resource of €200MM (out of €655MM) set aside for Bulgaria under the REACT-EU initiative is distributed in five of the existing operational programs from the programming period 2014-2020, which allow financing activities to support overcoming the effects of the crisis caused by the pandemic of COVID-19, and preparation for sustainable recovery (REACT-EU). A priority for Bulgaria remains the successful absorption of European funds and programs through which to achieve sustainable economic growth and the question is whether the country will manage to absorb the funds.

Thus, the fiscal stance for Bulgaria has been strongly expansionary in 2020 and 2021. The fiscal deficit on accrual basis for 2020 has increased up to 3.4%, exceeding slightly the 3% of GDP target (Bulgarian National Statistical Institute 2021) due to the one-off measures as a response to the pandemic. The impact of temporary revenue and expenditure measures related to preventing the spread of COVID-19 in the country is expected to be around 2.0% in 2020 and 2021.

Additionally, in 2022 and 2023 the acquisition of military equipment and related infrastructure aligned with the NATO responsibilities will have one-off negative effect on fiscal balance for 2022 and 2023. To finance the fiscal deficit the general government debt is expected to increase from 20.2% in 2019 to around 25% of GDP in 2020 and 26.5% of GDP in 2021, before returning to a downward trend in 2022. The debt increase should finance the primary deficit, but also serve as a precautionary borrowing for filling the required level of the fiscal reserve account (Figure 6).A fiscal consolidation during the following years is needed to return to MTO of 1% fiscal structural deficit. It should be achieved by a slight increase in revenues after the gradual recovery and withdrawal of emergency measures.

Figure 6: Fiscal balance of Bulgaria for 2020 – 2023 (% of GDP)



Source: European Commission, Bulgarian Ministry of Finance (2020)

Bulgaria will also benefit from the Recovery and Resilience Facility of the NGEU is €10 billion in grants and loans over the period 2021-2027. The impact on the aggregate demand from the EU additional funding should help gradually overcome the negative impact of COVID-19 outbreak on it.

4. Main conclusions

During the COVID-19 outbreak Bulgaria have launched a variety of emergency schemes, including provision of subsidies, benefits, loans and guarantees as well as the temporary postponement of tax obligations, increased social benefits and spending on healthcare, which pushed government deficits and debt levels above the heights reached during the 2008 financial crisis.

Public finances deteriorated significantly during both crisis, but during the 2008 global economic and financial crisis more of these negative consequences were not due to fiscal incentives. They were effects of automatic stabilizers (during the recession revenues decline and expenditure increase) and external factors (such as rescuing the banking sector). During COVID-19 pandemic Bulgaria similarly to the governments across the world increased significantly budgetary spending, which hampered temporally its fiscal sustainability.

The analysis of the present study on the effects of the fiscal policy response of Bulgaria to the COVID-19 outbreak leads to the conclusion that the strong fiscal discipline in Bulgaria during the times of growth built buffers, which have been used during the period of sudden macroeconomic shocks. Bulgaria's ability for additional spending has been determined by country's fiscal space and by good public debt levels before the crises.

The EU membership and additional EU resources from New Generation Europe as well as the MFF for 2021 – 2027 in support of the budget is expected to help Bulgaria alleviate its fiscal stance as a guarantor of macroeconomic stability. In a situation of emergency epidemic situation in Bulgaria a temporary deviation from the MTO of 1% structural fiscal deficit has been performed, but the envisaged gradual fiscal consolidation from 2022 is a positive sign for fiscal sustainability and macroeconomic stability.

Both crises have shown that Bulgaria and other member states need to create stable fiscal buffers to ensure fiscal space managing the consequences of the crises on economic activity.

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