From Fiscal Crisis to Fiscal Stabilization and Optimization: the Case of Bulgaria 1998-2012

George Manliev*

Summary:

The article reveals the process of fiscal stabilization and optimization following the serious fiscal and economic crisis that Bulgaria experienced in the period between 1996 and 1997. The currency board was introduced and Bulgaria started pursuing fiscal stabilization within the framework of cyclically balanced budget fiscal policy. Fiscal stabilization has been achieved largely due to retaining and rationalizing the budget expenditures in years of economic growth and increasing the tax revenues. Reforms in taxation, budget policy and partly in the social security system and healthcare contributed to the optimization of fiscal balances. Furthermore, the established fiscal rules have created fiscal discipline and supported fiscal stabilization. Due to this type of policy, the country weathered the economic crisis of 2009-2011 without worsening fiscal balances. In 2011 the counry prepared a Fiscal Constitution, but finally adopted the new Public Finance Law, which incorporated a number of fiscal rules, preventing short-term ineffective discretionary political decisions. As a whole Bulgaria met the fiscal requirements of the Fiscal Pact of the EU (signed 2012), but it is not ready to apply them yet because of the uncertainties surrounding the euro zone. Bulgaria is a suit to follow with regard to successful fiscal stabilization in the last 10 years and reaching fiscal balances contributed to economic growth and the gradual increase of welfare.

Key words: curency board, fiscal crisis, fiscal stabilzation, fiscal rules, fiscal reforms,fiscal pact

JEL classification: H1,H6

Introduction

Bulgaria went through a painful transition to a free market economy. In the second half of the 1990s, the country ran up debt and experienced an economic and social crisis which led to hyperinflation, a severe contraction of the business activity, a significant loss of incomes and impoverishment of the population. The introduction of the currency board in 1997 created monetary and fiscal discipline, which contributed to the recovery of the economic activity and subsequently led to economic growth. During this period Bulgaria achieved fiscal stabilization, which significantly improved the country's fiscal position. With the onset of the crisis in 2009, Bulgaria was faced with the dilemma to follow expansionary or contractionary fiscal policy. The decisions were in favour of retaining the levels of public spending and maintaining a low deficit, which preserved the robust state of the fiscal balances. Meanwhile, Bulgaria has undertaken steps to adopt legal rules on fiscal policy in order to ensure its fiscal stability, which is a precondition for joining the euro zone, which is the country's strategic goal.

* Associate-professor at Faculty of Management, Technical University; Department of Economics,University of National and World Economy, Sofia, Bulgaria; e-mail: g.manliev@gmail.com

To a large extent, the fiscal stabilization of Bulgaria after the fiscal crisis in 1997 is due to the implementation of new research approaches for sustainable fiscal stability. They were developed in the analysis of A. Alesina, M. Feldstein, J. Stiglitz, V. Tanzi, G. Tabelini, G. Perry, G. Kopitz and others, as well as in publications of the IMF, which were defined as "optimal fiscal policy".[1] It can be described as a process of adjusting the fiscal balances to sound and sustainable conditions and minimize their negative impact on the economic growth.

Only ten years after the fiscal crisis in 1997, Bulgaria managed to stabilize and optimize its fiscal condition. How did the country succeed in moving from a fiscal crisis to a sustainable fiscal stabilization? What were the fiscal decisions during the 2008-2012 crisis and depression, which prevented the fiscal balances from worsening? What are the decisive factors to maintain consistent and sound fiscal policy? These questions are the subject of analysis in the paper.

1. The 1997 Fiscal Crisis and Currency Board

Bulgaria is one of the Eastern European countries that made the transition from planned to a market economy. It required complex changes in the economic system related to: strengthening the right of private property and private initiative, market pricing of products and factors of production, capital market development, institutional building of market institutions and modelling of the regulatory role of the state. The transition to market economy is a politically determined process, which influences the pattern of change and the speed of its implementation.

Fundamentally, Bulgaria followed the Polish model of market changes, which is oriented to conduct a smooth, but relatively fast market reforms. However, when they were launched serious economic and social consequences ensued that hindered the process of transformation. A large number of Bulgarian enterprises lost their former markets and failed to find substitute ones for their products. This applies to both technology and traditional sectors in the Bulgarian economy. The shocking price rise and unemployment had a serious negative effect on the political forces in power, which slowed down the reforms in an attempt to find softer options for carrying out the market reforms. As a result, there was not only delay, but also inconsistency in the course of the reforms.

In the early 1990s, Bulgaria fell into a debt crisis, which triggered negotiations to reduce and restructure the debt through the Brady deal in 1994. It paved the way for the implementation of structural reforms in order to ensure that economic activity is based on market principles and regulations. Due to conceptual pondering and political indecision, privatization was further delayed compared to the average European countries (Poland, Czech Republic, Hungary). In order to protect some major state enterprises, the government stimulated their financing by extending loans from state banks. The latter significantly worsened their balance sheets, which imposed the refinancing by the central bank by increasing the money supply. Inflation picked up, the economic activity continued to decline and the unemployment increased. After 1994, Bulgaria lapsed into a structural crisis: the economically dominant state enterprises could not adapt to the market conditions, which required the adoption of stabilization measures in the spirit of «rescue the drowning.»

According to estimates released by the Institute for Market Economy, Bulgaria lost 32% of the GDP generated in the period 1989 - 1997[2], i.e. nearly one third of its economic potential. At that time, the officially registered unemployment was between 11 -

16%, plus a few additional points if we take into account the hidden unemployment. To counteract the declining business, the Central Bank pursued an encouraging monetary policy. The increased money supply increased inflation and depreciated the national currency. Imports become more expensive, which further increased the inflation, which considerably outstripped the income growth. Hence in 1997 the purchasing power of wages declined to 0.24% compared to 1990 and the average real pension to 0.18%[3]. Meanwhile, the soaring inflation dwindled away the savings and impoverished the population.

Table 1. Budget revenues, expenditures and debt 1990 – 1997 (in% of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997
Budget revenues	49	40,4	40,5	39,4	41,8	37,3	32,9	32,2
Budget expenditures	58	44,0	45,6	50,3	47,6	42,9	43,2	35,1
Budget deficit	-8,0	-3,6	-5,2	-10,9	-5,7	-5,6	-10,4	-2,9
External government debt: bln. $	10	11,3	12,1	12,5	10,4	9,7	8,7	8,7
Total government debt-% GDP	98	181	146	146	181	113	302	105
Interest rate on debt-% of the budget expenditures		14,3	14,1	18,7	28,5	33,0	45,5	23,7

Source: Ministry of Finance, www.minfin.bg

The transition to market economy required a reassessment of the place and role of the state in the development of business. It was imperative that the state restricted its role in the fiscal redistribution of GDP and adopted regulations that create incentives for the development of private business. This required that fiscal and budgetary reforms were carried out to adapt government intervention in the market conditions of development.

In effect, the state reduced its share in the redistribution of GDP: fiscal revenues fell from 49% in 1990 to 37% in 1995 and government spending from 58% to 43%. The algorithm of market change, however, required a second decisive step: the implementation of structural reforms, which required that state enterprises be privatized in a relatively short period, a regulatory mechanism be created for private business, the labour market and a new model of social security be established. However, this step was not taken due to political indecisiveness and changes in the political vision of the market reforms.

Throughout the transition period until 1997, the budget was running a deficit, which was covered by government loans and direct financing by the Central Bank. The external debt of the country, despite the Brady deal for its reduction and refinancing in 1994, amounted to 11-12 billion USD. It was a heavy burden for the country because the interests depleted valuable resources needed for its financial stabilization. Interest payments to creditors reached 45% of the budget spending of the country in 1996 and 19.5% of the GDP.

It was obvious that the stabilization policy aimed at bailing out the unprofitable state-owned enterprises and securing employment was ineffective. The fiscal and monetary measures drove up inflation along three lines: the budget deficit, its funding with increasing money supply and the subsequent devaluation of the national currency (the lev). The fiscal-monetary mix of the stabilization policy led the country to hyperinflation and economic crisis. The process was accelerated after 1995 when the Central Bank refinanced the commercial banks and extended unsecured loans to the sinking state enterprises. The bad servicing of these loans led to the failure of 14 banks. The foreign monetary reserves of the Central Bank began to melt away. There was a real risk that the country will have to impose a second moratorium (after the one in 1992) on payments to foreign creditors. Amid galloping inflation and economic uncertainty, the national currency began to depreciate rapidly: one dollar was worth 70 lev at the end of 1995, and one year later making 487 lev! Within a few years of slow and hesitant reforms and inadequate policy of stabilization, hyperinflation was unleashed and paralyzed the economic life in the country in 1996-97. Bulgaria entered a severe economic and social crisis.

The solution to bottom out of the crisis was found in the factor that had determined the crisis, i.e. the Central Bank's expansionary monetary policy, which brought about hyperinflation and the disruption of economic life. In such an environment the introduction of a monetary regime based on the anchor of a stable exchange rate was inevitable, i.e. the currency board! This institution replaces the Central Bank, which performs its emission function only under strictly defined rule: the issuing of local currency is available upon request against a backup of foreign currency with an exchange rate set by law, i.e. the national currency has the coverage of the country`s currency, characterized by stable performance indicators. This model of money supply reduced the inflationary expectations because the issue of the national currency is possible only when there is at least 100% coverage by the reserve currency.[4]

The first and necessary condition for the effective functioning of the currency board was the increase of its assets. At the beginning of 1997, several months before the introduction of the board, the foreign reserves of the country had dropped to a critical minimum of 381 million USD. Once the board had become effective, the Central Bank began to increase the reserve by purchasing national currency, with the positive balance of payments, the instalments from the IMF, as well as the revenues from privatization, which increased the budget revenues and the fiscal reserves of the government in the assets of the board. One year after the board was introduced the foreign exchange reserves reached 1.16 billion USD, and six months later, in August 1998, it exceeded 3.5 billion USD. This amount of the reserve was already large enough to ensure rising emissions of Bulgarian leva and revive the economic activity. At the same time, as a result of the board's operational mechanism of limiting the money supply, bringing it to real production level, inflation and interest rates plummeted. Many of the privatized companies quickly recovered their business, investments increased, and personal and aggregate consumption began to rise. These factors in their entirety pushed the economy into a phase of economic growth.

2. Fiscal Stabilization and Optimization in the period 2000 – 2008

The introduction of the currency board in 1997 created a monetary discipline and imposed a fiscal policy based on low budget deficits and the reduction of debt financing. The country's fiscal stabilization and economic recovery restored investors' confidence in the Bulgarian economy. The country entered a period of economic growth, which created favourable conditions for the implementation of structural reforms and the further stabilization and optimization of key fiscal balances. In 2002 Bulgaria started EU accession negotiations, which required that the country's fiscal times of crisis would drive it again into debt financing. After the bitter experience of the fiscal crisis in 1996-1997, the government decided to follow a counter-cyclical fiscal policy. It required the formation of a budget surplus during the economic boom, which was to accumulate as a fiscal reserve that will be spent in times of economic crisis. In this case, the fiscal reserve is a very lucrative source of financing government spending and aggregate demand, compared to debt financing. Under these circumstances, the country's fiscal policy acquired a countercyclical character oriented toward reaching a balanced budget within the framework of the business cycle.

Table 2. Main indicators of economic and financial stability 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Growth of GDP, %	5,8	4,0	4,0	4,3	6,6	6,2	6,1	6,2	6,0
Inflation%	10,3	7,4	5,8	2,3	6,1	5,0	7,3	8,4	12,3
Budget revenues% GDP	40,4	39,1	37,7	39,3	40,8	42,0	40,8	40,0	39,4
Budget expenditures % GDP	41,0	39,7	38,4	39,3	39,1	38,9	37,2	36,7	36,5
Budget deficit%GDP	-0,6	-0,6	- 0,6	0,0	1,7	2,9	3,4	3,3	2,9
Government debt% GDP	77	70	56	48	41	32	25	20	17

Source: Ministry of Finance: www.minfin.bg

balances meet the convergence criteria laid down in the Maastricht Treaty. Meanwhile, the government was faced with a serious dilemma of whether to continue its policy of fiscal restrictions after the initial stabilization or else, during the heavy post-crisis years, to continue its policy of boosting spending and improving social welfare.

The decision was critical because it was to determine whether the country would adopt a pro-cyclical fiscal policy, which in

The country`s accession to the EU in 2007, the stability of the currency board, the improvement in the fiscal balances, the increase in the domestic savings, the renegotiation of the external debt in 2003 ***and the increased inflow of foreign portfolio and direct capital*** are all factors that stimulated investment and economic growth. In the period 2000-2008, Bulgaria achieved average annual growth rates ranging within the scope of 5-6%, which

Table 3. Taxation trends in Bulgaria 2001-2008 г.

	2001	2002	2003	2004	2005	2006	2007	2008
Tax revenues	30,9	29,7	32,1	32,9	33,8	33,3	34,2	32,0
Direct taxes	7,5	7,5	7,5	6,8	6,3	6,6	5,6	6,0
Social security contributions	10,0	10,6	10,6	10,5	10,3	8,8	8,9	7,8
Indirect taxes	12,6	13,0	14,1	15,6	17,2	17,9	18,9	17,0

Source: Ministry of Finance: www.minfin.bg

are higher than those of the EU Member States. This allowed Bulgaria to pursue a policy of catching up with the European countries: in 2002, the country's GDP per capita stood at 31.1% of the average income in the member states, and in 2007, it had already reached 39%.[5]

During the period outlined, with some political consensus, Bulgaria pursued a monetary and fiscal policy to bring the fiscal balances in full compliance with the Maastricht Treaty criteria. Each Bulgarian government was tied to the currency board so the governments could not rely on monetary effects in its stabilization policy. The Central Bank focused on maintaining low inflation and strengthening the country's banking system. In such an environment fiscal policy played a key role in the country's fiscal stabilization. In this regard, several fiscal decisions deserve attention:

First, informally, under a gentlemen`s agreement, the ruling political forces in the country adhered to a *fiscal redistribution of GDP within about 40%*. The increased growth rate raised the tax collection rate in the budget, which in turn improved financing of the public policies. Moreover, the fiscal redistribution of GDP gradually dropped to 37% in the years before the economic crisis.

Second, *the optimization of the tax system*. In the outlined period, Bulgaria carried out tax reforms that strengthened the fiscal function of taxes, emphasised the efficiency principle of taxation and boosted the revenue agencies' institutional capacity. Table 3 shows the trends in tax revenues as a percentage of GDP. They expose a rising trend from around 30% in 2001-2002 to 34% of GDP in 2007, and to 25% of GDP without the social security contributions. In other words, taxes and insurance contributions financed 80% of the country`s spending, which explains their important fiscal role. However, the changes are significant in terms of their impact on economic agents.

In the structure of tax revenues, the role of indirect taxes has increased. The decrease in the relative share of direct taxes is due to the substantial reduction of tax rates on personal and corporate income. The revenues from indirect taxes: VAT, excise duty and customs duties amounted to 18% of GDP or 60% of the total tax revenues.

Since 2002, Bulgaria led a consistent policy of tax reduction of personal and corporate income, and of expanding the scope of the transactions subject to VAT. These changes boosted the efficiency of the tax system in terms of taxes on income and consumption. Furthermore, the reduction of tax and social security burden on businesses was perceived as an incentive to increase local and foreign investments. The positive effects of the tax changes stimulated the tax reform toward the attractive concept: 10-10-10 or 10% individual income tax, 10% corporate income tax and 10% social contribution, paid by employers and employees, or in total 20% on the salary.

In 2007, Bulgaria adopted a proportional (flat) 10% tax on individual and corporate income. This change made Bulgaria one of the countries with the lowest tax burden in the EU. The fiscal presumption was that the introduction of a low flat tax rate would create strong incentives for employment and investments and attract foreign direct investments. They are vital to increasing the dynamics of the country`s growth in terms of EU membership. The data show that for the period 2002-2007 the reduction of tax rates on individual and corporate income have driven up the respective tax revenues. This dependence, however, became obvious in the years of economic growth.

As a result of the tax reform, the tax and social security burden on the income dropped to 14-15% of GDP in the 2005-2008 period. Taking into account the burden of indirect taxes, the total tax and social security burden in the country stood at about 35-37% of GDP. It can be considered as moderately low, thus encouraging savings, investments and economic growth. It is another matter, however, whether this amount of tax and social security income is sufficient for the modernization of public infrastructure and the better funding of the public policies.

Third, *restructuring and rationalization of public expenditure*. Bulgaria's EU membership and the better funding of the public policies required an increase in public expenditures. At the same time, the restriction of the fiscal redistribution to 40% of GDP, and the formation of surpluses required that they are rationalized and restructured. This was achieved by bringing down interest rates on national debt and by moderately reducing the cost of many public policies. The budget expenditures for the period were reduced from 39.3 in 2003 to 36.5% in 2008. This result reveals the retention of government spending aiming to cool down the overheated economy, particularly in the post-2005 period. The expenditures for capital projects increased to about 4-5% of GDP after 2005, which contributed to the modernization of the country's public infrastructure, as well as to boosting the economic growth rate in the 2005-2007 period. The spending on social purposes, pensions, health insurance, welfare benefits were indexed, which led to their nominal increase. However, they reduced their share in the GDP from 13.4% in 2003 to 11.4% in 2008. The reduction in public expenditures, including the share of social spending, during the recovery period illustrates the counter-cyclical nature of fiscal policy as it reduces public and private consumption. Meanwhile, the reduction in public spending led to a chronic under-financing of education, healthcare, research, social activities and other sectors. This comes to show that the fiscal stabilization policy has a social price.

In the 2003-2005 period Bulgaria made a series of changes in the system of budgeting as it switched to medium-term budget estimates with a view to a greater continuity and consistency in the pursuit of public policy. Various budgets were consolidated into a single framework, a single budget account and a system of the transfer of budgetary resources to the primary officers was introduced, systems were established in each state institution for the financial management of budget funds and the rules governing the provision of subsidies to industrial and municipal activities were clarified. One of the significant reforms, however, was the introduction of programme budgeting (budget oriented to results).

Fourth, the currency board regime has a pro-cyclical effect because it increases money supply in times of economic boom and correspondingly reduces it in times of recession. In this case, the fiscal policy does not receive monetary support. On

Fig.1 Budget balance and fiscal reserves from 2003 to 2008 (billion leva)

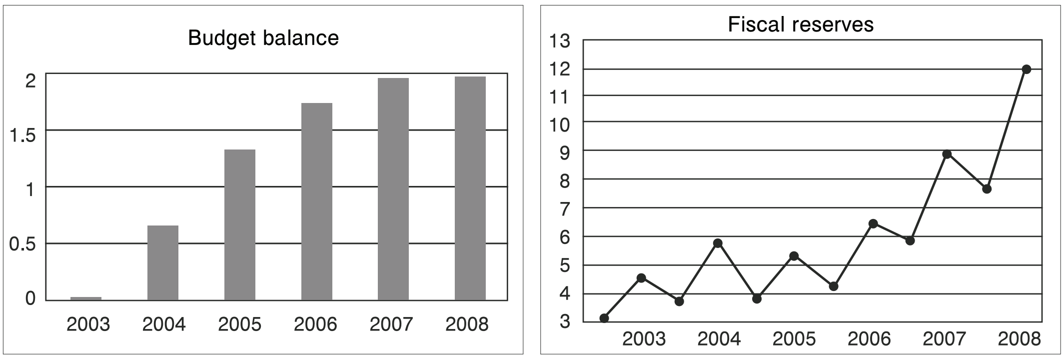
the contrary, its counter-cyclical effect is likely to be stronger. In other words, the fiscal policy in times of economic boom should be restrictive, whereas in times of recession - expansionary. This is the reason why, in 2003 Bulgaria adopted a *cyclically balanced budget fiscal policy*. It requires fiscal saving in times of economic boom and spending in times of economic crisis. In the 2003-2008 period Bulgaria implemented the first part of this model of counter-cyclical fiscal policy. The reduction of individual and corporate income tax rates and the adjustments made in the taxation of consumer goods stimulated economic activity and increased tax revenues in the budget. At the same time, as a result of the limited increase in expenditures the budget ran surpluses in the 2004-2008 period (Table 2). They accumulated in the government's fiscal reserves in the Central Bank, which increased to 12 billion leva at the end of 2008, or 17% of GDP. In this case, Bulgaria created fiscal space for increased spending in the event of a crisis in the fall of 2008.

Fifth, *lower debt financing and debt burden*. After introducing a currency board, in the midst of economic growth and limited debt borrowing, the amount and interest payments on the government debt of Bulgaria began to decline. In the early 2000, the government debt fell below 80% of GDP. In order to further reduce the debt burden and fulfil the Maastricht criteria for joining the Eurozone in 2002, Bulgaria adopted the Public Debt Act and the Strategy for Debt Management in the year after.[6]

In the Public Debt Act, Bulgaria introduced a rule whereby the consolidated government debt should be limited to 60% of GDP. As prevention measure in compliance with the rule, in the annual Budget Act a provision was introduced to limit the new debt, as well as the debt ceiling that the government may reach until the end of the year. The statutory rules of restrictions on government borrowing were complemented by a debt management strategy, which aimed to speed up the reduction and optimization of the country's debts.

In accordance with the debt management strategy, the government pursued policies that gradually reduced the size of public debt and the interest payments on it. In this regard, three fiscal actions are worth noting:

- ➢ The swap deal in 2003 for exchanging the Brady bonds (the deal with the London club in 1994) with global bonds of longer maturity;
- ➢ In a state of budget surplus and growing fiscal reserves, Bulgaria paid, ahead of schedule, debt obligations to the International Monetary Fund and the World Bank in 2006 to 2007;



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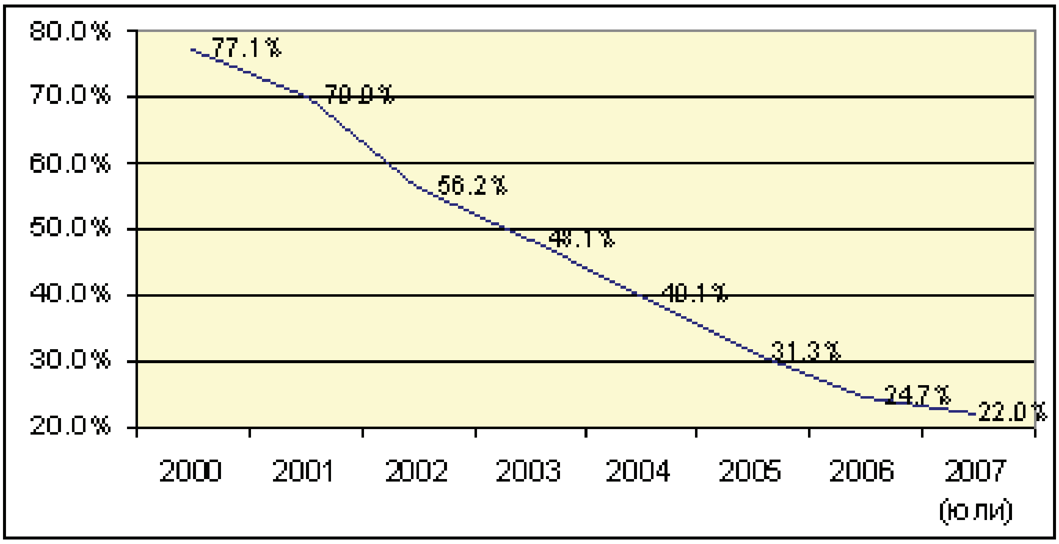

Fig. 2. Government and government-secured debt / GDP for 2000-2007(%)
Source: A Report on the 2008 Law of Budget, www.minfin.bg

- Third, the reduction in external borrowing was accompanied by the issuing of domestic loans in a relatively stable amount since 2003.

The successful implementation of the debt management strategy in 2003, which was updated and amended in the following years, led to a significant reduction in the public debt and interest payments of the country[7]. The nominal value of debt was reduced from 9.1 billion euro in 2002 to 5 billion euro at the end of 2007. In 2002 88% of the debt was owed by foreign investors, which increased the currency and interest rate risk for serving the debt. Within the space of just five years, the country's debt fell from 56 % to 17.9% of GDP in 2007. Of these, 12.2% are foreign liabilities and 5.7% internal debt. This change in the structure of debt minimized the leakage of financial resources from the national economy to foreign debtors. After the swap exchange of Brady bonds for global bonds, fixed interest rates bonds increased from 30% to 62%, and those with floating interest rates were reduced from 70% to 38%. This change increased the predictability rate of the interest payments on debt and contributed to the optimization of the budget expenditures. At the same time, the structure of the debt denominated in dollars and euro has changed: from 68% to 20% in 2001, to 33% and 67% in 2007. The average loan duration reached eight years in 2007, which reduced the interest burden of their service. Ultimately, the reduction of the debt as a share of GDP, the change in its currency and interest structure, as well as the increase in its maturity, reduced the annual amount of interest payments on government debt servicing by 2.2% in 2002 to 1.1% of GDP in 2007. The nominal values of the annual debt interest payments were moving within the 310-370 million, which no longer represented a serious burden on the state budget.

The policy to reduce the share of government debt in the GDP limited the debt financing as a source of funding budget expenditures. This result had a positive economic effect: increased the country`s investment rating, which cut the interest rates on loans and stimulated private investment and economic activity in the country. As a result, this led to a steady increase in tax revenues and in the country's fiscal reserve.

Sixth, the increase in the chronic deficits in the state pension and health fund generated increased the budgetary transfers for their maintenance payments. The rate of pension contributions was reduced from 29 to 23% in 2006, which decreased the revenues in the pension fund and required an increased budgetary support for its maintenance. In 2007 the budgetary transfers stood at 35-36% of its expenditures or one third of the total pension budget was funded with the money of all taxpayers. The adopted scheme for funding the deficit of the pension fund in terms of potential decline in budget revenues during the crisis poses a serious risk to its financial stability and to the fiscal system accordingly. In 2007, 100 employees provided for 82 retired, with the majority of the employees paying pension contributions on the minimum wage. This structural flaw of the temporary insurance system (pay as you go) increases the deficit in the pension fund. The situation is similar with the health insurance fund. Although the health insurance was increased from 6 to 8%, the budget of the health insurance fund is insufficient to finance the healthcare and hospital treatment of the country's citizens. Therefore, even in the period 2003-2005 there was a growing need for the implementation of a pension and healthcare reforms. The governments, however, took only partial measures that failed to tackle the fundamental problems of the social security system in the country.

Only a decade after the country's fiscal and monetary collapse in 1997, Bulgaria has succeeded to achieve a fiscal sustainability and to ensure fiscal space to meet potential the business risks in its development. This result was possible due to the strategic priority given to the Bulgaria's membership in the EU and the EU's monetary zone. They opened new long-term opportunities for economic prosperity of the country, but also imposed new demands on its development. Among them, the country's fiscal recovery and stability had crucial importance, because they are implicitly embedded in the Maastricht criteria as a precondition for entry into European monetary zone. They required the implementation of a series of fiscal reforms, which were largely followed by the Bulgarian government. The only weakness in the process of fiscal recovery was the postponement of the pension and health reform in the 2003-2008 period. The growing deficits in their budgets remained as "minefields" on the path to fiscal stability.

3. Fiscal decisions during the crisis and depression 2008-2012

In 2008-2009, the world economic crisis, albeit with some delay, affected Bulgaria as well. This is the first cyclical crisis that the country experienced after the transition to market economy. The politicians were faced with the dilemma of whether to implement the well-known Keynesian anti-crisis instruments or the new model of fiscal policy recently developed by A. Alesina, G.Tabelini[8].

The first alternative involves the reduction of income taxes in order to stimulate the levels of investment and consumption, boost exports, trigger into operation automatic stabilizers (social costs), increase capital costs, etc. The latter, in their integrity, increase aggregate demand and stimuli for supporting economic activity. The temptation to implement this package of anti-crisis measures was enormous because the country had a considerable fiscal reserve in place and fiscal space to attract loans and increase public debt. However, this approach has an effect of a rapid worsening of the fiscal balances and undermining of the country's fiscal stability. Moreover, the fiscal stimulation in a small and open economy such as the Bulgarian one amid the crisis does not have a significant effect on economic growth.

The second alternative for modelling the anti-crisis fiscal policy draws on the experience of the countries that refused to follow Keynes` precriptions at times of crises and did not undermine their fiscal stability and investor`s confidence in the country. This model requires that fiscal expenditures be adapted to tax revenues without a significant increase in the budget deficit and government debt. Thus, based on this approach, the fiscal policy is in the first place disciplining because it brings spending levels in line with tax revenues levels. In the second place, such a fiscal policy is responsible as it prevents the accumulation of new debt and shifts the tax burden onto the next generation.

Under this variant of fiscal policy the following package of anti-crisis measures are recommended[9]:

- possible reduction in the tax rates that can have a stimulating effect on the consumption, savings and investments in the economic activity;
- automatic activation of stabilizers which raise the social transfers for certain groups and respectively restrict the reduction of consumer costs;
- reduction in the current budget expenditures through their prioritization and rationalization;
- implementation of reforms in order to eliminate the chronic budget deficits (which impose frequent running into debt!) in spheres like social security, healthcare, economic activities subsidized by the state, education, state administration, etc.;
- attaching priority to increasing capital expenditures because the coefficient of the investment multiplier is greater than the budget multiplier (of the total budget expenditures) and accordingly generating serious effect of encouraging economic development. It is recommended that the financing of capital expenditures should be conducted through the effective reallocation of budget spending, the utilization of fiscal reserve and limited debt borrowing.
- Limited use of financing via government borrowing in order to prevent a further increase in the debt burden;
- Holding a fair and open public dialogue that unveils the government spending cuts and social reforms as a tool for fiscal recovery and the prevention of consequent sizable budget cuts or further indebtedness, which have negative economic and social implications.

The negative economic growth, the low inflation rate and the limited domestic consumption determined the decrease in the budget revenues during 2009. For the first time since the introduction of the currency board in 1997, the state budget was passed with a deficit! In order to be more restrictive, the government adopted a policy of restricting budget expenditures. However, as a result economic activity slumped, which in turn forced the government to resort to the fiscal reserve in order to finance the implementation of the agreed upon capital projects.

As a result the budget deficit reached 4 percent of the GDP in 2010. This was a sufficiently serious indicator that fiscal changes are needed to curb inflation and the budget deficit in compliance with the Maastricht criteria. Otherwise, the positive results of the fiscal harmonization during the previous years and the budget sacrifices would have been deprived of any meaning! Moreover, if the budget had been finalized for yet another year with a deficit ranging between 3-4 percent, the country would have joined the group of fiscally unstable EU member states. This result could have worsened the fiscal conditions and investment rating of Bulgaria. That is why, during the period of the crisis 2009-2011, the fiscal policy was focused on:

- maintain the tax levels of the republican taxes (an exception was the rise of the excise duties) which was not only an indicator of continuity in the tax policy but what is more, a stimulating measure for the private investments. The option to reduce the income taxes as an anti-crisis instrument in order to stimulate consumption and investment was not feasible because they were fixed at the low level of 10% in 2007.
- increase taxes and social insurance payments in order to raise the budget incomes and respectively to reduce the demand of deficit financing of the budget and the undertake of a new debt.
- smooth reduction of the budget deficit with a presumption to become zero within the space of 2-3 years. This meant that the deficit financing of government spending would have ended and the country could possibly reach a cyclical balancing of the budget in the 2013-2014 period.
- rise of capital costs mainly through the absorption of the funds from the EU aid. This measure boosts private investments, which is why it was set as a budget priority in 2011-2013.

After the critical fall in 2009, GDP marked a slight increase in the next 2-3 years. The country's economy was in the depression phase of the economic cycle. In this period the fiscal policy was anti-crisis oriented. Measures were put in action to stimulate aggregate demand and supply: the deficit financing of the budget by using part of the fiscal reserve and moderate debt borrowing, gradual increase of social spending, increase in public capital expenditure through EU funds, preserving the major tax rates. These measures, in their whole range, kept the declining economic activity and contributed to the maintenance

Table 4. Fiscal adaptation 2008-2012

Indicators	2008	2009	2010	2011	2012
GDP (bln.lv)	69.3	68.3	70.5	75,3	77,6
Budget revenues (bln.lv and% from GDP)	27.3 (39,4%)	25 (36,7%)	23.9 (34,0%)	25,4 (33,7%)	27,5 (35,4%)
Budget expenditures (bln.lv and% from GDP)	25.3 (36,5%)	25.7 (37,6%)	26.8 (38,0%)	27.0 (35,8%)	27.8 (35,8)
Budget balance (bln.lv and% from GDP)	2 (2,9%)	-0.6 (-0,9%)	-2,8 (-4,0%)	-1,5 (-2,0%)	-0,6 (-0,8%)
Fiscal reserve, January (bln.lv)	7.7	8.8	7.4	5.4	6,1
Government debt (% from GDP)	13,7%	14,6%	16,3%	16,3%	18,5%

Source:www.minfin.bg

of a modest economic growth. At the same time, the country's fiscal stability was not undermined because the budget deficit and public debt were maintained at low levels.

4. Fiscal rules and fiscal stabilization

In the past decade, Bulgaria adopted rules that restricted politicians' discretion in making fiscal decisions. They were forced to follow a fiscal policy based on rules rather than discretion. To a great extent, the introduction of the rules is a consequence of the economic crisis in 1997, which was sparked by politicians' discretionary fiscal measures and the political dependence of the Central Bank. The rules also impose a medium-term framework of fiscal policy since fiscal stabilization always takes several years to be achieved. At the same time, the rules with a shorter duration allow for a smooth improvement of the major fiscal balances.

The introduction of rules and restrictions on the conduct of fiscal policy in Bulgaria started with the adoption of the currency board arrangement (CBA). It laid down regulatory mechanisms that disciplined the Central Bank (CB) in its pursuit of monetary policy. The law banned the CB from granting direct loans to the government, which closed the channel to monetize government debt. The government was obliged to hold its current surpluses in a special account with the CB, which formed its fiscal reserve. It could be used at discretion depending on emerging needs for budgetary expenditures, including needs for financing deficit spending. All this comes to show that the currency board as a system of mandatory statutory rules for formulating monetary policy imposed discipline on the government's fiscal decisions.

The debt crisis, which Bulgaria experienced twice in 1990 and 1996, provided immunity to the irrational extension of loans and the accumulation of government debt. This explains the adoption of a special law on public debt, which required that the government fix a ceiling on its reasonable level each year. This is prescribed by Parliament in the State Budget Act. The four governments in the post-2000 period set lower debt targets each year to reduce its burden over time. For example, in the 2011 budget it is stated that the nominal amount of debt may not exceed 14.3 billion leva or 18.6% of GDP. Through the law of municipal debt, limits were imposed on the municipal debt financing and a channel for increasing public debt was thus removed.

In the Annual Budget Act fiscal constraints were introduced that prevent fiscal overruns. The "90+10" rule is a budget regulation that governs 90% of the public institutions` budgets and the remaining 10% were provided at the end of the year in case the revenue targets were met to the anticipated amounts. In general, the "90 +10" rule restrained budget spending and increased the fiscal reserve. In this respect, the rule has a counter-cyclical nature, given that during recovery it curbs government spending.

After 2010, the government abandoned the "90 +10" rule because it led to the accumulation of debts by the state institutions that relied on the 10% budget balance to settle their debt. The government covered them with their accumulated fiscal reserves by virtue of a discretionary decision in November each year. The public institutions have adapted to this model, many thus incurring serious financial liabilities. In order to break the fiscal indiscipline of the state institutions, the government determined their budget as a hard ceiling, so they could not rely on additional appropriations to cover the accumulated deficits (in the form of deferred payments to suppliers).

The decline in the fiscal reserves in the crisis years 2009-2010 forced the government to adopt a "sanitary minimum" rule for to its size of 4.5 billion leva (6% of GDP). This meant that the fiscal reserve could be used during the year, but at the end of the financial year it should be restored to the specified amount. Therefore, the rule of minimum fiscal reserve not only disciplined the government, but also reasserted its basic function as a tool ensuring stability of the currency board.

Apart from the legal rules that impose a mandatory fiscal discipline, Bulgarian politicians reached a gentlemen's agreement to limit the budget spending to GDP. According to the evidences of R.Barro, countries with a high level of fiscal redistribution of GDP reached a lower growth rate[10]. The fiscal redistribution of GDP ranging between 43-45%, which is typical of most European countries, increases taxes, decreases private investment and slows down economic growth, which means that Bulgaria would postpone reaching the average level of the European countries to the distant future. This concept was adopted by the major political parties in the country who agreed on 40% limit on the fiscal redistribution of GDP. Even during the crisis 2009-2010, the consolidated budget expenditures marked a limited increase from 36.5% in 2008 to 38.5 in 2010.

Bulgaria is increasingly adopting rules and procedures governing the pursuit of fiscal policy. They created a fiscal discipline that for several years brought the fiscal balances of the country in accordance with the criteria for entry into the European currency area. Bulgaria, however, failed to convince the EU that the introduced fiscal policy rules were sustainable and would not be abandoned at a later stage, as was the case with fiscal behaviour of Greece and Portugal in the past. In order to persuade its European partners that Bulgaria was invariably maintaining fiscal discipline in its fiscal policy, in early 2011 the government developed a National Pact for Financial Stability. It prescribes several fiscal rules that are crucial for the country's fiscal stability and should be included in the Constitution. Those rules relate to the level of revenues and expenditures, the budget deficit and government debt.

The Keynesian encouragement of the aggregate demand creates a lasting tendency to increase budget spending. In such cases, the increase in tax rates and the introduction of new taxes is seen as the first best decision to increase budget revenues and hence expenditures. The tax theory, however, reveals the negative effects of higher taxes on labour incentives, entrepreneurship and consumption, as well as the budget tax revenues. Therefore, the increase in taxes, especially if they are optimized, reduces economic activity. Furthermore, the discretionary decisions to change taxes create inconsistency of the fiscal policy, which prevents investors from making business plans. There is a specific Bulgarian argument against the change in tax rates. After the tax reform in 2007, the country created a tax system stimulating investments. Raising taxes would hold growth in investments, which are the most important force for accelerated economic growth. Therefore, in the National Pact for Financial Stability a rule to change the direct taxes was proposed with a qualified majority in parliament. (2/3 of the MP`s vote). Formally, the introduced rule seemed to prevent tax increases. The idea, however, was that since we have low tax rates, which encourage investment and growth, tax increases should take into account taxpayers' preferences through their representatives in the parliament, or if 51% or 66% of them agree to pay higher taxes, to consume more and ensure better quality of public goods.

The adoption of an empirically tested relationship between the size of government spending and the dynamics of economic growth over time underlies the proposed 37% limit of the fiscal redistribution of GDP. It excludes the fiscal revenues and expenditures coming from the EU funds. They refer to Bulgaria's contribution to the EU budget (amounting to 1.1% of GDP), EU funds and their co-financing from the national budget (20%). With the 2011 and 2012 budgets, including the exceptions, Bulgaria complies with the rule for 37% of GDP fiscal redistribution. Economic analyses, however, recommend a more limited fiscal intervention in countries which are at a lower stage of development as Bulgaria: ranging from 30% to 35%. However, there was a strong need to finance some public policies and therefore a higher 37% limit was adopted.

The deficit budget financing is the main anti-crisis tool in Keynesian policy. The size of the budget deficit, however, is a completely discretionary decision. The National Pact for Financial Stability allowed for an annual budget deficit of up to 2% (in the initial proposals up to 3%). In order to determine the current budget balance a formula with a special coefficient was developed. It was introduced to limit the increase of the budget deficit or surplus for the respective year within certain boundaries, i.e. the formula limits the pro-cyclical fiscal spending.

The last rule that is proposed in the National Financial Stability Pact is the share of government debt in GDP. The initial version of this pact envisaged that this share be fixed to 60%, i.e. 10% below the Maastricht criteria reaching the level that Poland implemented in its Constitution of 1999. With the onset of the EU debt crisis in 2011, the proposal was adjusted to 40%, which maintains the debt within a healthy range. Bulgaria, however, adopts a rule provided that the debt in 2012 amounts to 16-17% of GDP, i.e. the country ensures that it will have enough fiscal space to borrow, if necessary.

Some of the proposals for fiscal rules were introduced in previous years in the State Budget Act for the respective year. Procedural rules and restrictions are set out in the new Budget Act. Why are they proposed to be included in the Constitution? The answer is given by J. Buchanan in his interpretation of fiscal constitution[11]. The fiscal rules in the constitution limit the politicians' decisions on the fiscal redistribution of income, since the latter affects people's democratic rights. Furthermore, if the rules are adopted, each successive government can revoke the law and thus eliminate fiscal constraints. In this case, the fiscal policy is incoherent and does not ensure fiscal discipline.

The analysis of the fiscal stabilization in Bulgaria since 2000, until the adoption of the National Fiscal Pact in 2012 showed that the country has been moving towards the new fiscal requirements for accession to the euro area. At the end of 2010 the government proposed the above-described fiscal rules to be written into the Constitution of the country: to limit the fiscal redistribution of GDP, for a limited budget deficit, public debt ceiling, for procedures that allow deviation from the accepted rules. To a large extent, Bulgaria modelled itself the proposals, which were incorporated in the Fiscal Pact of the EU in 2012. The country, included in the Budget Act of 2012 the rule of a deficit of 2% and a ceiling of 40% debt, which are much below the requirements for fiscal stability in the euro zone. This way, Bulgaria renewed its application to enter the euro zone.

5. Conclusion - key factors for fiscal stabilization and optimization

After the fiscal crisis in 1997, the introduction of the currency board and the fiscal stabilization, Bulgaria adopted a fiscal policy of cyclically balanced budget. It was implemented through the following fiscal decisions:

- Optimization of the taxation, which ensured stable tax revenues and incentives for private consumption and investments;
- Rationalization of the budget spending that allowed the formation of a budget surplus in the years of economic boom. It accumulated as a fiscal reserve, which plays an important role in the fiscal policy of cyclically balanced budget;
- Gradual reduction of the share of fiscal redistribution of GDP, which released more resources for private consumption, investment and economic growth;
- Significantly diminished was the amount of the government debt to GDP: from 77% in 2000, to 14% for 2010. The interest payments on government debt were no longer a heavy burden on the budget of the country.

The only downside in the process of fiscal stabilization was to withhold the large deficit in the State Fund for Social Security (the health fund in particular). Therefore, optimization of the fiscal balances was not completely achieved.

The successful fiscal stabilization of one small and open economy with a specific monetary regime (currency board) for a period of ten years represents a special interest in the light of the fiscal crisis of similar countries in the recent years. We have an answer to the question why there was the fiscal crisis in Bulgaria 1997. The question now is: what are the key factors that contributed to its steady overcoming and the achievement of a fiscal stability with good levels of fiscal balances?

In the first place are the lessons from the fiscal crisis in the period 1996-1997. The hyperinflation, the monetization of debt and the massive impoverishment of the population created public and political sentiments against the conduct of expansionary fiscal policy, supported by debt financing. In the country, has been formed a proper understanding of fiscal policy, which spread to the fiscal resources of the country. The memories are too fresh for the policy makers to return to a fiscal policy with chronic budget deficits and debt financing. Therefore, there is general political consensus, despite the proposals for the use of these two instruments in times of crisis.

Secondly, the country‘s membership in the EU played an important role for the fiscal stabilization and optimization of the country. Since the beginning of the accession negotiations (2002), Bulgaria adopted a fiscal policy that was supposed to adjust the fiscal balances in accordance with the criteria of the Maastricht Treaty for joining the Eurozone. As of 2007, Bulgaria satisfied the criteria for inclusion in the EPM-2. The world economic crisis and the subsequent debt crisis in the EU slowed down this process. After in the crisis 2010 the country afforded a 4% budget deficit, which deviated from the criteria for entering the euro zone, the country immediately planned a budget deficit for 2011 at the extent of 2.5% (which in fact amounted to 1.7%). Although the country meets almost entirely the criteria of the European fiscal pact, it is not in a hurry to join it. This may require a fiscal coordination of the countries in the euro zone, which would eliminate the tax advantages in Bulgaria for foreign investors.

Thirdly, the introduction of fiscal rules that set limits to the discretionary fiscal decisions of the politicians. Their resistance to deficit and debt financing does not guarantee that the fiscal solutions to preserve fiscal stability in the country. The fiscal rules in the annual budget act and the law on government debt management put barriers to prevent political aspirations for increased costs and the imposition of pro-cyclical fiscal policy.

Fourth, the consistent policy of fiscal stabilization that all governments pursued (4th from 1998). The initial stabilization until 2003 was continued by taking fiscal measures for relieving the country's debt burden and increasing its fiscal reserves. Such fiscal stabilization transformed into a policy of fiscal optimization. As a result, gradually the main fiscal balances improved, reaching the levels of the pre-crisis period before 2008. Then, the conventional approach of applying short-term fiscal stimuli (with budget deficit and government borrowing) to aggregate demand was launched by few social groups as a anti-crisis remedy with budget deficit and government borrowing, which, however, would reverse the trend of fiscal stabilization. The dilemma was solved in favour of fiscal stability, because it quarantees long-term benefits for the country: accession to the eurozone, stable inflow fo foreign imvestments and growth of private investments. This fiscal decison was largely possible because of the country's access to European funds. They boosted public investments significantly, thus increasing economic growth by 1.5% annually after 2010. In this repect, the EU funds performed the role of anti-crisis tool, decreasing the need for government borrowing and allowing the government to pursue its anti-crisis fiscal policy.

Fifth, the political consensus for maintaining a healthy macro-fiscal policy was not accompanied by a political willingness to implement radical reforms in pension, health and education systems. The fiscal decisions in these three important social systems were partial and inconsistent. The reason is that the reforms would create social unrest and loss of votes in elections, so that governments delayed their implementation. This approach exacerbates the imbalances in their financing, which requires a more radical nature of the measures in the subsequent reforms. Without their conduct, however, Bulgaria cannot optimize its fiscal balances in their entirety.

Sixth, the heated public debate on fiscal decisions was essential to the country's fiscal stability and sustainable development. As usual, there are public groups that are pushing for a relaxed fiscal policy and even for the release of imbalances with a view to resolving the problems of investment, employment, income and social welfare. However, the groups that expose the negative consequences of populist fiscal decisions shape public **opinion** in favor of maintaining a rational fiscal policy. Although the fiscal crisis of 1997 had a very high social cost, it gave out a positive public signal that society did not want to repeat the fiscal development in the early 1990s. The debt crisis in Greece, which Bulgaria feels very close to, raises the awareness of the need to pursue a sound fiscal policy.

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