Economic Populism in Bulgaria and Its Consequences

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What if I told you that the poorest EU member state is a country in which economic populism is more often the rule of thumb, rather than the exception? Would that surprise you, or would you think it is a fate deserved by both the Bulgarian public and its government? Sure, when it comes to populism within the EU, Bulgaria seems like an OK place to be when compared to countries such as Greece and (arguably) Hungary. However, some recent developments have brought forward the question whether Bulgaria (the country which back in 2011-2012 was viewed as an example of fiscal responsibility in the heat of the European debt crisis), is going the right way, or has reversed course back to the well-charted, yet strangely endearing seas of cheap economic populism.

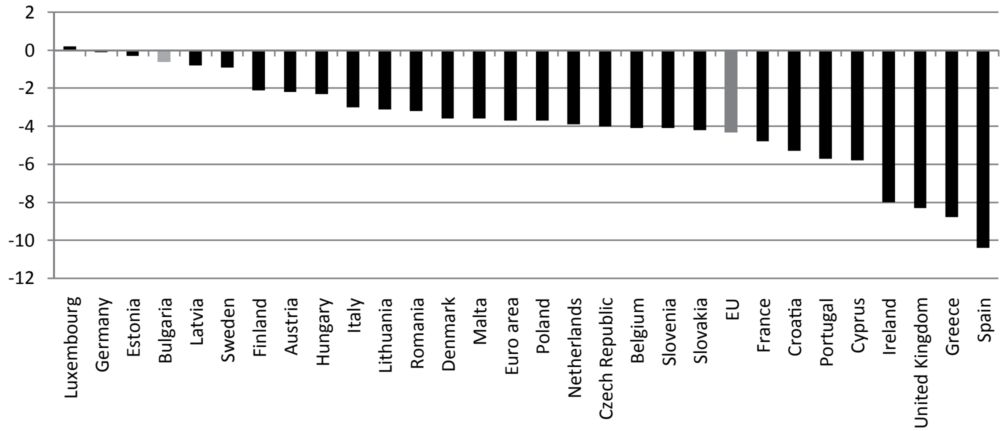
I would like to tell you a few recent stories that have led me to believe that the next couple of years may prove to be just as decisive for Bulgaria as the years right after 1989 and the pre-accession period. I would also like to point out that while most events described below have taken place during the term of the current government, their roots lie in the heritage of long ignored problems and some anachronistic aspects of the socio-economic structure and development of the country.

FISCAL POPULISM: THE PRICE OF POLITICAL INSTABILITY

Back in 2011, during what can only be described as the credit rating massacre throughout the EU, Moody's raised the country's credit rating from Baa3 to Baa2. In 2012, when most of Europe was huffing and puffing to meet the 3% annual deficit to GDP requirement, Bulgaria stood out as one of the few countries that seemed to have its fiscal situation under control and that looked more than capable of balancing its budget, provided it wanted to. The annual deficit that year stood at 0.6%, compared to an EU average of 4.3%, down from 4.1% in 2009 for Bulgaria and 6.7% in the EU. Granted, this consolidation effort was not carried out without some questionable government actions, such as the frivolous waste of the reserve of the National Health Insurance Fund at the end of 2010. Still, the numbers were impressive, especially when we bear the low debt/GDP ratios in mind (around 15%, compared to 78% at the EU level), which could have provided a convenient excuse for higher deficits in the short to medium term.

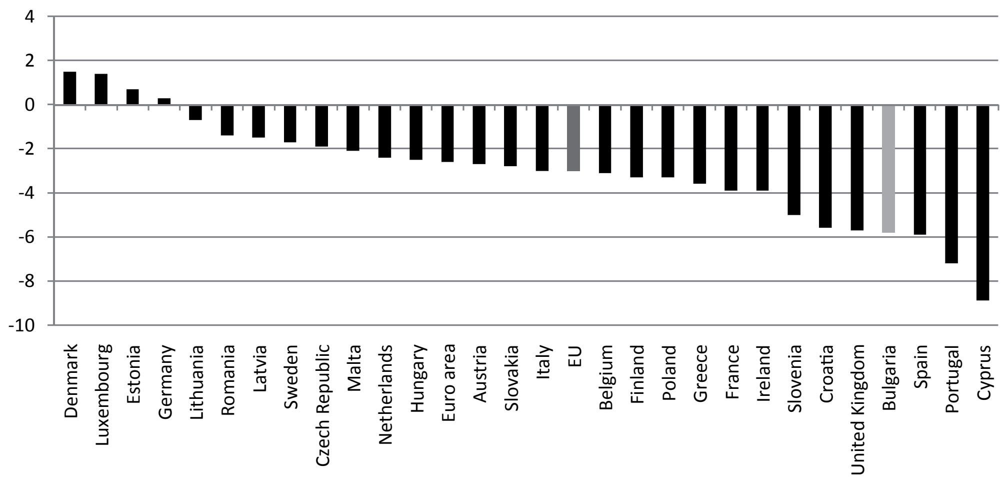
The only countries which managed to record a lower deficit to GDP ratio that year were Estonia, Germany and Luxembourg (Fig. 1). The poorest member state of the EU was hailed as an example of fiscal discipline, a praise that was well deserved, especially when one takes how heavily the country was hit by the economic and financial crisis into account.

Let us fast-forward to 2014 and what we see is a totally different picture. Bulgaria's annual deficit/GDP ratio stood at 5.8%, Figure. 1: General government deficit/surplus in 2012 (% of GDP)



Source: Eurostat

Figure. 2: General government deficit/surplus in 2014 (% of GDP)



Source: Eurostat

compared to an EU average of 3.0%. A ratio that just 2 years earlier was seven times lower for Bulgaria than for the EU, was about two times higher in 2014. While EU countries shrank their deficits, and there were even four countries reporting surpluses, Bulgaria headed to the bottom, joining Portugal and Spain (Fig. 2).

To a large extent, the horrifying 2014 deficit occurred due to the failure of one of the country's largest banks – Corporate Commercial Bank (CCB). All investigations and an analysis of the reasons behind its failure point to the conclusion that there were no innocent parties in regard to the operation and the supervision of the bank. The CCB management circumvented and

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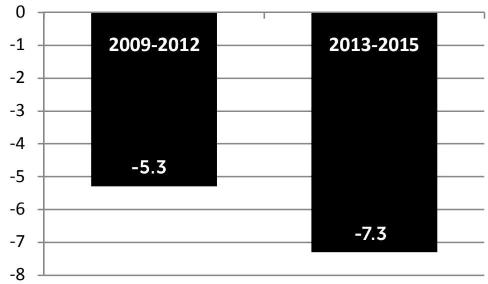
violated the regulations and good banking practices, offering large loans to companies it was clearly related to, while the Bulgarian National Bank (BNB) stood idly by and failed to enforce the letter of the law. In addition, many state owned enterprises, municipalities and other institutions held their deposits at the CCB. This allowed it to offer much higher than the average payments on its deposits, thus "sucking in" even more capital that was afterwards loaned out in a nontransparent manner.

The failure of the CCB should not be viewed as the cause, but rather as a symptom of the political crisis that is ravaging the country to this day, despite the present government's efforts to portray its reign as "a return to stability". The fact is that we managed to go through the 2009-2011 period without any major bank foreclosures, while most of Europe was struggling to shore up its banking system. We made it to the other side of the crisis just to find out that long postponed reforms in the judiciary, the prosecution, the administration, the pension system and the Ministry of Interior were about to cost us more than the Great Recession itself.

Any attempts to exclude the effect of the CCB on the fiscal results of recent governments, while entertaining for economists, would "cover up" the real price of those delayed reforms and thus – the actual state of the budget as a policy making instrument. If a government cannot depend on the country's central bank to carry out its supervisory role and then finds itself heavily involved (and invested) with what can only be described as a shady banking institution, how can it be trusted to uphold its fiscal promises? We should not take the CCB out of the equation, as it provides a clear context to the most immediate challenges that lie before Bulgaria, namely the financial and political dependences of some Bulgarian political parties to large business interests and the inability of regulators to enforce legislation, related to establishing and pursuing conflict of interest and outright corruption practices.

The comparison of the cumulative deficit that the country registered in the periods 2009-2012 (recession and recovery) and 2013-2015 (political instability, resulting in the change of three elected and two caretaker governments in the course of two years) shows that the latter has had a more negative impact on the stability of public finances (Fig. 3).

The effect of the severe recession was a cumulative deficit of almost EUR 2.7 billion, which was mainly financed by the fiscal reserve[1] of the country. The effect of the political instability, however, was much bigger. The cumulative deficit reached almost EUR 3.7 billion, which mainly impacted the sovereign debt (Fig. 4).



Source: Ministry of Finance, IME

It is evident that sinece 2012, the fiscal position of the country has been deteriorating and the willingness of Bulgarian politicians to uphold their written and unwritten commitments to fiscal responsibility has been wavering. Despite a growing economy and a recovering labor market, public expenditure went out of control via successive budget updates during 2013, 2014 and 2015[2].

In recent years, most increases in public expenditure have been adopted not through the annual budget procedure, but via updating the already in-force budget and using the revised calculations as a basis for the following year's budget. Not surprisingly, at the end of 2013 and 2014, S&P revised its credit rating for Bulgaria on two separate occasions all the way down to BB+. In the eyes of one of the big three credit rating agencies, Bulgaria was no longer a safe place to put your money.

We may draw at least three conclusions from our review so far:

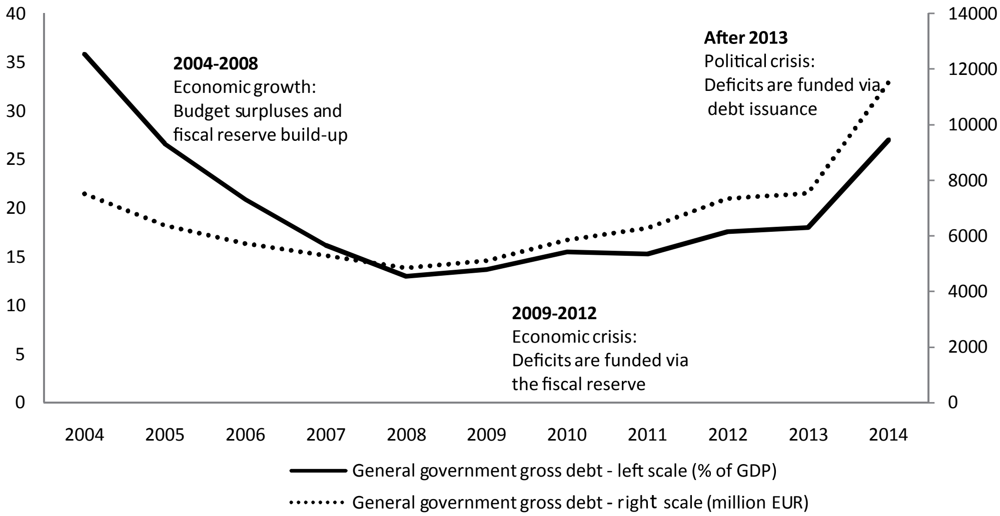
- The political instability in Bulgaria caused much bigger problems for the budget than the Great Recession;
- Since 2013, Bulgarian governments have been reverting to fiscal tricks (mostly successive budget updates) to cover for expenditures caused by delayed reforms;
- The deficit cannot be overcome without reforms of the ineffective public sectors, and in the lack of political will to carry those out, it is being presented as some kind of an unfortunate, but inevitable byproduct of the strive for "political stability".

Despite the fact that now and again some of the much needed reforms are being discussed in Parliament and presented as the long-term vision of the country, none of them have been specified in the medium-term framework up to 2018. What is more, as it will become clear in the next part of our review of economic populism in Bulgaria, it may

[1] Bulgaria's fiscal reserve consists of several funds with different functions. Most of it (including the so-called "Silver Fund", which is meant to support the pension system in future periods) is held at the Bulgarian National Bank (BNB). The fiscal reserve is also used to advance certified payments and expenditures from EU funds.

[2] Despite the fact that the government deficit in 2015 is expected to have been a bit lower than the initial projections, this is not due to consolidation efforts, but to the better than expected performance of the economy and higher tax revenues. If the government's own budget projections had come to pass, the deficit would most likely have been higher than what was initially adopted, because of growing expenditures.

Figure. 4: General gross government debt (2004-2014)



Source: Eurostat

be argued that we are moving backwards, rather than forward in some public systems.

SOCIAL SECURITY POPULISM: GIVE US YOUR RETIREMENT SAVINGS

Just before the Christmas of 2014, it became clear that the Prime Minister and two of the largest labor unions had signed a memorandum which not only halted the increase of the retirement age, but also threatened to change the pension model of Bulgaria as we know it – not that the

THE BULGARIAN PENSION SYSTEM

At present, the Bulgarian pension system consists of three pillars:

- a state owned pay-as-you-go pillar that collects most of the workers' social contributions (1st pillar);
- an obligatory private capital pillar (2nd pillar) that collects 5 percentage points of the workers' social contributions and consists of universal and professional pension funds, depending on the type of work performed;
- a voluntary private capital pillar (3rd pillar).

The changes discussed here affect the way social contributions are divided between the 1st and the 2nd pillar of the system.

The last pillar is yet to gain popularity among Bulgarians.

latter is adequate, or remotely suitable for the demographic predicament we find ourselves in (rather to the contrary). What was proposed looked like the first step of retreat to the "old times" of our social security system and threatened the *de facto* abolition of what little progress was made in the last two decades.

This course of action was decided upon behind closed doors, and was rushed through the Parliament within just a couple of days without any public consultation whatsoever. While some of the arguably most bewildering and backward-looking intentions of the government were ultimately scraped under civil society pressure, one cannot gain a complete understanding of the short-term populist motivations of the proposals without a careful consideration of the main ideas that had been laid out at the time. In brief, the "pre-Christmas reform" of 2014 included the following:

1. The changes gave "a choice" to individuals whether to redirect their current pension savings with private pension funds to the state pay-as-you-go system (via the National Social Security Institute, NSSI).

2. The initial legislation did not provide for the reverse choice, namely to retrieve one's pension savings from NSSI and invest them with private funds if one changed his/her mind.

3. Every Bulgarian that decided to move his/her pension savings to NSSI would have had not only the future pension contributions payments redirected, but all the money that had already been accumulated as well.

4. If new entrants to the labor market did not make their choice on a private pension fund within a legally predefined period, their entire pension contribution would have been automatically directed to the state pay-as-you-go system.

5. The planned increase in the retirement age, which was to follow a clear path, was "postponed" until it gathers wider support and "is better thought out" (as if it is some revolutionary innovative idea and not a socio-economic imperative that is being followed in the entire EU).

The motivation behind the government's action was quite simple. The NSSI is running a **multibillion annual deficit** that amounts to about half of its total expenditures. This gigantic hole is being filled every year with transfers from the national budget.

In the 1998-2014 period, the relative share of social policy expenditures (including pensions) increased from 29.1% to 35.1% of all public expenditure, and from 9.8% to 13.9% of GDP. The increase (Fig. 5) of annual expenditures over the 1998-2014 period (in nominal terms) amounts to EUR 4.6 billion, which is more than the combined increase in healthcare (EUR 1.6 billion), education (EUR 1.2 billion) and defense (EUR 1.1 billion).

The goal of the proposed "reform" was clear: to shrink the government deficit by reducing the amount of money that has to be paid out of it every year in order to keep the NSSI afloat.

It has to be noted that this is not the first time a Bulgarian government has tried to "utilize" private pension savings for its own purposes. Back in 2011, the previous Citizens for European Development of Bulgaria (CEDB) government actually transferred BGN 107 million from the professional pension funds to the NSSI. A few months later, the Constitutional Court confirmed[3] that the money in the private pension funds belongs to the insured persons, which in fact means that the government had illegally seized them.

This Constitutional Court's decision is probably the main reason why the government had to come up with an elaborate "voluntary" scheme in late 2014 in order to convince[4] some people to move their money from the private pension funds to the NSSI. The government could not proceed with the outright seizure of those funds, but had to try and lure people into taking the step by themselves or (in the case of young people) force them to take action by choosing a pension fund or risk losing control of their retirement savings.

The government not only neglected to adhere to the basic legislative principles of transparency and publicity, but had the nerve to put forward the results of "in-house calculations" that showed that should people decide to move their money to the NSSI, it would somehow provide higher pensions for future retirees than the current combination of the NSSI and private pension funds. Unsurprisingly, after these calculations were publicly ridiculed by a number of analysts and organizations, they were quickly swept under the rug.

Following widespread criticism, including from within the coalition itself, the senior ruling CEDB party started to step back on its initial plan. Draft amendments to the just-voted texts foresee that new entrants to the labor market will not be automatically directed to the state pension system (if they do not make their choice in time), but instead, will be automatically directed to one of the private pension funds. Also, those who have decided to move their personal pension savings from private funds to the NSSI, will have their money set aside in the so-called "Silver Fund" of the state. The latter is a part of the fiscal reserve and was established some years ago with the aim to provide financial support for the state pension system.

However, all future pension contributions of people who chose to make the switch will not be accumulated in individual accounts, but will be spent right away on the payment of pensions to current retirees. In addition, private pension savings that are moved to the Silver Fund will not be actively managed and so will not carry any yield. This means that if a group of people changed their mind and decided to move to a private pension fund: 1) all their pension contributions in the meantime will be lost, and 2) their potential yield on former and recent savings with a private fund will be foregone.

Even though some of the initial recommendations were scraped, there are plenty of Bulgarians, who may yet live to regret their own actions, should they decide (or should they be "persuaded") to opt in on the government's propaganda. Think of the people working in state companies, as well as all those working under collective labor agreements. Picture the thousands working for the Bulgarian State Railways – people whose employment depends almost entirely on the good will of the government (and its incapability to restructure as well as reluctance to privatize the railways).

It is still too early to tell how many Bulgarians will ultimately believe the promises of the PAYG system and if the current administration will settle for what is left of its 2014

[3] Decision №7/2011 of the Constitutional Court of the Republic of Bulgaria.

[4] The money collected in private pension funds is also inheritable. Their transfer to the NSSI effectively puts the inheritance out of the picture. There is no inheritance in the PAYG systems, save for the inheritance of the consequences of past populist promises by the government.

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> DESPITE THE FACT THAT AT PRESENT BULGARIA BOASTS ONE OF THE HIGHEST PER CAPITA POLICE FORCES IN EUROPE, CRIME LEVELS HAVE REMAINED HIGH AND PUBLIC TRUST IN THE POLICE – LOW

pre-Christmas reform package. What we have to look out for going forward is the obvious desire of Bulgarian governments to somehow "gain control" of the money build-up in private pension funds – especially in times of fiscal distress.

ECONOMIC POPULISM AND EVERYDAY LIFE: MORE RECENT EXAMPLES

The Ministry of Interior: We Like It the Way It Is

A big part of the pension system reform is the overhaul of the pension privileges of the people working for the Ministry of Interior and some of its subsidiaries.

In 2015, the government tried to push through legislation that would have gradually increased the retirement age of police officers to 55 years (compared to 52 today) and would have reduced the number of salaries that retiring servants of the Ministry received at the end of their careers. Despite the fact that at present Bulgaria boasts one of the highest per capita police forces in Europe, crime levels have remained high and public trust in the police – low. In addition, the fact that civil servants in the Ministry of Interior share much of the retirement privileges of police officers has proven a drag on the pension system, which has to be resolved in order to reduce future expenditures, increase effectiveness and provide for much needed and completely lacking capital investment at present.

This idea met strong opposition from the police officers' trade unions and even led to arguably illegal strikes. The unions claimed that every police officer should be allowed to retire under the conditions he/she entered the police force, which would mean a *de facto* postponement of the reform until the 2040s. Despite a wide public support for the reform, the government has so far been unable to enforce this much needed change.

Since the beginning of 2016, the current Deputy Prime Minister and Interior Minister Rumiana Bachvarova has taken steps to raise the issue once again, while the police officers' trade unions have claimed that the proposals that are being put forward are basically the same as last years' and so will probably be met with the same kind of opposition.

Social Payments: All Aboard!

Back in 2007, a few years before the economic and financial crisis descended upon Bulgaria, the ruling coalition government decided to expand the coverage of the child benefit programs. In the two years that followed, the size of the monthly allowance for children was doubled (from

EUR 9 in 2007 to EUR 18 per child in 2009) and the maximum income that allowed receiving them was increased to EUR 180 per household member, which amounted to 88% of the average per capita income at the time. Expenditures increased from EUR 99 million in 2007 to EUR 181 million in 2013, which amounted to 42% of the Agency for Social Assistance's budget, compared to 29% before the changes were implemented.

The aftermath of this populist pre-election decision by the 2009 ruling coalition was that the efficiency of the program fell victim to the number of people that it had to cover – over 540 thousand households and over 840 thousand children. For the next four years both the monthly child allowance and the maximum income level had to be left unchanged, because there was no way to finance further increases with that many people aboard. In 2014, it was decided that the second child would receive an additional EUR 8 per month, while the payments for the first, third and all subsequent children remained the same until 2016, when the monthly child allowance for a single child was raised by EUR 1 (yes, that is one euro, after six years). The first increase of the maximum income level is scheduled for the summer of 2016, when it will reach EUR 205 per household member.

The effects of all this are not difficult to foresee. What many analysts have been warning about will soon come to pass – expenditures and the number of households and children involved will increase further, while the size of the allowances will remain inadequate to provide families with the support they need. The 2015 attempt at reform stopped short of addressing the issues with the coverage, adequacy and effectiveness of the program. The annual expenditures are projected to rise above EUR 205 million in 2016, while other and arguably significantly more effective social programs such as the guaranteed minimum income and the heating allowances will remain underfunded.

This program is one of the prime examples of how difficult it is for Bulgarian governments to step back from the already initiated populist programs. Once a critical mass of voters sign up for a given benefit, it becomes politically infeasible to try and restructure ineffective programs such as the child benefit program. Once again – at present, the "promise first, think about it later" approach is the rule of a thumb, rather than the exception in regard to social policy.

The Minimum Wage: The Only Way Is Up

The fact that the minimum wage in Bulgaria is the lowest in the EU is something that many Bulgarian politicians find a suitable pre-election topic. Some parties have even campaigned under the motto of EUR 512 minimum wage, which would be 2.5 higher than the present one. While no one with even the most basic understanding of economics (regardless of their preferred school of thought) would entertain such an idea, the strive for higher minimum wages is something which a number of governments have viewed as an important part of their social policy, rather than their labor market policy.

During the term of the current administration, the minimum wage has already been increased three times. The cumulative increase from December 31, 2014 to January 1, 2016 is almost 23% (from EUR 175 to 215) – the highest in the EU. Thanks to a quickly recovering labor market, most negative effects of this policy have remained unnoticed by the wider public.

However, as the Institute for Market Economics (IME) econometric model of the effects of minimum wage hikes predicted, unskilled laborers and people with low education levels have found their labor market situation deteriorate further. Arguably, the same can be said for people under the age of 29, who seem to be the only age group that does not participate in the recovery of labor markets.

With productivity growing slower than the minimum wage, it is a question of *when* and not *if* the current government's policies will become a drag on the competitiveness of some of the poorest Bulgarian regions, and maybe even on the Bulgarian economy as a whole. In the meantime, however, the government takes great pleasure in praising itself for its "efforts" to increase the living standards of Bulgarians, while neglecting the fact that their policies force tens of thousands low-skilled workers into social exclusion.

Rent-seeking: UBER[5] Is Bad for Your Country

The last few years have also provided numerous examples of the negative effects of rent-seeking practices. In late September 2015, the Supreme Administrative Court confirmed the immediate execution of the decision of the Commission for Protection of Competition, which effectively banned UBER from operating in Bulgaria. The decision was reached under pressure from taxi companies, which claimed that the service was in unfair competition with them, because it did not have to cover the requirements that taxi companies have to comply with. The obvious thing to do was to limit the regulation of taxi companies, but the state institutions decided to go after UBER, despite its growing popularity and appreciation among citizens.

[5] An app-based transportation network. The company valued at USD 62.5 billion in late 2015 has caused a lot of controversy due to which the service was already banned in Spain and restricted in other countries.

> SO FAR, THE BULGARIAN ECONOMY HAS SOMEHOW MANAGED TO STAY A STEP BEFORE THE CURVE, BUT THERE IS NO TELLING WHAT THE DAMAGE OF ANOTHER BEHIND-THE-SCENES SHIFT OF POLITICAL AND (MAYBE MORE IMPORTANTLY) ECONOMIC POWER WOULD BE

The truth behind what happened had nothing to do with protecting the customers' safety, rights or satisfaction. What occurred afterwards was also to be expected – in the beginning of February 2016, with oil and gas prices at decade low levels, the taxi companies in Sofia agreed to raise the minimum price that they would charge per kilometer – a feat that would have been hard to accomplish had UBER stayed in the picture. In addition, the office of a small taxi company in the city of Varna was surrounded and attacked by its competitors due to the low prices that they offered (despite them being above the specified minimum price and thus – in line with the law).

CONCLUSIONS

As convenient as it would be to put all the blame on the current administration, it is hard to portray most of the described actions of the Bulgarian government as something which has been met with significant social opposition. In most cases these decisions were opposed by small, but vocal groups of analysts, journalists, citizens and, yes – politicians.

In regard to the fiscal costs of populism, the failure of CCB should not be viewed as the cause, but rather as a symptom of the political crisis that is ravaging the country to this day. It is evident that what we have witnessed in the last few years is a significant redistribution of economic and political power within some of the circles that have been running the country from behind the scenes during the last two decades (and arguably even longer). So far, the Bulgarian economy has somehow managed to stay a step before the curve, but there is no telling what the damage of another behind-the-scenes shift of political and (maybe more importantly) economic power would be.

In regard to social security populism, what the government did was to try and take advantage of the economic and institutional illiteracy among some groups of the Bulgarian society, as well as their discontent with the current size of the pension payments. While everyone knows that the rapidly deteriorating demographic structure of our population implies lower pension payments in the future, there is little understanding among the wider public as to how this problem should be tackled. By offering something (higher pensions) for nothing but a small administrative procedure (moving your retirement money that you have no direct access to anyhow until you retire), the government tried and to some extent succeeded in sowing the seeds of doubt among Bulgarians as to whether or not private pension funds are the best decision for moving forward.

There are numerous other examples of the ill effects that economic populism has had on Bulgaria in recent years. It has to be said that not all such policies are undertaken with the goal of appeasing large groups of voters – some are just a function of bad legislation, or government support for special business interests.

As things stand, the current government does not have the parliamentary and public support to push through major populist policies (such as the 2014 pension "reform"), but neither can it do much in the way of actual beneficial reforms (such as the 2015 Ministry of Interior reform). What we see on a daily basis is good ideas being scrapped and bad ideas being moderated, as the Bulgarian society and its political class are trying to find their way in what may be argued is a new economic, social and geopolitical context. However, as history has thought us over and over again, when it comes to economic and social development, standing still is not something you want to do. ●

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