



## SIGMA

**Support for Improvement in Governance and Management**

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# BULGARIA PUBLIC EXPENDITURE MANAGEMENT SYSTEM ASSESSMENT JUNE 2005

## 1. Budget Legislation

Public expenditure management in Bulgaria is based on the Organic Budget Law (OBL) of 1996. Although this law is basically well constructed, the Ministry of Finance (MoF) is aiming to establish a more comprehensive legal basis that will incorporate ongoing reforms for the development of a more global public expenditure management system and modernization of the budget process.

The new OBL is currently being drafted by a working group, which has only recently agreed to opt for a general framework law. It will include the introduction of programme budgeting, accrual accounting and a medium-term expenditure framework. Other structural changes envisaged are the establishment of a State Treasury and the introduction of supplementary appropriations for surplus fund usage, which will contribute to strengthening public expenditure management and the control of funds. Given the wide range of issues to be covered by the new OBL, its current draft status, and the national elections approaching in June, it seems unlikely that this new legislation will be in effect before the start of fiscal year 2006 and be fully operational by 2007. Consideration is being given to introducing provisions for legalising these reforms in the current OBL, in secondary legislation or in the State Budget Act, as an interim measure during the drafting period of the new OBL; however, concrete proposals have yet to be presented.

Detailed rules and procedures, including inter-governmental fiscal relations, are set out in the annual State Budget Act. It is important to note that the State Budget Act, in line with provisions of the OBL, does not specify budget appropriations per category for each spending unit but rather determines total revenue and expenditure limits plus financing. Expenditure categories are shown at the aggregate level only. The annual budget law assigns to the Council of Ministers (CoM) the approval of the budgets of public authorities, ministries and administrations by type of revenue, expenditures, transfers, subsidies and financing [Article 5 (7)].

Furthermore, complementary legislation has recently been adopted to control borrowing at the municipal level. The Law on Municipal Borrowing restricts annual debt payments, which should not exceed 25% of own revenues, and should be lower than or equal to the municipal subsidy of the previous year. The activated municipal guarantees are also restricted to up to 5% of the same amount. However, municipal borrowing is well below this ceiling. In line with the intention to further strengthen fiscal decentralisation, it is also suggested to amend the Constitution so as to give to municipalities the authority for introducing new local fees, as well as the right to determine the local taxation level.

***Baseline substantially achieved*** (1999 and 2000 baselines partially achieved; 2001, 2002, 2003 and 2004 baselines substantially achieved). **The fundamental, high-level principles set out in the baseline are well recognised, both within the Ministry of Finance and in line ministries. However, the drafting of the new OBL remains an outstanding task, which is not likely to be finalised until after the elections in June 2005. This means that implementation of the new OBL will be delayed until 2007. Nevertheless, the envisaged reforms do not depend solely on this new OBL, as they can be “legalised” through secondary legislation and transitional provisions in the annual State Budget Act.**

## 2. Parliamentary/Executive Relationship

The Standing Committee on Budget and Finance is the key instrument for interface between the National Assembly (NA) and the executive. This committee, together with the committees responsible for the respective budget agencies, discusses the draft budget before its first and second readings by the NA. These discussions take place before the beginning of the budget year, normally in November and December, which is in line with the formal CoM decision (Decision no. 74 of 7 February 2005 on the Budget Procedure for 2006) on introducing the draft 2006 State Budget Act.

Under the current OBL, the executive has substantial powers to amend the budget after its approval by parliament. The Ministry of Finance (MoF) is at the moment authorised to provide supplementary budgetary credit if it is offset by a surplus of own revenue or through the introduction of new sources of revenue – as long as the balance of the state budget is kept. The new OBL will minimize this practice, which provides an incentive for under-budgeting revenues and over-budgeting expenditures. To restrict the powers of the MoF in relation to the transfer of funds and the allocation of any end-of-year surpluses, supplementary appropriations are envisaged, to be provided twice in each fiscal year following approval by the NA. Moreover it is anticipated that line ministries, instead of the MoF, will be made responsible for defending these appropriations before the NA.

***Baseline substantially achieved*** (1999, 2000, 2001 and 2002 baselines partially achieved; 2003 and 2004 baselines substantially achieved). **The structure of the parliamentary/executive relationship is consistent with good EU practice. It is foreseen that the new OBL will allow for greater control over appropriations by the NA and closer involvement of the NA in any substantial budgetary changes introduced by the executive after its passage of the State Budget Act.**

## 3. Scope of the State Budget

There are few national Extra-Budgetary Funds (EBFs) remaining – the National Fund, Agriculture State Fund and Teachers' Pension Fund. Four more EBFs are included in the annexes of the 2005 State Budget Act, but not explicitly in the law itself – the Privatization Expenditures Cover Fund of the Privatization Agency, the special accounts of municipal councils for revenues from the privatization of municipal enterprises, the Privatization Expenditures Cover and Post-privatization Control Municipal Fund, and the Investments and Fixed Assets Special Fund of the corresponding municipal councils.

All EBFs are included in the consolidated budget and recorded in the State Budget Act.

Subsidies to public enterprises are also included in the State Budget Act, although only on an aggregate level as “subsidies for non-financial enterprises”. On the other hand, the annual Report on the State Budget Act, which is presented to the CoM by the Minister of Finance but is not part of the State Budget Act, details the subsidies for non-financial enterprises (e.g. railways, city transport, coal production, postal service), as well as for non-profit legal entities. The Tobacco Fund is not accounted for as an EBF but is now managed as a second-level level spending unit under the Ministry of Agriculture.

The Minister of Finance created a “quasi-EBF” through the establishment of the “Public Investment Project Enterprise” in 2004. This “company” supports an investment of BGN 220 million, which is controlled - by virtue of the priority directions and regulations specified by the Council of Ministers – by the company's board, consisting of two deputy ministers of finance, a deputy minister of environment and a deputy minister of regional development.

Financing from donors is captured insofar as it relates to the National Fund, an EBF under the MoF that is responsible for the financial management of pre-accession contributions granted by the European Union through the Phare, ISPA, and SAPARD programmes. However, the Report on the State Budget Act does not set out in detail the size and terms of use of national co-financing funds for EU programmes, in particular for the new Public Investment Project Enterprise.

In general, the budget documentation provided to the NA is rather comprehensive in terms of legal provisions, but lacking is the policy information that would enable the NA to form an opinion on budget policies and

consequently on the annual budget allocation. To a large extent, this information can be found in the Report on the State Budget Act, but this report is not presented to parliament.

In addition, the State Budget Act defines the maximum amount of new government debt and state guarantees; in 2005 this ceiling has been set at BGN 2.45 billion, while the maximum amount of the government debt at the end of 2005 should not exceed BGN 17.1 billion. Further information on the government's domestic and external debt, as well as on its financing, is provided in the Report on the State Budget Act.

***Baseline substantially achieved (1999 and 2000 baselines not achieved; 2001, 2002 and 2003 baselines partially achieved; 2004 baseline substantially achieved).*** **The scope of the state budget is sufficiently comprehensive to provide macro-level data for planning purposes. The remaining EBFs are for the most part sufficiently integrated to ensure macroeconomic control of the state budget. Worthwhile progress has been made in expanding the breadth of information made available in relation to the state budget, although there is scope for further refinement of the policy information presented in the consolidated budget. This concerns especially disclosure of information to the NA regarding the integration of EU budgetary funds. This information is even more important in preparing for the absorption of structural and cohesion funds as from fiscal year 2007. Of considerable concern in terms of transparency is the channelling of investment funds through the Public Investment Project Enterprise**

#### **4. Medium-Term Expenditure Framework**

A three-year budget forecast is an established component of the annual budget process (see under section 5 below). This budget forecast is based on medium-term estimates for existing budget policies, new policy proposals and priorities set by the respective line ministries, and proposals on tax policy and national expenditure policy prepared by the MoF. Estimates are prepared in fixed prices.

Following the consultations with first-level spending units (and with the National Association of Municipalities), the MoF prepares its Medium-Term Expenditure Framework (MTEF), consisting of a rationale for the macroeconomic forecast for the period, a proposal for key policies to be implemented by the government, consolidated budget aggregates by economic nature and functions, expenditure ceilings for first-level spending units (except municipalities), and a mechanism for reallocation of economic growth to the CoM for decision. The expenditure ceilings of ministries include expenditures for state-mandated activities of municipalities.

For the first time, the forecasting exercise in 2005 includes financial data on grants provided under the individual structural funds as well as on grants by sectors under the Cohesion Fund for 2007 and 2008.

After the CoM has approved the MTEF, a broad medium-term fiscal strategy is outlined in the Report on the State Budget Act. The MTEF is not made available as public information. The MTEF also encompasses extra-budgetary funds; the National Fund Directorate participates in the forecasting exercise that determines the anticipated flow of EU grants and national co-financing.

***Baseline achieved (1999 and 2000 baselines partially achieved; 2001, 2002 and 2003 baselines substantially achieved; 2004 baseline achieved).*** **This baseline has been achieved insofar as the MoF's medium-term expenditure framework provides an efficient basis for macroeconomic fiscal management, and the bottom-up approach is clearly reflected in budget procedures. However, some doubt might be cast as to the quality and effectiveness of the medium-term forecasts of line ministries as compared to the final document provided by MoF to CoM. The MTEF could be of more importance if it were made public.**

#### **5. Budget Process**

The budget process is timely run on a tight schedule and is respected and closely followed by its key stakeholders. It is based on the procedures described in the OBL and initiated by a CoM decision, detailing the two-stage budget process. This process starts with the MTEF (as described in section 4) and leads to initial expenditure ceilings, which are the starting points for determining the cash-based state budget for the next fiscal year. Before submitting the draft State Budget Act to the CoM, the MoF conducts dialogues with all first-level spending units, which result in individual formal agreements that specify the respective policy

priorities and detailed draft budgets within the approved expenditure ceilings. Once the CoM has agreed to the final draft (as per the CoM's decision by the end of October), the State Budget Act is introduced to the NA together with the Report on the State Budget Act. The NA is given two months for reading and discussion in committees and in the Assembly before the State Budget Act is promulgated.

It must be noted that parliament does not vote on separate appropriations by economic category for each first-level spending unit but passes the State Budget Act in the form of a law on budget components, including the key types of revenues and expenditures as well as limitations per spending unit. The approval of the detailed budget is assigned to the CoM, which is obliged to pass a resolution on state budget implementation within one month of publication of the annual state budget law.

In line with ongoing efforts to introduce programme budgeting, most ministries (Ministry of Environment and Water, Ministry of Labour and Social Policy, Ministry of Transport and Communications, Ministry of Energy and Energy Resources, Ministry of Education and Science, Ministry of Economy, Ministry of Youth and Sports, Ministry of Agriculture and Forestry, Ministry of Healthcare, Ministry of Regional Development and Public Works, and Ministry of Culture) are developing programme budgets in parallel with the methodology currently used. It is foreseen that the Ministry of Environment and Water, which has the most advanced programme budgeting pilot, will defend its 2006 programme budget before the NA; this budget will also be presented as an annex to the 2006 State Budget Act.

The MoF envisages the implementation of programme budgeting in all line ministries by the fiscal year 2007, although that seems overly optimistic. A difficulty inherited from the past is that the introduction of programme budgeting had initially focused on the MoF only, and that not enough attention had been given to its implementation in line ministries. Since the beginning of 2004, the newly established Public Finance School in the MoF is providing specialised training courses, in programme budgeting. Line ministries that have recently introduced programme budgeting (e.g. Ministry of Transport and Ministry of Education) are focused on determining objectives and identifying performance indicators, and on the challenge of linking the two functions.

A key element in the budget process is determining state transfers to the 264 municipalities, especially for so-called "state-mandated activities". These activities are mandated by the state as the state continues to set national standards according to which the municipal budget share is provided and monitored. Expenditures for state-mandated activities are mainly financed by personal income tax as well as by a supplementary subsidy. In addition, local activities are supported by a "fiscal equalizing subsidy", and a further target subsidy can be provided for specific capital expenditures. Around one-third of the municipal budget is provided by municipal own source revenues. Despite ongoing fiscal decentralisation efforts, dependency for management decisions (e.g. appointing teachers) on the central level is still very much felt by municipalities.

A remaining weakness in the budget process is the considerable amount of within-year changes made at the discretion of the MoF and CoM without approval of the NA. Such budgetary changes are financed by additional funds becoming available, as the conservatively forecasted revenues are collected above target. These funds are not only released in direct proportion to the promulgated budget, but are also used to reallocate between spending units.

***Baseline substantially achieved (1999, 2000, 2001, 2002 and 2003 baselines partially achieved; 2004 baseline substantially achieved). The budget process is well defined and is largely implemented by stakeholders. A clearer definition of the appropriations per organisation and economic category would be a welcome measure that should be considered prior to the introduction of programme budgeting. Further attention needs to be paid to the sustainable implementation of fiscal decentralisation. Another priority is the limitation of within-year changes that the MoF also seeks to address through revision of the OBL.***

## **6. Budget Management of Public Investments**

Following the 2003 restructuring of the MoF, responsibility for managing public investments was given to the Budget Directorate on the national level and the Local Government Financing Directorate on the municipal level. The State Expenditures Directorate has assumed responsibility for capital expenditures of public authorities and ministries, which request capital investment projects from the bottom up. Since December 2004

the Management of EU Funds Directorate has been responsible for managing public investments at the national level.

Within the budget procedure, the CoM approves new investment proposals involving applications for state loans and state guarantee financing.

It should be noted that after approval of the budget by the NA, the MoF can approve internal compensated changes within the budgets of first-level spending units for investment purposes. This practice indicates that planning capacity is still weak, but it is expected that programme budgeting will further improve public investment management in line ministries. However, the necessary project evaluation capacities have yet to develop, and recurrent costs derived from public investment have to be integrated in the analysis.

Capital investment funds provided by the European Union through the Phare, ISPA, and SAPARD programmes, as well as its national co-financing share (amounting to a total of BGN 472.4 million in 2005), are managed by the extra-budgetary National Fund. Ongoing discussions focus on whether the National Fund will continue to have sole responsibility for managing the funds made available by the European Union or whether the future management of structural and cohesion funds could be fully integrated in line ministries. Adjusting the structures for effective management of EU investment funds should also be directed to developing mechanisms for national co-financing, especially for the preparation and co-financing of municipal projects.

In either case, the seven-year Public Investment Programme needs to be carefully managed, taking into account both the imminent access to structural and cohesion funds and the absorption capacity of line ministries.

Finally, the Public Investment Project Enterprise established in 2004 is managing a considerable amount of public investment outside of the state budget (see above in section 3). This situation is highly undesirable, even though the CoM is participating in the investment decision-making process.

***Baseline partially achieved (1999, 2000, 2001 and 2002 baselines not achieved; 2003 and 2004 baselines partially achieved). Expenditures for public investment are an established part of the annual state budget process. Investments of the Public Investment Project Enterprise are not part of this annual budget process, which is a dangerous development. Project evaluation capacities need to be further strengthened. A challenge will be to adjust existing structures so as to be able to effectively manage investment funds provided by cohesion and structural funds.***

## **7. Budget Execution and Monitoring**

The State Treasurer, who operates under one of the five deputy ministers of finance, is responsible for the State Treasury Directorate, Sovereign Debt Directorate and National Fund Directorate. In addition, an External Finance Directorate deals mainly with relations with international financial institutions (IFIs) and other external public financiers. As from January 2004 the Treasury Directorate also includes the Central Harmonisation Unit for Financial Management Control (CHU), which ensures proper standards of internal control in line ministries. However, the position of the CHU is currently being reconsidered. The organisation and function of the Treasury are still subject to change. A twinning project is expected to give a decisive answer on the structure of the treasury function and of the CHU.

The Treasury Single Account (TSA) encompasses all line ministries and extra-budgetary funds. The electronic payments system – SEBRA – is used to channel all cash receipts into the TSA, from which all payments of first-level spending units are made (for municipalities, only for payments from the target capital subsidy). Payments that are initiated directly by first-level spending units are carried out automatically, as long as they are within the monthly cash ceilings set by the State Expenditure Directorate of MoF. These ceilings, based on regular forecasts by ministries of their revenues and expenditures, are provided as long as they are within the overall budget allocation. Spending is monitored on a monthly basis by the MoF, which receives aggregated reports on expenditures from each line ministry. No major discrepancies in comparison to forecast expenditures have been reported. First-level spending units are obliged to put in place an approved system of internal financial control and to appoint financial controllers.

It is important to note that monthly allocations for first-level spenders are made on the basis of 93% of the appropriation approved by the NA, with the remaining seven per cent “contingency” being allocated in the last quarter only if revenues actually reach the level initially forecast. For municipalities, this percentage has been set at 90%. While this requirement was introduced in the State Budget Act upon request of the IMF, in practice revenues are consistently above expectations. It appears that line ministries plan and commit 100 per cent of their annual expenditures with higher cash flows in the last quarter of the fiscal year.

The within-year budget changes (see sections 5 and 6) are authorised by law (OBL as well as State Budget Act), managed by the MoF, and processed in the annual report on state budget implementation, which is reviewed by the CoM and provided to the National Assembly. The fact that there is no multi-year commitment management on the central level is of concern, especially in preparing for the absorption of structural and cohesion funds.

***Baseline partially achieved (1999, 2000, 2001, 2002, 2003 and 2004 baselines partially achieved). At the aggregate level, control over payments is effective, with the MoF having the information and authority to prevent financial limits from being exceeded. It is expected that the new government will further support the development of an effective structure for the State Treasury. Focus should be directed on budget commitment management and monitoring at the central level.***

## **8. Accounting and Reporting**

Since September 2001 the Government Chart of Accounts has been based on GFS 2001 and ESA 95 conventions, thus widely covering all spending units, including municipalities, extra-budgetary funds and other general government accounts and operations.

Accrual accounting is applied in all central and local government units, except for tax revenue and debt of the central budget. For the preparation of notification tables for Eurostat, cash data for tax and debt payments are being adjusted by incorporating additional information from the tax system and debt register so as to provide information on a modified accrual basis. It is envisaged that the introduction of the information system of the National Revenue Agency will provide data for tax and social contribution revenues on an accrual basis. Currently, only the annual balance sheet is presented on an accrual basis, while the monthly, quarterly and annual reporting is carried out on a cash basis. The Treasury Directorate prepares by March a consolidated annual report. The National Audit Office audits the consolidated balance sheet and the aggregate statement and then prepares a consolidated audit report for submission to the NA by 30 June. Overall procedures for assessing efficiency and effectiveness of expenditure programmes – including funds provided by EC sources – have not yet been developed.

A major issue in financial reporting is the government’s Financial Management Integrated System (FMIS) strategy. This strategy has been updated for the period 2004-2008 after a partly unsuccessful attempt to implement a financial management system that is fully integrated into MoF and line ministries, using SAP R/3 ERP software. According to the revised strategy, a less ambitious approach was adopted, introducing FMIS initially only in the MoF, in both first-level and second-level spending units, accompanied by a more progressive implementation schedule.

It is expected that most line ministries will then put into practice their own systems by duplicating the MoF system. According to the revised strategy, all ministries will eventually equip themselves with the same or similar software, which will be ultimately connected through interfaces, forming the final architecture of Bulgaria’s public financial management system. However, line ministries have not been discouraged from launching their own FMIS, and it is difficult to imagine how these could be efficiently integrated to form an effective financial management system.

The new FMIS has been set up to serve two purposes: first, to allow the MoF to run its own operations in the same way as any other line ministry; second, to put in place an efficient budget management, state treasury and cash management system. While it is likely that the MoF will be successful in developing an integrated system to manage its own operations, there are doubts as to the budget, treasury and cash systems, and line ministries should also be involved in the development of these systems.

Ensuring reliable and real-time data flows between the Ministry of Finance and the spending units of line ministries is not foreseen in the new FMIS project. The timely involvement of line ministries will therefore be crucial for the overall success of this part of the project.

*Baseline partially achieved (1999, 2000, 2001, 2002, 2003 and 2004 baselines partially achieved).*

**The basis for a proper Chart of Accounts is in place. It is expected that the implementation of FMIS will provide an effective platform for managing the operations of the MoF. However, the successful implementation of an efficient budget management, state treasury and cash management system is hazardous. Another concern is that commitments are not sufficiently accounted for and reported.**

## **9. Capacity for Upgrading the Public Expenditure Management System**

In the past, the MoF has received considerable assistance under the Dutch-led Phare project and from the IMF's resident budget adviser, resulting in a number of reforms, especially the introduction of programme budgeting. To fully implement these reforms and secure their sustainability, further external assistance is required.

The indications of weaknesses, as provided in last year's assessment report, remain valid:

- Development of a new Organic Budget Law: A new law is required to address shortcomings in the current appropriation structure (discretionary spending of the government) and to increase budget accountability of line ministries vis-à-vis the National Assembly.
- Development of programme budgeting in line ministries: The introduction of programme budgeting is a substantial reform project that will need continuous support, especially in defining and measuring outcomes and outputs.
- Development of the Treasury: The structure and functions of the State Treasury need to be further reviewed in order to strengthen its operations. The development of the FMIS needs specific attention.
- Development of staff capacity: The Public Finance School has given priority to the training of MoF staff. To carry out the increasingly sophisticated budgetary tasks, key staff in all ministries require proper training, especially on project development and appraisal, budgetary analysis, and programme reporting requirements.
- Development of fiscal decentralisation: The full implementation of fiscal decentralisation would benefit from external support, especially in the areas of education and health.

Another crucial issue for development is the effective preparation for planning, management and absorption of structural and cohesion funds as from 2007. Focus on this priority area is required in the current stage of preparation for EU accession.

## **10. Summary and Next Steps**

In 2004/2005 progress in public expenditure management has been made by further implementation and deepening of reforms announced in previous years, including the consolidation of earlier reform steps. At this point in time, ministerial staff fully understand the issues of concern, and there appears to be overall consensus on the need to carry out the outlined reforms of the public expenditure management system. However, it must also be anticipated that the approaching elections will – at least temporarily – slow down the pace of reform implementation.

The new Organic Budget Law will set the legal framework for introducing programme budgeting, accrual accounting and the medium-term expenditure framework. While the expenditure framework is already practically in place and programme budgeting is progressing as scheduled, the Ministry of Finance envisages a very ambitious timetable for the implementation of accrual accounting over the next year. Meanwhile, further legal adjustments should ensure the strengthening of public expenditure management and of the control of funds. The public investment programme is an established part of the annual budget process, even though

project evaluation capacities need further strengthening. Investments of the Public Investment Project Enterprise, established in 2004, are not part of this annual budget process, which is a dangerous development.

In budgetary control, the establishment of the State Treasury has brought an improvement, although the final structure of the treasury function still requires fine-tuning. Further attention should be paid to budget commitment monitoring and reporting at central level. The Financial Management Information System project has yet to prove its effectiveness.

The following actions:

**A. Should be applied (or started) in the short term (or next 12 months):**

- Complete the review of the Organic Budget Law to eliminate the above-mentioned deficiencies in the current budget process, and in the interim period promulgate necessary amendments/secondary legislation to ensure full compliance with European good practice;
- Finalise the revision of the State Treasury's structure and functions, with a view to reflecting European good practice;
- Enhance the analytical capacities of the MoF and line ministries to evaluate and prioritise budget proposals, especially for capital investment projects;
- Adjust existing structures for the effective planning, management and absorption of structural and cohesion funds as from 2007;
- Increase transparency by informing the National Assembly and the general public regarding budget preparation and budget execution;
- Develop mechanisms for providing municipal co-financing of EU programmes;
- Reconsider the legal and organisational set-up of the Public Investment Project Enterprise and integrate investments of this public enterprise in the annual budget process.

**B. Should be applied (or started) in the medium term (or next two years):**

- Develop supporting documentation for programme budgeting as a tool for improving effectiveness and efficiency in public expenditure;
- Further strengthen the capacity of all budget-spending organisations (including municipalities and second-level spending units) to compare the cost-effectiveness of alternative policies, programmes and projects.
- Develop a new system of municipal financing, based on fiscal decentralization principles that will provide a sound basis for the absorption of EU funds.