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THE STUDY OF  
DEMOCRACY

## THE BULGARIAN ECONOMY: COMPETITIVENESS 2013

Policy Brief No. 39, June 2013.

### 1. Bulgaria in 2012-2013: Competitiveness profile and macroeconomic overview

In 2013, Bulgaria is one of the countries that have seen a decline in their competitiveness according to IMD's World Competitiveness Yearbook (WCY). **The country is ranked at 57<sup>th</sup> position** – 3 places below the position achieved in 2012 – 54<sup>th</sup>. **This is the lowest ranking of Bulgaria since its inclusion in the yearbook in 2006 and it is almost 20 places lower than its highest achievement in 2009 – 38<sup>th</sup> place** (see Figure 1)<sup>1</sup>. In 2013, only 3 countries lag behind Bulgaria in the IMD ranking – Croatia, Argentina and Venezuela and all of them ranked lower than Bulgaria in the previous edition of the yearbook, as well. Countries like Greece and Ukraine both of which ranked below Bulgaria in WCY 2012 move up to 54<sup>th</sup> and 49<sup>th</sup> respectively. There are no significant changes in the 'winners' trend in WCY 2013. The USA has regained the No.1 position due to a rebounding financial sector, an abundance of technological innovation and successful companies.

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<sup>1</sup> Source for data in Section 1 – World Competitiveness Yearbook, IMD, 2013 and National Statistical Institute (NSI)

#### MAIN POINTS

- Bulgaria is ranked at **57<sup>th</sup> position**, 3 places below the position achieved in 2012 and the lowest since its inclusion in the yearbook in 2006. This is almost 20 places lower than its highest achievement in 2009 – 38<sup>th</sup> place.
- The country continues to have a **fiscally stable, open and export-oriented economy** with one of the lowest living and business costs in Europe.
- Bulgaria continues to suffer from the **lack of adequate business culture and institutional framework**, while also being plagued by a labor market crisis leading to one of the lowest employment levels Bulgaria has reached in its post-communist history in 2013.
- The most pressing problem of the Bulgarian economy is surging **unemployment**, with youth and long-term unemployment being persistently high.
- The **5 main challenges** which Bulgaria faces in improving its competitiveness are:
  - Modernise public administration to increase evidence-based efficiency and regulatory quality;
  - Reduce administrative costs and provide EU funded incentives for innovation and entrepreneurship;
  - Strengthen the judiciary to tackle corruption and reduce business uncertainty;
  - Reform the governance of the energy sector to preserve cost competitiveness, diversify gas supply, and improve energy efficiency;
  - Tackle hidden economy and related labour market inefficiencies.

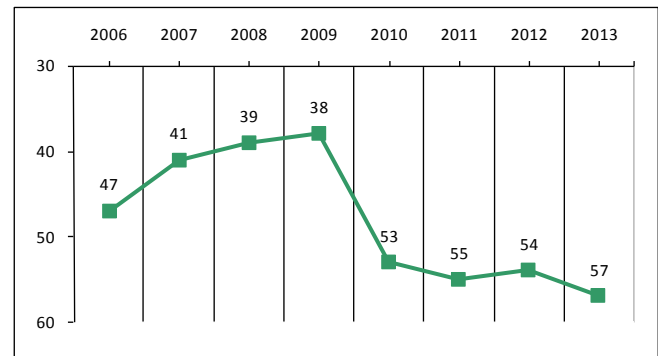
Countries like Singapore and Canada also have very stable and enduring competitiveness models that rely on long-term advantages such as technology, education and advanced infrastructure. **In Europe, Switzerland, Sweden and Germany share the same recipe for success: exports, manufacturing, industry diversification, competitive SMEs and budget discipline.** The fact that countries like Poland and Estonia, which share similar economic and political legacy as Bulgaria are among the fastest progressing countries (Poland is ranked 33<sup>rd</sup> while Estonia is at 36<sup>th</sup> ) clearly demonstrate the significance of appropriate reform approach (competitiveness boosting policy mix) while also indicating the untapped growth potential of Central and East European (CEE) countries.

Compared to its peers, Bulgaria's position has deteriorated as the country ranks 37<sup>th</sup> out of 38 in the EMEA (Europe-Middle East-Africa) rankings (as compared to the highest ever 23<sup>rd</sup> and 37<sup>th</sup> in 2009 and 2012 respectively) and 30<sup>th</sup> , out of 31 between the countries with population below 20m people (the highest ever 24<sup>th</sup> and 28<sup>th</sup> in 2009 and 2012 respectively).

### Box 1. Bulgaria in the World Competitiveness Yearbook

In 2013, Bulgaria was included in the annual World Competitiveness Yearbook of the Swiss Institute for Management Development (IMD) for the eighth consecutive time. The inclusion of Bulgaria in the yearbook is an achievement and a success in itself: it demonstrates that Bulgaria is considered as a stable economy and an attractive investment spot among the other top 60 economies reviewed in the publication. The inclusion in the IMD yearbook is a sign that the Bulgarian economy is seen as a functioning market economy with enough available reliable sources of data and information for accurate economic monitoring.

**Figure 1: Overall ranking of Bulgaria – place assigned in IMD WCY**



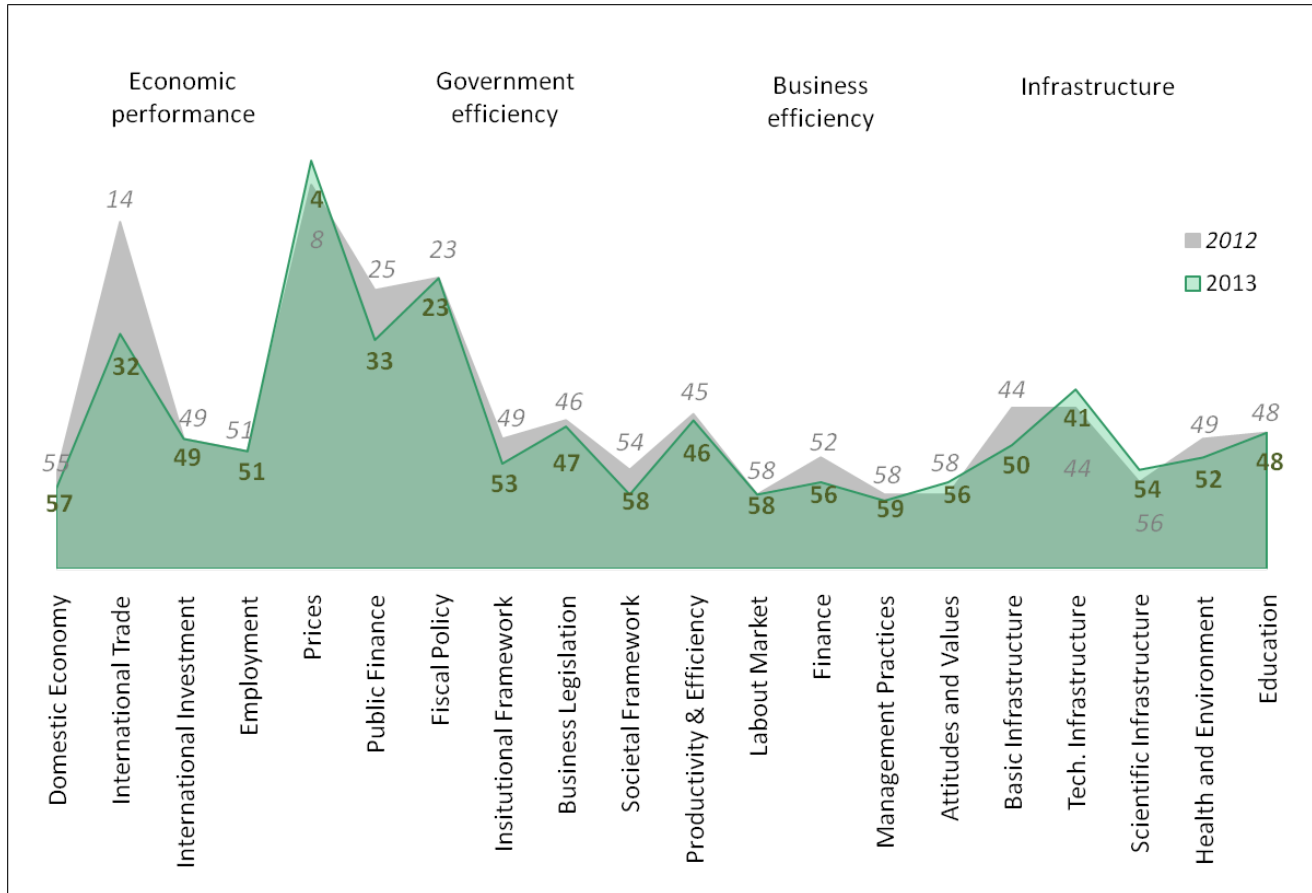
Source: IMD WCY 2013

The performance of key indicators of Bulgaria's competitiveness landscape indicates that Bulgaria has staid within the same limits in the last 3 years (2010-2013). With the dragging on of the economic crisis in Europe there has been mild deterioration of the majority of the competitiveness factors for Bulgaria, while few have moved upwards (Figure 2). This dynamics shows that Bulgaria has failed to strengthen its long-term competitiveness position in the good years until 2008 and has done little to change that in the years since the crisis set in. Once the crisis swept off the macroeconomic indicators, the many hidden competitive gaps of the Bulgarian economy laid bare for everyone to see.

The breakdown of the best and the worst performing areas clearly indicates the main characteristics of the current state of Bulgarian economy. On the one hand, **the country continues to be fiscally stable, open and export-oriented economy with one of the lowest living and business costs in Europe** as seen by the fact that Bulgaria is ranked highest in terms of:

- Prices /cost competitiveness (4<sup>th</sup> place among the 60 ranked countries)
- Fiscal policy (23<sup>rd</sup>)
- International trade (32<sup>nd</sup>, however falling back from 14<sup>th</sup> place in WCY 2012)

Figure 2: Competitiveness Landscape of Bulgaria 2012 - 2013



Source: IMD WCY 2013

On the other hand, **Bulgaria continues to suffer from the lack of adequate business culture and institutional framework, while also being plagued by a labour market crisis leading to one of the lowest employment levels Bulgaria has reached in its post-communist history in 2013.** These negative developments are directly related to the **weak domestic economy and social framework coupled with the lack of adequate support for innovation** (through building modern scientific and entrepreneurship infrastructure). Areas of poor competitiveness performance of Bulgaria include:

- Management practices (59<sup>th</sup> among 60 countries)
- Labour market (58<sup>th</sup>)
- Societal framework (58<sup>th</sup>)
- Domestic economy (57<sup>th</sup>)
- Scientific infrastructure (54<sup>th</sup>)
- Institutional framework (53<sup>rd</sup>)
- Employment (51<sup>st</sup>)

The evolution of Bulgaria's competitiveness highlights the main developments of key factors of Bulgarian economic performance in recent years. Some positive trends include:

- For the last fiscal year (2012), government budget deficit has been decreased to 0.80% from 2.09% in 2011;

- Direct investment flows abroad have increased from 0.17bn to 0.38bn from 2011 to 2012;
- Consumer price inflation has decreased 4.2 to 2.4 from 2011 to 2012.

Negative trends demonstrate the overall economic growth deceleration and social cohesion decline in addition to the relative (mild) decline in exports and increasing unemployment in 2012 - 2013:

- Real GDP growth has decreased to 0.8% for 2012 compared to 1.7% in 2011;
- Unemployment has increased to 13.8% in 2013 compared to 11.5% in 2011;
- Current account balance has turned negative to -1.33% in 2012 from 1.93% in 2011;
- Social cohesion has declined further according to the WCY business survey.

Only two factors have been outlined as comparative key attractiveness indicators by more than half of the respondents of the national Executive Opinion Survey, which shows Bulgaria's competitiveness is based on a very narrow basis (Figure 3):

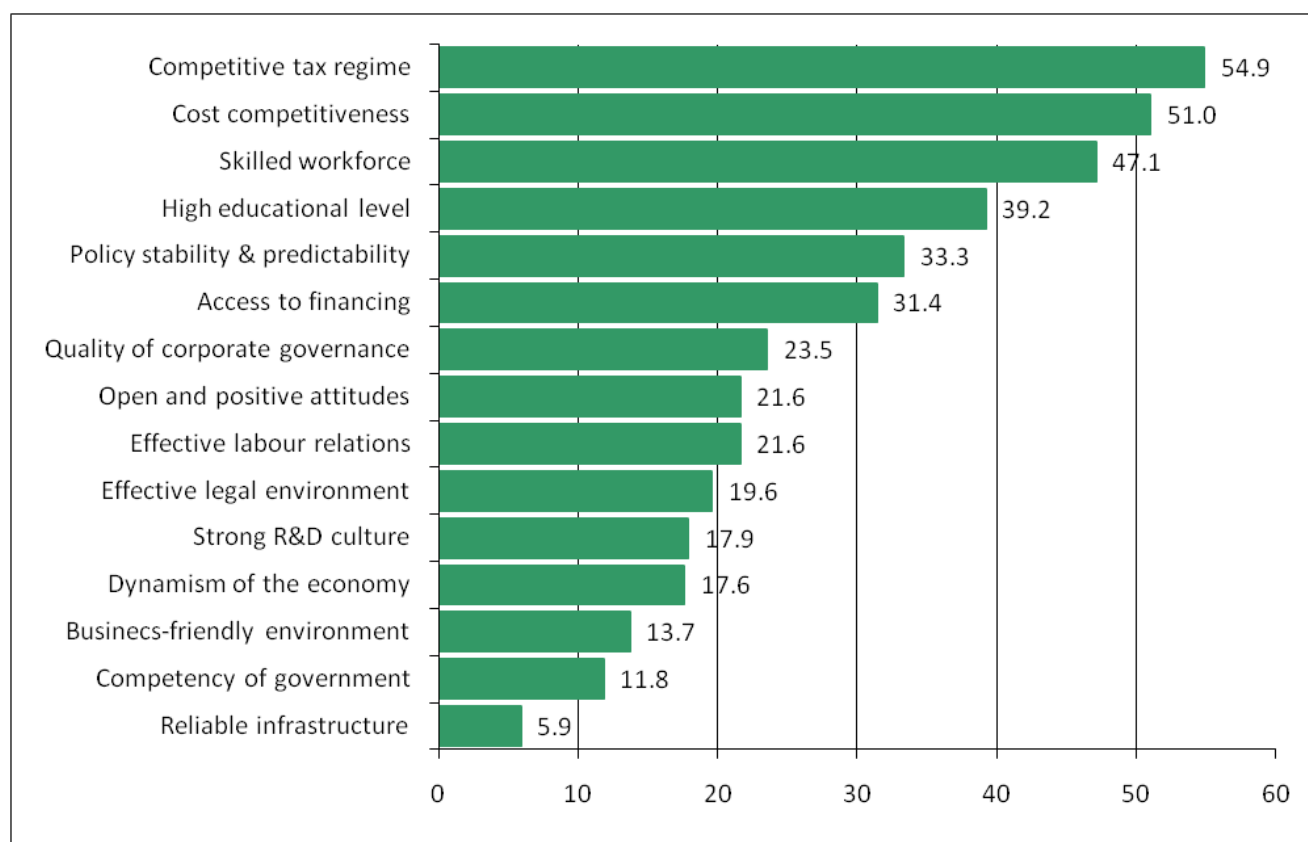
- Competitive tax regime (54.9% of respondents)
- Cost competitiveness (51.0% of respondents)

The next three to top executives' list of Bulgaria's comparative competitiveness attractiveness have declined in importance and are now seen as luring circumstances for less than half of the executives:

- Skilled workforce availability
- High education level (Bulgaria ranked last on this particular indicators among the other countries)
- Policy stability & predictability

Bulgarian executives have ranked worse the state of the infrastructure, the competency of the government and the quality of the business environment.

In summary, Bulgaria's competitiveness is based on very few factors, such as the country's fiscal stability and the relatively low living, labour and production costs, which is a narrow base for the many challenges the country faces. The increase of productivity on the back of rising unemployment has let Bulgarian businesses slowly recover profitability in the aftermath of the economic crisis, resulting in a slow export-led growth in the 2010 – 2012 period while the gradual recovery of domestic demand has galvanized the limited growth in 2012 with private consumption expanding 3.1% on an annual basis in 2012. Yet, the continuing instability in the Eurozone as well as the shallow labour market in Bulgaria, corrupt management practices and weak institutional framework in the country seriously undermine Bulgaria's future progress. As a result, GDP growth in 2012 was only 0.8% as opposed to the expected by the Bulgarian government 1.4%. If the Eurozone environment does not change, Bulgarian growth is likely to remain sluggish until 2015 - around 1% - 1.5%. The Bulgarian stock exchange's average index values (SOFIX) have decreased by 19.6% in 2012, in addition to 11.1% decrease in 2011 - a sign of further depreciation of Bulgarian companies' worth. FDI flows have registered modest increase to USD 1.9bn in 2012, however they still represent less than 20% of the pre-crisis FDI flows. In addition, although there was a slight increase in loans to the private sector in 2012, credit in the country continued to be expensive, which has led to redirection of households to out-of banks lending operations, further depressing domestic demand. In these conditions of continued credit limitations and foreign investment scarcity, EU funds have

**Figure 3: Key attractiveness indicators for Bulgaria, 2013**

Source: IMD WCY 2013

become the main source of financing in both the public and the private sector that have inevitably increased the risks of corruption and illicit income flows.

## 2. Surging Unemployment - the most pressing problem of the Bulgarian economy<sup>2</sup>

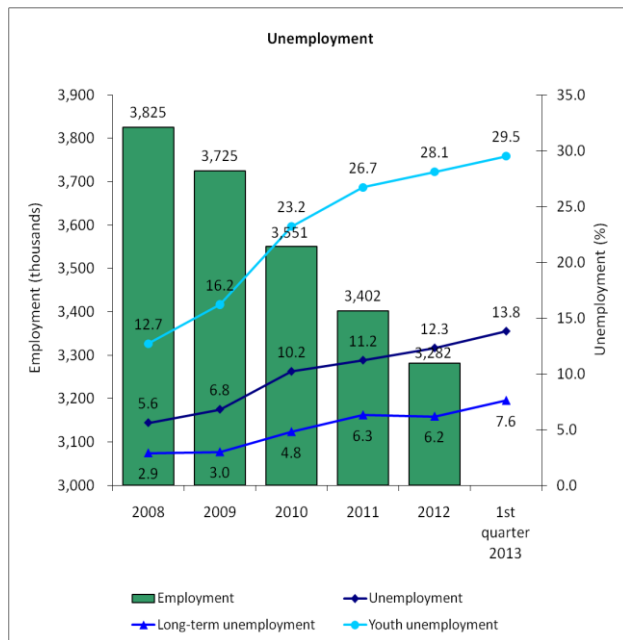
The sharp rise in unemployment in the aftermath of the financial crisis, especially amongst the young and lower skilled was not reversed in 2012

<sup>2</sup> All the information in section 2 is based on data from the National Statistical Institute, 2013

and in 2013 as the limited GDP recovery did not translate into growth and jobs. Unemployment stood at 12.4 % at the end of 2012, and rose even further to 13.8% in the first quarter of 2013 (Figure 4). Long-term unemployment also continued growing (Figure 4), representing 56 % of total unemployment, as did youth unemployment, which reached 29.5% (Figure 4). The effects of stubbornly high unemployment, weak employment market and skills mismatch between demand and supply of labour have been the result of profound structural deficiencies of the Bulgarian economy and lack of strategic policy-making on the part of the Bulgarian government to help offset these negative tendencies. The Bulgarian economy seems to have entered a paradox situation of simultaneous existence of high unemployment and labour

shortage in terms of highly – qualified workers. According to the National Statistical Institute business surveys in 2012, 8.9 % of the industrial enterprises pointed out the labour shortage as a factor limiting their activity in an environment of growing unemployment in recent years.

**Figure 4: Unemployment in Bulgaria (2008-2013)**



Source: NSI

There is no universal recipe to tackling the surging problem of unemployment, as it is a lagging not a leading economic indicator, so it is pretty much the result of already existing deep structural problems of Bulgarian economy. The lessons from the most competitive economies indicate the general route to long-term success: **exports, industry, with a focus on the manufacturing sector, energy diversification and building competitive SMEs.** In this regard, the gradual restructuring of the economy by investing in new technologies and skills, while simultaneously targeting new markets, would significantly improve Bulgaria's competitiveness in relation to

other EU member states. Shifting the focus on highly-skilled jobs would most likely lead to a temporary increase in unemployment, which could be addressed by re-training and developing other sectors of the economy. A more skilled labour force with higher incomes would be able to reap the benefits of the flat tax that was recently introduced as taxpayers could use their higher post-tax income for investment and development of new skills and technologies. Further incentives for the development of new enterprises by young, skilled people could be an easily-available credit system for start-up businesses, or social security payment exemptions for the first three years of employment of new entrants to the market.

In recent years Bulgarian policy-makers have predominantly focused on subsidized employment using national and EU resources. While such policies have eased some of the pain they have not been able to reverse employment fortunes of the most needy and have come at a steep cost in terms of administration and expenditures. At the same time, little attention has been paid to the regressive character of the Bulgarian tax system, which has caused new labour market entrants to stay away from the market or stay in the hidden economy. The Bulgarian government budget relies on VAT – a regressive tax by its character and Bulgaria is one of the very few countries in Europe that does not have a non-taxable minimum income threshold. These features of the tax system make the hidden economy persistent and counterbalance any efforts to subsidize youth and general employment. The design of the Bulgarian tax system is also likely to further exacerbate the deepening social and territorial division in the country. And while the newly elected parliament in May 2013 has already seen proposals for taxing the “super-rich” (defined as the ones receiving more than BGN 4,500 /~€ 2,300/), there have not been any policy proposals for the reintroduction of a non-taxable minimum

income nor for social-security free employment of young employees.

### 3. Competitiveness challenges and policy recommendations

The Center for the Study of Democracy (CSD), the Bulgarian partner of IMD in the World Competitiveness Yearbook has singled out five main challenges, which Bulgaria faces in improving its competitiveness:

- **Modernise public administration to increase evidence-based efficiency and regulatory quality;**
- **Reduce administrative costs and provide EU funds-backed incentives for innovation, entrepreneurs and start-ups;**
- **Strengthen judiciary to tackle corruption, speed up insolvency procedures and reduce business uncertainty;**
- **Reform the governance and regulation of the energy sector to preserve cost competitiveness, diversify gas supply, and improve energy efficiency;**
- **Tackle hidden economy and related labour market inefficiencies.**

The selected challenges are focused around few factors that have the potential of decisively changing the competitiveness profile of the Bulgarian economy. Those include the necessity for sustainable energy utilization and public finance optimization coupled with the goal of fostering the conditions to cultivate and reinvigorate entrepreneurship and innovation. There are three main factors that are discussed below as areas where improvement would have direct effect in overcoming the competitiveness challenges of the Bulgarian economy: efficient and transparent energy sector governance, limiting hidden economy effect and supporting innovation.

#### 3.1 Energy sector governance<sup>3</sup>

The energy sector is one of the most important sectors of Bulgaria's economy, representing 21% of its GDP for 2012. However, the sector suffers from opaque administration, lack of reform and restructuring, and most importantly a long-term decision-making strategy. This inevitably results in serious economic and social malfunctions as seen by the February 2013 protests that led to the resignation of the government. Moreover, a lack of transparency based on long-term opaque lobbying deems regulatory and public procurement decisions unsubstantiated and casts doubts over favouritism, obscure plotting and large-scale rent-seeking behaviour. Regulatory decisions are inconsistent and often conflicting, while related numerous changes seem based on trial-and-error and critically harm the country's image as an investment destination. As a whole the Bulgarian energy sector is defined by **lack of source diversification, unliberalized market coupled with extremely inefficient governance of state energy assets and non-competitive public procurement approach.**

As a result, in 2013 Bulgarian industry and households face rising energy prices and unclear policy perspectives. In addition, there is growing social pressure to counter the introduction of price-increasing renewable energy sources, while more than 60% of Bulgarian households use wood for heating, further deteriorating air quality. Most notably, as the average Bulgarian household is already considered energy poor by European standards, it is likely that downward pressure on energy prices will remain, capping needed future investment in energy grids and carbon-emission reducing facilities. Hence, one of the few available ways out of this trap seems to be a focus on energy

<sup>3</sup> All information in section 3.1 is based on data from the National Statistical Institute, 2013

efficiency in households and enterprises, using EU funds, preserving existing nuclear generating capacity for as long as possible, and turning towards technology development in green industries. In addition, Bulgaria needs to urgently tackle its excessively high external and internal dependence on a single supplier of natural gas; the country paid among the top highest gas prices in Europe in 2013. Developing new external and internal sources of gas supply is critical for boosting Bulgaria's competitive position.

The following measures could have a positive impact on the efficiency of state-owned enterprises and the transparency of the public procurement system in the energy sector:

- The involvement of political leaders in the operations of energy enterprises should be avoided.
- The current model should give way to decentralized production, liberalization of the energy market, and adequate mechanisms to cushion vulnerable energy poor groups against the transition.
- State-owned enterprises should be stabilized or restructured, rather than investing obscene amounts of money in new mega projects.
- Decisions to commence large energy infrastructure projects need to be based on clear factual analyses (incl. feasibility, sustainability, cost-benefit, Return of investment, etc.) that are publicly available and should be assessed in terms of their potential to resolve the most urgent energy issues in the country.
- Financial control should be utilized at its fullest in order to improve the governance system of the energy sector, through regular audits of the financial health of state-owned enterprises by the Public Financial Inspection Agency. Inspections of

the most recent periods should also be undertaken to alert the public prosecution of potential abuse.

- Companies should fully comply with current regulations on financial disclosure. Decree 114 should include OECD requirements on reporting and reporting activities should be compared and analyzed on the basis of the updated Decree 114 on a quarterly basis.

### 3.2 Hidden economy<sup>4</sup>

**The hidden economy in Bulgaria continues to be a major development obstacle** and practices such as undeclared work continue to be socially accepted, whereas general discontent with the business environment fuels widespread tax evasion. These trends are the result of traditional weaknesses of the Bulgarian economy such as the relation between strong oligarchic-type economic structures and the establishment of informal social and economic systems. Furthermore, the price of entrepreneurship remains high, SME access to EU-funds undermined by inefficient institutional framework and administrative incapacity, while internal consumer demand remains weak and unsophisticated. Thus, involvement in the informal sector continues to be an important means for a business start-up and small and mid-size business development.

In 2012 the values of the Business Hidden Economy Index and the Population Unreported Economic Activity Index decreased<sup>5</sup>, indicating a mild decline in the share of the hidden economy in Bulgaria. However, **perceptions among the businesses as to**

<sup>4</sup> CSD Policy Brief No. 37: The Hidden Economy in Bulgaria: 2011-2012, Sofia, 2013

<sup>5</sup> CSD Policy Brief No. 37: The Hidden Economy in Bulgaria: 2011-2012, Sofia, 2013



**the overall size of the hidden economy in the country remain largely unchanged.** Such perceptions are an indication of the persistently harsh economic environment in the country, in terms of both market prospects amid continuing uncertainty in Europe and regulatory environment and law enforcement within the country.

**Successful measures to reduce the level of hidden economy in Bulgaria and to remove competitiveness roadblocks may include:**

- introducing common efficiency and productivity indicators across government regulatory agencies
- tackling corruption through the introduction of e-services
- speeding-up VAT e-funds and reducing control checks on law-abiding companies;
- administrative reform to speed-up payments on European programs
- better legal framework on late payments and business-to-business private debt
- improving the work of administrative courts and targeting vigorously the practice of backdating insolvency
- promoting free enterprise and competition through improving the enforcement of the anti-monopoly legislation

### 3.3 Innovation<sup>6</sup>

Export-oriented innovative enterprises have a key role in overcoming the financial and economic crisis, in tackling unemployment and encouraging future economic growth, and in increasing the international competitiveness of the Bulgarian economy. Because of their low technological nature the added value of Bulgaria's exports remains amongst the lowest in the EU. However, as the country has a stable fiscal and

macroeconomic position, there is potential to create a favourable environment for the functioning of innovative export enterprises by introducing a sustainable and modern government innovation policy through a number of mechanisms:

- The introduction of an **integrated approach to national policies in the field of science, technology and innovation**, implemented through a single administrative body (ministry or agency) and as part of an overall national development strategy.
- A **smart specialisation strategy** and a smart approach to implement it need to be developed. Only bold institutional and administrative reforms will allow Bulgaria to emerge from its lethargy with regard to science and innovation. The current national and regional innovation systems are fragmented, administrative capacity is lacking and there are considerable differences in the innovation potential of the individual planning regions. A much more intensive dialogue between the main institutions in the field of science and innovation is needed to map out a common strategy to outline the priority axes for the next programming period.
- The shrinking of the R&D sectors of the economy and the country's low industrial competitiveness result in a patent system practically unused by Bulgarian enterprises, research organisations or citizens. Bulgarian innovators still rely on the most primitive forms of protection of their intellectual product, such as keeping it secret. The bulk of patents in Bulgaria are the property of foreign companies or Bulgarian individuals. **Bulgaria is still very far from achieving technological competitiveness** and will continue to rely mainly on low costs and low prices in the near future.
- The information and communication technologies (ICT) sector is of **key importance for the growth and innovativeness of the Bulgarian economy**. Thus, in spite of the great expectations for the ICT sector in Bulgaria, and the fact that it is developing more efficiently than other areas of the

<sup>6</sup> ARC Fund, 'Innovation.bg 2012', Sofia, 2012

economy, without a decisive and substantial change in policies in this area Bulgaria cannot be expected to have a leading position in ICT exports in Europe or even in the region. Evaluation of the added value and potential growth of ICT companies in Bulgaria shows that – contrary to popular opinion – local companies frequently make a larger contribution to the development of the sector than international ones. In this respect, policies in support of the development of ICT should seek a delicate balance between providing stimuli for multinational companies and providing adequate measures for promoting local enterprises.