

Economic Program

2008 Highlights

In 2008 the Economic Program at the Center for the Study of Democracy focused on three main areas: hidden economy, anticorruption, and competitiveness.

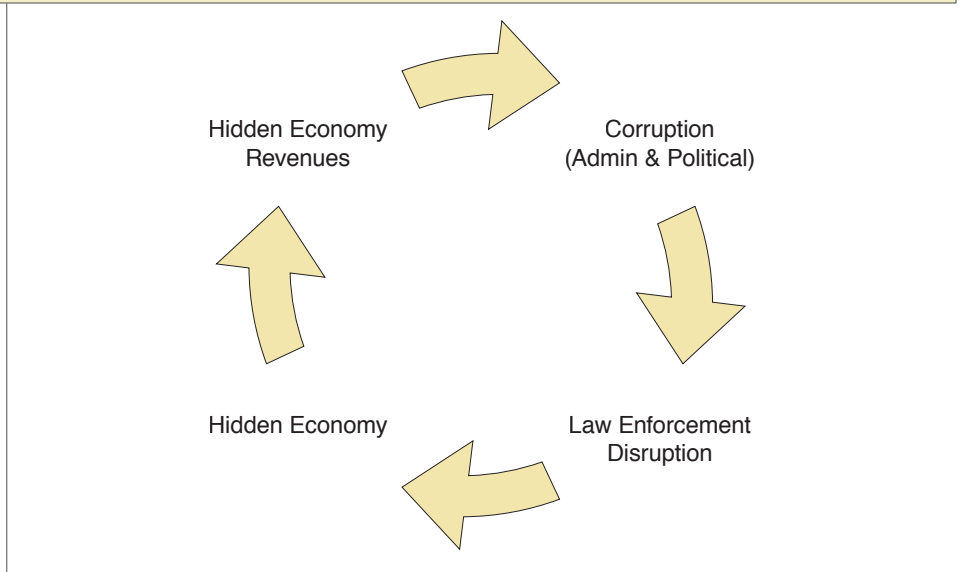
- Analysis of trends in hidden economic activity and its manifestations in Bulgaria. CSD updated its annual *Hidden Economy Index* with data for 2008. The organization also put forth a proposal for establishing a private-public platform for transparent governance and business ethics as a key instrument for reducing hidden economic activities in Bulgaria. In this respect, two main priority areas were identified – judicial and legislative reform and public funds management, including tighter control over public procurement, concessions, and land swaps.
- Preparation of a series of analyses and recommendations for the development and implementation of economic and anticorruption policies in Bulgaria, some of which were adopted by the Bulgarian Government and the European Commission: a) the closing of duty-free trade along the country's land borders as a tool for countering corruption and organized crime; b) supporting Bulgaria's preparation under the Lisbon Strategy of the European Union; and others.
- Contribution to Bulgaria's inclusion – for the third time – in the world's oldest and most comprehensive annual ranking of economic competitiveness: namely, the World Competitiveness Yearbook published by IMD (Institute for Management Development). The Bulgarian economy ranked 39th in 2008, moving up two places from the previous year.
- Provision – on the part of a CSD expert – of online training on anticorruption, innovation and entrepreneurship to serve the needs of the Development Institute at the Center for International Private Enterprise. The Institute's resources will be used to provide online training worldwide.

I. Hidden Economy and Anticorruption

The hidden economy is one of the main obstacles to investment and growth in Bulgaria. By various estimates, its size ranges between 20 and 35 per cent of GDP, with the actual value of transactions reported in some sectors being less than 50%.

In 2008, the Center for the Study of Democracy produced and presented – for the sixth consecutive year – new data provided by the Hidden Economy Index. The index data as well as CSD surveys over the past ten years indicate the existence of a vicious cycle of corruption and hidden economic activities in Bulgaria. The latter have become a source of corruption payments

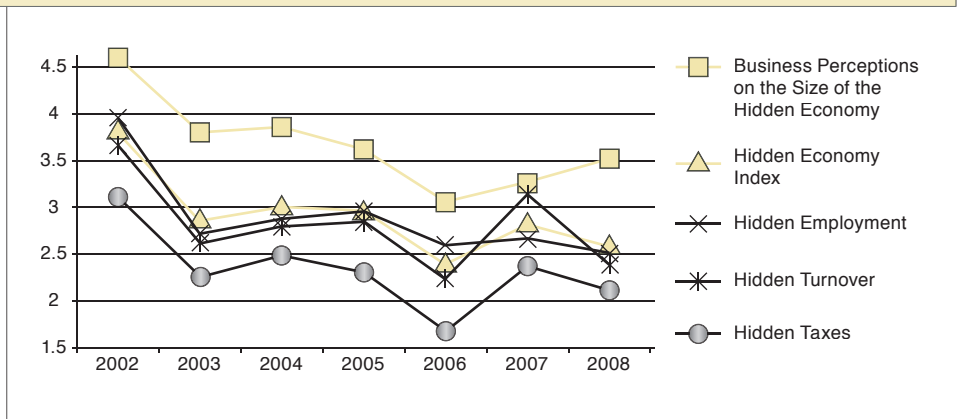
Figure 2. The Vicious Cycle of Hidden Economy and Corruption in Bulgaria



used for wide-ranging purposes – from evading fines or penalties to capturing the state. CSD has promoted the **Index** as an instrument for identifying both the efficiency of the measures adopted by the Bulgarian authorities in

countering hidden economic activities, and the problem areas in calling for further action in this respect on the part of the government and the business community.

Figure 3. The 2008 Hidden Economy Index



On December 3, 2008, the Center for the Study of Democracy and the Friedrich Ebert Foundation organized a round table discussion on the problems of the hidden economy and the impact of the world economic crisis on Bulgaria, during which CSD presented the annual Hidden Economy Index for 2008. **The Index has registered a moderate decline.** By way of comparison, when first estimated in 2002, the Index was 40% higher. The reverse tendency has been observed with regard to the **perceived size of the hidden economy among the business community**, which has been **on the increase since 2006.** This discrepancy between actual dynamics of the hidden economy as measured by the index and the business community's contrary perception that it has been on the increase in the country can be attributed to a combination of many factors, such as increasing distrust of institutions, growing foreign competition since the country's EU accession, and a sense of the deepening global economic crisis in 2008. Although as a whole the Index figures point towards improvements, there remain some **high-risk areas**, such as "envelope wages" employment

(i.e. remuneration over and above amounts declared in employment contracts) and **VAT fraud.**

Representatives of the Bulgarian government, finance and business leaders, non-governmental organizations, and the media discussed possible ways of averting the **danger for the level of hidden economy to rebound in line with the increasing risks for the country's economic growth** resulting from the economic recession in the advanced world economies, incl. the Eurozone.

The discussion participants noted several of Bulgaria's **starting point advantages** for confronting the impending economic crisis compared to the other new EU member countries, such as the country's budget surplus and low level of public debt, as well as its sound financial system with little exposure to toxic assets. Nevertheless, like most other peripheral economies, Bulgaria remains **highly exposed to external shocks**, particularly to the suspension of credit provision and the recession in the Eurozone, as observed toward the end of 2008. The main vulnerabilities of the Bulgarian economy are associated with



From left to right: Boyko Borissov, Mayor of Sofia, Marc Meinardus, Director, Friedrich Ebert Foundation, Sofia, Ognian Shentov, Chairman, Center for the Study of Democracy, Petar Dimitrov, Minister of the Economy and Energy, Plamen Oresharski, Minister of Finance.

institutional uncertainty, high levels of the hidden economy, corruption and crime, compounded by the large current account deficit, unsustainable credit boom, overpriced (real estate) assets, high levels of private external debt (over 90% of GDP), weak export competitiveness, and limited, albeit increasing, local demand. Against this backdrop, the ever more conspicuous **lack of domestic leadership** in alleviating the negative effects of the economic crisis reinforces perceptions of institutional instability.

In a deteriorating international economic environment, **pressures for the expansion of hidden economic activities in Bulgaria will intensify** in the three main zones of the hidden economy:

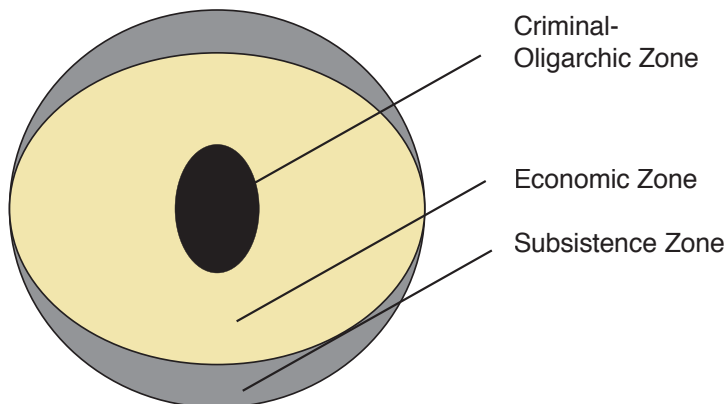
- **Subsistence** (a surge in subsistence farming, or the production of goods for personal consumption among the poorest and marginal communities);
- **Economic** (increasing strains on business and household incomes, combined with the weakening of state control mechanisms, including in relation to the

higher levels of administrative uncertainty due to the upcoming parliamentary elections and the expected decrease of budget revenues, will increase incentives for tax evasion); and

- **Criminal-and-oligarchic** (the economic recession will lead to a greater dependence of businesses on government decisions, e.g. in public procurement and concessions, which will encourage attempts at the redistribution of public resources by means of “pulling political strings”. At the same time, the probable increase in unemployment, depending on the duration and intensity of the crisis, will lead to an increase in the labor supply for criminal organizations).

In 2008 the Center for the Study of Democracy held a series of consultations with representatives of government institutions, business, and non-governmental organizations on the feasibility of a **public-private partnership platform** on the issues of good governance and fair competition on the example of developing policy responses to the grey economy.

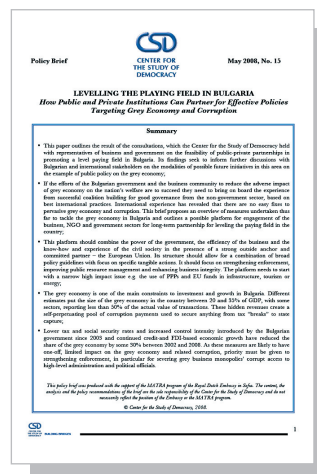
Figure 4. Hidden Economy Zones



As a result, CSD prepared a policy brief entitled “Levelling the Playing Field in Bulgaria. How Public and Private Institutions Can Partner for Effective Policies Targeting Grey Economy and Corruption”. The brief included an overview of the measures undertaken in Bulgaria to reduce the hidden economy, as well as the possibilities for enlisting the participation of the business community, NGOs, and government institutions in a long-term partnership arrangement targeting hidden economic activities. According to the analysis, the lower tax and social security rates and increased control intensity introduced by the Bulgarian government since 2003, and continued credit- and FDI-based economic growth have **reduced the share of the hidden economy by some 30% between 2002 and 2008**. As these measures are likely to have one-off, limited impact on the hidden economy and related corruption, government policy must give priority to **strengthening law enforcement**. In this relation it is particularly essential to sever the corrupt connections between shady business monopolies and high-ranking politicians and officials.

The proposal for the establishment of a public-private platform for good governance and business ethics as an essential tool for dealing with the problem of the hidden economy in Bulgaria was presented on the 27th of May, 2008, at the Sheraton Hotel in Sofia. On this date, the Center for the Study of Democracy, with the support of the Royal Netherlands Embassy, organized a round table discussion of the challenges to Bulgaria’s economic development and competitiveness posed by the hidden economy. During the event, two priority areas were identified with a view to reining in the hidden economy: judicial and legislative reform and the improvement of public resource management, including stricter control

over public procurement, concessions, and land swaps.



As a specific example of effective private-public partnership, the round table participants noted CSD’s role in the elaboration of anticorruption policies. At the beginning of 2008, CSD offered an analysis of the corruption-generating effect of duty-free trade along the country’s land borders and came up with a proposal to reduce that effect. Policy Brief No 13 *Effective Policies Targeting the Corruption – Organized Crime Nexus in Bulgaria: Closing Down Duty-Free Outlets* demonstrated that through the Law on Duty-Free Trade adopted at the very end of 2006, the Bulgarian Parliament ignored the Government’s public and international commitments to gradually close down duty-free outlets and gas stations along land borders. In fact, Bulgarian MPs granted outlet owners permanent licenses without tendering and gave them the right to offset the losses sustained as a result of the closure of duty-free shops at the now internal EU borders by opening new outlets along the external borders of the Union. The adoption of this piece of legislation was in fact one of the most blatant examples of state capture by economically powerful private interests.

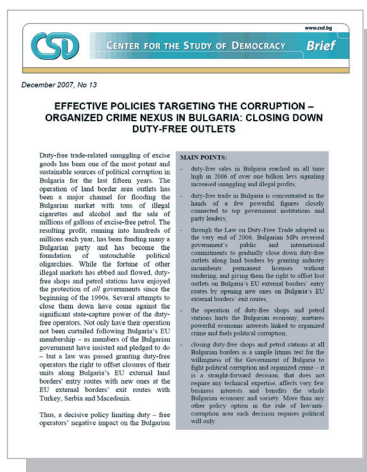


From left to right: Stefan Szyszkowitz, Chairman of the Managing Board of EVN Bulgaria; Bozhidar Bozhinov, Chairman of the Bulgarian Chamber of Commerce and Industry; Plamen Oresharski, Minister of Finance; Mihail Mikov, Minister of Internal Affairs; Willem Van Ee, Ambassador of the Royal Netherlands to Bulgaria; Dr. Ognian Shentov, Chairman of the Center for the Study of Democracy; Boyko Borisov, Mayor of Sofia Municipality; Professor Valeri Dimitrov, Chairman of the Bulgarian National Audit Office

CSD put forth two possible approaches to reducing the adverse effects of duty-free trading along Bulgaria's land borders:

- **Closing down duty-free outlets and gas stations.** The implications for the economy would be immediate and unquestionably positive (radical approach);
- **Banning the sale of cigarettes at duty-free outlets and introducing restrictions on the sale of petrol at gas stations:** 30 liters for cars and 200 liters for trucks. This would require tighter control and strict law enforcement (moderate approach).

After the European Commission identified duty-free trade along the country's land borders as a hotbed of corruption and organized crime in a February 2008 report, in June of 2008 Bulgaria finally opted for closing down duty-free outlets.



II. Knowledge Economy

CSD continued its work on the topic of the knowledge economy in 2008. Its experts prepared the policy brief entitled "Bulgaria and the Lisbon Strategy: Challenges and Opportunities". The brief presents an overview of the European Commission's

assessment and recommendations in regard to the Lisbon Strategy and Bulgaria's National Reform Program. It recommends a number of specific policy measures for improving the country's competitiveness, most notably by means of:

- Creating a Coordinating Unit in charge of the country's National Reform Program; and
- Focusing the National Reform Program's priorities on competitiveness and innovations, improving the business environment, and reducing corruption and the hidden economy.

The policy brief was presented at a meeting of the Public Consultations Council of the National Assembly's European Affairs Committee on March 19, 2008. In a report, the Committee endorsed most of the recommendations made by the Center for the Study of Democracy.

Between October 17th and 19th, 2008, the Center for the Study of Democracy, in

collaboration with the University of Oslo organized a workshop entitled "Innovation, Intellectual Property Rights and their Multilateral and Regional Regulation. The Case of the SEE Transition Economies". The workshop was part of the activities of the GARNET EU Research Network.

Some of the main topics of discussion at the workshop were the relationship between global and regional institutions, and the processes of knowledge creation and dissemination: the internationalisation of education, research and innovation systems, as well as the governance of the access to and the dissemination of knowledge. The workshop explored the question of how the different regional and multilateral governance mechanisms of IPRs and innovation have affected the performance of knowledge economies in the areas of foreign trade and FDI, local company performance, human capital, ICT, etc.

For the purposes of the workshop the organizers issued a call for papers



Workshop: Innovation, Intellectual Property Rights and Their Multilateral and Regional Regulation. The Case of the SEE Transition Economies, 17-19 October, 2008

exploring how multilateral and regional regulatory agencies and institutions, such as the WTO's GATS and TRIPS, UNESCO, and the EU, affect innovation and the use of IPRs at the regional and national levels.

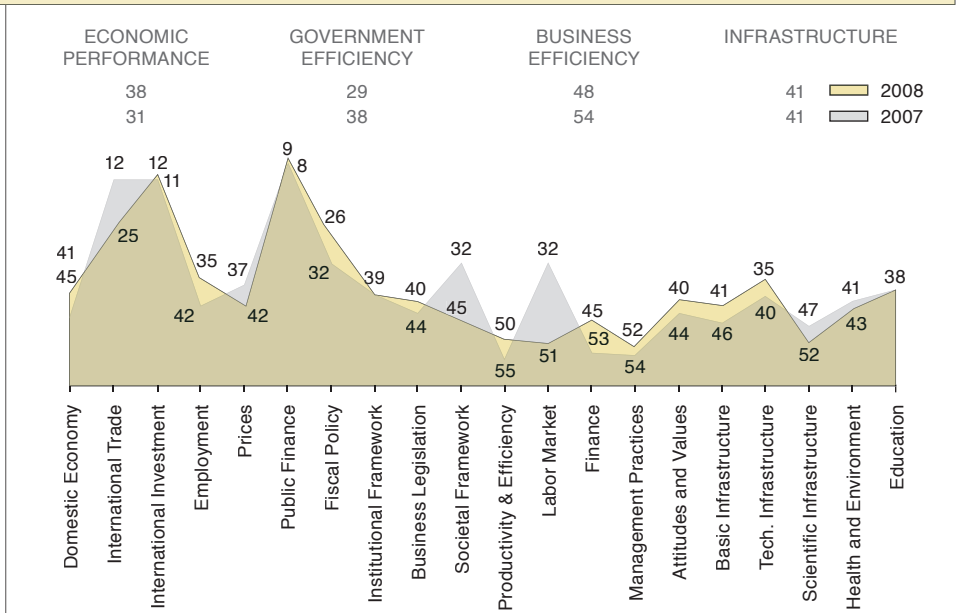
III. Competitiveness

With CSD's help, in 2008 Bulgaria was included for the third time in the world's oldest and most comprehensive annual ranking of economic competitiveness: the World Competitiveness Yearbook of IMD (Institute for Management Development), published annually since 1989.

This year Bulgaria **ranked thirty-ninth out of a total of fifty-five economies,**

up two places from the previous year. The positive development was due to factors such as increasing foreign investments, stable public finances and steady currency exchange rate, falling unemployment, low corporate income tax rates, improving basic infrastructure, and cheaper and more accessible technologies. The most alarming tendencies were observed with regard to the labor market, political environment, and scientific infrastructure categories, in each of which Bulgaria's competitiveness ranking had dropped. Still regarded as serious problems were the current account deficit, the export of goods, the ageing of the population, the presence of corruption, and the lack of ethical practices among businesses.

Figure 5. Competitiveness Landscape of Bulgaria



The indicator values show Bulgaria's position in each category among the 55 countries included in the ranking.

Source: World Competitiveness Yearbook, IMD, 2008 and 2007

Bulgaria had the highest rank in **government efficiency** (twenty-ninth compared to thirty-eighth place in 2007), in contrast to last year when it ranked best in **economy efficiency** (thirty-first, then declining to thirty-eighth place in 2008). The country's good performance with respect to the government efficiency indicator was largely due to the substantial budget surplus. At the same time, the 2008 Competitiveness Yearbook indicators clearly indicated that there remain significant obstacles to economic competitiveness in terms of the poor management of public property and services, the hidden economy, and corruption. The most alarming development regarding the competitiveness of the economy in 2008 was the rising rate of inflation, which was in part due to the international business cycle, yet also to insufficient competition in the domestic market. **Business efficiency** was assessed higher in comparison to the previous year (at forty-eighth place compared to the next to last fifty-fourth place in 2007).

There was no change with regard to **infrastructure**, where Bulgaria ranked forty-first out of fifty-five participating economies – the same place as last year. The main obstacles to Bulgaria's improved performance under these last two groups of indicators were the unstable socio-political environment over the past eight months, the emerging massive deficits in the labor market, and the lagging-behind in scientific infrastructure.

IV. Distance Learning Center

In 2008 CSD's Distance Learning Center developed online training materials and presentations on the following topics for the needs of CIPE's Development Institute (<http://www.developmentinstitute.org/>):

- Entrepreneurship and innovation as engines of economic growth;
- Business approaches to counteracting corruption;



Press Conference: Bulgarian Competitiveness in 2008, 14 May 2008

- Challenges to reformist thinking.

The CIPE Development Institute is to provide training to universities

worldwide, which will considerably enhance the visibility of CSD's Distance Learning Center. The first courses will be conducted in 2009.