

# Economic Program

In 2005 the Economic Program focused its work on the issues of corruption, hidden economy and more specifically corruption in the tax administration and its impact in the context of EU accession. The Economic Program's activities also included elaboration of innovative approaches to promote local and regional development, as well as analysis of innovations as an instrument for development of a knowledge-based economy.

## 2005 Highlights

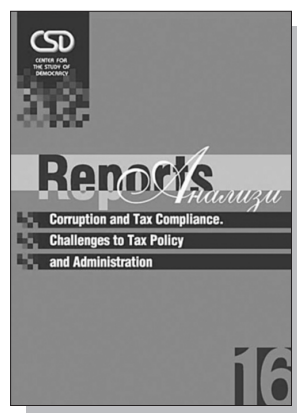
- The Economic Program continued to monitor the trends in the various manifestations of the **hidden economy**. According to the Hidden Economy Index in 2005 the share of the informal economy remained relatively stable. The Economic Program put special focus on analyzing corruption in the tax administration and the challenges it poses to tax policy.
- In 2005 the Economic Program continued to promote **good local governance** and to explore the opportunities for application in Bulgaria of the best European practices in decentralization. In the sphere of local development, CSD, is a partner in the RIS BRIDGE initiative, which aims to build regional capacity for work with the financial instruments of the Cohesion Policy after Bulgaria's accession to the EU and to enhance the potential of the regional authorities to set up policy measures designed to meet the actual technology and innovation needs of SMEs.
- CSD contributed to the annual report *Innovation.bg*, which monitors Bulgaria's preparedness for the knowledge-based society. In 2005, it analyzed the **National Innovation System**, based on five key indicators: innovation product, entrepreneurship and innovation networks, investment and financing, human capital, and information and communication technologies. CSD participated in the elaboration of the *Report for the President of the Republic of Bulgaria: Bulgaria 2010 – The Economic Challenges* in the chapters, dedicated to informal economy and business competitiveness.
- In 2004 CSD became host to the first **Bulgarian Distance Learning Center** of the World Bank's Global Development Learning Network. In 2005 the Center continued to offer a wide range of topics and useful knowledge to students, government and private sector representatives, and professionals in different spheres of the economy.

## I. Informal Economy and Anti-Corruption

According to the Hidden Economy Monitoring System of *Coalition 2000* the size of the hidden economy has decreased since 2002, but the shares of the hidden employment and hidden turnover remain high. Hence, as a whole its levels, together with its variations remain of concern.

One of the aspects of corruption, on which the Economic Program focused its efforts in 2005, was corruption in the tax administration. Though it is perceived to be at lower levels compared to customs, the police or the judiciary, surveys among businesses show that most of them believe that most of the tax officers are involved in corruption. The amount of the money involved is also among the highest as compared to that in other types of corrupt practices.

The Report *Corruption and Tax Compliance. Challenges to Tax Policy and Administration*, published in October 2005, makes an in-depth analysis of the phenomenon and its individual and institutional behavior. It also offers rec-



ommendations for improvement of the work of separate departments in the tax administration, as well as information about the level and incentives of tax-related corruption, which could be used for an update of the anticorruption policy.

*“Broadly speaking, business pays for two groups of corrupt services: tax evasion and ‘preferred customer’ treatment. To the briber, the net benefit of tax evasion equals the tax saved less the bribe. In the case of preferential*



*Konstantin Pashev, Senior Fellow of the Economic Program of CSD presents the main findings of the report *Corruption and Tax Compliance. Challenges to Tax Policy and Administration*, 18 October 2005*

*treatment, the briber's net benefit equals his or her opportunity cost of time saved less the bribe. Where such preferential treatment concerns a tax refund, the 'service' has a value directly measurable as a proportion of the tax refund. Hence, all other things being equal, the higher the tax burden and the lower the administration's effectiveness and the price of corrupt services, the higher the briber's incremental benefit. Another consideration to plug into this equation is the briber's level of certainty that the corrupt tax officer will deliver that for which he or she has been paid....*

*Despite some early signs of a downward trend, tax corruption in Bulgaria is still a major obstacle to market competition based on the principles of the level playing field and clear and predictable rules of the game. To curb tax corruption is therefore a major priority of economic policies seeking to improve the business environment and the economy's competitiveness, and to encourage investment, innovation and growth."*

Corruption and Tax Compliance.  
Challenges to Tax Policy and  
Administration  
Center for the Study of Democracy,  
2005.

In 2005 CSD continued to expand its expertise and to promote knowledge sharing in the sphere of anti-corruption practice and analysis of the informal economy. On 1 February 2005 CSD and Vitosha Research presented the dynamics of the Hidden Economy Index among the population for the period 2002 – 2004. The surveys show that the share of the population, who do not pay in full social and healthcare security contributions, has increased. The incentives for the business in favor

of the hidden economy remained high despite the administrative measures of 2003 for obligatory registration of all labor contracts. These measures proved to be of no tangible improvement in the administrative environment. As a result the level of confidence in public institutions and services remains low. On the other hand, the Index marks a decrease in the subsistence economy employment, which is a result of the gradual penetration of market forces in traditional home-made production spheres.

The hidden economy topic was additionally covered by the following series of events, organized by the Economic Program:

- CSD experts presented the trends in informal economy development according to the Hidden Economy Monitoring System of *Coalition 2000* at a conference *Grey Economy and Undeclared Employment*, organized by the Ministry of Labor and Social Policy on September 9 and 10, 2005.
- CSD experts presented the report *Corruption and Tax Compliance. Challenges to Tax Policy and Administration* at a round table on October 18, 2005 to representatives of the Parliamentary Anti-corruption Commission, the Ministry of Interior, the General Tax Directorate, and the Financial Intelligence Agency. The report was also discussed at a special meeting of the Parliamentary Anti-Corruption Commission with the participation of representatives of the tax administration. The findings of the report had wide media coverage and prompted changes in the *Law on VAT*.

One of the highlights on the Economic Program's agenda in 2005 was the international conference *EU Prospects and Security in South Eastern Europe*:



*The opening session of the EU Prospects and Security in South Eastern Europe conference*

*Hidden Economy, Transborder Crime and Development* held on October 28 and 29, 2005 with the support of the Friedrich Ebert Foundation and the Japan Foundation.

The event brought together researchers from prominent scientific institutions in Europe to share their views and discuss possible solutions to hidden economy challenges. The discussion centered on the social, business, national and regional security issues. During the event CSD experts presented the updated trends in the Hidden Economy Index as well as the possibilities for introduction of the flat tax in Bulgaria. The conference contributed to the design of an integrated research methodological framework to the informal economy, informal labor and transborder crime that is both targeted and comprehensive.

## II. Local Development and Self-Governance

One of the major activities of the Economic Program in 2005 was to continue to promote local development. A round table *Innovative Approaches for Enhancing Local Development and Self*

*Government of the Regions in Europe*, organized jointly with the Council of Europe on June 30 and July 1, 2005, representatives of the Chamber of the Regions of the Congress of Local and Regional Authorities of the Council of Europe, the National Association of Municipalities in Bulgaria, Municipal Governors and other stakeholders exchanged good practices for local and regional development. CSD experts discussed the **decentralization policies in Europe** and prospects for their application in Bulgaria. The participants defined the challenges facing local self-government, among which the still strong financial centralization at regional level and the mismatch between the rights, responsibilities and the resources of the municipalities. The participants discussed the necessary supplementary institutions and mechanisms at local and regional level, the need to improve the democratic system and horizontal accountability of the municipalities and the regions, and the influence of the EU membership on local government accountability.

The **establishment of Sofia Economic Council**, the strengthening of the local ombudsman institution, the Regional Development Plan and the development

of Regional Innovation Strategy for the South West Planning Region in Bulgaria were the three main recommendations for the improvement of economically effective local and regional governance in Bulgaria.

On May 30, 2005 CSD took part in the official presentation of the elaborated by fourteen non-governmental organizations report *Monitoring of the Work of Sofia Municipal Council 2004-2005*. The report analyses the Sofia Municipal Council's policy related to the management of municipal property and finance. One of the main conclusions was that Sofia Municipality needs to improve the planning process of its activities and to faster develop its working programs.

In 2005 CSD partnered in the launch of an initiative for the elaboration of the **Regional Innovation Strategy (RIS)** for the South West Region of Bulgaria. The RIS is an instrument of the European Commission for preparing the regional and local authorities to work with the

financial instruments of the Cohesion Policy after Bulgaria's accession in the EU. It also aims to improve the capacity of the regional authorities to set up policy measures designed to match the actual technology and innovation needs of the SMEs. The Center works on RIS BRIDGE in cooperation with partners from Greece, the UK and Germany.

The initiative is expected to wire up the innovation system of the South West region, to enhance the potential of the regional authorities to set up policy measures designed to meet the actual technology and innovation needs of the SMEs, and to build regional capacity to work with the financial instruments of the Cohesion Policy after Bulgaria's accession in the EU.

Three information days were held on November 11 and 25, and December 7, 2005 in the towns of Pernik, Blagoevgrad and Kyustendil in order to introduce the RIS BRIDGE initiative to the local authorities and initiate a networking and consensus building process.



*Participants in the RIS BRIDGE Information Day, 11 November 2005, Pernik*

### III. Innovation and Knowledge Economy



CSD recognizes the importance of innovation and knowledge economy as key factors for the increase of the Bulgarian economic competitiveness. Representatives of the Center participated in the elaboration of the report *Innovation.bg*, which was published in October 2005. The report monitors Bulgaria's preparedness for the knowledge economy on an annual basis. It makes an overview of the level of economic development in the context of capital and technology supply and describes the existing institutional and organizational structure of the National Innovation System and the market environment in which it operates. The report also discusses the state and possibilities for future development of the National Innovation System and focuses on the capacity of the national economy to absorb and diffuse foreign innovation and investment in new technologies. The analysis is made on the basis of five groups of indicators: national innovation product, entrepreneurship and innovation networks, investments and R&D financing, human capital and the state of the ICT sector.

As a recommendation the authors of the report stress that the Bulgarian innovation policy should focus on attract-

ing FDI with higher R&D content and stimulate the integration of the foreign investors in the national innovation system. They also put emphasis on the three main characteristics of the modern innovation-driven economy which Bulgaria should aim at in order to achieve better competitive positions in the world economy:

- routine innovation activity in the companies – in order to maintain their competitive advantages companies should create special R&D departments to plan and perform innovation;
- secure ownership rights and revenues for entrepreneurs – this includes but is not limited to rule of law, protection of intellectual property rights and developed market for technologies; and
- create opportunities for quick interaction and networking for innovation among economic agents through developing modern ICT infrastructure, quality education and better communication culture.

The Economic Program contributed to the fourth annual Knowledge Economy Forum **Business Environment and Knowledge for Private Sector Growth** organized by the World Bank and the Government of Turkey in Istanbul on March 22-24, 2005. The business environment, innovation, and learning and skills development were the three broad areas of discussion. These themes are essential for development of a Knowledge Economy and are key determinants of private sector growth. At the Forum, Mr. Ruslan Stefanov, Project Coordinator at CSD presented its practical experience in improving the business environment at local level in Bulgaria through the introduction of the Sofia Economic Council.

CSD was co-organizer of another major knowledge economy event in 2005 – **the Second National Innovation Forum**. The Forum, held on October 25, 2005, promoted dialogue among stakeholders in the country's national and regional innovation systems. It serves as a platform for exchange of ideas and cooperation between the government, the business community and research organizations. The main focus was on the Regional Innovation Strategies in Europe and in Bulgaria.

Mr. Ruslan Stefanov presented the report *Innovation.bg* to the Forum, and stressed that economic growth in Bulgaria during the last three years has not resulted in a sizeable increase in the overall technological level of Bulgarian firms. According to the data in the report, Bulgaria lags behind CEE countries regarding its share of innovative enterprises, quality of education, investment in R&D, availability of venture capital funds, access to innovation networks and political long-term vision for innovation. Major hindrance to investment in R&D is the lack of vision and political will for reform in the R&D sector, which remains dominated by the state, while the private sector stays disinterested.

The Forum set the stage for a number of interesting proposals for improving the functioning of the national innovation system. It filled an important gap in Bulgaria's economic policy by providing for the first time an overall estimate of the country's economic performance through innovation. The participants agreed that the driving force of the Bulgarian economy should no longer be the low cost of production factors, but rather innovation, technological improvement and human capital.

CSD experts also contributed to the elaboration of the **First Report for the**



**President Bulgaria 2010** with analyses of the informal economy and the Bulgarian economic competitiveness. In January 2004 the President commissioned the report highlighting the need to expand economic policy horizons beyond Bulgaria's EU accession expected in 2007. The President requested experts from various academic and research organizations to join efforts in identifying key economic challenges Bulgaria might face in the five years till 2010.

On January 23, 2005 the President of Bulgaria hosted a round table for the launch of the *Bulgaria 2010* report. The report makes an overview of the economic challenges facing Bulgaria beyond its EU accession. It highlights that the country should focus on key structural changes to improve the competitiveness of its enterprises while preserving the currency board arrangement and its balanced budget policy until the adoption of the euro as an official tender. The main focus of government attention till 2010 should include improved competitiveness and business environment, more efficient innovation and ICT adoption policies. The authors of the report underline that despite the slight upward trend, the levels of innovation development remain low. Bulgaria still needs to rebuild the interconnections in the national

innovation system, avoid duplication of efforts in the different research areas, and create incentives for increase of the business R&D spending and human capital, involved in the research sphere.

#### IV. Distance Learning

CSD continues its activities for supporting the exchange of knowledge through its Sofia Distance Learning Center. The Distance Learning Center is part of the World Bank's Global Development Learning Network (GDLN), which unites over 60 countries all over the world. Its objective is to create possibilities for training, exchange of knowledge and

dialogue between specialists, engaged in development issues. In 2005 the topics in the Distance Learning Center's agenda included anticorruption (CSD elaborated and delivered a series of five videoconferences on public private partnerships in countering corruption, hidden economy, corruption monitoring and assessment techniques, and the relationship of corruption and organized crime) auditing and accounting, global issues, investment climate, competitiveness and poverty reduction, strengthening of the *Commercial Law* framework, security and human development needs, and presentation of the World Development Report 2005.



*Videoconference: Presentation of the World Development Report 2005, April 18, 2005*  
 From left to right: Mr. Georgi Stoeff, Managing Partner, Industry Watch Group,  
 Mr. Ruslan Stefanov, Project Coordinator of the Economic Program, Center for the Study of  
 Democracy and Mr. Oscar de Bruyn Kops, World Bank Country Manager for Bulgaria