THE ECONOMIC CHALLENGES

BULGARIA 2010

REPORT FOR
THE PRESIDENT
OF THE REPUBLIC
OF BULGARIA
2005

Bulgaria 2010:
The Economic Challenges

Report for the President of the Republic of Bulgaria

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Table of Contents

Abbreviations

BNB	Bulgarian National Bank
BTC	Bulgarian Telecommunications Company
CBA	currency board arrangement
CoM	Council of Ministers
ECB	European Central Bank
EMU	Economic and Monetary Union
ESA95	European System of Accounts
EU	European Union
GDP	gross domestic products
GMI	guaranteed minimum income
ICT	Information and Communication Technologies
IFS	International Financial Statistics
IMF	International Monetary Fund
NSI	National Statistics Institute
OECD	Organization for Economic Cooperation and Development
OSCE	Organization for Security and Cooperation in Europe
Q	quarter
SMEs	Small- and medium-sized enterprises
TABD	Transatlantic Business Dialogue

Foreword

This report was written on the assignment of the President of the Republic of Bulgaria. It aims to identify and analyse the main macroeconomic challenges related to economic developments in the next few years and Bulgaria's accession to the European Union. The process of economic integration is complex and lengthy. It depends both on the dynamics and policies pursued in the EU and on the national policies adopted. The main conclusion of the report is that Bulgaria should develop proactive and purposeful policies that it would pursue at least in the following several years and which would ensure successful integration in the Union. These policies should simultaneously take into consideration the priorities and the dynamics of the development of the EU and the need for accelerated development of the Bulgarian economy and minimization of the disparities with the present members. The authors substantiate this conclusion with the argument that these policies should be focused on the increase of productivity of the national economy and of its competitiveness respectively. Concurrently, the chosen economic policies should not pursue abstract objectives but should be utterly specific, measurable and should take account of the social balances in Bulgarian society. It is very important to emphasize that Bulgaria cannot just adopt the common EU policies but has instead to identify its own ways and means to catch up and remove the existing gaps with the developed countries.

The report focuses on the economic challenges. They are related to the expected macroeconomic shocks and the instruments for absorbing these shocks, creating at the same time a favourable and sustainable economic environment. Because of these reasons no exhaustiveness or discovery of miraculous solutions should be sought in it. What distinguishes it is that on the basis of an in-depth expert analysis it highlights the main challenges, studies the strengths and weaknesses of Bulgaria and recommends specific priorities and ideas. As a result the possible focus, priorities and long-term economic policies are practically outlined.

The report unfolds in four parts. The first part outlines the key macroeconomic risks for the EU accession, stocktaking of the main instruments available to the government administration is performed and compliance with certain priorities is recommended. This section is developed on the basis of an original study of the convergence of the Bulgarian economy to the EU economy. The second part outlines the main fields in which policies for increasing productivity and competitiveness should be directed. The specific objectives and measures are analysed that should be implemented in partnership between the government institutions and business. The third part analyses two important macroeconomic indicators that are exposed to risk in the EU accession process: employment and incomes. The last, fourth part, deals with the opportunities and challenges presented by the South-Eastern Europe for the processes of Bulgaria's integration in the EU.

All subjects are developed on the basis of an analysis of the current situation, existing trends and expected future challenges in the next few years. This allows for regular data updating and monitoring the extent to which the set objectives are met. This report is the first regular economic report prepared for the President of the Republic.

The report was written by experts and representatives of nongovernment organizations. The authors (in alphabetical order in Bulgarian) were: Prof. Vassil Tsanov

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We express our gratitude to the consulted experts for the very valuable opinions they expressed and for their comments.

The opinions expressed herein bind only their authors and not the institution they are employed by.

The authors

Part One
Challenges to Macroeconomic Development

Let us imagine Bulgaria's economy in 2007 after the country has become a member of the European Union (EU) as well after 2009 – a full member of the Economic and Monetary Union (EMU).[1] This would not be a theoretical exercise providing an idea what could be expected but would rather have immediate practical significance for choosing present economic policies. Nowadays Bulgarian politicians have focused all their efforts on the country's accession to the EU relying on a favourable and painless future after the accession. Such conduct is highly shortsighted and may bring about disappointments with unforeseen economic and political consequences. This could be explained partly by the fact that the advantages and costs of Bulgaria's integration will be unevenly distributed both among all individuals and groups and over time.

Two analysis directions are particularly significant from the point of view of macroeconomic development: (i) the state of the country's convergence to the EU and (ii) public finance dynamics as the main instrument reflecting the government ability to govern convergence (since under the currency board monetary policy is restricted).

Chapter I.
Convergence of the Bulgarian Economy to the European Economy

The extent of convergence of the Bulgarian economy to the EU economy as well as the state of its integration in the common European economy is a key point in choosing middle- and long-term economic policies. At a low level of convergence EU policies (monetary, fiscal, incomes, *etc*.) would not have any effect and may even harm our economy. With a poor (or absent) synchronisation with the EU economic cycle the Bulgarian economy would be more vulnerable to different types of shocks (a shock is a drastic disruption (upset) of the economic system).[2] For example, the loss of independent monetary policy (interest rate) and the policy of nominal exchange rate would cause much more negative effects if the correlation of the monetary shocks in the EU and in Bulgaria is low. As a whole, the more we move closer to the EU and the euro, the more macroeconomic conditions are defined from outside the country and the choice is restricted, and the more significance macroeconomic conditions acquire which should have primacy in the process of catching up and economic growth.

Undoubtedly, under the currency board arrangement (CBA), part of this effect is consumed in advance. The matter is that if the economy is exposed to asymmetrical shocks (of if there are asymmetries in the economic structures) the lack of price and wage flexibility may not be compensated by a change in the stock of national money. This is so because one could not expect that asymmetrical shocks

[1] The political decision to introduce the euro envisages this to happen two years after Bulgaria's accession to the EU, *i.e.* in 2009–2010.

[2] There may be different types of shocks and in general they may be defined as external and internal, general and specific (idiosyncratic), real and nominal, shocks of demand and supply, *etc*.

would be balanced on central EU level in the case of membership, and still less in the process of accession when *de facto* the common EU policies are being followed albeit unilaterally without any commitment on the part of the Union.

The introduction of the euro posts even tighter requirements for quick synchronisation of the Bulgarian economy with the EU economy not only during the intermediary period (2002–2009) but also in a medium-term prospect after 2009. Surely, it is possible to believe that the introduction of the euro itself will stimulate our convergence to the euro area by increasing trade flows and movement of capital price transparency, higher confidence in the monetary authorities and as a whole by increasing competition.[3] In spite of this reverse causal relationship it is quite logical to assume bilateralism: a certain preliminary level of convergence is required while the introduction of the euro would have a reverse stimulating effect on the integration of the Bulgarian economy.

Chart 1. **Convergence and Adoption of the Euro: Mutual Influence**

It should be pointed out that quick convergence and synchronisation cut both ways. In the short run the European economy enters a phase of slowdown and this would automatically be transferred to the Bulgarian economy. In this sense the quick integration to the EU would have also negative consequences for Bulgaria (it is not coincidental that the countries of Eastern Europe with the highest growth – Estonia, Lithuania and Latvia – have the lowest correlation of their cycles with the ones of the euro area). In this aspect the decrease in income differences between the EU and Bulgaria, *i.e.* the genuine convergence, requires quicker and in a sense different ways of overcoming the differences in the other variables such as interest rates, productivity, *etc*. The loss of macroeconomic flexibility has to be compensated with microeconomic flexibility, which makes structural policy and competitive policy crucial for adapting the Bulgarian economy to the EU economy.

The above entails the analysis of: (i) the state of the Bulgarian economy, the extent of its integration into the EU one, (ii) the different channels and methods for absorbing shocks (cf. the box below)[4] (iii) the possibly shocks and risks before our economy and (iv) the opportunities for improving the stability of the economy through particular policies that facilitate the traditional or offer new balancing mechanisms. The logic of research is shown on Chart 2.

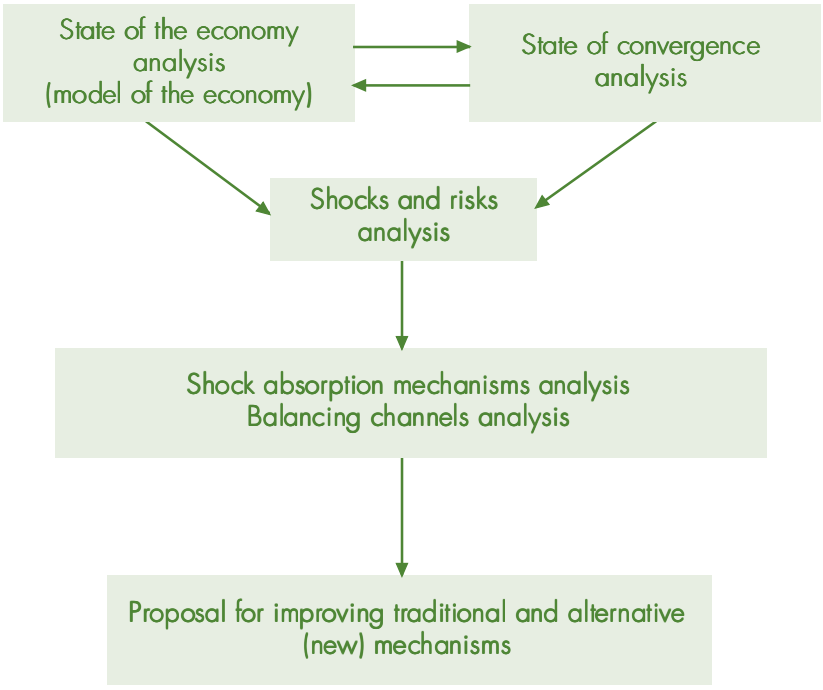
[3] According to calculation of the European Central Bank (ECB) the growth of competition on the expanded commodity and labour markets would bring about a one-off 12% income growth in the EU (*Bayomi et al.*, 2004).

[4] The content of the box on p. 11 is based on the optimal monetary zones theory which tries to answer the question when and under what terms it is more expedient to adopt common money or to fix the exchange rates between them. This theory, in spite of a number of restrictions, remains the leading theoretical and political model for analyzing the processes of European integration. This is confirmed by the vast amount of theoretical and purely practical analyses.

POSSIBLE SHOCK ABSORPTION MECHANISMS
(flexibility of the economy)

1) **Monetary and fiscal policy**
   - Currency board
   - Public finance, fiscal reserve
2) **Labour movement and labour market**
   - Real wages (price flexibility and nominal wages)
   - Workforce movement within the Bulgaria
   - Migration to the EU
3) **Movement of capital and banking system**
   - Movement of capital
   - Integration of the banking system
4) **Openness, diversification, specialisation**
   - Intersectoral specialisation (horizontal)
   - Intrasectoral specialisation (vertical)
5) **Productivity, competitiveness, innovation**
   - Productivity
   - Competitiveness and innovation
6) **Unofficial economy**
   - GDP, labour and incomes
   - Fiscal losses
   - Balance of payments
7) **EU fiscal transfers**
   - Types of funds
   - Capacity to use of funds

Chart 2. **Bulgaria's Macroeconomic Development Analysis Scenario**



The research will benefit additionally if alongside the data on Bulgaria the ones on Romania are reviewed as well on a newly acceded country in the EU such as the Czech Republic. Bulgaria and Romania are moving jointly in the political integration process albeit they follow different macroeconomic and especially monetary policy models. It would be interesting to see from this comparable perspective to what extent these differences (that are rather a result of political choice) provide an advantage to one or another country in the convergence process as well as determine the different risk vulnerability under the asymmetry of cycles.[5]

1. Degree of Convergence: Comparative Analysis of Bulgaria and Romania

In general the degree of convergence indicates to what extent the Bulgarian economy functions as an inherent part of the common European economy, of the common European division of labour. The more similar the Bulgarian economy with the EU economy the more favourable the effect on it is of the supranational European policy. And *vice-versa*, the low level of similarity indicates significant differences from the average European level and respectively minimal chances for the European economic policy to achieve the desired effects. Moreover, the low convergence often requires opposite economic measures to those in other countries. Since Bulgaria will have low influence on the EU economic policy, it is obviously more advantageous for the country to adapt on its own to the EU's policies, that is to achieve higher convergence. As we have indicated, however, the short-term prospect (due to the EU downward cycle) may come into contradiction with the country's long-term real convergence (the desire to catch up with the income level).

To a large extent convergence is a result of the activity of Bulgarian producers and consumers, *i.e.* it is a decentralised process driven by microeconomic motives. At the same time convergence is gauged by macroeconomic indicators. The empirical research the results of which are summarised herein, encompasses nominal convergence (represented by the price level, inflation, interest rates and monetary aggregates) and real convergence (represented by real income and productivity).[6] Nominal convergence shows rather the degree of synchronisation of the monetary sector and the degree of 'monetary illusion'[7] while real convergence synthesises in itself the idea of economic growth and catching up with developed EU countries. There is no doubt that convergence in real incomes may be regarded as one of the utmost objectives of Bulgaria's integration into the EU. On the other hand, nominal convergence is considered as a condition for overcoming the fluctuations in the movement of real exchange rates within the common monetary area.

In 2004 the degree of convergence of Bulgaria and Romania to the European economy is as follow:

[5] Empirical research the results of which are produced (cf. the Annex for details) encompasses the 1997–2004 period (quarterly data, a period for which complete data on both countries and aggregate data on the EU is available).

[6] The logic of research is as follow: (i) we are interested in the extent of convergence of Bulgaria and Romania to the EU through an analysis of the correlational matrixes of the variables; (ii) we use the cointegration and error correction techniques in order to describe both long-term equilibrium and the absorption of deviations from it. It is important to point out that several similar analyses of both countries' convergence with the EU for the same and prior periods show similar results (*Horvath*, 2000; *Brada and Kutan*, 2001, 2002, 2002a; *Holscher*, 2004, *Dupuch, et al.*, 2004, *De Grauwe and Schnabl,* 2004), *Suppel* (2003). This makes us believe that the results and the conclusions we draw are close to what is actually happening.

[7] The monetary illusion indicates the degree to which economic agents may differentiate the movement of the actual variables behind the movement of the nominal ones.

Table 1

Convergence to the Euro Area (by the end of the first quarter of 2004)

	REAL CONVERGENCE		NOMINAL CONVERGENCE			
	Real income	**Productivity**	**Price level**	**Inflation**	**Money stock**	**Interest rate**
Bulgaria	None	Average 11 (7.1) * 8 **	Average 2.6 (8.2) 5	None	High 2.2 (8.0) 3	Low 1.1 (10.5) 30
Romania	None	None	Low 4.2 (3.4) 99	None	High 4.2 (18) 3	None
Czech Republic	Average 2.3 (1.9) 8	Average 10.1 (4) 5	High 1.3 (8) 2	High 1.3 (3.4) 8	High 2.3 (7.4) 7	Low 2.3 (0.8) 15

* long-term equilibrium ratio, ( ) – significance of the relationship (t-statistics).
** Velocity of restoring the equilibrium in quarters.

Source: own calculations

In terms of **nominal convergence** the Bulgarian economy displays comparatively low but clearly pronounced values. They are much better than the Romanian ones.

- Convergence of *interest rates* (in this case yield of three-month government securities) for Bulgaria is low and for Romania is totally absent. This is due to the still poor integration of the financial and banking sector in the European financial space, to the existence of foreign exchange and country risk as well to the uncertainty generated by the discretionary monetary policy (in the case of Romania). Still, due to the lower level of risk and to the more conservative monetary regime (currency board) Bulgaria's nominal convergence is more prominent than Romania's. The membership in the EU and later in the euro area will automatically bring interest rate levels to the average values of the EU. However, differences will remain and will be associated with the level of demand for debt resources by the state budget as well as with the amount of the specific government debt.[8]
- In the case of the common *price level* a comparatively quicker convergence to the European level is observed for Bulgaria and a much slower or even none for Romania.[9] *Inflation* in both countries is substantially higher than the one in the euro area. For Bulgaria (under the CBA) this may be explained primarily by the catch-up effect[10] and imported inflation while in the case of Romania reasons for inflation are purely monetary.[11] Empirical studies show that the functioning of the currency board and the confidence in it eliminate to a large extent the susceptibility to monetary inflation typical of governments with discretionary central banks.[12] The apprehensions that the introduction of the euro as

[8] In the Czech Republic convergence is low but it is higher than that of Bulgaria and long-term equilibrium is restored in five quarters.
[9] The Czech Republic is approaching relatively quickly the European level both in terms of prices and inflation. Long-term equilibrium is restored in two quarters. This is attributable to the efforts of the country's central bank to follow closely the behaviour of the European Central Bank.
[10] The existence of the catch-up effect whose main component is dual inflation component (different price dynamics in the tradable and nontradable sectors) brings about contradictory results in the Bulgarian case (*Chukalev*, 2003, *Nenovsky and Dimitrova*, 2003, *PEP*, 2004). This ambiguity stems besides everything else also from the difficulties in choosing a classification of tradable and nontradable goods.
[11] When fixing the exchange rate the flexibility of relative prices is of key importance for the dynamics of the real exchange rate, which is directly related to the country's spending competitiveness.
[12] Since under the currency board the purely monetary sources of inflation do not exist the main factors remain imported inflation and that related to the catch-up effect (also known as the Balassa – Samuelson

official money in 2009–2010 will bring about a drastic one-off price leap is exaggerated to a large extent because the Bulgarian economy would have already been part of the common European economy for two years and would have adapted to its requirements. The common market forces will lead to a quick balancing even with a slight initial pressure. The fixed exchange rate helps during the entire period the currency board prices to be easily expressed in euro, which concerns external and internal economic agents.

THE PRICE ISSUE

According to one of the Maastricht criteria inflation in the country that wishes to adopt the euro should not be higher than 1.5% of the average for the three countries with the lowest inflation rates in the EU. This requirement comes into contradiction with the natural price convergence which supposes that prices in the catching up countries would grow faster, *i.e.* that there would be higher inflation (the so-called Balassa – Samuelson effect – BS). Such is the trend in Bulgaria too. In the case of Bulgaria the issue of compatibility of catching-up with the CBA also exists due to the fact that a rise of the real exchange rate is theoretically possible. Thus a triangle is formed: 'Maastricht criterion – price catching-up – CB' where pressure is building up at each corner.

In spite of the fact that the fundamental key for overcoming the contradictions lies in productivity growth it is possible to conceive a change in the Maastricht requirement. This may occur in several forms: (i) to measure the catch-up effect for each country through standardised accounting of the BS effect by country; (ii) to set different inflation levels for individual groups of countries according to income *per capita* (countries with lowest incomes will have the highest inflation levels); (iii) to determine the Maastricht criterion not according to the three countries with the lowest inflation but according to an average for the entire area or according to the Harmonised Index of Consumer Prices (HICP); and (iv) to abandon the Maastricht inflation criterion since it impedes real convergence.

- Convergence is strongest in monetary aggregates (in this case the narrow monetary aggregate M1). This may be explained by the wish of the two Balkan Central Banks to follow closely the ECB conservative policies. In the case of Bulgaria this is necessitated also by the specific institutional form of the currency regime when the monetary base (and the money stock respectively at a constant level of money multiplier) is linked to the country's external exposure. After the accession to the euro area the Bulgarian part of the *seigneurage* will be calculated according to our capital share in the ECB (which on its part will be based on the weights of population and GDP of the country in the those of the euro area)[13]. There will be some disparity since it would be logical that the actual *seigneurage* that the country would receive would be determined by the volume of money in circulation in Bulgaria. It is rather difficult to assess this volume since even now when we are not a full-fledged member of the common market Bulgarian currency is circulating in neighbouring countries such as Macedonia, Serbia and Montenegro and Turkey. However, it might be assumed that *seigneurage* will become a less significant source of incomes (and its specific Bulgarian inflationary part will disappear entirely).

In terms of **real convergence** both Bulgaria and Romania show very low values of incomes and relatively better values of productivity:

- There is no convergence of real income in both countries. As far as income per capita is concerned catching up is low for Bulgaria and none for Romania.[14]

effect). Such are the studies on a number of countries (dynamic panel models) conducted by the IMF and the World Bank. Two empirical confidence studies have been done on Bulgaria; one based on the dynamics and structure of the household deposits (*Ganev*, 2004) and through sociological survey polls (*Carlson and Valev,* 2001, 2004).

[13] Although in principle Bulgaria would have a greater influence on monetary conditions in the country and in Europe as a whole compared to the CBA (due to its future presence in the ECB structures).

[14] Convergence in the Czech Republic is average with a recovery of balance in eight quarters.

- As to *productivity* a stronger average convergence is observed in Bulgaria and the equilibrium upset as a result of the influence of productivity changes in the euro area is restored in eight quarters. In the long run changes in European productivity explain about half of the fluctuations of productivity in Bulgaria.[15]

The low *nominal convergence* of Bulgaria does not cause serious concerns[16] since in principle it is quick and is most likely to accelerate in the future. Nominal convergence depends to a large extent on the actions of the government and the central bank since they are able to exert substantial influence in a certain direction. In Bulgaria this is already being done partly through the operation of the CBA. Bulgaria's good and stable macroeconomic indicators in recent years are related exactly to the policy that leads to nominal convergence with the developed economies of the EU. The cost of achieved results reflects the lower level of provided public services, the limited public investment and the inability of the exchange rate to influence the competitiveness of national production and the respective accumulation of a substantial foreign trade deficit. On the other hand, such a policy inevitably leads to disciplining the economy and an active search for a better competitiveness on the part of companies. The matter is that if this process is left solely to corporate interests and abilities the issues of real convergence will not be solved. With the absence of real convergence the achievements of the nominal one are not sound and are threatened by significant social and economic risks.

Achievement of *real convergence* is much more difficult. It is an extremely slow and inertia-prone process. Today's low values attest to lower efficiency and competitiveness of the Bulgarian economy as a whole. Having achieved results in nominal convergence the economic policy should focus its efforts on bringing closer productivity and real income levels. This is a complicated exercise inasmuch as it supposes coordination between the corporate sector and the central authorities, as well as long-term approach and strategic planning. In principle the corporate sector should be the leading factor in real convergence but the government policy should establish the necessary prerequisites and provide support for guaranteeing the long-term perspective and the provision of financial resources for substantial investments where necessary. Both government institutions and businesses are responsible for establishing a very transparent and comprehensible policy in this respect that would be capable of generating public support. Without such support the central authorities tend to set store on a short-term economic policy which is inadequate for accomplishing long-term objectives. This is exactly what has been happening in Bulgaria since a policy of stimulating real convergence with the EU countries is absent instead of supplementing the financial stability policy. As it was already said the delay in raising productivity and real incomes leads to social instability and increasing political risk, on the one hand, and to inadequacy of the national economy *vis-a-vis* the common European policies, on the other hand.

[15] In the Czech Republic convergence is again average and long-term changes in European productivity account for about 40% of the productivity fluctuations in the Czech Republic.
[16] In spite of the Maastricht requirements. For further details on the Maastricht criteria see the public finance section.

Chart 3. **Dynamics of Interest Rates in the Euro Area, Romania and Bulgaria**

Chart 4. **Dynamics of Prices in the Euro Area, Romania and Bulgaria**

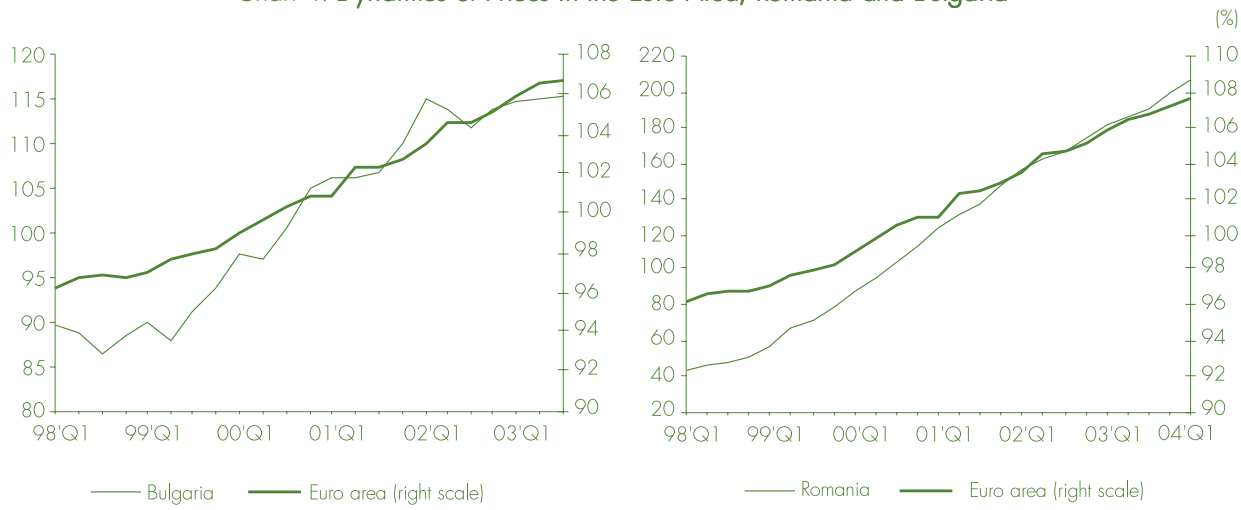


Chart 5. **Dynamics of Inflation in the Euro Area, Romania and Bulgaria**

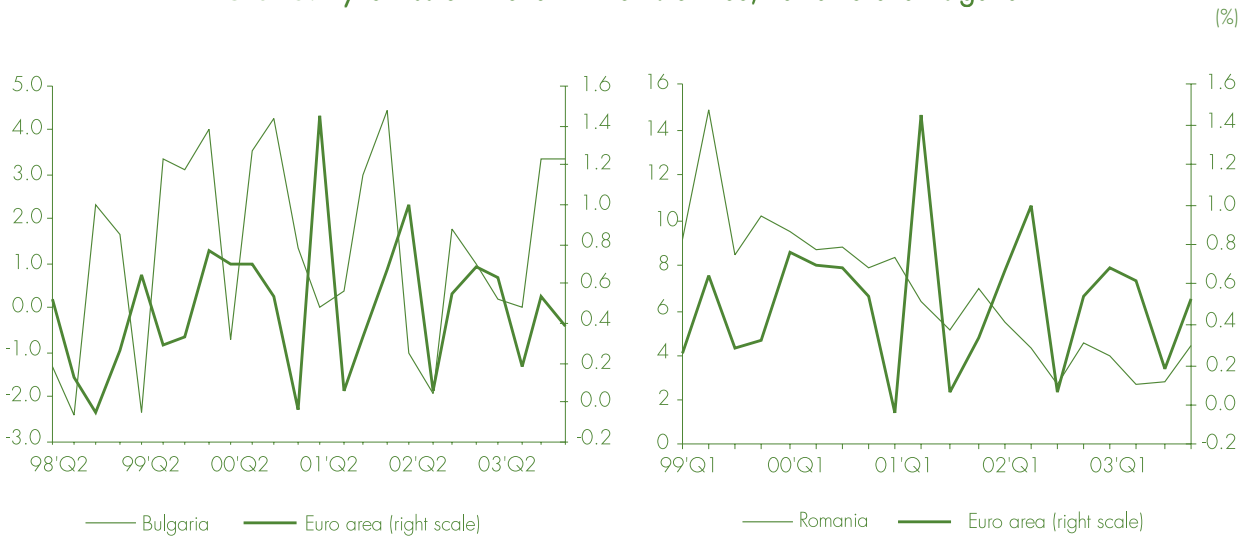


Chart 6. **Dynamics of M1 in the Euro Area, Romania and Bulgaria**

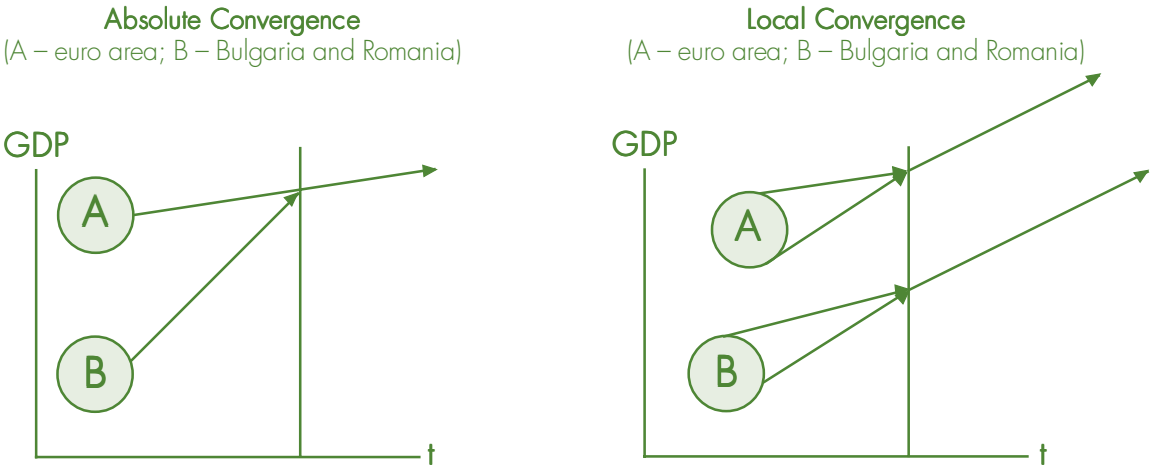
Chart 7. **Dynamics of Credit in the Euro Area, Romania and Bulgaria**

Chart 8. **Dynamics of Real Income in the Euro Area, Romania and Bulgaria**

Source: International Financial Statistics, own calculations,

Local convergence is theoretically possible (the existence of two levels of convergence where it could be assumed that Bulgaria and Romania as peripheral countries are aiming at a long-term trend of their own and not at the euro area, cf. Chart 2).[17] This may be verified empirically through the existence of a long-term relationship between identical variables for both countries. The empirical results indicate that no common Romanian-Bulgarian trend can be observed in real incomes, that the relationship between interest rates and prices is weak and that only convergence of the monetary aggregates exists. These results are in line with the behaviour of both countries' variables *vis-a-vis* the ones of the euro area. It could be assumed (for the time being) that no peripheral convergence block is being formed. In other words the attraction to the euro is stronger than between the countries peripheral to the EU.

Chart 9. **Absolute and Local Convergence**



According to the logic of the analysis (Chart 2) the next step is to analyse the shocks and risks that might affect Bulgaria's economy.

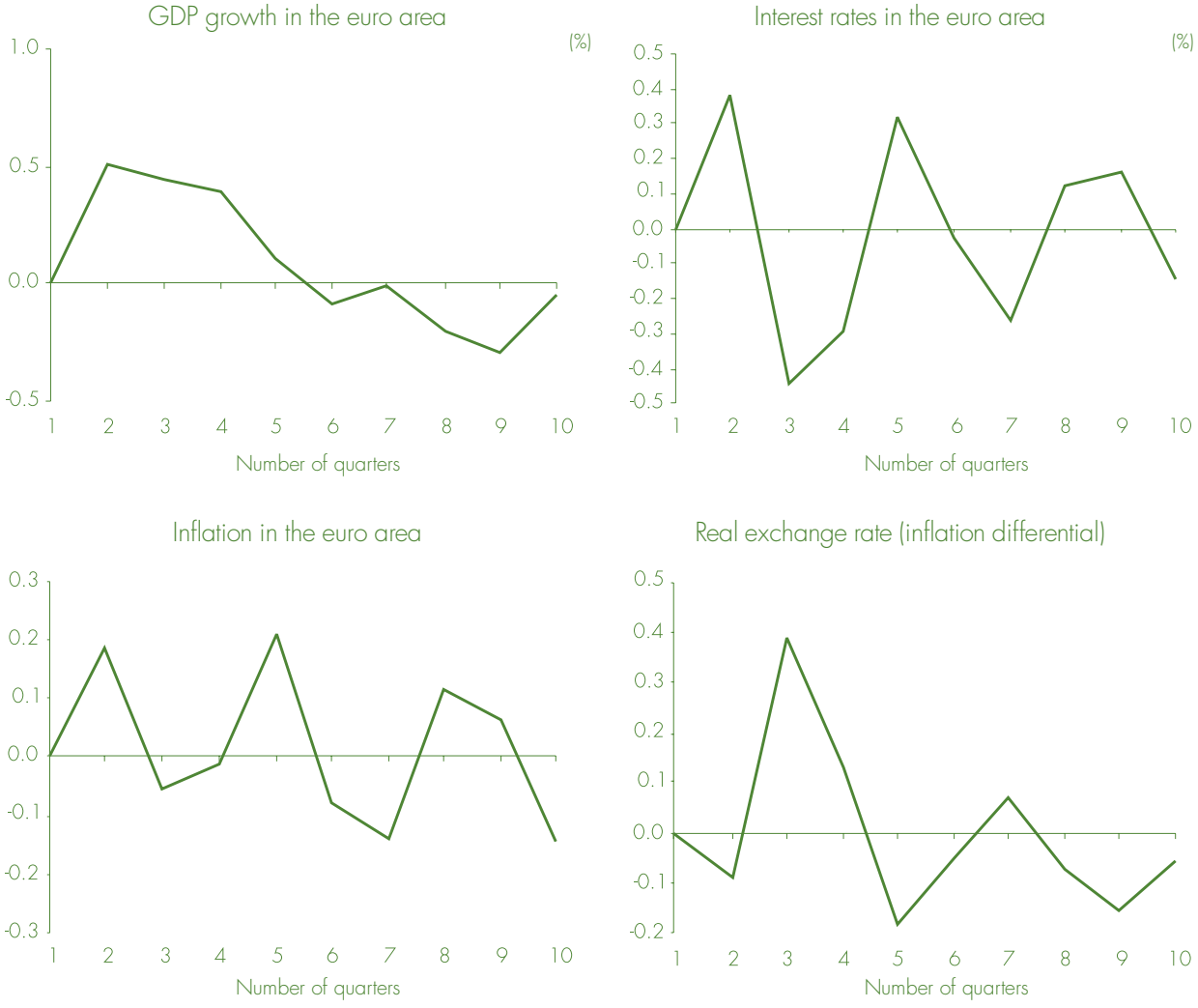
2. Shocks and Macroeconomic Risks

The low level of convergence enhances the vulnerability of the Bulgarian economy to asymmetrical shocks that cannot be absorbed with the help of the integration channels or through redistribution of resources within the EU. Apparently the negative effects of these shocks will have to be dampened only with the capabilities of the national economy, which will be rather limited. Moreover, over time shocks in the EU will become Bulgarian shocks while the Bulgarian shocks will not become European ones, *i.e.* there is asymmetry. Or to put it otherwise: the big influence the small but the small do not influence the big. With our pending accession to the euro area (2009–2010) the internal monetary shocks will be removed and the shocks related to the nominal exchange rate will become external for the country (although theoretically Bulgaria would have influence on common monetary policy decision-making). It is precisely here that the need to innovate comes about, *i.e.* to seek for new balancing mechanisms.

[17] The hypotheses of both countries' peripheral development (as part of peripheral South-Eastern Europe) have a long history and have been repeated on a number of occasions, *e.g. Rosenstein-Rodan* (1943), *Winiecki* (2004).

Chart 10. **Internal Shocks on Real Income in Bulgaria** as a result of:

Chart 11. **External Shocks on Real Income in Bulgaria** as a result of:



Source: own calculations

In order to see how the Bulgarian economy would react we consider three types of shocks on Bulgaria's real income: (i) external (or also known as *exogenous*) coming from the euro area (along the line of income (consumption), inflation and interest rates; (ii) internal (or also known as *endogenous*) shocks which we reduce to internal price and credit changes (as in the absence of a monetary policy within the CBA we consider credit endogenous[18]); and (iii) a shock related to the real exchange rate defined as a difference in the inflation levels in Bulgaria and the euro area.[19] The results can be summarised as follows:

- Within the internal shocks the growth of the general price level does not exert a systemic influence on internal demand. The initial growth of real income quickly subsides and in the long run is compensated by its drop. Therefore, it could be assumed that the price level and inflation rate changes in the future (either taking into consideration the catch-up effect or the introduction of the euro) will have no long-term effect on real economic growth. The influence of credit, which affects income growth insignificantly, is similar and its effect subsides in a year to eighteen months. As a whole it could be claimed that credit exerts no long-term influence on real income. This neutrality does not mean that its influence could not be sought on the state of the banking system or the stability of the country's monetary regime. Besides, in the dynamics of credit a shift in the trend is possible, which might be supposed to happen in the last year (this structural opening is hard to predict). This way it is not clear whether the present credit movement is under or above (whether it deviates or comes closer) to its long-term equilibrium level.
- As far as the shocks coming from the *euro area* are concerned the following relationships are observed. Real income growth in the EU (part of external demand for Bulgaria) is affecting favourably real income growth in Bulgaria albeit this positive shock subsides in about eighteen months. A drop of production follows and the initial balance is restored in two and a half years. The net effect of the positive shock in the EU is slightly positive.
- Price changes in the euro area impact quickly Bulgarian prices (balance is restored). As far as interest rate changes in the euro area are concerned which reflect not only the state of the EU cycle but also the ECB discretionary policy, their increase is also neutralised quickly in spite of the fact that this happens much slower that after the price increase in the euro area.
- In general real shocks on the part of the EU account for about 20–25% of the changes in Bulgarian income. Within this model the common European external shocks (real income, prices, and interest rate) account for about 50% of the changes in Bulgarian real income. This is logical having in mind the exposure of the Bulgarian economy to the EU (approximately 60% of the country's trade).
- The inflation differential between Bulgaria and the euro area (which reflects to a large degree the dynamics of the real exchange rate of the Bulgarian lev to the euro) has an insignificant influence on the country's income (the shock is absorbed in about a year). An effect of a peculiar protruding curve is even observed (where growth in Bulgaria slightly improves initially but after that deteriorates quickly).
- As far as Romania is concerned the situation is quite different. The results on external shocks show that it is much more detached from the European cycle than Bulgaria. Since Bulgaria is more 'elastic' to the shocks coming from the EU it would react in a manner much more similar to the that in the EU coun-

[18] That is the new dynamics is determined by the impulses coming from business and households, transferred later to the banking system but as a whole assigned externally for the central bank.
[19] Due to the fact that the nominal exchange rate to the euro is fixed. We are using VAR models which show the mutual reaction of the variables in case of shocks.

tries in case of a possible common shock on them (*e.g.* on petrol prices, a financial crisis experienced by a common trade partner, *etc*.).

Table 2

Reaction of Real GDP in Bulgaria, Romania and the Czech Republic to the Shocks Coming from the European Union

	Shocks Coming from the European Union			
	From Real GDP	From Real Exchange Rate (Inflation Differential)	From Inflation	From Interest Rate
Bulgaria	Average (initially (+), later (-), as a whole slightly positive effect)	Weak (alternating (-) and (+) effects, as a whole neutral effect)	Average (initially (+), later (-), as a whole slightly positive effect)	Weak (alternating (-) and (+) effects, as a whole slightly positive effect)
Romania	None	None	None	None
the Czech Republic	Average (initially (+), later (-), in the long run positive effect)	Weak (alternating (-) and (+) effects, as a whole slightly negative effect)	Weak, very slightly positive effect	Average (initially (+), later (-),as a whole slightly positive effect)

Source: Own calculations

In general, the analysis shows that the openness of Bulgaria's economy make it vulnerable to the shocks coming from the EU. Hence, the main threats include the macroeconomic static position of Bulgaria and the insignificant capacity for response of the country within the EU common policy.

3. Shock Absorbing Mechanisms

Let us consider the balancing mechanisms (cf. the box on p. 11).

• *Monetary and fiscal policy*

The commitment to maintain unilaterally a CBA (without passing through the ERMII) and to introduce the euro two years after the EU accession is a strategic and political choice of Bulgaria.[20] Monetary policy instruments (and first of all the active influence on liquidity through the interest rates) will be restored within the ECB system. Bulgaria has undertaken not only to preserve the stability of the lev and the financial system but also to build institutional and organisational capacity to embed itself in the ECB systems. In the period until the adoption of the euro the monetary aggregate dynamics will depend on the behaviour of households, businesses and banks which will reflect on the balance of payments. In principle, the sources for creating money will continue to be beyond the control of the central bank.

The CBA restrictions (first of all the waiver of changes in the nominal exchange rate) set the framework of public finance. This is necessary for the country to command sufficient fiscal and foreign exchange reserves in order to service the foreign debt, the fluctuations of the current account deficit and other possible imbalances. This applies in particular to 2007 due to the accumulation of debt payments, the country's contribution to the EU budget, the amounts that need to be set aside for cofinancing in relation to the EU, for losses of customs revenues, *etc*. This also reflects on the requirement to maintain a budget, which is balanced, or close to the balance (this is considered in details in the public finance section).

[20] Bulgarian National Bank (2004).

MACROEQUILIBRIUM MODEL OF THE BULGARIAN ECONOMY

There is a model of the Bulgarian economy (presented in the Annex) that makes an assessment and a forecast of the potential GDP, of the balanced real exchange rate and of the balanced unemployment level.

According to the model the underused production capabilities are in the range of 5–6% of GDP. The actual values in unemployment unlike the GDP practically follow the balanced ones. Since the second half of 2003 the effective unemployment level exceeded the balanced level to a certain degree. The macroeconomic policy pursued since 1997 has stabilised inflation but has led to a systematic underuse of the opportunities for uninflationary growth. What is happening is not only retention of unemployment above the uninflationary level but also artificial delay of real incomes. The results of the study do not suggest that the Bulgarian economy is overheated and restrictions on lending are required. A serious deviation of the real balanced exchange rate from the effective and sizable current deficits are emerging coupled with underuse of production capacities.

According to the model's authors two solutions are possible – deceleration of growth with a view to reducing external deficit, and the opposite – stimulating growth of internal savings, investment and incomes. The second option is possible since with the faster increase of savings over investments the external deficit will diminish as a share of GDP due to the main macroeconomic characteristic. The overtaking growth of savings suggests on its hand some combination of two prerequisites: income growth and favourable investment conditions on the domestic capital market. Consequently, an optimistic scenario for the development of the Bulgarian economy suggests stimulation of the growth in the banking sector and encouraging income growth rather than restriction.

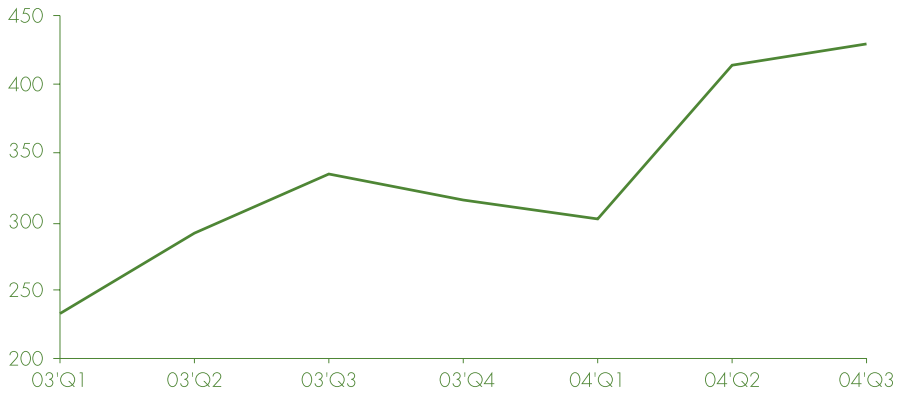
As a whole one could summarise that fiscal and in particular monetary policy leaves relatively small room for manoeuvre.

• Workforce mobility and labour market

Under the conditions of the CBA the flexibility of the labour market becomes a key factor for absorbing shocks on the Bulgarian economy. It could be deemed that the very restriction of the CBA increased significantly labour market flexibility (real wages and workforce mobility) forcing businesses to manage more efficiently their labour costs.[21] As a whole labour market flexibility is satisfactory in order to be able to absorb possible negative shocks on the GDP. However, the existence of an unofficial sector in the economy should be also taken into consideration, which is extremely flexible and may serve as a buffer in case of a relatively high rigidity of the official sector.

Chart 12. **Private Transfers**

(million BGN)



Source: BNB.

[21] *Nenovsky and Koleva* (2001).

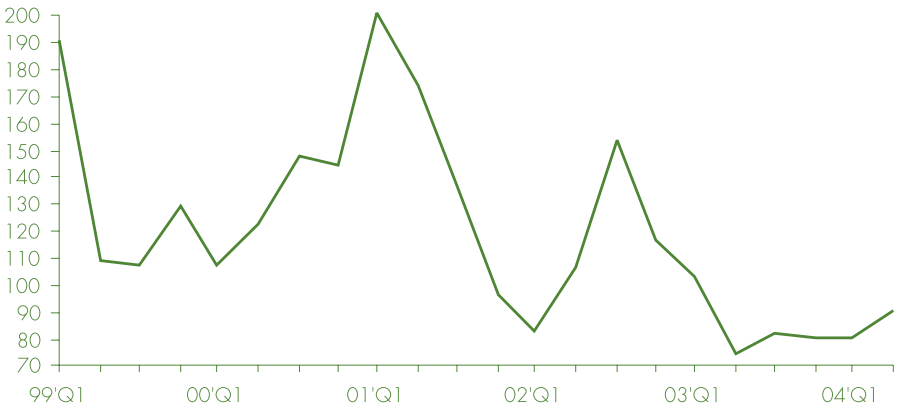
In spite of the postponement of the full labour market liberalisation in the EU the current state of migration flows shows that Bulgarians are *de facto* free to move within the EU but not to work there. An indirect evidence of this is the dynamics of immigrants abroad (about 700,000 have emigrated in the last 15 years) a large number of whom work in the EU countries.

Notwithstanding it is necessary to sustain in this trend searching for mechanisms for greater workforce mobility both inside the country and abroad. The movement of nominal wages should adhere to the rule of conformity of the growth to labour productivity and this conformity is most easily attained when negotiating pay on a company level (further details on the labour market are presented in Part Three).

• Movement of capital and the banking system

The possibility of compensating consumption in case of an eventual shock may take place also through inflow of capital (direct foreign investment, portfolio investment and loans drawn from abroad). In the last year Bulgaria is addressing relatively well the attraction of capital, which is witnessed not so much by absolute figures but rather by the fact that the current account deficit is covered almost entirely by the capital account.

Chart 13. **Coverage of the Current Account Deficit with Foreign Direct Investment in Bulgaria**



Source: BNB and own calculations.

The accession to the EU and subsequently to the Economic and Monetary Union will allow Bulgaria to borrow in its own currency (euro) and to achieve a greater conformity between the debts foreign exchange structure and the money stock, which as a whole reduces systemic risk. It may be assumed that with the introduction of the euro borrowing from abroad will become less expensive (due to the fact that it will be in the own currency – the euro) in spite of the fact that sovereign risk will remain.[22] Within the Balkan region one might expect intensified competition for attracting capital, which raises the requirements for overall improvement of Bulgaria's business climate (business climate is discussed in detail in Part II). The free movement of capital comes also with its risks related mainly to the possibility of its sudden flight under certain conditions.

With the BNB's limited functions as a lender resort last (which have been re-

[22] According to some economists after the introduction of the euro short-term interest rates will drop but long-term rates may increase because they will incorporate the risk premium for increasing the probability of discontinuing foreign debt payments because the economy becomes more rigid.

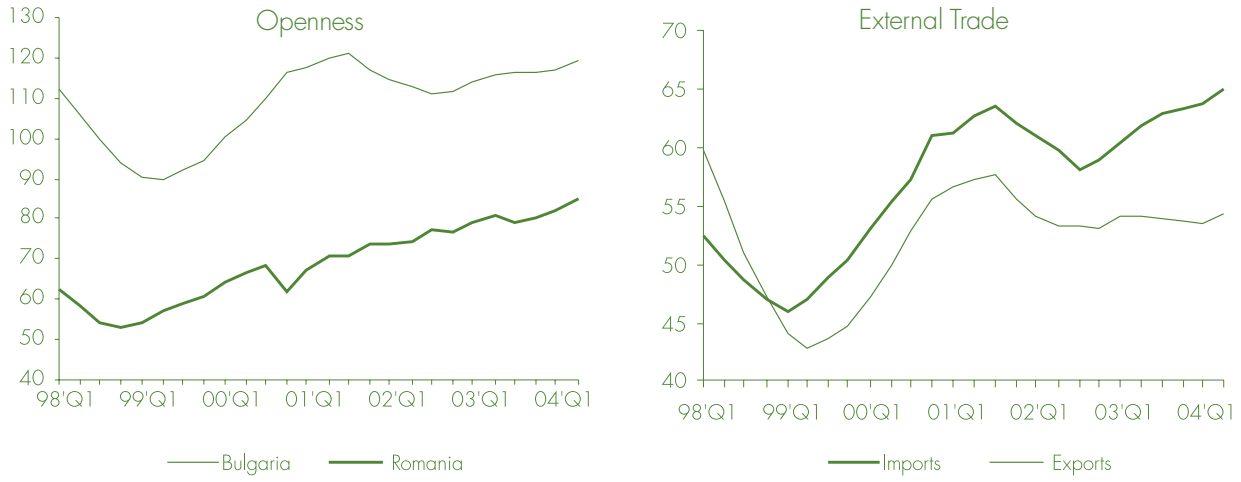
duced to a situation of a systemic risk) the integration of the banking system is an important condition not only as a liquidity source. The movements and the structure of the bank assets and liabilities may be regarded as an integral part of the balance of payments/money stock relationship. Today Bulgaria's banking system is almost entirely owned by foreign banks (predominantly European). The share of foreign banks in the banking system's assets accounts for 81%. The presence of large foreign banks has a positive effect on the financial system of the host country but the experience of other countries (Argentina) shows that these banks are prepared to close quickly or to limit the operation of their subsidiaries in case of a crisis in the host country.

• Openness, diversification, specialisation

The openness of the economy is one of the main indicators measuring the integration of a country in the world trade (and in particular in the EU). Openness is the relationship between the amount of the imports and the exports of a country, on the one hand, and GDP, on the other hand.[23] In the 1998–2004 period (second quarter) Bulgaria has been more open than Romania. The average value of the indicator for Bulgaria was 108.8%, while for Romania it was 68.4%. The openness of the economy in Romania displayed a clear upward trend during this period and reached its maximum of 82% at its end. For Bulgaria the indicator dropped in 1998 and the beginning of 1999 and reached its minimum of 89.8% in the second quarter of 1999. At the same time, exports reached their law of 42.8% for the reviewed period. The two years under review were characterised by important international developments: the crises in Russia and in Kosovo. After the second quarter of 1999 the openness began to grow which was due to the almost symmetrical increase in the shares of exports and imports in the GDP and the difference in favour of imports oscillated between 4.3% and 6.2%. The high reached for the period under review was in the third quarter of 2001 amounting to 121.3% and coincided with the exports high of 57.7%. Thereafter, exports stabilised at around 53% – 54.5% of the GDP, while the fluctuations of imports determined the behaviour of openness. After the third quarter of 2002 imports grew sustainably and the difference between imports and exports reached 10.6% at the end of the period when openness accounted for 119.5% of the GDP.

Chart 14. **Dynamics of Openness and Foreign Trade in Bulgaria and Romania**

(Share of GDP,%)



Source: IFS, own calculations.

[23] The indicator is based on trade and GDP as a sum of the last four quarters in order to address the problem with the seasonal nature of data. Exports and imports of goods and nonfactor services are considered.

Diversification and the nature of specialisation of Bulgarian production or the so-called *structural convergence* is of particular importance for absorbing shocks (reducing risks) . The most appropriate form is the diversification of the production structures on the basis of intersectoral (and especially vertical) specialisation. According to IMF calculations[24] the established trade flows within the Economic and Monetary Union are the strongest between countries that have intersectoral specialisation. There are a number of empirical studies showing an unfavourable picture and forecast (Table 3).[25] They show a strong intersectoral specialisation of the Bulgarian economy, primarily in traditional sectors that are labour intensive with low level of qualification and using low technologies (as a whole they depend on labour costs). This is typical of all Balkan countries where intersectoral specialisation prevails at the expense of the intrasectoral one (interindustrial trade) – for example for Bulgaria the former is 86% and for Romania 85% (measured by the *Krugman* specialisation index). Moreover, in Bulgaria and Romania (unlike the countries of Central and Eastern Europe) specialisation is intensifying in low-technology industries and in the low-technology segments of high technology sectors, *i.e.* these two countries are entering a 'low-technology gap' (Table 4).

This is not a positive fact since the high specialisation in the labour-intensive sectors in the Balkan countries increases the probability of forming a peripheral zone within the EU; for such a zone it would be difficult to survive the common shocks on the euro area and would experience shocks of its own.

Table 3

Specialisation Type of Selected Countries and Bulgaria

(%)

	Intersectoral Trade		Intrasectoral Trade
	horisontal	vertical	
Czech Republic	9.6	38.1	52.3
Hungary	6.4	30.9	62.7
Slovenia	4.8	27.3	67.9
Slovakia	5.7	19.7	74.6
Poland	2.7	20.6	76.6
Romania	1.7	13.3	85
Bulgaria	2.6	11.2	86.3
Lithuania	1.1	5.9	92.9
Latvia	0.9	4	95.1
Estonia	0.8	3.5	95.7
EU	19.23	42.28	38.5
Greece			
1980	2.02	11.33	86.65
1995	4.6	9.0	86.5
Spain			
1985	10.12	26.35	63.52
1995	19.5	34.2	46.4
Portugal			
1985	4.13	10.45	85.42
1995	10.5	22.1	67.4

Source: *Dupuch et al.* (2004).

[24] *Farquee* (2004).
[25] For example, *Henriot* (2003), *Dupuch et al.* (2004), *Dulleck et al.* (2004).

Table 4

Specialisation and Quality of Specialisation of the Countries of Central and Eastern Europe

(%)

	Specialisation (first level)					
	Central Europe			Bulgaria and Romania		
	1995	2000	Growth	1995	2000	Growth
Low-technology	3.27	3.45	0.01	0.81	1.49	0.17
High-technology	1.96	3.12	0.12	0.08	0.13	0.11
Total	2.73	3.66	0.07	0.39	0.53	0.07
	Specialisation (second level)					
	Central Europe			Bulgaria and Romania		
	1995	2000	Growth	1995	2000	Growth
Low-technology	3.27	3.45	0.01	0.81	1.49	0.17
1	2.74	3.57	0.06	0.36	0.54	0.10
2	2.78	2.87	0.01	0.81	1.35	0.14
3	4.25	3.89	-0.02	1.27	2.50	0.19
High-technology	1.96	3.12	0.12	0.08	0.13	0.11
1	3.96	6.57	0.13	0.15	0.27	0.16
2	1.44	2.63	0.17	0.09	0.13	0.09
3	0.52	0.84	0.12	0.02	0.03	0.01
	Improvement of Specialisation Quality					
	Central Europe			Bulgaria and Romania		
	1995	2000	Growth	1995	2000	Growth
Low-technology	-0.03	0.05	0.08	-0.29	-0.15	0.14
1	-0.06	-0.04	0.02	-0.27	-0.11	0.16
2	0.02	0.14	0.12	-0.20	0.00	0.20
3	-0.03	0.06	0.09	-0.37	-0.24	0.13
High-technology	-0.35	-0.17	0.18	-0.74	-0.35	0.38
1	-0.36	-0.21	0.15	-0.62	-0.29	0.33
2	-0.48	-0.33	0.15	-0.94	-0.79	0.15
3	-0.55	-0.32	0.23	-0.81	-0.94	-0.12

1 – the lowest value, 2 – average value, 3 – the highest value

Source: *Dulleck et al.* (2004).

The problems of specialisation illustrate in the best way the need to think not only in the categories of the nation state but to look at regional and company level. The latter will become all the more crucial for Europe's economic development.

- Productivity and Competitiveness, Innovation

The main source of real convergence and of catching-up remains the rapid and scalable increase of the productivity and the competitiveness of the Bulgarian economy as a whole. This is particularly important having in mind the CBA restrictions and the fixed exchange rate.

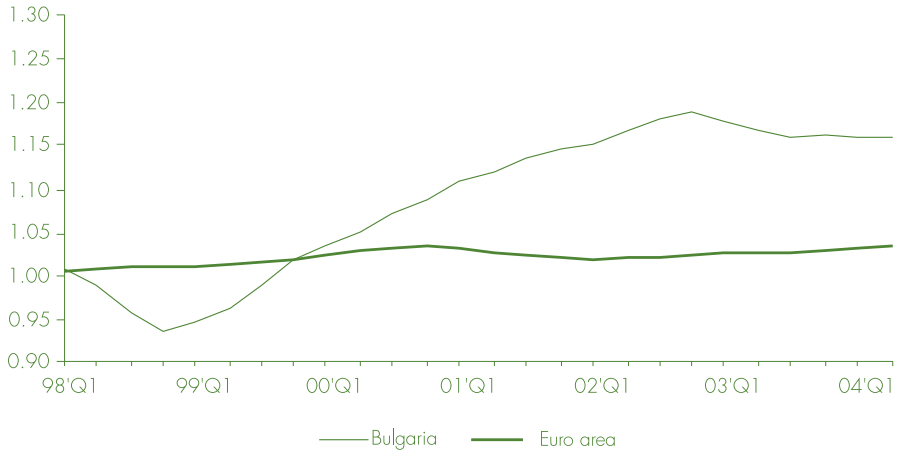
Between 1998 and the end of the second quarter of 2004 productivity in Bulgaria increased cumulatively by 16% while in the euro area it grew by 3.6%.[26] The lag in the absolute levels of productivity has been compensating but at a relatively slow rate.[27] There was a drop in labour productivity in 1998 since employ-

[26] We obtain the indicator as a ratio between the real GDP and the number of employed persons. The real GDP for the last four quarters we divide by the average of the number of employed persons in the last four quarters. In this way we even out the seasonal fluctuations.

[27] There are employment statistics for Romania for a very short which in all accessible sources comes to an end in the end of the third quarter of 2003.

ment grew at higher rates than real GDP. This was due to the economic recovery after the 1996–1997 crisis. The restructuring in the period from 1999 to the end of the third quarter of 2001 led to a decline in employment combined with a GDP growth and an increase in productivity. The high for the period from early 1998 was reached in the fourth quarter of 2002 when the cumulative growth of productivity was 19%. After that there was again a decrease due to the faster employment growth.

Chart 15. **Dynamics of Productivity in Bulgaria and the Euro Area**



Source: IFS, NSI, own calculations.

Competitiveness and innovation in Bulgaria as a catching-up and balancing mechanism are described in details in Part Two.

- Unofficial economy

The existence of a large sector of the informal economy is typical of the transition economies. Bulgaria is not an exception (according to different calculations it is estimated at about one-fourth of GDP).[28] On the one hand, the divergence between the reported and the actually produced GDP underestimates the fulfillment of the formal (monitored) criteria and the state of nominal and real convergence.[29] On the other hand, the unofficial sector is an important source for absorbing shocks (in incomes, the labour market, *etc*.) because flexibility is significant there. The dynamics of this sector affects the state of the balance of payments (unaccounted transactions, smuggling) as well as the state of public finance. As a whole the difficulties of measuring the unofficial economy impede the accurate assessment of the convergence processes and the implementation of the Maastricht criteria. It may be asserted that if the unofficial sector was reported, real convergence of the country to the EU would be much more rapid. Some of the nominal convergence indicators have also been improving – the ones for the public debt/GDP ratios and deficit/GDP ratio.

- Fiscal Transfers from the EU

The transfers from the EU are an important compensatory mechanism in case of shocks on the income in Bulgaria (either on the part of demand or of supply). These transfers would provide the opportunity for restoring aggregate demand in case of negative shock. Usually, they are regarded also as a financial source of

[28] Cf. for more details SSD (2004)
[29] In this sense it would be logical to measure the convergence indicators taking into consideration the unofficially produced GDP (even in relative terms). If permanence is assumed in the *official/unofficial* ratio sector the measurements of convergence on the basis of the official sector could be deemed trustworthy.

real convergence and a source of economic growth. It has to be stated clearly that in spite of their importance they cannot be the main source for the development of the Bulgarian economy. Bulgaria will receive EUR 1.207 billion under the PHARE, ISPA and SAPARD programmes in the 2004–2006 period. In 2009 when Bulgaria will absorb all resources from the EU the total sum that the country will receive from the EU budget will be equal to 7.1% of GDP, which exceeds the double sum that the ten countries will receive in 2006 (3.3% of GDP). The effective use of these resources is of paramount importance so that the EU funds would not become a means for redistributing wealth and for forming new pressure groups.

Due to the monetary policy restrictions (the CB) the fiscal policy concentrates in itself the traditional abilities for government influence on the macroequilibrium and on its adaptation to the EU.

Chapter II.
Public Finance Management Prospects

Public finance management in the medium run should continue to be based on sustaining the currency board which has the task to preserve fiscal discipline and monetary unit stability as well as to ensure a smooth adaptation of the economy in the pending adoption of the euro as legal tender after the country's accession to the EU.

In the period prior to the country's accession to the EU and immediately thereafter public finance is facing several key tasks which also predetermine the desired trends in pursuing the fiscal policy:

1. Supporting by the BNB the established monetary system of a fixed exchange rate to the euro on the basis of the following currency board principles.
2. Maintaining macroeconomic equilibrium and counteracting the main macroeconomic disbalance, which is expected to emerge in the forthcoming years: the foreign trade deficit and the balance of payments current account.
3. Accelerating economic growth through encouraging private sector businesses and implementing a larger scale investment programme.
4. Increasing the welfare of Bulgarian citizens and households through an adequate income policy compliant with the country's economic performance.

The implementation of these tasks suggests a balanced approach in the fiscal policy inasmuch as they suppose the implementation of mutually confronting instruments. Thus, the support for the monetary system and the maintenance of the country's macroeconomic balances suggest low or even zero budget deficits and limited government borrowing in the financial markets. The acceleration of economic growth, the need of establishing a modern infrastructure and restoring environmental balance require serious public spending and investment, which will exert opposing pressures on fiscal balances.

The fiscal instruments and the overall financial mechanism should allow maneuverability in view of a possible need to counter unfavourable external impact on our economy. In this context the practice of maintaining sufficient fiscal reserves should be continued and overseeing public spending efficiency should be enhanced.

1. Income System

In the last years the public sector mobilises comparatively the same GDP share: nearly 40% and just over 30% of these revenues are tax and social security incomes. However the tax system structure has undergone certain changes. Direct

income taxes were reduced at the expense of increasing the indirect taxes and mainly excise duties. Thus, corporate tax fell consecutively from 38% in 1997 to 15% in 2005 and the marginal limit of the income tax was reduced from 40% to 24% in the same period. These changes in the taxation rates changed the direct to indirect taxes ratio from 57% – 43% in 2001 to 51% – 49% for 2004 and in 2005 the share of direct taxes in the total tax revenues will drop below 50%.

In structural terms upward trend in excise duties should be maintained so that they could comply with the minimal levels harmonised within the EU. In particular these increases concern mineral oils, tobacco products and alcoholic drinks. A trend toward further increase of the established minimal excise duties levels and expansion of their scope (fuels and electricity) has emerged in the Community, which also determines the prospects for our fiscal policy in respect of its revenue side.

The forthcoming step-by-step increase in excise duties of the specified important commodity groups as well as the regular excess of budget revenues over expenditure are arguments in favour of a continuous decrease in other taxation forms. The following reductions are possible in the medium term without substantial risks for the revenue side:

- Corporate tax may be reduced to less than 15% at least for the period prior to Bulgaria's accession to the EU taking into consideration the probability of the possible harmonisation of this form of taxation. A further reduction of corporate tax is advisable in order to decrease the total tax and social security burden on the private sector inasmuch as more palpable reduction of the social security payments (for pension and health insurance) would violate the financial independence of the National Social Security Institute and the National Health Insurance Fund.
- It is advisable to optimise income tax by reducing its upper rate in combination with increasing the tax base, including the tax exemption minimum. Insofar as households realise incomes that are different in terms of structure and sources due to existing differences of the spouses' working capacity, equivalent taxation requires the introduction of parallel taxation scales of individual income (the current principle) and the total family income. Such changes in income tax will help balance household incomes also in the context of the future increase in the share of social security payments, which will be assumed by the insured persons. In this way the growing social security burden on incomes of individuals and households will be dampened by the lower burden of the income tax.
- The current level of the value added tax is also subject to reassessment toward reduction. The opportunities in this respect are within the range of the current 20% to the established 15% minimum in the EU. An eventual reduction of the VAT rate will distribute the effect of the released income between the economic sector and consumers depending on price elasticity. In both cases the results may be defined as positive for businesses and for increasing household incomes.

It is imperative to further strengthen the administrative capacity of the tax administration. The introduction of a single agency on revenues should be speeded up. It should unite the services for collecting taxes and social security payments and assist the more efficient cash management of public resources. It would be useful to develop a mechanism for separating the cash collection functions of the central government budget and the budgets of the local authorities in view of providing a greater institutional incentive to increase collection of public revenues. Tax discipline is still not at the required level for a country that is to be a future EU member. For this purpose legislation regulating penal sanctioning of persons and companies evading their tax obligations should be subject to review.

The opportunities discussed for adjusting the total tax burden should be viewed through the prism of the need of the state budget to continue mobilising sufficient resources that would ensure the effective implementation of the fiscal policy objectives. This means that no substantial reductions under established 38–40% in the last years should be expected in the total share of the public sector in the GDP. The reductions may be implemented after appropriate assessments for preserving public sector stability and the overall macroeconomic balance without becoming overenthusiastic with proposals that are flashy in terms of form but dubious in terms of economic advisability of the sort of the idea to introduce the so-called flat rate tax.

With respect to the unity of the taxation system the established neutral fiscal attitude to all economic industries and sectors has its substantial advantages. However, the introduction of a limited number of tax deductions for general functional activities may be considered such as investments in technical and technological equipment, investment in improving staff education and expertise, realised export products requiring a high degree of processing. Enforcement of any of these measures as well as the specific functional forms of application will have to be evaluated by the degree of their efficiency and from the point of view of subsequent profit and loss of budget revenues, *i.e.* after an analysis of the specific advantages and costs of any individual change.

2. Expenditure system

The main task in budget expenditure management in the medium-term prospect remains expenditure reduction and enhancing spending efficiency. It may be assumed that in the next few years interest expenditure in the budget will grow depending on the behaviour of foreign interest rates and will account for 2.5–3% of GDP which preset a level of noninterest expenditures within the range of 35–36%.

The structure of noninterest expenditures should be reoriented towards investment and social spending at the expense of reducing particular subsidies whose effectiveness is rather dubious.

Education expenses should be raised compared to their relatively low level of recent years. At the same time, education reform should ensure continuity of education of all individuals in active age through education and qualification forms appropriate for each professional aspect and age group. Science and scientific research should be supported by the government to a degree to which the respective academic teams cooperate in their efforts with foreign partners and/or develop joint research with interested economic entities, which should provide a part of financing.

Defence and security expenditures may be maintained at the same level, which requires a review and reduction of part of them so that resources could be released for modernisation of the system in compliance with the country's commitments associated with the NATO membership.

Social spending should also be subject to increase in order to meet the possible higher prices of some utilities and educational and health services. However, the scope of social benefits should remain minimal and should be defined on the basis of objective poverty criteria which include the whole property status and not only current incomes. This will lead to a more efficient and rational spending of social benefits and will not probably require significant additional resources compared to those allocated currently.

3. Fiscal Decentralisation

Strengthening local government requires further development of fiscal decentralisation. It supposes delegation of more functional and hence management competencies and financial resources from the central to the local government authorities. The existing situation places Bulgarian municipalities at the bot-

tom of the list in terms of scope of resources they dispose with. Currently operating standards (norms) on necessary spending , which the central budget owes local budgets to finance the activities delegated by the government in the educational, cultural and social fields, should be objectified and should be transformed into a key instrument of the relationships between the central and local budgets.

Local authorities should acquire full competencies to determine the level of local taxes within the centrally defined ceilings. It would be advisable to establish municipal services for collection of and control over local revenues. The procedure for issuing municipal debts and insolvency of municipalities should also be subject to the respective legislative regulation.

4. Budget Deficits

Fiscal policy should continue to be based on low budget deficits. In compliance with the criteria of the Treaty of Maastricht the country should not allow budget deficits exceeding 3% of GDP. The two additional factors specific for the Bulgarian economy, the functioning CBA and the exacerbating balance of payments current account deficit, allow for substantiating a lower budget deficit compared to that allowed according to the Maastricht criterion.

The maintenance of a currency board presupposes limited budget deficits without any direct link to the sources of their financing. This makes pointless the arguments according to which the government may allow higher budget deficits as long as it does not finance them through issuing treasury instruments and does not disturb financial markets.

Public finance control is the quickest and a relatively efficient means for combating the increase in the balance of payments current account deficit. In this aspect no budget deficits shall be allowed that would increase internal demand and will result in foreign trade deficit and current account deficit. All other conditions being equal the restriction on budget deficits as an instrument for influencing the country's foreign economic balances is preferable to the withdrawal of liquidity from the banking system used to compensate for any possible higher budget deficits.

5. Debt and Fiscal Reserve Management

Bulgaria's public debt (including domestic and foreign debt of the central government and the local authorities) accounts for around 40% of the GDP compared with 120% in 1996 and more than 70% in 2001. The current level is quite acceptable from the point of view of the Maastricht criteria: maximum 60%. With further favourable management of the government debt it will cease to be a potential macroeconomic threat as it was in the first half of the period of economic reforms: from 1990 to 1999.

In the medium run there are no serious risks for servicing government debts. The internal debt is well-rescheduled inasmuch as the bulk of it is represented by five-year and longer term treasury bonds. The maturity dates of the foreign debts are also comparatively evenly distributed. In 2007 the eurobonds issued in 2001 will mature but their volume of EUR 250 million should not cause problems in terms of their refinancing.[30] More significant concentrations of debt falling due are in 2013 and 2015. No significant foreign exchange and interest rate risks exist.

Debt management policy should restore the ambition for minimal debt servicing costs as a key objective for the respective government authorities. The conducted active debt management operations for exchanging foreign debt bonds in 2002 are an ample illustration of the losses that the country might suffer from debt transactions pursuing objectives other than reducing the total debt, including interest rate burden.

[30] At the same time, however, other important budget expenses emerge such as the contribution to the EU, the expenditures for cofinancing the European projects and the losses of customs revenues.

A tuning up of the system is required for approving investment credits by the government or guaranteeing such credits provided they do not meet the requirements of social and economic efficiency.

The policy of maintaining a sufficient fiscal reserve should be sustained in order to ensure the country's financial security in case of the emergence of risks of various nature, including any external shocks on the country's economy.

6. Preaccession Preparation in the Fiscal Field

Insofar as there is no standard European model of fiscal systems and policies the preparatory work for EU accession requires pursuit of a prudent financial and in particular fiscal policy that would guarantee macroeconomic stability and compliance with the Maastricht criteria. Bulgarian governments should commit themselves to the requirements of the Stability and Growth Pact in respect of fiscal policy and limit budget deficits as a prerequisite for the overall macroeconomic balance and should assist the central bank in its efforts to maintain currency and price stability. Bulgaria should continue and accelerate the reform of the main public sectors in order to improve the efficiency of provided public services. The strict implementation of the single budget account, further development of the treasury functions in public resource management and the introduction of programme budgeting will help improve public spending and enhance sustainability of fiscal balances. It is necessary to improve the budget accounting methodology in compliance with ESA 95 standards and to ensure full transparency and conditions for effective control both over local public funds and the funds received from the EU.

The main specific tasks may be summarised as follows:

- Special attention should be awarded to the financial flows from and to the EU budget in the first few years after the accession. Since the contributions paid to the Community budget are Bulgaria's unconditional liabilities and the funds that will be received shall be programme-oriented, time differences of cash disruption type will occur between the incoming and outgoing cash flows. In the initial years there is even a potential danger that the country would not be a net beneficiary of Community funds, which threatens to aggravate the general fiscal position by increasing the budget deficit. This potential fiscal problem requires the maintenance of adequate fiscal reserves and flexibility expenditure side of the budget in order to prevent sudden rises in budget deficits.
- Maintaining and progressively improving the institutional and functional system for managing the funds disbursed from the EU under the three preaccession instruments: PHARE, ISPA and SAPARD, the structural funds respectively after the country's accession to the Community.
- Building administrative capacity for the accurate accounting and transferring the country's contributions to the EU budget on the basis of the gross national income, the average weighted amount of the value added tax, customs duties for import from third countries. It is necessary to enhance dramatically the efficiency of disclosing customs abuses.
- Strengthening the control institutions: the Audit Chamber and the state internal financial control for guaranteeing efficient spending of Community funds under the preaccession and structural programmes.
- Developing the administrative, technical, information and expert capacity of the customs administration since it will practically become a customs administration of the Community. Regulating the coordination among different government institutions and services that are related to the country's borders and establishing close cooperation with similar institutions in other EU member states.
- Removing the existing incompliances in Bulgaria's tax regulations in respect of established standards in the field of excise duties, value added tax and corporate taxation. Functional strengthening of tax administration.

Part Two
Building a Competitive Knowledge-based Economy

The main conclusion drawn from the analysis of the macroeconomic challenges facing the Bulgarian economy in Part One is that **it is particularly important, in the medium-term prospect for it to have a structure generating high value added and competitiveness which will provide substantial and stable export and investment flows.** It is only in such a case that the economic risks will be reduced substantially and the opportunities for maintaining high living standards will increase.

The attainment of high competitiveness is influenced by the government's economic policy but the major factor is corporate (microeconomic) governance. This means that **the government has to create an adequate environment but businesses are the driving force for the enhanced competitiveness.**

This Chapter will review the competitiveness of the Bulgarian economy. It will be compared to the EU dynamic pattern in the implementation of the Lisbon Strategy. A more detailed analysis will cover the most important factors for the growth of productivity, *i.e.* business innovations, the implementation of new information and communication technologies, regulations on the business environment and the development of small- and medium-sized enterprises.

Chapter III.
Competitiveness of the Bulgarian Economy

The need for increased competitiveness of the Bulgarian economy becomes particularly relevant on the threshold of Bulgaria's full EU membership. Over the recent years, competitiveness has focused the attention also of EU member states due to the insufficient productivity growth rates and the loss of advantages of the European economy compared to competitors like the United States or the countries in Eastern Asia.

Competitiveness is a synthetic category, reflecting the results of the overall economic policy. It reveals the ability of nations to attain higher productivity based on an innovative approach to human resources, capital and physical assets. Such an approach makes it possible to withstand the challenges of free international markets. The growth of productivity leads to higher real income levels and standards of living. Hence, **the main issue in attaining growth is *how to create conditions for higher productivity,* *i.e.* *to make human labour, capital and natural resources generate higher value.***

The national productivity depends directly on the productivity of companies. The national economy cannot be competitive if the businesses operating within it are inefficient. This calls for higher qualifications of human resources, better information, more sophisticated infrastructure and more intensive competition.

Nowadays, companies change their strategies by shifting towards competitive advantages resulting from unique products and processes of better quality and higher value added. The ability of governments to build an environment in which businesses can produce complex differentiated products of high value added to meet the high demands of consumers creates conditions for prosperity.

If efforts in Bulgaria continue to be focused only on maintaining macroeconomic stability without implementing an active policy intended to enhance competitiveness, disappointments will result from insufficient economic growth.

1. Bulgaria in International Comparative Competitiveness Studies

The Bulgarian economy is not sufficiently competitive. **However, some positive changes have occurred in the last few years.** This conclusion is based on Bulgaria's participation[31] in the regular Global Competitiveness Report of the Global Economic Forum. The annual report is the most comprehensive and thorough study on competitiveness. The observations and conclusions can be used to highlight the priorities and measures to be undertaken in the future.

The Forum's Report[32] constructs two indices to assess competitiveness: one of them characterises the growth potential of national economies long-run perspective (competitiveness of the economy or potential competitiveness), while the other gauges the competitiveness of companies (competitiveness of business). The former is the leading index, which reveals the ability of the national economy to attain growth.

Table 5

Ranking of Bulgaria, 2003 and 2004[33]

Competitiveness of the Economy			Competitiveness of Business		
	2003	2004		2003	2004
	64	59		77	70
Macroeconomic environment	73	60	Corporate strategies	85	79
Public Institutions	62	56	Business Environment	75	67
Technological development	63	59			

1.1. Competitiveness of the Economy: the National Level

The main objective of the potential competitiveness index is to enable the analysis of the capacity of national economies to attain economic growth in the medium and long run. It aggregates indicators in the field of institutional strengthening and structural changes. By combining the quantitative indicators with the subjective judgement of representatives of business circles, the research team of the Forum has decomposed the potential competitiveness index into three subindexes: macroeconomic stability, quality of public institutions, and technological development. These are the factors, which, in the opinion of the Forum's team, determine to the largest extent the growth potential of economies, noting *the decisive role of technological development*, especially in the medium and long run.

Macroeconomic Environment

Bulgaria has made substantial progress in comparison to the previous year: from the 73rd to the 60th place in the ranking. Three groups of factors are identified within the macroeconomic environment: macroeconomic stability, public spending, and credit rating. In terms of the macroeconomic stability and credit rating, Bulgaria has moved forward to the 54th place. Less favourable is the situation with regard to public spending, where the country ranks 83rd.

Bulgaria has comparatively good quantitative indicators: GDP growth rates, low fiscal deficit, low inflation rates, improving credit rating. At the same time,

[31] Bulgaria was included in those reports in 1999.
[32] The latest Global Competitiveness Report 2004–2005 was officially presented on 30 October 2004.
[33] The latest Global Competitiveness Report includes 104 countries.

results are more unfavourable with regard to some indicators related to the subjective assessment given by entrepreneurs: inefficient spending of public resources, expected recession. The other negative indicators include the high level of budget transfers, the low level of savings, *etc.*

Public Institutions

Public institutions ensure protection of property rights, speedy and fair settlement of trade disputes and transparency at all government levels. Two subindexes are also identified; one of them evaluates the extent to which corruption is spread, while the other is a measure of the efficiency of the legislation and judiciary.

Over the last three years, the Global Competitiveness Reports have given the highest ranking to Bulgaria in connection with public institutions and, contrary to public perceptions, primarily with regard to the spread of corruption. The corruption level is an important indicator of the extent to which the government provides working, transparent and clear rules and framework for the development of business, as well as effective and fair mechanisms for the provision of services to individuals.

In terms of this index, Bulgaria moved from the 35th place in the previous year to the 30th place in the latest report, *i.e.* it ranks in the first half of countries with lower level of spread of corruption. As to the 'spread of corruption' indicator, Bulgaria compares positively to most Central and Eastern European countries. Estonia is the only country from the region to rank higher than Bulgaria (the 29th place), while most of the others – the Czech Republic, Hungary, Lithuania, Latvia, Poland, fall behind Bulgaria.

The problem with the spread of corruption is undoubtedly serious and it is one of the spheres in which Bulgaria continues to be criticised by the European Commission. At the same time, Bulgaria compares quite well to some Central and Eastern European countries. In our opinion, it is only fair to note this fact. Of course, this ranking gives no grounds for complacency but it confirms that corruption can be found in any society; it is a complicated phenomenon which is difficult to gauge or assess in a straightforward manner. The authors of the Report pay special attention to the corruption problem and note that previously corruption was believed to be almost exclusively 'the patent' of poor nations. But it is pointed out that corruption is a problem which exists and creates difficulties in all countries, including rich ones.

The major difficulties associated with public institutions in Bulgaria continue to be the lack of speedy, efficient and unbiased judiciary (81st place); the spread of organised crime (the 98th place); clientelism (the 89th place); insufficient protection of ownership rights (the 80th place).

Technological Development

As mentioned earlier, technological development becomes increasingly important for enhancing the competitiveness of economies.

The differences in the use of modern technologies are transformed into discrepancies in the productivity level and affect seriously the economic growth capability. The successful development and use of information technologies largely determine the innovative potential of countries, create conditions for the development of information society and knowledge-based economy, promote research and technologies in all spheres, *i.e.* they are closely linked to the future of all countries, including Bulgaria. These are the reasons for paying special attention to these issues in this report.

The Global Competitiveness Reports note that Bulgaria does not use the opportunities for technological development to a sufficient degree. At the same time, the country has made progress on a year-to-year basis, moving from the 63rd to the 59th place. Generally, technological development is achieved in two ways:

through the development of new technologies (innovative potential) and through transfer of technologies from abroad. Therefore, the technology index can be subdivided into several subindexes: *innovation index, transfer index, and communication and information index.*

- *Innovation Index*

The innovation capacity is assessed by means of a number of indicators, the most important being the patented new products, processes and technologies; the percentage of university students; the availability of qualified engineers and researchers. The highest-ranking countries in this respect are the United States, Canada, Western European countries, Japan, Korea, Singapore, *etc*. These countries account for 15% of the world's population but they hold 99% of the patents on new products and technologies. They are in the third and highest stage of development of the modern world, the innovation-oriented stage following the resource and investment stages.

The other countries basically import foreign technologies and products, which means that they have to build their potential for transfer and successful implementation of modern technologies. The highest growth rates are scored by those countries, which succeed in attracting substantial foreign investments from innovative countries. Investments are associated with an inflow of new technologies and products, capital and managerial skills. Examples of such countries are China and Ireland, as well as Estonia in the Eastern European region.

Bulgaria ranks 46th in terms of the innovation index. Estonia and Slovenia are the countries, which feature best among Central and Eastern European countries. Bulgaria stands close to the Czech Republic and Slovakia in this ranking. The conclusion related to these countries and Bulgaria is that they have some innovation potential which provides a good basis for accelerated development.

- *Information and Communication Index*

Bulgaria ranks 47th in terms of this index compared to its 49th place last year. Estonia, Slovenia and the Czech Republic rank higher. The quantitative indicators used here are the number of telephone lines, the number of Internet users, the number of Internet hosts, the number of cell phones, *etc*. Bulgaria has scored some good achievements in terms of these quantitative indicators.

One should note that individuals are more active in the use of information technologies in Bulgaria. The application of modern information technologies is largely due to the personal initiative of entrepreneurs and there is still lack of sufficient awareness of their importance for corporate strategies.

- *Technological Transfer Index*

The main problems in the field of technological development result from the lack of an active corporate policy in the transfer of modern technologies – here Bulgaria ranks 62nd (the 67th place in the previous ranking). The transfer of technologies is one of the most efficient channels for inducing economic growth and renovation of production. Regrettably, businesses in Bulgaria are of the opinion that foreign investments fail to play the expected role of conduits of modern technologies. In Hungary, Estonia and Slovakia, for instance, this is a major driving force of development. It is relevant to recall in this respect that, from the perspective of the economic development, what matters is not just any investment but investment in high-tech spheres.

1.2. Competitiveness of the Economy: the Corporate Level

For quite some time, it was believed that the stable macroeconomic environment, the efficiency of institutions and liberalisation were 'the cornerstones' of economic growth. The research of various teams, including the team of the Forum under the leadership of Prof. Michael Porter, comes to show that they are neces-

sary but not sufficient conditions for the attainment of sustainable economic growth. Experts firmly believe that **the growth generated by a successful macroeconomic policy is unsustainable without reforms at the *microeconomic level* and it would hardly lead to tangible GDP growth.** Adequate microeconomic reform is needed to bring about higher productivity and competitiveness of companies. The existence of greater opportunities for entrepreneurs and the creation of new jobs are much more important than the increase of the government intervention and the attempts at compensating the role of private enterprise.

Businesses become increasingly aware that sustainable growth can be achieved only through improvement of corporate competitiveness. It is determined by two major factors, *the quality of the microenvironment* and *the efficiency of strategies*, which enable them to cope successfully with the competitive pressure.

Bulgaria falls behind in terms of corporate competitiveness, ranking 70th against the 77th place last year. Estonia, Slovenia and the Czech Republic are those new EU member states, which rank highest.

As to ***the business environment***, Bulgaria ranks 67th and it has managed to move forward quite substantially from the 75th place in the previous ranking. This comes to confirm that the measures undertaken over the recent years in the field of regulatory arrangements, the protection of competition and other have started to gradually yield results. The assessment of the business environment builds largely on such indicators as the opportunities for start-ups; the lack of administrative barriers; the effective protection of competition; the access to financing, *etc*. Bulgaria continues to lag behind in terms of the opportunities for starting new business. The expected changes in the trade registration (the removal of the registration of companies from the judiciary and the development of a strategy for the establishment of a central registry of legal entities and an electronic registration centre of the Republic of Bulgaria) are likely to speed up the process of starting new business. The more active application of the adopted Restriction of Administrative Regulation and Administrative Control Act, as well as the expected changes to ease some of the most difficult regulatory arrangements will bring about an overall improvement of the business environment. This issue will be examined in detail below.

The main elements of ***corporate strategies*** which influence the productivity of companies, in the opinion of the Forum team, are as follows: improvement of production processes, choice of competitive advantages; staff training and upgrading of qualifications; improvement of the quality of marketing. Generally, the quality of corporate strategies continues to receive the most negative assessments, putting the country in the least favourable position as far behind as the 79th place in the ranking.

Bulgarian companies face the most serious difficulties in the following spheres: lack of an adequate policy for training and retraining of human resources, insufficient marketing and poor quality of professional management, lack of an active policy for acquisition and introduction of modern technologies. These serious problems result also in lower competitiveness of Bulgarian enterprises.

1.3. Other Indicators of Competitiveness

The Report notes that Bulgaria holds comparatively good positions in the regulation of the labour market and some elements of the human resources management: the relative flexibility and freedom in the establishment of wages and salaries and in the practices of hiring and dismissing employees and the *labour productivity to pay* ratio. Good results have been achieved with regard to the gender equality in the hiring and remuneration in the private sector.

The positions related to the protection of the environment and the environmental policy spending are unfavourable. Bulgaria continues to stand in the bottom of the ranking in terms of the commitment of entrepreneurs to charity causes and the support of companies to voluntary activities of their staff, the insufficient measures

to fight poverty, *etc*.

Generally, the opinion of businesses is that there is lack of a national policy to systematically enhance the competitiveness of the economy causes concern. The grounds for optimism in this respect lie in the Government's decision to identify the enhancement of competitiveness as a strategic priority in the National Economic Development Plan and in the work that has started for drafting the related operational programme.

2. Opportunities for Enhancement of the Competitiveness of the Bulgarian Economy

The enhancement of the competitiveness of Bulgarian enterprises and the economy as a whole is of decisive importance for the successful withstanding of the pressure of competitive forces in the EU. To this end the recommendations can be formulated both at the national and corporate levels:

At the national level, the government should:

- improve the business environment and create conditions to promote competition;
- encourage companies to engage more actively in investments in R&D activities;
- pursue a policy to encourage start-ups and new industries;
- meet the specific demands of small- and medium-sized enterprises;
- promote the use of new technologies in education, business and everyday life;
- create conditions for liberalisation of trade and investment;
- upgrade educational standards with a view to the successful development of the knowledge-based economy;
- promote the transnational and transregional transfer of technologies;
- maintain an active dialogue with businesses and encourage business-to-business partnerships.

Such measures will result in: new opportunities at lower costs, better quality, greater choice for consumers, new forms of exchange among the participants, and overall increase of the potential for change.

This could be achieved by means of:

- developing a *strategy* to enhance the competitiveness of the economy;
- developing a *programme* with specific actions to implement the strategy[34];
- establishing a *specialised institution*, *e.g.* a Competitiveness Board, to make analyses, monitor the Bulgaria's progress towards greater competitiveness, and propose measures and solutions;
- analysing the competitiveness of *regions*, including municipalities, in Bulgaria.

At **the corporate level, businesses should:**

- develop their strategies on the basis of modern technologies and innovations;
- introduce quality control standards, focusing on customers and building their trust and confidence;
- introduce systems to manage efficiency, by using the best manufacturing practices which create opportunities for reduction of cost, expenditures and losses and enhance the productivity of the main business activities;
- create conditions for upgrading employee qualifications;
- participate in clusters (networks of related industries). It is particularly relevant to SMEs. This approach has advantages and leads to improvement of corpo-

[34] It should be noted that the enhancement of competitiveness features as a major priority in the National Economic Development Plan of Bulgaria. In accordance with the drafting methodology, in September 2004, a working group was set up to prepare an operational programme for the enhancement of competitiveness.

rate strategies along the following lines:

- *improving product design, creating greater opportunities for exchange of ideas and know-how in the development and production of goods and services;*
- *improving the image through active work of business associations and advocacy before government institutions;*
- *improving technological processes through active exchange of technological know-how and development of new products and technologies;*
- *better access to distribution and services;*
- *availability of market information – opportunities for exchange of information on potential buyers (demographic features, needs, demands), market set-up;*
- *logistics – better cooperation in the movement of goods or information among the participants in the cluster or network;*
- *improving the quality of human resources through easier acquisition of new skills.*

The measures enumerated above do not comprise an exhaustive list of all possible actions for increasing productivity, and hence for greater competitiveness of the Bulgarian economy. However, their relevance is beyond any doubt. **The further economic reforms call for public-private partnership, focusing the economic policy on the increase of productivity.**

The following chapters will examine the dynamic patterns and objectives of the EU economic policies, which Bulgaria should not only take into consideration but also fully adopt. The analysis will cover all four major elements of the policy for high productivity and accelerated growth: innovations, information and communication technologies, development of favourable business environment, and support to small- and medium-sized enterprises.

Chapter IV.
Adjustment of Bulgaria's Economic Policy to the EU Objectives

The convergence of the Bulgarian economy to the EU, the importance of which is covered in Part One of this report, calls for the adoption of the same objectives and policies. Bulgaria's economic policy should become part and parcel of the EU economic policy, while its objectives should fit into the overall picture of the EU objectives. This is a way to remove a number of doubts and misunderstandings related to the priorities of the economic policy, as its main task becomes to reduce the discrepancies with the EU levels.

1. The European Way to High Competitiveness: the Lisbon Agenda

The Lisbon Agenda is a fundamental document underlying the EU economic policy. It was adopted by the European Council in Lisbon in 2000. The main objective, which the document sets for the European economy, is to make it the world's most competitive and dynamic knowledge-based economy by 2010. At the same time, while paying considerable attention to competition and the free market development, European leaders put the emphasis on the indispensable requirement for the economic restructuring to be coupled with adequate social policy ensuring the active involvement of citizens in economic and social life.

There are several main spheres of intervention for the attainment of the objectives of the Lisbon Agenda: promotion of competition and entrepreneurship; encouragement of innovations; ensuring higher employment rates, laying the emphasis on education and the upgrading of the qualifications of human resources;

modernisation of the European social model. The positive changes in these spheres are expected to bring about higher productivity in European countries, which will inevitably lead to greater international competitiveness of these countries. The issues raised in Lisbon relate to both the 'old' and 'new' EU member states, as well as Bulgaria and Romania.

Shortly before the middle term of the Lisbon Agenda, its major objectives seem difficult to achieve. Leaving aside some improvements in the field of information and communication technologies, the results in the other spheres are far from being satisfactory. This has triggered a lot of research, including the study as to whether it is worth continuing the implementation of the Strategy at all. The general assessment is that the insufficient success is due primarily to external factors (the collapse of high-tech companies on U.S. stock exchanges in 2001, global terrorism, weakening of the European economy). The internal EU factors are also powerful: limited constitutional powers of the common European structures, poor involvement of national governments, the almost total lack of commitment on the part of many national authorities and citizens.

All these problems raise the issue of the viability of the Lisbon Agenda and the sense for Bulgaria to comply with it. It is true that accession countries are not explicitly obliged to work for the attainment of the objectives of the Lisbon Agenda. As a matter of fact, EU Member States do not have such an obligation either. Nevertheless, **Bulgaria has to fully adjust its policy to the objectives of the Lisbon Strategy** and to make greater efforts in this respect than the member states. In this case, the long-term national interests fully coincide with those of the EU. The key words in the Lisbon Agenda for economic reform are growth, employment and productivity. These objectives are particularly relevant to Bulgaria at its present stage of development. Moreover, **if the country allowed lagging behind the EU economy in terms of productivity, innovation and technological level, this would put it into the EU periphery for a long time.**

The report of the High Level Working Group, chaired by the former Dutch Prime Minister Wim Kok *Facing the Challenge: The Lisbon Strategy for Growth and Employment* was published in November 2004. That report noted the lagging behind in terms of the objectives set out in 2000 and, at the same time, emphasised their importance and relevance and made recommendations to speed up the processes. The five main spheres in which recommendations were made to the EU member states that were very relevant to Bulgaria as well, were as follows:

- **Knowledge society** – involvement of a greater number of scientists and researchers, making R&D a major priority and deep penetration of information and communication technologies;
- **Internal market** – removal of the barriers to the free movement of goods and capital, accelerated completion of the common market for services;
- **Business climate** – alleviation of the total administrative burden, improvement of the quality of the regulatory environment, support to start-ups, creation of a business supporting environment;
- **Labour market** – quick results in the implementation of the recommendations of the European Working Group on Employment, development of life-long learning strategies and employment at more senior age, promotion of partnerships for growth and employment;
- **Environment** – dissemination of environmental innovations, application of policies leading to long-term and environmentally friendly increase of productivity.[35]

The priorities of the Bulgarian economic and social policy could be expanded but the spheres pointed out in Win Kok's report will certainly occupy a leading position among them.

[35] *Facing the Challenge: The Lisbon Strategy for Growth and Employment, High Level Working Group*, chaired by Wim Kok, November 2004, http://europa.eu.int/comm/lisbon_strategy.html.

2. The Lisbon Agenda: the Groundwork for the Bulgarian National Policies

Only in the first three years of implementing the Lisbon Strategy, by the end of 2003, the Union has adopted over 70 directives and EUR 100 billion were utilised in accomplishing the objectives of the Strategy. However, as mentioned in the report there are significant problems which hold back the entire Strategy. According to the latest progress report under Lisbon Strategy approved by the EU Council in April 2004 "Insufficient implementation of the Lisbon strategy could produce significant net costs for Europe: in terms of reduced growth, delayed improvements in employment levels, and a growing gap with some of our large industrial partners in the fields of education and R&D."[36] The EU is expected to become more active in the implementation of the Lisbon Strategy in the years to come. Therefore, Bulgaria is faced with a very difficult task: it has to ensure such development rates of the knowledge-based economy and increase of productivity and employment, which will enable it to catch up with the EU, notwithstanding its own high growth rates. In fact, this task becomes less complicated if the country succeeds in using its advantages.

Traditionally, economic growth is explained by the elements of the simple production function. These are raw materials, labour and capital. The increase of any of them, all other conditions being equal, should bring about an increase of production. Today, the economic understanding of growth is very different. Actually, the end result may increase or decrease without any change of the level of production factors. The reason lies in the different productivity in general. Hence conventional factors are to be coupled with some other and productivity is among the most important ones. Modern economies focus on the use of this 'new' production factor. It is covered also in the Lisbon Agenda, which makes the absolutely correct correlation of productivity with high qualifications, innovation and high technologies.

The increased productivity is the major growth resource for economies like Bulgarian. While the Lisbon Strategy is expected to bring additional 0.5 to 0.75% of GDP growth[37], this 'additional' growth should be much greater in the accession countries where the starting level is much lower. For the last five years, the EU (15) has generated a real annual growth rate of 1.8%. Bulgaria has scored 4.8%. If one applies the same dynamic pattern to the knowledge-based economy accelerator, the additional growth in Bulgaria can be expected to reach 1 to 1.5% per annum within the framework of the Lisbon Agenda.

One of Bulgaria's advantages mentioned above is that the current economic environment is not characterised by too many traditional links. This situation matched with the small size of the economy makes the reform and restructuring process much easier. What is needed is just ***a clear view supported by political and public consensus on the reforms to be undertaken*** in order to achieve the desired structure and competitiveness of the economy. In addition, it is necessary to identify the specific steps and incorporate all that in **a national programme for the development of the knowledge-based economy** in conformity with the Lisbon Strategy. The philosophy of this programme has to be geared to the specific features of the European economic and social model to which Bulgaria belongs.

A good description of **the European economic and social model** is given in the recent study of the European Policy Centre. It is characterised by development of the free market but also by active intervention of the government, especially when negative economic developments are to be mitigated. Researchers find this model to be linked to relatively high taxes, maintenance of universally accessible services, mainly education and healthcare, high level of social security payments, quite influential trade unions, maintenance of public enterprises and macroeco-

[36] Report from the Commission to the Spring European Council: Delivering Lisbon Reforms for the Enlarged Union, COM (2004) 29.
[37] *Ibid*.

nomic stability through prudent fiscal and monetary policies.[38] The European model itself is changing towards more market and more restricted role of government but the change is very slow. This enables **Bulgaria to make adjustments in compliance with the expected developments in the EU**. Hence, the Bulgarian model should be more liberal than the European one but going to any extreme would generate difference and would make more difficult integration of the country into the EU.

The comparison between Bulgaria and the EU in terms of the indicators measuring the progress in the Lisbon Strategy reveals that the country is seriously falling behind in a number of them (Cf. Annex 2.1). The country reports 26% of the GDP per capita of the EU (15), slightly over 30% of its productivity, 9.5 times greater energy intensity per unit of output, and 40% of the level of prices. There is an alarming rift in R&D spending which accounts for 0.5% of the GDP in Bulgaria and 2% in the EU and the gap is continuously growing. The employment level is the lowest among old and new EU Member States and the percentage of long-term unemployment is several fold higher than the EU average. It should be noted that the situation has improved on the labour market after these surveys. Bulgaria is reporting comparatively good levels of employment among people of more senior age, favourable data on poverty levels, and regional differentiation in terms of employment and especially in terms of young people who have completed secondary education.

This is the starting point and these levels should be improved progressively and rapidly in the years to come. It should be noted that some efforts have been made recently to improve the existing situation but they are not elements of a comprehensive and clearly defined economic and social policy. The existing strategies and the legal framework (Cf. Annex 2.2) are not integrated into a single system; often they contradict each other or overlap and, what is most important, they still face the challenge to be successfully implemented. A negative example to this effect is the case of the electronic signature regulation, where Bulgaria is among the first countries in the world to adopt legislation on its use. Nevertheless, the electronic signature is hardly used due to its high price, the limited number of services provided against it, the existing bureaucratic and financial barriers, *etc*. Another pertinent example is the condition of the e-government. The list of all good intentions that have hardly been implemented can be much longer.

The next chapters will dwell on some major aspects of the knowledge-based economy with an analysis of the current situation and the possible development prospects.

Chapter V.
Innovations and Economic Growth

Bulgaria's main priorities in the EU accession process are related to streamlining the national innovation system and developing the innovation potential of the Bulgarian economy.

1. The National Innovation System and the Innovation Development Potential

Innovation systems (national, regional or sectoral) bring together the activities of various public and private institutions with various objects, goals and growth opportunities but equally involved in the process of use and development of the innovation potential. All stages from the creation of new knowledge through its

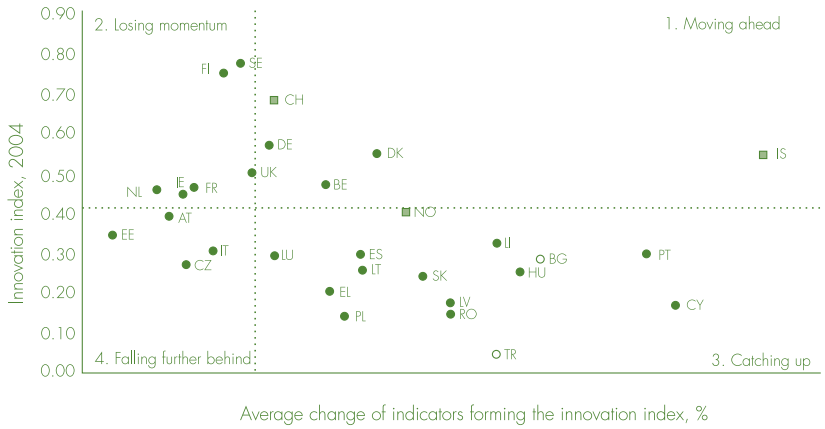
[38] Lisbon Revisited – Finding a New Path to European Growth, The European Policy Center, working paper, March 2004/WP08.

transfer to the subsequent practical implementation are equally important for the result of their interaction (innovative products, processes and organisation).

The structural changes in the national economy and its institutional framework and the lack of adequate reform of the government have brought about, to a large extent, almost full falling apart of interconnections in the national innovation system. The result is low level of interaction, duplication of efforts in the development of certain research areas at the expense of priorities that are not covered at all and inefficient use of the innovation potential as a whole. For all practical purposes, there is an aggregate of public and private organisations involved in innovative activities, which do not maintain any internal integrity.

Despite the unsatisfactory level, last year saw some moving ahead to the average European levels as reported in the European Innovation Scoreboard for 2004 (Chart 16).

Chart 16. **Innovation Index SII-2[39], 2004**



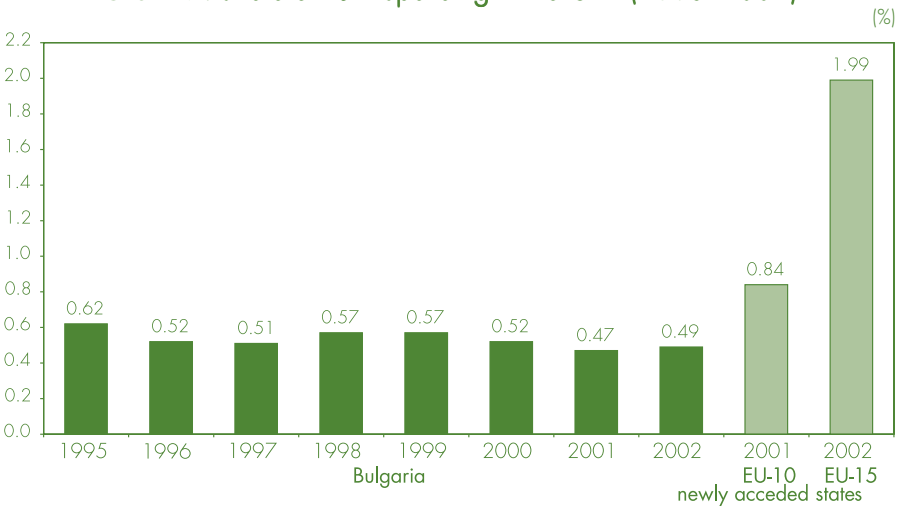
Source: Innovation Scoreboard 2004, http://trendchart.cordis.lu/scoreboards/scoreboard2004/inno_index.cfm.

Compared to 2003 Bulgaria has made progress with regard to the Innovation Index SII-2 calculated by the European Commission, moving from Group IV to Group III. However, the data should be interpreted very cautiously, given the low starting level for implementing innovation development indicators and the substantial gap between the quantitative and qualitative aspects of education and training of human resources in Eastern Europe. Tangible results can be achieved also in the years to come only if growth rates are sustained.

If the low levels of innovation persist in the next few years, the country will fall further behind the average European levels of innovation development indicators and the ambitious objectives of the Lisbon Strategy – R&D spending equalling 3% of GDP, in which business should account for two-thirds of the expenditures. Chart 16 shows that **R&D spending** has not just been at a very low level but it has tended to decrease in Bulgaria for the last few years. Such a development is diametrically opposite to what is going on in the EU. Even greater concern is caused by the lack of interest or conditions for businesses to spend on R&D (Chart 18). The main gap and long-term problem facing Bulgaria is to create an adequate environment for innovation, which will encourage enterprises to supplement the public spending for R&D and innovations. If the country manages to reach a two-thirds participation of businesses in the R&D financing, at the current levels of public

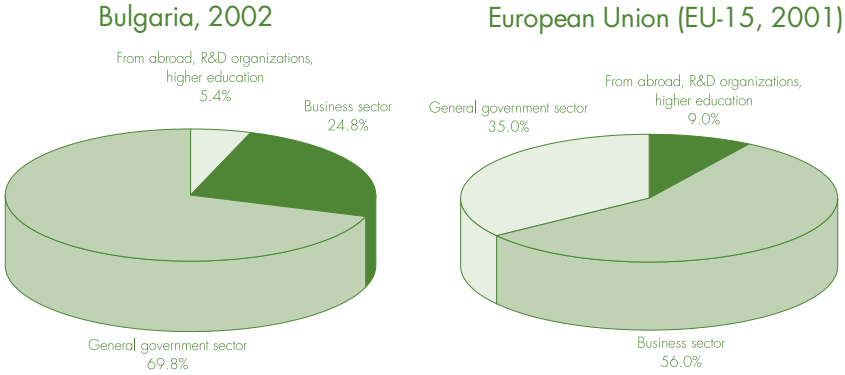
[39] SII-2 is based on 12 indicators: five of them are related to human resources, six of them concern patents and R&D costs and one indicator includes the share of expenditure on ICT development in the GDP. The selection of indicators is based on the accessible information and data available on all countries included in the study. The interrupted lines in the chart show the average levels according to the EU-25 indicators.

Chart 17. **Share of R&D Spending in the GDP (1995–2002)**



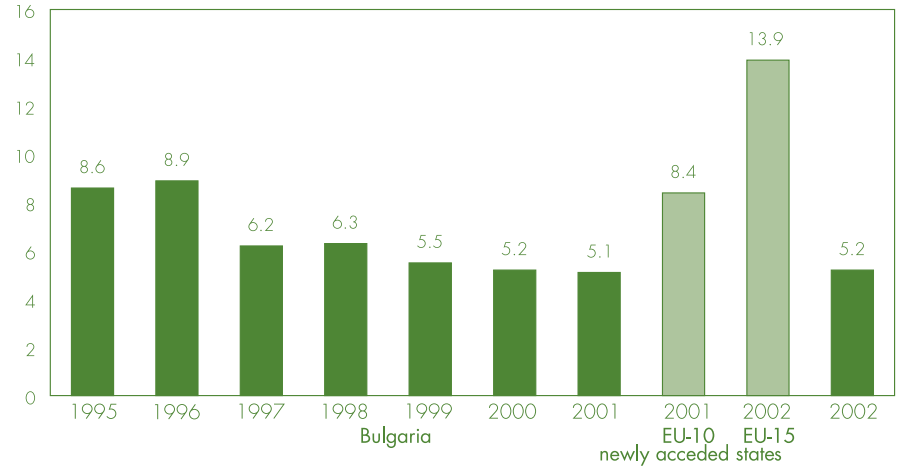
Source: Innovation Index.bg 2004, Applied Research and Communications Foundation on the basis of NSO data; Eurostat-Statistics on Science and Technology in Europe/2003

Chart 18. **Structure of R&D Spending by Source of Financing (2001, 2002)**



Source: Innovation Index.bg 2004, Applied Research and Communications Foundation on the basis of NSO data; Eurostat-Statistics on Science and Technology in Europe/2003

Chart 19. **Staff Involved in R&D per 1000 Employees (1995–2002)**



Source: Innovation Index.bg 2004, Applied Research and Communications Foundation on the basis of NSO data; Eurostat-Statistics on Science and Technology in Europe/2003

spending, Bulgaria will catch up with the leading countries among the new EU member states (Charts 17 and 18).

Human resources involved in R&D are an important factor for the generation and transformation of technological knowledge into innovative products. Bulgaria has scored a substantial decline in terms of the human capital involved in the development and use of scientific knowledge for the last decade.

In 2002, the research staff almost halved comprising 45.1% of the 1995 level, unlike the upward trend in the EU, indicating a 15% increase on average in the number of people involved in R&D (Chart 19).

At the same time, there are some positive processes as well. In 2002, the percentage of university graduates in the active age population was commensurate to the average EU (15) level (21%) and exceeded the average level in the ten new member states by six percentage points. Furthermore, the number of university graduates in science and technology per 1000 people of the population aged from 20 to 29 in Bulgaria (8.3%) was larger than the average number in the ten new EU member states (7.2%), whereas the EU-15 average was 10.4%. All this comes to show that the country is gradually reorienting from a potential to develop research to a potential to adopt and implement it. In the next four to six years, Bulgaria should be expected to start finding its niche in the research and innovation development in Europe, on the basis of which it could achieve higher economic growth rates.

Negative trends affect also the changes in the number of **R&D organisations**. According to the Organisation for Economic Cooperation and Development (using the Frascatti methodology), there was a 20% decrease over the period from 1994 to 2002. Their structure reflects the still existing asymmetry in the financing and development of the national innovation system which is too concentrated in public institutions. It is necessary to shift to a market-dominated system, where the government would commission and expect research for its needs from both sectors on equal footing.

Table 6

R&D Organisations by Sector

Sectors	1994	1995	1996	1997	1998	1999	2000	2001	2002
Total Number	450	436	474	458	447	436	410	377	361
Enterprise Sector	118	111	115	159	143	117	103	107	96
Public Sector	227	219	228	208	207	222	207	163	159
Higher Education	100	102	98	86	88	87	91	98	99
Nonprofit Organisations	5	4	33	5	9	10	9	9	7

Source: Innovation Index.bg 2004, Applied Research and Communications Foundation on the basis of NSO data.

The promotion of the innovation activity of businesses and the development of the innovation potential of the country require effective protection of intellectual and industrial property rights. The measures provided in **the patent system** create opportunities for the use and transfer of existing technological products and recovery of the funds invested in R&D. Thus, it turns into a factor to protect the competitive advantages acquired in the process.

In its Regular Report on Bulgaria's progress towards EU accession, the European Commission noted the high level of conformity of the legislation with the *acquis communautaire* achieved in the protection of intellectual property rights. One should also point out the importance of the series of international agreements, conventions and treaties in the field of intellectual property rights, to which the Republic of Bulgaria is a party. These assessments, however, do not reflect the actual implementation of the patents system in the country, where the lack of sufficient market experience is clearly visible and difficulties can be expected upon the occurrence of the first more serious patent disputes (Table 7).

Table 7

Intellectual Property Rights Protection Index

	Bulgaria	Western Europe	G-7 Countries
Intellectual Property Rights Protection	2.47	7.92	8.18

(0 – minimum, 10 – maximum).

Source: World Bank, Knowledge Assessment Methodology (KAM 2004).

Bulgarian businesses are passive with regard to patent applications. Despite the increase reported in terms of this indicators, Bulgaria is still catching up with the other European countries (Table 8, Annex 2.3).

Table 8

Number of Applications Filed for Inventions and Utility Models and Number of Patents Issued by the Bulgarian Patents Office

Year	Applications Filed			Patents Issued		
	Bulgarian applicants	Foreign applicants	Total	Bulgarian applicants	Foreign applicants	Total
2000	337	710	1047	217	337	554
2001	389	785	1174	187	294	481
2002	416	735	1151	211	257	468
2003	407	679	1086	160	214	374

Source: Patents Office of the Republic of Bulgaria.

One of the problems in both reporting and management of innovations is the lack of clarity for businesses to distinguish between R&D and other activities of their own. In their assessment, most companies are guided by the tax treatment of these activities rather than the actual content and goal. According to a survey conducted jointly by the Applied Research and Communications Foundation and Vitosha Research Agency[40], over a half of the respondents (57.26%) do not perceive basic and applied research as an element of innovations. 72.74% do not see any direct link between the acquisition of nontangible assets and the development of their innovative potential. There is an obvious need against this backdrop to raise the awareness of businesses and train them to fully utilise the intellectual property system as a factor to build competitive advantages and to promote their presence on the market.

One cannot expect the government to fill in the gap or compensate for the lack of innovative activity on part of businesses. Companies have to be involved and encouraged to seek solutions in this respect. In this sense, it is necessary to support activities like the development of **regional innovation systems** and the establishment of **clusters**. The development of Bulgaria's first Regional Innovation Strategy for the South Central Region[41] proved that if effective partnership among companies, the public administration and nongovernment organisations was established in the process of its drafting and implementation, it could provide the basis for a lasting alliance generating continuous incentives for the development of innovations.

[40] One of the latest surveys of the innovation potential of businesses conducted jointly by the Applied Research and Communications Foundation and Vitosha Research Agency in the middle of 2003. The survey covered a representative 1053 companies operating in various industries.

[41] The project was implemented by a consortium comprised of the Applied Research and Communications Foundation, the Regional Commission for Economic and Social Cohesion of the South Central Region, the Ministry of Regional Development and Public Works, tti Magdeburg GmbH and the University of Thessalia, Greece over the period from 2001 to 2004.

The sectors and activities identified as suitable for the establishment of entrepreneurial networks or clusters are the IT sector, textile industries, timber processing, the production of essential oils, perfumery and cosmetics, food industries, *etc*. The proper positioning of clusters by the businesses involved in them could provide real opportunities for the development of an innovation-oriented environment and promote the participation in various forms of technological transfer. The advantages of such interaction are associated mainly with the sharing of R&D expenditures (which are often unaffordable to most companies on their own) and the vertical integration aimed at bringing together the stages of the technological cycle from the processing of raw materials to the manufacturing of the finished product.

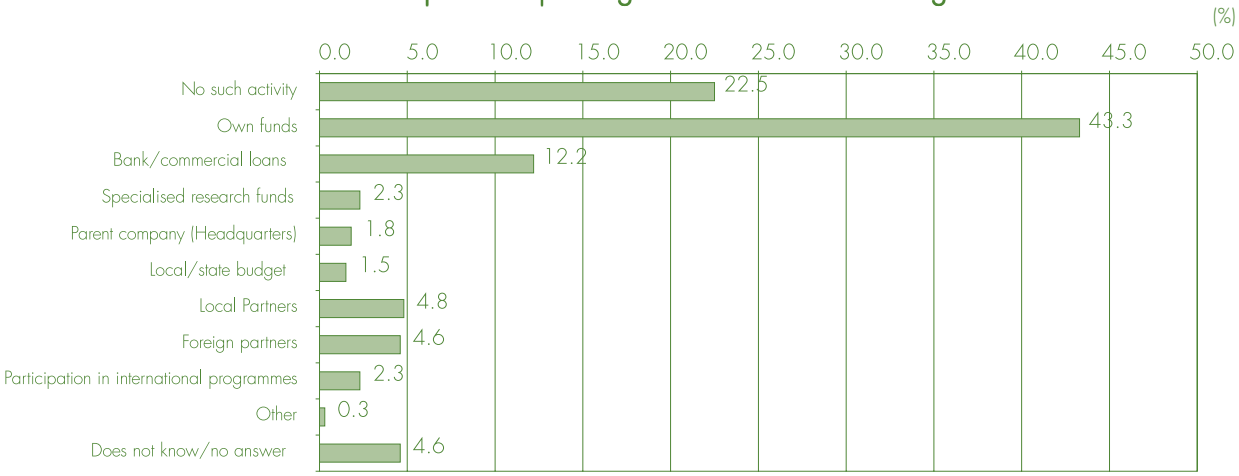
2. Development of Innovation Culture

The ability of business entities to choose highly innovative projects and to create conditions for their successful implementation largely depends on the innovation culture they have developed. The experience of advanced nations shows that the innovation culture is most often expressed in the existence of such features of management systems as a strategic view on the development of the business, awareness of the essence and importance of innovations and a striving for improvement of the corporate know-how through independent R&D or through transfer of technologies in various forms.

The condition, in which most of the Bulgarian companies find themselves, calls for aggressive behaviour in the field of the innovation policy and the transfer of technologies so that to reach the competitiveness levels of global leaders. Businesses should invest more not only in fixed assets but also in R&D (Chart 20) in order to reach growth rates enabling Bulgaria to catch up.

One of the reasons for the weak innovation activity of businesses lies in financing. Seventy five percent of the respondents state that they have no financial resources to develop innovative products.

Chart 20. **Distribution of Companies Depending on the Source of Financing for R&D Activities**



Source: Applied Research and Communications Foundation on the basis of data provided by Vitosha Research Agency

The analysis of the innovation development of the Bulgarian economy provides the groundwork for identifying the main challenges in the context of the EU accession and defining the measures to move ahead and catch up with the average European levels of innovation indicators.

The specific actions and project initiatives should be carried out in a comprehensive manner and oriented to all stakeholders in the system: businesses, research units, educational establishments, intermediaries, representatives of central and regional authorities.

The following forms seem effective in promoting interrelations and integrating the efforts of individual innovation centres:

- **the cluster approach** within individual industries and also in related industries;
- **high-tech business incubators** and the full use of the whole range of opportunities they offer: shared infrastructure, work space, access to equipment, shared office services, flexible lease schemes.

As to the innovation culture and the aptitude to innovation **at the corporate level**, the following impact areas can be discerned:

- Training in matters related to the protection and use of **intellectual property rights**. The development of unique products different from those of competitors and capable of attracting new customers calls for knowledge of the opportunities offered by the patent laws and benefiting from own production or transfer of technologies.
- Promotion of the whole set of **innovation supporting activities** (information services, preparatory work for production processes, needs assessment, marketing of innovative products). This can largely reduce the financial and market risks in the implementation of such projects and ensure the success of new or improved products.

The measures proposed in the specific priority areas fully comply with the objectives of the European Commission in support to the Lisbon Strategy.

Chapter VI.
Development of Information and Communication Technologies

The second important factor for building a highly competitive economy is the access to modern information and communication technologies (ICT). The information society and knowledge-based economy are political priorities for Europe and their effective implementation is a prerequisite for higher productivity and competitiveness of business and for higher standards and quality of life for individuals.[42]

1. The Situation in 2004

1.1. E-infrastructure

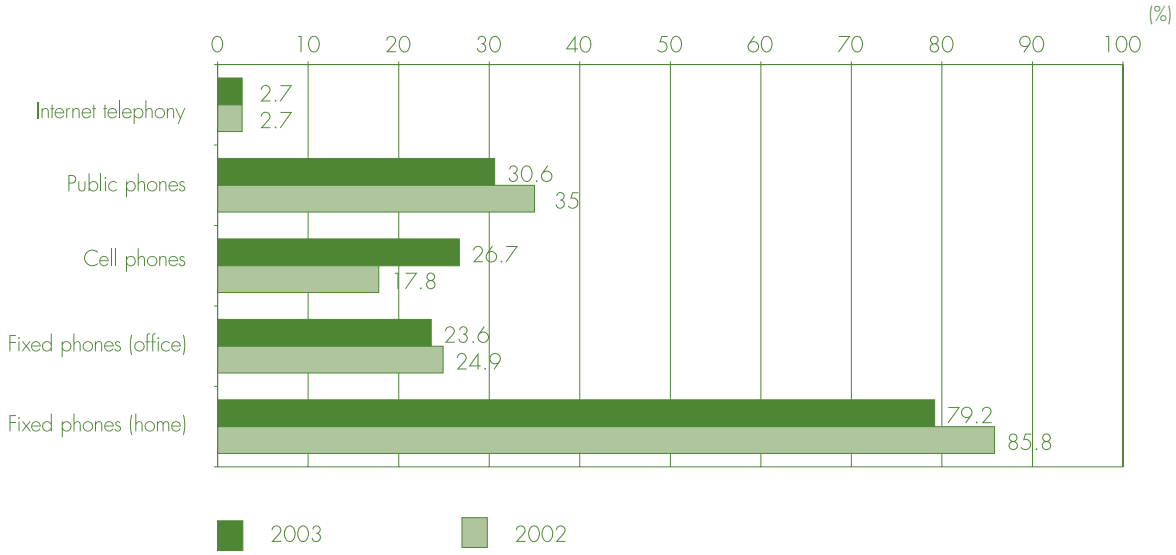
The establishment of suitable infrastructure for ICT development has scored substantial progress for the recent years. This has become possible since the liberalisation of the market for telecommunication services. Two-thirds of the households have already obtained the opportunity for broadband Internet access mainly *via* a cable modem or LAN. ASDL is still making its way quite modestly primarily as a service offered by BTC. Unlike **2001 and 2002** when the VoIP traffic was mainly **international**, 2003 and 2004 saw reversal of the trend and now **the local traffic is gaining momentum quickly**. There are much greater technical options for the provision of high-speed Internet through the establishment of new optical networks and satellite connections.

Chart 21 gives a visual representation of the increased access to ICT. The progress is expected to be even greater in 2004. Bulgaria's dynamic pattern in terms of these indicators is comparable to that of the new EU Member States. The limited penetration of computer equipment is still a considerable obstacle to the wider spread of ICT. The problem is particularly relevant to educational establish-

[42] The analysis in this chapter is based on the 2004 e-Bulgaria survey of the ARC Foundation and Vitosha Research Agency (www.arcfund.net)

ments and households, although there are still a number of small enterprises that do not have the necessary computer equipment. The reason lies in the low income levels and the relatively high prices of computer devices. In 2004 the government made some positive steps in this regard with the renewed initiative to open computer rooms at schools and to offer Internet access at public places, as well as with the favourable depreciation policy. These efforts should be not only retained but also further promoted.

Chart 21. **The Share of Adult Persons with Access to ICT Services**



Source: Vitosha Research Agency, National Representative Surveys, January 2002 and May 2003.

The other problems of the infrastructure include the burdensome procedures and the high costs of using the .bg domain and the electronic signature.

1.2. E-society

One of the basic measures of e-society is the use of Internet. A positive development is the increased use of Internet from home. While the access to computers at home accounted for **2.6%** of the population in 2000, it has already reached **7.2%** of the population. The increase is the result of many factors such as the natural growth, the replacement of business computers in 2003 and 2004, in which some of the old computers went to households, the 'saving' of expenditures for Internet clubs and the wide choice of movies through local area networks. It should be noted that an increasing number of people tend to use alternative devices for Internet access such as cell phones (**7.1%** of the Internet users) and palm computers (**2**% of the Internet users). Evaluations of the exact number or percentage of the Internet users differ substantially but the survey of Vitosha Research Agency conducted in November 2004 registered that **21.7%** of the age group in the 15 to 74 bracket used by the European Commission for comparative purposes had used Internet in the previous month.

Notwithstanding all these positive developments, Bulgaria continues to lag behind in terms of computers and Internet use in comparison to both old and new EU member states. Alongside the financial reasons for this negative fact, there are too many people who do not use Internet because they are not interested (39.6%), because they cannot use a computer (18.9%) and because they do not use foreign languages (24.5%). This means that, **alongside with financial incentives, the development of the information society in Bulgaria should be promoted through awareness raising and training.**

1.3. E-education

Bulgaria is falling behind in the development of education through ICT. The reason is not only the limited penetration of computers at households and schools. **There is dramatic lagging behind of teachers**, especially in nonmath subjects, in terms of the skill to use computers and Internet for learning purposes. This **subcategory**, together with **the IT education**, is the only one which has not achieved any tangible progress since 2001. About **63.2%** of the schools **have no single teacher** to use Internet in teaching nonmath subjects. It should be noted that the success of national teams and the islands of stability at some universities cannot change in a short-term horizon the average level which is not simply stagnant but falling drastically according to international assessments **(TIMSS)**. Only **4%** of schools have an official website and a mere **18%** of schools have submitted an e-mail address for correspondence to the Ministry of Education (November 2003). Distance learning has not been recognised and even regulated adequately. This creates difficulties even to the simple importation of best practices and technologies in distance learning, which could be useful for Bulgarian educational institutions.

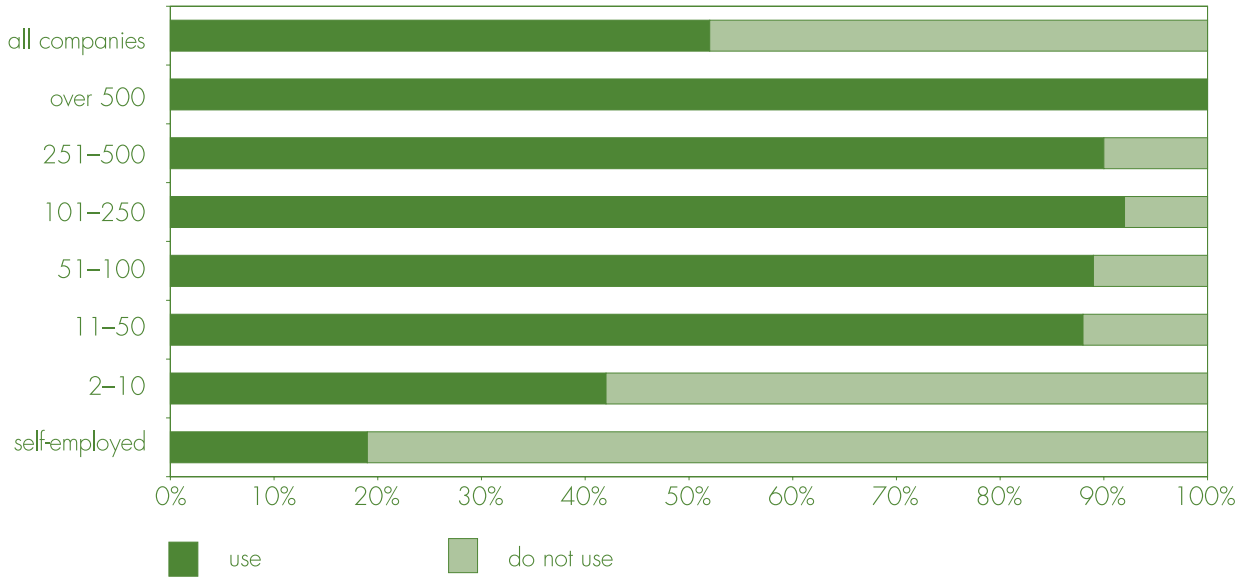
1.4. E-business

The ICT use in business changes its internal organisation and enhances management efficiency. It also transforms dramatically the environment and markets in which companies operate. Therefore, from the perspective of the knowledge-based economy, the use of new technologies is of crucial importance.

These technologies spread quickly among Bulgarian businesses and still there are a number of disparities. Chart 22 shows that few self-employed people and small enterprises with up to ten employees use personal computers. The problem is further aggravated when the Internet use is analysed.

Chart 22. **Use of Personal Computers Depending on the Number of Employees**

(% of companies which use or do not use computers)



Source: Vitosha Research Agency.

Companies with websites have increased from about **5%** in 2001 to some **16%** to **28%** (depending on whether the company has just a website or updated meaningful information of interest to consumers is provided) in the summer of 2004. In 2000, computers, if they were available at all, were not efficiently connected in networks and they were basically used as smart typewriters. In

2004, approximately **55%** of companies with more than one computer **have linked them into a network** which, in spite of the progress since 2000, is assessed as **insufficient**. Companies engaging in e-commerce are still few (6.6%). **Over 11%** of (computerised) companies use open-code software and another **10% are planning or considering** this option.

These indicators are rather modest against the background of EU practices. Bulgarian companies and the government should make considerable efforts to encourage businesses to use ICT as this has direct impact on the corporate competitiveness.

1.5. E-policy and E-government

Bulgaria was among the first countries among the new EU Member States to undertake real steps towards the information society. In 1998 the Coordination Council for the Development of the Information Society was set up to work with all government units and a year later the strategy and programme were adopted for the development of information society in Bulgaria. Subsequently, however, the initial momentum was lost. Since 2001 the government has focused on ICT rather than the broader issue of information society. As a result of this delay, most of the new EU member states have already achieved better results in its implementation than Bulgaria. This conclusion is particularly relevant to the introduction of e-government. The building of e-government is a powerful tool for making a comprehensive e-policy and supporting the development of the information society and it should be viewed and assessed as such. The insufficient human and financial resources with the Minister of Public Administration who is responsible in this cabinet for the introduction of e-government led to the slow development and the modest results in this sphere. The minimum set of 20 services to be provided to individuals and businesses electronically will be made available as agreed with the EU but this does not ensure the momentum needed for the development of e-government. At present, several projects for the establishment of e-municipality are being implemented thanks to various donor programmes. The registry reform slowed down but if it is completed successfully in 2005, one can expect serious pressure on the government to provide more electronic services, especially those related to public procurement, licensing and authorisation arrangements.

2. The Development of Information Society in Bulgaria

In the years to come, Bulgaria has to work actively for building information society which includes ICT as one of its elements. The government policy plays a key role in this respect. It determines a lot of factors starting from the quality and content of education and reaching to the easier use of the electronic signature and the provision of electronic services. The achievements along these lines can tangibly change the competitiveness of the Bulgarian economy and also the quality of life of individuals.

It is necessary to clearly identify also the national priorities in ICT. The first and very successful step in this respect is the ICT Development Strategy worked out in collaboration between representatives of the business community and the public administration. Bulgaria has to further promote its growing prestige as a producer of high-quality software. The manufacturing of electronic components and devices will generally be inhibited by the competition of China and other Asian manufacturers but the country can retain niches that it has gained in recent years. It is particularly important for the Bulgarian ICT industry to penetrate deeply into prospective economic sectors, bringing innovation and globally competitive achievements there.

The development of e-government is of paramount importance. It will greatly facilitate administrative services to individuals and companies and reduce corruption opportunities. Its introduction will lead to release of administrative capacity and better

working conditions in the public administration at the central and local levels.

It would be appropriate to follow the example of other countries among the new EU member states and to introduce electronic personal identification documents and to outsource central and local government services provided that their high quality and the active use of new technologies are safeguarded.

Chapter VII.
Improvement of the Business Environment

The bureaucratic obstacles to business are measured by the time and money which entrepreneurs invest in order to observe regulatory requirements. Coupled with this direct economic effect, on a longer-term basis they generate market distortions from productive investment to rent seeking and bring about inefficient allocation of resources. Most often, these obstacles are associated with an increase of the rights of the administration at the expense of individuals and businesses, lack of transparency, slow administrative decision-making process, unjustified prices of services, *etc*.

A good indicator of how serious these obstacles are to Bulgarian businesses is the international comparison. The Global Competitiveness Reports rank countries in terms of the assessment which businesses give to the burden of various administrative obstacles. In the 2004 ranking which includes 102 countries, Bulgaria features among the lowest 20% in terms of a number of indicators of the regulatory burden. Bulgaria ranks 91st in terms of the time that businesses spend to overcome bureaucratic barriers (the so-called 'time tax'); 90th in terms of the assessment of entrepreneurs of the transparency and predictability of policies; 89th in terms of the efficiency of the tax system; 87th in terms of the level of administrative discretion and favourtism of certain companies in the application of regulations (Annex 2.4). These conclusions are corroborated by the analysis of the authoritative freedom index of the Fraser Institute and the Heritage Foundation, which also put Bulgaria quite behind in the world ranking in terms of the business regulation burden[43], [44]. Foreign assessments coincide with the opinion of Bulgarian businesses (Table 9).

Table 9

The Obstacles to Business in Bulgaria in 2004

(% of respondents specifying them as 'a big problem')

Obstacles	February	April
Unfair competition	46.7	47.1
The amount of taxes	45.4	43.7
Crime	47.3	39.7
Authorisation procedures	39.7	38.9
Access to financing	43.7	34.3
Corruption among administrative officers	34.6	33.7
Macroeconomic situation in the country	35.7	30.1
Rules and procedures for the acquisition of land	28.0	23.8
Corruption among the counterparts in the chain	20.2	21.3
Inspections/checks by controlling authorities	24.4	19.0
Judiciary	20.6	18.4
Performance of the local government administration	16.8	15.9
Performance of the central government administration	16.1	14.4
Current political situation	17.2	14.0
Procedures for hiring and dismissal of employees	13.6	10.5
Start-up rules/procedures	8.5	5.0

Base: N = 478

Source: Vitosha Research Agency (2004a).

[43] *Fraser Institute* (2004), the 2004 Report and the database – on www.freetehworld.com. The assessment of the burden of regulations is based on the data from the Global Competitiveness Report.

[44] *Heritage Foundation* (2004), p. 118. Regulations have the lowest assessment among the ten factors contributing to the overall assessment of economic freedom, which accounts for defining the Bulgarian economy in 2004 as rather unfree and ranking it 78th among 161 countries in the world.

The linkages between the excessive regulation, the shadow economy, corruption and slow growth rates are well established in the economic literature.[45] The next sections will dwell on the EU requirements that Bulgaria has to meet rather than on the theoretical tenets.

1. EU Regulations: Requirements to Bulgaria with Regard to the Improvement of Business Environment

The business regulatory and administrative environment is a pivotal issue in the European Union, especially in the context of the Lisbon Strategy. The main objectives of EU policies with regard to the business environment are to simplify the regulatory framework and to encourage SMEs to realise their entrepreneurial and innovative potential. The key tools at the national level are the ex-ante impact assessment of regulations, the reviews of the existing arrangements, the benchmarking to the best European practices and standards and their introduction, especially in electronic services, one-stop-shop services, tax incentives, *etc*. (Cf. Annex 2.5).

The European Union has no special requirements to the harmonisation of the legislation in the regulation and control of business activities or the encouragement of small businesses. In their policies in this sphere, EU member states are guided by the European Charter for Small Enterprises of June 2000 and the Multiannual Enterprise Programme 2001–2005. All accession countries have joined the Charter and the regular reviews of the Programme's implementation since 2002.

Comparative research comes to show that many of the poorest economies in the world are also among the most heavily regulated ones.[46] The loss of competitiveness is increased when excessive regulation is coupled with insufficient administrative capacity for its implementation or an inefficient judiciary. Then the results are administrative high-handedness, corruption, and low or negative growth rates. Hence transition countries like Bulgaria are expected to undertake convincing measures to limit regulations and to create liberal market conditions for their successful integration into the European economy.

One should not go to extremes when talking about limitation of regulations. The EU has a huge number of regulations and new ones are adopted all the time. The motivation is that the asymmetrical information and the other market imperfections make market mechanisms insufficient to guarantee the protection of the interests of the general public and consumers. To put it in a nutshell, the big issue of the administrative reform is not just to reduce the regulatory burden but to strike the optimal balance between regulation and economic freedom.

Upon its accession to the EU, Bulgaria will have to adopt both good and not so well justified practices. The most important changes to take place are those related to safeguarding the four major economic freedoms on which the EU is built, *i.e.* the free movement of goods, people, services and capital among Member States. For example, the free movement of goods calls for harmonisation in the standardisation and certification of products, the legal framework of the compliance assessment and the market oversight, as well as the regulation of public procurement. The free provision of services guarantees the freedom of establishment and the free provision of services by craftsmen, traders and farmers. In the field of financial services, it requires harmonisation and mutual recognition of licenses and the market oversight, as well as establishment of minimum standards to this effect. The *acquis communautaire* in the field of company law regulates the most important issues of the registration, accountancy, the protection of industrial and intellectual property rights and trademarks, which are all of fundamental importance to the functioning of businesses. The competition policy regulates the merger and acquisition rules, as well as state aids and state monopolies. The goal of all

[45] Cf. for example *Djankov et al* (2003) *Gray et al* (2004).
[46] *Doing Business in 2004*, p. XIII-XV

these measures is to reduce the restrictions to the free movement of goods, services, people and capital. In fact, the fulfillment of the requirements of the European Union increases the administrative difficulties facing some companies in various sectors. The mandatory introduction of the higher EU standards in such spheres as protection of the environment, food and garment production, *etc*. leads to additional costs for many Bulgarian companies. However, it should be noted that these expenditures open much larger markets to manufacturers and increase their market competitiveness. In this sense, the way in which each business will assess the additional investment related to the EU membership depends exclusively on its strategy and market horizon.

Reforms in the Bulgarian regulatory environment create a serious dilemma for government institutions. The EU is hardly the best paragon of the business regulatory and administrative environment. In a number of cases, the average EU indicators still fall behind the rapidly growing economies in Asia and even some new member states.[47] Hence the best option for Bulgaria is to ensure maximum liberalisation of the business environment by applying mainly the minimum required EU regulations. The negative economic consequences of a 'shock regulation' related to the EU membership are avoided in certain areas through negotiating transition periods. Here Bulgarian businesses are faced with a *fait accomplit*: Bulgaria's accession negotiations have been finalised. Therefore, special attention should be paid to the justified claims of large Bulgarian producers that the lack of adequate transition periods, especially in the protection of the environment, will bring about high costs over a short period of time and to loss of productivity and competitiveness.

2. The Burden of Administrative Regulation and Control in Bulgaria

Regulatory regimes occupy a special place among the direct barriers to the starting up and conduct of business operations. In 2004 over 80% of Bulgarian companies depended on a certain type of authorisation, while more than a half of them depended on a licensing regime, where the average number of licenses for that group was more than two per company (Table 10). Most of those licenses and registrations are linked to specific time limits and they are subject to renewal, while most of the authorisations are issued for each individual transaction. Authorisations are the greatest obstacle to business. According to a survey published by the Ministry of the Economy, over two-thirds of the companies using authorisations, assess them as a medium or big obstacle to their activities.[48]

Table 10

The Share of Companies Which Need the Respective Number and Type of Certificates for Operation in 2004

(%)

Number of certificates	Type of certificates		
	Licenses	Registrations	Authorisations*
0	41.1	11.2	6.7
1	22.3	43.3	11.3
2	17.5	13.6	16.7
3	5.6	7.6	13.8
Over 3	7.1	15.8	38.9
No answer	6.7	8.7	12.6

Base: N=538

* and equivalent forms

Source: Vitosha Research Agency (2004b, Appendices).

The statutory time limits for the issuance of most certificates is up to 30 days but, in practice, one-third of the companies covered in the above mentioned survey commissioned by the Ministry of the Economy reported that the procedure took more

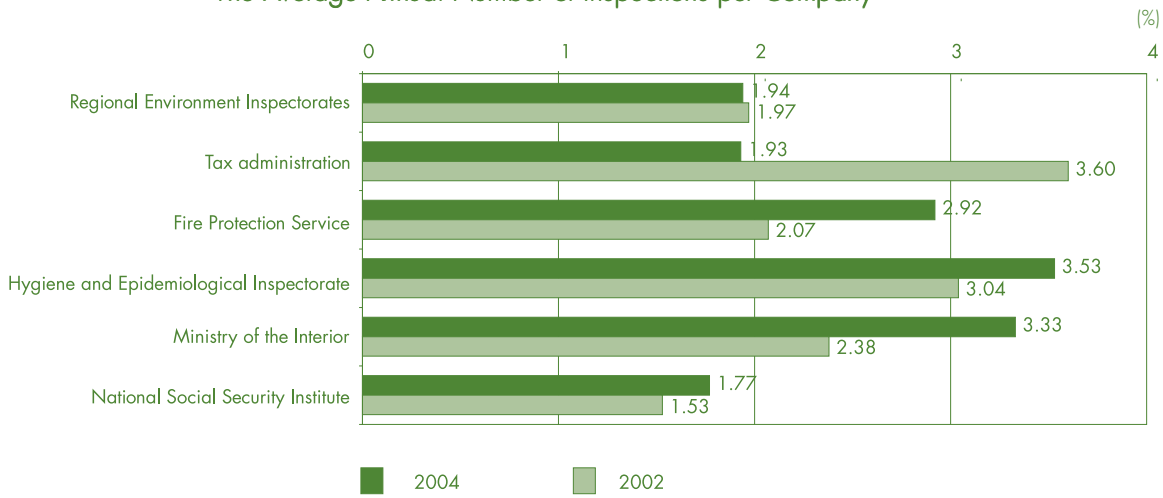
[47] See Global Competitiveness Report (2004), Data Tables Sections VI, VII, VIII and X.
[48] Vitosha Research Agency (2004b).

than a month, while 8–10% of the companies reported over 100 days. Therefore, when assessing the burden of regulatory regimes, most businesses have in mind mainly the loss of time related to the application of numerous and not always clear requirements and the submission of documents, some of them have already been entered into public registries. The regulated expenditures are less of a problem to businesses than the administrative 'procrastination' of procedures. It urges companies to resort to unregulated graft payments. Regulatory regimes feature high in the ranking which businesses make in terms of the frequency and size of bribes.[49]

The issuance of licenses, registrations and authorisations is a barrier that companies have to overcome. But it explains only part of the time and resources that entrepreneurs spend in order to observe statutory requirements. **Most of the 'time tax' is due to inspections, checks and the mandatory filling in of forms once the business activity has been licensed.** According to *Vitosha Research Agency* (2004b, p. 48), only one out of ten companies has not been inspected for the last 12 months and approximately one out of five companies has been inspected more than ten times. The tax and social security administration and the sanitary inspection authorities account for the largest share of the administrative control burden. It is even more essential to note that this burden has grown for the last two years (Chart 23).

Chart 23. **The Burden of Inspections**

The Average Annual Number of Inspections per Company



Average Duration of Inspections

[49] Vitosha Research Agency (2004a), FIAS (2004).

It would be useful to compare the indicators of the scope, frequency and duration of inspections in the surveys among businesses to indicators of their efficiency. For instance, if less than ten out of 100 inspections end up with penalties (as companies report), this is indicative either of corruption or excessive control, *i.e.* loss of both private and public resources.

In addition to inspections and audits, there are various requirements for filling in reports and forms, which determine the bureaucratic burden of operational control. Leading in this respect are again the tax and social security administrations, where the requirements for monthly returns and reports, matched with the limited use of electronic services, lead to queues and loss of time every month. The filling in of statistical forms is another substantial burden. The NSI still uses complete rather than sample data used in international practices.[50]

The problem of excessive regulation has regional and sectoral dimensions. According to FIAS (2004), for instance, businesses in Plovdiv are most affected by lack of predictability and by inconsistency in the interpretation and application of the legal framework. The largest number of respondents (two-thirds) dissatisfied with the quality of administrative services to business is reported in the Region of Sofia, Russe, Plovdiv and Lovech. The 'time tax is' the highest again in Plovdiv and Lovech. It takes the longest time to obtain a permit to build in Burgas and Haskovo. As to the sectoral distribution of the administrative burden, the most acute need for alleviation of regulations exists in the manufacturing of vehicles, furniture, chemical products, metals and foods.

3. The Recent Improvements in the Regulatory Environment

It should be emphasised that most of these conclusions are no novelty at all. Efforts have been made to reduce the regulatory burden for the last few years.

MEASURES TO REDUCE THE REGULATORY BURDEN

Special efforts have been made to improve the regulatory environment since 1998, when the National Strategy for Encouragement of the SME Development (1998 – 2001) and its Action Plan (CoM Decision No. 398/7 of 7 August 1998) were adopted. The improvement of the business regulatory environment was a priority also in the new National SME Strategy until 2006 and the Work Programme for its implementation. The same objectives were set out in the Industry 2002 Programme of 2002 and the Report on the Competitiveness of the Economy of 2003. It was the central issue also in the Strategy for Modernisation of the Public Administration: from Accession to Integration 2003–2006 and its Action Plan (CoM Decision No. 671/24 September 2003) and in the E-government Strategy (CoM Decision No. 886/28 December 2002), as well as in the Open-stop-shop Services Concept (CoM Decision No. 878/29 December 2002). That was the time of the initial pilot projects for the introduction of the one-stop-shop principle in six regions. The greatest achievements of the policy in this sphere are as follows: the Review of Regulatory Regimes of 2002 (CoM Decision No. 392/7 June 2002); the Restriction of Administrative Regulation and Administrative Control of Business Activities Act (in force as from December 2003); the Electronic Document and Electronic Signature Act (in force as from October 2001); the Amendments to the Foods Act of November 2003; the Amendments to the SME Act; the Investment Promotion Act (in force as from August 2004); and the reform of the tax and social security administration, which started in 2003 in connection with the establishment of the National Revenue Agency.

One is impressed by the huge quantity of strategies and documents and the small practical result. According to FIAS (2004), over the period from 2002 to 2004, the time for the registration of companies was reduced from 42 to 16 days on the average; the average number of tax inspections per company was reduced from 3.6 to 1.9; the time limit for VAT refunding was reduced from 59 to

[50] Since 2001 (with the support of DfID) a sample methodology has been developed to collect statistical information but, for some obscure reasons, it has not been introduced yet. Furthermore, the personal data protection requirements impose restrictions on the use of data by the tax administration for statistical purposes.

41 days on the average. Over 110 municipal information and service centres were set up. Nevertheless, the results are far from being satisfactory in comparison to other countries. Bulgaria remains a regional leader in the 'time tax' (25%) and the unregulated payments (4.8% of sales), leaving far behind Poland, Romania and most Balkan and former Soviet republics.[51]

Here are several reasons for Bulgaria's lagging behind in the alleviation of regulations. First comes the lack of long-term and systematic efforts to this effect. The documents adopted are short-lived and campaign-oriented and then they disappear from the priorities of the public administration. The second reason is the uncontrolled adoption of new regulations, which is faster than the removal or improvement of old ones. The third reason lies in the lack of efforts to reduce the number of inspections and to enhance their efficiency, as mentioned above. Last but not least, there are poor organisation and poor conditions for the provision of administrative services. The broad introduction of e-government would avoid those obstacles.

4. Prospects for Reducing Regulatory Burden and Improving the Business Environment

The efforts to improve regimes should focus on those **regimes which create the greatest and most widely spread difficulties to enterprises.**

Another important aspect is to study the condition of **regulatory regimes administered at the municipal level**. There regimes should be registered and reduced and the opportunities for subjective judgement in these regimes should be minimised.

The further improvement of the business environment and the promotion of enterprise calls for:

- Establishment of a **specialised institution** to monitor regulatory regimes, to prepare in advance impact assessment studies of these regimes on the business environment, and to make substantiated proposals on the alleviation of certain regimes. The first step in this direction could be the restoration of the Interdepartmental Working Group on Regulatory Regimes;
- Urgent and speedy introduction of practices to provide **electronic administrative services,** thus minimising the direct contacts between businesses and the administration;
- Undertaking of measures to **remove the duplication** of the information, documents and forms which the public administration collects, including the introduction of an integrated database;
- Adjustment of fees to the **actual cost** of providing the respective administrative services; removal of fees or those elements of the fees that have the nature of taxation;
- Maintenance and further development of the existing **public registry** of applicable regimes by the public administration so that to help individuals in undertaking action for the organisation of small and medium-sized businesses;
- Taking into account of the EU requirements for promoting competitiveness and SMEs, which provide for a shift from quantitative to **qualitative indicators** , *i.e.* to measure the time and resources spent for the observance of statutory requirements rather than the number of regimes;

[51] In comparative terms, according to FIAS (2004), the value of the so-called 'time tax' exceeded that in Serbia two times, in Poland and Romania 2.5 times, and in some former Soviet republics (Tadjikistan, Kyrgizstan, Uzbekistan, Kazakhstan and Moldova) three times. The value of the 'graft tax' exceeded that in Romania two times, in Kazakhstan, Moldova and Serbia two to three times, and in Uzbekistan and Poland three to four times.

- Reform of the commercial registration, introduction of a **single identification code**, speeding up of the implementation of the existing Strategy for the Establishment of a Central Registry of Legal Entities and a National Registration Centre of the Republic of Bulgaria;
- Wider use of **one-stop-shop** practices;
- **Continuing decentralisation** and transfer of more responsibilities to local authorities in administering regulatory regimes, especially with regard to small- and medium-sized enterprises.

This list of recommendations is far from being exhaustive. It raises issues that can be resolved in partnership of all parties concerned, particularly small- and medium-sized enterprises.

Chapter VIII.
Small- and Medium-sized Enterprises: the Small Big Business

Small- and medium-sized enterprises (SMEs) are very important for the national economy. They are the driving force to speed up economic growth, to develop high-tech industries and products with high value added, to promote the competitiveness of the economy, to reduce regional disparities, to resolve the unemployment problem and, last but not least, to raise the standards of living of individuals.

1. The Role of SMEs in the National Economy

For the last few years, there has been continuous increase of the number of SMEs in absolute terms, in their share of the total number of enterprises, in their percentage of employment and the value added (the gross domestic product respectively).

Over the period from 1996 to 2002, the **number of SMEs** increased from 175,000 to 202,000[52], where microenterprises accounted for the biggest increase. As early as 1996, SMEs exceeded 97% of all enterprises and their percentage gradually increased to over 99% in 2004. The picture in Bulgaria in terms of this indicator comes close to that in the EU, where SMEs account for more than 99%[53] of the total number of companies.

The main feature of small and medium-sized business in Bulgaria continues to be the existence of **a great number of microenterprises** with a very low average employment level (2.1 employees per enterprise) and low labour productivity of almost a half of that in the groups of small- and medium-sized enterprises. Over the recent years, there has been a reduction in the number and share of microenterprises and, at the same time, increase in the number of enterprises with ten to 49 employees, which have the best growth potential among all SMEs (1–99).

The positive dynamic pattern of small enterprises (10–49) is indicative of some **specific advantages** in the organisation of production in this group as compared to either the smallest businesses or medium-sized enterprises. Their employees are 30% more than those in microenterprises and twice more than employees in medium-sized enterprises. Small enterprises have 42% more fixed assets than microenterprises and 96% more fixed assets than medium-sized companies.

[52] The analysis builds on the old definition of SMEs valid as of the date of this paper: microenterprise – 1–9 employees; small enterprise – 10–49 employees; medium-sized enterprise – 50–99 employees; SME sector – 1–99 employees. This analysis refers to nonfinancial enterprises in the sectors from C to K. The statistical data pertain mainly to 2001 and 2002 as more recent statistical data is not available. The source of data is the Report on SMEs in Bulgaria 2002–2003, SME Agency, Economic Development Centre.

[53] EU data from Manfred Schmiemann. *Statistics in focus INDUSTRY, TRADE AND SERVICES THEME 4 . 39/2002:* Enterprises in Europe – does size matter?, EU 2002.

Trade continues to be the most attractive sector for the development of small and medium-sized private business, followed by reprocessing industries. Over a half of private SMEs are concentrated in trade; 12% of the enterprises operate in reprocessing industries; slightly over 10% are the enterprises engaged in real estate operations and business services, as well as hotelry. The value added generated by SMEs in reprocessing industries and construction tends to increase while the value added in trade is declining. **In terms of the sectoral structure of SMEs, the number of companies in high-tech and innovative spheres is rather small. This is a major problem in the structure of these enterprises**.

Big *regional disparities* continue to exist in the characteristics of small- and medium-sized enterprises in Bulgaria. From the regional perspective, the South-west planning region, including Sofia, is still the most attractive place for development of small- and medium-sized private business. This region accounts for more than 30% of private SMEs; over one-third of employees; almost a half of the turnover of private SMEs; over 50% of the output. Almost a half of the value added of SMEs is generated in this region. It concentrates almost 50% of gross investments in fixed assets and 46% of the fixed assets of all small- and medium-sized private enterprises in the country. The insignificant structural contribution of the North-western operating region is at the other extreme, the share of which ranges from 2% (turnover) to 4.7% (number of enterprises). This concentration of SMEs is unfavourable but it reflects an objective fact: SMEs develop better at places where the economy operation, including medium-sized and big enterprises,. This fact should be taken into account in the SMEs promotion policy because they cannot be expected to compensate for the lack of strong economy in some areas.

Employment in SMEs **is growing**. They employ almost 850,000 people or 54% of the employees and 47% of the people hired in the nonfinancial sector respectively. There is a visible trend of increasing the contribution of private SMEs to employment – the shares of SMEs in the number of people employed and hired grow by some two percentage points on a year-to-year basis. In all planning regions, over 50% of the growth of employment is concentrated in small enterprises (10–49).

SMEs are a **source of rapid economic growth**. The value added of SMEs grows faster than the value added of all enterprises and the value added of the economy as a whole. In 2002, small and medium-sized enterprises generated value added of BGN 3556.3 million or 34% of the value added created by all enterprises in the nonfinancial sector. In 2002, the real annual growth rate of the value added of small- and medium-sized enterprises in Bulgaria exceeded 13 percent. **That growth was four times faster than the growth of all nonfinancial enterprises and almost two and a half times faster than the growth of the value added in the economy as a whole**.

The real growth of the **labour productivity** per employee in SMEs (5.9%) was faster than the estimated labour productivity growth for the economy as a whole (4.7%). Labour productivity grew faster in enterprises with a greater number of employees; thus productivity increased in microenterprises by 3.6%; in small enterprises by 4.9%; and the fastest growth was scored by the group of medium-sized enterprises (6.9%). The higher labour productivity levels in enterprises with a greater number of employees were observed in sectoral terms and also at the regional level.

The **liberalisation** of the economy produced a positive impact on the SMEs sector and the share of SMEs in the total number of enterprises engaged in foreign trade increased.

SMEs considerable share in the value of exports and imports is indicative of their flexibility and potential to use their advantages. The group of medium-sized enterprises (50–99) tends to have more stable growth and better positions in exports, while microenterprises (1–9) cope better with imports. Most dynamic

are relatively larger enterprises (100–249), whose foreign trade activities double annually, while their number has increased by only 4.5 percent. The reason lies in the ongoing restructuring of many big enterprises (over 250 employees) and in the better ability to adapt and the greater competitiveness of this type of companies with sufficient capacity but free of complicated structures.

SMEs are still **insufficiently attractive to foreign investors**: they account for about one-third of investments. The main recipients of foreign capital in the SMEs group are microenterprises.

2. The Preparatory Work of SMEs for the Common European Market in Their Own Strategies

Despite their importance for the national economy as a whole, individual small- and medium-sized enterprises face substantial difficulties in their own preparatory work for the EU membership. Their problems relate to their capacity to process and analyze information, the degree of preparedness of their management, and the opportunities for finding the necessary financial resources. Insofar as the initiative for change should come from companies themselves, and the government should support them in areas where they need help, their corporate strategies become particularly relevant. On the basis of the quantitative information and the specialised survey among SMEs representatives, one can outline the following **picture of corporate strategies:**[54]

- Most of the Bulgarian managers have a **short-term horizon** of their mindset, and they do not take into account the opportunities and risks associated with the EU membership;
- Companies still rely primarily on **the price competition** but this strategy condemns them to low-demand markets and strong competition;
- **Problems in managing** SMEs: an insufficient interest in various training courses or other forms of professional training for managers;
- **Marketing skills** are familiar to and used by SMEs in Bulgaria; almost two-thirds of the enterprises have information on how customers perceive their product (service);
- **Information** on market trends is obtained through a limited set of personal contacts;
- Few SMEs use **Internet as a source of information** for their business but Internet is moving forward in the ranking of information sources for technologies to be introduced at SMEs; this will produce a positive effect on business from the medium-term perspective (1–3 years);
- The sizable input of **raw materials** is a major problem for the enterprises, following immediately the access to financial resources which is traditionally problem number one of SMEs;
- The training of **human resources**, including the command of foreign languages, is not among the most common methods of enhancing the competitiveness of SMEs;
- Leaders in the SME sector are more prone to introduce **new technologies;**
- In spite of some weaknesses, **government programmes** to support business are appreciated and produce positive results for the SME sector.

The behaviour of companies largely determines the priorities in the support to be provided by the government institutions.

[54] Data obtained from the specialized survey conducted in November 2003 in the course of the drafting of the Report on SMEs 2002–2003.

3. Government Policy for SMEs Integration into the Single European Market

Bulgaria's EU membership will put to test small- and medium-sized enterprises. As stated earlier, they are an important part of the national economy but, on an individual basis, they lack the capacity and opportunities of big companies to obtain the information they need and to be adequately proactive. Therefore they should be supported by a specially focused government policy and by their business associations. It is necessary to give answers to a number of questions: what are the opportunities that the EU accession offers; are SMEs ready to meet the requirements upon accession; do they have a specific strategy to withstand the competitive pressure of European enterprises; do they intend to introduce ISO standards prior to the EU accession.

The actions that enterprises have undertaken to be better prepared for the European market can be summarised in the following table:

Table 11

Measures Initiated by Enterprises in Connection with the Preparatory Work on EU Accession

Measures initiated	Share of enterprises (%)
Improvement of quality control	26.9
Staff training	21.7
Improvement of technological equipment	16.8
Establishment of contacts with strategic partners	15.4
Investment in new technologies	14.3
Obtaining of ISO certificates	11.2
Meeting the environmental requirements to products and manufacturing	9.3
Meeting of technical requirements to products and manufacturing	7.5
Assessment of the costs for meeting the requirements of the EU single market	5.8
Managers training	5.6
Protection of intellectual property rights	3.7
Protection of industrial property rights	1.4
No preparations started	45.1

Source: Estat.

The better the condition of enterprises, the greater the awareness of the need for government support in the introduction of international quality standards, which would tangibly increase their competitiveness on the European markets: 28.6% of well-performing SMEs in very good condition of their business assess the lack of such support as the major obstacle to the introduction of these standards. These enterprises rely more on *quality* than on *price* as a competitive advantage on the single market (50% and 7% respectively), which meets the high requirements of this market and the solvent demand. Obviously, the opportunities for **increasing the export potential of the economy** should be sought with these enterprises.

An additional negative phenomenon is the fact that two-thirds of companies that have not started preparations for the EU accession are not interested at all in special programmes and projects of the public administration to support business. This means that about 30% of all small- and medium-sized enterprises do not put on their agenda the issues related to Bulgaria's accession to the EU and especially the impact of the enlargement on their business.

A positive fact is that most companies are aware of the problems facing them in the accession process and they try to resolve these problems. SMEs, for which the poor organisation of marketing and production processes is the most serious problem, tend to be more active in seeking ways to obtain ISO certificates (38.9% and 37.5% of all companies with this type of dominating problems respectively). Companies, for which the main problem is the low quality of labour force are leaders in the staff training (45.7% of these companies); companies hav-

ing problems with their high raw material and energy intensity opt for improving quality control (37.9%). Companies improving the quality control are leaders in the quality assurance training offered to their staff (49.3%).

This statistics gives grounds to focus the government support policy for SMEs in the process of the European integration mainly on the provision of information and research data, the introduction of quality control certificates, the training of managers, the promotion of innovations, the protection of intellectual property rights, and the provision of financial resources.

The immediate policy objectives for enhancing the competitiveness of Bulgarian small and medium-sized enterprises are as follows:

- **Improving business environment**, laying the emphasis on some elements of the institutional environment (the judiciary, start-ups, regulatory regimes, anti-corruption measures);
- Developing a competent, unbiased and quick **public administration** to support SMEs and provide them methodological and information support also at the regional level;
- Working out various tools to support SMEs **in the initial stage of their development and high-tech SMEs;**
- Establishing **a guarantee scheme** to support the SME financing in priority areas (high-tech, exchange of technologies, *etc*.);
- Training and **capacity building in SMEs** and their representative organisations for the preparation of projects and absorption of EU funds;
- Establishing **a single database** with information on the condition and needs of SMEs, as well as on the existing programmes and policies to support this sector;
- **Improving coordination** among all government and nongovernment institutions and organisations working to support SMEs.

A well structured and focused government support will be welcome and it will produce great effect in enhancing the competitiveness of SMEs, especially if they are involved in drafting and implementing of the respective policy through their representative organisations.

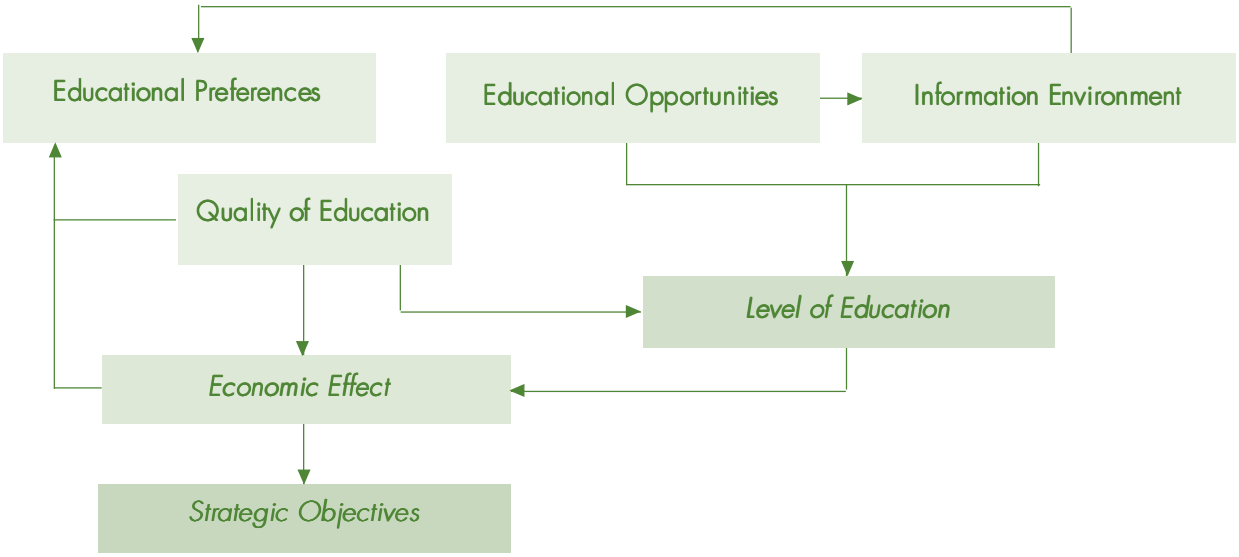
Chapter IX.
Education as an Economic Development Factor

Education is one of the spheres which are often discussed, continuously changing, and failing to yield the results that society expects. We are not going to dwell on the various strategies and concepts for development of education. We are going to examine it from the perspective of its influence as an economic factor. In the context of the Lisbon Strategy, education is a major prerequisite for building knowledge-based economy. The good education is a must in the development of the information society, the creation of a favourable investment climate and competitive economy, and the development of a modern social protection system.

It is very important to note that education as an economic factor **is very important in medium and especially in the long run**. This is the time horizon in which education has substantial impact on economic growth and on the social and demographic situation in the country. The fact that the measures do not produce an immediate effect comes to explain to a great extent why it is inappropriate to go to extremes and claim that the efficiency of education is gauged by the meeting the immediate needs of companies for a specific type of specialists. The balanced approach should reflect the understanding that business influences the training of human resources and, vice versa, specialists influence the development of

business. Hence education should combine the needs of companies with the implementation of a long-term economic and social policy of the government.

If the level of education[55] becomes the main objective of the policy, it is important to analyze its prerequisites and the expected effects. These correlations can be presented graphically as follows:



1. Preferences, Market Opportunities and Information Environment

The preferences for a certain type and quality of education are largely determined by the opportunities and the information environment, including the family and the social partners of young people. Hence, it is necessary to influence these factors in order to ensure an influence on preferences. The role of information has increased in the professional orientation for the recent years. The Internet and media provide access to considerable information, which can be compared and analysed. It is in this context, that the perception of prestige and good professional prospects is created as a leading factor for the choice of an educational establishment. Educational establishments play a crucial role in this respect. They have to give the fullest possible picture of what they offer and the achievements of their alumni. Unfortunately, mainly universities and some private schools have websites and participate in educational fairs and exchanges for the time being. Thus secondary schools run by the government or municipalities lose competitiveness at this very early stage. It is true that many of them rely on the traditions but, this way they become a typical example of asymmetrical information, which the Nobel Prize winner for economics John Ackerloff calls 'the law of poor lemons'. In his view, when a choice is insufficiently informed, the worst pieces are chosen because this is the attitude on both the supply and the demand side. In the assessment of the possible choice it is also very important to analyse comparable and independent information. Therefore, **educational establishments should be assessed not only by the government accreditation authorities but also by independent rating agencies.** Ratings will be even more useful, especially those of universities and some specialised schools, if they provide for international comparability since Bulgarian students will be able to choose an educational establishment within the framework of the whole European Union in two-years' time.

[55] Perceived as the extent to which one is educated rather than as formal completion of an educational degree.

Along with information, **the educational opportunities** play an important role in the choice of an educational establishment. In this respect, the government policy has the complicated task to resolve several problems simultaneously: first, it has to guarantee that all children will be covered by the educational system; second, it has to enhance the quality of education, preventing any increase in drop-outs; and third, it has to create conditions for all children willing and prepared to study to do so until they complete their higher education.

The good information environment and the educational opportunities, be it personal or public, are not sufficient for the choice. Very important is **the motivation** of the choice. Bulgaria has excellent traditions in this respect: the striving for good education of the children has always been a family priority. Unfortunately, this factor has weakened over the recent years. One of the reasons is that diplomas and education degrees devaluated in the initial years of the transition period. The linkage between the social status and education was severed and that was strongly demobilising for young people and older generations alike.

Another equally important problem arises when the choice of education is made without a long-term perspective. It is a way to increasing the group of highly qualified unemployed who hold diplomas but fail to find application of their knowledge.

The responsibility for the well-assessed motivation of the educational choice cannot be transferred to the government alone. It goes to society as a whole: educational establishments, the business community, the family, and the social environment.

2. Quality of Educational Services

The quality of education is of paramount importance. On the one hand, it is a factor which determined the quality of life and the competitiveness of the economy. On the other hand, it is through **the quality of its product that the educational system competes on the European market.** The EU membership, which will open the market for educational services, may bring about two different effects. The universities and specialities, which are convertible, guarantee European quality of education and have sound presence in the research area, will attract high-quality Bulgarian and foreign students. Conversely, universities of local importance will rest content with weaker interest and their alumni will have more limited career opportunities. It is realistic to expect a limited number of universities of the former type in Bulgaria. The objective is to make this happen. **It will be a success if one or two Bulgarian universities join the European elite**. Thus, the country will attract and generate highly qualified specialists which, in its turn, will be an incentive for education and hence for the economy to develop. The European experience shows this is possible only in the case of **a specialised government policy, investment of public resources, competitive environment among educational establishments and research units, effective use of national and European funds and massive entry of high technologies in education**. This implies a policy which is much different from the current one, trying to restrict the foreign competition on the educational market without sufficient incentives for the development of Bulgarian institutions.

Life-long learning should be taken into account when the quality of education is assessed. It is important insofar as knowledge and technologies are very dynamic and call for continuous refreshing and upgrading of knowledge. The good life-long learning resolves not only economic problems but also some very serious social problems mainly in connection with the professional fulfillment of middle-aged and more senior people in the active age bracket.

3. Challenges to the Educational System

Often, the problems accumulated in education are explained by factors external to it. Undoubtedly, they have a role to play. The level of economic development determines the attractiveness of the educational system and the establishment of a structure adequate to the business requirements and the long-term national interests. The problems in healthcare and the pension system prevent any significant increase in the resources for education because of the high priority of all these spheres. The concentration of poverty in certain areas and social groups, a clearly pronounced trend in recent years, affects the educational system, especially in these underdevelopment sectors.

Still, regardless of the negative trends related to the economic and social environment in this country, the problems of education as a whole are due primarily to circumstances within the system rather than to external factors. Frequent change of regulations, the lack of efficiency indicators, the worsened average quality of education, the lack of clear and long-term priorities are among the major shortcomings of the Bulgarian educational system.

In terms of many important education-related indicators, Bulgaria is at the EU level or even exceeds the EU average level. These indicators reflect the educational level achieved by young people aged 20 to 24. This advantage has to be utilised. At the same time, it is important to take into account some problems like the negative trends in these indicators in Bulgaria for the last few years and the decreasing quality of education.

Some of the major challenges to the educational system are as follows:

- The dynamic pattern of the educational structure of employees over the period from 1999 to 2003 reveals **gradual increase in the share of employees with higher education and decrease in the employees with elementary or lower education**. This means that education becomes increasingly important on the labour market. In fact, this is a way for the priorities on this market to go back to normal and for the main focus of the government policy to become clearly to upgrade the education and skills of people threatened with unemployment or already out of job;
- Over the 2000–2003 period, Bulgaria showed **negative dynamics of the educational level of the 20 to 24 age group**, which is the target of special monitoring and measures in the EU with a view to its strategic significance as a factor of building a competitive knowledge-based economy. To this end, the share of people aged 20 to 24 who have completed at least secondary education is being monitored in the EU. The 2003 data come to show that in terms of this indicator, Bulgaria (75.6%) holds a more favourable position than the EU (74%). The concern is that since 2000 Bulgaria has reported an annual decline of this indicator and its dynamic pattern is opposite to that of the EU. The quality of education is also relevant in this respect. It has obviously deteriorated in Bulgaria for the recent years and the fact that a large percentage of young people have secondary educational diplomas becomes less and less indicative of their real knowledge and qualifications;
- Notwithstanding the positive changes in the educational structures of employees, there is alarming **stabilisation of the group of unemployed with elementary and lower education**. Over the 1999–2003 period, they accounted for 35% of the unemployed or some 150,000 people. Due to the extremely low level of education, it is most difficult for them to find a job and they are the overwhelming majority of long-term unemployed;
- The gradual increase in the percentage of employees with high level of education is accompanied by a **discrepancy between the expectations and requirements of businesses and the actual training of labour force**. This is very vividly seen in the opportunities for foreign investors to find employees with

the desired qualities on the Bulgarian labour market. Local employers, too, have recently raised the issue of the rift between the real and nominal education within the framework of the national educational system. Again, there is lack of coordination and sometimes incompatibility between business and educational establishments. This is a serious problem created by the lack of proactive attitude on both sides;

- **The continued training of employees** is directly related to the availability of competent labour force. According to the surveys, only 1.4% of the people employed in Bulgaria are involved in this type of training, which is far below the EU level (9.7%). This condition can be associated with the relatively low technological level of most organisations, which provides short-lived relief to employers in Bulgaria with regard to the pressure for investments in the training of their staff. At the same time, the introduction of modern technologies as a factor of the growing competitiveness and productivity cannot take place without parallel and even preceding activities to train the staff of organisations.

4. Priorities Needed

The Lisbon Strategy notes that the role of the government support in many areas of socio-political and economic life is a crucial factor for the attainment of the strategic objectives of the EU. Undoubtedly, education is a high priority for the EU. In Bulgaria education has been identified as a priority area for government financing and support only for the last few years. As a result some strategic documents have been adopted but the policy pursued and its results are still very volatile.

Bulgaria's accession to the EU calls for clear identification of and concentration on several priorities. They should include:

- Efficient measures to involve all Bulgarian citizens who have not received the relevant educational degree in the compulsory education. No long-term concentration of uneducated or poorly educated Bulgarian citizens should be allowed in specific regions or ethnic groups;
- Urgent measures to upgrade the average quality of education at all levels;
- Incentives to educational institutions capable to offer an educational level which is competitive in the EU;
- Emphasis on the training in the field of information and communication technologies at all levels of education and provision of the human resources required for development of high-tech industries and research intensive services;
- Promotion of competition in the educational system with the participation of public and private educational institutions on the basis of identical criteria;
- Specialised measures to support employers who invest in the training and development of their staff. Efficient measures to promote the impact of life-long learning;
- Increase of the public resources for education, while measuring their efficiency. Comparisons show that currently Bulgaria allocates 4.2% of GDP for education, while OECD member states allocate 5.6%;
- Decentralisation of the management of education, in which the central government institutions will retain basically the right to develop and supervise the compulsory minimum standards.

At present, Bulgaria relies on competitive advantages of rather low order: low level of technologies and high labour, energy and material intensity. Having in mind the relative instability of this type of competitive advantages, one can conclude that specific measures need to be undertaken in the years to come in order **to improve the quality of labour force in this country as an element of the overall strategy for gradual increase in the competitive advantages of the Bulgarian economy.**

Part Three
Social Aspects of Medium-term Economic Development

The development of Bulgaria's economy in the medium term faces some serious challenges in the social area. These cover almost the entire range of social policy issues, yet in the context of Bulgaria's forthcoming accession to the EU and the implementation of the Lisbon Strategy, two areas take particular precedence: the labour market and the income policy. The European Union attaches priority to the role of employment in ensuring economic and social welfare of people. The challenges in these two areas of social development are significant and stem from Bulgaria's lagging behind EU member states.

This section will discuss employment and income policy issues, the priorities and development trends.

Chapter X.
The Labour Market

In early 1990's, Bulgaria's labour market displayed features typical of a reforming economy. The functional parameters of the Bulgarian labour market differ from those of the EU member states (EU-15) but they are quite similar to the level of countries in Central and Eastern Europe (EU-13). The reasons for those differences are evident: the country was undergoing sizable economic and institutional, including legal reforms.

The main indicators for the status of the labour market (level of economic activity, employment and unemployment rates) clearly indicate **that the national labour resources were underutilised.**

Economic activity among active people (aged 15 and above) was relatively low. Less than half of the active-age people participated on the labour market. Over the 1993–2003 period, the rate of economic activity decreased by almost 7 percentage points (Cf. Chart 24).

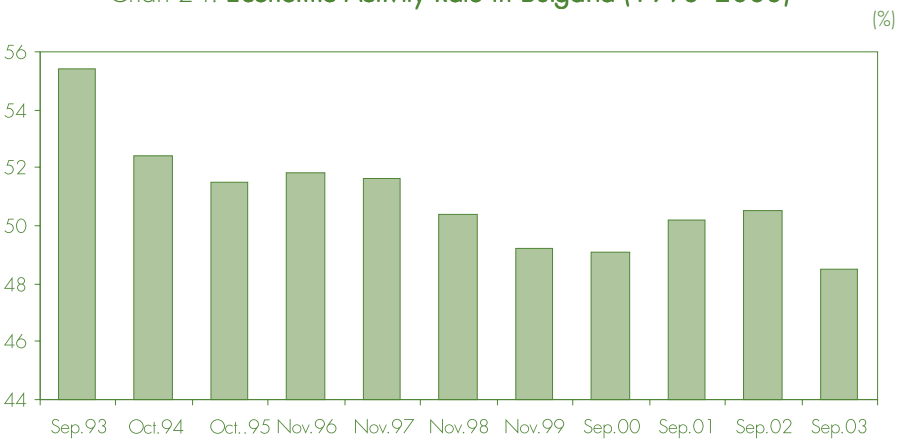
The limited opportunities to find an officially paid job led to the discouraged-worker effect and the increase in the unofficial employment in the shadow economy, thus negatively affecting the public funds. According to data from the labour force survey, in 2003 the number of discouraged workers more than doubled compared to 1994 (Cf. Chart 25) increasing from 300,000 to 400,000 people.

The percentage of labour market drop-outs has also doubled (from 5.6% to 12.1%).

A typical characteristic of this process is that it became more prominent after 1997, *i.e.* in an environment of economic growth. The possible reasons for this inconsistency may be divergent in nature[56]; however, there is an obviously low capacity of the labour market to adapt to the changing environment.

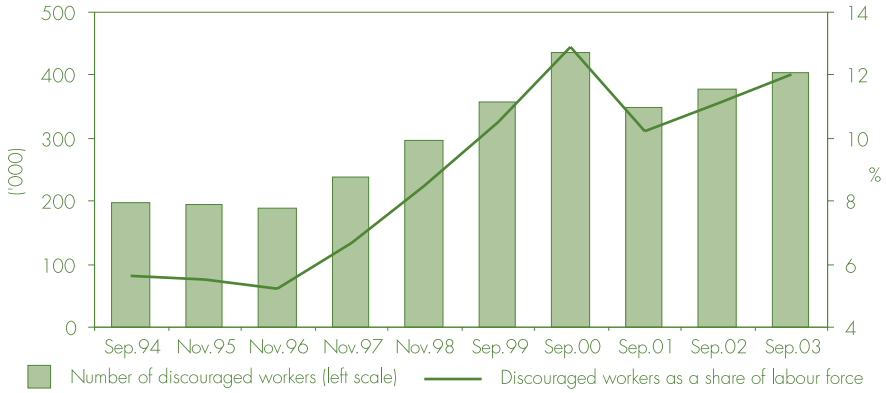
[56] Growth without job creation, economic realignment, a gap between labour force qualifications and the job requirements, *etc*.

Chart 24. **Economic Activity Rate in Bulgaria (1993–2003)**



Source: Labour Force Monitoring, NSI.

Chart 25. **Dynamics of Discouraged Workers in Bulgaria (1994–2003)**



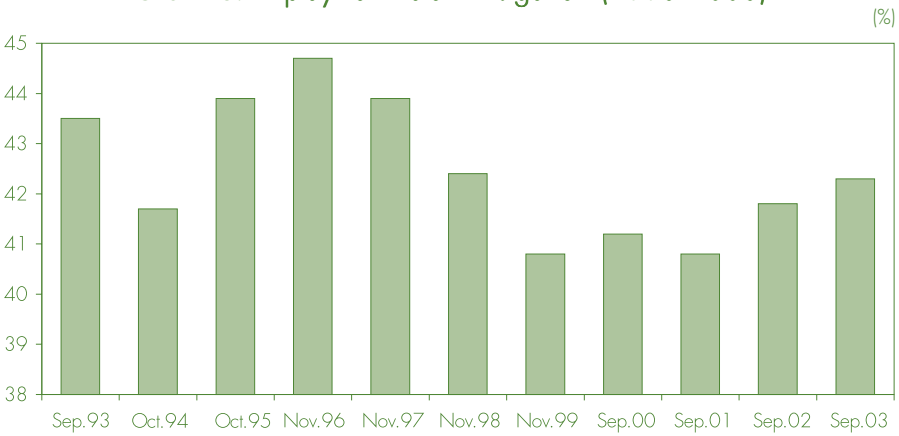
Source: Labour Force Monitoring, NSI.

The level of unemployment in Bulgaria is till too high compared with EU (15) member states (13.6% versus an average EU (15) of 8%) and just below the average (14.3%) for the newly acceded countries. Recent years have seen the beginning of a **downward trend in unemployment**. There are several major reasons at work here. On the one hand, between 1999 *and* 2003 the labour force decreased by over 100,000. Important factors determining this change are the external migration (where part of the unemployed left the national labour market) and the increased number of discouraged workers. On the other hand, large-scale programmes for subsidized job creation were implemented in 2002 and 2003, which created temporary employment for about 100,000 people. This employment is not related to any real growth in the jobs available on the primary labour market (with enterprises and institutions) but it does have a substantial contribution towards a decrease in the unemployment rate. A certain part of the positive changes in the level of unemployment came as a result of the introduction of mandatory registration of employment contracts. In this context, in 2003 some of the persons previously employed in the shadow economy joined the group of employed persons and this also has a positive impact on the unemployment level.

1. Evaluation of Employment in Bulgaria: The State and Trends

The low level of activity of economically active people is accompanied by a low employment rate. From this perspective, the labour market does not offer jobs for a major portion of the active-age population. In the 1993–2003 period, the employment rate oscillated within the range of 38 – 45% (Cf. Chart 26). This implies that **just over one-third of people aged 15 and above has found a job and is working.**

Chart 26. **Employment Rate in Bulgaria* (1993–2003)**



* The ratio between the number of employed persons and the active population aged 15 and above.

Source: Labour Force Monitoring, NSI.

The main characteristics of employment in Bulgaria in recent years can be summarised as follows:

- **The level of employment in Bulgaria is the lowest amongst the twelve acceding countries**, despite the fact that after 1999 the number of employed persons has increased by 1.8%. According to Eurostat data, the 2003 level of employment[57] in Bulgaria reached 52.5%, substantially lagging behind the level of employment in the EU, which in 2003 was 64.4% (Table 12).

Table 12

General Employment Rate, Employment among Women and Employment among People aged 55–64 years in Bulgaria

(%)

	1998	1999	2000	2001	2002	2003
Employment rate (15–64), Total						
EU-15	61.4	62.5	63.4	64.1	64.3	64.4
EU-25	61.2	61.9	62.4	62.8	62.8	62.9
BULGARIA	:	:	50.4	49.7	50.6	52.5
Employment (women)						
EU-15	51.6	52.9	54.1	55.0	55.6	56.0
EU-25	51.8	52.9	53.6	54.3	54.7	55.1
BULGARIA	:	:	46.3	46.8	47.5	49.0
Employment rate of people aged 55–64						
EU-15	36.6	37.1	37.8	38.8	40.1	41.7
EU-25	35.8	36.2	36.6	37.4	38.7	40.2
BULGARIA	:	:	20.8	24.0	27.0	30.0

Source: Eurostat.

[57] The employment level is calculated as a ratio between the number of people in employment to the number of active population aged 15–64.

- **Considerable divergences in the employment perspectives between the different age groups**. Employment among young people (aged 15–24) and the elderly at preretirement age (55–64) is considerably lower than the rate for adults from the middle-aged groups. In terms of its dynamics, **employment among young people displays an alarming decline**. During the past three years, a more favourable trend has been observed in the 55–64 age group. Employment in this age category of the labour force has increased by 10 percentage points, which should be related to the effectiveness of implemented labour market measures as well as with the extended retirement age after year 2000.
- **Ageing of the active people**. Data indicate that in 2003 over 1 million people from the active age population group fall within the 40–49 age group, with another 1 million people or so falling within the 55–64 age group. Future demographic developments in Bulgaria will be marked by a gradual increase in the number and share of people aged between 55 and 64. In accordance with EU's Lisbon Agenda, this group is subject to regular monitoring and measures to increase the level of their employment, with the goal to have the employment rate of this age group in the EU reach 50% in 2010. Data indicate that in terms of the employment rate of people from the 55–64 age group, Bulgaria is lagging behind the EU, which means, *ceteris paribus*, a higher pressure on the financial resources required for pensions and for social assistance in Bulgaria.
- **Increasing regional disparities** in employment and unemployment. There are regions emerging where unemployment has traditionally exceeded by far the average national levels: Targovishte (29%), Razgrad, Shoumen, Montana, Vidin, Smolyan (20%). The number of municipalities where unemployment is higher than the average for Bulgaria rose from 60 municipalities in 2002 to 78 municipalities in 2003.
- **Realignment of employed persons by sector and by employment status**. There has been a growth in the number of persons employed in the services sector; in 2003 they accounted for 47% of all employed persons in Bulgaria, remaining, however, below the EU average (60%). At the same time, the share of the service sector in Bulgaria's GDP is 51%. In terms of the employment status, the 1999–2003 period saw a rise in the share of self-employed within the general number of employed persons in Bulgaria. In 2003, there were more than 270,000 self-employed, comprising 9.2% of all people employed in Bulgaria.

Changes in employment take place under **a steady decrease in the annual productivity rate**[58] **of labour** after 2000. This trend is clearly pronounced in the private sector employment. One reason behind this may be sought in the relatively high growth rate in the number of self-employed, which is not accompanied by the relevant growth rate in gross value added. One of the arguments supporting this interpretation is the fact that in 2002 small and medium-sized enterprises employed more than half of all employed persons in Bulgaria, while at the same time the sector generates about one-fifth of the gross value added in Bulgaria.

An important source of productivity and competitiveness is the level of employment in high-tech industries and knowledge-intensive services[59] **(Table 13).**

[58] Measured by gross value added per an employed.

[59] High-tech and medium-tech industrial sectors include the following industries: 1) *High-tech industrial sectors*: manufacturing of computers and office equipment; manufacturing of radio, TV and communication equipment and instruments; manufacturing of medical and optic equipment; 2) *Medium-tech industrial sectors:* manufacturing of chemicals; manufacturing of machine tools and equipment; manufacturing of electrical machines and appliances; manufacturing of electrical equipment; manufacturing of vehicles. *High knowledge-intensive services includes*: 1) high knowledge-intensive services: telecom-

Table 13

Level of Employment in High-Tech Industries and Knowledge-Intensive Services

(%)

	EU-15	Denmark	UK	Greece	Bulgaria
Total, employed	100	100	100	100	100
High and medium-tech industries	7.4	11.4	6.7	2.2	5.3
Knowledge-intensive services	33.3	44	40.8	22.7	22.2

Source: *High Tech and Knowledge – Intensive Sectors Creating Employment in Europe*, European Commission, Eurostat 2003.

Bulgaria differs considerably from EU averages (yet does come quite close to that of Greece) in terms of the relative share of employed persons in both sectors. Meanwhile, it should be noted that it is precisely **in high-tech and medium-tech industrial sectors that Bulgaria generated growth in labour productivity, in the post-2000 period, which considerably exceeds the average growth in labour productivity in the industry as a whole**. Thus, for example, in the 2000–2003 period, the growth in labour productivity was 116.7% for Bulgaria's industry in general. For the same period the productivity growth in manufacturing of machine tools and equipment, manufacturing of electrical machines and appliances, manufacturing of electrical equipment and manufacturing of vehicles was over 145%.

2. Employment Policy Priorities and Goals

The main priorities and goals of employment policy were formulated on the basis of conclusions drawn from the analysis of the current state and in connection with the specific objectives addressed by the EU in the mid-term prospect. By 2010, the EU should achieve an employment rate of 70%; for women this indicator should reach 60%, with 50% for the 55–64 age group. Currently, for Bulgaria these goals are difficult to achieve. To this end, effective and efficient solutions are being explored so as to ensure that the unemployed and discouraged move to the employed persons group and reduce the inflow of new unemployed and discouraged.

The main direction in which adequate solutions are to be sought to increase employment and decrease unemployment could be summarised as follows:

1. Increase the attractiveness of employment as a source of fulfillment from working, professional development and opportunities to combine work and nonwork life

The wide proliferation of illegal employment and social security practices in a number of organisations, low and irregular payment lacking any clear connection with efforts made and performance results and unfavourable (frequently unhealthy) conditions at work feature among the main reasons behind the change in attitudes towards work, which has in recent years definitely changed and eroded, for various reasons. In terms of labour market this implies relatively poor incentives for unemployed and discouraged to join the group of employed persons. Data indicate that a part of the discouraged and the unemployed persons prefer permanently the use of suitable alternative income opportunities such as social payments and/or the shadow labour market. In the future, opportunities should be explored **to expand the scope of organisations implementing pay systems related to the level of labour performance; organisations which offer opportunities for personnel training and development and invest in the provision of safe and healthy working conditions.**

munications and postal services; computer services; R&D; 2) other knowledge-intensive services: water transport; air transport; financial intermediation; insurance and pension funds (excluding mandatory social security); property transactions; other business services; education; healthcare and social welfare; recreation, culture and sports activities.

Providing opportunities to attract some of the unemployed and the discouraged to the group of employed persons is related to **further expansion of flexible forms of employment**, including part-time jobs which are relatively underdeveloped in Bulgaria. The reasons behind the low popularity of the part-time employment are usually seen both in the popular preference for traditional forms of employment (due to the opportunities for higher income and job security). To promote the spread of flexible forms of employment, Bulgaria will adopt a policy of providing an equal treatment of part-time employees and employees on a fixed-term contract to the rest of employees. It is necessary to develop and apply **the appropriate legal framework to guarantee that persons employed under more flexible arrangements that they would not be discriminated in terms of pay, social security, working conditions, training and development, protection in case of lay-offs and in case of unemployment**. The establishment of these features of flexible employment would serve as an incentive to attract into employment certain groups of the population, particularly those who have an interest in combining work with education and/or family commitments.

To increase the attractiveness of employment, efforts are underway to find an increasingly **better balance between minimum salary levels and the level of social benefit payments and unemployment benefits**, thus providing incentives to shift away from the group of the unemployed and the discouraged to the group of employed persons. To this end, there will be regular reviews of the ratio between the minimum salary amount and the amount of social benefit payments and of unemployment benefits, and the ratio between the tax and social security/health insurance in unemployment and employment at the minimum salary. To provide effective incentives to move from the group of the unemployed to that of the employed, opportunities will be explored to ensure **a faster growth of the minimum salary *vis-a-vis* the increase in social benefit payments and unemployment benefits**.

2. Targeted retraining of unemployed persons

The rapid integration of the unemployed into the group of employed persons depends also on the degree to which their professional qualifications match the requirements of the labour market in terms of the labour force demand in a given period of time. The labour force which has one or more of the following characteristics finds itself in the relatively least favourable situation: low educational level, lack of working experience, relatively outdated package of knowledge and skills, which is seen as a limitation in terms of capacity to adapt to the dynamic changes in organisations. In this connection, three groups of persons emerge which are subject to specialised training programmes in all EU member states: young people, long-term unemployed and persons from the 55–64 age group.

Training activities are a traditional element of the labour policy in the EU member states and the rationale for this is the desire to make **timely changes in the professional and qualifications structure of the unemployed to meet the requirements and specificity of the labour market**. Taking into account some of the characteristics in the structure of unemployed persons in Bulgaria, the main challenges are associated with three target groups: young people, long-term unemployed and unemployed from the 55 – 64 age group. Hence, retraining programmes tailored to the specific needs of these groups will be implemented in the coming years. Development and implementation of effective programmes in this direction depends of their compliance with the labour market demand. In the coming years Bulgaria should start to implement modern instruments **to study the labour market demand and harmonise training programmes with the results of such studies**. Concurrently, considering the strategic direction to promote the entry of information technology in the workplace, there will be increasing opportunities to develop the necessary **computer skills among trainees in the various training programmes for unemployed**.

The targeted improving the qualifications of the unemployed intended to rapidly integrate them into the group of employed persons includes specialised programmes to develop entrepreneurial skills and knowledge in starting up businesses.

Within the training programmes for the unemployed, special prominence should be given to actions targeted at **people with the lowest qualifications who have the least favourable prospects of employability on the labour market** and which typically form the majority of the group of the long-term unemployed. In recent years in Bulgaria, the number of persons with primary and lower education in the unemployed group has decreased, yet it does not fall below 150,000 on an annual average. Their future integration in the primary labour market requires a comprehensive package of interference measures. On the one hand, it is necessary to have training programmes developing a certain package of knowledge and skills while on the other hand in subsidised programmes for temporary employment it is necessary to develop and reinforce work habits in these people who have been jobless for a long time.

3. Effective interaction and cooperation between education and business

In addressing this priority it is acknowledged that business is the main user of the educational product and considering its requirements for the labour force will have a positive effect in reducing the inflow of unemployed. In the coming years, opportunities should be sought to stimulate interaction between education and business, including through **joint forms of training during the final phase of the respective educational level**. In training in bachelor and master degree programmes, the final stage of students' training should rely on **a network of companies where internships are taken and/or research takes place** in connection with preparing the respective bachelor's or master's thesis. The employers are interested in this practice since they have the opportunity to observe the students in a real-life working environment and select suitable job applicants. At the same time, companies may encourage their highly qualified experts to take part in the educational process as lecturers at educational institutions. This is seen, on the one hand, as a tool for personnel development and, on the other hand, provides opportunities to observe in advance and recruit job applicants from among the trainees.

Interaction between education and business can be a useful tool **to synchronise curricula at the various educational levels in line with modern changes in the respective fields**. In this respect, the role of the educational system as a source of the necessary cadre for high-tech and medium-tech industries and knowledge-intensive services will rise. The further development of these is part of the strategy to increase the productivity and competitiveness of Bulgaria's economy. In parallel, **computer and language proficiency provided by the educational system should improve**. In this respect, it should be remembered that the EU has set a specific goal: by 2010 all schools in the Community should have the necessary number and quality of computers.

4. Support of the adaptability of enterprises to changes in technology, organisation and personnel

In any period of reorganisation and restructuring, enterprises are a potential source of increasing of the inflow of unemployed. Changes in companies most frequently affect people whose qualifications are characterised by the following features: a relatively low educational level and an outdated mix of knowledge and skills, which is seen as a limiting factor in their capacity to adapt quickly to the coming changes. For company, laying off personnel means a cost that can affect various resources: financial (redundancy payments, recruitment and selection of new, suitable staff), organisation and management effort, *etc*. Therefore, organisations are also interested in identifying and applying measures to reduce

cases of making their labour force redundant when there are changes in technology. In this respect, they rely on the following measures: **a systematic increase and enrichment of qualifications of personnel, and introduction of flexible forms of employmen**t (part-time employment, flexible payment, flexible working hours, *etc*.).

In the coming years, many companies in Bulgaria will experience changes associated both with introducing the respective manufacturing standards, and final stages of the privatisation. It is necessary **to create an environment that encourages employers to invest in staff training**. Key instruments in this respect include appropriate financial mechanisms (incl. tax benefits in the treatment of training expenditure) and the implementation of donor programmes for training of employed persons financed from various sources, including the European Structural Funds. In implementing these instruments, it is important to remember **the strategic objective of preventive preparation and active involvement in training programmes of elderly workers who, in case of changes in the companies are particularly vulnerable to lay-offs**. This is seen as an effective measure to increase employment among the active population from the 55–64 age group. The extensively employed measures for staff training in the companies will require the introduction, when necessary, of flexible work time for trainees.

In parallel, it is necessary **to develop the network of institutions offering continuing training**. The main requirements for their activities are set out in laws and regulations, yet the coming years will see the substantive part of efforts towards the practical implementation of legal requirements for the system of vocational education and training in Bulgaria.

The proposed priorities and goals of the employment policy refer, by virtue of their nature, to the activities at the macrolevel which will in the long run change the behaviour and efficiency of the key players at the microlevel: employers, employees, unemployed, self-employed. In their entirety, the proposed interventions should lead to a synergy effect: an increase in employment in Bulgaria combined with improvement in the quality of employment, the most comprehensive indicator for which is productivity growth.

Chapter XI.
Income Policy

Bulgaria is one of the EU candidate countries which will join the European Community with the lowest standard of living and income level. The economic growth generated in recent years has had a positive effect on the dynamics of incomes of individuals, but to an extent which is inadequate to the achieved results. This poses some serious challenges to the income policy associated with better **tying up of economic results with the income of individuals, changes in the labour market after EU accession, curbing the shadow economy,** *etc*.

1. Income Policy: the Challenges

The level and dynamics of incomes in recent years have posed some challenges to the income policy which can be summarized as follows:

1.1. Overcome the lag in income of individuals. As a result of the restrictive income policy pursued in the 1990s, high inflation, decapitalisation of the economy and the redistribution of assets, the purchasing power dropped considerably. **Real incomes of individuals in 2003 amounted to just 43% of the 1990 level**. This decline has affected all major sources of income of the population (salaries, pensions and social benefits). In the 1990–2003 period, salaries

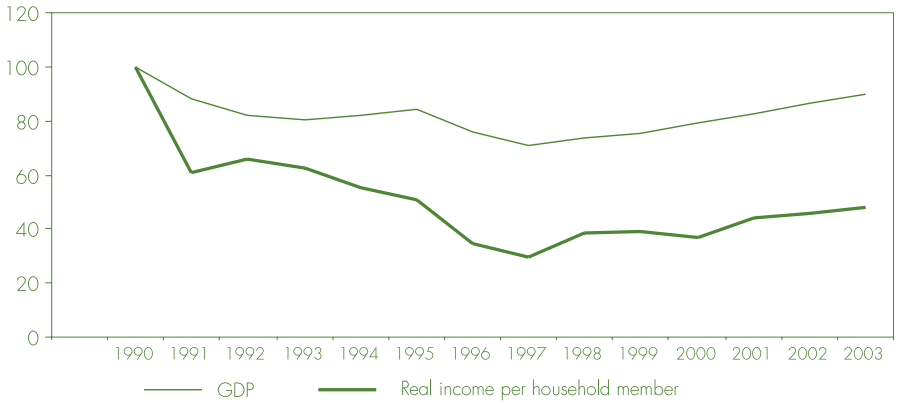
declined by 51.6% in real terms, while pensions dropped by about 65%. The decrease in minimum payments in real terms (minimum salary, social pension and social benefits) is even stronger.

The problem with the considerable loss of purchasing power was further exacerbated by the extremely low level of income compared to EU member states and the ten newly acceded states. The average monthly income per household member in 2003 was EUR 94, while in EU-15 it is more that ten times higher. Among Central and Eastern European countries, Bulgaria has the lowest income per household member.

The dynamics of real incomes of individuals has been lagging considerably behind that of GDP. In the 1990–2003 period, GDP fell by almost 10%, while real income per household member was down by 52% (Chart 27). This huge difference of 47 percentage points is a serious challenge to the income policy and is indicative of the need of changing the policy.

Chart 27. **GDP Dynamics and Real Income of Individuals, 1990–2003**

(Index 1990=100)



Source: Statistical Yearbook, NSI, Household budgets in the Republic of Bulgaria, NSI, corresponding years.

1.2. Establishment of socially acceptable income differentiation and fragmentation of individuals. The differences in the dynamics of the various sources of income have **speeded up the process of income separation in society**. It exhibits strong polarization trends[60] that are not the result of an increase in income through improvement of efficiency and productivity rates.

The *Jinni* coefficient, which measures differentiation among households according to the amount of income, shows a volatile development trend. Until 1995, it grew from 0.23 to 0.38, and then dipped to 0.31 in 2000. In the last three years, there was another rise in income differentiation, reaching the level of 0.33 (Table 14).

The polarization of the population in terms of income measured by the ratio of income between the poorest and the richest groups of the public shows the same trends as the income differentiation. In 1995, the ratio between the ten percent of the richest to the ten percent of the poorest households was 11.9 times, and in 2000 it fell down to nine times. In 2003, the ratio was 9.6 times.

In terms of salary, industries are grouped around the two extremes with a clear-cut trend towards widening the gap. Extracting industries and financial intermediation offer the highest level of pay (Table 15). Reprocessing industries (textile and clothing, leather industry), agriculture and hospitality and catering are at the other extreme. The differences between them in terms of pay are almost 3–4 times.

[60] Mostly between income earned from salaries and pension; among salaries in the various sectors and industries of the economy; between salaries and social payments.

Table 14

Differentiation of Households by Income Volume

Indicators	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Jinni coefficient	0.33	0.34	0.37	0.36	0.34	0.34	0.32	0.31	0.31	0.32	0.34	0.33
Income ratio between the poorest 10% and the richest 10% of households	7.7	8.6	10.7	11.9	10.4	10.2	9.3	8.9	9.2	9.3	10.5	9.6
Share of income of groups of persons in total income:												
- the poorest 20%	8.3	7.9	7.2	6.8	7.3	7.2	7.5	7.6	7.4	7.4	7.0	7.3
- the richest 20%	40.0	40.6	44.6	43.2	42.1	42.6	40.9	39.8	39.8	40.0	42.5	40.9

Source: Household Budgets in the Republic of Bulgaria, NSI, 1994, 1996, 1999, 2001, 2003.

Table 15

Pay Structure between Economic Activities with the Highest and the Lowest Pay, 2001–2003

(as a percentage of the average salary))

	2001	2002	2003
Economic activities with the highest pay			
- production of coke and refined oil products	241.7	239.8	231.6
- financial intermediation	212.4	214.8	228
- utilities	185	180.3	179.2
- extraction of energy resources	170.8	170.2	159.3
- extraction, excluding extraction of energy resources	150.1	150.2	139.6
Economic activities with the lowest pay			
- agriculture, forestry and hunting	77.3	74.6	74.2
- textile and clothing production	64.6	63.5	62.2
- hotels and restaurants	62.5	60	65.6
- leather and leather articles production	60.8	60.9	57

Source: Statistical Fact book, NSI, 2004.

The process of fragmentation in industry developed between employees in monopoly and subsidized industries (energy, coal mining and metallurgy) on the one hand, and the profit- and loss-making industries, on the other hand. A characteristic feature of the pay structure in manufacturing is that it has shown almost no change comparative to the years before the reform. There has been an increase in differentiation only between the highest- and the lowest-paid industries.

1.3. Increased social protection for the low-income groups. As a result of the restrictive policy, significant changes occurred in the ratios between the various types of income. The growth of the minimum salary, minimum pension and social assistance payments is lagging far behind the dynamics of the average salary (Table 15). The ratio of minimum salary to the average salary fluctuates within the range of 20–40%, and during the past 3 years it rose to 38.7% (in 2003). The social pension comprises about 19.7% of the average salary, and the average pension 39%. The guaranteed minimum income, on the basis of which social benefit payments are determined, is lagging far behind the dynamics of salary developments in recent years. In 2003, the level of GMI stood at 14.1% of the average salary.

Table 16

The Minimum Salary, Unemployment Benefits and Guaranteed Minimum Income to the Average Salary Ratio, 1992–2003

(%)

Ratios	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Minimum salary/ Average salary	35.9	38.3	35.7	32.6	27.4	23.9	24.6	31.8	33.6	37.5	36.9	38.7
Social pension/ Average salary	22.0	23.5	23.0	20.6	16.8	15.6	17.4	17.8	18.7	18.9	19.6	19.7
GMI/Average salary	19.4	23.9	21.0	18.7	16.4	13.6	14.9	18.6	16.6	14.9	14.7	14.1

Source: Calculated on the basis of data provided by the Ministry of Labour and Social Policy.

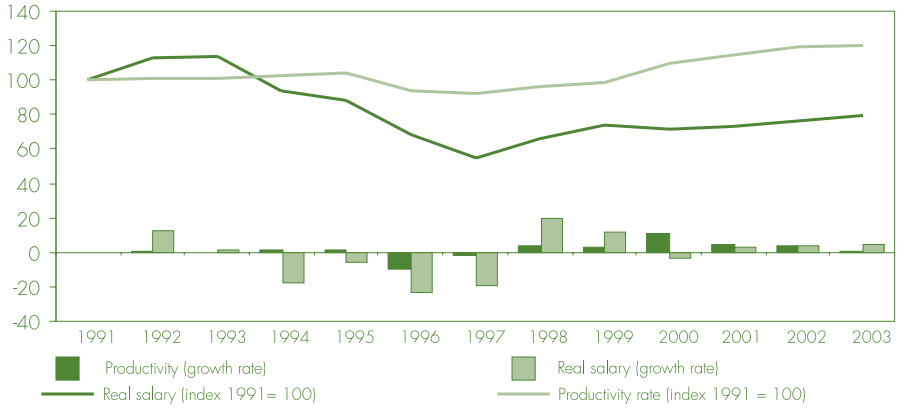
These ratios indicate that **the amount of minimum payments dooms their recipients to poverty**. Guaranteed minimum income was introduced for the purposes of social aid provision in 1992. It is determined by the government depending on the inflation rate and the available financial resources in the state budget. **Guaranteed minimum income can hardly be accepted as an adequate poverty line because it does not reflect the minimum subsistence needs of people**. The share of the people with incomes below this line is quite small (3–4%). In 2003 the GMI level was BGN 40, with about 4.3% of people having lower income. Since GMI is largely dependent on what the state budget can afford, during the entire period of the 1990s it was adjusted at a rate lower than the inflation rate. As a result, GMI has lost about 45% of its 1990 level in real terms.

According to the results of the study on poverty carried out in 2003, the recommended poverty line was BGN 102 per capita. This implies a need to update social policy in view of the new realities.

1.4. Improving the independence between the salary and economic performance. **During the 1990s, real salary fell considerably behind labour productivity** (Chart 28). Compared to 1990, labour productivity measured in terms of gross value added per person employed increased by 19%, while the real salary decreased by 24%. The gap between the indices of these two indicators showed an upward trend: from 8.8 percentage points in 1994 to 43 percentage points in 2003.

Chart 28. **Dynamics of Labour Productivity* and Real Salary, 1990–2003**

(Index 1991 = 100, growth rate)



* Gross value added per employed.

Source: Statistical Yearbook, NSI, corresponding years.

While in 1999 the salary growth in all industries was higher than the productivity growth, in the following three years, for most of the economically significant industries (textiles and clothing, chemicals, metallurgy, *etc*.) the productivity growth rate was faster than salary growth.

In 2003 labour productivity continued to grow, although at a considerably slower rate compared to the prior year. This was due to employment rate recovery which began in 2002 and is still continuing. Labour productivity across the economy in 2003 grew by 0.5%. The growth rate remained quite below the average for the latest five years (6%). **At the same time the real growth rate of salaries has been considerably higher than that of labour productivity.** In the period from 2000 to 2002, labour productivity grew faster than salaries in real terms. This was one of the conditions to increase the competitiveness of the Bulgarian economy in terms of more efficient utilization of labour resources.

The slower growth of the average salary compared to labour productivity growth, particularly in the private sector, indicates that private business has some potential for further increase in pay levels. Therefore, it can be expected that in the following couple of years there will be a faster rise in real salaries compared to labour productivity; this, however, cannot be sustained as a long-term trend.

The poor interdependence between salary levels and economic performance is one of the reasons behind the relatively weak impact of economic growth on the welfare of people. Problems exist at the microlevel, and they stem from salary bargaining. The role of income policy should be viewed in terms of creating conditions to strengthen social dialogue and bargaining at the enterprise level.

2. Income Policy: Medium-term Priorities and Goals

The challenges faced in terms of income levels in the process of Bulgaria's accession to the EU require the pursuit of an effective policy which should, on the one hand, lead to a gradual convergence to the income levels of other EU member states in the long run and, on the other hand, to the establishment of effective mechanisms to maintain social balances and particularly in terms of supporting low-income people in the short- and medium-term prospects. Such a policy should be based on clear priorities and goals as follows:

2.1. Increase in the main types of income in accordance with economic performance. This priority should be leading in the income policy in the short and medium run. It is directly related to improving distribution and redistribution relations. This means that income of individuals should be formed on the basis of real economic performance in manufacturing industries and the financial potential in the public sector. Forming income of individuals on the basis of economic and financial performance should become an underlying principle of income policy. This refers not only to salary in all sectors of the economy but also to pensions and social payments, which depend on the efficient management and operation of the respective pension and social funds and on the support of the state budget.

The capacity to implement this priority is dependent on the dynamics of economic growth and its distribution. With an estimated GDP growth of 4–5% per annum and retaining the existing distribution relations, it is possible to achieve an income growth of 3–4% per annum. This growth of income of individuals will hardly change Bulgaria's ranking in terms of the EU average. A larger increase in income levels may be expected if there is a change in distribution and redistribution relations. A closer linkage between income and productivity of labour will result in a relative increase of salary levels; this, however, is achievable in the medium- and long-term prospects. This is the most effective structural approach to increasing income without damaging the competitiveness of the national economy. Eurostat data indicate that the scale of the difference between the Bulgarian and EU average income is almost identical to the scale of difference in competitiveness.

In the short run, income growth can be generated by an increase in social transfers, and by restricting the shadow economy and legalizing income from it. There is an option, similar to what was done in Hungary, for a one-off considerable raise in income in the public sector. This will inevitably lead to an increase in all types of income, yet the effect of such an action is quite controversial. At the macroeconomic level, the consequence will be an increased budget deficit and debt, rising prices and higher unemployment. In terms of companies, this will push their competitiveness downward.

More significant changes in income levels can be expected after Bulgaria's accession to the EU in 2007. The preconditions for such expectations are based on the higher share of external funding as a result of utilizing EU structural funds. These resources will, on the one hand, increase public investment, and on the other hand they will help implement projects in underdeveloped regions, creating new jobs and increasing demand for labour force. As a result, economic growth can be accelerated, and the effect of that will trickle down into increasing household income levels. This will probably raise income levels (mostly from salaries) by an additional 1 or 2 percentage points.

EU membership implies that in the medium run the Bulgarian economy needs to converge to European average levels. Prices will experience the strongest pressure. This will lead to higher inflation. Initially, this will suppress additionally real income, which will be followed by strong public pressure to raise incomes. An adequate government policy can prevent any drastic adverse changes by creating in advance conditions to increase incomes. A structurally reasonable way to do this is through investment and increasing competitiveness; however, other short-term measures can also be used.

EU membership will change the conditions on the labour market as well. The opportunities offered by student exchange programmes will increase competition in higher education and it will improve its quality. Thus, Bulgarian companies and public administration will have more opportunities to recruit highly qualified but also higher salaried specialists. However, if they do not make the best use of this opportunity, it is possible to see the other extreme, with educated young specialists seeking professional fulfillment outside Bulgaria. Then, the structure of qualifications of the labour force will further exacerbate, which will affect income levels. In other words, there is a real risk that the Bulgarian economy may integrate into the EU, specialising in labour-intensive, low-skill industries that generate little value added.

2.2. Adequate social protection for the poor and low-income groups of people. This priority of the income policy should be realised within the framework of existing financial restrictions and on the basis of a balance between the flexibility of the labour market and security for the low-income groups. This balance should provide such a protection for the income of the low-income groups that will motivate them to participate in the labour market and actively search for jobs.

The efficiency of social protection depends on adjusting the existing system to present realities. The purpose should be to restructure the system in such a way as to ensure that funding reaches its designated beneficiary: the low-income person, the pensioner and the unemployed.

The social protection system should provide a mechanism and incentives to take the low-income people out of this group and provide them with sufficient own income. Unless this is done, the trend towards having a permanent contingent of low-income people and their reproduction will be sustained. This problem is particularly severe for the emerging ethnic and regional 'pockets of poverty'.

Social protection should be tied up with the poverty line. Indeed, the government is not in a position to provide incomes to all low-income groups with incomes that would ensure that they put poverty behind. Yet it should set such a socially acceptable line that would ensure an income level that would be sufficient to ensure

physical survival. The acceptable line might be 50–60% of the poverty line set for Bulgaria.

It is not realistic to expect that it would be feasible to ensure a high degree of social protection of one of the weakest economies in the EU such as Bulgaria's. Therefore, it is even more important that funds allocated to social protection be spent efficiently and under clearly set priorities. A definite priority is poverty reduction. Although in the past several years the general level of poverty in Bulgaria has decreased, its concentration causes serious concerns. Various programmes designed to reverse negative demographic trends should be another priority. Yet the third priority is to improve the education and skills of the low-income people, which will enable their integration in the public.

The goals of social support will be more successfully realised provided they are placed within a feasible mid-term strategy backed up by appropriate funding.

2.3. Creating conditions for a closer linkage between income and economic performance. The capacity of the government to exsert influence through its income policy is limited. Tying up income with economic and financial performance is a priority and subject of bargaining between employers and workers at the microlevel. The government can exert influence through several major instruments: minimum salary, mandatory social insurance floors, social transfers, level of pay in the public sector, and the legal framework of bargaining.

Employment of an appropriate measure and a balanced package of regulatory mechanisms may achieve a more favourable environment encouraging a stronger interdependence between salary levels and financial results. Incentives for higher pay and higher labour activity of workers can be implemented not only through regulatory mechanisms but also through broader implementation of modern payment systems (profit sharing, share options, *etc*.).

2.4. Achieving a socially acceptable differentiation of income of individuals. The current situation of strong polarisation of income levels, the transfer of income from the poor, middle- and upper middle-income groups to the richest and the generation of illegal income is alarming and requires urgent measures. In this respect, the income policy should support the other measures targeted at mitigating the factors that generate this bi-polar model of social stratification. The directions relate to: 1) smoothing out the drastic differences between income realised from salary, entrepreneurship, pensions and social payments and 2) restricting redistribution of national wealth by means of profit stripping and profit privatisation.

Differences between work pay and social transfers form the level and inequality in the income of the low- and middle-income groups. This category should also include income of the small business owners. Powerful redistribution processes carried out primarily through the shadow economy form a highest-income group that is insignificant in size but has a large weight in total income. What is typical of income in this group is that it is not generated by ownership but rather by criminal or semicriminal economic activity.

In the short run, this problem will hardly be resolved; however, urgent measures are required to restrict and mitigate it. It should also be noted that economic growth is unable to automatically regulate and reduce income inequality. Conversely, if the current redistribution processes remain in place, it will even promote inequality.

It is expected that EU membership will serve as a powerful factor to restrict the shadow economy in Bulgaria. We are already witnessing an intensive pressure in this respect from international partners. Once Bulgaria's membership is a fact and the country has become the external border of the Community, then the shadow economy fostered by illegal customs or tax transfers will be strongly squeezed out. At the same time, there is a real risk of a rise in corruption related to public spending, including EU funds.

Restricting the shadow economy will have a positive effect not only on narrow-

ing differentiation of income but also on bringing out into the sunshine and taxing significant new volumes and incomes. Unfortunately, despite the many programmes and statements made by the Bulgarian institutions and political forces during the transition, the shadow economy has far from subsided; on the contrary, it has manifested impressive flexibility, adaptability and foresight and has developed in various areas. It participated in the decapitalisation of state-owned enterprises, in privatisation, in drug trafficking, in tax evasion. This process created a stratum of people of very high income and powerful influence.

A change in terms of limiting income from the shadow economy will occur only when this becomes not an externally imposed task but rather a necessity recognized by Bulgarians. This will only occur in the presence of strong political will, close interaction among institutions and consistent support by the civil society.

In addition, with the increasing share of people who earn high legitimate income, it is adamant to adopt more effective measures and programmes (based primarily on taxation) designed to form a transfer of income from the rich to the poor. This should occur in the long run and very carefully, taking care not to destroy taxpayer motivation. In the coming ten years, we should aim at maintaining some of the lowest income tax rates and overall tax burden in Europe, including social security contributions. Taxation should also provide incentives to increase savings.

3. Income Policy Instruments, Mechanisms and Effects

Income policy is based on a limited range of tools and mechanisms for intervention. The key question is to what extent these tools and mechanisms are suitable for implementing a policy adequate to the adopted priorities and goals. The answer to this question is not trivial. It requires an in-depth analysis of the consequences of applying one set of intervention mechanisms and instruments or another.

The minimum salary has primarily a social and safety function: to protect low-skilled workers from poverty. In principle, it is not linked to economic performance but with cost of living. Increasing the minimum salary affects not only a limited range of working people but also the overall pay structure. *Ceteris paribus,* its increase will decrease the existing differentiation of pay, while exercising pressure on the size of other types of pay. A considerable raise in the minimum salary and the inability for employers to raise proportionally other salaries may discourage the staff. Therefore, the use of the minimum salary as an instrument to stimulate the increase of work pay should be cautious.

The expected rise in the minimum salary from BGN 120 in 2004 to BGN 150 (EUR 75) in 2005 will considerably overtake the nominal growth of the average salary. As a result, the *minimum salary to average salary* ratio will rise to about 53%, approximating the ratio in some developed EU member states. The increase in the minimum salary over the coming years at the same rate (25% per annum) is not desirable since this will offset the differentiation in the level of pay. Retaining this ratio in the range of 40–50% is achievable by increasing the minimum salary at rates that come close to those of the average salary.

Modification of the **minimum social payments** (social pension and social benefit payments) should be tied up with the poverty line. In this respect, it is necessary to increase the social pension and the guaranteed minimum income. The percentage increase should match the affordability in terms of public finance. With a poverty line at BGN 102 per equivalent person, GMI can be set in the range of 65–70% of that amount. On the one hand, this amount of GMI will guarantee subsistence for the poor people, while on the other hand, it will stimulate participation in the labour market and job seeking.

The linkage between the social pension and the poverty line should be stronger since the recipients of that payment cannot, take part in the labour market for

a number of objective reasons. It is logical to assume that the level of the social pension could be at least 80–90% of the poverty line.

The level and dynamics of **public sector pay** as an instrument of the income policy has an indirect effect on the formation of income of individuals. Despite the relatively small share of the public sector in GDP, the level of pay in it plays an important role for accelerating or decelerating salaries in the private sector. According to official statistics, the average level of salaries in the public sector exceeds that in the private sector. For example, in 2003 the average salary in the public sector was BGN 342 versus BGN 248 in the private sector. This anomaly is largely due to tax evasion in the private sector, which has a damaging effect on the state budget and on social security funds. The effect of the dominating role of salaries in the public sector is felt in the gradual decrease of the difference in salaries. In 2002 the average salary in the public sector rose by 10.6% versus 6.9% in the private sector, and in 2003 the situation changed: a 6.2% increase in public sector salaries versus 13.7% in the private sector. Evidently, the role of the public sector as a stimulator of increasing the average level of salaries should not be underestimated.

The key instrument for forming the level and dynamics of income from work is the **bargaining system**. The role of collective and individual labour bargaining as a major mechanism to form salaries at enterprises is extremely important. The government as a partner in the social dialogue can exert influence, but such influence occurs mostly at the macrolevel. At the enterprises, problems are resolved on a bilateral basis between employers and trade unions. It is necessary to set up legislation providing much more opportunities but also responsibilities for direct bargaining between employers and trade unions by streamlining legal requirements at the central level.

A key issue in bargaining is the weak linkage between the salary and labour productivity. In the public sector, this is due largely to the application of regulating mechanisms which provide a weak link to performance. In the private sector there is a better match between salaries and labour productivity.

Along with income regulation, a number of issues related to **the savings of individuals** also needs to be addressed. It is necessary to create conditions and interest in increasing savings, particularly when these are related to investment in pension or health insurance funds.

Therefore, resolving the issue of a closer dependence between salaries and economic performance presupposes such a microenvironment at the enterprises that would not predispose to a proinflationary setting of salary levels. This will lead to elimination of salary regulation in these organisations. Within the general financial restrictions and improvement of financial discipline, the issues boil down to balancing the powers between the bargaining parties and reinforcing the decentralised model of collective labour bargaining.

IN FOCUS

Bulgaria on the Balkans and in the European Union. Basic Economic Imperatives in the Period until 2010

Preliminary Points

A number of conventions have been adopted in the preparation of this analysis and forecast. Quite a few publications have recently been confusing the Balkans, as a political and economic region, South-Eastern Europe, which is undoubtedly a term of a broader scope than the Balkans and includes Greece, Turkey, Slovenia and other countries. The Balkans themselves, too, is a rather unclear notion in terms of the countries included. Unless deliberately stated, in our further analysis we shall consider as 'the Balkans' all countries in the region, excluding Greece, Turkey and Slovenia.

The term 'Western Balkans' has also gained currency in recent years, 'interposing' it additionally between the terms 'the Balkans' and 'South-Eastern Europe.' A number of economic and business publications and papers use the notion of 'South-Eastern part of Central Europe' as well.

Without analysing critically these various usages, we would emphasise that, for the working purposes of our analysis, we have opted for the historically established convention to call our region 'the Balkans.' At the same time, however, considering the comparative focus of the analysis, we try to draw a comparison not only with the economies of the Balkans, nor just with the economies of South-Eastern Europe, but with a broader spectrum of countries, including a number of Central European countries as well as Bulgaria's neighbours such as Greece and Turkey.

I. Introduction

Bulgaria's economic development in the coming ten years could not be discussed and forecast in isolation from the international economic and geopolitical environment, both region-wide and within the European Union area. After more than three and a half years of near stagnation, Europe's economy is not likely to bottom out in the next couple of years, either. Labour productivity is admittedly lagging behind that of the US. The European economy is burdened by serious structural and social problems that require not mere solutions but completely new concepts and models replacing the ones that have been there since the end of World War II. The historic process of the continent's integration is advancing, but the difficulties are aggravating. Deep-going and all-embracing reforms of the regulation of Europe's financial, labour and industrial markets are obviously coming, and they will undoubtedly influence the process of integration and harmonisation of the Bulgarian economy into the European economic space.

As Europe expands, the process of its consolidation as a single political and economic union is increasingly impeded by a number of political, cultural and economic factors.

As a whole, the world economy is in a state of considerable disequilibrium and imbalance due to a series of factors, primarily the state of the US economy and specifically the US current account deficit and, on the other hand, the processes of development and structural adjustment of the Chinese economy. The geopolitical environment is also in a process of momentous change, which differs in nature

from the changes over the last ten years.

The economies and the overall development of the countries on the Balkan Peninsula in particular and of South-Eastern Europe at large are also undergoing a number of substantial changes. The World Bank's latest report, *Global Economic Prospects 2005*, noted that all developing countries in the world showed faster growth in the 2003–2004 period than their average growth rate in the 1980s and 1990s. Nevertheless, the expected deceleration of the growth of the world economy as a whole in the 2005–2007 period will have an adverse impact on the Balkan region as well. All this requires an analysis of the regional and international environment, an analysis that would make it possible to outline the crucial imperatives facing the Bulgarian economy during the present decade.

II. The Balkans: New Economic and Political Characteristics

At the dawn of the 21st century, the Balkans have arguably left behind the turmoil and military conflicts experienced over the last 15 years, democracy and market economy are coming to stay region-wide, and each of the countries is working hard for its prosperity. For the first time in decades, democratically elected governments run all States in the region. For the first time they all declare common values and maintain an exceedingly active dialogue at all levels. For the first time in decades, the governments in South-Eastern Europe pursue common strategic objectives: membership in the European Union and NATO. The region's 'Europeanisation' is irreversible and gives a decisive impetus to the economic and social reforms in each of the countries. The European prospect of South-Eastern Europe was confirmed firmly and unequivocally at the NATO Summit in Prague and at the Porto Carras European Council. The EU, the OSCE and the Stability Pact play a vital role for the stabilisation of the region as a whole.

At the same time, however, viewed against the background of the sweeping globalisation and economic processes in the rest of the world, it must be emphasised that the Balkan Peninsula is the Europe's poorest part at the end of 2004. In terms of economic reform and modernisation of its economies, the Balkans in general, including Bulgaria, still lag behind their former socialist partners like Poland, the Czech Republic and Hungary. In a number of indicators they also trail the three Baltic republics that have recently joined the EU. Without discussing the history of the economic and industrial development of the countries on the Balkans, we can note that quite a few international investors continue to regard this region as risky. A number of Balkan economies have underdeveloped infrastructure and weak judicial and regulatory systems, inadequate to the progress of the ongoing reforms.

1. The Balkan Region: Economic Significance

Excluding the economies of Slovenia, Greece and Turkey, the Balkans consist of seven countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Serbia and Montenegro, Macedonia and Romania. These countries have an aggregate population of some 54 million, or 14% of the EU population. This size of population on the Balkans approximate or is slightly below the population of France or UK, but the aggregate GDP is some USD 108 billion, or 1% of the EU's GDP.

GDP per capita for 2003 varies from some USD 2500 in Serbia and Montenegro to some USD 10,700 in Croatia or USD 6400 on average, which is less than 15% of the average for the EU. The tables below include, for the purpose of comparison, Greece, Turkey and Cyprus, as well as the newly acceded countries of the former socialist bloc.

Table 17

GDP per capita (2003 estimates)

(USD)

Country	GDP per capita
Bulgaria	7 400
Romania	7 300
Greece	20 000
Turkey	7 000
Serbia and Montenegro	2 500
Albania	4 500
Croatia	10 700
Slovenia	19 000
Bosnia and Herzegovina	6 000
Macedonia	6 700
Hungary	13 900
Czech Republic	15 700
Poland	11 100
Cyprus	19 200
Slovakia	13 300
Estonia	12 300
Lithuania	11 400
Latvia	10 200
Russia	8 900

Source: Annual national statistical reports of the countries included; Database Central Europe for 2003; CIA World Factbook

As evident from the data by GDP per capita Bulgaria lags far behind all its former socialist partners that are now EU member states in terms of GDP per capita.

The next table shows the GDP produced in real terms in the countries of the region, as well as in the newly acceded EU member states former the former socialist bloc:

Table 18

Gross Domestic Product, 2000–2003

(million USD)

Country	2000	2001	2002	2003
Albania	3700	4110	4700	5400
Bosnia and Herzegovina	4570	4770	5250	5800
Bulgaria	12050	13600	15560	19930
Croatia	19030	20110	21790	27230
Czech Republic	49510	56410	69370	85390
Estonia	4970	5450	6410	8480
Hungary	45720	51850	65790	82730
Latvia	7140	7580	8440	10350
Lithuania	11230	11990	13800	18230
Macedonia	3910	3730	3740	3970
Poland	166300	185560	191670	209570
Romania	36690	39320	44430	55450
Russia	251090	309700	346060	433440
Slovakia	19120	19940	23690	32520
Slovenia	19100	19620	22120	27650
Serbia and Montenegro	-	10880	15560	-

Source: Annual national statistical reports of the countries included; Database Central Europe for 2003; CIA World Factbook

While region-wide generalisations are difficult, anyway the industrial sector continues to be based primarily on obsolete and fading technologies. Agriculture remains a rather significant sector on the Balkans, accounting for 10 to 49% of GDP of the Balkan countries' economies, against not more than 5% on average for the EU Member States.

The Balkans, whether referring to the Western Balkans or to all countries of the region, is on the whole facing serious economic challenges. The region has a number of advantages, and if the appropriate policy is pursued and international support is provided, the countries in the region can speed up and improve substantially their economic development.

In general the long-term priorities of the region include ensuring political, economic and social stability and sustaining economic growth. The key to this growth lies in the countries' capacity to attract foreign investment. It could be said that this process has been substantially accelerated over the last three years. The macroeconomic conditions and results vary by individual country. Still, to a lesser or greater extent, they are all on the way of building a relatively stable macroeconomic environment for their economies.

As evident from Table 19, since 2000 almost all countries of the region have been showing sustainable economic growth.

Table 19

GDP Growth (on a year-to-year basis)

(%)

Country	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Albania	9.6	9.4	8.9	9.1	-7.0	8.0	7.3	7.8	6.5	4.7	6.0
Bosnia and Herzegovina			32.4	85.8	36.6	10.2	9.9	5.8	4.5	3.8	-
Bulgaria	-1.5	1.8	2.9	-9.4	-5.6	4.0	2.3	5.4	4.1	4.8	4.3
Croatia	-8.0	5.9	6.8	5.9	6.8	2.5	-0.9	2.9	4.4	5.2	4.3
Czech Republic	0.1	2.2	5.9	4.3	-0.8	-1.2	-0.4	2.9	3.6	2.0	2.9
Estonia	-8.2	-1.6	4.5	4.5	10.5	5.2	-0.1	7.8	6.4	7.2	5.1
Hungary	-0.6	2.9	1.5	1.3	4.6	4.9	4.2	5.2	3.8	3.3	2.9
Latvia	-14.9	0.6	-0.8	3.3	8.6	3.9	1.1	6.6	7.6	6.1	7.5
Lithuania	-16.2	-9.8	3.3	4.7	7.3	5.1	-3.9	3.9	5.9	6.7	9.0
Macedonia	-7.5	-1.8	-1.1	1.2	1.4	3.4	4.3	4.5	-4.1	0.9	3.2
Poland	4.3	5.2	6.8	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.7
Romania	1.5	3.9	7.3	3.9	-6.1	-4.8	-2.3	1.6	5.3	4.9	4.9
Russia	-13.0	-13.5	-4.1	-3.6	1.4	-5.3	6.4	10.0	5.0	4.3	-7.3
Slovakia	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2	3.3	4.4	4.2
Slovenia	2.8	5.3	4.1	3.6	4.8	3.6	5.6	3.9	2.7	3.4	2.3
Serbia and Montenegro	-30.8	2.5	6.1	5.9	7.4	2.5	-17.7	6.4	6.2	3.8	2.0

Source: Annual national statistical reports of the countries included; Database Central Europe for 2003; CIA World Factbook.

As evident from Table 19, despite the high economic growth rates for 2003 Bulgaria ranked third or fourth on the Balkans and seventh among the Central European countries and Russia. In respect of Bulgaria, as well as Romania, the region's largest market, these growth rates are clearly insufficient to offset the huge deceleration in both economies between 1990 and 1997. In the case of Bulgaria, it is important to note that if it continues to develop at annual rates of 5.5–6%, it will still not catch up in terms of standard of living with the economies of Central Europe even by 2010, which shows that Bulgaria needs a quantum leap in economic policy.

The region of the Western Balkans consists of relatively small-sized economies. Albania, Bosnia and Herzegovina, Croatia, Serbia and Montenegro and Macedonia 'nominally' belong to this region. Serbia and Montenegro is the largest country, with a population of 8.5 million, while Croatia is the strongest economic power with a GDP of over EUR 22 billion or USD 27.2 billion. The aggregate population of the Western Balkans region approximates 25 million, or 6.5% of the EU population and some 30% of the population of the ten new EU members states. The GDP of the Western Balkans region reached some EUR 52 billion in 2003 equivalent to some 0.6% of the EU's GDP or 40% of the GDP of Portugal alone. Nominal GDP per capita at current exchange rates is about EUR 2000. At the end

of 2002 the World Bank officially classified all Western Balkans countries with the exception of Croatia as low- to middle-income economies.

It could be said that this region, economically inseparable from the Balkans, follows the macroeconomic trends typical of the rest of the countries. Table 20 includes some of the key macroeconomic indicators of the region for the 1998–2002 period.

Table 20

The Western Balkans: Macroeconomic Trends, 1998–2002

Indicators	Measure	1998	1999	2000	2001	2002
Real GDP growth	%	3.8	-3.2	4.5	4.0	3.8
Inflation (end of year)	%	15.7	16.4	36.4	12.0	6.1
Exports (excl. Kosovo)	EUR mln	8,801	7,776	9,729	10,320	11,220
Imports (excl. Kosovo)	EUR mln	16,690	15,036	18,423	21,461	23,050
Trade balance with EU	EUR mln	-4,426	-4,205	-5,061	-6,721	-7,120
Foreign direct investment	EUR mln	1,138	1,618	1,713	2,542	2,111

Source: National sources; IMF and European Commission reports.

Since the end of the Kosovo crisis in 2000, the countries of the region have been showing high growth rates (an average annual growth rate of 4%) despite the recession of the world economy. Albania posted the highest real GDP growth rate (6.5%), followed by Serbia and Montenegro (5.5%).

The Balkans at large and the Western Balkans in particular, arguably continue to pose a number of barriers, mostly at the macroeconomic level, to the attraction of foreign investments to the region.

In general, privatisation of state-owned enterprises did not follow the preannounced criteria and, failed to contribute to the emergence of a strong and competitive private sector. Nor did privatisation help achieve adequate and timely structural reforms in a number of inefficient or obsolete sectors.

The banking sector is financially and institutionally weak, especially in the smaller economies of the region, with the exception of Bulgaria, Croatia and Romania to a certain extent. Almost all national economies on the Balkans are insufficiently integrated into the surrounding markets.

Even the weak regional bilateral or multilateral cooperation of the pre-1990s period no longer exists. Development and expansion of a far more open regional market is one of the foremost priorities for the region's economies.

To develop regional trade and reciprocal cross-border investment, the countries of the region should reduce or even eliminate the trade barriers between them, harmonise customs procedures, and work together for implementing the most important regional infrastructure projects. All this implies that the region, as a whole, needs **complex long-term development strategy** to bind together the processes of accession to the EU and the practice of regional economic, trade, scientific and technological cooperation, as well as the development of the regional transport, physical and communication infrastructure.

Such a strategy could incorporate the various regional cooperation initiatives and ensure their better coordination and interaction.

This idea, already promoted at a number of high level fora by Mr Georgi Parvanov, the President of the Republic of Bulgaria, is gradually being flashed out as practical ideas: mutual opening of the countries of the region and establishment of a Southeast European free trade area; easing the movement of people in the region; development of cross-border industrial and agricultural zones, efficient use of water and energy resources and the creation of a regional energy market.

A number of large foreign investors, investment banks and multinational companies interested to enter the region also support the idea of a stronger cross-border cooperation among the relatively small and weak economies in the region.

Quite a few of the projects, mostly in the field of transport and engineering infrastructure, could not be implemented unless treated as supranational, international, cross-border projects. In turn, this requires new rules of economic and financial integration, new rules of management and financing of such projects, and new rules for operating the facilities.

To this end, political and economic trends clearly show that integration of Balkan countries and the entire South-Eastern Europe will continue to intensify at a very fast pace. The economic processes at the heart of united Europe steer the region towards such development. The migration of a number of production areas from the EU industrialised economies due to the ongoing far-reaching and deep-going reforms of labour legislation is an additional factor of the quest for new economic territories.

In terms of economic criteria, the countries of the region show divergent performance. The ongoing control over the size, allocation and quality of public spending is a key fiscal challenge, along with the reform of the taxation systems intended to improve substantially tax collectability.

Generally, it could be concluded that macroeconomic stability has been restored in almost all countries in the region, particularly since 1999.

Table 21

Average Annual Consumer Price Indexes (Inflation)

(%)

Country	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Albania	85.0	22.6	7.8	12.7	32.1	20.9	0.4	0.0	3.1	5.3	2.3
Bosnia and Herzegovina	-	-	0.2	-13.7	9.5	0.6	3.4	5.1	3.1	0.3	0.1
Bulgaria	72.8	96.0	62.1	121.6	1058.4	18.7	2.6	10.3	7.4	5.8	2.3
Croatia	1516.6	97.5	2.0	3.5	3.6	5.7	4.1	6.2	6.2	2.2	1.8
Czech Republic	20.8	10.0	9.1	8.8	8.5	10.7	2.1	3.9	4.7	1.8	0.1
Estonia	89.8	47.7	29.0	23.1	11.2	8.2	3.3	4.0	5.8	3.6	1.3
Hungary	22.5	18.8	28.2	23.6	18.3	14.3	10.0	9.8	9.2	5.3	4.7
Latvia	109.2	35.9	25.0	17.6	8.4	4.7	2.4	2.6	2.5	1.9	3.6
Lithuania	410.4	72.1	39.5	24.6	8.9	5.1	0.8	1.0	1.3	0.3	-1.2
Macedonia	338.7	127.5	15.7	2.3	2.6	-0.1	-0.7	5.8	5.3	2.4	1.2
Poland	35.3	32.2	27.9	19.9	14.9	11.8	7.3	10.1	5.5	1.9	0.8
Romania	256.1	136.7	32.3	38.8	154.8	59.1	45.8	45.7	34.5	22.5	15.3
Russia	878.8	307.5	198.0	47.9	14.7	27.8	85.7	20.8	20.7	16.0	13.7
Slovakia	23.0	13.4	9.9	5.8	6.1	6.7	10.7	12.0	7.3	3.3	8.5
Slovenia	31.9	21.5	13.5	9.9	8.4	7.9	6.2	8.9	8.4	7.5	5.6
Serbia and Montenegro									89.2	16.5	9.4

Source: Annual national statistical reports of the countries included; Database Central Europe for 2003; CIA World Factbook

Apart from Romania, which is progressively reducing its substantial annual inflation rate, throughout the Balkan countries the average annual index has been stabilised at a relatively low level.

As another positive development, economic growth of the Balkan region countries is largely due to remarkably accelerated development of the industrial sectors at the expense of agriculture. Moreover, this trend has been sustained. This trend emerged in early 2000 and is still in place, having even accelerated. There is a ground to believe that it will sustain until the end of the decade. The efforts of the governments in the region to enhance the competitiveness of their economies, which disrupted after 1989, is one explanation. Certainly, quite a few problems in agriculture remain unsolved, and this will probably be one of the new 'waves' of development between 2005 and 2010.

Table 22

Industrial Production Growth

(%)

Country	1996	1997	1998	1999	2000	2001	2002	2003
Albania							-	-
Bosnia and Herzegovina						-		-
Bulgaria			-7.9	-9.3	5.8	0.1	2.6	4.0
Croatia			3.7	-1.4	1.7	6.0	5.4	4.1
Czech Republic	2.0	4.5	1.6	-3,1	1.5	10.8	4.8	5.8
Estonia	2.9	14.6	4.1	-3.4	14.6	8.9	8.2	8.3
Hungary	3.4	11.1	12.5	10.4	18.1	3.8	2.6	6.4
Latvia	1.4	6.1	2.0	-8.8	3.2	8.4	5.8	6.5
Lithuania	5.0	3.3	8.2	-9.9	2.2	16.1	3.1	16.1
Macedonia						-3.1	-5.3	4.7
Poland	8.3	11.5	3.5	3.6	6.7	0.6	1.1	8.4
Romania			-13.8	-7.9	8.2	8.2	6.0	3.1
Russia						4.9	3.7	7.0
Slovakia	2.5	1.2	5.4	-2.0	8.4	7.6	6.7	5.3
Slovenia	1.0	1.0	3.7	-0.5	6.2	2.9	2.4	1.4
Serbia and Montenegro				-23.0	11.0	0.0	1.7	3.8

Source: Annual national statistical reports of the countries included; Database Central Europe for 2003; CIA World Factbook

The most striking impression that the figures cited leaves is that **Bulgaria is the worst laggard in terms of industrial production growth compared to all other countries in the region (excluding Serbia and Montenegro).**

This implies that the volume of production is still below the potential capabilities of the Bulgarian economy and that Bulgarian industrial products are noncompetitive. The low level of Bulgarian exports is also one of the main reasons behind the accumulated balance of payments current account deficit. This low level furthermore results from poor and inefficient privatisation policy and practice, as well as from the delayed structural reforms.

On the whole, compared to the rest of the former socialist countries, the structural reforms in Bulgaria's industry are most belated and are largely unfinished. Hence this determines the low competitiveness and the number of latent risks to the Bulgarian economy, especially in the sphere of employment. A number of industrial sectors in Bulgaria, like heavy mechanical engineering, the chemical and fertilizer industries *etc*., are essentially untouched by a modern structural reform. Their economic and technological stagnation continues to hold back the Bulgarian economy.

Table 23

Total Export (at current prices)

(million USD)

Country	1996	1997	1998	1999	2000	2001	2002	2003
Albania	-	-	-	-	-	-	-	-
Bosnia and Herzegovina	-	-	-	-	-	-	-	-
Bulgaria	4 689	4 809	4 194	4 006	4 825	5 107	5 739	7 439
Croatia	-	-	4 517	4 302	4 432	4 659	4 904	6 164
Czech Republic	-	-	25 906	26 242	28 998	33 403	38 116	48 723
Estonia	2 104	2 942	3 238	2 995	3 832	4 012	3 432	4 511
Hungary	-	-	23 005	25 012	28 092	30 498	34 337	42 891
Latvia	1 451	1 679	1 816	1 717	1 866	2 008	2 288	2 910
Lithuania	3 356	3 863	3 711	3 004	3 809	4 583	5 476	7 217
Macedonia	1 147	1 237	1 311	1 191	1 319	1 155	1 113	1 359
Poland	24 440	25 751	28 229	27 407	31 651	36 092	41 010	53 577
Romania	-	-	8 302	8 487	10 367	11 385	13 876	17 618
Russia	-	-	74 400	75 600	105 000	101 600	107 301	135 404
Slovakia	-	-	10 720	10 229	11 845	12 635	14 381	21 840
Slovenia	8 306	8 372	9 051	8 546	8 732	9 252	10 357	12 539
Serbia and Montenegro	-	-	-	-	-	-	2 275	2 537

Source: Annual national statistical reports of the countries included; Database Central Europe for 2003; CIA World Factbook

To complement the picture, let us also consider import figures by year and by country, which illustrates the sustained upward trend of trade deficits in the Balkan economies.

Table 24

Total Imports (at current prices)

(million USD)

Country	1996	1997	1998	1999	2000	2001	2002	2003
Albania	-	-	-	-	-	-	-	-
Bosnia and Herzegovina	-	-	-	-	-	-	-	-
Bulgaria	-	-	4 957	5 515	6 494	7 261	7 903	10 742
Croatia	-	-	-	-	-	9 044	10 722	14 199
Czech Republic	-	-	28 432	28 073	32 169	36 489	40 397	51 306
Estonia	2 448	2 804	4 380	4 587	3 556	4 930	4 787	6 475
Hungary	-	-	25 706	28 008	32 079	33 682	37 612	47 673
Latvia	2 333	2 734	3 196	2 935	3 190	3 519	4 056	5 270
Lithuania	4 559	5 643	5 794	4 835	5 457	6 353	7 709	9 803
Macedonia	1 627	1 779	1 915	1 776	2 085	1 688	1 962	2 211
Poland	37 137	42 308	47 054	45 911	48 940	50 275	55 113	68 004
Romania	-	-	11 838	10 557	12 050	14 354	16 487	24 003
Russia	-	72 000	58 000	39 500	44 900	53 800	60 966	75 418
Slovakia	-	-	13 073	11 321	12 734	14 760	16 497	22 482
Slovenia	9 397	9 366	10 111	10 083	10 116	10 145	10 932	13 596
Serbia and Montenegro	-	-	-	-	-	-	6 320	7 510

Source: Annual national statistical reports of the countries included; Database Central Europe for 2003; CIA World Factbook

Certain analysts are trying to attribute Bulgaria's trade deficit to the fact that this country's growth rates are higher than the growth rates of its major trading partners and this activates the so-called *Houthakker – Magee* Effect, named after two US economists who discovered the effect in 1969.

In other words, Bulgaria's growth 'absorbs' more imports than the growth of its major trading partners of the EU can 'absorb' from Bulgarian exports.

However, statistics on the Central European EU members states, such as the Czech Republic, Poland and Hungary show that these three economies have relatively stable trade surpluses, even though they are far more open to the EU than the Bulgarian economy.

Thus, the three Central European economies showed the following trade surpluses for the January – August 2004 period:

Chart 29. **Foreign Trade Growth (EUR-denominated) of the Czech Republic, Hungary and Poland, January – August 2004**

(per cent, year-on-year basis)

The income situation in the Balkan region economies is an essential component of the economic picture there. In each of these economies, the real income is far below the average in the EU (15).

This indicator is particularly low in the case of Bulgaria, even in comparison with economies that have recently been affected by civil wars and political and economic instability. Official statistics on gross monthly wages show the following state of play:

Table 25

Average Gross Monthly Wages

(USD)

Country	1996	1997	1998	1999	2000	2001	2002	2003
Albania		61	71	87	92	102	-	-
Bosnia and Herzegovina			258	274	255	298	318	414
Bulgaria			104	109	112	114	131	164
Croatia					588	602	663	806
Czech Republic	356	337	362	366	350	385	479	599
Estonia	251	258	284	301	287	315	370	484
Hungary			315	326	311	361	474	611
Latvia	181	207	226	240	247	256	281	339
Lithuania	155	195	232	247	252	245	276	345
Macedonia						285	300	368
Poland	324	324	355	430	442	503	524	566
Romania			149	125	133	146	160	198
Russia	154	164	103	61	79	112	141	180
Slovakia			284	259	247	256	298	391
Slovenia	952	900	951	953	863	877	967	1 204
Serbia and Montenegro						-	-	-

Source: Annual national statistical reports of the countries included; Database Central Europe for 2003; CIA World Factbook

Bulgaria has the lowest average gross monthly salary, ranking behind such countries as Bosnia and Herzegovina, Croatia and even Macedonia. This lag suggests that the country's integration into the EU will be particularly costly in social terms, especially considering that Bulgaria has not yet completed structural reforms in a number of key industrial sectors. The further progress and completion of structural adjustment will result in more redundancies that will exert pressure on the labour market whose capacity is too limited for an adequate reaction. The income situation in Bulgaria is explosive and leads to a delay in a number of other economic processes in the country.

Notably, some of the major challenges to improvement of the economic situation of the Balkan countries, albeit of a receding significance, are of a noneconomic nature.

Political instability in some of the countries, as well as the existing and latent hotbeds of potential conflict or war, retain their influence as very strong deterrents to a number of international investors. Corruption affects both the governments in the region and the private sector. The judicial systems are still weak, and many of the small national economies have not aligned their legislation with European law, have undertaken legislative revisions of unpredictable volume, quality and timeframe, and have inefficient judicial procedure and overall application of legislation. In this sphere, the international donor community can exert a far more significant and effective influence than it has so far. The "fullest possible integration of the countries of the Western Balkans into the political and economic mainstream of Europe," confirmed in June 2000 by the Santa Maria da Feira European Council as its objective, offers a strong incentive for gradual adoption of the standards of conduct and accountability and the economic criteria of the euro area by all countries in the Balkan region.

Albeit to a lesser degree, Serbia's slowed-down economic development remains among the key barriers to full economic stability and development in the region. The recovery and growth of the Serbian market will give essential impetus to an overall economic revival of the region.

2. The Balkan Region: New Characteristics and Imperatives

An analysis of the economic performance of the countries in the region clearly identifies a trend towards faster and higher-quality economic growth compared to the first half of the 1990s and particularly in the post-2000 period. The key to turning this growth into a sustained characteristic of the economic policies of most of the countries in the region lies in an improved attraction of both private domestic and foreign investments.

A number of international organisations as the World Bank, the Organisation for Economic Cooperation and Development (OECD), the Stability Pact Round Table on economic reconstruction, development and cooperation, the Transatlantic Business Dialogue (TABD) organisation, the European Round Table of Industrialists *etc.*, have done a huge amount of work in recent years, analysing the key problems and factors determining acceleration of investment in the Balkan region. Instead of reproducing a number of their conclusions, we will dwell on some of the most critical factors that define economic development of the region and respectively of Bulgaria during the present decade.

It is important to emphasise that, for a number of geopolitical reasons the international community is starting slightly to lose interest in the Balkans. The 'window' of an intensified official financial support that had been opened for several years now is likely to close. Over the next five or six years, political, financial and institutional Europe will be preoccupied with its own restructuring and social reform problems. At the same time, these several years until 2010 will be critical for the Balkan countries, given the delayed reconstruction of their economies, the completion of market reforms, and the creation of an environment capable of attracting and promoting investment and of maintaining the appropriate economic growth without external assistance.

Continued structural reforms. A number of governments in the region share the understanding that strict policies of fiscal and monetary discipline will be sufficient for economic success. Certainly, principled macroeconomic policies resting on strong fiscal discipline are vital for a sustained macroeconomic stability of the countries in the region. But they are far from sufficient to ensure effective and successful economic development.

In the coming years, the governments and the private sector will tend to concentrate their efforts on the microeconomy. The focus will be on the second wave of privatisation or on the ongoing post-privatisation process, on a further privatisation and restructuring of a number of state-owned and social assets, on further liberalisation of all existing legal and regulatory measures related to the functioning of private sector and labour market, as well as on further strengthening the financial and banking sector.

A number of Bulgarian economic sectors will have to 'open' to a more active investment policy. The energy industry ranks first among these sectors. The severe deficit of generating capacities will require after 2007 a series of strategic steps on the part of the Bulgarian government. The country's lag in the transport, physical and communication infrastructure is just as critically important. Bulgaria will undoubtedly experience an exceedingly strong competition from its neighbours Turkey and Greece in these industrial sectors.

Structural reforms in the sphere of pensions and social insurance will receive particular attention in the next couple of years. Taking into account that united Europe is launching sizable reforms in this sphere, as well as in liberalisation of

labour market regulation, this shift will be simply imposed on all countries of the region, both the EU members and those that will start negotiations for membership.

The consolidation of the banking and financial sector, including financial services, will continue. Given the huge intercompany debt, whether the business community likes it or not, the private sector will experience cataclysmic changes that will radically transform the existing structure of a number of large private companies. This will make possible a narrower specialisation of a number of sectors and hence, their region-wide and Europe-wide internationalisation.

Comprehensive new policy aimed at improving the business environment and the investment climate. As repeatedly emphasised above, the key to the really needed acceleration of economic growth lies in the attraction of domestic and foreign investment. In general, the South-Eastern Europe (the Balkans plus Greece, Turkey, Slovenia and Cyprus) attracted a relatively small amount of foreign investment in 2003 according to world standards: just USD 3.2 billion. In the case of the Balkan countries, the reasons are clear: a weak and underdeveloped infrastructure, political instability, high company indebtedness illogical by world standards, incompetent, unwieldy and corrupt bureaucracy. All these reasons put off the majority of venture investors and prevent these economies from projecting a new, attractive image.

Regardless of the fast increase in the volume of foreign investment attracted to Bulgaria over the last eighteen months, this volume is still below the capacity of the Bulgarian economy to 'absorb' effectively a specific amount of direct investment. As a result, some sectors of the Bulgarian economy remain paralysed, and the national communication, engineering and transport infrastructure does not meet the standards required from a country preparing to become a full EU member. Certain legislative measures have been taken over the last two years to improve the investment climate, to speed up the competitive bidding procedures for sale and privatisation, to liberalise all regulatory requirements, from a foreign legal person's establishment to full-fledged functioning, but this still leaves much to be desired.

Foreign investors and investment banks invariably rank Romania as the country that offers the most attractive investment climate in our region. Bulgaria and Turkey contest the second and third place, and Greece ranks fourth. Not accidentally, Romania tops the ranking of Central and Eastern European countries by the value of cross-border mergers and acquisitions concluded between January and September 2004, as emphasised in the official classification of *The Economist*. The amount of individual company purchases in Romania hit a record high in the region in 2004. Romania reported a record high throughout Central and Eastern Europe. All this shows that despite its relatively better legislation, Bulgaria is losing the race against Romania for the time being. At the same time, the radical improvement of the economic environment in Turkey, the wide scale privatisation programme planned by the Greek government, and Serbia's further opening and reform will stiffen the competition for attraction of foreign investors to this region.

One should keep in mind that at the end of 2004 Bulgaria ranked a distant ninth among all countries of Central and Eastern Europe in terms of attracted foreign investment. This position, coupled with the fact that Bulgaria has the largest gap to close with the newly acceded EU members of Central Europe and the three Baltic republics, reveals the importance of the economic policy that has to be implemented in coming years.

From this point of view and given the vital need of enormous investments for radical acceleration of the economic and social processes in Bulgaria, the need of a continued and accelerated improvement of the overall investment climate in the country is obvious. The next Bulgarian government should adopt such improvement as its active policy.

Such a policy will require revision of a number of effective legislative standards and acts, such as the Privatisation Act, the Commercial Act, a number of tax laws and regulations, licensing systems *etc*. A number of institutions, established to attract and assist foreign investors, will have to review their structures, objectives, functions and methods of operation. A number of issues as transfer pricing, international property rights, access to local and international financing, sales of local property *etc*. are not addressed at all by the effective statutory framework in Bulgaria.

This issue should not be underestimated because Bulgaria will enter a completely new competitive environment in 2007, a new competitive environment not only in the EU but in this region as well. The 'return' of Serbia and Montenegro as a regional economic power will catalyse additionally regional trade and all communication links; it will "bring back into the game" a market of 10 million consumers. This will be a major advantage for those knowing how to use it but, at the same time, will add one more competitor for foreign investments in this region.

Radical and effective fight against corruption and organised crime. There are no incumbent or potential investors that do not place organised crime and corruption on top of their list of stumbling blocks to their development in the region. Regrettably, Bulgaria is not an exception.

For most countries, the key problem is the ubiquity of corruption, but in some countries of the region organised crime has institutionalised itself to an extent that it poses a threat to statehood and law and order. Corruption dominates both the public and the private sectors. In the public sector, the mechanism of decision-making with its numerous steps of obtaining clearances and consents, with the lack of openness and information, as well as with the lack of a clear and categorical legislative environment, breeds an environment in which corruption cannot be stopped but, worse yet, it thrives and puts off any investment that does not match the rules of corrupt behaviour.

In this sense, it could be said that corruption has established itself as a fixture of local business culture over the 15 years of reforms. The fight against corruption can produce tangible results only if the firm EU anti-corruption and corruption prevention measures are introduced and clear legislation and open procedures for all decisions are adopted. This question is also related to judicial reform.

A new imperative of economic development in the coming years is particularly important for Bulgaria. **The conventional understanding of the emerging economies is likely to change over the next two or three years, and Bulgaria should benefit from this**. During the last 15 years of reforms, emerging economies were traditionally associated with the inherent nature of institutional maladjustment to the market, with their internal vulnerability to external shocks, including exchange rate fluctuations *etc*. The bulk of the emerging economies now are characterised by far greater tenacity and resistance to external shocks, by macroeconomic stability which also allows them to follow a broad spectrum of investment strategies.

This phenomenon, typical of much more stable financial and economic conditions, manifests itself in countries like China and India, Brazil, Mexico, Russia and South Africa; it also largely applies to Bulgaria. The country displays a faster economic growth, advanced trade relations with its major trading partners, an acknowledged market economy, fairly advanced institutional forms of this economy, an improving quality of credit, a dramatic reduction of the impact of traditional inflationary pressures, internationalisation of the local banking system, *etc*.

In other words, Bulgaria as part of this group of fast-developing emerging economies is already on the verge of a different type of economy. The country's credit rating upgrade is also a proof. There are only two such economies on the Balkans: Bulgaria and Romania. In a number of the indicators listed above, Bulgaria performs better than its northern neighbour does. This progress, the increased international credibility, however, is not properly employed for comprehensive internationalisation of the Bulgarian economy.

Turkey is the other neighbouring country that runs neck-and-neck with Bulgaria on these indicators. During the present decade, the Turkish economy is expected to unfold its full potential and to turn into one of the most successful economies straddling the Europe – Asia divide. This progress is not only related to Turkey's European prospect, it is the result of over 30 years of economic crises and wavering in economic policy, but also of consistently carried out reforms. In the coming years, the Turkish economy will be growing at an annual rate of at least 7.5% (the country's GDP grew by 5.9% in 2003 and by 10.1% for the first quarter of 2004), under they ongoing strong structural reform in the public sector. Annex 4.1 presents some key macroeconomic correlations for the Balkan countries and Germany as a base of comparison, annualised for the 1994–2003 period.

In the light of this analysis, it would be correct to say that Bulgaria and Turkey are the two economies in South-Eastern Europe and on the Balkans capable of making really radical progress within the present decade. Greece is plagued by a dramatically unbalanced budget and the disequilibrium will take several years to redress. Besides, the Greek economy is under the strong influence of the euro area economies, and is thus susceptible to a number of Europe's weaknesses. **What Bulgaria needs is a principled policy of noninflationary growth based primarily on improving labour productivity and modernisation of the entire national economy**. Bulgaria stands little chance of relying on an economic growth induced by positive external shocks due to the fact that Europe, as a whole, is entering a new phase of instability and slow growth.

III. Conclusions

The analysis invites the following conclusions:

- The region of the Balkans and of South-Eastern Europe as a whole is well positioned in respect of the changing economic conditions within the present decade. The region's economies are recovering, largely boosted by the need of domestic reform, as well as by irreversible 'Europeanisation' of all countries in the region.
- The emerging tendency of a global economic slowdown during at least three or four years to come will dictate a faster and stronger expansion of regional integration efforts, whereupon the traditional cooperation capabilities of the private sector should be complemented by a series of cross-border infrastructure and other public projects and initiatives.
- The opportunities to improve the regional indicators of the individual countries' economic development should also lead to a broadening and deepening of the regional financial markets with appropriate integration into the international financial and capital markets. In this sense, both foreign and local investors and companies should view the region as a source of long-term investment opportunities for extraregional capital, but also as a potential for further diversification of intraregional capital.
- The focus on the Balkans as a region should not be absolutised. The strong differentiation among individual economies is a reality. Changes down the years are also dynamic, which means that the shift of policies, the attraction of investments, *etc*. can change the situation of one economy or another.
- At present, regional cooperation is not pursued on the basis of vertical integration, whether in manufacturing or trade. This is one of its weak points. In the coming years, this vertical integration process will intensify dramatically. The region needs an **integral long-term development strategy** to bind together the processes of accession to the EU and the practice of regional economic, trade, scientific and technological cooperation. Such a strategy could incorporate

various regional cooperation initiatives and ensure their better coordination and interaction. Furthermore, such a strategy is required in order to accomplish the practical objectives of implementing a number of supranational, cross-border projects in this region.

- It is important to emphasise that Bulgaria, as well as the rest of the Balkan countries, stand everything to gain from the development and implementation of such a strategy. The developed countries in the region such as Bulgaria, Romania, Turkey and Greece should undertake the responsibility for development of an effective policy and strategy to support and promote the development of all neighbouring countries. This will by all means boost the Bulgarian economy as well.
- In the coming years, the governments and the private sector will concentrate their efforts on the microeconomy. The focus will be on the second wave of privatisation or on the ongoing postprivatisation process, on further privatisation and restructuring of a number of state-owned and social assets, on a further liberalisation of all existing legal and regulatory measures related to the functioning of private sector and labour market, as well as on further strengthening the financial and banking sector.
- In attracting foreign investments Bulgaria is losing the race against Romania for the time being. At the same time, the radical improvement of the economic environment in Turkey, the wide scale privatisation programme planned by the Greek government, and Serbia and Montenegro's further opening and reforming will stiffen the competition for attraction of foreign investors to this region.
- From this point of view and given the vital need of enormous investment for radical acceleration of the economic and social processes in Bulgaria, the need of a continued and accelerated improvement of the overall investment climate in the country is obvious.
- Regardless of the relatively stable and high economic growth shown by Bulgaria, even with an average annual growth rate of some 6%, by the end of 2010 Bulgaria will still have not reached the standard of living of the new EU member states from Central Europe.
- Unless a different economic and social policy based on a more radical modernisation of the national economy is adopted, Bulgaria will start lagging behind Romania as well in key standard-of-living indicators. In terms of GDP per capita and standard purchasing power, Bulgaria will be the economically and socially poorest country upon its entry into the EU in the beginning of 2007.
- What Bulgaria needs is a principled policy of noninflationary growth, based primarily on a radical improvement of labour productivity and on modernisation of the entire national economy.
- A number of serious world forecasts show that a 'geopolitical quake' can be expected in the Middle East and in Asia at the end of the first decade of the 21st century. In any case, Bulgaria should be prepared, economically and socially, for any geopolitical surprises that may occur in the world. This all the more requires a more radical economic policy geared to the keen competition that Bulgaria will face both from the EU and in respect of global geopolitical changes. Traditionally, authoritative publications like *The Economist* forecast that Bulgaria will slow down its economic growth. If this alarming forecast proves right – which depends on the economic policy pursued, then Bulgaria's lag will already be fateful.

Summary

Bulgaria's integration in the European Union is a lengthy process. Its beginning was marked when the country started complying its legislation and institutions with the ones of the Union and companies started adopting strategies that would make them equitable actors on the common European market. Today, when Bulgaria has implemented all membership criteria adopted by the European Union in Copenhagen, when accession negotiations have already come to an end and we expect the accession treaty to be signed in a few months, when nearly 60% of foreign trade turnover is with EU member states, we are still in the middle of the road. When will Bulgaria's integration in the EU end? The reply is difficult but in any case this will not be the membership date. Maybe this will be the day on which the Bulgarian economy will become part of the European one and the country will be interested in its economy to be regulated by supranational European institutions. Or when we stop being net recipients of resources from European funds and the level of development allows our contribution to be at least equal to the resources received. As a matter of fact the date is of no significance – what is important is the development as of this moment. The challenge to Bulgaria, which is at the bottom of the list among the EU member states in terms of the major economic indicators, is to become an organic part of the EU with a contribution of its own to its strengthening and development.

Consequently, this country should develop faster than the current EU member states. The faster the better. This is the **first** challenge. The **second** challenge is related to the partial waiver of national economic policy and the adoption of the policy of the supranational European institutions. The danger in this case is that if a certain event affects the Bulgarian economy more than the larger part of the European one (which in the language of economics is called an asymmetrical shock) then we would not be able to rely that the European institutions will take the appropriate measures. And *vice versa* – when these institutions decide to act it would be better for Bulgaria to have the same problems and advantages as most European countries. The **third** challenge is related to the vast economic and social imbalances that exist between Bulgaria and the EU. They will lead to substantial tensions in the course of integration, which will require both public consent and support and adequate compensatory policy on the part of Bulgaria. The **fourth** challenge is connected with companies and their capacity to simultaneously comply with European law and to be competitive on one of the most developed and demanding world markets. Here the link between macroeconomic and microeconomic policy, which permeates the entire report, becomes particularly clear. The adaptation of companies is not only a corporate but also a government issue. It requires coordination between national policies and corporate strategies that are to achieve common objectives.

1. Economic Policy: Clear Objectives, Long-Term Priorities and Cooperation

The challenges specified require setting clear objectives and pursuing a proactive policy for their achievement. One of the main indicators of the extent of integration of the Bulgarian economy is its convergence. Convergence means not

only connection through the channels of trade and financial flows but unity: the higher it is the more one could say that the Bulgarian economy is an organic part of the EU one. Then the common European policies that are grounded on objectives common for the EU and not on the objectives of individual members will be relevant and useful for Bulgaria. Consequently, convergence is an important objective in the medium and long run and should be encouraged and measured continuously according to clear and transparent indicators. It is an absolutely essential condition also for Bulgaria's participation in the euro area and the adoption of the euro. The convergence of the Bulgarian economy outlines very clearly the economic policy that has to be pursued, and this way protects society to a great extent against irrational actions of the government with unpredictable consequences. In this sense it is a highly disciplining restrictor. In spite of these positive aspects the policy of enhancing economic convergence should not be overestimated. It is a response to the second challenge and facilitates the partial waiver of national sovereignty and the adoption of the supranational European policies. However, it provides no answer as to how exactly accelerated economic development will be achieved that would overcome the great economic and social differences between Bulgaria and the EU member states. A reply should also be given to the question how under still low level of convergence and the consequent asymmetrical negative shocks in Bulgaria their effect will be absorbed and dampened.

All these issues have a solution that is related to the substantial increase of the economy's productivity. Why is productivity the 'magic' element that has to become the core of economic policy in the next decade? Because higher productivity means higher economic growth and higher standard of living. Because it provides the answer to the question how will incomes grow with the inevitable growth of prices on entering the EU. Because higher productivity makes the national economy competitive and inoculates it against negative foreign influences.

In general the productivity of the economy is measured by a unit of produced product per an employed person. However, while we analyse the general economic and the general social aspects of productivity we analyse the gross domestic product per capita. This is indeed the accurate measuring unit for the product that is created by every Bulgarian citizen. Consequently, the more GDP is created by a constant number of the country's population the higher the productivity. The report analyses the main channels for increasing productivity. In the modern economy they are less related to increasing the traditional production factors – material resources, labour and capitals. The answer should rather be sought in the more efficient use of these factors. In the EU this is called the 'knowledge-based economy'. The quality and effectiveness of the legislation and the institutions, creating the framework for the economic activity are another crucial factor in that sense.

Two main remarks are made in the course of studying productivity, which are extremely important for determining the respective policies. In the first place it should be taken into consideration that productivity should be analysed by assessing the dynamics of the EU. After the adoption of the Lisbon Strategy in 2002 the EU is making significant efforts for and is investing much resources in increasing its productivity and for building a knowledge-based economy. Consequently, Bulgaria is facing the difficult task not to lag behind, in addition to increasing its own productivity faster than the EU, especially in the long run, in order to be able to reduce the differences with the Union. The second important remark is connected to the fact that the production of the national economy depends on business: it is the one that creates GDP. State policy cannot substitute corporate strategies and similarly companies cannot establish on their own the required stable economic and market environment. Thus, the policy of increasing productivity should engage the efforts of government institutions and business for achieving

common objectives. This policy should be pursued also in a favourable political environment, which means that it should be transparent and should achieve positive social results. It is important also to make an important specification: the policy of enhancing productivity and building a knowledge-based economy should be a long-term one. This means that these priorities should be lasting and should engage imperatively any new governing majority. The Bulgarian public is sufficiently mature to require this longevity and to accept that it is important to comply with certain principles that would bring the desired results at a later stage. Elaboration of such principles, priorities and objectives of economic policy would guarantee high growth and successful integration of Bulgaria in the EU.

2. Macroeconomic Policy: Convergence, Stability and Conditions for Accelerated Growth

The original study of convergence presented in the report prompts some very important conclusions. In relation to nominal convergence measured by the prices level, inflation, money stock and interest rates Bulgaria is already showing clear, albeit feeble, symptoms of accession to the EU economy. Inflation and interest rates are still driven by different factors compared to the ones in the EU but this process will probably continue for some time in the future. It is a fact that nominal convergence depends directly on the macroeconomic policy currently pursued, and thus its values can change relatively quickly and easily. It is a different issue when matters concern real convergence, which is much more sluggish and is the result of substantial accumulations. What is positive there is that in relation to productivity a certain degree of convergence is observed which is one of the results of the significant commodity and financial flows between Bulgaria and the EU. However, there is still no convergence in relation to real incomes. This prompts the conclusion that the country's efforts should be directed towards bringing closer the productivity and incomes levels to the EU ones. Otherwise, the common economic policy of the Union would not correspond to the Bulgarian specificities, which might bring about very adverse consequences.

The low level of real convergence requires envisaging mechanisms on a national level for dampening the possible negative asymmetrical shocks. It might be expected that the shocks related to integration such as the different price level, the growth of the European economy, the EU interest rates would affect relatively slightly real incomes in Bulgaria. In most cases they are absorbed by the economy within several quarters. The existing, albeit not very high, degree of elasticity to the shocks coming from the EU would allow the Bulgarian economy to react in a manner similar to the European one upon the occurrence of negative factors such as oil price increases or crises on the international financial markets. This means that the respective reaction on a European level would be in a direction that is favourable for Bulgaria but insufficient in terms of impact.

The instruments for dampening negative shocks available to the country are known. The maintenance of financial stability, which should remain a priority, and the existence of a currency board determine the conservative monetary and fiscal policy that is being pursued. Thus these instruments have a very limited capacity to exert influence upon occurrence of a shock. The functions of fiscal policy should of course be regarded in a wider context. It is expected from it not only to guarantee financial stability but also to create conditions for increased productivity. This means implementing infrastructure projects, ensuring efficient spending of public funds and providing a certain amount of public services with a quality that is acceptable to the public as well as creating the required reserves for spending related to structural reforms or for short-term absorption of negative shocks. In this respect the transfers of EU funds will have a positive effect.

Another instrument, workforce mobility, will be set into motion somewhat automatically with the increased opportunities for Bulgarian citizens to work in the EU.

Next comes the movement of financial flows and this is one of the fields in which the country should continue its efforts to attract permanent and long-term investments. The issue related to the economy's specialisation gives cause for worry. Although the Bulgarian economy is quite open it has significant intersectoral and relatively low intrasectoral specialisation. Should this tendency continue and production cooperation between Bulgarian enterprises and companies remains at a low level the national economy would become marginalised and peripheral. Consequently, substantial efforts should be employed for stimulating production cooperation. The long-term instrument for limiting negative shocks remains the increase in productivity and the economy's competitiveness.

The analysis in the report shows that macroeconomic policy may meet the expected challenges and alongside the maintenance of financial stability it could create conditions for encouraging productivity in the companies and their intrasectoral cooperation with EU partners.

3. Building a Competitive Knowledge-based Economy: Partnership between Institutions and Businesses

Enhancing productivity may be specified in concrete clearly measurable policies. The report analyses the measuring units of competitiveness and makes specific recommendations for the respective policies both on national and corporate level. These policies should have the same objectives and should be complementary. By their nature these policies should aim at the widest possible access to information, innovation, limiting costs that are not inherent in production, establishing intercompany partnerships. The main weaknesses and advantages on which the Bulgarian economy can rely may be discerned in international comparisons. The strong sides are in the good macroeconomic indicators, the wide scope of the education system, the accumulated industrial traditions, the reassertion of the role of public institutions, the most general improvement of the business environment in recent years. The weaknesses are the low innovation activity, the burdensome administrative environment, the lack of sufficient research and development and what is most important – of application of technological and scientific novelties. On the other hand, companies are still passive and do not pay enough attention to developing long-term strategies, staff training, purposeful pursuit of business innovation, introduction of quality control standards.

Such comparisons outline the main priorities of economic policy in pursuit of its main objective: enhancing quality and competitiveness. The priorities are related to several fields. In the first place is innovation and proactive attitude of companies in introducing new products and technologies. This issue is related to another aspect: the development of new products and issues in the research and development units and the path of these developments to their implementation. Second is the issue of developing information and communication technologies as a separate sector but also as an element of the development of all economic sectors. New information and communication technologies rapidly change the standard of living, of doing business, of education. Bulgaria has certain advantages in this respect and given an appropriate policy ICT may become specialization and a powerful motor for the overall development of the country. Here the role of the state is important not only in relation to creating a favourable business environment but also through active introduction of new technologies in its own activities and placing high standards for performing public services including in education. Third, the possibilities are considered for reducing the administrative burden on individuals and companies. In this respect there are some positive results in the last years but they are not considered sufficient by business. Besides, it is necessary that the business environment should be improved not in the course of campaigns but continuously and purposefully encompassing not only the permission and li-

censing regimes but also the ineffective follow-up inspections. EU membership in itself supposes compliance with heavy regulations and procedures and the national administration should facilitate and not burden additionally these regimes. The fourth prerequisite for enhancing productivity is related to small- and medium-sized enterprises. They are a very important part of the national economy not only because of their number but also because of the persons employed in them and the share of the GDP they produce. As a whole these enterprises can be most flexible and increase most quickly their productivity. In spite of how substantial a factor SMEs might be as a whole, individually they have no sufficient capacity to address the high market requirements and challenges, and therefore they need targeted government support. Having in mind the specificity of the SME sector in Bulgaria the main support should be in relation to information, training, including management and easy access to financial resources. Fifth, but not last the report analyses the role of the educational system as a powerful instrument for stimulating economic growth and building a knowledge-based economy.

All these main fields related to competitiveness are reviewed through the prism of the Lisbon Agenda and the priorities of the EU member states. This is a particularly important angle since it is very important that Bulgaria should comply its policy right away with the objectives and policies of the Union. Moreover, in this case the national interest requires that the building of a knowledge-based economy and enhancing competitiveness should be developing much more dynamically than in the EU.

4. Social Balances: a Mandatory Element of the Bulgaria's Economic Policy

To pursue a specific economic policy cannot be an end in itself. It should be aimed at achieving certain social results and generating public support and consent. The report analyses two particularly important issues related to macroeconomic tensions in the course of integration to the EU. These are the labour market and the income level. In relation to the labour market a conclusion is made that in spite of the positive trend towards reducing unemployment very serious structural problems exist which require a proactive government policy. The number of discouraged persons and persons who have dropped out of the labour market is significant. They are not reported in the unemployment statistics but appear when measuring the employment level which is lowest compared to all other EU member states. This requires special programmes and incentives for encouraging the labour activity of these people. The indicators of unemployed young people and continuously unemployed are also very high compared to the European scale. This also requires special attention. It is absolutely imperative to prevent permanent high unemployment in certain regions and ethnic groups. The specified priorities of the employment policy are particularly important in view of expected developments related to Bulgaria's integration in the EU.

In relation to income policy a number of disparities are also detected which will cause substantial problems and tensions in the integration process. A structural problem is the low level of real incomes compared to the ones of the EU. At the same time, the income level is lagging behind the productivity level, which means that there is some potential for increasing the overall income level. As a trend though, the real growth of incomes should be linked to increasing productivity in order to prevent structural problems and loss of competitiveness in the economy. An additional source of growth will be the resources received from EU funds, which will create greater demand on the labour market. It is necessary to solve some structural problems related to the level of social spending, including the guaranteed minimal income, stimulating active search for employment through increasing the proportions between the minimal salary and social benefits, *etc*.

Special attention is paid to the need for life-long education that would limit the unemployed and encourage employment for people in retiring age. The expected influence of the unfavourable demographic trends on the income level and the labour market is also analysed.

5. Bulgaria on the Balkans: An Advantage or a Burden

Bulgaria's European integration cannot be detached from the regional context. The report pays special attention to the advantages and shortcomings of the region of South-Eastern Europe. In spite of the fact that Bulgaria is much more advanced in the processes of European integration compared to many of the countries in the region, some disturbing tendencies are observed and it could be expected that if they continue the country will lose its comparative advantages in the next few years. Insofar as competition in the region in terms of attracting investment and supply of goods and services not only exists but will also intensify, the Bulgarian economic policy should be based on clear priorities that would stimulate regional economic cooperation, the development of the regional markets and free competition, as well as the integration of the entire region in the European economy. At the same time, though, the country should develop and reaffirm its competitive advantages and should not lose but avail itself of the development and opening of the regional markets and of the development of the regional economy.

All issues reviewed in the report refract the analysis of the current state and trends in individual fields through the risks and opportunities that Bulgaria's integration in the EU provides. The recommendations made for priorities in the economy and for practical action do not aspire to be exclusive or exhaustive. They are an attempt to systematize the main priorities that are needed by the Bulgarian economic policy in the next few years in order to achieve successful and quick integration of the country in the European Union.

Annexes

Annex 1

Analysis of Bulgaria's Economy with the Use of Nonmonitored Quantities

1. Nonmonitored quantities, optimal macroeconomic policy (control) and optimal assessment (maximum information) of economic processes

In the last years the interest of economists towards the so-called nonmonitored quantities has grown. For example the nonaccelerating inflation rate of unemployment (NAIRU) and the natural real equilibrium exchange rate (NATREX), the potential GDP, *etc*. belong to them.

These quantities are nonmonitored since the actually measured unemployment and the effective exchange rate deviate substantially from the equiaxial levels. This deviation is significant since it is related to the so-called internal and external imbalance of the economy and possibly to lengthy periods of economic stagnation.

The assessment of nonmonitored quantities (state variables) is performed with the so-called *Kalman* filters. They represent a summary of the method of the least squares.

The development of the theory of the assessment of nonmonitored quantities and the optimal control theory led to the formulation of the so-called dual problem of optimal evaluation and optimal control.

Duality means that optimal control and optimal evaluation constitute the same problem, *i.e.* the choice of control logic reflects on the optimal evaluation of the system parameters (the choice of the system filter). Consequently, control helps the divulgence of the complete information on the monitored system (learning and probing functions of control).

In our case the variables characterizing the state of the system are the potential GDP, NAIRU, NATREX as well as potential consumption, *etc*. Control or the control variables should be all the main macroeconomic quantities, which depend on the decisions of the government or other government institutions.

The measured variables or the output variables are the main macroeconomic dimensions of the economy: GDP, imports, exports, current balance of payments, capital account, savings, investment, interest rates, *etc*.

The objective is to obtain an optimal evaluation of the state of the system taking into consideration the fortuitous influences and the errors in measuring at the systems' output. This optimal evaluation supposes the formation of optimal control of the system, a principle reflecting the duality of control and the evaluation of the analysed object.

2. Approach and Result of the Analysis of the Bulgarian Economy

The main hypothesis of the analysis is that there is a long-term balance of the main macroeconomic components of the GDP and the deviations from it are due partially to external, partially to internal nonfortuitous factors (economic policy), as well as to fortuitous factors. In the long run the economy seeks to reach its state of equilibrium.

The data used on the Bulgarian economy are quarterly, seasonally evened out and on an annual basis. They include the period from the first quarter of 1998 to the third quarter of 2003. The model used includes an assessment of the potential GDP, the equiaxial real exchange rate, the equiaxial unemployment level, *etc*.

Potential GDP is calculated after assessing the relationship with expected and actual inflation by quarter. Actual inflation with a lag of one month was used for approximation of expected inflation. It turned out that this approximation provides the best results compared to the alternative options. The following procedure was used to obtain the potential GDP:

In the equation:

$$\pi_t = \pi_t^e + \beta(y_t - y_t^n) + \varepsilon ,$$

where π_t, π_t^e are the actual and expected inflation respectively, y_t, y_t^n are the reported and potential GDP, and β is an unknown parameter, we input the an initial value of the unknown parameter.

We calculate the potential GDP which is the only unknown for each t. Since the string obtained is with a great variation due to the specificity of inflation in Bulgaria additional evening out is required by four lags which eliminates all seasonal effects on the potential GDP.

After that we calculate the nature of the deviations between the evened out and the unevened out potential GDP and the changes in the growth of the potential GDP. It is expected for the first deviations to be evenly spread

The model was developed by the Institute for Economy and International Relations

out and for the second ones to be independent from one another (the former ones cannot be independent since the ones are obtained after evening out the others).

We change the value of β and repeat the procedure, and finally we compare the nature of the deviations and establish the existence or the absence of progress.

After applying the above procedure a value of β = 0.49 and values of the potential GDP were obtained for this value.

In order to find the potential consumption a function is used of the type:

$$(C_t - C_{t-1}) - a_2 (C_t^* - C_{t-1}) + e.$$

The procedure for finding potential consumption is the same as the preceding one.

The equiaxial level of investments is such level under which capital depreciation is equal to investments. Due to the absence of any assessment of capital as well as a clear idea of the rate of the annual depreciation we have assumed the equiaxial level to be 25% of the GDP.

This level has not been reached from 1990 to the present day and in every case of approximating it the investment process has been delayed, which might mean that investors do not suffer from shortage of capital. Therefore, the level of 25% looks natural.

In order to find the equiaxial net exports an assessment has been used base on the notion of 'equiaxial real exchange rate'. After the consumption and investments have been established what remains is to find exports.

In principle, there are two possibilities for finding the equiaxial exports: the first one is to assess the relationship with the equiaxial real exchange rate and the second is to use this relationship indirectly using the definition that the current account deficit should equal 0 in the equilibrium. Since the direct evaluation did not provide a satisfactory result the second approach was used. Under this approach the equiaxial income and transfers to the current account were assessed at 1.3% of GDP after which the exports were obtained directly.

To assess the change of the unemployment level the so-called NAIRU approach was used comparing expected and actual inflation in a manner similar to establishing potential GDP. After finding the seasonally evened out unemployment data an autoregression equation was assessed with a view to establishing the long-term equilibrium of unemployment in Bulgaria.

This correlation was calculated with actual values of the GDP and the unemployed and with the respective potential values. The 'gap' in productivity thus obtained is explained with the difference between the real and effective exchange rate and the equiaxial effective exchange rate NATREX.

The elasticity of the deviations of productivity versus the deviations of inflation was 0.77, *i.e.* 1% reduction in inflation corresponded to 0.77% growth of inflation (since external factors are exogenous this corresponds to the so-called *Balassa – Samuelson* effect). Moreover this does not explain the entire inflation but only the one, which does not include administrative prices. The inclusion of the latter causes a shift of evaluations and inadequacy of the model.

The underuse of production capacity is substantial (5–6% of GDP). Since the levels of actual and potential GDP are in a dynamic relationship the low level of actual GDP depresses the long-term equiaxial growth rates.

Unlike the GDP the actual values of unemployment practically follow the equiaxial ones. Since in the second half of 2003 the effective level of unemployment overtakes to a certain extent the equiaxial one.

The divergence will be preserved until 2006 and will even grow irrespective of the expected evening out of actual and potential GDP. This shows that under the existing labour market conditions the workforce is not in a position to obtain its share of the increased productivity.

The results of applying the method of nonmonitored quantities thus described allows for several key conclusions:

- First, the macroeconomic policy pursued after 1997 stabilises inflation but leads to a systematic underuse of the opportunities for noninflationary growth;
- Second, there is not only retention of unemployment above the noninflationary level but also artificial delay in real incomes;
- Third, the study data do not confirm the idea that the Bulgarian economy is 'overheated' and a restriction on credit activity is required;
- Forth, a serious deviation of the actual equiaxial exchange rate from the effective one and high current deficit along with the underuse of production capacities are emerging.

Two solutions are possible: delay of growth aimed at reducing foreign deficit, and the opposite: encouraging growth of internal savings, investment and incomes.

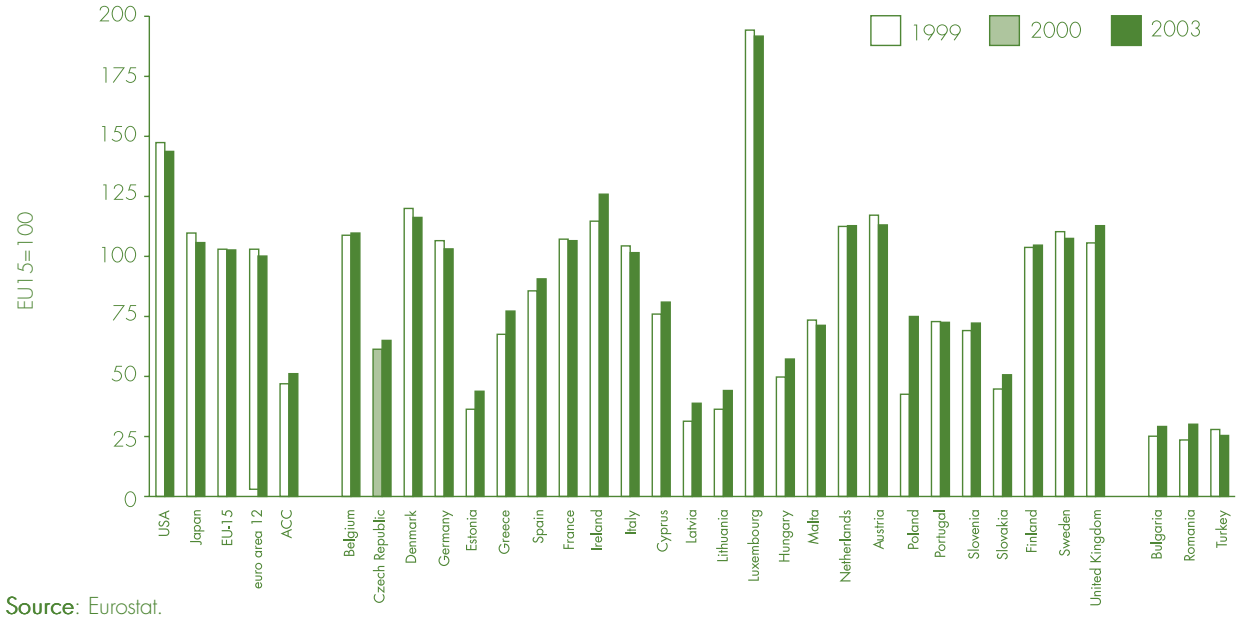
The second option is possible since with quicker growth of savings (in relation to investments) the foreign deficit will drop as a share of GDP as a result of the main macroeconomic identity.

The faster growth of savings presupposes a combination of two prerequisites: income growth and favourable conditions for investment in the internal capital market.

Annex 2.1.

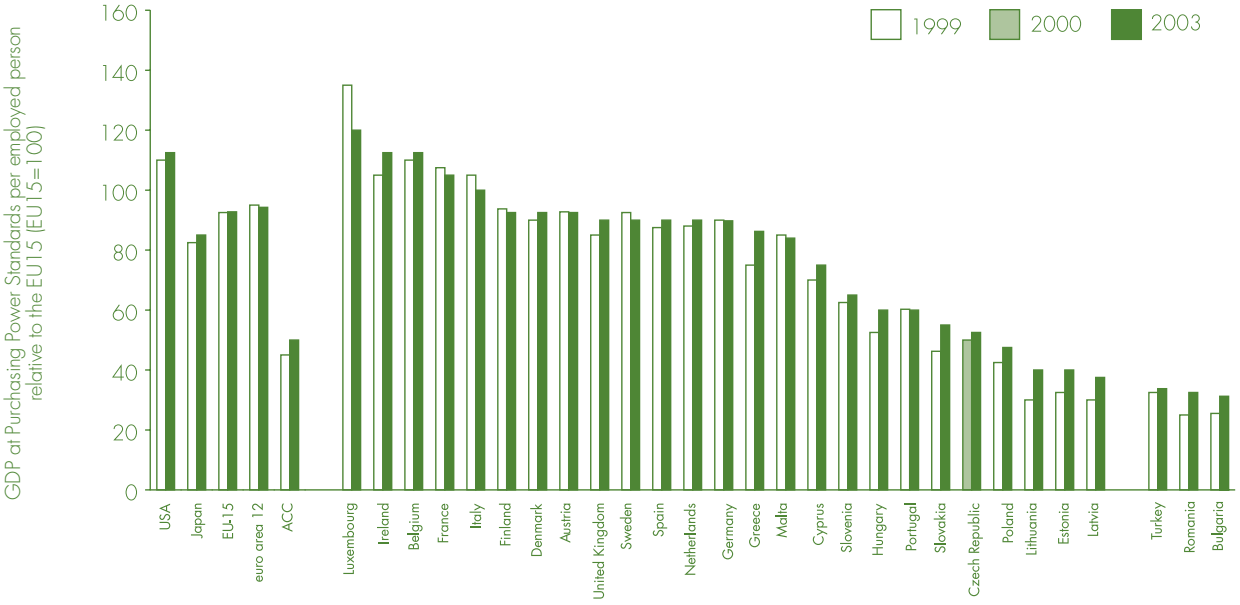
STRUCTURAL INDICATORS
(The 2004 Report of the European Commission for the Spring European Council)

Chart 30. **GDP per Capita**
(at Purchasing Power Standards)



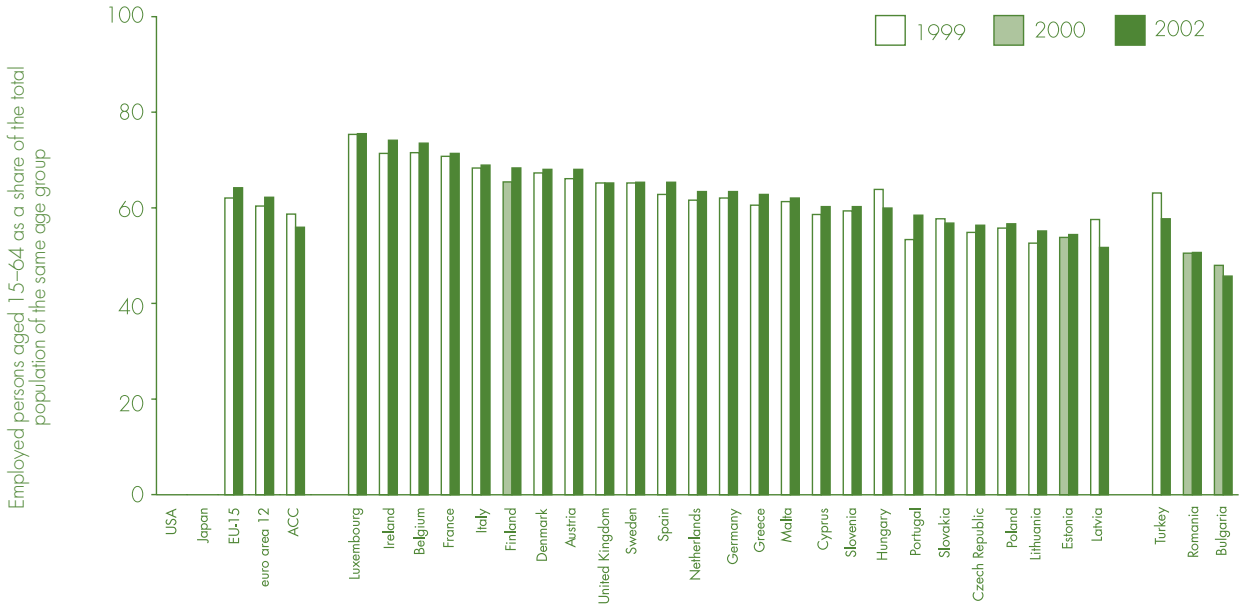
Source: Eurostat.

Chart 31. **Labour Productivity per Employed Person**



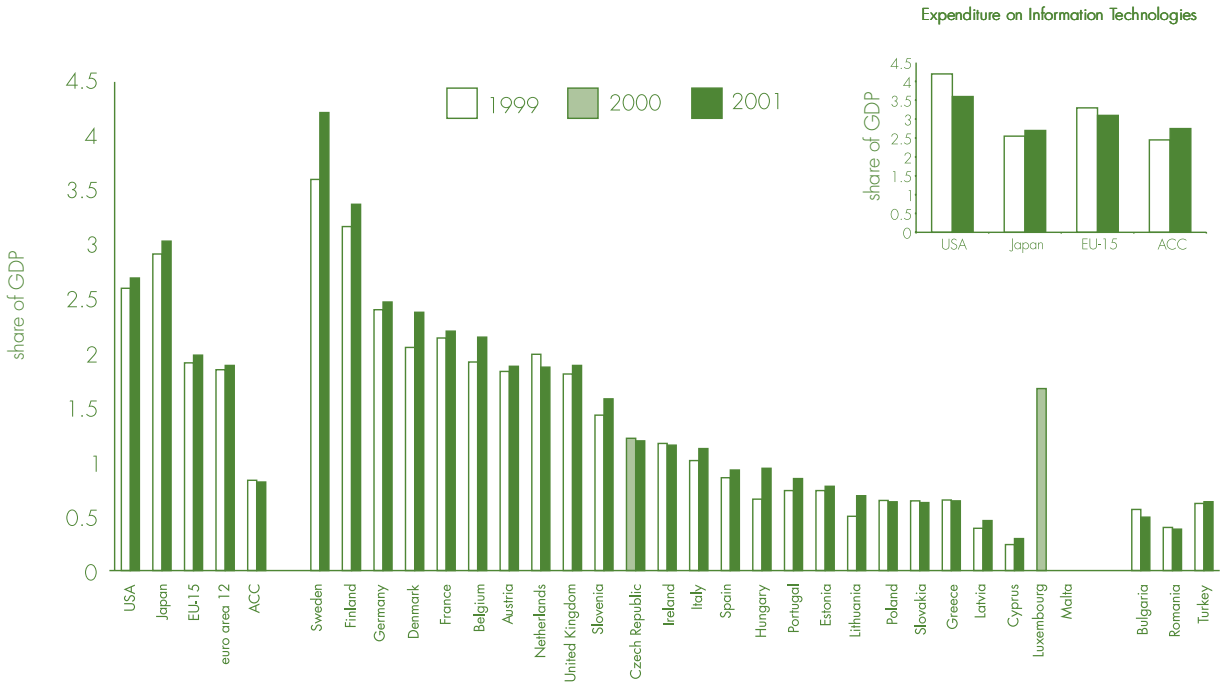
Source: Eurostat.

Chart 32. **Total Employment Rate**



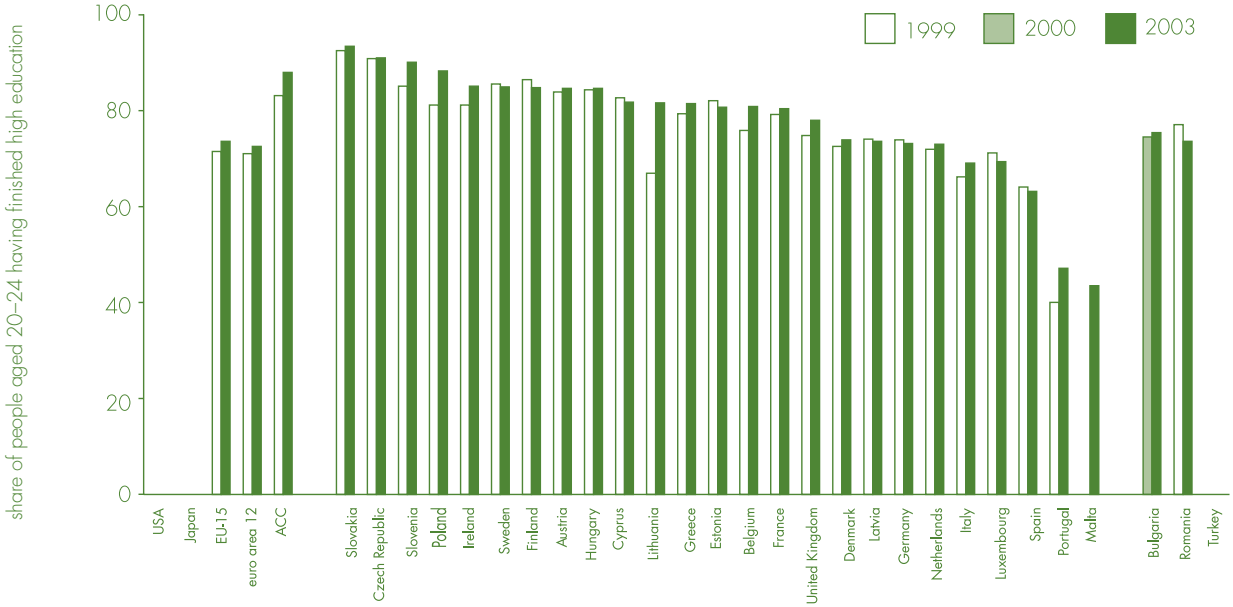
Source: Eurostat.

Chart 33. **Gross Domestic Expenditure on R&D**



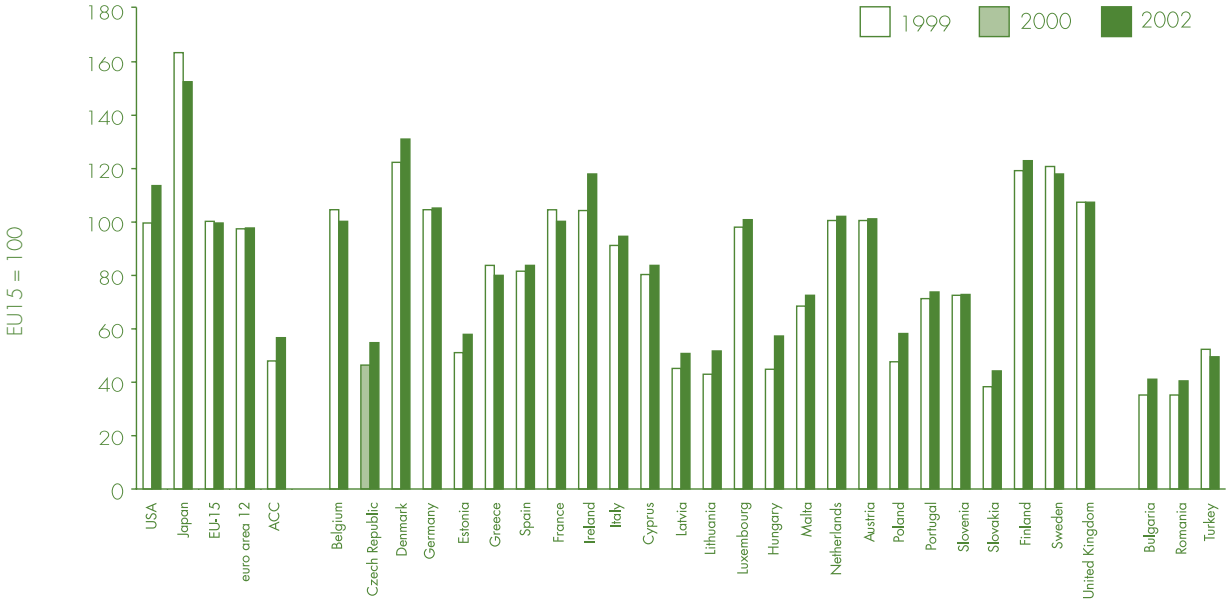
Source: Eurostat.

Chart 34. **Youth Educational Level, Total**



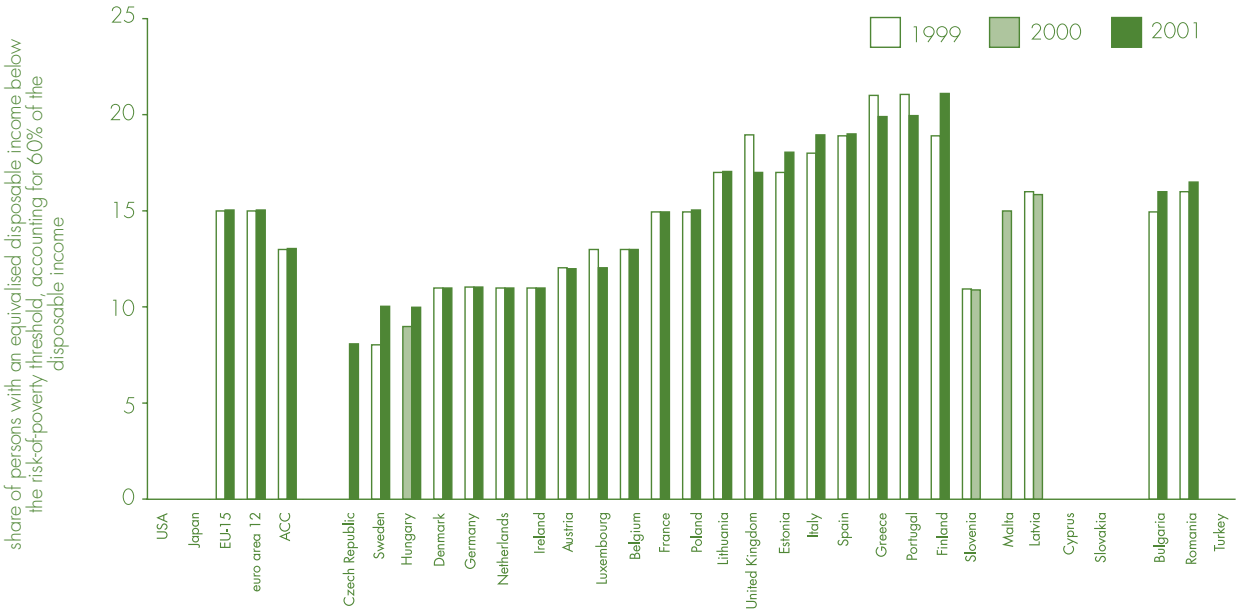
Source: Eurostat.

Chart 35. **Comparative Price Levels of Final Consumption**
(including indirect taxes)



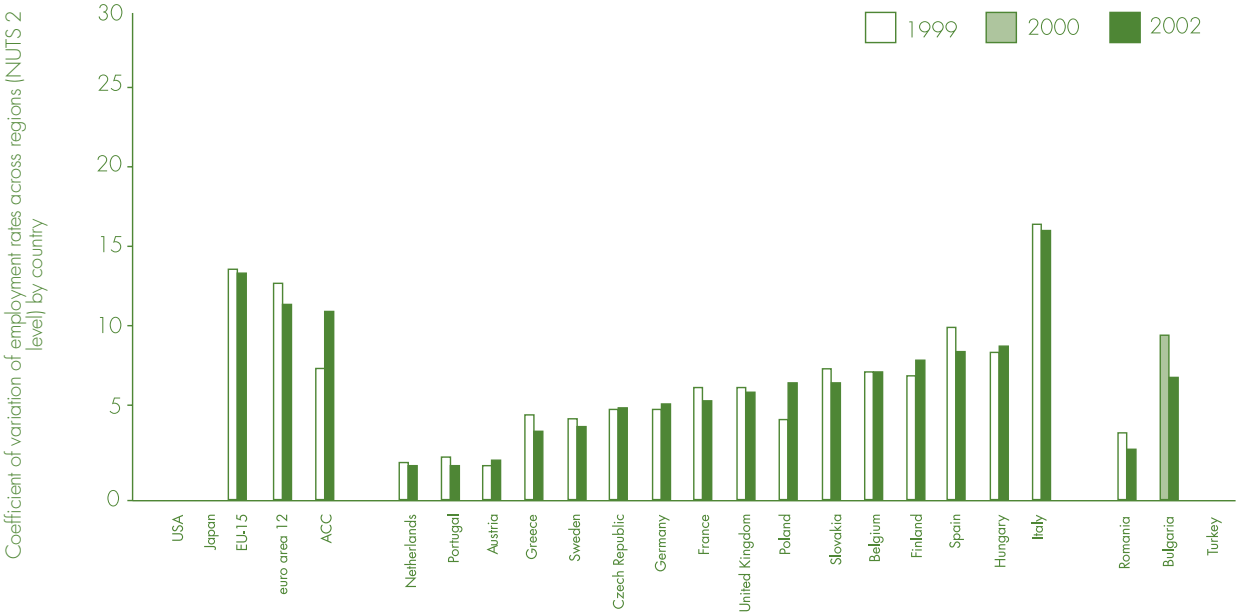
Source: Eurostat.

Chart 36. **Total Poverty Rate after Social Transfers**



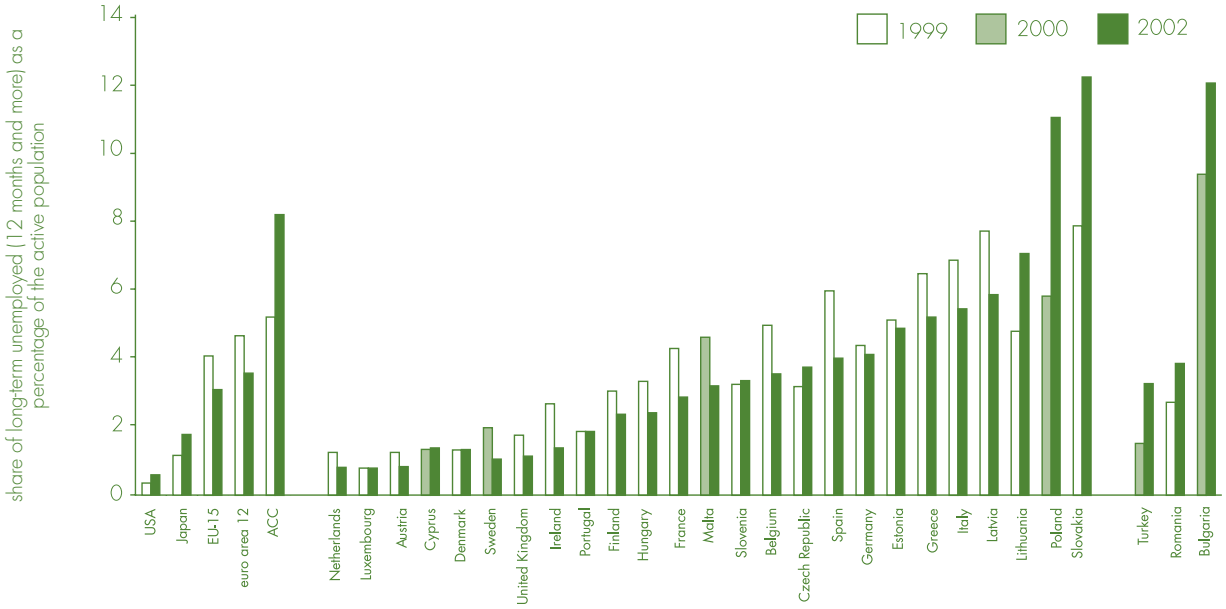
Source: Eurostat.

Chart 37. **Total Dispersion of Regional Employment Rates**



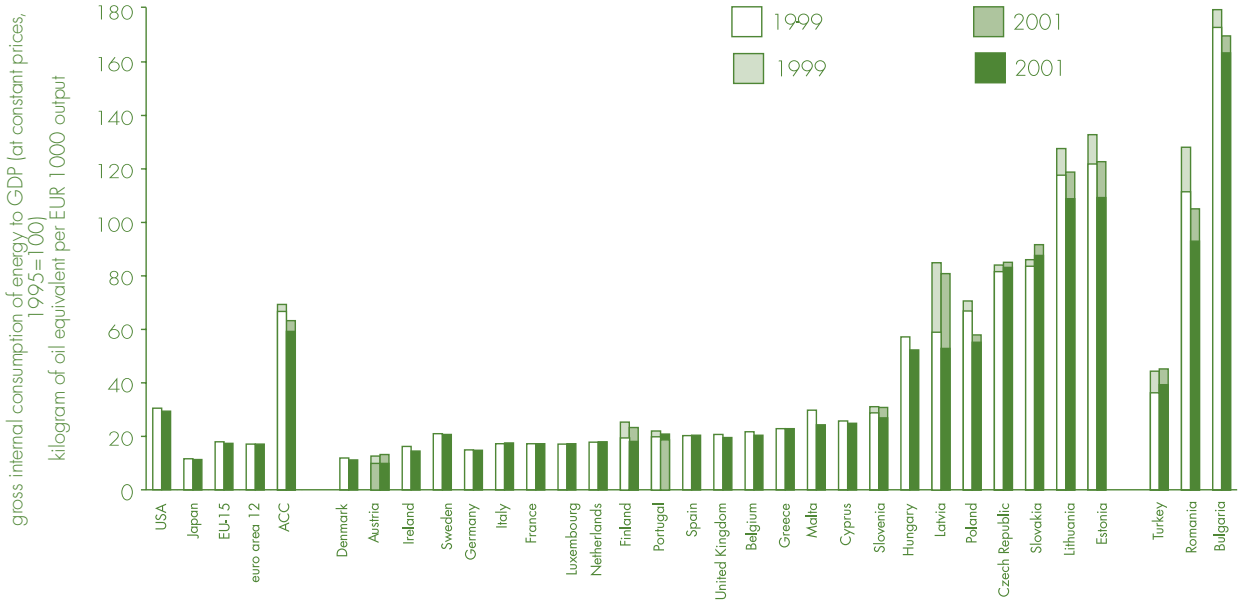
Source: Eurostat.

Chart 38. **Total Long-term Unemployment Rate**



Source: Eurostat.

Chart 39. **Energy Intensity of the Economy**



Source: Eurostat.

Annex 2.2.

Main Documents, Related to Establishing a Knowledge-based Economy in Bulgaria

In the first place is the updating of legislation regulating information and communication technologies and research combined with preparation for adopting some new mandatory elements for the transition to an information society. The following may be specified among the main strategic documents relating to the development of *information society* (IS):

- **Strategy and National Programme for the Development of Information Society in the Republic of Bulgaria** (adopted in October 1999). This is the fundamental document in the filed of information society providing the overall outline of information society in Bulgaria and the recommendations for achieving the objectives set. The two documents *per se* are in compliance with the EU guidelines and the delay in implementing the objectives set results from the insufficiently consistent policy and financial resources.
- **E-Government Strategy** (adopted in December 2002). The main objective is to organize and ensure the support by the government for the processes of providing electronic administrative services. The adoption of an action plan was delayed which reflects unfavourably on the achievement of the objectives and their implementation is currently at a comparatively low level.
- **Strategy and Plan for Enhancing Competitiveness of the Bulgarian Information and Communication Technology Sector on Global Markets** (adopted by the Economic Growth Council in early 2004). The idea is to outline a common view and consent of business and the government for the development of the ICT industry in Bulgaria and its transformation into a motor for Bulgaria's economic development.

A number of new laws have been adopted and old ones are being updated and the more important amendments include:

- **E-Document and E-Signature Act** (effective as of October 2001). It ensures the legal regulation of electronic documents and electronic signatures and the rules and conditions for providing ascertaining services. It was drafted in conformity with EU directives and includes all requirements for conducting e-commerce and interaction with E-government.
- **Personal Data Protection Act** (effective as of January 2002). The act regulates the protection of citizens in relation to personal data collection and processing and the access to them. It reflects the commitments undertaken by Bulgaria in respect of harmonizing Bulgarian legislation with EU law concerning protection of human rights.
- Amendments to the existing legislation aimed at adequately addressing the problems of modern world (**computer crimes, misuse of information, *etc***.). In September 2002 the Penal Code was updated with a view of ensuring protection of citizens and business against newly appearing cases of crimes *via* Internet. The amendments made are in conformity with the Council of Europe Convention on Cyber Crime signed by Bulgaria in 2001.
- Entirely new **Telecommunications Act** guaranteeing the liberalization of the telecommunications market and the protection of user rights. Despite the fact that it was not complied with the latest EU directives (adopted in 2003) the Act follows the prescriptions of the previous set of directives which actually refer to the initial state after liberalizing telecommunications.
- Updating the legislation concerning **intellectual property**. The Copyright and Neighbouring Rights Act and the Patents Act were amended in 2003 in view of changes in the modern business world.

Annex 2.3.

European Classification, 2004
Indicators for Creating New Knowledge

Chart 40. **Number of Patent Applications Filed at the European Patent Office per 1,000,000 Persons**

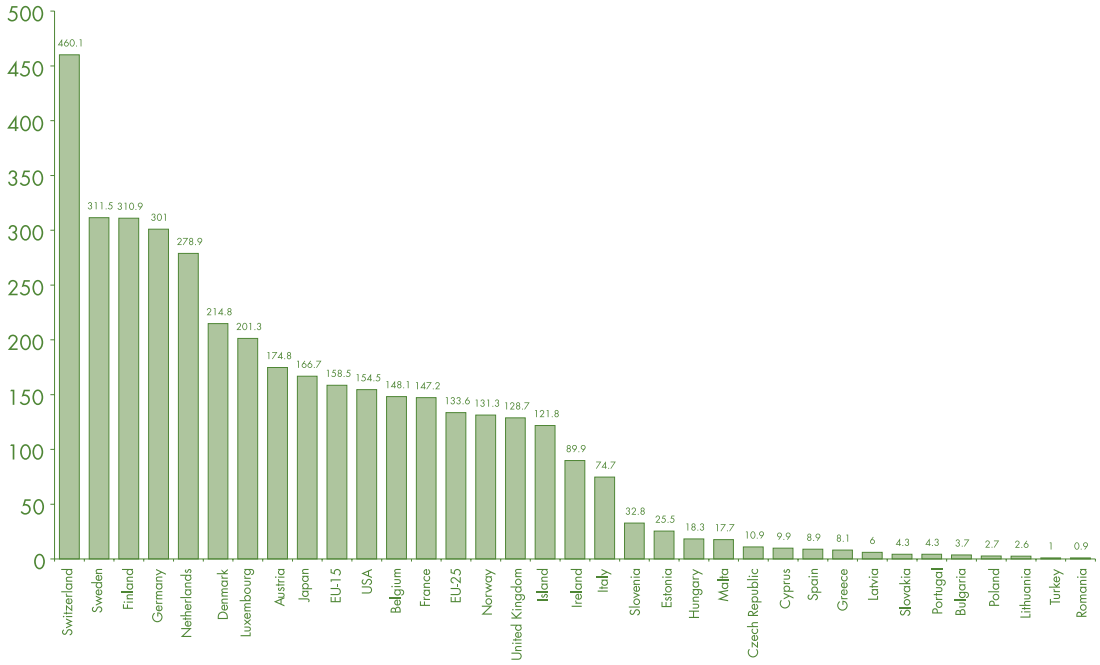


Chart 41. **Number of Patents Issued by the American Patent Office per 1,000,000 Persons**

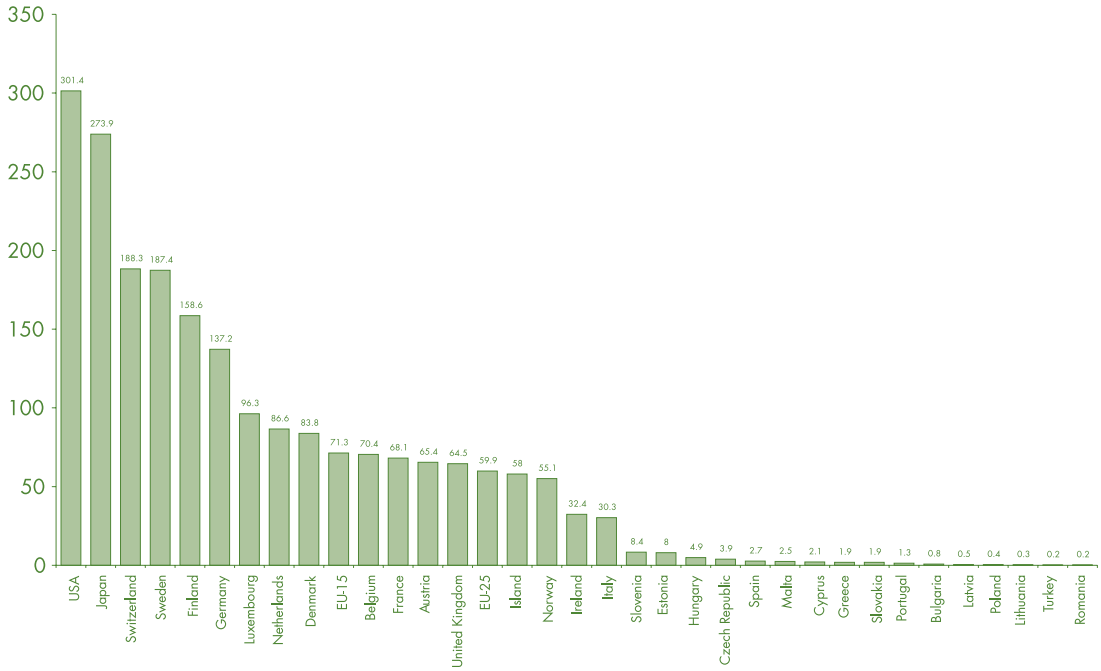


Chart 42. **Number of Patent Applications in the Hi-Tech Sector Filed at the European Patent Office per 1,000,000 Persons**

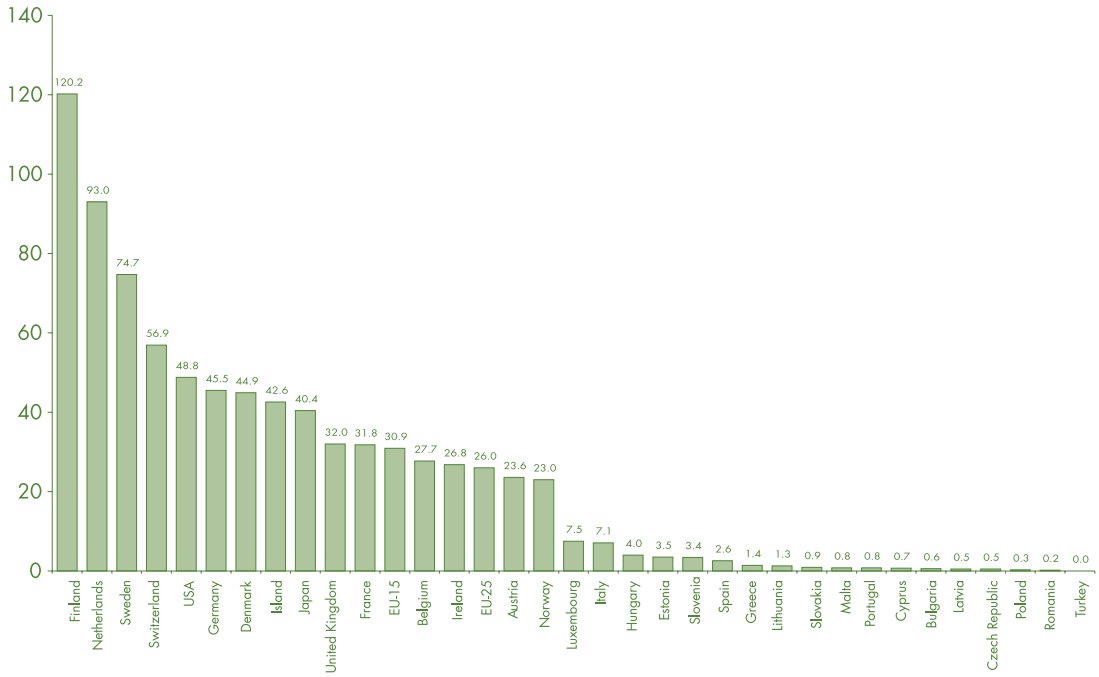
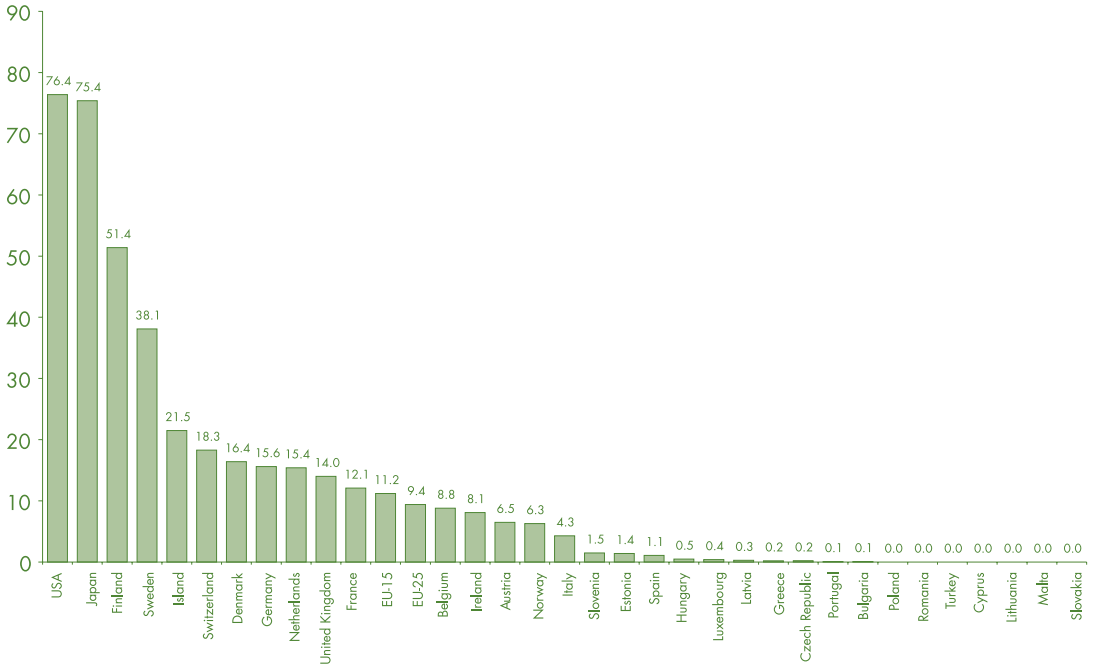


Chart 43. **Number of Patent Applications in the Hi-Tech Sector Filed at the American Patent Office per 1,000,000 Persons**



Annex 2.4.

Indices of the World Economic Forum

Table 26

Indicators	2003 (80 countries) Place	2004 (102 countries) Place (102)	Place (80)
Regulation burden Regulations in your country are (1 = burdensome, 7 = light)	43	65	52
Transparency of policies Companies in your country are usually informed clearly and transparently by the government on changes in policy and regulations concerning your sector (1 = never, 7 = always, fully and clearly)	75	90	70
Favouring decisions When deciding on applying a policy and with respect to contracts, public servants (1 = usually favour those with connections, 7 = are neutral in respect of companies and individuals)	58	87	67
Degree of bureaucratisation of the administration How much time does senior management spend for work/ negotiations with employees as % of working time (1 = 0%, 2 = 1–10%, 3 = 11–20%, 8 = 81–100%)	68	91	76
Legislation efficiency *How* efficient is the national Parliament as a legislative and monitoring body? (1 = Ineffective 7 = very effective, the best in the world)	59	85	65
Efficiency of the tax institution The tax system in your country is (1 = very complex and deforms business decisions, 7 = simple and transparent)	70	89	79
Informal sector What percentage of business in your country is in your opinion unofficial or unregistered? (1 = under 5%, 2 = 6–10%, 3 = 11–20%, 9 = over 70%)	67	78	63
Business cost of corruption Do illegal payments by other companies aimed at influencing policy, laws and regulations cause losses or other negative consequences? (1=cause great losses, 7= do not incur any costs/no relation)	58	92	76

Registration burden

The results illustrate well the limitations of individual judgments. According to objective criteria in terms of number of procedures, duration, registration costs Bulgaria is looking much better in international comparative terms than according to the subjective judgment of its entrepreneurs which is not comparison-based

2003	Place	Indicator
Administrative barriers at the start Starting business in your country as a whole is (1 = exceptionally difficult and lengthy, 7 = easy)	79	2.3
Number of administrative procedures for registering a business (2002)	36	10
Number of days for registering a business (2002)	16	30
Costs for registering a business 2002 (USD)	6	120
Total registration costs, % of GDP per capita (2002)	20	7.92%

Source: Global Competitiveness Report (2003, 2004).

Annex 2.5.

EU Policy for Improving the Business Regulatory Environment

In September 1997 the Commission established a Business Environment Simplification Taskforce (BEST). Its report (May 1998) became the basis of an Action Plan for Entrepreneurship, which was approved in 1999. In 2000 a Commission report was dedicated to the implementation of this plan for improving the business environment. In 2001 it was decided to prepare the same report on the 13 candidate countries for EU membership (CC BEST Report).

The Lisbon Programme (March 2000) raised the issue of simplifying the regulatory business environment with new force. It aims at transforming Europe by 2010 into the most dynamic economy in the world based on knowledge with productivity and employment exceeding the ones in the USA. Poor legislative regulation was highlighted as the main impediment for economic growth. Key elements of the Programme are its simplification and encouraging SMEs with a view to realising fully their entrepreneurial and innovation potential. The Lisbon European Council called for a preliminary assessment of the impact of regulations in consultation with business and other participants concerned who would guarantee that the proposed regulatory acts did not impose unnecessary burden on business and are sufficiently simple and clear to be applied successfully. In this view the Council called for a comprehensive review of the existing regulatory framework. However, the shortest route for achieving these objectives would hardly be the traditional regulatory approach, *i.e.* transposition of directives into the national jurisdictions. A more flexible approach was chosen based on the 'open coordination approach' which set store mainly on exchange of information, benchmarking and introduction of best practices as well as on opening the countries, in particular the acceding countries for monitoring and evaluation of the results. Practical implementation of this approach were the projects within the so-called 'BEST procedure' which also form the third pillar of the five-year SME programme together with the Euro-Info Centres and the schemes for financial support.

SMEs are in the focus of EU efforts with a view to improving the normative environment. As a matter of fact it could be said that there are few common European policies that do not refer to SMEs. However, the key instruments of the Community in this respect are the European Chart on Small Enterprises (June 2000) and the Multiannual Programme for Enterprise and Entrepreneurship, Council Decision 2000/819/EC, 20 December 2000). The Chart and the Programme place in the center of the policy on SMEs the simplification and improvement of the administrative and regulatory environment and servicing business. Among the ten key fields in the Chart are ensuring less expensive and quick start of operation, improving legislation and regulations, easing the tax burden, increasing Internet-based services, *etc*.

Since November 2002 the Commission has been applying quantitative indicators for assessing the implementation of the business environment policy. These are national measures of the quality of administrative and regulatory environment, which the countries aim at in compliance with the Lisbon Programme. They include both entrepreneurship indicators (number of new registrations, actually started companies, new versus the closed enterprises, self-employed, *etc*.) and direct indicators of the administrative and regulatory environment (cf. Table 27). This is an attempt to integrate benchmarking, target setting and monitoring in a comprehensive approach for improving business environment and enhancing competitiveness of member states. The candidate states are a subject of special monitoring and assessment of the achieved results in the context of the Lisbon Programme and the Chart on Small Enterprises as well as of the Multiannual Programme for Enterprise and Entrepreneurship (2002–2006).

(http://europa.eu.int/comm/enterprise/entrepreneurship/index.htm.)

Table 27

National Quality Indicators of the Administration and Regulatory Environment

Country	Indicator	State (year)	Objective (year)
Belgium	Administrative burden		Reduction by 25 %
Denmark	Administrative burden		Reduction by 25 % (2010)
Germany	Share of Internet services by the federal government		100 % (2005)
Spain	Time to register a firm	84 days	Reduction by 50 % = 42 days (2006)
Spain	Share of Internet services provided by the government		40 % (2006)
Ireland	Assessment of the effect of legislation	0% (2001)	100 % (2006)
the Netherlands	Administrative burden		Reduction by 25 %
Portugal	Time to register a firm	10-25 days	Reduction by 50 %
Portugal	Time to obtain an industrial licence	About 150 days	Reduction by 50 % = 75 days (2003)
Portugal	Share of Internet services provided by the government		100 % (2005)
Sweden	Assessment of the effect	100% (2001)	100 % (2001 - 2010)
UK	Assessment of the effect		100 % (2005)
UK	Share of Internet services by the government		100 % (2005)

Annex 3.

Correlation Between the Balkan Countries

Table 28

Income per Capita

	Albania	Bulgaria	Bosnia and Herzegovina	Croatia	Germany	Macedonia	Romania	Slovenia	Turkey
Albania	1.00	0.69	0.64	0.48	-0.49	-0.27	0.80	-0.12	0.09
Bulgaria	0.69	1.00	0.92	0.59	0.31	-0.19	0.79	0.17	0.38
Bosnia and Herzegovina	0.64	0.92	1.00	0.15	0.05	0.55	0.19	0.85	0.30
Croatia	0.48	0.59	0.15	1.00	0.08	0.17	0.81	-0.18	0.58
Germany	-0.49	0.31	0.05	0.08	1.00	0.89	-0.25	0.65	-0.06
Macedonia	-0.27	-0.19	0.55	0.17	0.89	1.00	-0.14	0.64	0.06
Romania	0.80	0.79	0.19	0.81	-0.25	-0.14	1.00	-0.09	0.26
Slovenia	-0.12	0.17	0.85	-0.18	0.65	0.64	-0.09	1.00	-0.25
Turkey	0.09	0.38	0.30	0.58	-0.06	0.06	0.26	-0.25	1.00

Table 29

Credit Growth

	Albania	Bulgaria	Bosnia and Herzegovina	Croatia	Germany	Macedonia	Romania	Slovenia	Turkey
Albania	1.00	0.76	0.21	-0.20	0.32	0.56	0.22	-0.58	0.32
Bulgaria	0.76	1.00	0.12	-0.30	0.29	0.41	0.35	-0.51	0.33
Bosnia and Herzegovina	0.21	0.12	1.00	0.14	-0.17	-0.54	0.42	-0.43	-0.79
Croatia	-0.20	-0.30	0.14	1.00	-0.39	-0.12	-0.02	-0.25	-0.35
Germany	0.32	0.29	-0.17	-0.39	1.00	-0.46	0.66	0.44	0.85
Macedonia	0.56	0.41	-0.54	-0.12	-0.46	1.00	-0.46	-0.70	-0.15
Romania	0.22	0.35	0.42	-0.02	0.66	-0.46	1.00	0.26	0.37
Slovenia	-0.58	-0.51	-0.43	-0.25	0.44	-0.70	0.26	1.00	0.35
Turkey	0.32	0.33	-0.79	-0.35	0.85	-0.15	0.37	0.35	1.00

Table 30

Interest Rates

	Albania	Bulgaria	Bosnia and Herzegovina	Croatia	Germany	Macedonia	Romania	Slovenia	Turkey
Albania	1.00	0.57	0.93	0.62	0.24	0.29	0.76	0.49	0.69
Bulgaria	0.57	1.00	0.16	0.71	0.36	0.42	0.26	0.70	0.57
Bosnia and Herzegovina	0.93	0.16	1.00	0.68	0.38	0.61	0.40	0.74	0.64
Croatia	0.62	0.71	0.68	1.00	0.73	0.60	0.61	0.80	0.83
Germany	0.24	0.36	0.38	0.73	1.00	0.67	-0.11	0.78	0.47
Macedonia	0.29	0.42	0.61	0.60	0.67	1.00	0.60	0.91	0.42
Romania	0.76	0.26	0.40	0.61	-0.11	0.60	1.00	0.23	0.60
Slovenia	0.49	0.70	0.74	0.80	0.78	0.91	0.23	1.00	0.61
Turkey	0.69	0.57	0.64	0.83	0.47	0.42	0.60	0.61	1.00

Table 31

Price Level

	Albania	Bulgaria	Bosnia and Herzegovina	Croatia	Germany	Macedonia	Romania	Slovenia	Turkey
Albania	1.00	0.99	0.59	0.95	0.94	0.65	0.86	0.93	0.78
Bulgaria	0.99	1.00	0.68	0.93	0.92	0.61	0.85	0.91	0.76
Bosnia and Herzegovina	0.59	0.68	1.00	0.54	0.46	0.33	0.42	0.46	0.30
Croatia	0.95	0.93	0.54	1.00	0.99	0.58	0.96	0.99	0.90
Germany	0.94	0.92	0.46	0.99	1.00	0.60	0.97	1.00	0.93
Macedonia	0.65	0.61	0.33	0.58	0.60	1.00	0.41	0.58	0.34
Romania	0.86	0.85	0.42	0.96	0.97	0.41	1.00	0.98	0.99
Slovenia	0.93	0.91	0.46	0.99	1.00	0.58	0.98	1.00	0.95
Turkey	0.78	0.76	0.30	0.90	0.93	0.34	0.99	0.95	1.00

Table 32

Inflation Rate

	Albania	Bulgaria	Bosnia and Herzegovina	Croatia	Germany	Macedonia	Romania	Slovenia	Turkey
Albania	1.00	0.83	-0.32	0.36	0.30	0.07	0.81	0.19	0.65
Bulgaria	0.83	1.00	-0.05	0.16	0.49	0.12	0.88	0.22	0.53
Bosnia and Herzegovina	-0.32	-0.05	1.00	-0.07	-0.05	-0.45	0.20	-0.45	-0.38
Croatia	0.36	0.16	-0.07	1.00	0.18	0.08	0.45	0.42	0.74
Germany	0.30	0.49	-0.05	0.18	1.00	0.34	0.27	0.58	0.22
Macedonia	0.07	0.12	-0.45	0.08	0.34	1.00	-0.10	0.88	0.46
Romania	0.81	0.88	0.20	0.45	0.27	-0.10	1.00	0.05	0.60
Slovenia	0.19	0.22	-0.45	0.42	0.58	0.88	0.05	1.00	0.64
Turkey	0.65	0.53	-0.38	0.74	0.22	0.46	0.60	0.64	1.00

Source: IFS, own calculations.

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