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BULGARIA'S LAGGING ECONOMY

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ABSTRACT

GDP per capita in Bulgaria has been systematically lagging behind the corresponding indicator for former member states of the Council for Mutual Economic Assistance, which later joined the EU. Bulgaria's economic problems are somewhat traditional and remain unresolved. Bulgaria is the most corrupt country in the EU. Legislation is unsustainable, chaotic and ineffective. The National Assembly often disregards the operation and requirements of its own laws. Bulgaria systematically maintains one of the lowest ratios of accumulation. The country is negligent in public investment and lags behind the other EU-countries. The overall regulatory and business climate in the country does not stimulate foreign capital inflow. A significant flight of local capital abroad has been observed. Bulgaria needs to maintain annual GDP growth rates in the range of 5-7% in order to be able to leave its last-ranking in the EU. The acceleration of economic development requires the raising of the population's general political and economic literacy, as well as improvement of the political infrastructure in accordance with modern standards. The functions and forms of macroeconomic policy should be reconsidered in accordance with modern standards, taking into account the impacts of our de facto membership in a monetary union.

Key words: macroeconomic policy, cross border capital flows, institutional reforms;

INTRODUCTION

1. Why does Bulgarian economy rank last in the EU?

The definition of "*lagging economy*" implies comparison between economies. Bulgaria is a member of the EU, therefore such comparison should be made first and foremost with fellow EU countries. Before the 1990s, a group of countries within the EU had been developing together. These were the former member states of the Council for Mutual Economic Assistance (CMEA), which later joined the EU. The group consisted of 9 countries: Bulgaria, Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia. The economies of the 9 countries were comparable, the countries joined the EU (almost) together and therefore it is justified to draw comparisons between them. The designation "*CMEA-EU countries*" has been adopted for these 9 countries.

GDP p.c. in Bulgaria has been systematically lagging behind the corresponding indicator for CMEA-EU countries **(Figure 1).** In 2020, GDP p.c. in Bulgaria in current EUR was 73% higher than in 2010. However, in Romania this indicator increased by 82% for the same period! The Baltic countries (Estonia, Latvia and Lithuania) had a remarkable success - the indicator's growth rate

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was 86%, thanks to which Estonia held the leading position among the CMEA-EU countries by 2020. The relative growth of the groups' richer countries was lower. Poorer countries however should achieve faster economic growth. If GDP dynamics remains the same, Bulgaria will need at least 35 years to reach the group's average level.

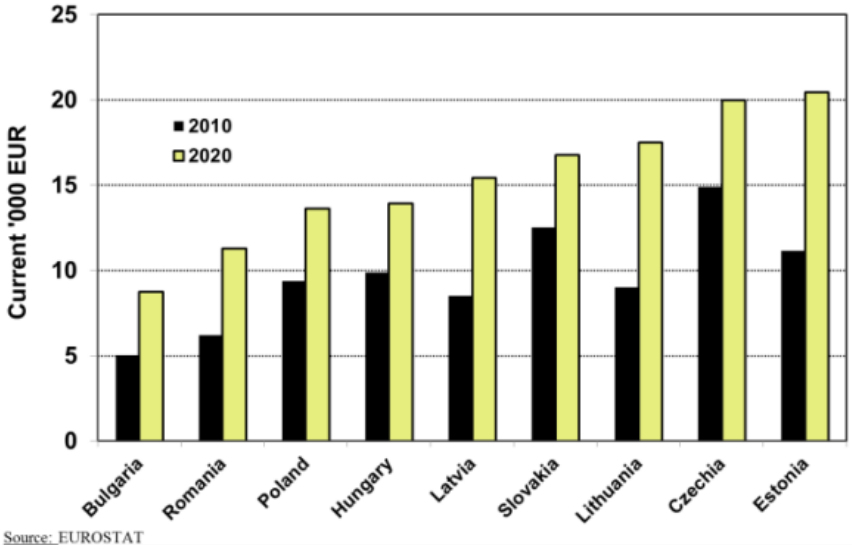

Figure 1. GDP per capita

The European Commission (EC) regularly publishes its economic forecasts (winter and summer ones). The EC forecasts are compact and focused on two main groups of indicators for all EU countries: *first*, GDP growth rate and *second*, Consumer price index (CPI).

Below is information from the EC's 2021 Summer forecast. The information is for 2020-2022. Real data is quoted for 2020, and forecasts are presented for 2021 and 2022.

The positive aspect of the proposed forecasts is that they are all based on a single methodology (although certain details of the methodology are not stated explicitly). This provides good foundation for cross-country comparisons.

The period covered by the forecast is characterized by the emergence, impact and overcoming of the Covid-19 crisis. The EU countries have had various perceptions and reactions to the pandemic, which is why its economic impacts on individual countries for 2020 are not unambiguous and comparable.

The recession of 2020 has been universally followed by a compensatory economic recovery in 2021 and an upward economic trend for 2022. Therefore the fragmentary monitoring of individual countries' economic dynamics for 2021 and 2022 is not indicative enough. It must include the whole three-year period 2020-2022, in order to take into account both the uneven economic recession by countries in 2020 and the corresponding uneven recovery and positive growth in the next year or two.

Figure 2 shows the EU-forecasted aggregate GDP growth rate of individual CMEA-EU countries for the three-year period 2020-2022 (1). The EC envisages Czechia to achieve a minimal rate of GDP growth for this period, but Czechia's GDP p.c. is one of the highest among the countries in the group.

It is indicative that Bulgaria is likely to achieve one of the lowest rates of GDP growth for the period, regardless of the country's persistently lagging economic position. All other CMEA-EU countries are expected to grow economically faster than Bulgaria. It is worth noting the

projected dynamics of our neighbor Romania, with which Bulgaria was comparable at the beginning of this century. The EC forecasts Bulgaria's economic growth for 2020-2022 at 4.3%, while the number for Romania is 8.3% (i.e. almost twice as much!).

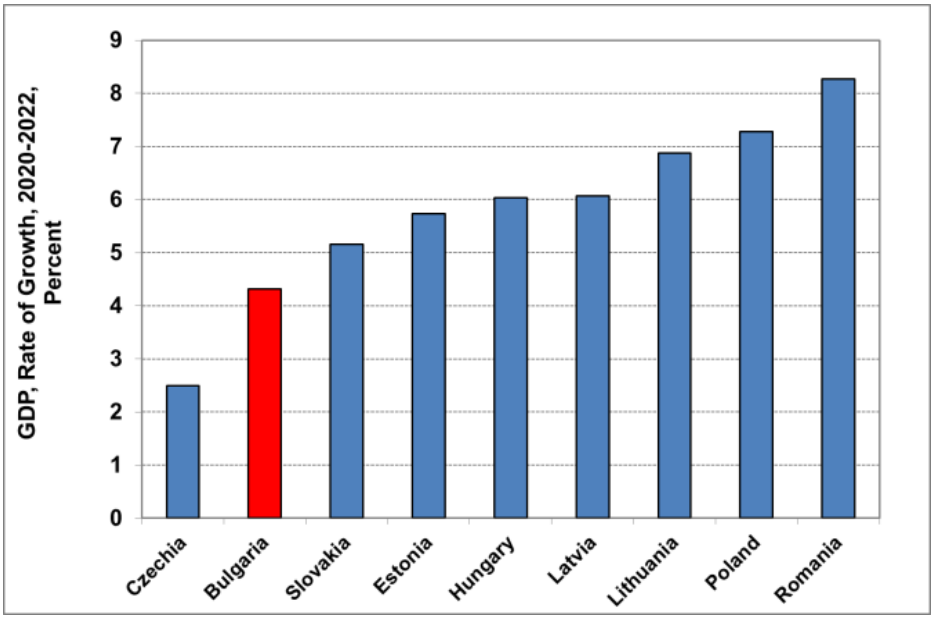

Figure 2. European commission: summer 2021 economic forecast

Economic dynamics are naturally linked to the growth of GDP p.c. The EC does not explicitly assess this indicator (it only estimates the total rate of GDP growth for the country), but the difference in growth rates cannot be significant.

Figure 3 shows the GDP p.c. for 2019 (real) and the level of the indicator foreseen by the EC for 2022 (having in mind the above consideration). It is not necessary to go into details in order to see that the unfavorable lagging position of our country not only persists, but even worsens.

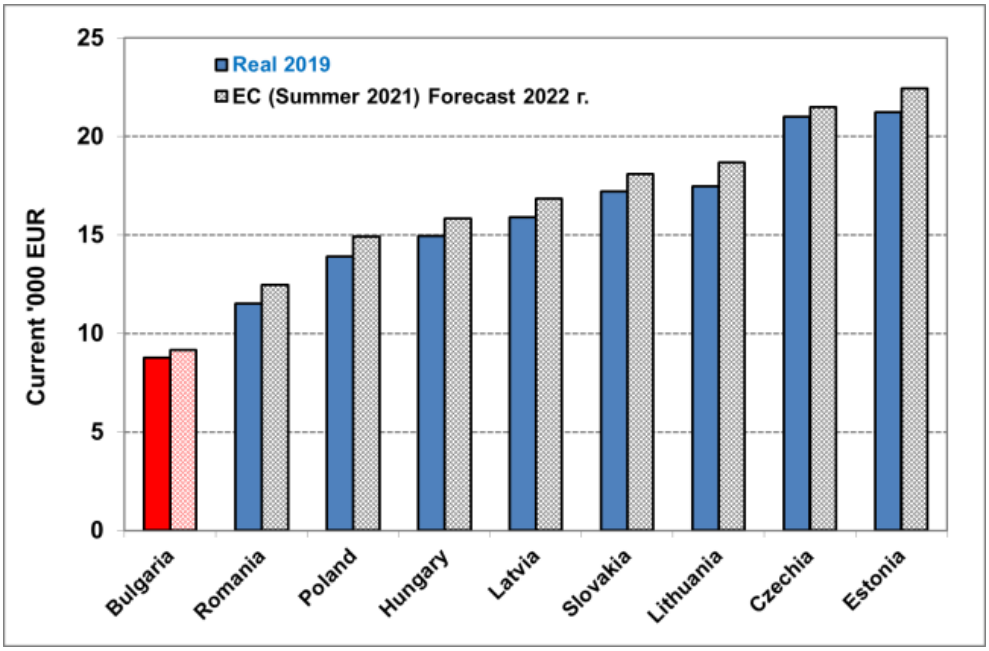

Figure 3. GDP per capita: Real 2019 and European commission (Summer 2021) forecast 2022

Both **Figure 2** and **Figure 3** demonstrate that economic processes in Bulgaria are not developing well in comparison to other CMEA-EU countries. The reasons lie in the specifics of the country's macroeconomic management. One can confidently claim that the corruption, the low competence of management teams and the unfair justice system hold back economic prosperity and firmly cement the country's lagging position in the EU.

The EU also offers its own price dynamics forecasts. Their analysis deserves special attention. What is striking is that the member states of the euro area have lower inflation than those outside the euro area. Bulgaria joins de facto the first group of countries. The problem with inflation in our country is that we (still) maintain the lowest price levels in the EU, which cannot last too long. A process of relative price convergence should start. Given the fact that the exchange rate in Bulgaria is fixed, this process can only take place if the domestic inflation rate is higher than the one in the euro area.

The Ministry of Finance in our country is obliged to regularly publish its own medium-term forecasts, as well as winter and summer ones. They serve as the basis for designing next year budget proportions. By nature, government macroeconomic forecasts need to be more of a government agenda. They are (and should be) different from the forecasts of the IMF, the World Bank, or even the EU. The main difference is that the government can influence the course of the national economy and is not merely an observer of what is happening inside the country.

The government however cannot influence certain elements of the forecasts. Such are, for example, the USD exchange rate, the prices of basic resources on world markets, the GDP growth rate of the world's leading economies and other exogenous variables. Domestic economic and investment activity is subject to endogenous management policy. The government management should plan in the medium term and specify accordingly its fiscal program for the first year of the period. The medium-term government commitments should be clearly spelled out and monitored by the National Assembly (NA), as well as by civil society organizations.

Bulgarian macroeconomic management has established a practice of traditionally ignoring comparisons with CMEA-EU countries' economic dynamics. However, the latest government document (28) clearly raises the issue of achieving economic growth, that will make possible active convergence with the average European economic levels in the long run.

Bulgaria is the poorest country in the EU and maintains the lowest rates of economic growth among comparable CMEA-EU countries. A special study by the EC (2) states that Bulgaria's economic problems are somewhat traditional and remain unresolved. Many studies indicate that the lag of an individual country and region is mainly due to weaknesses in internal macroeconomic governance (3). In order to overcome the persistent doom-like lagging, we need to identify the factors, that are holding back the country's economic development, and design measures to alleviate them.

2. Factors for lagging

2.1. The international organization Transparency International conducts annual surveys and evaluates the level of corruption in individual countries worldwide. Based on these observations, a Corruption Perception Index is formed, positioned in the range 0-10. The left end of the interval indicates that the country is corrupt, while at the right end are positioned countries with less corruption.

Traditionally, the CMEA-EU countries are seen as a more corrupted EU region. In 2020 the average Corruption Perception Index for the CMEA-EU countries was 5.4, while the average value of the same indicator for all EU countries was 6.4. The fact is indicative that since the crisis of 2007-2008, the corruption environment has deteriorated for almost all CMEA-EU countries. From 2012 onward however there has been a slight trend of improvement.

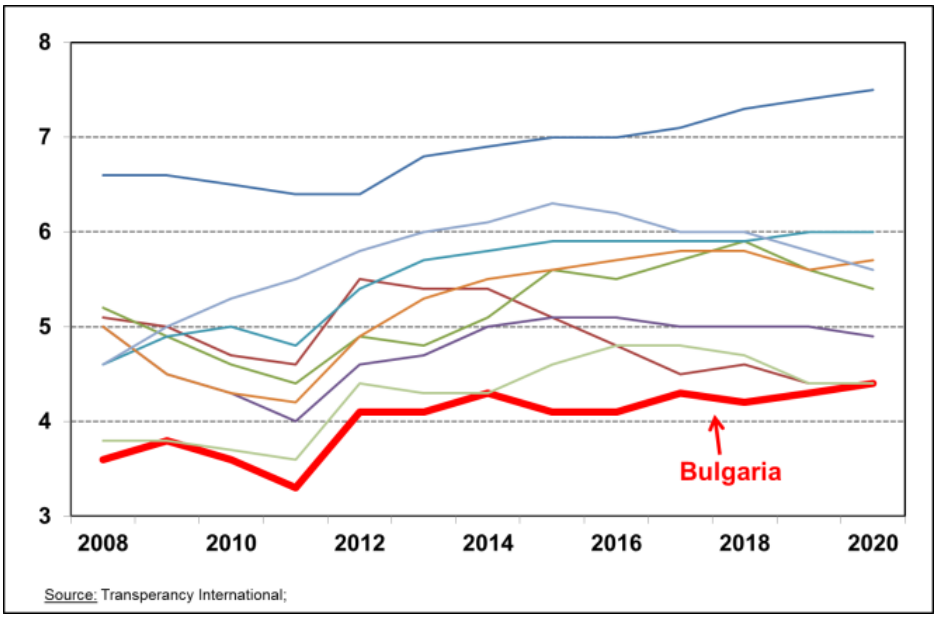

Figure 4. Corruption perception index, CMEA-EU countries

Traditionally, Bulgaria is the most corrupt country both among CMEA-EU countries **(Figure 4)** and in the EU. Estonia manages best to improve its corruption rate from 6.6 in 2008 to 7.5 in 2020. This positive trend is also related to the Estonia's leading GDP p.c. position, as shown in **Figure 1**.

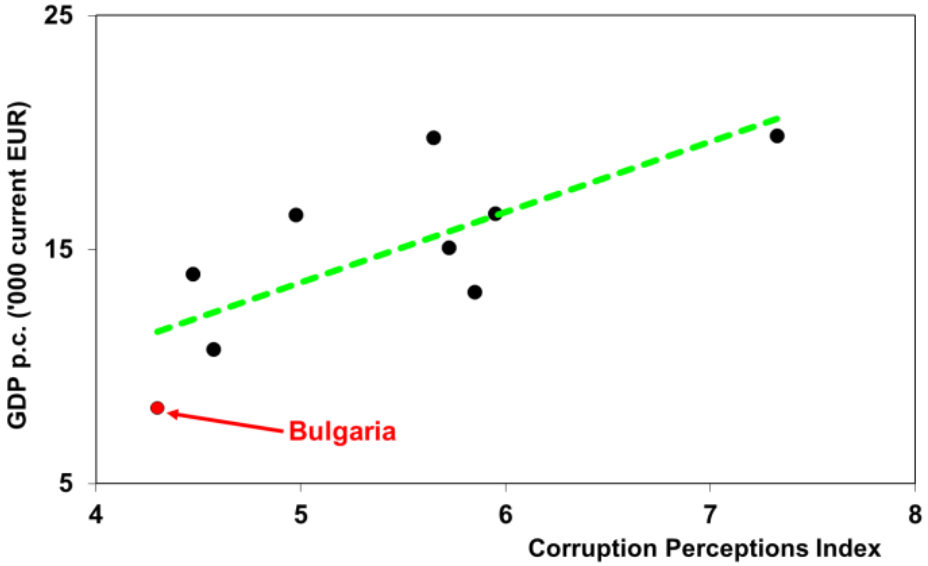

Figure 5. CMEA-EU countries, 2017-2020: corruption and economic prosperity

The data show a direct correlation between the level of corruption, on the one hand, and economic prosperity, on the other **(Figure 5**). Corruption holds back economic growth. Research shows that corruption can cause economic loss (measured as a percentage of GDP) of impressive proportions (4).

Corruption and its related malignant economic processes are first and foremost a political problem. State-business collaboration is just another name for corruption (5). Brennan & Buchanan (6) point out that corruption is contagious and reproduces itself! It breeds enduring behavior patterns. They have a

Gresham's law kind of impact on social interactions, whereby corrupt political behavior displaces conscientious political practices and almost unconsciously pushes policy makers to deliberately and preemptively satisfy their own selfish interests. According to Kindleberger (7), there is nothing more disturbing to a person's well-being than the unjust enrichment of their unworthy neighbor.

Evidence also suggests that inequality fosters perceptions of widespread corruption and correspondingly habituates norms of corruption as "*the way things are done*" (8).

2.2. Legislation is unsustainable, chaotic and ineffective. Key economic laws change frequently and chaotically (9). If one traces the frequency of changes, it becomes clear that important economic laws are being amended every hundred days on average. There are drastic examples of such amendments.

According to the Annual Report of the Administration Modernization Department of the Council of Ministers (10) in 2018 the Social Insurance Code was ammended 12 times, the Labor Code - 7 times, the Public Procurement Law - 11 times, Credit Institutions Law - 9 times, the Energy Law - 8 times, the Financial Supervision Commission Act - 6 times, the Corporate Income Tax Law - 6 times!

Such frequent, even chaotic amendments to the legislation that lies at the core of economic management inhibit stable business practices. Business management has to constantly adapt to legislators' whims rather than to market fluctuations. This, as a matter of fact, raises transaction costs, as noted by Coase (11) and North (12). Business management is kept busy predicting legislative changes rather than assessing probable market changes.

One can point out the following reasons for these frequent law amendments:

The first reason is the effect of the so-called lobbyist interests. A member of parliament (or a group of MPs) defends the interests of particular producers. This activity remains unregulated and confidential. The respective MP is interested (in the broadest sense) in changing the legislation to a certain end and does his best to achieve it. If the MP fails, he/she tries to persuade some colleagues and then tries again in a month or two. This course of action is directly linked to various corruption practices.

A second reason for the frequent legislation amendments may well be the fact that most MPs do not qualify as members of the NA. In other words they are incompetent, have no understanding of the laws, are unable to foresee the consequences from the application of the amendments. This necessitates the need for frequent amendments. Moreover, ignorance frequently begets confidence.

Thirdly, no doubt, some of the MPs are professionals in their fields. However, they are not committed enough to their immediate tasks as MPs for various reasons. They might practice lobbyism or simply think this work is not worth wasting time, energy or too much fretting. They are also prone to hopelessness and often give up, when undesirable changes are supported and passed.

Bulgaria is obliged to adhere to EU legislation directives. This guarantees an overall acceptable quality of the legislation. Problems arise when slight deviations are allowed, which consequently bend the law's functioning. The final outcome is a legislation of unsatisfactory quality which impedes business growth and economic development. Economic agents have to take into consideration both physical and social environment. The legislative uncertainty raises the question: Who determines the rules, whom do they serve, and what are their objectives (12)?

The Center for Legislative Evaluations and Legislative Initiatives and the Bulgarian Industrial Association evaluate the legislative activity of the NA (13) and conclude that lawmaking lacks vision.

In general, the legislator does not have a systematic approach to key public interactions in economy, finance, taxes and administration.

2.3. The NA often disregards the operation and requirements of its own laws.

An additional burden on the overall legislative framework was put by the selective search of responsibility for the non-abidance of current laws in action. Various bodies, authorized by the legislative powers, whose functions are to sanction natural and juridical persons for the non-compliance with laws adopted by the NA, do not always keep a close eye on the infringements made. One of the gravest problems is that MPs prioritize the loyalty to their political party and its representatives. Such loyalty strongly undermines the independence of institutions.

A specialized study of legislative activity (14) states that only 5% of the motives of the bills fully meet all requirements of Article 28, paragraph 2 of the Law on normative acts. Most importantly they don't meet the requirement for impact assessment.

2.4. Bulgaria systematically maintains one of the lowest ratios of accumulation (measured as a share of the Gross Fixed Capital Formation from the GDP) among the CMEA-EU countries **(Figure 6).**

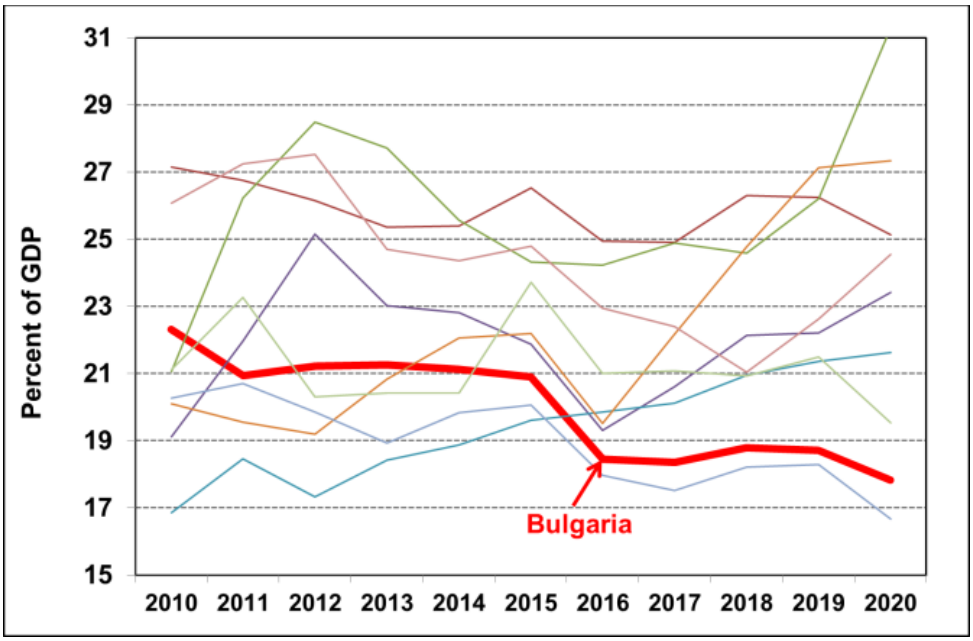

Figure 6. CMEA-EU countries: ratio of accumulation

Private investment is not subject to direct macroeconomic management. However, an appropriate investment climate is necessary that is favorable for the development of private investment activity. In this respect it is indicative that at the beginning of the second decade of the current century investment activity in Bulgaria was average in comparison to the CMEA-EU countries, but subsequently (especially during the second half of the decade) the situation worsened.

The government's influence on private investors is multifaceted. The creation of a stimulating investment climate is associated with the provision of fair rules and regulations, a sense of security in relation to upcoming government moves, an impartial judicial system for resolving industrial disputes. Effective and principled regulations make markets more predictable and improve the accuracy of projections (15). Ultimately, rules and regulations are created by the few, but they directly affect the behavior of the majority of the economically active population (12).

According to economic research (16) low investment activity can be attributed to the difficulties investors face when starting new, modern-day business. The reasons for this problem should be sought in the failure of the education system to prepare students to successfully navigate in today's complex environment. This is also the reason why economic growth is considered to be a consequence of smarter work, rather than harder work (17).

2.5. Bulgaria is negligent in public investment and lags behind the CMEA-EU countries **(Figure 7).**

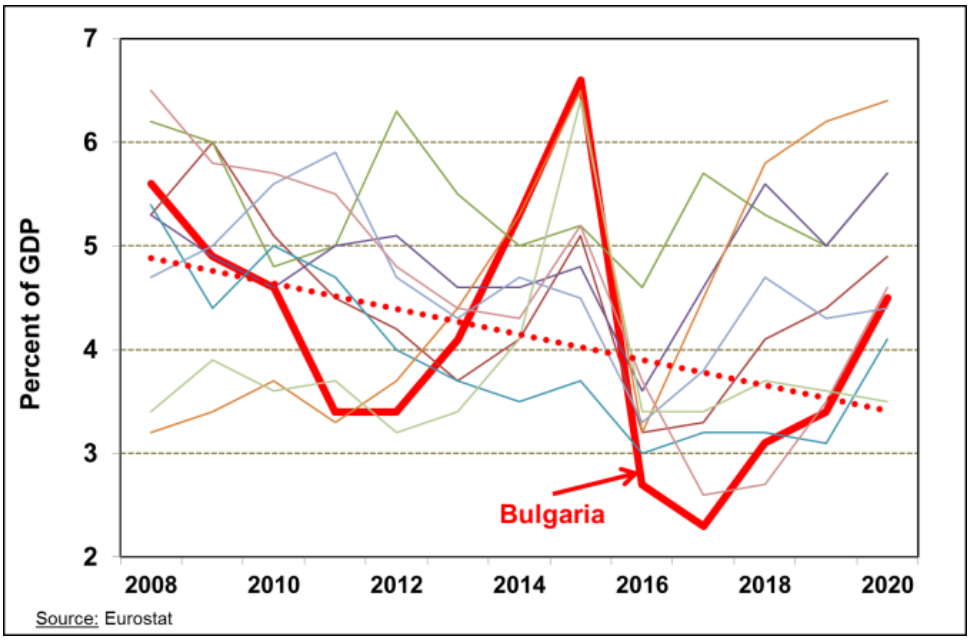

Figure 7. CMEA-EU countries: public investments

Research (18) shows that public investment in transportation, education, and scientific advancement is especially strategic to economic growth. Heilbroner & Bernstein (19) find that the government's long-term investment programs create preconditions for acceleraton of economic growth. The secret to economic growth is the fact, that as each generation faces the challenges of nature, it can rely not only on its own energies and resources, but also on the heritage of equipment accumulated by previous generations. It is indicative that according to Keynes the value of the instantaneous expenditure multiplier is greater than the unity independent of the public or private character of that expenditure and independent of whether the expenditure is for extra investment or extra consumption (20).

Development economists have often argued that some of the current spending on health, education, administration and so on can have important effects on growth at least over the longer run (21).

However, one risks slipping in this direction. Moreover, the distinction between running costs and capital costs is not always clear.

Bulgaria is a grave example of neglecting the need of developing a comprehensive public investment program. The content of the "Capital expenditure" item in the state budget is dominated by components that are not relevant to long-term public investments. The financial reports of the Ministry of Finance include expenses for long-term public investments, many of which are not truly long-term ones. As a matter of fact, long-term public investments form only about a third of Capital expenditure, and are mainly aimed at major highways construction. At the same time, the country has an urgent need to develop modern public infrastructure in various domains.

Investments in education **(Figure 8**) as well as healthcare **(Figure 9** and **Figure 10**) are lagging.

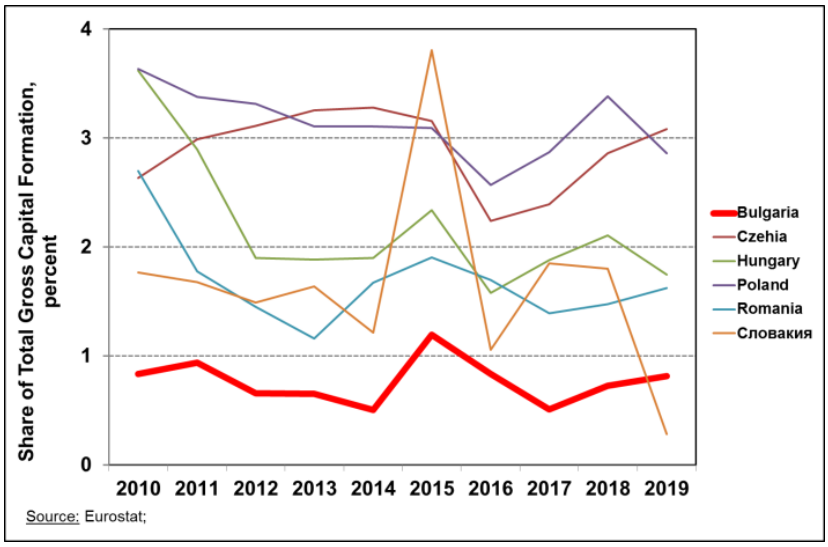

Figure 8. Gross capital formation for education

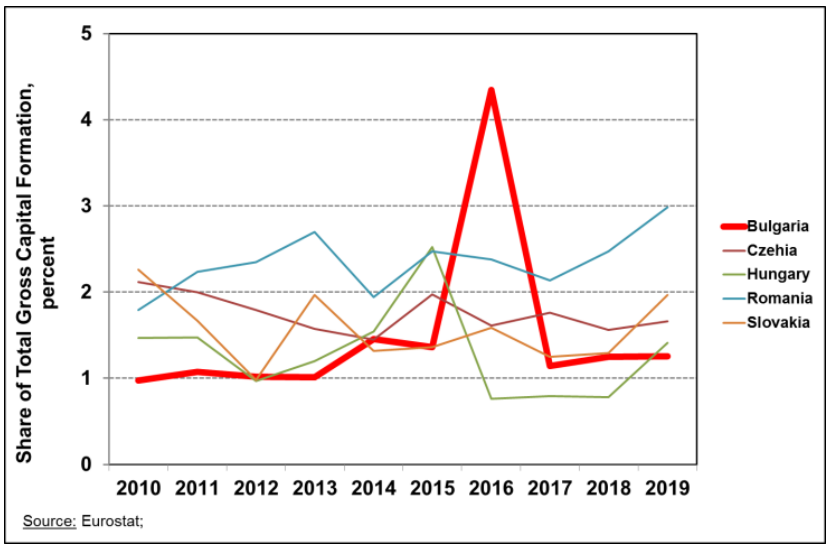

Figure 9. Gross capital formation for human health activities

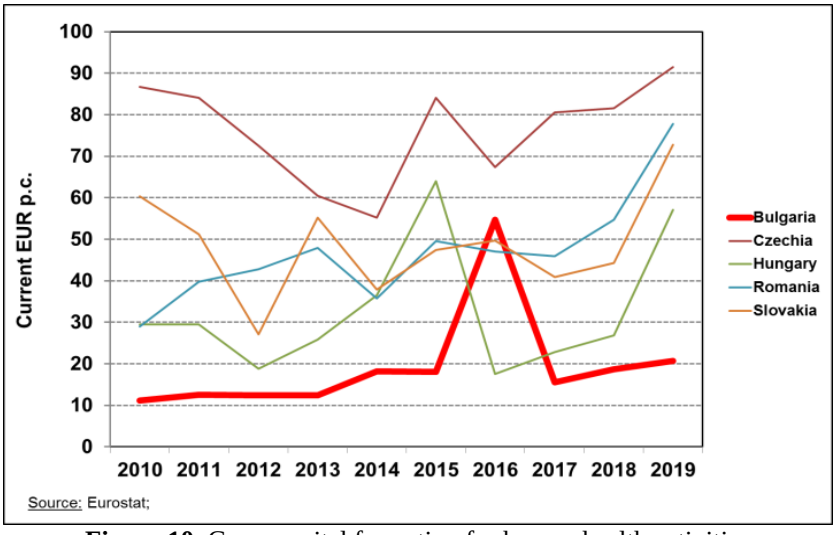

Figure 10. Gross capital formation for human health activities

2.6. The overall regulatory and business climate in the country does not stimulate foreign capital inflow **(Figure 11).**

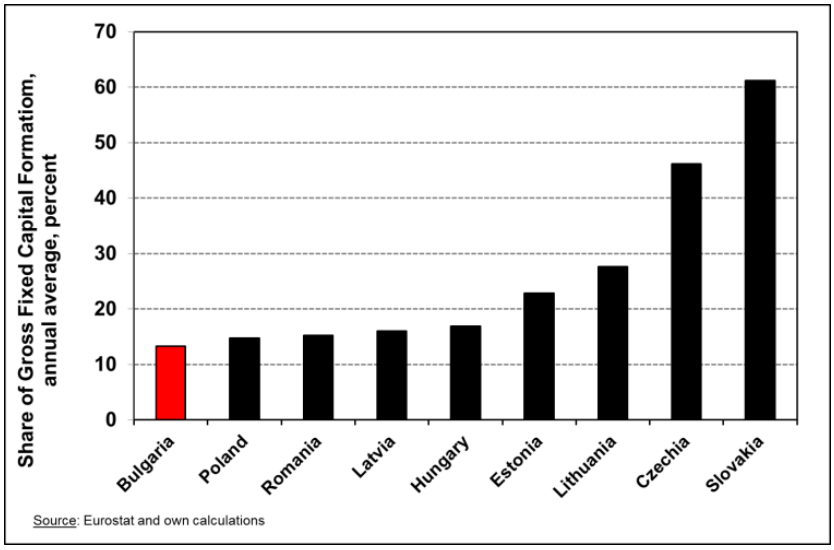

Figure 11. CMEA-EU countries: inflow of foreign capital (net), 2016-2019

The attractiveness of individual countries for foreign capital depends entirely on the current state of the economy, the opportunities for accelerated economic dynamics and predictable and acceptable returns. Last but not least is the assessment of the business environment in the host country (22). As a rule, macroeconomic management does not give due consideration to this issue, as it is viewed to affect mostly domestic relations, which are being sacrificed for the sake of more important current decisions.

The euro area does not provide advantages for attracting foreign capital. The relative magnitude of foreign capital inflow should be assessed as restrained - a UNDP study shows that for the pre-crisis period (years before 2010) the average share of the Foreign Direct Investment (FDI) in transition economies is over a quarter of domestic investment (23). It is significant that in five out of nine CMEA-EU countries (Bulgaria, Poland, Romania, Latvia, Hungary) the share of foreign capital inflows in the Gross Fixed Capital Formation (the local investments) for 2016-2019 is within the range of 15 -17%. This is true in spite of the fact, that the countries are quite different - one of them (Latvia) is a member of the euro area, Bulgaria has adopted currency board, i.e. partakes in the advantages and disadvantages of the euro area, but Poland and Romania do not intend to join the euro area in the foreseeable future.

The positioning of the countries on **Figure 11** also shows that the widespread expectation that low wages in some countries will make them more attractive to foreign capital is not justified. The configuration of the countries on Figure 11 shows that the level of economic growth achieved in individual countries, measured by GDP p.c., has a positive impact on foreign investors' decisions. Their interest in investing grows exponentially to the GDP p.c. Siddiqui (24) arrived at a similar conclusion by studying the inflow of foreign capital into developing countries. In an earlier study, Petranov (25) showed correlation between domestic investment in previous years, on the one hand, and the current FDI in Bulgaria, on the other. Such a finding supports the conclusion that FDI favors countries with proven sustainable current economic dynamics.

Foreign capital is sought after and desired by all developing countries. However, it is not a free commodity. FDIs have long-term orientation and low liquidity, unlike portfolio and other kind of investments. Even attracting FDI should be

subject to requirements, considering the national economy's stability. There is awareness of this issue at the EU level, which is why it recommends and insists on FDI screening (26). The volatility, typically observed in foreign investments, is contraindicated for sustainable finance. The inflow of foreign capital accelerates economic development, but its withdrawal has a negative effect.

Attracting and retaining more liquid foreign investments in the form of portfolio investments depends on the operation of the local capital market. Any signs of non-transparency and possible manipulation of the capital market either repel investors, or invite them to also try various manipulative schemes while keeping an open route for timely escape without consideration of the consequences.

2.7. A significant flight of local capital abroad has been observed.

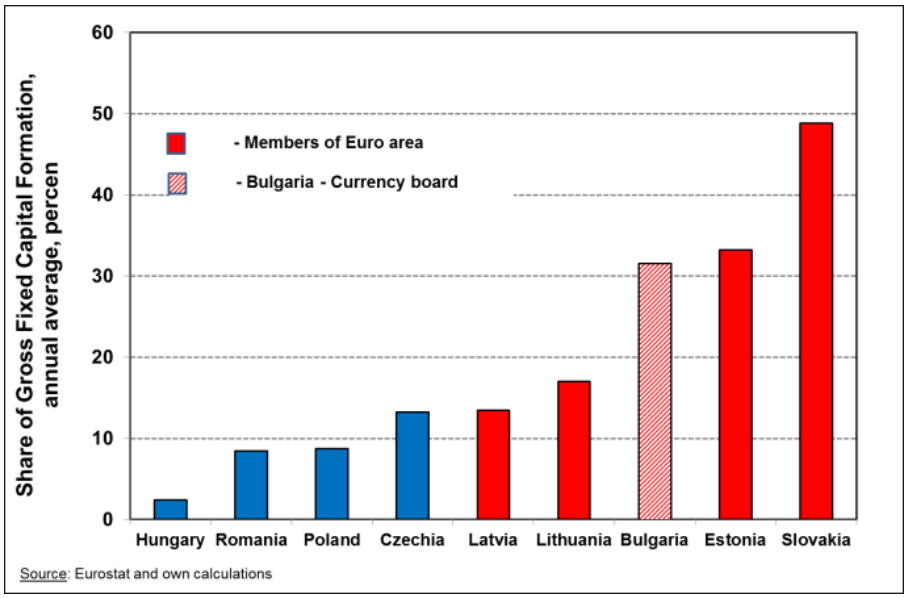

Figure 12. CMEA-EU countries, 2017-2019: outflow of local capital (net)

Figure 12 clearly shows the dividing line between the two groups of CMEA-EU countries: (1) Non-members of the euro area; (2) Members of the euro area. In the two CMEA-EU countries, which are members of the euro area (Slovakia and Estonia), as well as in Bulgaria, the relative value of cross border outflows of national capital is significantly higher than in the other six countries - roughly three and half times as high.

Euro area membership eliminates certain transaction costs related to foreign exchange, which allows for a more secure, seamless and cost-free cross-border capital movement. The size of the transaction costs is institutionally determined and correlates with the quality of government institutions (11). The above information shows that this makes developed countries more attractive to capital from poorer and lagging countries. A kind of capital gravity is activated, which attracts capital to the developed countries of the euro area. The economic agents and the population in the less developed countries of the euro area direct their capital and savings to the much better organized and predictable economies of the rich West. This leads to a slowdown in the overall technological renewal of the poorer eastern eurozone.

The outflow of capital from developing economies in the eastern part of the EU is also linked to the accumulation of illegitimate capital and the search for security and cover outside the reach of domestic law. In Bulgaria, for example, deposits of households and economic agents as an element of foreign assets increased from BGN 4 billion by the end of 2002 up to BGN 20 billion by the beginning of 2020. The growth of this

indicator was particularly intensive from 2012 (BGN 12 billion) to 2017 (BGN 27.5 billion), i.e. with an average annual growth rate of 18%, while the annual average GDP growth rate for the same period is 2.7%! A great part of this increase can be attributed to the desire to escape national tax authorities.

Euro area membership is not unequivocally a winning game for all participants, and it is not an unconditionally beneficial endeavor. There are certain reservations in the consideration of this matter. Assessments should not be absolute. Membership consequences always require professional consideration on the part of macroeconomic management. Euro area membership opens the door to economic integration, but the effects can be mixed, at least at first, especially when taking into account the deeply rooted domestic psychological patterns.

3. Anti-lagging policy

Bulgaria should find a way to leave its tail-end position among EU countries. If no solution is found, the country is doomed! The situation resembles the conundrum Kuhn talks about (27). In addition, the Darwinian process of competitive rivalry guarantees that only those who actually maximize will survive (20).

Bulgaria needs to maintain annual GDP growth rates in the range of 5-7% in order to be able to leave its last-ranking in the EU.

The policy needed to achieve this goal is clear. It has been defined in theory, as well as in practice. It comprises of:

First, the rule of law;

Second, sustainability, transparency and predictability of lawmaking;

Third, strict adherence to competition-based approach to public officials' recruitment and public investment distribution;

Forth, active use of budget leverage;

Fifth, a clear position of macroeconomic management on the monetary union (euro area) implications on Bulgaria, taking into consideration that the country is under currency board.

Bulgaria's current problem is:

Why has Bulgaria been neglecting elementary truths about economic and social management during the three decades of transition to a market economy and a democratic society?

According to Public choice theory the answer lies in the way of selection of state authority officials (MPs), as well as in the absence of effective public control.

The sovereign people fail to nominate representatives, worthy to be entrusted with Bulgaria's future. The reason should be sought in the population's poor socio-economic awareness, as well as in the traditional disregard for the role of macroeconomic management.

Bulgarian intelligentsia all across the range is in debt to their own people, one of the reasons for this being the poor quality of education.

CONCLUSION

Bulgaria ranks last within the EU due to the poor level of national intelligence and the specifics of political affairs.

The acceleration of economic development requires the raising of the population's general political and economic literacy, as well as improvement of the political infrastructure in accordance with modern standards.

The functions and forms of macroeconomic policy should be reconsidered in accordance with modern standards, taking into account the impacts of our de facto membership in a monetary union.

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