Bulgaria: The way ahead

Author Kristofor Pavlov, Chief Economist for Bulgaria*

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Bulgaria's progress in income convergence remains insufficient. Most recent data put GDP per capita in Bulgaria at 38% of that in Germany (see Chart N1), which is the smallest among all eleven CEE countries that joined the EU since the collapse of communism in the early 90's of the past century. Perhaps more importantly, data show that Bulgaria's progress in improving its living standard has been smaller than that in most of the new EU member states from the CEE region (see Chart N2). For the last nineteen years per capita GDP in Bulgaria relative to that in Germany increased by 11.3 pps, from 26% in 1995 to 38% in 2014. This is the eighth strongest result, with only Slovenia, Czech Republic and Croatia posting smaller progress of respectively 9.2 pps, 8.0 pps and 5.9 pps. However, comparisons with these three countries should be made with a pinch of salt, because with per capita GDP of 58%, 60% and 42% of that in Germany all three had a much stronger starting position when compared with Bulgaria, where per capita GDP was just 26% of that in Germany in 1995. Comparing Bulgaria with Romania and Baltic countries, that had very similar starting position back in 1995, looks more relevant. But such comparison provides even less comfort, because living standard improvement (relative to that of Germany in the 1995–2014 period) was 32.6 pps in Lithuania, 32.4 pps in Estonia, 25.7 pps in Latvia and 20.0 pps in Romania, while Bulgaria comes fifth with 11.3 pps improvement.

Chart 1: Income convergence, average GDP per capita in CEE (11), in PPS terms, Germany=100

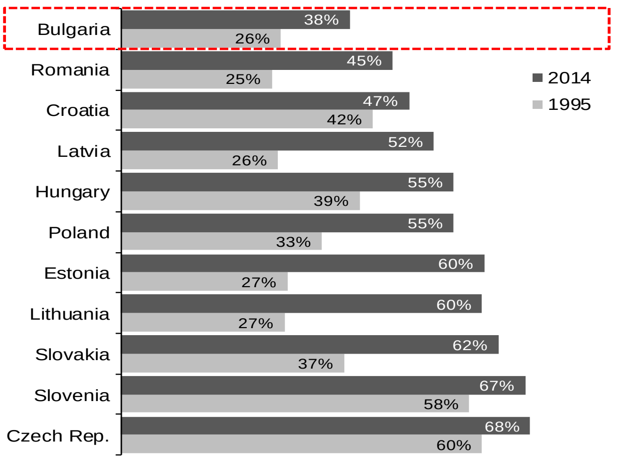
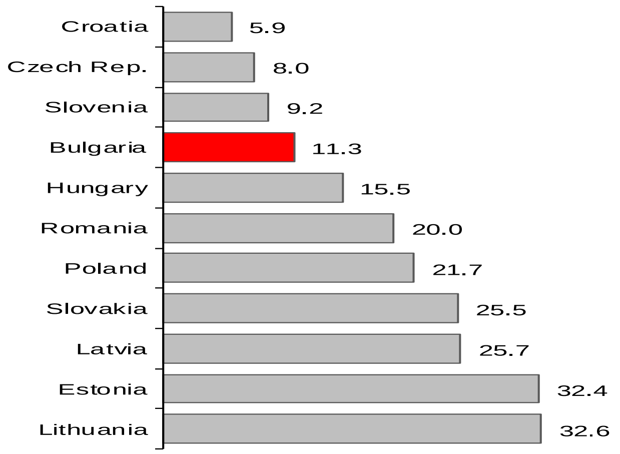


Chart 2: Income convergence progress 2014 vs 1995, average GDP per capita in CEE(11), in PPS terms, Germany=100



Source: Eurostat, UniCredit Bulbank Economic Research

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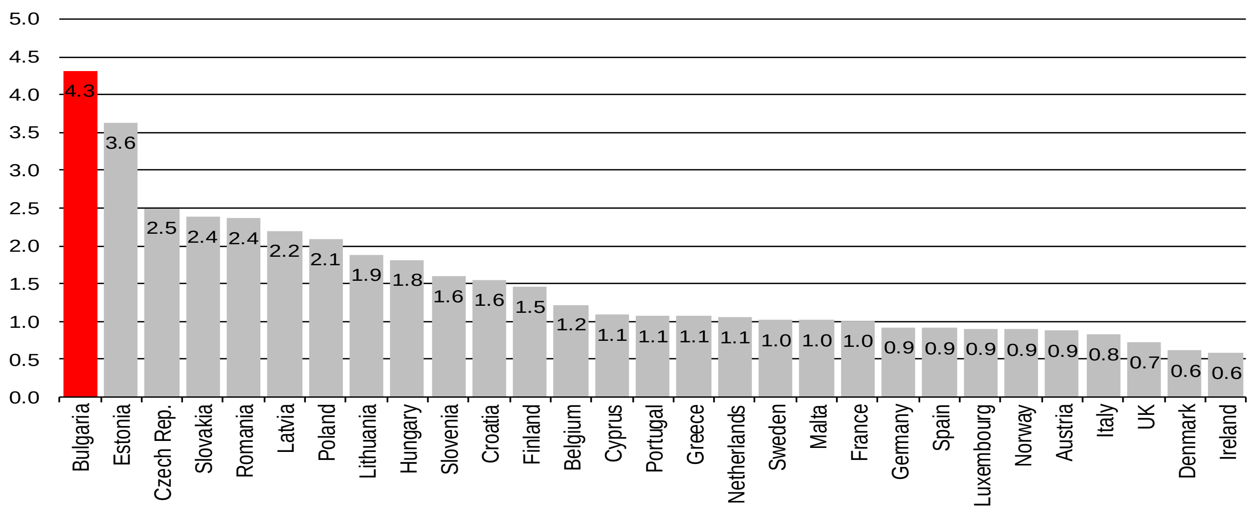
In terms of income convergence, performance so far was depressed by the difficult legacy from the retrograde regime of the last communist dictator Todor Zhivkov along with the mismanagement of the early stages of transition from a centrally planned to a market economy, which led to the devastating financial and economic crisis in 1996-97. At the same time, Bulgaria seems to share the same societal and organizational capabilities - that many economists believe to eventually determine a country's growth catch-up potential - as the other CEE economies, which suggests that Bulgaria can do much better when it comes to improving its living standard. This encourages us to believe that slowly but surely Bulgaria will catch-up to the norm that one should expect. To mention any specific numbers is very risky. Nevertheless, it wouldn't come as a surprise to me, if Bulgaria's per capita GDP rose to around 60% of that in Germany in the next two decades.

In what remains of this short analytical piece I will elaborate on some of the policies which, in my view, can help unlock Bulgaria's development potential and accelerate income convergence process.

There are some low hanging fruit when it comes to income convergence. Above all, this includes making energy more easily available by diversifying supply routes and sources of primary energy resources. This will also require investing more to boost energy efficiency, which remains the lowest in the EU28 (see Chart N3). Isolation of Russia on the global scene, after annexation of Crimea and invasion in Ukraine, creates a window of opportunity that Bulgaria can seize. If the latter is used wisely, Russian near monopoly position as supplier of primary energy resources for the local energy sector can be dismantled in an orderly manner within less than a decade.

Chart 3: Energy intensity in EU countries (kilogram of oil equivalent per 1000 euro GDP), EU 28 = 1 (2013)

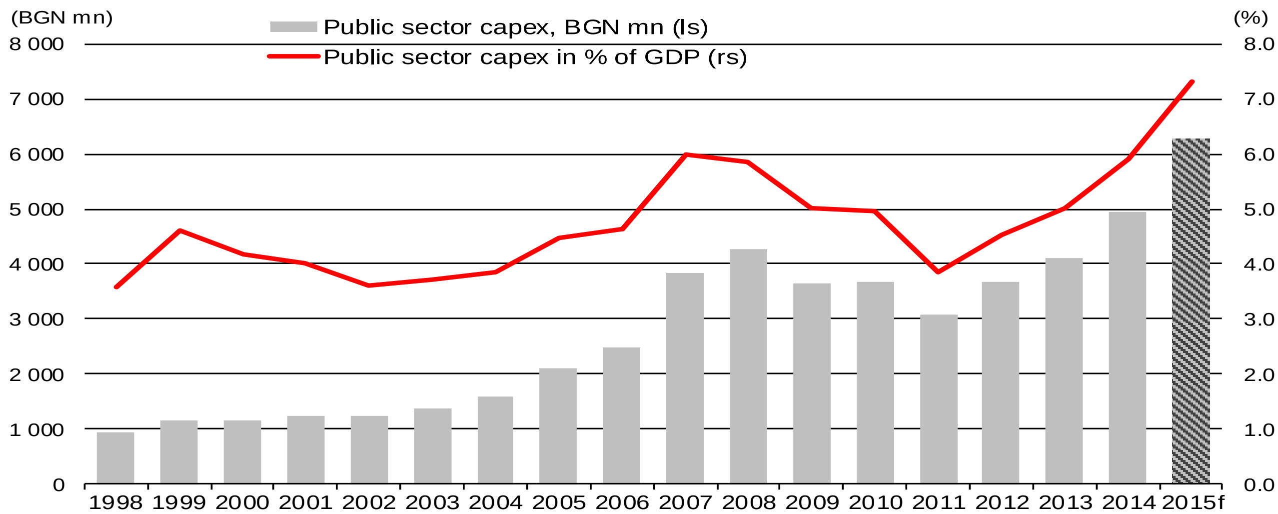


Source: Eurostat, UniCredit Economic Research

Another policy needed to accelerate income convergence is to increase infrastructure investments. Government investments in infrastructure form the basis for growth in the economy. These investments not only expand the economy themselves, but also make private investments to become even more attractive. As the European Commission noted in its July statement on the creation of its infrastructure fund: “Weak investments in the euro area has a considerable impact on the capital stock, which in turn holds back Europe’s growth potential, productivity, employment levels and job creation”. Unfortunately, similarly to the euro area, Bulgarian economy has suffered from a pronounced underinvestment in infrastructure over most of the last 20 years. Initially this was due to the large debt servicing costs following the 1996-97 crisis, which led to drastic cutbacks in practically all public sector related spending. Later, when public debt went down to more manageable levels of close to 20% of GDP in 2007, the resulting fiscal space was rather used to cut taxes than to increase spending. Only very recently, underpinned by improved absorption of EU funds, the public infrastructure spending has stabilized at higher levels, which if sustained long enough will eventually bring the period of underinvestment in infrastructure to an end.

But the harm has already been done, and underinvestment in infrastructure - including roads, ports, air transport infrastructure and most disappointingly energy sector related infrastructure, has increasingly turned into a factor constraining Bulgaria’s economic development. We need to think big to reverse this negative trend. This won’t be easy. We need to acknowledge that country’s infrastructure needs far exceed EU funds that it will be entitled to receive in the future. An ambitious infrastructure development program is thus needed in response - a program which has both scope and scale large enough to erase the remaining infrastructure bottlenecks. The program should have clear sources of financing which match the size of targeted investments. Such a program, in my view, should ensure that public investments in infrastructure relative to the country’s GDP remain close to the 7% mark already reached in 2015 (see Chart N4), for a prolonged period of time of perhaps at least two decades.

Chart 4: Capital expenditures of the public sector



Source: NSI, MF, UniCredit Economic Research

But economic development needs investments not only in physical capital but also in human capital. We have to increase investments in our own people to allow them to acquire the knowledge and skills that would make them more competitive on the global market place. In a world which has become more digitalized we have to have a more sophisticated labour force. Education is not only what changes minds and mindsets, but also what enables hyper specialization on the market place that is so vital for the success of many businesses. Unfortunately, pressure to cut public spending has also encompassed the education sector. As Chart N5 below shows, general government spending for education in Bulgaria over the last 5Ys is lagging well behind that in the rest of the countries in CEE. On average Bulgarian government spending on education was 3.7% of GDP, which is way below that, reported in the CEE countries that have achieved most in terms of income convergence.

Against this backdrop, it is perhaps not surprising that, as Chart N6 below shows, Bulgarian students are performing poorly on PISA tests when compared with their peers in CEE, and particularly when compared with the students in the industrialized economies. While it is clear that underinvestment in education is not the only reason for deteriorating educational attainments of Bulgarian students, the policy response needed here, among other things, should include significant increase in the investment in education. Without this unlocking the country's full development potential would be hard to achieve, because in the global economy there are only two ways to improve competitiveness of the labour force: you should either cut labour costs or invest in your people to allow them to get the skills and knowledge needed to make them more efficient and productive.

Chart 5: General Government spending for Education, as % of GDP, (2009-2013 average)

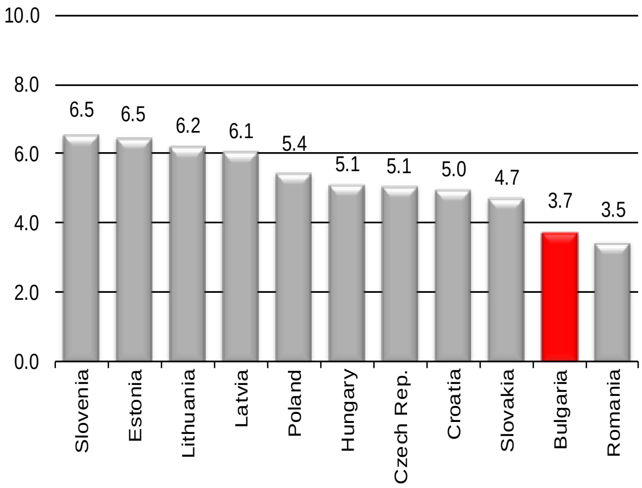


Chart 6: PISA literacy index*, (2012)

Country	Reading		Mathematics		Science	
	Score	Rank	Score	Rank	Score	Rank
Bulgaria	436	11	439	11	446	10
Croatia	485	6	471	9	491	8
Czech Republic	493	3	499	4	508	4
Estonia	516	2	521	1	541	1
Hungary	488	5	477	8	494	7
Latvia	489	4	491	5	502	5
Lithuania	477	8	479	7	496	6
Poland	518	1	518	2	526	2
Romania	438	10	445	10	439	11
Slovakia	463	9	482	6	471	9
Slovenia	481	7	501	3	514	3
CEE simple average	480		484		493	
BG vs CEE	44		45		47	
OECD trend score	496		494		501	

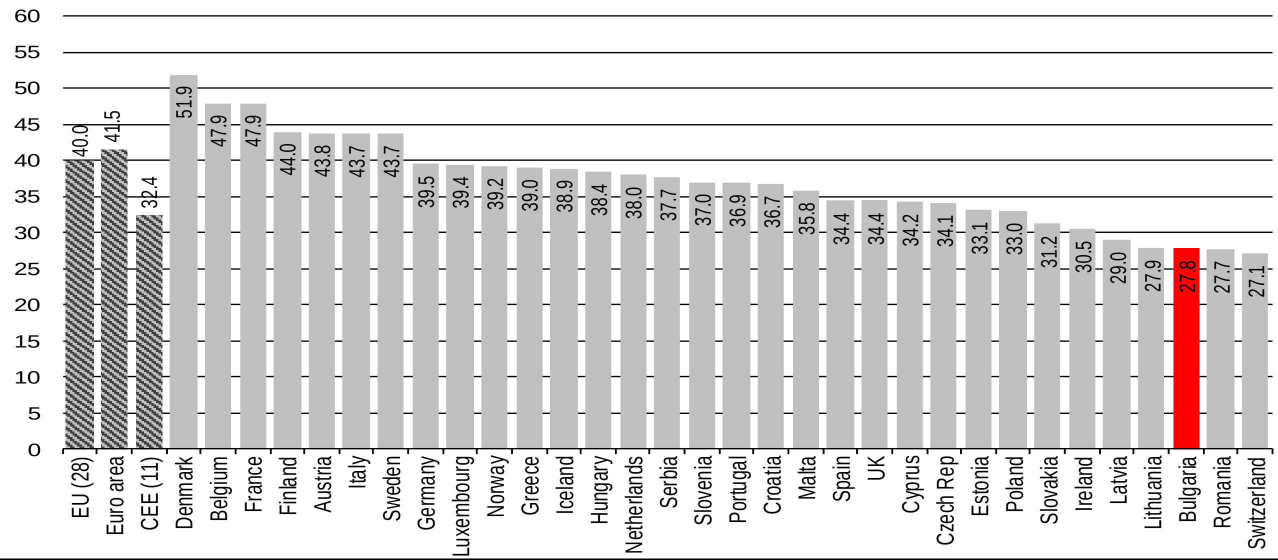
Source: Eurostat, National Center for Education Statistics, UniCredit Bulbank Economic Research

**The Programme for International Student Assessment (PISA) aims to measure the knowledge and skills of 15-year-olds from 65 economies in the following fields*

To point out at a specific number is tricky. Still it seems that if Bulgaria really wants to regain its competitiveness in this crucial area it should push public sector spending on education to around 6% of GDP in the next 2-3 years, while at the same time making sure that universities deliver the knowledge which is most in demand on the labour market. This looks challenging, because when needs for investment increases in both infrastructure and education sectors are taken together, Bulgaria would have to increase tax revenues by some 4% of its GDP, pushing its total tax revenue to GDP ratio closer to the levels of CEE star performance in income convergence – Czech Republic, Slovenia and Slovakia (see Chart N7).

To this end we have to boost tax collection. But to make increases of investments in education and infrastructure conditional only to tax collection improvements would simply not do the job. On top of tax collection improvements, some redesign of the tax system would also be needed to open a fiscal space large enough to accommodate targeted increases in both education and infrastructure spending. The latter, in my view, should come to around 2.5-3% of the country's GDP, assuming that tax collection improvement can add the remaining 1-1.5% of GDP.

Chart 7: Total tax revenues (including social contributions) as % of GDP (2014)

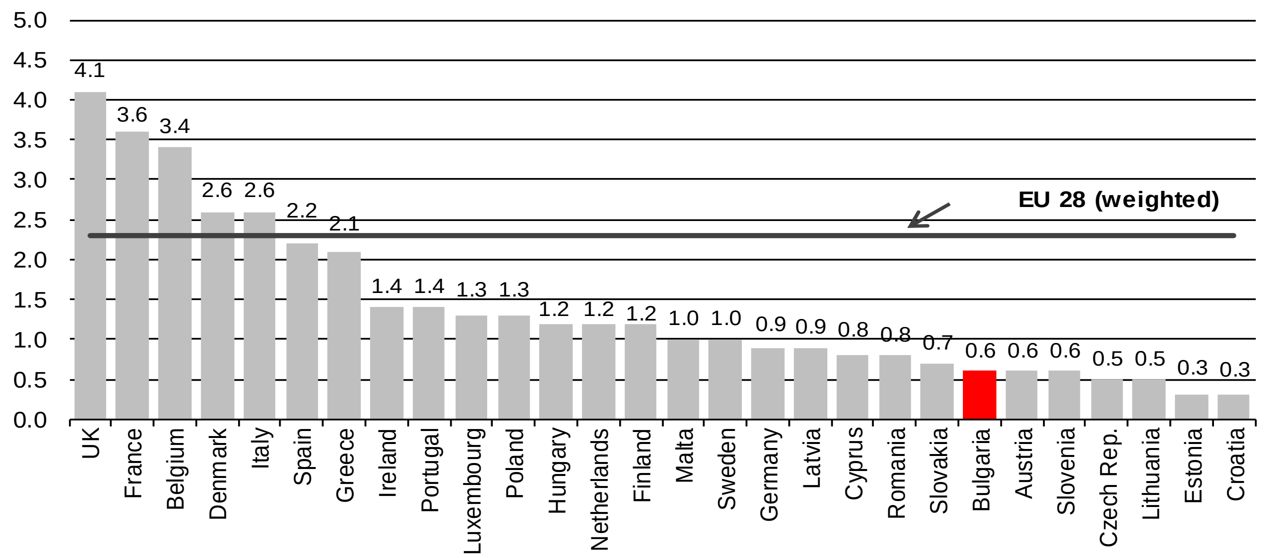


Source: Eurostat, UniCredit Economic Research

Redesigning the tax system promises to be hard, but hopefully not impossible. The preferred option here, in my view, would be to increase taxation on pollution, because this will boost fiscal revenues without increasing market distortion usually associated with taxes. Economic theory suggests that those who pollute do not bear the full costs they impose on the rest of the society. Not charging polluters for the costs they impose on the environment is, in effect, a hidden subsidy, the theory goes on. This is a major source of distortion in the economy which increased taxation of pollution can correct, thus also helping to shift some resources into areas where social contribution is higher. When the car importers push for low taxation on sales of second hand vehicles or the oil processing companies push for laws that free them from the full consequences of an oil spill, they are, in effect, asking for a public subsidy. The list of water, soil and air polluters can be extended further to include coal firing electricity generation utilities, manufacturing companies producing toxic waste and households using wood or coal for house heating purposes, which taken together can form a significant tax base leading potentially to a similarly significant tax revenue. But environment pollution is not the only harmful activity which makes sense to be taxed. Pretty much the same arguments can be used to justify an increase in taxation of cigarettes and alcoholic beverages and for the introduction of new taxes on foods causing obesity as well as other socially and economically significant diseases.

Besides taxation of harmful activities there are other options to raise fiscal revenues in a way that is not detrimental to economic efficiency. For example authorities can consider raising property taxes which in Bulgaria, as Chart N8 below shows, are low by any conceivable standard. The scope of the property tax can be expanded to involve ownership of farm land which at the moment is tax free, while a higher tax rate can be set for second home owners.

Chart 8: Fiscal revenues from property taxes in EU, as % of GDP (2012)



Source: Eurostat, UniCredit Economic Research

Other ways to accelerate income convergence are more elusive. The most promising avenue here is to boost quality of institutions (see Chart N9 and chart N10). Economic theory suggests that the differences in living standards above all reflects differences in the quality of public sector institutions, or the broad rules that govern the economy. This means that reducing corruption, ensuring the rule of law, cutting rent seeking, strengthening application of antimonopoly laws, and establishing a sense of a more equitable and fair society has a huge development potential. Providing stronger social protection to ordinary people in case of unemployment and illness will lead to better motivation of the work force and therefore to a more efficient and dynamic economy. Policies aimed at redistributing income from the large cities to the less developed rural areas and particularly from those on top of the income distribution chain to the less fortunate part of the society should also help to stimulate income convergence, if implemented.

Chart 9: Quality of institutions index¹, score ranges between 1 (worst) and 7 (best), (2015)

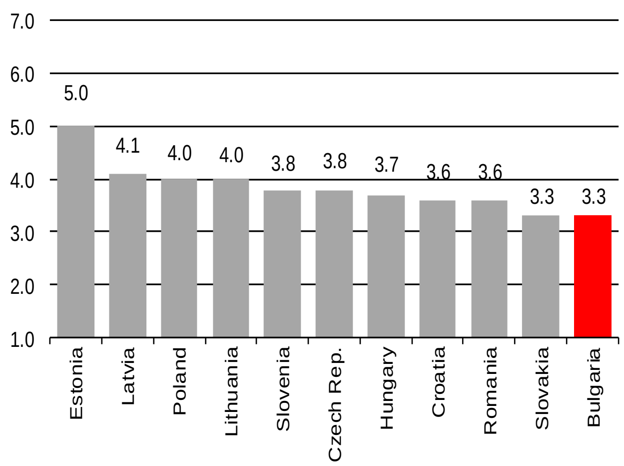
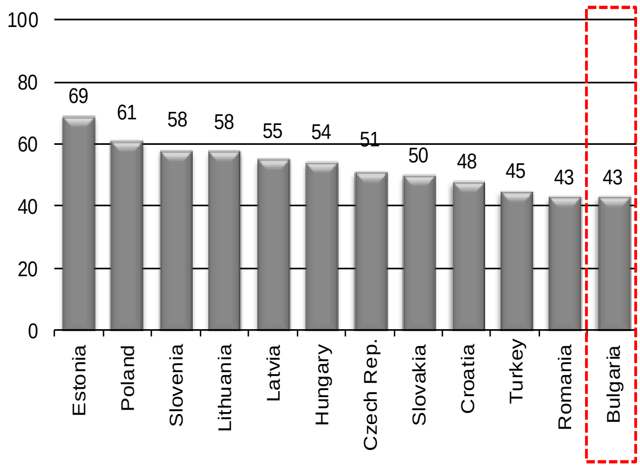


Chart 10: Corruption perception index², score ranges between 100 (highly clean) and 0 (highly corrupt), (2014)



Source: Eurostat, World Economic Forum, Transparency International, UniCredit Bulbank Economic Research

¹Quality of institutions index 2015 - The institutional environment is determined by the legal and administrative framework within which individuals, firms, and governments interact to generate wealth; ²CPI 2014 Score - Relates to the degree to which corruption is perceived to exist among public officials and politicians by business people and country analysts. Score ranges between 100 (highly clean) and 0 (highly corrupt).

In conclusion let me stress that concerted national efforts would be needed to implement any of these policies. They will be hard to agree, because while there would be mostly winners there will be also some losers. Difficult trade-offs will have to be tackled, but if implemented these policies will shift income convergence into higher gear, which will allow to accelerate the processes of absorption of foreign technology and modern production management practices which the start of transition to a market economy triggered 25 years ago. What is perhaps even more important is that, if implemented, these policies will help to stop the brain drain and reverse the negative demographic trends, which threaten to irreversibly damage long-term supply side potential of the Bulgarian economy, and which is increasingly recognized by many as the greatest long-term challenge that our society faces.

Failure to make progress on this ambitious development agenda will likely lead local elite to the same short-sighted rent extraction pattern of behaviour that we have seen to materialize so many times in the underdeveloped world, and that will ultimately put Bulgaria at risk of becoming just another corrupt country stuck in the middle-income relative development trap.

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