This report was prepared by Jakov Milatovic, Principal Economist at the Economics, Policy and Governance (EPG) department at the EBRD, under the supervision of Mateusz Szczurek, the Lead Regional Economist, and analytical support of Dan Meshulam, intern at EPG. Important contributions to the analysis were made by Dimitris Sourvanos and Oleg Levitin on political economy and governance, Martin Pospisil and Federica Foiadelli on innovation, Svenja Peterson on small and medium enterprises, Philipp Paetzold and Olivia Riera on value chain analysis, Kjetil Tvedt and Susanne Wischnath on infrastructure and Marko Stemsek on labour market issues. We are grateful for guidance and comments provided by Mattia Romani (Managing Director, EPG), Artur Radziwill (Director, Country Economics and Policy) and Peter Sanfey (Deputy Director, Country Economics and Policy). We are also grateful to numerous other colleagues in EPG for helpful contributions. The report has benefited from comments from EBRD colleagues in other departments, including Banking (Larisa Manastirli, Director, Head of Sofia RO and Mark Davis, Director for Romania and Bulgaria), Office of the Chief Economist, Office of the General Counsel, Country Strategy and Results Management, Energy Efficiency and Climate Change. The views expressed in this paper are those of the authors only and not necessarily those of the EBRD. The report is based on data available as of end-2018.
Country diagnostics are an EBRD tool to identify the main obstacles to entrepreneurship and private sector development and to help shape the Bank’s strategic priorities and project selection in new country strategies. Each diagnostic informs the EBRD’s policy engagement with the authorities in the country.

Each country diagnostic assesses the progress and challenges of the country of operations in developing a sustainable market economy. Private sector development and entrepreneurship are at the heart of the Bank’s mandate in the regions of operation of the bank, but the private sector in all EBRD countries faces a range of problems and obstacles. The diagnostic highlights the key challenges facing private companies and shows where each country stands vis-à-vis its peers in terms of six qualities of transition – competitive, well-governed, resilient, integrated, green, and inclusive – and points out the main deficiencies and gaps in each quality.

The diagnostics draw on a range of methodologies and best practice for assessing how big different obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), as well as other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and OECD. For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical for private sector development in the country.

The diagnostics are led by the EBRD’s Country Economics and Policy team, drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

The views expressed in the diagnostic papers are those of the authors only and not of the EBRD.

For more information, go to: https://www.ebrd.com/publications/country-diagnostics
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Executive summary

There are a number of factors which make Bulgaria an appealing investment destination, including the EU membership, macroeconomic stability, a favourable tax regime, relatively diverse economy and the strategic location in South East Europe.

However, the absence of appropriate incentives for private sector led growth slow down income convergence. Current GDP per capita, adjusted for purchasing power standards, is half the average in the European Union (EU).

Narrowing the gap in living standards will require an intensification of structural reforms. Although the country has been a member of the EU since 2007, it still has some way to go towards a sustainable market economy status.

Key obstacles to private sector development in Bulgaria, identified in this paper are the following:

- **Economy suffers from limited capacity to generate value added and to innovate**
- **Business environment and governance face serious constraints**
- **State presence is still pervasive in key industries.**
- **Social challenges, including the lack of public trust, in addition to low level of digital skills hinder the process of digital transition**
- **Economic performance is hampered by labour and skills shortages, resulting from the population ageing, strong outward migration and skills mismatches**
- **The state of transport and municipal infrastructure is poor and the sector is facing a number of challenges**

To better understand the key obstacles to private sector development, the diagnostic study provides a short political and economic overview.

The section on the **convergence potential** shows that full convergence with average EU living standards could take years. A baseline scenario, which uses the average growth rates for the period since 2000, of ca. 3.7 per cent for Bulgaria and 1.7 per cent for the EU, implies that the country could achieve the average GDP per capita in the EU in about 30 years’ time. However, in case of an intensification of reforms the catch up may come much sooner, or in a pessimistic scenario – it may never happen.

The section on **economic overview** provides a short outline of the country’s economic structure, including the important role of the small and medium size enterprises, foreign trade and investment, and the extent of its integration in the global (and European) value chains.

While elaborating on the factors which have negatively impacted the speed of reforms in Bulgaria since the beginning of transition, particularly the polarised political system and the short lifespan of governments, the **political economy** section helps in understanding what is that can be expected going forward.

The section on the forthcoming **Euro adoption** explains the process of Bulgaria’s entry into the single currency union, and its implications for private sector development, including through the more resilient banking sector.

The diagnostic exercise presented in the paper finishes with the short description of each of the six desirable **qualities of a sustainable market economy**, as per adopted EBRD methodology for measuring transition, namely: competitive, well-governed, green, inclusive, resilient, and integrated.
1. Convergence potential

Economic development of Bulgaria since the fall of the Berlin Wall can be divided into four distinct phases: early transition, boom, bust and recovery\(^1\) (Chart 1). The first phase lasted for almost ten years throughout most of the 1990s, and was characterised by a significant fall of output (cumulatively of ca. 40 per cent of the 1989 levels) and a number of years of skyrocketing inflation. Price stability was brought back with the introduction of the currency board in 1997. During the second phase, which lasted from 2000 through the onset of the global financial crisis, economy experienced a dynamic growth, of 6 per cent on average. The economic revival was stopped by a steep recession in 2009, with its aftermath of marginal growth. The economy returned to a more dynamic growth rates, of more than 3.5 per cent, in 2015.

**Chart 1: Bulgaria’s economic growth, %**

Full convergence with average EU living standards could take years. Current GDP per capita, adjusted for purchasing power standards, is half the average in the EU. A baseline scenario, which uses the average growth rates for the period since 2000, of 3.7 per cent for Bulgaria and 1.7 per cent for the EU, implies that the country could achieve the average GDP per capita in the EU in about 30 years’ time (Chart 2). An optimistic scenario, which adds 2 percentage points to Bulgaria’s growth rate, in line with the country’s pre-crisis growth rates of the boom phase (of 6 per cent), would yield catch up with average EU living standards in 15 years, while a pessimistic scenario, which subtracts 2 percentage points from the baseline, in line with the post-crisis average growth rate, implies no convergence.

**Chart 2: Convergence scenarios**

Narrowing the gap in living standards will require an intensification of reforms needed for building sustainable market economies. There are a number of factors which make Bulgaria a relatively appealing investment destination, including the EU membership, macroeconomic stability, a favourable tax regime, relatively diverse economy and the strategic location in South East Europe. However, the absence of appropriate incentives for private sector led growth slow down convergence. Although the country has been a member of the European Union (EU) since 2007, it still has some way to go towards a sustainable market economy, defined as one that is competitive, well-governed, green, inclusive, resilient and integrated.

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\(^1\) See “Economic and Policy Foundations for Growth in South East Europe” by Adam Bennett et al, Palgrave Pivot 2015.
2. Economic overview

2.1 Economic structure

Bulgaria's economy is relatively diverse. Industry and trade each deliver about one quarter of the value added (Chart 3). Manufacturing, as an industrial subsector, is mainly related to labour-intensive food processing, textiles and basic metals, while utilities subsector, including energy production, is also sizeable. Public administration is the third largest sector, although is relatively small compared to its EU peers. Agriculture accounts for a relatively high, albeit falling, economic share, which is at 4 per cent lower only to Romania.

Chart 3: Economic sectors, % of gross value added

Source: National Statistical Institute, 2018

Financial and ICT sectors are developing rapidly. The financial sector and ICT sector are the fifth and the sixth largest sectors, with the latter being among the largest in the EU, in relative terms. This can be seen through their relatively large contributions to growth over the past 15 years, of about 0.4–0.5 percentage points on average per year (Chart 4).

MSMEs in Bulgaria play a more important role in the economy than in the average EU member state. Economy is predominantly based on micro, small and medium enterprises (MSMEs). They contribute about 75 per cent of employment and almost two thirds of value added, both above the EU averages of 66 and 57 per cent, respectively (Chart 5). After a dip post financial crisis, the value added by MSMEs has seen a more rapid growth than the EU average, over 60 per cent between 2011 and 2017. Similarly, in recent years Bulgaria had a share higher than the EU average of enterprises that experienced an annualised employment growth of over 10 per cent. Both of these facts imply that (generally less productive) micro firms, accounting for more than 90 per cent of MSMEs, are slowly graduating.

Chart 4: Contributions to growth, average 2001–17

Source: National Statistical Institute, authors' calculations

Chart 5: Share of MSMEs in economic activity
MSMEs contribute just under half of Bulgarian exports in terms of value. This is significantly higher than in the EU peer countries (i.e. Hungary, Poland, Romania, Slovenia and Slovakia) where MSMEs only contribute around 35 per cent of exports (although this may also be a result of a relatively weak large corporate sector). MSMEs are mainly active in wholesale and retail trade (42 per cent). Manufacturing businesses, although accounting for less than 10 per cent of MSMEs, contribute a significantly higher share of value added and employment among MSME businesses, at 21 and 25 per cent, respectively.

2.2 Foreign trade and investment

Bulgaria’s foreign trade to GDP ratio has increased significantly over the past years. Foreign trade stands at about 130 per cent of the country’s GDP, equally split between exports and imports (Chart 6); a significant increase from less than 80 per cent of GDP in the early 2000s.

The EU is by far the country’s most important trading partner. Two-thirds of Bulgaria’s exports are with the EU, an increase from less than 50 per cent twenty years ago. This is a natural result of the country’s 2007 EU membership, and the free trade agreements which preceded its EU accession. The increase of the share with the EU came from a relative decrease in importance of CIS countries and other European countries, including those of the Western Balkans. Turkey is also an important trading partner, with about 8 per cent of the country’s exports, a relatively stable share.

Bulgaria’s economic complexity index is low. Economic complexity index takes into account the diversity of a country’s export basket as well as the number of countries which are also able to produce and export the same products. Despite having a diverse export basket, the technology level of Bulgaria’s exports is low (high tech products account for only 5 per cent of total exports), implying that most of other countries are able to produce them as well. In 2016, Bulgaria ranked second to last out of all EU countries in economic complexity, and its rank did not improve, but stagnated over the transition period (Chart 7), which is in contrast to some of its regional peers.

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2 Economic Complexity Index summarises data from countries’ exports basket to form a measure of the knowledge-intensity of their economies, by weighting both the diversity of the export basket and the ubiquity of it (i.e. the number of countries who are also able to produce and export the same products). A country would score high in the complexity index if it exports a wide range of products which few other countries are able to produce.
FDI inflows in Bulgaria in the recent years were higher compared to all its EU regional peers. FDI inflows averaged about 3 per cent of GDP in the period 2014–18 and improving towards the end of this period. However, these flow figures (of the last few years) are still lower compared to the pre-crisis annual average of more than 10 per cent of GDP.

FDI stock per capita is lower compared to most of its regional peers (Chart 8). As in other regional EU peers, most of the FDI stock comes from the EU; however, opposite to those peer countries, where most of the FDI stock was in the manufacturing sector, real estate sector is dominant (about a quarter of all investments). Manufacturing, financial sector and wholesale and retail trade come next. Importantly, the ICT sector is developing rapidly, and is now among the largest in the EU in relative terms.

Bulgarian integration in global value chains (GVC) has stalled since 2012, in line with the global trend of trade slowdown. Nevertheless, Bulgaria shows a high degree of GVC integration, whereas 52 per cent of all Bulgarian exports are sourced and sold in GVC linkages. Bulgaria’s GVC Participation Index is above the EU-28 average, but lower than in Slovakia and Hungary.

Bulgaria has on average stronger backward linkages than forward linkages, indicating that it sources a higher share of foreign value-added intermediates for its exports (36 per cent of total exports) than it sells domestic value-added intermediates to third countries for their further processing and exportation (16 per cent of total exports).

Bulgaria is highly integrated in the regional value chain with the EU. 48 per cent of foreign value added content (FVA) in Bulgarian exports are sourced from EU (mainly Germany, Spain

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3 The key concepts of the following analysis follow the approach of Koopman et al. (2014), the OCED-WTO (2014) and the IMF (2017). Generally, gross exports can be split up into domestic (DVA) and foreign (FVA) value-added content. Furthermore, a part of domestic value-added content of exports can be classified as domestic-value intermediates exported to third countries for further export (DVX). Using both FVA and DVX components enables to determine the participation and the position of an economy in GVCs.
and Italy). Other important FVA partner countries are Russia (18 per cent) and Turkey (6 per cent). 19 per cent of the country’s exports to EU are then further used as inputs by the EU countries.

The manufacturing sector has a stronger integration into GVCs than the primary and services sector. On average, 71 per cent of all manufacturing exports have GVC linkages, whereas about 31 per cent of services exports have GVC linkages. The chemicals & mineral products and basic & fabricated metal products sectors show high backward linkages, while both sectors plus the electrical and transport equipment show high forward linkages.

The Bulgarian economy is structurally transforming and former highly integrated sectors in 2005 lost relevance in both DVA output and GVC integration over time. On average, most sectors have seen positive growth rates in DVA and GVC volumes between 2005 and 2015, but the importance and relevance in both export and GVC terms have changed for many industries in Bulgaria since 2005. While the DVA and GVC share of important export sectors (logistics, tourism, metal and chemical products) declined over time, smaller industries (food products, agriculture, wholesale, electrical and transport equipment) increased their shares of DVA and GVC.
Since the beginning of transition, the pace of reforms in Bulgaria has been uneven. The political support for reforms has been hampered by three factors: i) lack of certainty about the short-term gains; ii) polarised political system, especially in the first two decades of the transition iii) short lifespan of governments and frequent policy changes.

Bulgaria joined NATO in 2004 and the EU in 2007. Despite difficult economic circumstances, which led to the collapse of the banking system in 1996–97, and serious deficiencies in the judicial system, the country made progress in many areas.

The fragmentation of the political system, which more recently has led to unstable coalition governments and three consecutive early elections in 2013, 2014 and 2017, has been one of the key challenges that the country faced. As a result, key growth drivers – such as productivity gains and policy effectiveness – remain below potential, even though economic activity and employment have reached record levels since the beginning of transition. In addition, the resurgence of nationalist rhetoric, as well as Eurosceptic sentiments, is an obstacle for pro-reform forces.

Centre-right, pro-EU party GERB, headed by PM Boyko Borissov, has been in power since May 2017. Following a period of political turbulence, GERB won the March 2017 parliamentary elections and formed a coalition government with an alliance of nationalist parties a few weeks later. Together, they have a narrow majority in the parliament, which has remained stable despite internal differences. The coalition can also rely on votes by opposition Volya party in parliament. GERB, which established itself as a new power on the Bulgarian political scene in the May 2009 European election, before coming to power for the first time later in the same year, is popular among businesses and industry and has a relatively broad voter base. Head of state President Rumen Radev won the presidential election in November 2016 and was mainly backed by main opposition party centre-left BSP.

Trade unions remain an important factor with relatively high bargaining power engaged in a regularised consultation with the government. Citizen participation outside the two largest trade unions (KNSB and Podkrepa) is much lower, but has been increasing in recent years.

According to the latest CVM report, published in October 2019, Bulgaria’s progress has been sufficient to meet the country’s commitments made at the time of its accession to the EU. The monitoring of continued implementation of the reforms put in place in the country will have to be ensured by the domestic post-monitoring Council and the comprehensive rule of law mechanism, which the EU is planning for all member states.

Bulgaria’s first ever term at the helm of the EU Council in the first half of 2018 overall was a success, particularly as regards championing EU approximation for the neighbouring Western Balkans, which culminated with Sofia hosting the first EU-Western Balkans Summit in the last 15 years.

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4 The EU’s Cooperation and Verification Mechanism (CVM) on Bulgaria (and Romania) was set up when the country joined the EU in 2007 in order to help in the areas of judicial reform and the fight against corruption and organised crime, where progress still had to be made.
4. Euro adoption

**Euro adoption is top priority of the Bulgarian government.** One of the criteria for joining Eurozone is the exchange rate stability, which is verified with the participation in the Exchange Rate Mechanism II (ERMII) for at least two years. To this end, the Bulgarian authorities and the ERMII parties\(^5\) have agreed on a set of additional commitments before entering into ERMII. The commitments cover both the banking sector and the non-banking financial sector. They also include measures to strengthen institutional quality and governance.

The government sees April 2020 as the target date to join the ERMII mechanism and the Banking Union. This would follow the formal application and the request for “close cooperation” with the European Central Bank (ECB) both sent in mid-2018. Successful entry would mean joining both the Single Supervisory Mechanism and Single Resolution Mechanism, the two pillars of the Banking Union. Also, Bulgaria would be obliged to join the European Stability Mechanism (ESM), set up to help the euro area countries in severe financial distress. The legal requirement is that the country needs to stay for at least two years in the ERMII before joining the Eurozone. After the two years, a new assessment of the country’s readiness is taken, and in case of a positive result – the country could join the Eurozone.

The Banking Union membership as the precondition to joining the Eurozone is not a treaty requirement. It is a result of the institutional developments in the Euro area in the past years, the experienced banking system instability in the current Eurozone members in 2010s, and, more recently in Bulgaria. Confidence in the Bulgarian banking sector was shaken with the collapse of the fourth-largest bank (Corporate Commercial Bank) and a subsequent run on the then third largest First Investment Bank in 2014. Government intervention, through an emergency-aid package stabilised the situation, and confidence-building measures followed.

**Comprehensive asset quality review and stress test of six banks by the ECB was launched in late 2018.** The assessment is part of the country’s application to the Banking Union. ECB has reviewed the top three banks, including UniCredit, OTP and KBC, as well as three other systemically important banks – First Investment Bank (FIB), Central Cooperative Bank and Investbank (IB). The results, announced in July 2019, identified a capital shortfall in two banks – FIB and IB.

**The regulatory and supervisory framework follows EU rules, but implementation could be stronger.** The experienced liquidity pressures by two banks in 2014 led to improvements in the regulatory framework with developments such as the transposition of the EU’s Recovery and Resolution Directive (BRRD) and the Basel III banking regulations. Still, there is room for further improvements, such as in areas of concentration of exposure on banks’ balance sheets, implementation of corporate governance norms, strengthening of Anti-Money Laundering (AML) framework, and capacity building in the resolution area. Also, some of the new rules are not yet fully operational.

**The current exchange rate regime constrains provision of emergency liquidity.** The country’s currency board arrangement (in place since 1997) limits emergency liquidity that the Bulgarian National Bank (BNB) can provide. The 2014 crisis exposed these limitations; the extraordinary injection of liquidity came from the government, but it needed EU approval. This is a particular concern for the domestically owned banks, which do not have access to parent liquidity. The eventual accession to Eurozone would help to alleviate the problematic ability of BNB to act as the lender of last resort.

\(^5\) The ERMII parties are: Eurozone ministries of finance and central banks, ECB and Denmark’s ministry of finance and central bank, which is the only non-euro area member of the ERMII.
Eurozone membership is expected to bring a number of benefits for private sector development, including: i) stronger supervision of the banking sector, thus strengthening the country’s financing stability and lowering its systemic risks and ii) more stable interest rates, thus making borrowing costs for corporations less volatile.
5. Key obstacles to private sector development

5.1. Economy suffers from limited capacity to generate value added and to innovate

Bulgarian economic development is hindered by low capacity to generate value added and to innovate especially in sectors that face less competition. Bulgaria’s productivity remains low compared to its peer countries from the EU (Chart 9). Moreover, Bulgaria’s productivity convergence towards more advanced countries has been slow.

Low productivity, limited capacity to generate value added, and weak innovativeness of the Bulgarian economy can be demonstrated through the lenses of the EBRD Knowledge Economy (KE) Index. Bulgaria’s 2018 KE score, framed around the four pillars, namely (i) institutions, (ii) skills, (iii) innovation systems, and (iv) ICT infrastructure, is 5.2 (on a 1 to 10 scale), significantly below OECD comparator countries (7.4)7. The score is pulled down by a particularly inefficient innovation system (the way inputs are used to produce output); while the country’s improvement in the KE Index between 2011 and 2018 was mostly driven by improvements in the ICT infrastructure (Chart 10). Moreover, Bulgaria’s gap towards OECD comparators has not fallen significantly. The following paragraphs analyse why Bulgaria is lagging behind the frontier OECD countries with a discussion framed around the four pillars.

The state of rule of law, regulatory quality and government effectiveness hinder quality of institutions. Bulgaria scores visibly below the OECD comparators (5.9 versus 8.1). This hinders innovation and investment, which particularly affects the higher value added production. At the same time, thanks to the EU membership, Bulgaria is an open economy, with low international tariffs and relatively easy trading across borders, which is even better than in some OECD comparators. On average, however,

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6 The Index measures the ability of an economy to grow through productivity enhancements and innovation. The Index contains 38 indicators organised in four pillars: (i) institutions for innovation, (ii) skills for innovation, (iii) the innovation system, and (iv) the ICT infrastructure.

7 Sweden, USA, United Kingdom, Germany, Canada, Japan, France, and the Czech Republic. These are advanced OECD countries where the EBRD does not operate and that are used for the computation of the EBRD in-house Assessment of Transition Qualities (ATQ) indices, as well as the Knowledge Economy index.
Bulgaria made small progress with respect to quality of institutions between 2011 and 2018.

**Skills gaps are large, partly driven by demographics (ageing) and emigration.** On skills, the country also scores visibly below OECD comparator countries average (5.3 versus 7.1). ‘Brain drain’ combined with relatively weak quality of education (e.g. low PISA results, at par with Romania, but much lower than Hungary or Poland) hinder innovative capacity. Bulgaria also does not have enough Science, Technology, Engineering and Maths (STEM) graduates. There are only 443 technicians in R&D (per million people) in Bulgaria, well below 1,443 in OECD comparators. While the number of people with tertiary education has converged to EU levels, top researchers are lacking. In 2018 the EU withheld innovation funds after Bulgaria failed to identify enough sufficiently qualified scientists to evaluate the research proposals. At the same time, Bulgaria has made some progress in this area between 2011 and 2018. Firms offering formal training increased from 31 per cent to 43 per cent, top-managers’ experience in their sector increased approximately from 16 to 19 years, and the proportion of companies considering an “inadequately trained workforce” a hindrance to operations has decreased.

**Efforts to boost science are undermined by a lack of funds, and scientific outputs are lagging behind regional peers.** Bulgarian government cut its 2018 science and higher-education budget by 25 per cent, which will postpone investment in science infrastructure and hinder scientific collaboration. The country devotes only 0.8 per cent of GDP to R&D, far from the OECD comparators (2.4 per cent). Science articles (per 1000 people) are only 0.4 in Bulgaria, far behind OECD comparators (1.4). Intellectual property rights are also significantly below the state in OECD comparators, although the situation has somewhat improved in the recent years (as per the Index of Economic Freedom). Nevertheless, some improvements happened in this area between 2011 and 2018; mostly due to stronger linkages within the innovation system, better availability of certain types of innovation financing (e.g. venture capital) and somewhat stronger cooperation between firms and academia. A good example is the Sofia Start-up Expo 2018, the first Bulgarian exposition for start-up innovative companies.

**Bulgaria’s ICT infrastructure is generally good and this is the pillar where Bulgaria has the smallest gap to OECD comparators.** Bulgaria’s availability of fast bandwidth and mobile broadband is at levels comparable to the frontier countries. However, broadband penetration remains low in remote areas. The rapidly growing IT sector is changing the composition of the economy. Bulgaria made a remarkable progress on their ICT infrastructure between 2011 and 2018, the largest improvement among the four pillars of knowledge economy. Active mobile broadband subscriptions (per 100 inhabitants) increased from 35 to 92. The e-participation index (that focuses on the use of online services) is now almost approaching the OECD comparators.

### 5.2. Business environment and governance face serious constraints

**Business environment**

**Business environment is seemingly becoming more difficult.** According to the latest World Bank Doing Business 2020 report, Bulgaria ranked 61st out of 190 economies, dropping two places from the previous report and being below most of its regional peers. Procedures for getting electricity, starting a business, and paying taxes remain burdensome, although, as most EU members, Bulgaria performs well in trading across borders. The country’s ranking has experienced a significant drop from the 36\(^{th}\) place in 2014, not necessary because it has become more difficult, but because in other countries it has improved more.
Weak institutions are driving down the country’s score in Global Competitiveness Index. Bulgaria was ranked 49th in the latest 2019 Global Competitiveness Report, an improvement from the 79th position ten years ago. The country stands somewhere in the middle when compared to its regional peers. Bulgaria scores particularly well in the area of macroeconomic environment, not least because of the country’s low public debt, low and stable inflation, and stable exchange rate. On the other hand, the country scores poorly on the innovation capability, product market and quality of institutions.

Chart 11: Business environment obstacles

Informal sector, political instability and perceived corruption are perceived as problematic. According to the latest EBRD/World Bank Business Environment and Enterprise Performance (BEEPS) survey, the top five business environment obstacles identified by Bulgarian firms were i) competitors’ practices in the informal sector; ii) political instability; iii) perceived corruption, iv) electricity issues and v) access to finance (Chart 11).

Competitors’ practices in the informal sector remained a major issue. The share of firms that competed against unregistered or informal firms increased from 54 per cent in BEEPS IV round (2009) to almost 60 per cent in the latest, BEEPS V (2016), round.

Political instability and perception of corruption have been worrying issues since transition. Political stability has improved following the 2017 elections, as also shown in the latest World Governance Indicators (Chart 13). On corruption, almost 60 per cent of firms interviewed in BEEPS V reported making informal payments to “get things done” at least once in a while. The level was higher than the 55 per cent reported in the previous round, and more than 16 percentage points above the BEEPS V average. However, firms considered corruption to be more of a solution than a problem, which is also disconcerting.

Finding skilled labour force is perceived as the largest problem among the SMEs. According to the 2018’s survey on SMEs conducted by the European Commission and the ECB, almost 30 per cent of SMEs identified availability of skilled staff or experienced managers as their biggest problem.

Financial literacy in Bulgaria is relatively weak with only a third of the population being financially literate according to the S&P FinLit Survey, compared to more than 53 per cent in OECD members. Similarly, only about third of SMEs prepare audited financial statements, according to BEEPS V, in line with other EBRD-EU members.

Bulgarian SMEs lag behind when it comes to digitalisation. Even though the share of Bulgarian SMEs employing an ICT specialist is in line with the EU average of 19 per cent, small firms seem to make very little use of digital and online tools, which can be an important avenue to develop a market presence. Only 6 per cent of SMEs have online sales, the lowest share in EU (where the average is 17 per cent).

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8 The Standard & Poor’s Global FinLit Survey asks questions about basic financial concepts such as interest and inflation and classifies people as financial literate who are able to answer 3 out of 4 questions correctly.
Failure rate in setting up a business is rather large. According to the latest Life in Transition Survey, a third of people who have tried to set up a business in Bulgaria failed to do so. This is significantly more than in Slovakia and Slovenia, where failure rates were less than 10 per cent (Chart 12). Out of those who did not succeed in setting up a business, lack of sufficient capital and too much bureaucracy were mentioned as the most prominent reasons.

**Chart 12: Share of those who did not succeed in setting up a business**

Source: EBRD’s Life in Transition survey

Governance

Bulgaria faces governance challenges, due to structural constraints such as the loss of human capital, which require long-term strategic thinking and implementation of policies in several fields. The NATO and EU memberships have contributed to high policy consistency in the areas which are closely linked with them; however stronger policy continuity and policy learning is needed.

Most aspects of public governance lag behind EU standards, using the World Bank’s Worldwide Governance Indicators (WGI) as a benchmark. According to WGI, the most problematic areas are the control of corruption and the area of the rule of law (Chart 13). Regulatory quality has the highest score, reflecting implementation of the EU acquis, rather than the capacity of the regulators. As a matter of fact, several private sector interlocutors point to obstacles to market access in certain sectors, as well as lack of a level playing field, as some of the factors hindering economic activity in Bulgaria.

The country’s multi-level governance structure is well defined by laws, but remains problematic due to large regional disparities, depopulation of rural areas, and poor administrative capacity. Bulgaria has a unitary system of government with three levels: i) central; ii) regional; and iii) local. Regional governments and municipalities, especially in the north-eastern part of the country, are unable to generate revenue from taxes and rely mostly on funding from the central government. This situation creates political as well as financial dependencies, thus undermining the idea of self-governance, as acknowledged by EU reports. Public administration is highly centralised with over 75 per cent of the general government employment being within central government. According to the EC’s latest reports, public administration reform has been slow and has yielded little concrete change. Due to the fact that all recent governments have been either coalition or minority ones, informal coordination among ministries plays a vital role.

**Chart 13: Worldwide Governance Indicators**

Source: World Bank’s Worldwide Governance Indicators Scores range from -2.5 (weak) to 2.5 (strong)
Politicisation in civil service is relatively high, while the pay gap between the public and private sector remains large. There has been some improvement in the competition-based recruitment; however the overall efficiency remains relatively poor. Also, there has been high turnover of personnel with every new administration, which hampers policy continuity.

The judiciary has benefited from legal and institutional reforms associated with EU accession, but practical gains in efficiency have been lacking. According to the 2019 Index of Economic Freedom, court backlogs and delays are a significant issue, while the court system remains the least trusted government institution. In addition, according to the 2018 EU Justice Scorecard the perceived independence of the judiciary is among the lowest in the EU, although Bulgaria has improved compared to previous years. Similarly, the Global Competitiveness Report, points to the same issue, with companies reporting low trust in the independence of the judiciary and the efficiency of the legal framework.

The Criminal Code prohibits various types of corruption, including, trading in influence, facilitation payments and bribery of foreign officials and extortion. Nevertheless, the complex legal framework and weak enforcement hamper the country’s ability to effectively tackle all challenges. According to Transparency International Corruption Perception Index, Bulgaria remains below other EU member states, ranking 77th overall in the 2018 report.

At the end of 2017, the country adopted a comprehensive anti-corruption law, setting up a single anti-corruption agency to tackle corruption among high-level officials and to deal with issues such as conflicts of interest and declaration of personal assets. The agency is based on a merger of existing institutions and is now fully operational. Civil society organisations raised a number of concerns about the draft legislation (including the election of the agency’s members only by a simple parliamentary majority), which was eventually implemented in January 2018, after overriding a Presidential veto. Even though the agency’s establishment is a welcome step, its first activities and results should be evaluated at a later stage.

According to the latest CVM report, published in October 2019, Bulgaria’s progress has been sufficient to meet the country’s commitments made at the time of its accession to the EU. The European Commission’s Cooperation and Verification Mechanism (CVM) on Bulgaria was set up when the country joined the EU in 2007 in order to help in the areas of judicial reform and the fight against corruption and organised crime, where progress still had to be made. The CVM was initially envisaged to run for three years after Bulgaria joined the EU. Serious shortcomings in the area of corruption (i.e. the lack of conclusive trials for high-level corruption cases and corruption in public procurement) did not allow the country to exit the mechanism. However, the completion of CVM is finally on the horizon for Bulgaria, according to the latest CVM report, published in October 2019. Bulgaria will need to continue working consistently on translating the commitments reflected in the CVM report into concrete legislation and on continued implementation. In addition the Bulgarian government recently decided to establish an additional, more comprehensive mechanism for domestic post-monitoring. The monitoring of continued implementation of the reforms put in place in the country will have to be ensured by the domestic post-monitoring Council and the comprehensive rule of law mechanism, which the EU is planning for all member states.

Reform of public procurement system is ongoing and positively assessed by the latest CVM report. The broader area of public procurement is governed by EU and Bulgarian authorities have been encouraged by the European Commission to draw on additional expertise if needed in specific areas. However,
the high levels of perceived corruption affect also perceptions over the procurement process, despite recent progress.

**New anti-money laundering legislation was adopted in March 2018**, following the Fourth European Union Money Laundering Directive (MLD4) of 2015. Among the main innovations of the new Act is the obligation for collecting and filing information on what are referred to as ultimate beneficial owners (UBOs) of companies and other entities.

### 5.3. State presence is still pervasive in key industries

**Most economic activities are privately-generated.** Private sector share in GDP accounts for ca. 80 per cent, as per a tentative EBRD calculation, a significant rise from about 40 per cent in mid 1990s (Chart 14). This is somewhat lower than in some more advanced transition countries, including Estonia and Hungary, at par with Poland and Lithuania, and higher in comparison to Croatia and Romania.

**Chart 14: Private sector share in GDP (per cent)**

![Chart 14: Private sector share in GDP (per cent)](source: EBRD Transition Report, 1994 and 2010)

**Nevertheless, state presence is still pervasive in key industries.** There are ca. 850 companies with a 50%+ state owned majority. Although these companies have about 35 per cent of GDP in asset size, they create only about 3 per cent of the total value added; however, they account for about 15 per cent of the employment in the country, the highest percentage amongst the regional peers (Chart 15).

**Chart 15: SOEs employment, % of total**

![Chart 15: SOEs employment, % of total](source: Orbis database)

**SOEs mostly dominate utilities and the transport sector.** The five largest SOEs account for more than half of total SOE assets. These include National Electric Company (NEK), National Railway Infrastructure Company, Kozloduy Nuclear Power Plant, Electricity system operator and Bulgartransgaz. The above mentioned energy companies are, together with many other energy production and transmission companies, part of the Bulgarian Energy Holding (BEH), which is listed at the Bulgarian Stock Exchange. Railways Holding, which includes both passenger and cargo railway companies, as well as the Sofia Airport are also among the major SOEs in the country. Bulgarian SOEs make up for 60 per cent of the assets of the top-10 companies in the economy (Chart 16).

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9 This section is based on the study Non-financial SOEs in EBRD CoOs by Sanja Borkovic and Peter Tabak.
The BEH Group, the country’s largest SOE, forms the backbone of the Bulgarian energy sector, comprising electricity and gas transmission networks and generation assets accountable for 60 per cent of the country’s electricity output. The energy sector is in the process of structural reform to gradually move towards full market liberalisation. While full ownership unbundling has not been completed, BEH has completed unbundling in line with the EU’s 3rd Energy Package, selecting the Independent Transmission Operator (ITO) model. However, fair and transparent private sector participation in the sector remains in question. In 2018, the Group was fined EUR 77 million in an antitrust case by the EC for blocking competitors’ access to gas infrastructure. Further strengthening of the sector regulator in line with the EU Regulation on Wholesale Energy Market Integrity and Transparency (REMIT) is required to ensure efficient market functioning.

BEH electricity subsidiary NEK remains the largest player in the wholesale electricity market despite recent years’ move towards a more competitive market structure and the privatisation of a number of generators. A competitive wholesale market for electricity remains to be established, which would require mandatory participation in the Bulgarian Energy exchange by all significant generators. Meanwhile, NEK is not fully financially sound, relying on intracompany debt provided by BEH. As a result of the financial crisis and inadequate sector policies and regulation, electricity subsidiary NEK has accumulated a structural tariff deficit which now has largely been eliminated.

**SOE performance in Bulgaria shows a mixed picture.** Bulgarian SOEs are the least profitable among the regional peers. Return on assets (ROA) of SOEs was negative 1.0 per cent over 2014–2016 (Chart 17). Financial debt of SOEs stood at only 2 per cent of GDP, at par with Hungary, and much smaller than in Croatia, Slovenia or Greece. In September 2019 the Bulgarian Parliament adopted a Law on public enterprises, which aims to improve corporate governance, transparency and disclosure by SOEs, aiming to increase their efficiency.

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*Electricity distribution system is geographically divided and fully privatised in 2012, by EVN (Southwest Bulgaria) and Energo-Pro (Southeast Bulgaria) and CEZ (Sofia and Western Bulgaria).*
5.4. Social challenges, including the lack of public trust, in addition to low level of digital skills hinder the process of digital transition

The country has made steady progress in the digitisation area. Digitisation agenda in Bulgaria started in early 2000s; however, at that time, the strategies were designed with incoherence and did not have enough financial input for implementation. Today, they are replaced with a more common framework, i.e. national strategy on e-government (last renewed for the period 2019–2023). Also, with the creation of the State e-Government Agency, in 2016, under the Council of Ministers, implementation of e-government policy has been centralized, thus giving more “visibility” to the digitalisation agenda. The experts on the ground confirm that, within the last two years, the Agency marked a significant milestone for the Bulgarian digital transformation. Lastly, financing for e-government projects became larger, with the country’s availability of different EU funds. All these factors have speeded up Bulgaria’s progress in the field of digitisation, which could be observed in the international rankings. For instance in the UN e-government Development Index, in 2014–2018 Bulgaria moved from the 73rd to 47th place.

Digital solutions in line with international trends are being introduced, although their usage is still relatively low. In 2007, the country launched the official e-Government portal for electronic services egov.bg. However, although the portal is currently giving access to 1,300 services, at this stage of development they are fragmented, and their usability is at a low level. Besides, establishing the Open Data Platform in 2014, the government enabled the citizens to access a number of datasets and co-create digital innovation. The Bulgarian government is now also working on the e-procurement system. Among the most significant successes, the interviewed experts mentioned full digitalization of the document exchange in the Bulgarian administration (since November 2018 there is no paper document exchange within the state administration). Among priorities for the coming years, experts mentioned i) increasing the functionality of a single point of contact for electronic administrative services (e.g., providing e-services on mobile devices) and increasing the availability of services promoting digital solutions, including eIDs, to be launched in 2020, and conducting e-voting.

Low level of digital skills is among significant challenges in the digitisation process. According to the Digital Economy and Society Index (DESI) 2018, only 29 per cent of Bulgarians have at least basic digital skills. It is worth noting that the problem has also been identified in the younger age groups; only 54 per cent of Bulgarians in age 16–24 years possess at least basic digital skills. Although, according to DESI 2018, 62 per cent of citizens uses the Internet, online tools are mainly used for communication and entertainment purposes. For instance, only 9 per cent of people use online banking. Lack of digital skills goes hand in hand with relative lack of human capital. According to DESI 2018, ICT specialists in Bulgaria accounted for less than three per cent of total employment. Simultaneously, the percentage of STEM graduates is less than 15 per cent. In Bulgaria, as in other peer countries, the demand for IT engineers in public administration is high. Nevertheless, competitive wages in the private sector and opportunities for professional development abroad cause lack of ICT specialists in the Bulgarian administration. However, it should be noted that the government puts a lot of effort into the improvement of digital skills. To increase the level of digital skills, Bulgaria, among other things, has raised the
number of classes, is training teachers in digital skills, and has created coding clubs funded by the European Social Fund (ESF).

**Lack of public trust, in addition to low digital skills, makes people reluctant to use digital solutions.** Bulgarian experts and practitioners agreed that the biggest challenge nowadays is to convince Bulgarians to use e-government solutions. Only 15 per cent of Bulgarians declared their interest in interacting digitally with the Bulgarian administration, as most preferred face to face interaction. Besides, only 5 per cent out of those interested in the digital solutions could identify themselves electronically in a secure way and knew how to do it, as only 16 per cent of Bulgarians have a qualified electronic signature or other accepted e-identifier.

**Also, lack of interoperability, fragmentation of the existing systems and lack of an assessment mechanism are perceived as areas for improvement.** This is reflected in the 2017 eGovernment Benchmark report, comparing the country specific e-government development with the EU average, which categorised the Bulgarian e-government system as non-consolidated, meaning that both its digitisation and penetration are at a low level. Besides, delays regarding the introduction of some digital solutions are not rare (for example, the introduction of eID has been postponed several times). Also, despite discussions on certain topics, in the area of developing e-identification tools (such as BankID, MobileID), the country has no specific action plans.

### 5.5. Economic performance is hampered by labour and skills shortages resulting from population ageing, strong outward migration and skills mismatches

**Demographic outlook**

**The population of Bulgaria is both shrinking and rapidly ageing.** Over time, this will exacerbate existing labour shortages, placing a potentially significant strain on Bulgaria’s economic and social institutions. Bulgaria’s total population peaked in size around the mid-1980s at a little less than 9.0 million inhabitants, according to estimates from the UN Population Division. Since that time, Bulgaria’s population has shrunk to around 7.2 million inhabitants. It is projected to fall further still to around 5.7 million within another generation (i.e. by the mid-2040s) – among the sharpest declines of any EU country.

**The composition of Bulgaria’s population has changed rapidly over time, with old-age dependency rising fast.** The share of residents aged 65 and above has increased from just 25 per 100 of the working-age population (i.e. those aged 15–64) around the mid-1990s to 33 today. Within another generation, the ratio is expected to increase further still to 51 per 100 of the working-age population. Meanwhile, the median age of Bulgaria’s population has steadily increased from 38 years around the mid-1990s to 44 today. Within another generation, it is expected to rise further still to 49 years – slightly higher than the EU average. The population pyramid below illustrates the projected shrinking of Bulgaria’s population in all of the age-categories below 70 over the coming three decades (Chart 18).

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Falling fertility and negative net migration are two principal factors shaping Bulgaria’s demographic outlook. Fertility in Bulgaria fell from 2.1 in the 70s and 80s to around 1.5 live births per woman today (UN Population Division). Meanwhile, outward migration flows from Bulgaria outpace the numbers of new arrivals as more nationals migrate towards other EU countries and beyond driven, in large part, by the opportunity of better pay, higher living standards and greater career development opportunities. 12.5 percent of Bulgarian nationals’ aged 20–64 are resident in another EU member state. Roughly half of Bulgaria’s outward migrants are of the prime working ages between 20 and 39, and this share is relatively constant in the period 2007–2018. However, on the more positive side, the number of immigrants of the prime working ages (20–39) has been increasing steadily, implying a less negative net migration balance in the recent years.

Chart 18: Population in Bulgaria by sex and age-group, estimates for 2015 and projections for 2045 (thousands)

Skills mismatches

Employers in Bulgaria experience a number of key issues around skills. Higher education institutions and vocational schools tend to interpret and adapt only very weakly to labour market demand. Young entrants into tertiary education, meanwhile, are inadequately drawn to high demand learning profiles (such as engineering, technical education or middle management) while already over-supplied occupations (including lawyers, psychologists, social and political scientists and others) tend to attract an overabundance of applicants. As in most other EBRD countries of operation, vocational schools in Bulgaria are largely under-subscribed.

More employers are participating in training activities, though the overall share remains low by international standards. The number of enterprises reporting that they offer training to their workers has risen from 29 percent in 2005 to 42 percent by 2015. The figure, however, was still considerably lower than the EU average of 73 percent in that same year (Eurostat).

SMEs are reportedly hampered by stiff competition for skills (especially in services sectors) and high turnover of workers, creating a barrier to growth and expansion. Longer-term investment in human capital development is considered a luxury by most small and medium-sized enterprises.

Youth inactivity is correspondingly high. The proportion of those aged 15–24 who were neither in employment nor in education or training stood at almost 19 percent in 2017 (including 15 percent among young men and 23 percent among women) – around 5 percentage points higher than the EU average and with a broader gender gap (ILOSTAT Database).
Obstacles around employability continue to hamper some groups disproportionately to others. Despite the decline of employment to pre-crisis levels, the long-term unemployed, inactive young people, Roma and people living in poorer regions and rural areas continue to face significant difficulties in entering or re-entering employment. Roma women and girls, moreover, face additional barriers in accessing employment opportunities. Both inclusion considerations and reported labour shortages strengthen the case to target more support and attention towards Bulgaria’s most disadvantaged members.

5.6. The state of transport and municipal infrastructure is poor and the sector is facing a number of challenges

Transport sector in Bulgaria is dominated by road based transportation following a continued modal shift away from railways. This trend has continued over the last decade, partly driven by the rise in car ownership, and thus stressing the importance of the road infrastructure for the country.

In the last ten years, Bulgaria has almost doubled its motorway network, but it still remains inadequate. The 800 km of motorway and 3,000 km of first class roads constitutes a small network in terms of density when compared to similar countries in the region. Investment in new motorways is also moderate, especially given the great availability of EU investment grants. However, Bulgaria struggles with EU grant absorption and as of end-2018 the overall utilisation in terms of commitments was about 68 per cent, with only 27 per cent of the funds being disbursed.

The road infrastructure in place is struggling to keep up with the demand in the light of a steady increase in traffic (Chart 19) and in car ownership (~ 60 per cent increase in the number of passenger cars per 1000 inhabitants compared to 2007 figures). As the trends in car ownership and traffic (particularly freight) are likely to continue, significant investments to complete and/or upgrade of the existing road infrastructure (including the motorway corridors) will be important to improve mobility and to facilitate Bulgarian goods to come to the markets. In addition, there is also a widespread problem of under-maintenance of the existing road infrastructure which is deteriorating fast.

Chart 19: Road traffic per total length of road

Source: OECD, Eurostat and author’s calculations

The Bulgarian rail sector has been in decline for years. The falling demand can be partially explained by scale-back of commodity processing industries which in turn led to less demand for rail based cargo transportation and by the increase in car ownership coupled with the overall poor quality of the rail transport. Following years of under-investment and poor maintenance the service level and quality has suffered. 63 per cent of the railway users consider the quality of the rail services as poor.

Similarly, along with Romania, Bulgaria is at the bottom of the BCG Rail Performance Index.

14 The EU Council’s Recommendation on the National Reform Programme of Bulgaria (2018)
15 MTITC 2017a
16 MTITC 2017a; Report 2, chapter 4, pp. 110–115
Ranking of the EU countries (BCG, 2017) both in terms of quality and in terms of overall performance.

**However, Bulgaria has significantly increased its investment in the railways sector in the recent years.** Chart 20 shows that over the period 2014–16, Bulgaria invested 0.6 per cent of its GDP per year in railways, a figure which is notably higher when compared to other countries in the region. Although premature to say, data seem to indicate that the investments might be beneficial as total rail traffic has started to pick up recently after a severe drop in the past years.

**Chart 20: Rail and Road Investment and Maintenance, % of GDP**

Source: OECD, Eurostat and author's calculations

**Bulgaria is lagging behind regional peers in terms of air connectivity.** In terms of airport connectivity (i.e. the degree of integration of a country within the global air transport network), the most recent IATA data show that Bulgaria is lagging behind in terms of connectivity when compared to other countries in the region. The total number of air passengers has skyrocketed across the region in the last five years and Bulgaria is no exception. The average traffic growth from 2015 to 2018 is almost 60 per cent higher when compared to EU average. Despite the growth in traffic, which shows no signs of stagnation, the capacity is not following. The PPP for Sofia Airport, with 35 year concessionaire chosen in July 2019, could help to address this challenge to some extent.

**Following the shift from rail to roads and the rising car ownership congestion and mobility become increasingly problematic.** Unreliable municipal transport services, partly replaced by sometimes poorly regulated minibus services, have further impaired the economic inclusion and the air quality in metropolitan areas. This has been a problem both in Sofia and other secondary cities in the country.

**Some initiatives have been taken to improve public transport assets** together with sector planning and policy initiatives, including through the EBRD-supported two Green Cities Action Plans (GCAPs) under development in Bulgaria. However, these plans together with other strategies and urban development programmes will require a lot of resources and efforts to implement. Reallocation of road space from private cars to public and active mobility and the use of parking policies to discourage private cars can all be politically costly but should be pursued together with efficient and enhanced public transport services. Despite significant efforts and investments put into the public transport services in Sofia, the share of public transport fell from 65 per cent to 48 per cent between 1999 and 2015. At the same time, the share of trips by car has almost doubled from 17 per cent to 32 per cent.

**The Bulgarian water sector is struggling with efficiency and financial sustainability.** This traditionally municipal sector has a strong presence of central state ownership, which often creates a lack of clear ownership to the development of the sector. Non-compliance with the EU directives for water (and sanitation) is widespread and the utilities have a weak financial position. This is partly due to a tariff regulation which is penalising losses rather than supporting investments and partly linked to the depopulation in rural parts of the country, which
generally have a well-developed network of water services. 2017 figures from the Bulgarian water regulator show that more than 99 per cent of the population has access to water supply services, 72 per cent has access to sewage services with 59 per cent having access to wastewater treatment services.

**Connection and treatment rates for urban wastewater are still relatively low despite significant investments from the EU in water supply and sanitation in the last decade.** Only about 26 per cent of Bulgaria's wastewater is collected; 20 per cent is subjected to secondary treatment and only 7 per cent undergoes more stringent treatment where required.

**The waste sector is facing real challenges.** The country needs to ensure full alignment with the EU targets set out in the Circular Economy Directive. These targets include a 50 per cent of municipal waste for re-use/recycling by 2020, and 65 per cent by 2035. The recycling rate of municipal waste in Bulgaria at 23 per cent is far below the EU average of 44 per cent. Furthermore, Bulgaria still has one of the highest landfill rates at 74 percent (2014) in comparison to the EU average of 28 percent and the country needs to either close or rehabilitate numerous non-compliant landfills. The capacity of municipalities to organise, procure and manage waste collection and treatment is limited. A 'pay-as-you-throw' principle was formally introduced but is not enforced.
6. Qualities of a sustainable market economy

**Bulgaria ranks 11 out of 38 countries of operations** in the EBRD’s 2019 Assessment of Transition Qualities (ATQ) scores. This index is based on a simple average of scores for the six transition qualities: competitive, well-governed, integrated, inclusive, resilient, and green. Bulgaria scores on average 6.26, on the 1–10 scale, across the six qualities, (Chart 21). Bulgaria ranks better than EBRD average and the regional (SEE) average for all of the six transition qualities, but lags behind the Central European and Baltic (CEB) states, and more so the OECD average.

The qualities with the lowest score are competitive (5.71) and well-governed (5.79). A more detailed look shows that (in)capacity to generate value added (i.e. low labour productivity, inadequate quality of education and relatively low credit intermediation) is what drives down the competitive quality, while weak rule of law, issues regarding judicial independence and enforcement of contracts, is what pulls down the good-governance quality.

**Green** quality (6.04), although assessed as somewhat better compared to well-governed and competitive, is an area in which the country performs below all other EU member states. Inadequate climate change mitigation in place, as part of the physical indicators component (i.e. low electricity production from renewable sources and high CO2 emissions per unit from industry, transport and residential buildings) as well as insufficient climate change adaptation as part of the structural indicators component is what drives down the green quality.

Regional disparities between Bulgaria’s more developed south and less developed north are dragging down the overall inclusive quality (6.24). Limited alternative sources of funding is the bottleneck of further financial development, and the resilient quality (6.91) while relatively poor state of domestic transport infrastructure is driving down the integrated quality (6.85).

**Chart 21: Bulgaria – transition qualities**

Note: The level of development within each of the qualities is measured from 1 to 10, with 1 meaning little or no progress and 10 representing the frontier.

Regional average includes scores for the countries of South-eastern Europe (SEE): Albania, Bosnia and Herzegovina, Bulgaria, Cyprus, Greece, Montenegro, North Macedonia, Serbia and Romania.

Central European and Baltic (CEB) states include: Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic and Slovenia.

Comparators average includes scores for a number of advanced OECD countries, including: Canada, the Czech Republic, France, Germany, Japan, Sweden, UK and USA.

EBRD average includes scores of all EBRD countries of operation, from those in Central Europe to those in Central Asia.

Source: EBRD

The following sections provide brief snapshots of each quality.
Bulgaria ranks 13th out of 38 EBRD countries of operation in the Competitive quality index. As in other EU member states, Bulgaria’s market structures and institutions overall offer a well-functioning regulatory environment where enterprises, including SMEs, can prosper, meet international standards and access international markets. In contrast, larger gaps (and greater challenges) can be identified in the country’s capacity to generate value added and innovate.

**Market structures and institutions for competition**

Bulgaria is characterised by a relatively well-structured regulatory framework where the private sector has opportunities to thrive. As evidenced by the score of the *ease of doing business* indicator, Bulgaria’s performance is better than the average of the EBRD region, is aligned with the performance of the South-eastern European (SEE) countries (the region which includes a number of non-EU countries from the Western Balkans); however there is a clear gap with Central European and Baltic (CEB) states, and to a larger extent with the 8 OECD comparators. This translates into opportunities for Bulgaria to narrow this gap, although the country’s performance since 2011 has already improved.

Further evidence of the existence of market structures and institutions that favour competition can be found in the role that small and medium-sized enterprises (SMEs) play in the country. However, the score of the adjusted EBRD SME index reveals that non-bank financing and business skills and standards for SMEs are areas that should be strengthened.

Compliance with international standards that in turn facilitates access to foreign markets and creates more efficiency is widespread. ISO certifications are widely adopted and Bulgaria stands out in terms of alignment with ISO 9001 quality management standards. The country places itself as one of the best performers on this dimension across the EBRD region, together with other EU member states.

**Capacity to generate value added**

The score on the indicator that measures the perceived *quality and efficiency of logistics* (Logistics Performance Index) is particularly low in Bulgaria. This seems to correspond to a region-specific challenge. Solid infrastructure and logistics are essential for well-functioning markets and particularly GVC integration, another area where Bulgaria is lagging behind regional peers and more advanced countries.

Bulgaria’s performance in relation to *labour productivity* (measured as output per employee) compares favourably to peers in the SEE and EBRD regions and has also shown an upward trend over the period 2011–2018. Nevertheless, the level achieved still lags behind the EU average. Economic complexity is also below the EU average, and has not improved over the transition period.

Bulgaria appears to be more *knowledge-oriented* than the SEE and EBRD regions on average and improved its position in the EBRD Knowledge Economy Index (2011–2018), being ranked 12th out of 38 countries in 2018. Progress was mainly driven by more available and sophisticated ICT infrastructure, but the gap to OECD and CEB countries still remains significant. Skills gaps, lack of funding and limited R&D activities in the private sector all translate into low innovation outputs.

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17 SEE region includes: Albania, Bosnia and Herzegovina, Cyprus, Greece, Kosovo, Montenegro, North Macedonia, Serbia and Romania.

18 CEB region includes: Croatia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovak Republic, and Slovenia.
constraining an important potential driver of growth.
Well-governed [ATQ = 5.79]

- 57th in the quality of institutions among 141 economies (WEF GCR 2019)
- 105th in property rights protection, 101st in intellectual property protection, among 141 economies (WEF GCR 2019)
- 89th in judicial independence among 141 economies (WEF GCR 2019)
- 40th in corporate governance among 141 economies (WEF GCR 2019)
- 33rd in protection of minority investors among 190 economies (WB Doing Business 2019)

Bulgaria’s well-governed quality has the second lowest score among all six qualities according to the latest results of the ATQs (2019). However, it remains above the EBRD average (5.47). A closer analysis on the list of indicators suggests that further progress towards improving judicial independence and protection of private property is required.

World Bank’s Worldwide Governance Indicators (WGI) show control of corruption, rule of law, government effectiveness and political (in)stability, as the most worrying issues in Bulgaria.

According to Transparency International (TI) Corruption Perceptions Index, Bulgaria was ranked 77th out of 180 countries in the 2018 report, below all other EU member states. The consequence is weakening competition in some sectors. The report mentions that prosecution and punishment of corruption crimes in general remain inadequate. According to TI, key shortcomings in the enforcement system include the heavy workload of judicial practitioners, and the lack of adequate training and expertise of enforcement authorities.

The latest (2019) EU Cooperation and Verification Mechanism (CVM) report assesses positively the progress of Bulgaria in the areas of judicial reform and the fight against corruption and organised crime. Bulgaria is now ready to exit the mechanism, which was initially set up at the time of its EU accession in 2007.

According to the latest World Bank Doing Business 2020 report, Bulgaria ranks 61st out of 190 economies in ease of doing business, dropping two places compared with the previous year. This is among the lowest rankings in the EU. Procedures for starting a business, paying taxes and getting electricity remain burdensome, although, similar to most EU member states, Bulgaria performs well in trading across borders (i.e. importing and exporting procedures).

**Competition from the informal sector** is perceived as the biggest obstacle facing businesses, according to the latest round of BEEPS.

Bulgaria ranks 37th out of 180 economies in the Index of Economic Freedom 2018 (The Heritage Foundation), with low scores in government integrity and judicial effectiveness.

Bulgaria’s corporate governance standards are mixed. The legislation and practices suffer from a number of weaknesses. According to the 2017 EBRD’s corporate governance assessment areas of strength include the rights of shareholders and transparency and disclosure, while weaknesses include the structure and functioning of the boards, internal control, and stakeholders and institutions.
Ethical behaviour of firms
Structure and functioning of the board
Transparency and disclosure
Rights of shareholders
Internal control
Stakeholders and institutions
Private property protection
Transparent government policy making
Judicial independence
Framework for challenging regulations
Enforcement of contracts
Rule of law - overall picture
Perception of corruption
Government effectiveness
Burden of government regulation
Informality
Freedom of media
Political instability
Regulatory quality
Effectiveness of courts
AML/CFT/tax exchange standards

Source: EBRD.

Note: Visit https://2019.tr-ebrd.com/reform/ for the list of indicators, data sources and methodological notes.
Carbon intensity is the highest in the EU at 0.33 CO2/GDP PPP vs 0.18 CO2/GDP PPP.

Air pollution causes an estimated EUR 3 billion per year on health-related costs.

The country has one of the highest landfilling rates of municipal waste in the EU (74 per cent in 2014 compared to the EU average of 28 per cent).

While the country has experienced significant improvements in its environmental performance, the implementation of environmental requirements agreed at EU level remains a challenge, particularly in the areas of sustainable energy, air quality, and further advancement in municipal infrastructure management.

Bulgaria’s energy and carbon intensity remains one of the highest in the EU-28 despite relatively rapid improvement since the 1990s. However progress seems to have stalled since 2005\(^\text{19}\). Targeted measures, including objective and transparent assessment criteria, could maximise the impact on energy saving, carbon emissions and effectiveness of invested public resources and unlock a substantial energy saving potential in the transport and residential sector.

Most (85 per cent) of the CO2 emissions from fuel combustion are due to electricity and heat generation and transport. While the Energy Strategy for the period to 2020 confirms that ‘energy efficiency has the highest priority in the country’s energy policy’, the country is lagging behind on its progress towards achieving its 41 per cent reduction of primary energy intensity in 2020\(^\text{20}\) compared to 2005 as stated in the National Energy Action Plan 2014–2020\(^\text{21}\). Lignite, used mostly for electricity generation, represented 35 per cent of the primary energy supply (unchanged since 2005), while oil represented 35 per cent of the final energy consumption, largely driven by the transport and agriculture sectors.

The increased use of energy from renewable energy sources – mostly hydro (78 per cent in 2016) but increasingly solar PV, wind and biogas – is a positive trend, reaching 14 per cent RE share in 2016\(^\text{22}\) (18 per cent in 2015). Electricity from renewable energy sources is mainly promoted through a feed-in tariff scheme. This is in line with the 2020 renewable energy target of 16 per cent of share of energy generated from renewable sources in gross final energy consumption\(^\text{23}\), in the National Renewable Energy Action Plan\(^\text{24}\), which also sets targets for heating and cooling and transport.

Air quality continues to give cause for serious concern. Bulgaria remains among the EU countries with the most pollution-related deaths, number of years of life lost associated with air pollution, and urban population exposure to micro-particles. This is linked mainly to energy and heat generation, very high and continuously increasing share of old vehicles (over 40 per cent of registered cars are over 20 years old and one million cars are 15–20 years old\(^\text{25}\)), and industrial processes\(^\text{26}\). Multiple exceedances of air quality indicators were reported in 2014 above levels stipulated in the National Emission Ceilings Directive.

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\(^\text{21}\) Bulgaria NEEAP 2017.
\(^\text{23}\) Bulgaria NREAP, 2011.
\(^\text{24}\) Bulgaria NREAP, 2011.
Bulgaria still has one of the highest landfilling rates of municipal waste in the EU. Recycling of municipal waste, including composting, remains relatively low at 25 per cent compared to the EU average of 44 per cent, and significant efforts will be needed to meet the EU recycling target by 2020 of 50 per cent. Municipal waste generation in Bulgaria has slightly increased in 2014 breaking the downward trend since 2008 but remains 7 per cent below the EU average.

The country will need to close and rehabilitate all non-compliant landfills and enforce the ‘pay-as-you-throw’ principle.
Labour and skills shortages are becoming the paramount challenge facing enterprises in Bulgaria. The population is both shrinking and rapidly aging. This will exacerbate existing labour shortages, but can help inclusion of economically inactive parts of the population.

Expanding economic inclusion is critical for Bulgaria to transition towards a sustainable market economy. However, the country has a long way to go in relation to a number of different indicators captured under the ATQs.

Bulgaria performs relatively well on most of the indicators captured under the **Gender** Inclusion ATQ. Bulgaria, for example, was recently ranked among the highest performing economies in women’s legal rights affecting work by the World Bank’s Women, Business and the Law Index\(^{27}\). Still, women in Bulgaria are 19.8 percent less likely than men to participate in the labour force – a large gap, though relatively small compared with other EBRD countries. Women in Bulgaria make up only 39.2 per cent of managerial positions and make up only 28 per cent of total employers – although higher in both cases than shares in most other EBRD countries. Women in Bulgaria also have a relatively high share in terms of financial inclusion, with 73.6 per cent owning a formal bank account in 2018. Bulgaria also performs relatively well on the OECD’s Social Institutions and Gender Index (SIGI) – a composite indicator evaluating discriminatory social institutions that restrict women’s and girls’ access to rights, justice and empowerment opportunities.

On the indicators measured under the **Youth** Inclusion ATQ, Bulgaria generally performs around the EBRD average. Skills gaps are high, partly driven by the quality of education and partly by high outward emigration. Bulgaria’s quality of education is perceived rather poorly by employers, though neither more nor less so than in other EBRD countries. Performance on international education rankings, youth financial inclusion and hiring and firing laws are also all ranked more-or-less in line with the averages in the rest of EBRD’s geography, although lower than the EU regional peers. The gap between youth and adult unemployment is, however, smaller in Bulgaria than in virtually every other EBRD country of operations (except Kazakhstan), with youth making up only 10.7 percent of total unemployment.

Bulgaria performs relatively badly on most of the indicators captured under the **Regional** Inclusion ATQ, though access to water and establishments with bank accounts represent relatively moderate inter-regional disparities.

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Source: EBRD.
Note: Visit https://2019 треbrd.com/reform/ for the list of indicators, data sources and methodological notes.
The financial sector is bank-centric. The insurance industry is small and dominated by subsidiaries of foreign firms. The capital markets remain relatively underdeveloped, with the market capitalization of the Bulgarian Stock Exchange at about 10 percent of GDP. The pension system is a three-pillar system. Although there is a large number of banks (25), indicating that the sector is probably over-banked, the system remains concentrated, with the five largest banks controlling around 60 per cent of banking system assets.

Consolidation and change of ownership in the banking sector, fuelled by the exit of the Greek banks, are ongoing. Greek banks are selling off subsidiaries as part of their restructuring plans. The sector is dominated by EU banking groups. First Investment Bank (9 per cent of market share) and Central Cooperative Bank (5 per cent) are the largest locally-owned banks. There is only a negligible share of sector assets controlled by state.

The banking sector has very strong capital buffers. At end-2018, sector capital adequacy ratio was 20 per cent, well above the regulatory minimum of 13.5 per cent. Capital was of high quality, comprising overwhelmingly Tier I instruments. Profitability, as measured with RoAA of 1.7 per cent and RoAE of almost 13 per cent in 2018, is the highest in the past few years.

Cross-border exposure was limited, notwithstanding the high foreign ownership. Banks are largely deposit-funded. Customer deposits represented 94 per cent of the banking sector funding at end-2018. Deposits grew by 8 per cent in 2018. About one third of deposits are of corporates.

Although credit to households is low, Bulgaria has the highest corporate debt to GDP ratio among new EU member states, at around 80 per cent as of end-2017. Credit growth stalled in 2009 and has been subdued until recently when signs of recovery in the household sector began to appear. The notable dip in credit growth in 2015 was due to the withdrawal of Corporate Commercial Bank after its failure.

NPLs are high but declining. NPLs continued to decline over 2018, both in absolute terms and relative to gross loans. The banking system's NPL ratio was a still relatively high 8 per cent as of Q1 2019, with provisioning coverage at about 60 per cent. The improvement in asset quality has been supported by economic growth and portfolio sales.

Due to its favourable geographic position, Bulgaria has the potential to serve as a regional energy node. At the moment, the main source of gas supply in Bulgaria is Russia, through the single route via Ukraine, Moldova and Romania. The government is working on diversifying its gas supply and developing the infrastructure for becoming a regional energy node. To support this agenda, the government launched the Balkan Gas Hub project with construction works commencing in late 2018. The project will include expansion of the country’s gas network infrastructure through the interconnector with Greece (and hence tapping into the Azeri’s gas brought to Europe via TANAP/TAP gas pipeline) and the one with Turkey (thus connecting onto the “Turkish Stream” for Russian gas).

Electricity network infrastructure is broadly sufficient, but investments will continue to be required to support increased renewable energy penetration and support energy efficiency, including through the continued roll-out of smart meters.
**Power sector reform** is based on two elements: i) financial restructuring of the sector, mainly aimed at eliminating NEK’s accumulated arrears to power generators, resulting partly from the 2009–14 economic slowdown, and ii) gradual liberalisation in line with the EU legislation. The Independent Bulgarian Energy Exchange (IBEX) launched intraday trading in 2018. Energy and Water Regulatory Commission (EWRC)’s administrative and technical capacities have been strengthened.
**Integrated [ATQ = 6.85]**

| **Trade as a share of GDP:** 128.7 per cent, compared to OECD average of 71.4 per cent. |
| **FDI inflows as a share of GDP:** 3.7 per cent, compared to OECD average of 2.1 per cent. |
| **Portfolio inflows as a share of GDP:** 1.3 per cent, compared to OECD average of 3.0 per cent. |
| **Quality of transport infrastructure:** ranked 68th out of 141 countries (WEF GCR, 2019) |
| **Logistics performance (international index):** ranked 52th out of 160 countries (WB, LPI database, 2018) |

Bulgaria is strong in its external integration into global markets, but reaches a lower score regarding its domestic integration and the energy infrastructure.

**External integration**

While Bulgaria performs well in terms of trade and portfolio inflows, even compared to advanced comparators, its performance compared to OECD average and regional averages is worse in terms of FDI inflows.

**Trade environment:** Exports and imports of goods and services as a share of GDP have risen steadily in Bulgaria, which also benefits from being part of the European Single Market since 2007. The EU membership involves being part of 41 regional trade agreements (EBRD countries average: 18), but also being part of a large number of non-tariff measures.

**Investment environment:** Bulgaria’s openness to FDI flows (3.7 percent) is below the regional/SEE (5.2 percent) and EBRD countries’ averages (4.3 percent), but above OECD country level of 2.1 percent. As part of the EU, the country is part of 115 bilateral investment agreements (EBRD countries average: 65).

**Non-FDI environment:** Bulgaria’s capital account openness is high, above SEE and EBRD and similar to OECD countries averages. However, portfolio inflows as a percentage of GDP are 1.3, which below the EBRD and OECD countries averages.

**Internal integration**

**Domestic transport:** Bulgaria is facing bottlenecks to economic growth in terms of quality of infrastructure, especially regarding the quality of roads. The quality of ports is above the SEE and EBRD countries average, as well as the logistics competence and the timeliness.

**Cross-border integration:** Bulgaria’s logistics performance ranks highest in the SEE region and well above the EBRD average. The country is performing better regarding its customs and border efficient and the ease of arranging international shipments, but has catch-up potential in the assessment of the transport infrastructure. The cost of trading across borders (measured as the time and cost associated with the logistical process of exporting and importing goods) is low.

**Energy and ICT:** The quality of electricity supply in Bulgaria is below the SEE and OECD averages; and it takes particularly long to obtain a permanent electricity connection. Around 60 percent of the population are internet users (compared to 64.2 per cent in SEE, 62.5 in the EBRD countries and 86.9 in the OECD countries).
Source: EBRD.
Note: Visit https://2019.tr-ebrd.com/reform/ for the list of indicators, data sources and methodological notes.