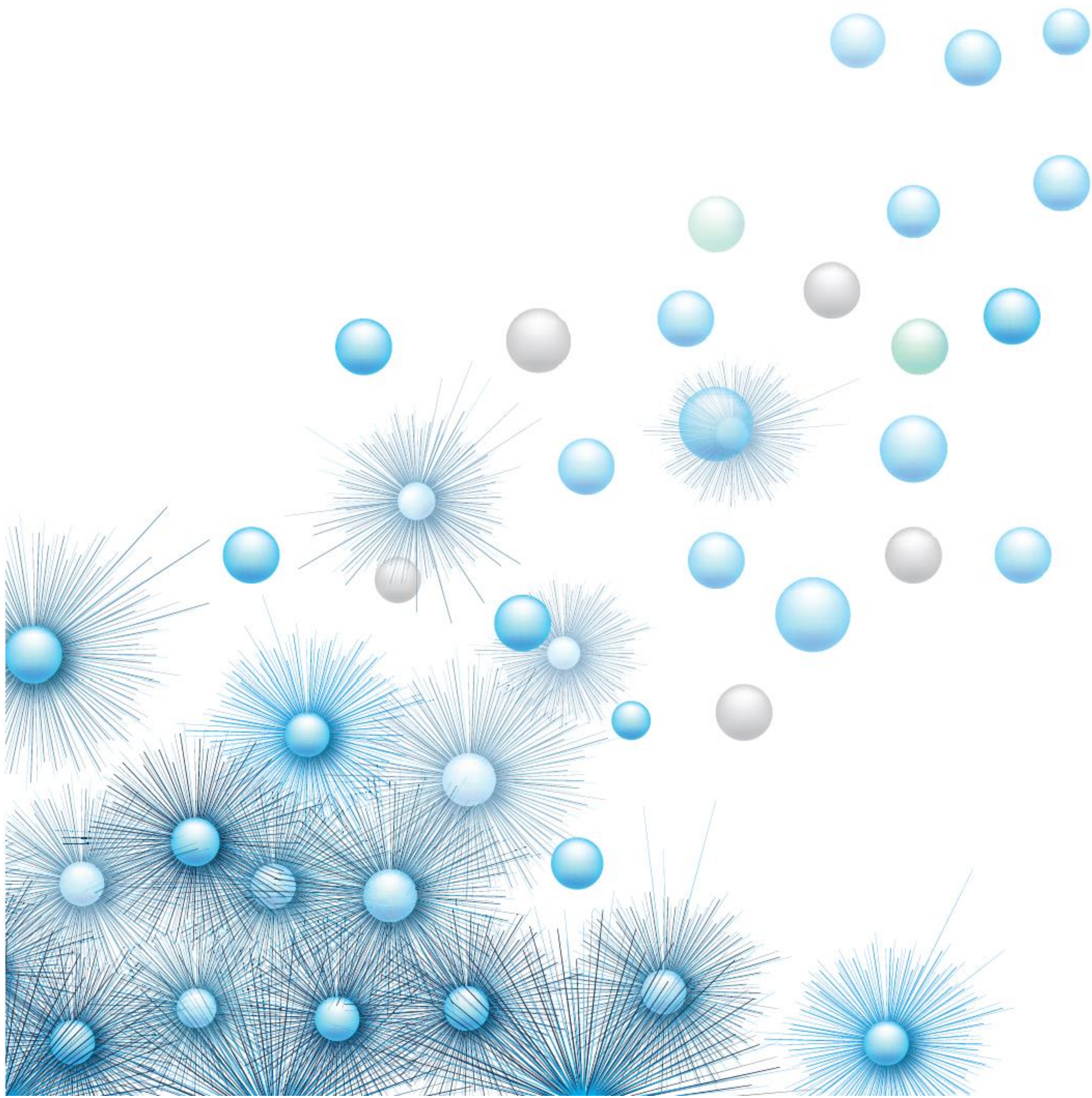
IME

Institute for Market Economics

REGIONAL PROFILES: POLICY PROPOSALS

2015



AMERICA FOR BULGARIA FOUNDATION

Фондация Америка за България

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FOREWORD

The data on the development of Bulgarian regions for the past 10 years emphasizes the need for a radical shift of the regional development philosophy. Even though policy makers are aware of many of the problems, the approach to dealing with them remains highly administrative and strongly centralized – a factor, which decreases the efficiency of the conducted policies. Furthermore – to this day Bulgarian regions remain hostages to political interests and to a large degree are unable to oppose the negative demographic, social and economic trends they are subject to.

The problems of local municipalities can be best understood on a local level.

At the same time a large portion of the EU funds are spent for projects which have no direct relationship to the problems of the people living in a given area. In the long-term the insufficient fiscal independence and own resources of local governments is one of the factors that accelerates the degradation of local communities and undermines the democratic process.

- The recommendations, presented in the next pages, are a result of three years of work by the Institute for Market Economics in the regional development sphere. The recommendations on local finances intend to restore the relationship between "taxation" and "political representation" on the local level, as well as to create real financial incentives for local institutions to work towards attracting investments and creating jobs.
- The recommendations on the labor market will help decrease the negative effects of different administrative decisions on workers and businesses in some of the poorest regions in the country.
- The recommendations on the business environment and investments will help to increase the engagement of local with the socio-economic processes within their territory.

LOCAL FINANCE

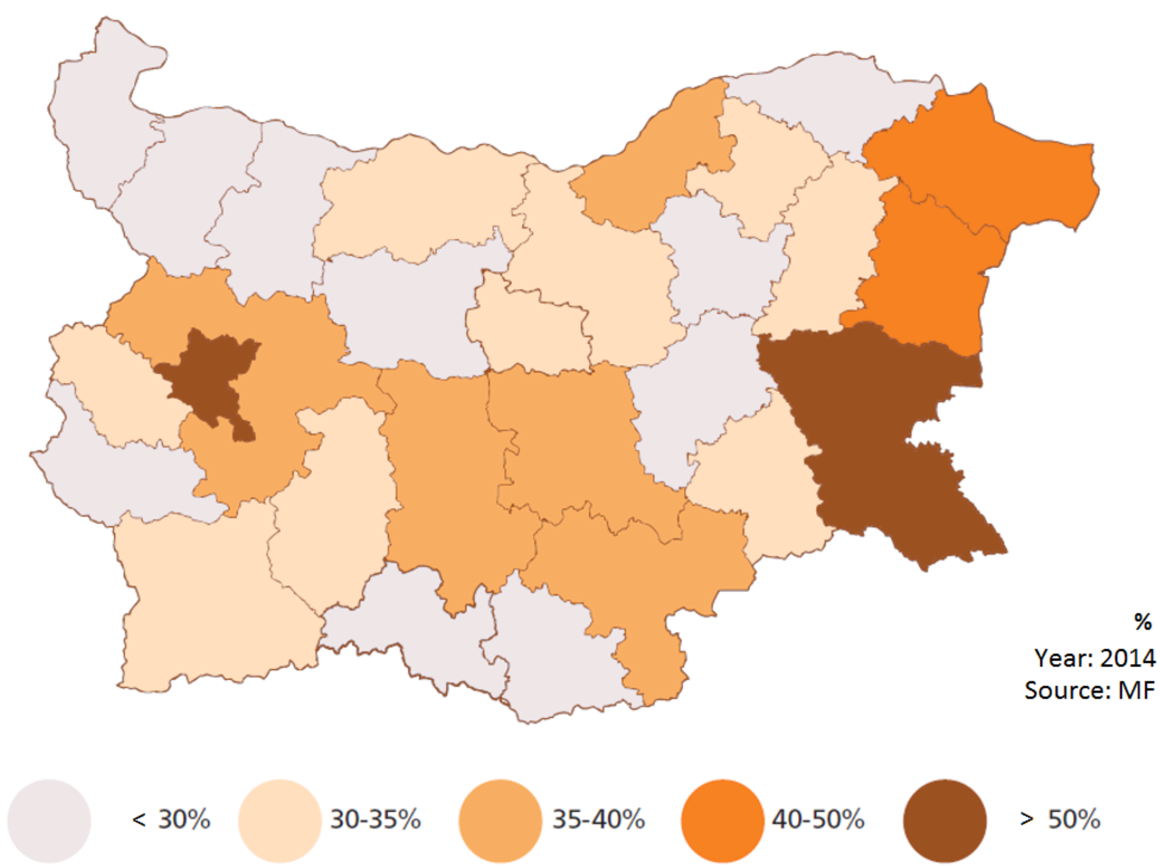
What are the problems?

Although the course towards financial decentralization was set upon over a decade ago, to this day transfers from the central budget are in most cases towering the municipalities' own revenues. Only in the capital and several tourist destinations do own revenues account for 50% of the municipal budget. The relegation of some taxation rights from the central administration to the municipalities in the last few years could not change the overall trend of strong dependency of the municipalities from the government.

On one hand, there is a growing expert and public support for improved financial independence of municipalities and relegating taxation rights, on the other – political ambition for centralized control of the budget revenue flow. In 2014, the government program "Growth and Sustainable Development of the Regions" attempted to incorporate a competitive principle in distributing funding to municipalities, but could not hide the governments political bias when allocating the funds.

FINANCIAL INDEPENDENCE OF MUNICIPALITIES

Weighted average share of their own incomes from the total municipal revenue



The municipalities' own revenues, which generally form less than a fifth of their budget, come mainly from property taxes. This revenue structure has no direct correlation to the citizens' incomes and the profits of enterprises, operating within their borders.

This makes amassing enough capital to cover for the necessary capital expenses of municipalities almost impossible. In a large part, the latter are financed with European funds. This adds another degree of separation between public investment and the local economy and transforms it into an administrative process, putting municipalities in ever-stronger dependency from EU funds.

What are the solutions?

Recommendation I: Automatically redirect 20% of income tax revenues to the local budges on the principle "money follows the ID"

A change of both financial incentives and the relationship between representation on a local level and municipalities' budget is possible only through restructuring direct taxes. Income taxes, to be more specific.

In the short-term one fifth of income tax revenue can be relegated to the municipalities without a change in the overall tax burden, on the principle "money follows the ID". That can happen automatically, based on the taxpayer's permanent address. This approach allows citizens who have a permanent address in one municipality, but live and work in another, to choose where their taxes would go – by changing or not changing their address registration.

Giving a part of the income tax revenues to municipalities is a neutral change in regards to the overall tax burden in the economy. The tax collection process remains the same, but municipalities have more resources to invest in important projects. Such a change does not imply a lowering of budget transfers towards the poorer regions.

Recommendation II: Initially the relegated resources are used strictly for repaying old debts and for investments.

Taking into account the high indebtedness of some municipalities, a period in which the new revenues are used only for paying off old debts and for capital investment seems prudent. This will be a period of concurrent healing of local finances and of executing key local projects, such as road works, reinforcing water reservoirs and clearing riverbeds.

In the mid to long term we recommend a shift towards splitting income tax revenue between the state and the municipalities, and even giving the entire income tax revenues to the municipalities.

Recommendation III: Creating incentives for local authorities to work in the direction of improving investment activity

The challenges to municipal finances stem mainly from the strong dependence of local budgets from the central budget and EU funds. The structure of local budgets contains no incentive for local authorities to attract and retain investors. The lack of relationship between local economic activity and budget revenues means there is no incentive for local administrations to improve the quality of administrative services.

Our observations from the past few years show that, while in practice all municipalities work towards getting EU funding (with varying degrees of success), a very small number of them can show any real actions towards attracting foreign investment.

Improving the financial independence of the municipalities and tightly binding their revenues to financial activity within their borders will create incentives for a more proactive attraction of investments. More jobs will mean more income for the budget, and therefore more funding for local projects.

LABOR MARKET

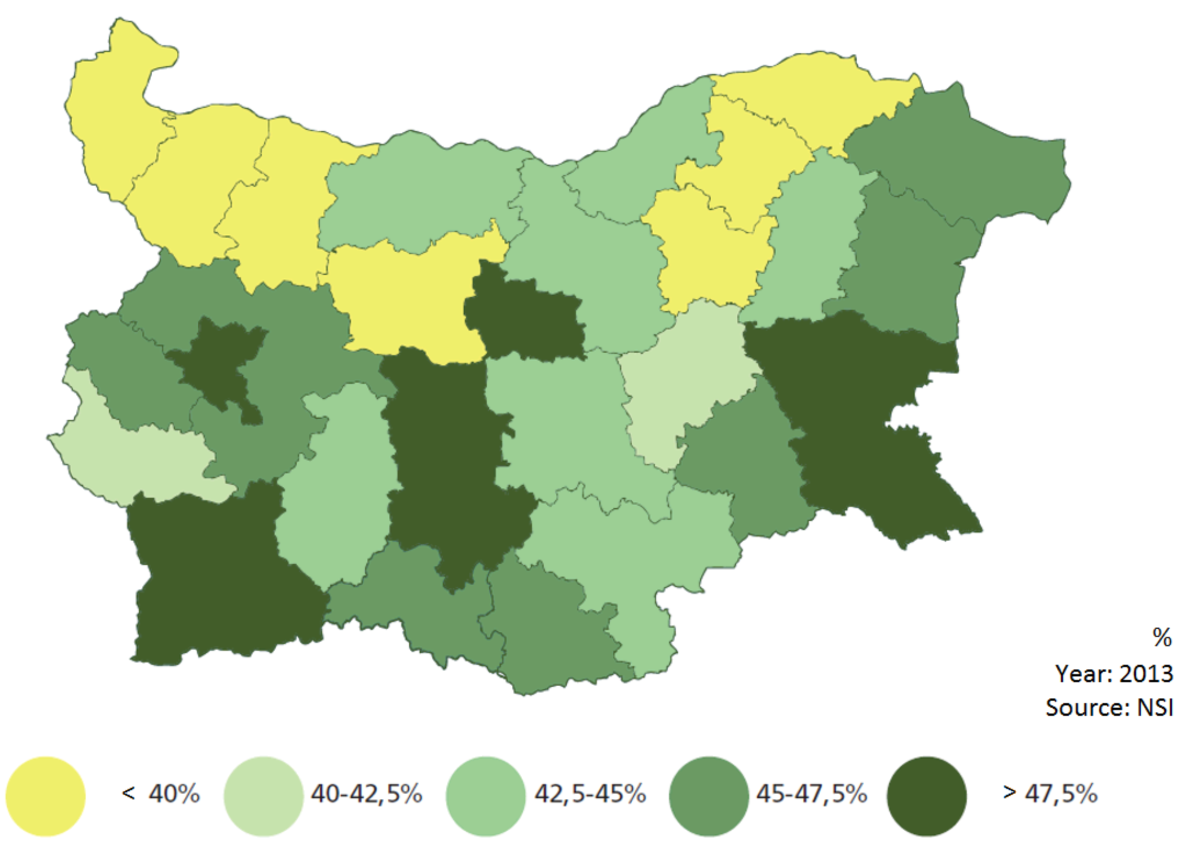
What are the problems?

The Bulgarian labor market suffers from serious long-term problems, among which the low mobility of workers and the serious discrepancies between regions. Labor demand is mainly focused on high-qualified personnel in some specific sectors, which creates conditions for increasing share of structural unemployment in the country.

Centralized government policies have different effects on different regions, which sometimes contributes to deepening the rift between them. IME's research on regional level points to a clear negative correlation between minimum wage hikes and employment amongst low qualified workers.

In addition, the administrative hike of the minimum wage and taxes on labor have a stronger negative effect on employment in regions, where the salaries are lower and thus closer to the minimum wages and social security thresholds.

EMPLOYMENT RATE



Labor market data show that the crisis of 2009 deepened the differences between Northern and Southern Bulgaria. While the employment in Southern Bulgaria is gradually recovering in 2013 and 2014, the situation in most of Northern Bulgaria remains critical. Employment rates in seven of the northern regions remain below the critical 40%.

The majority of the problems of the labor market are a direct consequence of imperfections in the labor legislation. Bulgarian labor law is anachronistic and gives the administration significant power to interfere in employer-employee relations. In particular, the state's attempts to protect some of the so called "vulnerable groups on the labor market" (such as unemployed youth, people, living in remote regions, young mothers, disabled people, etc.) often has the opposite effect, decreasing the incentives of employers to hire them and condemning them to social exclusion.

Part of the problems of the labor market are a result of the structure of the education system in the country, in particular the tertiary education system. As long as the public funds continue to be allocated only on the basis of the number of enrolled students, no meaningful change in the structure and content of the curriculum and the teaching methods can be expected.

What are the solutions?

Recommendation I: Accounting for regional differences when formulating national policies

Decisions to increase the minimum wage or social security payments must be taken after taking into account their effects on the less developed regions in the country. The size of the minimum wage as a share of the average wage varies significantly on a regional level: 29% for Sofia-Capital compared to 60% for Vidin (data from 2013). The constant increase of the minimum wage, with a speed, higher than the increase in labor productivity, threatens the recovery of the labor market in the country and creates prerequisites for further increase of structural unemployment.

Particularly in the regions, where the salaries are lowest, the negative effects of such politics are most strongly expressed. Jobs in those regions are fewer, workers are paid less, and employers in the general case have lower revenues and thus lesser capabilities to adapt to the changing requirements. Taking into account that the minimum wage level is decided on a national level, the best approach for addressing this problem is for further increases to consider the realities in the poorest regions. The same applies for social security payments, which in their present form are often subject to criticism from the European Commission.

Recommendation II: Improving the quality of the labor market programs

This can be achieved through constant monitoring and evaluations of the programs for subsidized employment and requalification. Creating registers, tracking the subsequent career realization of the beneficiaries, would provide the required feedback for evaluating the quality of programs and their efficiency. Based on that information and the analysis of it, the characteristics of the programs can be altered in a reasonable period.

This is a mid-term measure for improving the active measures on the labor market. Postponing it in time leads to lower efficiency of the invested capital and to unemployed and economically inactive people dropping out of the programs.

It is also necessary to shift attention from the direct job creation to programs supporting employment and entrepreneurship. According to the latest EC data (from 2011), 70% of all active Bulgarian labor market politics are aimed at direct job creation, compared to only 11.3% in the EU on average.

Recommendation III: Introducing flexible approaches for regulating seasonal employment

In Bulgaria, there are not enough flexible tools for regulating short-term employment. The procedure requirements for signing temporary labor contracts must be relaxed, in order to allow employers, who have urgent need for seasonal/temporary labor force to hire them in time, following the legislative requirements. That can be achieved through the development of standardized requirements for hiring “day workers” and maintaining an online register. Those steps will help decrease the gray economy, especially in agriculture and tourism related activities.

The large share of the gray economy in seasonal employment is a factor that increases the uncertainty of workers and eliminates their ability to claim unpaid salaries. Simpler normative requirements for seasonal employment could also increase the work mobility both in the territorial sense as well as in regard to the type of jobs that workers could or would be inclined to accept.

BUSINESS ENVIRONMENT AND INVESTMENTS

What are the problems?

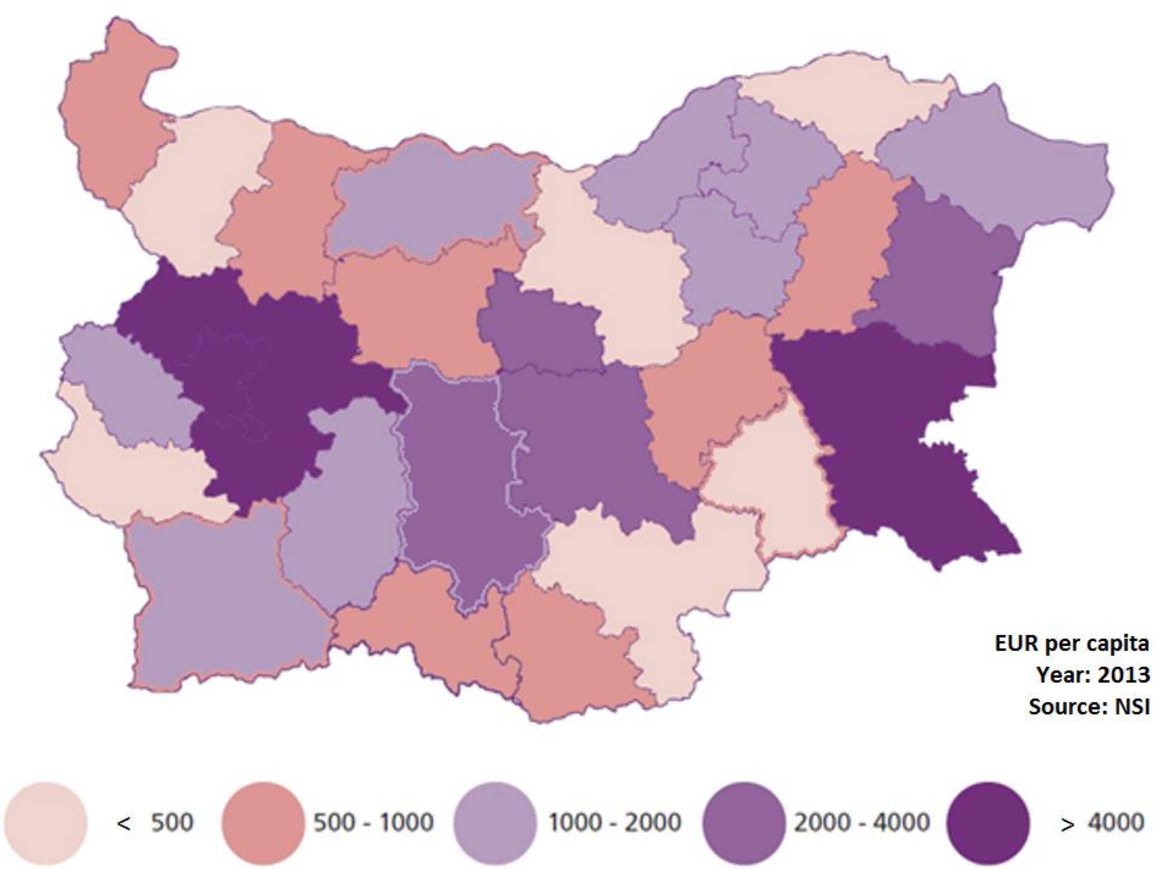
Investment activity in the country remains low, and the contrast between the least and most attractive districts for FDI remain significant. The spread of cumulative foreign direct investment in the country shows that the capital remains the unrivaled champion both in the period of accelerated growth as well as in the following financial crisis and recovery.

The difference between the chart-topping Sofia and the region with the least amount of attracted foreign investments – Montana, is 35 times. As of the end of 2013, Sofia has attracted 9 245 euro foreign direct investments per capita, compared to Montana's 267.

The lack of investment leads to lowering the competitiveness of the local economy, which in the mid to long term is on the main reasons for lower employment, accelerated migration and therefore worsening demographic situation.

FOREIGN DIRECT INVESTMENT PER CAPITA

Accumulated FDI in the non-financial sector firms



Since 2012 public corruption perception has been increasing, and the evaluation of local administrations' work quality has been worsening. That shows the local authorities are not putting enough effort towards improving the business and investment environment. Instead, their focus is aimed at absorbing European funds.

At the same time, the absorption of European funds on the local level also shows significant differences in the local administrations' abilities to win and successfully execute such projects. While some municipalities have already accumulated significant expertise in preparing and executing EU projects, others do not have the required administrative capabilities to secure access to those funds.

Despite significant infrastructure project funding over the past years, including from Europeans funds, Bulgaria's infrastructure development remains uneven. The key projects of the past years have been focused in South Bulgaria. The share of roads in good condition decreased in 2013.

A series of IME analyses over the factors that determine the economic development and investment in the regions comes to the following conclusions:

- The main factors for economic development of the regions are investments, infrastructure, quality and quantity of human capital, as well as entrepreneurship. That means that the regions that attract more investments, are the ones that have educated and sufficient work force, more entrepreneurs and developed infrastructure. They enjoy the highest level of development and standard of living.
- Investments are directed to regions with a higher share of working age population and higher percentage of people with higher education, and vice versa – highly educated people and those of working age remain or relocate to regions which attract more investments.

What are the solutions?

Recommendation I: Attracting private investments must be the highest priority for local administrations

The volume and flow of domestic and foreign investment are strongly correlated to local well-being, measured by GDP-per-capita. On the one hand, the more a territory attracts investments, the more its economy prospers and the more its income increases. On the other hand, high degree of development of a given region, significant business activity and high wages also attract investments, because of the higher potential of the local market and the wider possibilities for partnership with other businesses.

Redirecting some efforts from applying for European and national funds to attracting private capital will help guarantee the sustainable development of Bulgarian regions and will increase local wages in the long term.

Recommendation II: The fight with the demographic crisis goes through improving the local environment for business and investment.

There is a strong correlation between investments, on the one hand, and general demographic indicators such as the age structure of the population and net mechanical population growth (the difference between immigrants and emigrants), on the other. Policies for overcoming the heavy demographic crisis in some parts of the country must therefore aim at improving the investment environment. Investments are the main job and income-creating factor, thus keeping and attracting young people in those areas.

Increasing the financial independence and encouraging tax competition between municipalities could be one of the ways to spur this process. From the central administration's point of view, the efforts for improving the local investment and business environment could also be supported by using a more balanced approach towards executing infrastructure projects.

Recommendation III: Local strategies for attracting investment must put an emphasis on training and educating the workforce

The presence of a sufficient work force, as well as its quality are both a factor and consequence of attracting investments. This conclusion applies both for local and foreign investment. This is why the training and education of the work force must be the main priority when working out national and local strategies for attracting and retaining investments.

This forces municipalities to adopt a more active, mediator role in regards to relationships between local business, local educational institutions and the central administration. In addition, building better practices in the sphere of vocational education and re-qualification are a prerequisite for increasing the competitiveness of the work force.

That way the focus is placed not on executing programs, creating subsidized employment, but on education and training of the local population, which would then help attract investments.

REGIONAL PROFILES: DEVELOPMENT INDICATORS

Since 2012 the Institute for Market Economics (IME) analyses the social and economic regional development in Bulgaria. The study "Regional Profiles: Indicators of Development" includes in-depth information on the development of the Bulgarian regions. By providing separate profiles for each region and thematic analyses on different issues, this study investigates both the economic and social aspects of life and business in the regions.

The recommendations in this publication are based on:

- 3 years of research;
- Annual socio-economic profile of each of the 28 districts;
- 10 thematic analyses on local finances, employment, investment, growth factors, education, and others;
- 30 focused analytical materials on topics such as labor market, household incomes, infrastructure quality, living standards, e-government development, European funds, education and others;

The analyses are based on:

- 58 statistical indicators on the social and economic development of the regions;
- 6 sociological studies among businesses and citizens on a local level;
- Over 700 requests through the Law for Public Access to Information to all regions;
- 6 regional and 3 national round tables;
- Tens of regional meetings with representatives of local business, administration, media and public figures;
- Years of cooperation with the Bulgarian Chamber of Commerce and Industry, the National Statistical Institute, the National Association of Municipalities in the Republic of Bulgaria and many other organizations.

You can find more about our research, on the project's dedicated web page:

WWW.REGIONALPROFILES.BG