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## **Bulgaria's Membership in EU: Does the Actual Year of Accession Really Matter to Economic Performance?**

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### **Abstract**

*The paper tries to assess the short- and medium-term effects of a possible delay of Bulgaria's accession to EU on the country's economy. Several scenarios in terms of trade liberalization, level of foreign direct investment and EU transfers are developed which help to distinguish the different consequences from integration with EU and actual membership. The overall results suggest that the link between actual year of accession and higher economic performance is relatively weak. Although a later entry may discourage foreign companies from investing in the country, given the protectionist nature of EU, sound internal economic policies may prove more beneficial for growth in Bulgaria than an earlier date of membership.*

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## 1. Background

The main proclaimed goal of the present Bulgarian government is to join EU in 2007 and the European Commission gave signals that they are willing to realize this scenario. However, Commissioner Verheugen recently expressed his doubts that this is possible if the Bulgarian Parliament did not make the necessary amendments to the Constitution related to the judicial reform in order to comply with the *acquis communautaire*. There could be many other reasons as well for delaying Bulgaria's accession to EU: not completing the negotiation process in time (for example, lack of adherence to deadlines concerning the nuclear power station in Kozloduy), political pressure on EU decision-makers or too slow pace of reforms in the country. This paper tries to briefly assess the consequences on Bulgarian economy of a later entry date by distinguishing the essence of the various effects involved and comparing the outcomes of the different scenarios. It is not discussing the political implications of not joining EU in 2007, provisional lack of confidence and government changes.

## 2. Uncertainties and Benefits of Integration with EU

The issue Bulgaria is facing now is not related to the dilemma "enter or not". A part of the reasons for that have to do with the wide support of the population for EU membership, the reforms already undertaken and the advanced stage of negotiations.

The existing uncertainty is over the actual date of accession. In order to approach the subject properly and avoid any misconceptions one must first generally consider the costs and benefits of the whole process of integration with EU.

### Channels of impact

There are various channels through which the EU accession process affects the economy of an applicant or a member country. The direct ones stem from EU pre-accession programs, EU funds for less developed members, establishment of Free trade zone, Customs union, Single market and Monetary union, implementation of *acquis communautaire* and free movement of labour, capital, goods and services. Furthermore, the changing attitudes of investors and other foreign institutions due to the stimuli for applicant countries to comply with certain rules for internal policies play an active role in economic development as well.

### Benefits

The main economic benefit from the EU accession process is the improved efficiency of allocation of resources due to free movement of factors of production like capital, technology and labour within an economy of a larger scale. When Bulgarian companies become part of the Single Market, they will have to cope with strong competitive pressure from foreign firms. In their effort to attract larger market shares they will be forced to minimize their costs, use economies of scale and increase productivity. The whole process is likely to cause certain sectoral employment shifts that may further enhance economic growth. Additional gains from trade liberalization include improved international competitive position, growth of consumer welfare due to lower import prices<sup>2</sup> and attraction of investments from export-oriented companies.

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<sup>2</sup> If EU imports substitute for imports of roughly the same price/quality ratios from other locations.

The process of preparation for EU membership involves financial transfers to the applicant countries in the area of agriculture, ecology, institutional reform and infrastructure. EU accession also serves as a guarantee for conducting transparent and predictable internal economic policies, ultimately resulting in higher level of physical investment. At the same time EU membership is a precondition for joining the EMU. In economic terms this means higher macroeconomic stability, lower transaction costs in the economy and easier planning of business activities.

### Costs

The costs of EU membership should be tackled very carefully because of their controversial nature. They are associated mainly with the drop in production and employment as a result of intensified foreign competition, costs of modeling the institutions in accordance to EU requirements, the additional investment necessary to comply with EU standards in areas like, for example, ecology. The negative effects grow considerably if one adopts the view that EU stands for “outdated and ill-guided models of economic policies”<sup>3</sup> because of its relatively heavy regulations for the business, protectionist against outside-world nature, oversized welfare states and rigid labour markets.

### Time patterns

Even the brief discussion of the effects from integration with EU gives an idea of how difficult it is to identify their time patterns. So far the EU accession process has proved to be rather lengthy and gradual. The complex pre-accession arrangements have dispersed the costs and benefits to the applicant countries over a considerable time horizon. In this context, it is worth mentioning that the driving forces behind this pattern of development have been to a large extent political. The non-clarity concerning the time pattern of EU membership consequences makes it quite challenging to identify the pure effects for the Bulgarian economy resulting from actual accession or its delay. The issue becomes even more complicated when it comes to quantifying these effects since there has been rather insufficient research in that area so far. An additional difficulty arises with the ever-present problems with research in transitional economies, namely lack of consistent statistics and longer time series.

## **3. Lessons from previous enlargements**

One way to address the subject of time patterns is by making parallels with previous EU enlargements. If there are common effects on the new entrants' economies after the actual accession of the respective countries, then certain projections for Bulgaria's case could be derived. However, such analogies turn out to be in some respects inappropriate and misleading due to several reasons.

First, the present applicant countries show quite different patterns of economic development from those in the previous enlargements. For example, the countries that

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<sup>3</sup> Kohler and Wilhelm, “Fifty Years Later: A New Marshall Plan for Eastern Europe?”, In: G. Bischof, A. Pelinka, and D. Stiefel, eds., *The Marshall Plan in Austria*, Contemporary Austrian Studies, vol. 8, New Brunswick & London: Transaction Publishers, pp. 402-446.

enter last in 1995 – Sweden, Finland and Austria – had income levels compatible to the income levels of the member countries. In contrast, the average GDP per capita of the 12 candidates in 1998 was only 38 % of the EU level. That is why some researchers perceive the Southern enlargement in the 1980s as a better benchmark for the present accession process although the problem remains there as well but in smaller scales. The current enlargement is also the first one when EU is going to accept ex-socialist countries as members. All previous applicants had longer traditions of functioning market economies, making it easier for them to comply with EU requirements and additional competitive pressure.

Second, the current EU enlargement is expected to have stronger effects on the agricultural sector and labour migration in the accession countries. Although the size of the agricultural sector in present candidates is comparable to those in Spain, Portugal and Greece in the 1980s, the latter exhibited higher productivity rates compared to the average EU level than the former. Furthermore, there is higher potential for labour force mobility in the present applicant countries because of the substantial income level differentials and geographical proximity of most of the accession states to the current EU members. We can conclude from these circumstances that the effects from EU accession in the those areas may be stronger for the transition countries today than for the Southern states in the 1980s although they may take place in the medium- or long-term perspective.

Third, the EU itself has changed considerably in the years after the benchmark Southern enlargement. Now EU accession means adopting significant amount of regulations and standards by the applicant countries and that is very likely to have an additional impact on economic activity. Although free movement of labour, capital, goods and services remain the ideological base for EU, a complex legislative framework and various institutions have emerged, affecting the way of calculating EU membership costs.

#### **4. Bulgaria's actual accession: implications**

Since comparison with other enlargements may not prove to be very appropriate, one can try to evaluate the effects from actual accession one by one in order to assess the various scenarios for Bulgaria. This approach also can be seen as controversial because some effects are hard to separate from one another. Still, that was the way the issue was tackled by one of the most general analyses of economic consequences of EU enlargement<sup>4</sup>. It will allow us to quantify the effects from EU accession in 2007 or later and eventually to compare the results.

##### Scenarios

The present paper focuses on two scenarios – Bulgaria's entry in EU on January 1<sup>st</sup>, 2007 and January 1<sup>st</sup>, 2011. The first one is the most probable one up to the moment. The second one takes into account the time when some other Balkan countries may be ready for membership and considers the four-year extension of the accession process as the largest one that will still remain credible.

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<sup>4</sup> Directorate General for Economic and Financial Affairs, The Economic Impact of Enlargement, The Economic Impact of Enlargement, June 2001

Another important assumption is that the decision for Bulgaria's membership in EU is exogenous to the economic situation in the country, i.e. the delay of the accession will not be a result from deteriorated business climate or lack of appropriate reforms.

The effects from earlier or later EU accession are assessed in terms of average annual GDP growth in the period 2007-2010 as a deviation from the trends of development of the index until 2006 inclusive.

#### **4.1. Agriculture and labour mobility**

The effects from agriculture and labour migration resulting from EU accession are not subject to quantification in this analysis. Labour is the most immobile factor of production. Apart from that the planned five- to seven-year transition period in the implementation of *acquis communautaire* in respect to free movement of workers from the new member countries implies that EU accession will not influence that area in the short run.

Labour migration from Bulgaria to EU, though not entirely legal, has already intensified after Bulgaria became part of the Shengen space. All these factors suggest that the effects from labour mobility could be excluded in the examined 2007-2010 period without loss of accuracy.

Some of the effects from agriculture greatly depend on the freedom of movement of labour, which will not proceed in a fast pace. Sectoral employment shifts by no means will occur but most likely in a longer time horizon. Other consequences from agriculture resulting from trade liberalization are included in the gains from trade quantified below.

EU membership also means more subsidies to the agricultural sector. This together with the other EU transfers are examined below as well. These are the reasons why the effects from EU accession on agriculture are not separately tackled here.

#### **4.2. Trade liberalization**

Trade liberalization is a powerful source of economic growth. However, Bulgaria, like all the other accession countries, has already consumed a great deal of the benefits from trade integration with EU due to the preliminary free trade agreement. The Interim Agreement on Trade and Trade Related Matters covering trade components took effect on 31 December 1993. Tariffs between Bulgaria and the EU countries had been gradually reduced until their full abolishment since 1 January 2002. Actual EU accession will induce further trade liberalization in agriculture and some other sensitive sectors, which according to EBRD<sup>5</sup> account to up to 20 per cent of total exports for some accession countries. This estimation determines the scenarios for gains from trade considered below.

#### Analytical model

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<sup>5</sup> EBRD, Transition report update 2003, Economic transition in central and eastern Europe and the CIS, p. 5, May 2003

The quantitative link used here was established by Frankel and Romer<sup>6</sup> who found that an increase in trade share to GDP ratio of one percentage point increases income per person by 0.5 %. In the model used here this gain is evenly distributed in a 5-year period so that there is enough time for the effects to take place. Trade share is measured as the sum of imports and exports. We consider the trade share development only for goods exchanged between Bulgaria and EU and CEFTA (as future members in EU), as percentage of GDP. Services are not taken into account since they are very little affected by tariffs. Then we calculate the average growth of the ratio between trade of goods between Bulgaria and EU and CEFTA and GDP for the period 1995-2002 – 2.63 %. That gives us a projection for the development of this index until 2006 or until 2010 (if Bulgaria enters EU in 2011).

### Scenarios and results

We examine two scenarios for the effects from trade liberalization stemming from EU accession in 2007. In the optimistic case the analyzed index grows by further one fifth of its size and in the pessimistic – by further one eighth after entry.

We use two scenarios because of the uncertainty about the trade reallocation effect – trade liberalization with EU may cause not only growth of the trade sector but just a change in the trade partners. Thus, the gains from trade after EU accession in terms of GDP growth are further average annual 0.13 % in the optimistic case and 0.08 % in the pessimistic case.

## **4.3. Foreign direct investment**

Foreign direct investment (FDI) in transition countries is frequently referred to as a key factor in determining economic growth. It contributes to physical capital accumulation, transfer of technology and knowledge and job creation. The slow pace of privatization and unfavourable conditions for foreign investors in terms of heavy regulation, entry barriers and corruption did not allow Bulgaria to attract as much foreign investment as, for example, the Czech Republic, Poland, Hungary or Estonia.

The effect of EU membership on this indicator is not so straightforward as in the case of trade liberalization. The EU accession process as a whole positively affects the level of FDI since it acts as a kind of guarantee to foreign investors that the country is not a very risky place to invest. However, the membership itself may contain some uncertainties. They arise from the above mentioned protectionist nature of EU institutional framework and legislation. It is possible that EU accession may stop the increase of FDI-to-GDP ratio.

Although that was not the case with Portugal and especially with Spain which definitely benefited in this respect from EU membership, in the first years after accession the level of FDI in Greece and Ireland remained almost unchanged. However, that can be attributed to factors other than regulatory framework as well.

If Bulgaria stays longer out of EU, the country might be able to attract larger FDI in the short run partly also because of the relatively low labour costs there in comparison

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<sup>6</sup> Frankel, J. A. and Romero, D. (1999), Does Trade Cause Growth, The American Economic Review, vol. 89, 3, p. 379-399

the newly accepted members. Many companies would also like to invest in countries that are just about to become part of the Single market in order to take advantage of it right from the start and avoid higher entry barriers later. It should be underlined here that Bulgaria has already adopted some of the EU regulations affecting the business environment. If Bulgaria fully complies with *acquis communautaire* before accession, then in this respect there will be no difference for the country whether it is an actual member of EU or not.

The effects from delay of membership are also uncertain.

If the investors are sure that eventually the country will become part of the EU that may not affect their behaviour at all. On the other hand, if they assume that is a sign of a retreat of EU from the country, they may cancel their plans for investment in Bulgaria. All these arguments make it necessary to consider various scenarios for the development of FDI in both cases.

We consider three cases for EU accession in 2007

- (A) no further increase in FDI-to-GDP ratio after membership;
- (B) keeping the same rate of increase of FDI-to-GDP ratio as in the previous years;
- (C) doubling the rate of growth of FDI-to-GDP ratio after accession.

The estimations for two cases for accession in 2011 are:

- (1) no further increase in FDI-to-GDP ratio after 2006
- (2) keeping the same rate of increase of FDI-to-GDP ratio.

A base forecast is derived from the period 1995 – 2003 (for 2003 projections of EBRD are used) by calculating the average annual growth of FDI to GDP ratio. Taking out the growth due to privatization (for the period 1998-2002 privatization account to up to 27 % of total FDI on average) we come to 0.381 %. The reason for this exclusion is that the process privatization is expected to be over until the end of 2006. In the context of the model at a certain moment that may cause a drop in GDP growth but that would be a one-time phenomena and would not influence the relative differences in economic performance between the analyzed scenarios. Another reason for not including the effects of privatization on growth is the controversial nature of the link between these two indicators.

### Quantification

To quantify the impact of FDI on GDP growth we should distinguish two separate effects. The direct one is related to physical capital accumulation. Growth of FDI-to-GDP ratio increases the overall level of investment to GDP ratio. A viable assumption here is that FDI will not crowd out domestic investment. To measure that effect we use the scheme in the cited paper by Directorate General for Economic and Financial Affairs according to which 1% increase in investment to GDP ratio would induce 0.17 % increase in GDP growth in the first year after accession and 0.11 % on average in following five years. To estimate the total effect we should consider the indirect or the spillover effect that measures the impact of introduction of more efficient new practices and innovations. For that purpose we use the results from the paper of Borenszstein, Gregorio and Lee<sup>7</sup> who relate the effect from foreign investment with

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<sup>7</sup> Borenszstein, E., Gregorio, J. and Lee, J-W. (1998), How does foreign direct investment affect economic growth?, *Journal of International Economics* 45, p. 115-135.

the level of human capital in the country. For Bulgaria we use that a 0.005 change in FDI to GDP ratio induces 0.35 %<sup>8</sup> additional growth of GDP evenly distributed over a five-year period. We come to the following results for the sum of two effects:

**Table 1. Average annual change in GDP growth for 2007-2010 due to FDI-to-GDP ratio change as a deviation from the trends of development in GDP growth until 2006**

Scenarios	A	B	C	1	2
EU accession 2007	-0.28 %	0 %	0.28 %		
EU Accession 2011				-0.28 %	0 %

Source: BNB, own calculations

#### 4.4. EU transfers

The actual accession considerably affects the amount of EU transfers that Bulgaria is going to receive. Currently, the country has access to programs like PHARE, ISPA and SAPARD, which main goal is to provide part of the necessary investment for preparation for EU membership. After accession the country will become eligible for larger transfers from CAP, Structural funds, Cohesion funds and other sources of financing. However, even if Bulgaria does not join EU in 2007, in the period 2007-2010 the country will receive more EU pre-accession aid if EU Commission is willing to speed up reforms in Bulgaria and reallocate funds from recent applicant countries.

EU transfers enhance growth by financing infrastructure and contributing to human capital development. Nonetheless, one should not forget that part of transfers goes to consumption and not to investment. In addition to that, these transfers are only a part of the investment needed to meet certain EU standards. Sometimes, as every kind of subsidy works, they may also have even deteriorating effect on the economic activities.

The estimates<sup>9</sup> show that the increase of EU transfers with 1 per cent of GDP will induce further 0.14 % growth in the first year and 0.08 % on average in the next five years.

The present pre-accession aid to Bulgaria accounts to up 1.2 % of GDP. Based on the amount Greece receives from EU and the ceiling of 4 % of GDP a country can get in the form of EU transfers, we consider two scenarios for EU accession in 2007:

- (A) 3.5 %
- (B) 4 %

of EU payments to GDP.

There are two scenarios for EU accession in 2011 as well for the transfers received in the period 2007-2010

- 2.25 % and
- 2.8 % of GDP.

The results are as follows:

<sup>8</sup> There are no specific estimates for Bulgaria in the paper but we use the fact that given the method of calculation of the index of educational attainment, its value for Bulgaria is considerably higher than the average for the developing countries in the 1980s.

<sup>9</sup> Directorate General for Economic and Financial Affairs, The Economic Impact of Enlargement, The Economic Impact of Enlargement, June 2001

**Table 2. Average annual change in GDP growth for 2007-2010 due to increase of EU transfers as a deviation from the trends of development in GDP growth until 2006**

Scenarios	A	B	1	2
EU accession 2007	0.25 %	0.31 %		
EU Accession 2011			0.12 %	0.18 %

Source: UNDP, Ministry of finance, own calculations

#### 4.5. Overall assessment of the results

Combining the effects from all three factors described above, we derive 24 scenarios for EU accession in 2007 and 4 scenarios for EU accession in 2011.

**Table 3. Contribution of the various factors to average annual change in GDP growth for 2007-2010 as a deviation from the trends of development in GDP growth until 2006**

##### a. EU accession 2007

Scenario	Trade	FDI	EU transfers	Total
Worst scenario	0.08 %	-0.28 %	0.25 %	0.05 %
Best scenario	0.13 %	0.28 %	0.31 %	0.72 %
Average scenario	0.11 %	0.00 %	0.28 %	0.39 %
Most probable scenario	0.08 %	0.00 %	0.25 %	0.41 %

Source: own calculations

##### b. EU accession 2011

Scenario	Trade	FDI	EU transfers	Total
Worst scenario	0.00 %	-0.28 %	0.12 %	-0.16 %
Best scenario	0.00 %	0.00 %	0.18 %	0.18 %
Average scenario	0.00 %	-0.14 %	0.15 %	-0.01 %
Most probable scenario	0.00 %	0.00 %	0.12 %	0.12 %

Source: own calculations

1. The calculations above reveal that the difference in average annual GDP growth in the period 2007-2010 between the scenarios with EU accession in 2007 and EU accession in 2011 is most likely to be under 0.40 %. We may consider this number as relatively insignificant and subject to compensation by other factors. It is less than one tenth of the average GDP growth in Bulgaria for the last three years - 4.53 % or the estimated 4 % needed by most candidate countries to reach 75 % of EU income level in 20 to 30 years from now<sup>10</sup>.

2. Under certain not so implausible assumptions the scenario of accession to the EU in 2011 may prove more beneficial for Bulgaria. The critical factor in the model is FDI. If Bulgaria does not enter EU in 2007, the state institutions and legislative framework must be prepared to take advantage of the possible favourable consequences of a

<sup>10</sup> If EU grows by 2 % annually. See EBRD, Transition report update 2003, Economic transition in central and eastern Europe and the CIS, p. 5, May 2003

membership delay. That means less regulation for the business, lower entry barriers for the foreign investors and promises for a soon full integration with the Single market.

3. However, one should not forget that some of the positive effects of an earlier entry date will be present in the long run as well. They have not been estimated here but include earlier membership in EMU and further benefits from the factors already described in this paper.

4. The derived results to some extent differ from the one obtained in the paper of Directorate General for Economic and Financial Affairs which predicts additional 1.3 % to 2.1 % to the annual rate of economic growth after EU accession. Among the reasons for this are the somewhat different approach used here and the focus on Bulgaria in particular. In this case the Directorate does not make a clear distinction between the process of integration with EU and the actual accession itself. An optimistic forecast of the effect from reforms is considered under the assumption that such efficient reforms otherwise would not be undertaken at all.

## 5. Conclusions

From all the considerations described above we can conclude that actual EU accession is not so important to economic performance of the country in the short and medium run. What really matters is the guarantee that the Bulgarian government will make the necessary reforms to improve the business climate in the country and will not retreat from the given promises. Trade and capital liberalization with EU are already in an advanced stage and there are no signs that they will be slowed down in case of later membership of Bulgaria in EU. Major developments in labour mobility are not to be expected soon no matter the date of accession. However, there can be political costs associated with the delay of EU membership that should not be ignored. That could mean lower support of the population to the reforms and less incentives for industrial restructuring.

The results show that actual accession affects Bulgarian economy mainly through the increased amount of transfers. However, that should not be attributed to their highly beneficial nature but to the poor past and current performance of other indicators in the economy, which are the base for most of the projections in the paper. The EBRD report suggests that in order to enhance economic growth transition countries like Bulgaria must implement policies that “go beyond those encompassed in *acquis communautaire*, such as the promotion of research and development activities, education/training, tax competition and labour market flexibility”. Surveys<sup>11</sup> reveal that the level of business regulations is still very high in Bulgaria and prevents the country from attracting considerable investment. If such tendencies persist, the question “2007 or later” becomes meaningless for no matter the date of accession, Bulgaria will not be able to take advantage of the respective benefits in any scenario.

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<sup>11</sup> See, for example, Morisset, J. and Neso, O. L. (2002), Administrative Barriers to Foreign Investment in Developing Countries, WP 2848, World Bank Working Papers.

