



SUPPORTING INSTITUTIONAL CHANGE

2003 Annual Report

On January 31 and on March 15, 2003 IME marked the tenth anniversary of its establishment and formal registration in the Sofia City court.

Background

2003 IME priorities dealt with supporting institutional reforms.

This focus was motivated by the fact the 2002 in terms of economic policy has been marked by sustaining macroeconomic stability, with a relatively large and growing share of government expenditures to GDP, and virtually unlimited number administrative and regulatory excuses to intervene, exercise preliminary controls and impose entry barriers.

In early 2003, IME realized that administrative barriers add an additional though not easily quantifiable burden of business. We believed that with the process of EU accession those barriers would impose restrictions to wealth creation.

In a middle class entrepreneur existed in Bulgaria in 2003, he or she would have been a net supporter of 2/3 of the population.

Population above 15 years of age

	Million.	% of those above 15
Employed by the private sector	1.9	28
Employed in government owned industries	0.3	5
Employed in government financed activities	0.6	9
Unemployed, students, other	1.5	22
Pensioners	2.4	36
Total	6.7	100

Source: IME non NSI 2002 data on the population and 2003 on employment

If that citizen was 30-40, working on a contract or as sole proprietor, who receives a gross monthly income of BGN 1,000, he or she would encounter the following tax situation.

He/she should pay 29% (compulsory) pension insurance and 6% (mandatory) health insurance on BGN 850; in other terms he/she contributes to quasi-government funds BGN 297.5. The income tax on the remaining BGN 702.5 is BGN 149. The remaining BGN 553.5 is for consumption. According to the MOF and NSI assumptions, he/she will spend 80% of this amount on VAT-taxed products and services, i.e. another BGN 74 would go to the treasury. If he/she drives a car and consumes 50 liters a month, excise duties would be BGN 22 and if he/she smokes and drinks as the “average” Bulgarian, duties are BGN 12. What remains is BGN 445. The calculation is not complete but choices must obviously be difficult since there are other options to invest, consume, and redistribute within the family, etc.

IME response to 2003 challenges

In the described situation IME decided to give priority to the following activities:

1. To advocate the adoption of the bill to reduce administrative controls on economic activities,
2. To sustain and support with an articulated argument the campaign to reduce taxes in Bulgaria,
3. To allow for faster accumulation of capital via removing barriers to raise capital,
4. To facilitate adoption of credit information bureau, in order to set conditions for easing the costs of credit and encourage competition between banks and enhance responsibility of credit seekers,
5. To sustain the campaign for cost benefit analysis of regulation and policies,
6. To support all above efforts with the dissemination of already established IME products: the weekly and monthly bulletin (in Bulgarian and English respectively) and the Economics Access Station of Internet.

Administrative barriers

A key development of policies to improve the business environment was the adoption of a special policy to reduce administrative barriers. In June 2003 the Parliament adopted the Law on Reducing Administrative Regulation and Administrative Control over Economic Activities (LRARACEA).¹ On December 18, 2003 the Law entered into force. It summarized the efforts of two administrations to improve the administrative environment for business via reducing barriers to business (established by myriad of licensing/permit regimes) and it was a major success of the incumbent administration.

Meanwhile the 2003 constellation required and require further efforts.

According to some estimates, the cost to European firms responding to EU and national administrative requirements amounts to 540 billion Euros per year (3-4 percent of GDP).²

There is an overlapping Bulgarian and EU tendency of a steady widening of regulatory objectives (justified by referring to risks for the general public) and for creating potential

¹ State Gazette, 55/June 17, 2003

² SIGMA, Improving policy instruments through impact assessment, Sigma paper No. 31, 17 May 2001, Paris, OECD, p. 40.

for over-regulation. Regulatory choices are made as a result of complex bargaining between interest groups, and compromises between tiers of government that reflect neither any underlying, neither assessment of what is optimal nor a vision of how matters should evolve.

The rate of transposition of EU Law is 1:3-4, meaning that one EU entry barrier corresponds to 3-4 barriers in Bulgaria's implementation. Meanwhile, the Acquis expand and change when they are harmonized by applicant countries. Estimated compliance costs in Bulgaria in 2000 were 12% of GDP – a much higher rate and cost of compliance than in EU.

Reduction of taxes

Between 2001 and 2003, the consolidated government budget expenditures are maintained at a level of about 40% of the gross domestic product with a low level of 39.4% in 2002. The revenues are increasing, reaching a 41.7% of GDP – the highest level since the middle 1990s.

The reduction of taxes for the period since 2001 has not been significant, and the overall level of expenditures to GDP remained relatively high in comparison to countries that are about to join EU in 2004.

	2001	2002	2003
Corporate tax	28%	23.5%	23.5%
Income tax	20-38%	18-29%	15-29%
Social security tax	42.7%	42.7%	42.7%
VAT	20%	20%	20%

Country	Total Fiscal Burden as % of GDP (2002)
Slovenia	39.8
Bulgaria	39.4
Poland	39.1
Hungary	38.8
Czech republic	35.4
Estonia	35.2
Slovakia	33
Cyprus	32.5
Latvia	31.3
Malta	31.3
Lithuania	28.8

Source: Eurostat

In this situation, in order to re-ignite the tax reduction debate one of the IME staff economists, George Angelov, initiated a work to draft an alternative to the government version of the state budget, calculated at 10% corporate and income tax and 16.5% social

welfare tax. It turned out the 2004 budget was realistic at these assumptions, with cuts of subsidies, and some inefficient allocations to unjustified government investment project.

The IME campaign was one of the factors to reduce the corporate tax to 19.5%, beginning in 2004.

Faster accumulation of capital

In 2003, IME drafted (in cooperation with bankers and capital market specialist) and convinced members of parliament to submit to the legislature a bill on special purpose investment vehicles.

It has been adopted in December 2003 and will be enforced in mid 2004; it allows for capitalization and securitization via special investment companies, which helps investors to avoid double taxation. We believe that such companies would enter first the real estate market and only then move to other sectors.

Credit information bureau

IME in cooperation with the Bulgarian American Enterprise Fund initiated a public debate on the prospects to create a private credit bureau. IME conducted a feasibility study and outline prospect for negotiations with provisional investors in such an institution, investors like IFC, Experian, and CRIF/TransUnion. We expect that the credit bureau will be formally established in 2004.

However, there are related positive impacts: the Bulgarian National Bank launched a program to widen and facilitate access to its own credit bureau, which currently is not used due to high fees and slow process of obtaining information.

Cost benefit analysis of regulation and policies

This campaign is led by IME since 1998.

The above-mentioned law, LRARACEA, requires regulatory impact analysis of policies that introduce licensing and other forms of controlling economic activities.

Immediately after we finalized the work on LRARACEA it became obvious that Bulgaria environment need further campaign to explain the merits of such an approach applied to broader set of regulations and all sources of regulatory initiative.

We plan a the two-year project aimed at increasing public awareness through impact assessment on selected regulations and transferring parts from international best practice on RIA. IME efforts include legal analysis of present legislative process and necessary changes to allow for quality RIA within the government and a survey and dissemination of a comprehensive study on incumbent preconditions to establish a better regulation agency with the executive to launch coordination of regulatory policies and conduct cost benefit analysis on its own.

In 2003 produced and disseminated the paper Better Regulation Unit for Bulgaria.

This year the effort continues in the area of education public officials on general principle of RIA and drafting a new law on normative acts that would require cost benefit analysis of draft laws and regulations.

Newsletters and EASI

In 2000-2002 the *Economic Policy Review* bulletins (EPR, in English and Bulgaria) were supported (at 50% of the costs) by MSI/USAID. The number of addressees is over 3,500; it seems it is more popular than some Sofia newspapers and is reprinted at the rate of 40-45%.

Since the beginning of 2003 IME has an agreed six months support for the EPR from the Open Society Fund – Sofia.

Economic Access Station on Internet has become popular via the EPR's but in 2003 is collected its own unique materials: there are already three courses, those of Pierre Garelo and Richard Stroup, a rich set of translations and theoretical material in market economics.

Other achievements

In 2003, IME re-affirmed its status of market reform advisor for the Region; we have worked:

- In the area of business registration reform in Bosnia and Herzegovina, in cooperation with Bannock Consulting – London, and Unilob in Warsaw.
- In Kyrgyz Republic, IME worked under the World Bank assessment to establish a unit, dealing with RIA and Cost benefit analysis unit at presidency and the council of ministers. IME initiated a study that would help EU enlargement officials better understand the Balkans, Study of Incentives, Characteristics and Strategies of Firms Operating ‘in the Shadows’ (180 Firms Survey in Bulgaria, Romania and Serbia),
- In September 2003, IME (Krassen Stanchev, the executive director, and Martin Zaimov, IME board member and then a deputy governor of the Bulgarian National Bank) have been a part of a group of eighteen reformers from eleven New Europe countries to visit Baghdad and advise on economic policies the Coalition Provisional Authority.

Krassen Stanchev

March 2004,

Sofia