

TRADE LIBERALIZATION: THE CASE OF BULGARIA

By Martin Dimitrov¹

1/ Is Free Trade Beneficial?

IME is part of an international research network dedicated to promote ‘Economic Freedom’ worldwide – Economic Freedom Initiative² (Fraser Institute is the coordinating and leading party). Trade liberalization is one of the major components included in the overall index measuring ‘Economic Freedom’ and having benchmarking value.

It is likely that Balkan economies with greater openness would sustain greater output and, over time, would achieve higher income. In the framework of the Economic Freedom Initiative has been constructed a Trade Openness Index (TOI),³ designed to measure the interception of basic growth factors with international trade. It has 4 components: a) tariff rates, b) the black market exchange rate premium, c) restrictions on capital movements, and d) the actual size of the trade sector.

The trade Openness Index, Convergence, Key Policy Variables, and Income

	Real GDP per capita 1998		Average annual growth rate of real per capita GDP-a		
	(1)	(2)	(3)	(4)	(5)
Trade Openness Index (1980-98)	3.1 (9.6)*	2.0 (5.96)*	0.4 (3.85)*	0.4 (2.8)*	0.3 (2.13)**
Per capita GDP 1980				-0.1 (3.13)*	
Property rights rating 1980		1.0 (5.32)*		0.2 (2.33)**	0.2 (2.46)**
Inflation variability rating		0.5 (2.27)**		0.4 (4.81)*	0.5 (4.89)*
Intercept	-8.1 (4.29)*	-12.2 (6.29)*	-1.0 (1.5)*	-3.6 (5.00)*	-4.3 (4.91)*
N	87-b	87-b	87-b	87-b	66-c
Adj R- Squared	.52	.65	.14	.36	.38

t- statistics in parenthesis

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² For more information see – www.freetheworld.com

³ J. Gwartney, C. Skipton, R. Lawson, *Trade Openness, Income Levels, and Economic Growth*, 1980 – 1998. James Gwartney and Robert Lawson are editors of the Economic Freedom Index of the World, published since 1997 by the Fraser Institute in Canada; IME is a co-publisher of the Index.

* significant at 99% level; ** significant at 95% level

a – Real GDP numbers are derived using the purchasing power parity method and are in U.S. dollars

b – There are 87 countries in this analysis

c – High income, long standing OECD members are excluded.

The results in equation 1 illustrate the relationship between country's average TOI rating during 1980-98 and a given country's 1998 per capita GDP, the correlation is positive and highly significant. The adjusted R-squared comparison indicates TOI explains 52% of the variability in 1998 per capita GDP among the 87 countries. Equation 2 includes inflation and property rights, which significantly correlate at 95%. The TOI remains highly significant ($t = 5.96$). The R-squared adjustment shows that all three variables explain 65% of cross-country variations in per capita GDP. Equation 3 looks at the relationship between the TOI and the growth rates of real per capita GDP for 1980-98. The t – ratio for the TOI is highly significant with R-squared indexes explaining 14% of the cross-country variation in growth. If we exclude from the equation 5 the high-income industrial countries (21 long standing OECD members) and reran the model the results are quite similar to those for all countries. The TOI remains positive and significant explanandum low-income countries.

2/ Trade liberalization effects for Bulgaria (mostly EU agreement).

A/ The Initial Position

Bulgarian exports prior to political and economic reform of 1990-1991 had the highest CMEA (Council of Mutual Economic Assistance) share in comparison to other member countries. Also, Bulgaria (along with Czechoslovakia) was the last to reduce CMEA-export in 1989, while others started as early as in 1986. Another peculiarity was that Bulgaria exported mostly to the ex-Soviet Union while others traded more significant volumes with one another. Roumen Dobrinski⁴ calculated that Bulgarian CMEA-trade in the second half of 1970's and 1980's averaged around 60% of the total. Closest to Bulgaria was Czechoslovakia, with 51-52%, Romania had a less than 30%, while Hungary and Poland were always between 40% and 50%. In early 1980's Bulgaria has had an exclusive intermediary position between East and the West, importing cheap raw material and resources from the Former Soviet Union (FSU) and selling it recycled to international markets, and trying to resell back to the East COCOM-embargoed hi-tech products and computers. Between 1984 and 1989 it enjoyed virtual CMEA-monopoly in this trade. This pre-history has long-term impacts on the reform years.

B/ Improvement of comparative advantages (change in the level of processing of exports).

Bulgaria signed an asymmetric agreement for trade liberalization with the EU in 1995 in the context of its accession schedule. From 2002 trade on industrial goods was fully liberalized, while trade on agricultural goods reached significant level of liberalization⁵.

From the very beginning there were severe discussions in Bulgaria whether trade openness would be harmful for local firms. Ten years later having the necessary statistical basis we can reveal what actually happened.

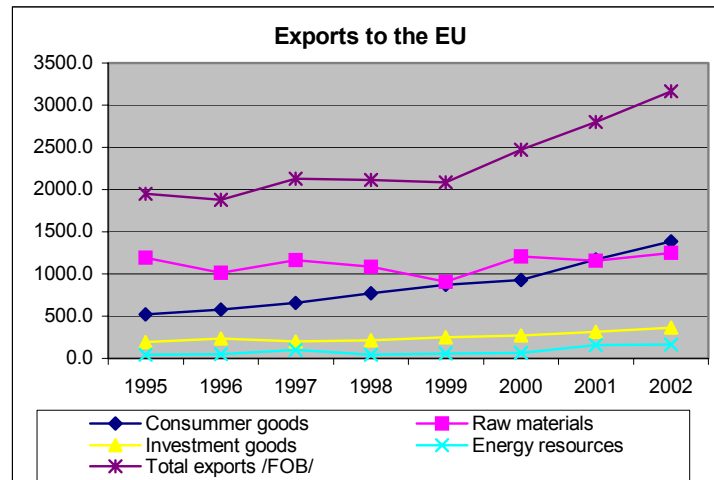
Exports to the EU increased by 63% between 1995 and 2002. It is important to mention that, there is a change in the structure of trade within the period in question. The most dynamic increase was registered for consumer goods - 167%, which are characterized

⁴ See Roumen Dobrinski, *Transition Failures: Anatomy of the Bulgarian Crisis*, Vienna, WIIW, 1997, p.7.

⁵ Agriculture remains a special case because there are still concessions, standstill provisions and quotas.

with higher level of processing. These goods overpass the share of raw materials in 2002. In addition, exports of investment goods also increased by 85%.

Summing up, the change is towards increasing the average level of processing of exported goods to the EU. Partially, the reason is that free trade is providing for imports of investment goods (machines and technologies) and improves the competitive position of local players.



Source: BNB

Comparative advantages

The calculations on comparative advantages are based on the formula -

$$RCA_i^j = \frac{(X_i^j - M_i^j)}{(X_i^j + M_i^j)}$$

RCA_i^j - is revealed comparative advantage in production of commodity i in respect of a given country

X_i^j - is the value of exports of commodity i to a given country by country j

M_i^j - is the value of imports of commodity i from a given country to country j

This indicator can take values from -1 to +1. The general idea is to monitor how the relation export/import changes for different commodity groups over time.

For the period 1995-2002 the relation export/import in EU trade became slightly negative starting from balanced position. As it was mentioned before, EU market increased its importance in terms of imports of investment goods.

Most of comparative advantages in EU trade (measured as net exports) were concentrated in consumer goods (we register a quite stable tendency here) and energy resources (despite some inter year fluctuations).

In 2002 the leading export positions in EU trade were (as a % of the overall exports): Textile articles – 32.3%, Other base metals and articles thereof – 19.1%, Machines and equipment – 10.2%, Mineral products – 6.1%.

Comparative advantages in EU trade

EU countries	1995	1996	1997	1998	1999	2000	2001	2002
Consumer goods	0.2	0.3	0.4	0.3	0.2	0.2	0.2	0.2

Raw materials	0.1	0.1	0.1	0.0	-0.1	0.0	-0.1	-0.1
Investment goods	-0.5	-0.4	-0.5	-0.5	-0.6	-0.6	-0.6	-0.6
Energy resources	0.4	0.6	0.7	0.0	0.2	0.2	0.5	0.5
Total	0.0	0.0	0.1	0.0	-0.1	-0.1	-0.1	-0.1

Source: author's calculations based on BNB data

During the transition period the highly expressed comparative advantages are in SEE trade. Despite postponed regional liberalization Bulgarian firms and individuals increased its presence on neighbouring markets. Leading export positions in 2002 (as % of total exports) were Mineral products – 20.9%, Textile materials – 20% and Other base metals and articles thereof –19.2%.

It is worth mentioning that the same commodity groups (although in other proportions) are the leading positions in exports to the EU.

Comparative advantages in SEE trade

SEE countries	1995	1996	1997	1998	1999	2000	2001	2002
Consumer goods	0.8	0.9	0.7	0.3	0.8	0.9	0.9	0.8
Raw materials	0.6	0.6	0.5	0.4	0.6	0.6	0.7	0.7
Investment goods	0.6	0.7	0.7	0.7	0.7	0.7	0.8	0.8
Energy resources	1.0	0.9	0.3	0.4	1.0	1.0	0.9	0.8
Total	0.7	0.7	0.6	0.4	0.8	0.8	0.8	0.7

Source: author's calculations based on BNB data

Concentration of Exports

Conventionally speaking, trade liberalization creates incentives producers to specialize in domains characterized by comparative advantages. Therefore, free trade provides for better utilization of resources.

In 1992 the four leading commodity groups (in terms of weight in exports) constitute 52.1% of the overall exports. Ten years later we observe both a change in the structure (Mineral products and Textiles and textile products replace Prep. foodstuffs, beverages, tobacco and Chemicals and related products in terms of weight) and increase in export concentration to 61.1%.

The reasoning here is that with trade liberalization production and exports were re-oriented towards sectors characterized by comparative advantages.

HS commodity groups as % of total exports

1992		1995		1999		2002	
Prep. foodstuffs, beverages, tobacco	12.8	Prep. foodstuffs, beverages, tobacco	12.3	Mineral products	11.4	Mineral products	11.2
Chemicals and related products	10.8	Chemicals and related products	14.1	Textiles and textile products	17.5	Textiles and textile products	22.3

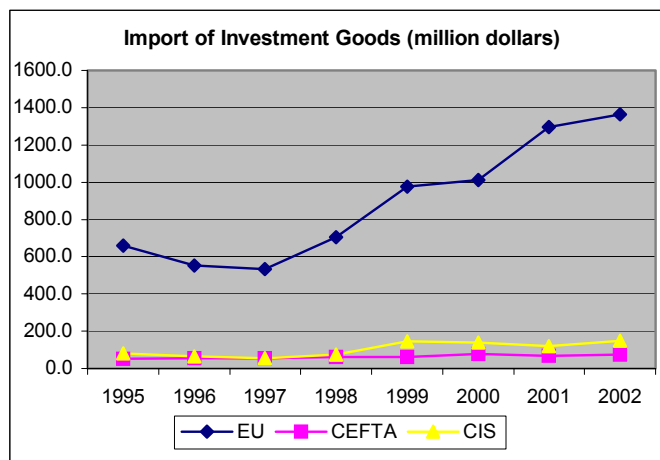
Base metals and products	14.9	Base metals and products	19.2	Base metals and products	16.3	Base metals and products	16.7
Machinery and electrical equipment	13.6	Machinery and electrical equipment	9.5	Machinery and electrical equipment	9.8	Machinery and electrical equipment	10.9
Total (as % of total exports)	52.1		55.1		55		61.1

Source: NSI

C/ Imports of investment goods.

Balkan economies were decapitalized to a larger or smaller extent after the socialist period. Therefore, importing investment goods was and is of virtual importance to revitalize industrial sectors.

EU trade agreement played a decisive role in this respect in the Bulgarian case. Between 85% and 95% of the overall imports of investment goods originated from the EU.

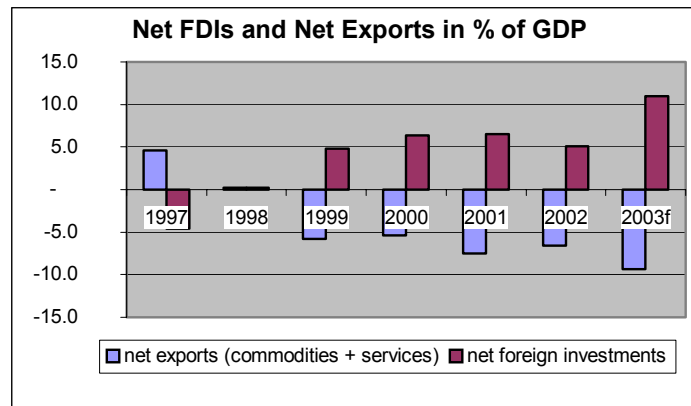


Source: BNB

D/ Spillover effect to attract more FDIs.

Foreign investments are often transposed to import of investment goods. Therefore trade openness is an important pre-condition for attracting FDIs lowering the administratively imposed costs on imported goods.

If we regard the period after 1998, the increase of net foreign investments is manifested in larger deficits of the current account.



Source: BNB

Conventionally speaking, decision to invest is risk adjusted profit analysis. Therefore, trade liberalization played an important role in the following aspects:

1. Improvement of environment for EU investments and/or production cooperation with EU firms. Around 60% of the overall FDIs in Bulgaria originated from EU countries between 1992-2002.
2. The access to EU market creates incentives for outsiders to invest in Bulgaria and locate their enterprises on its territory. With this respect, it is important that all countries that are adopting EU 'acquis communautaire' are granted standstill provisions for the implementation of EU production and environment standards, which means that meantime, investors can start and organize businesses within transition periods.
3. Improved specialization of production because artificial barriers to competition are lifted. Incentives for specialization are determined by comparative advantages.
4. Other trade agreements (with CEFTA countries and SEE countries – on bilateral basis) additionally provide for better utilization of resources and regional specialization.

E/ Trade liberalization is only one of the pre-conditions that enhance economic development

Free trade taken separately is not likely to change environment significantly. Bulgarian case indicated that there are other factors that should go along with trade liberalization in order to achieve sustainable economic development:

- Development of the private sector. The privatisation and liquidation of the state-owned companies contributed to the change in the ownership structure of GVA as the share of the private sector reached 72.7 per cent in 2002, starting from almost zero in 1989;
- Stable macro environment. The CBA established a system of strict and automatic rules for monetary policy in the place of the previous entirely discretionary central banking. The immediate impacts of the new monetary system were price and exchange rate stabilization and beginning of the restoration of confidence in the commercial banks. The CBA eventually brought: (1) more stable and predictable business environment that was conducive for higher economic activity, and (2) stabilized interest rates and gradually narrowing margins between deposit and lending rates;
- Capital account liberalization. The capital account was considerable liberalized in 1997-1998, which contributed for attracting FDIs;
- Tax and quasi tax competition (including compliance costs and control);

3/ The invisible barrier before EU integration of the Balkans⁶.

Our recent survey (in Bulgaria, Romania and Serbia and Montenegro) wrapped up with the conclusion that the large spread informal economy together with other factors (such as inefficient contract enforcement) would have deflecting role for small and medium foreign investment. Larger investments that can reach economies of scale and that are mainly directed towards sectors characterised by natural advantages would be influenced to a minor extent, because such investments can shape environment and therefore, the informal economy is not an exogenous factor.

A/ Productivity Gains and Capital Formation

Integration of the post-socialist economies into EU is technically a process of opening markets and unifying institutional frameworks. At the same time, it is a process of convergence of productivity and incomes. This convergence – as it happens on voluntary basis – is beneficial for all the economies: for those that run ahead and for those that catch up.

Therefore the incomes convergence must be viewed in the framework of productivity gains (rather than redistribute policies), which take place in all the economies although at a different pace. The faster productivity improvements in the post socialist economies may initially come through channels like privatization of assets and liberalization of markets. At a later stage however productivity improvements are only possible through the ‘conventional’ channels of capital accumulation and lengthening of the production processes.

How can the informal economy in SEE be related to the prospects of capital formation, and thus productivity improvement, in the process of EU integration?

To answer that question, we have first to articulate the mode by which the integration can be related to capital formation. In theory, economic improvement may be related to the integration process in two general forms: (1) increased capital formation due to foreign investment inflow, and (2) improved effectiveness of labor due to the integration of the resources into international production chains.

There are different possible scenarios about the future volume of foreign investment. Some expect that there will be a dramatic increase of the foreign investment volume, while others assume that the effects of future integration have already been absorbed and thus there will be only a slight change, if any, after the accession. The forecast about those developments is beyond the scope of this research. Thus we focus on the second channel of economic improvement via accession.⁷

What might happen due to the integration of Balkan economies into EU is a change in the structure of capital formation – more precisely, a reorientation of capital flows from industries that satisfy immediate consumer wants to intermediate product sectors. In other words, the improved productivity in SEE is expected to come through a change in the production processes (alongside with a probable increase of volume of capital stock).

The expected change of the production processes is one that is better known as *lengthening* of the production or development of *more roundabout* processes of production of

⁶ It is part of a report prepared by – Dimitrov, M., Bogdanov, L., Stoeff, G., Hristova-Yonkova, A., edited by Stanchev, K., 2003, ‘Study of Incentives, Characteristics and Strategies of Firms Operating in the Shadows’, performed within the ‘Integrating Balkans into the EU’ project, financed by the EU under the Cordis programme

⁷ Moreover, there are some empirical reasons to hold that productivity improvements over time are due mostly to improved effectiveness of labor rather than to increased physical-capital-per-worker ratios. See for instance empirical findings quoted in Romer, D., 1996, *Advanced Macroeconomics*, McGraw-Hill, p. 23-24.

consumer goods. The other side of the same coin is of the continuous specialization of labor, the search for new knowledge, that is the improved *effectiveness of labor*.

The lengthening of the production processes can take generally two forms in the case of the SEE economies. First, it is the reallocation of resources between different sectors in the same economy to achieve a qualitatively new production structure. Secondly, it is the integration of (some of) the sectors into international chains of value-added creation.

The contribution of the EU accession to the productivity improvements in SEE would come primarily through the second channel – integration of companies and sectors from SEE into longer international production processes. This is the macroeconomic logic behind our expectations, which lead us to the link between informal economy on Balkans and their EU integration. The link might go in both directions:

- 1) A significant in size shadow economy may in fact hinder this process.
- 2) The integration process may have certain formalizing effects.

What we register now are foreign investments in stages of production processes, which are almost immediately close to the final consumer: e.g. retail store chains, production of textiles and footwear, cosmetics, food industry (wine, beer, chocolate and candy, etc.) They are the final stages of international value-added chain, which however integrate only a portion of the economy into the world economy. What we do not register are investments into intermediary stages of production processes, which leaves the bulk of resources employed in the economy non-integrated. The widespread exogenous informality might contribute to the preservation of this state of the economy.

Meanwhile, the integration process might itself help for the formalization of the Balkan economies. Institutional frameworks that generally welcome foreign investments would be adopted in those economies in the pre-accession period. Thus new investments would somehow come into sectors previously predominated by the informal sector (just like it happened with the retail trade in Bulgaria after the entry of Metro, Billa, Mr. Bricolage). The foreign investment would attract resources from previously informal activities. This contribution would be to both directions: diminishing the size of informality and changing the perception of an exogenous informal sector.

B/ Entry barriers for small and medium investors

Regarding the Balkans in EU integration context, one of the important challenges is whether the informal economy (together with other factors) would hamper further economic integration. We consider the following issues having influence in this direction:

1/ An important fact-finding of our survey is that 46% out of 180 randomly selected firms declare to operate within environment of unfair competition. We consider this as an indication for a large scale of unregistered transactions. Generally, the bigger the informal economy is the more unreliable the statistical figures would be. This would mean that the cost of market information (data on demand, competitors, prices, etc.) is getting higher since the only way of acquiring is direct field surveys⁸. Besides, it would be logical to assume that non-complying firms would be in a better competitive position than any outsiders (foreign investors) when competition is based on price and the informal economy is an exogenous factor.

2/ Other important characteristic of business environment in Bulgaria, Romania, Serbia and Montenegro (potentially in SEE) is that state contract enforcement mechanisms

⁸ A study of car repair business in 2000 in Bulgaria for example shows that the official statistics records less than 10% of sales in the sector. See Kyle, S., Warner, A., Dimitrov, L., Krustev, R., Alexandrova, S., and Stanchev, K., 2001, *Measuring the Shadow Economy in Bulgaria*, Department of Applied Economics and Management Working Paper 2001-09, Ithaca: Cornell University

are considered to be unreliable (52% out of 180 firms). Therefore, firms use other paths called 'informal' to ensure completion of contracts.

3/ The overall administrative burden appears to be much higher than its visible part. This conclusion stems from the fact that considerable part of firms assessed the procedure and formalities as larger burden than the size of the tax on several occasions (this holds true for personal income tax, the social security, health and other mandatory insurances and for the taxes and payments for administrative permits).

4/ We should also mention that most SEE countries experienced severe economic crisis and/or wars during the 90ies, which is rendering an image of constant instability to the region.

Summing up, all these create entry barriers for outsiders to access the market. If we regard EU accession as economic integration aiming to achieve synergic effects, the existence of entry barriers (as described above) would deflect small and medium investments. Larger investments that can reach economies of scale would be influenced to a minor extent, because such investments can shape environment and therefore, the informal economy is not an exogenous factor. For instance when a big investor as 'Metro Cash & Carry' entered the market in Bulgaria it had the bargaining power to influence terms of trade in Bulgaria.

In addition, sizeable (bigger) companies would be in a position to a larger extent to afford the costs of market information (in a large spread informal economy environment) financing field marketing studies and/or relying on specialized agencies.

In general, bigger firms have more options to deal with contract enforcement issues because on the one hand can impose pre-payment requirements and on the other, contractors are interested to keep long lasting relations.

Decision making to invest is risk adjusted profit analysis. Whenever investments take place in domains characterized by natural advantages (absolute advantages) the above-mentioned additional costs might be compensated by extra profits. However when these opportunities are exhausted further investments might be restricted because the net present value is either negative for small and medium projects and/or risk measurement presumes large standard deviation.

Investments are a conventional example of a limited resource. Therefore it is reasonable to expect that one project may take place in SEE, CEE or any other economy alternatively (whenever it is not a matter of absolute advantage). Thus investment decisions are generally dependant on environment for doing business.

If entry barriers in SEE countries are implying higher costs than these in Central European countries it would be expected that most of risk sensitive investments would be oriented towards CEE. Therefore, the existence of excessive entry barriers in SEE would impede and slow down the economic integration with the EU.