COUNTRY BRIEFING BULGARIA

Vienna Institute for International Economic Studies

Industrial Policy for a New Growth Model

Country Briefing Bulgaria

EUROPA

FRIEDRICH EBERT STIFTUNG

EUROPA

Europe needs social democracy!

Why do we really want Europe? Can we demonstrate to European citizens the opportunities offered by social politics and a strong social democracy in Europe? This is the aim of the new Friedrich-Ebert-Stiftung project »Politics for Europe«. It shows that European integration can be done in a democratic, economic and socially balanced way and with a reliable foreign policy.

The following issues will be particularly important:
- Democratic Europe
- Economic and social policy in Europe
- Foreign and security policy in Europe

The FES will devote itself to these issues in publications and events: we start from citizens' concerns, identify new positions with decision-makers and lay out alternative policy approaches. We want a debate with you about »Politics for Europe«!

Further information on the project can be found here:
https://www.fes.de/politik-fuer-europa/

Friedrich-Ebert-Stiftung

The Friedrich-Ebert-Stiftung (FES) is the oldest political foundation in Germany with a rich tradition dating back to its foundation in 1925. Today, it remains loyal to the legacy of its namesake and campaigns for the core ideas and values of social democracy: freedom, justice and solidarity. It has a close connection to social democracy and free trade unions.

FES promotes the advancement of social democracy, in particular by:
- Political educational work to strengthen civil society
- Think Tanks
- International cooperation with our international network of offices in more than 100 countries
- Support for talented young people
- Maintaining the collective memory of social democracy with archives, libraries and more.

FES programme »European Economies of the East«

This publication is edited by the FES programme on Economic Development in Central Eastern and South Eastern Europe »European Economies of the East«. The program is headed by Ernst Hillebrand.

Please find all the publications of the programme under its webpage:
https://eastern-europegrowth.fes.de/

About the authors

Vienna Institute for International Economic Studies:
Alexandra Bykova, Rumen Dobrinsky, Richard Grieveson, Maciej Grodzicki, Doris Hanzl-Weiss, Gábor Hunya, Niko Korpar, Sebastian Leitner, Bernhard Moshammer, Ondřej Sankot, Bernd Christoph Ströhm, Maryna Tverdostup, Zuzana Zavarská

Special thanks to Maciej Grodzicki (Jagiellonian University), Michael Landesmann (wiiw), Julie Pellegrin (CSIL), Slavo Radosevic (UCL) and Roman Stöllinger (wiiw, WU) for their valuable inputs and guidance in the writing of the report.

CENTRAL AND EASTERN EUROPE NEEDS INDUSTRIAL POLICY TO ESCAPE THE MIDDLE INCOME TRAP

Since the early 2000s, the EU member states of Central and Eastern Europe (EU-CEE) have achieved an impressive economic catch-up process. However, the previously successful model of taking over labour-intensive production steps as an 'extended workbench' of Western corporations has reached its limits. Combined with major global challeges such as decarbonisation and digitalisation, this makes it essential for EU-CEE to develop a new, innovation-based economic model. Only then will these states be able to complete the catch up with Western Europe in terms of productivity and living standards. The situation is exacerbated by the economic consequences of the war in Ukraine, such as permanently higher energy prices and higher inflation, which pose grave challenges for the region's external competitiveness.

The problem is that the central technological competences and those parts of production with the highest added value are located in the 'headquarter economies' of Western Europe. Meanwhile, the EU-CEE countries – Poland, Czechia, Slovakia, Hungary, Slovenia, Croatia, Romania, Bulgaria and the three Baltic states – are still extremely specialised in labour-intensive production. They depend heavily on lower labour costs, and this restricts their prospects of catching up economically with Western Europe. A good example of this is the car industry, which is so important for the region as indicated by its high share of value added, jobs and exports, especially in the Visegrád states, Romania and Slovenia.

The study shows that the EU-CEE countries have so far lacked a constructive approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy, weak investment environments for start-ups, and the activities of state-owned enterprises have not been aligned with the greater development goals. In general, there is a lack of state entrepreneurship in these countries that could nurture promising industries. This is particularly challenging for regions that are lagging behind within countries, as they lack the technical capacities for industrial policy. Due to these factors, the study argues that the EU-CEE countries are struggling to get out of their middle income trap.

Their EU membership offers unique opportunities for industrial policy, but also challenges. On the plus side are access to funds, participation in research networks and the opportunity to shape industrial policy on the EU level. Importantly, industrial policy in the EU has taken a much more prominent role in recent years as shown by initiatives such as the European Chips Act or the Important Projects of Common European Interest (IPCEI). This provides some momentum for the development of industrial policy in the EU-CEE countries. Strict state aid rules and an EU competition policy that gives preference to free market principles, on the other hand, are challenges for an effective industrial policy.

As discussed above, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. For countries like Poland, the green transition is a major challenge. This transition can only be managed through huge public investments in green technologies and digitalisation, combined with the right conditions for private enterprise to thrive, to create a fully joined-up approach combining the best of the public and private sectors and academia. This means more money for education, research and development, as well as active labour market policies to manage the transition.

Above all, however, the countries of the region need a strategically oriented industrial policy to support the emergence of more globally competitive companies and to emphasise their own economic strengths. While a true "entrepreneurial state" may be too ambitious for many EU-CEE countries in the coming years, steps in this direction are the way to go. We propose eight steps, that should be taken:

1. Create a national innovation system in each country, bringing together the private sector, universities, key ministries, and business agencies. Within this biotope, new ideas can be developed, tested, and financed. Each country should define which sectors and specialisations are promoted, rather than relying solely on external market forces.

2. Make full use of EU funds and maximise participation in EU research initiatives to advance industrial policy goals. Governments should also get more involved in industrial policy debates at the EU level. Greater participation in the EU's Horizon Europe research funding programme or in the EU's Important Project of Common European Interest (IPCEI) initiative would also be particularly important for the region's technologically less advanced countries.

3. Learn from each other's successes stories to emerge as frontrunners in the digital economy. Estonia is generally well prepared in this area and often raised as an example. However, there are also other positive cases in the region. Romania and Croatia have a particularly high proportion of graduates in ICT, relevant for digitalisation. Czechia shines with its digital start-ups, the Baltic states with the quality of their digital public services. The Visegrád countries and Slovenia have highly digitalised and automated industries.

4. Harmonise investment schemes to attract foreign companies with national industrial policy. Instead of providing blanket support for all investments by foreign companies, national governments should strategically consider which sectors and parts of the value chain they want to attract, and create incentives that maximise the potential for spillovers from foreign giants to domestic firms.

5. Identify and exploit promising niches. Given the lack of technological experience, the establishment of the semiconductor industry in the EU-CEE countries, for example, would not be very promising. However, each country has traditional strengths that should be built upon.

6. Institutional reforms. In some states of the region, the quality of public institutions has declined significantly in recent years. This is worrying. Countries in East Asia have a lot of experience in building adequate institutions for an active industrial policy, even if the framework conditions there partly do not meet Northwest European standards. This experience should be used.

7. Structural change must be cushioned socially in order not to lose the support of the population. EU-CEE countries should aim for a flexible labour market to ease the transition from old to new jobs, but underpin this with extensive retraining programmes and a social safety net that means that workers themselves do not bear the costs of the transition.

8. Each country needs a tailor-made industrial strategy adapted to its specific needs. While the Baltics, for example, are well positioned for the digital transformation, they are struggling above all with distribution problems and a shrinking population. Czechia, Poland or Slovenia are industrially the most advanced, but must make the transition from ‘extended workbench’ to innovative economy. For the less developed parts of EU-CEE such as Bulgaria and Romania, the priority should be on maximising the transfer and knowledge and innovation from big foreign investors.

COUNTRY BRIEFING BULGARIA

COUNTRY OVERVIEW

Bulgaria is at the bottom of most EU rankings, including those on industrial competitiveness, innovation performance, digital performance and green transition. During the transition from plan to market the economy suffered deindustrialization of a massive scale and as a result all of the previous industrial giants were either liquidated or radically downsized. The share of the manufacturing sectors in GDP is much below the EU and EU-CEE averages. During the past three decades the country also suffered a setback in its global rankings on human capital development. Digital transition is one of the exceptions thanks to the preservation of the tradition of good quality IT education and a relatively well-developed IT sector.

Manufacturing employment is still dominated by low-value added sectors such as textiles and apparel (17.9 % of total manufacturing employment), food products (17.7 % of the total, basic metals (13.3 %). None of the more sophisticated manufacturing sectors is present among the top 5 sectors by the number of employed. No global manufacturing brand is present in Bulgaria with a large-scale production facility. Moreover, large manufacturing facilities generating economies of scale and supporting efficient participation in global value chains are all but missing in Bulgaria. For example, only four manufacturing companies are present among the 20 largest business employers in Bulgaria.

While Bulgaria benefited from large FDI inflows after EU accession, most of this investment was directed to real estate, tourism and finance, offering limited scope for industrial upgrading. Manufacturing FDI in earlier periods was mostly directed to small and medium sized facilities in traditional sectors such as textiles and food processing. In the last decade or so, especially after the accession to the EU in 2007, FDI started to flow also to more sophisticated manufacturing sectors but also in small and medium sized facilities. One of the factors that contributed to the attraction of such FDI flows was the establishment of several industrial zones and the incentives they provided, initially under the general Investment Act and later under the Industrial Parks Act of 2021.The ICT sector and the provision of ICT services is one of the few success stories in Bulgaria's recent technological development. In 2021 the outsourcing industry accounted for 4.0 % of the country's total employment and contributed 5.5 % of the GDP. In recent years it has also been the fasted growing sector of the Bulgarian economy.

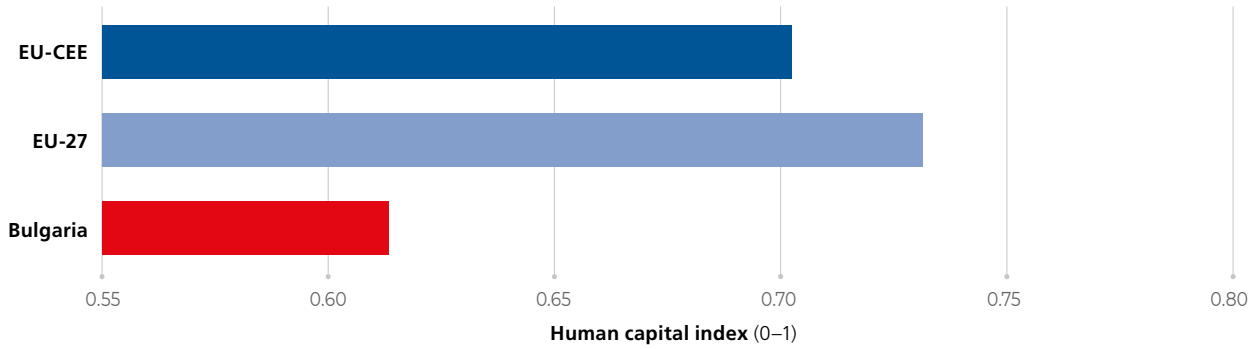
Targeted industrial policy actions have been all but missing dung the past three decades and were partly revived thanks to the participation in common EU policies and programmes. The recent Industrial Parks Act is probably the only homegrown industrial policy legislation. The National Development Programme Bulgaria 2030 specified five priority development areas including Innovative and Intelligent Bulgaria, Green and Sustainable Bulgaria, Connected and Integrated Bulgaria.

Industrial development – I

	Competitive industrial performance index	Manufacturing value added (MVA) (% of GDP)	Medium- and high-tech MVA (% of total MVA)
Bulgaria	0.05	12	33
EU-27	0.14	15	41
EU-CEE	0.10	17	38

Note: 2020 values. The CIP index assesses the strength and complexity of an economy's industry, with Germany claiming the maximum score in 2020 at 0.42.
Source: UNIDO

Human capital quality



Note: A Human Capital Index of 0.75 means a child born today will be expected to be 75 percent as productive at the age of 18 as they would against a scenario of having enjoyed complete education and full health.
Source: World Bank

INDUSTRIAL COMPETITIVENESS – SWOT

Strengths

- Relatively diversified industrial and export structure which contributes to higher resilience of the economy to external shocks.
- Industrial zones have become drivers of industrial development attracting also new enterprises conforming with the green economy.
- The relatively large ICT sector with high quality IT specialists is among the few strong components of Bulgaria's economic structure.

Weaknesses

- Aging population marked by a trend shrinking of the workforce is a source of increasing labour and skills shortages.
- Manufacturing is still dominated by relatively unsophisticated industries. High-tech, high value-added products account for a small share of the country's exports.
- Very low aggregate energy efficiency.
- Very low levels of R&D investment by both the public and the private sector; poor innovation performance.
- Stagnation in the average quality of the workforce which acts as a hurdle for the technological upgrading of the industrial structure.
- Lack of a coherent long-term strategy for green transformation consistent with the European Green Deal.

Opportunities

- Relatively low dependence on fossil fuels for electricity generation.
- The ICT sector and the digital economy have a potential to grow in importance provided there will be targeted policy support for an increase of the pool of ICT specialists.
- The country is considered as an attractive destination for the outsourcing of IT services.

Threats

- Skill and labour shortages coupled with a continued exodus of skilled labour may create increasing bottlenecks both for economic growth and for the technological upgrading of the economy.
- Recurrent populist policy motions for postponing energy efficiency measures against the background of disruptions in energy supplies and rising energy costs.
- Lingering political instability and lack of long-term policy vision and strategy may delay further the digital and green transition.

INDUSTRIAL POLICIES AND STRUCTURAL REFORM DEVELOPMENTS

FDI promotion and value chain upgrading

- Bulgaria's investment promotion mechanisms apply to both foreign and local investors.
- Large investment projects, which are deemed particularly important for the economy may be classified as priority projects and be granted additional incentives.
- There are no promotion mechanisms targeting specific sectors or industries or the entry to major global value chains
- Industrial zones (Industrial parks) are probably the only mechanism promoting FDI by providing certain incentives to resident investors. Most of the industrial zones are dominated by foreign companies and the predominant share of their production is exported.

New technologies, digitalization, innovation

- Bulgaria's draft Recovery and Resilience Plan (RRP) is built around education and skills, research and innovation, and the smart industry as primary targets for future investment.
- The Innovation Strategy for Smart Specialisation 2014-2020 (ISSS) had identified several priority thematic niches including Information and communication technology, Mechatronics and clean technologies, Industries for healthy life and biotechnology (including food), New technologies in creative and recreation industries.
- So far there has been no comprehensive assessment as to what extent the ISSS succeeded in pursuing its objectives. But it is already a fact that one of the key strategic goals, namely that by 2020 Bulgaria would move from the group of "modest innovators" into the group of "moderate innovators" was not achieved.

Green transformation of industry

- The RRP sets rather modest targets for green spending (27 % of the total), well below the EU's 37 per cent climate-spending benchmark
- The RRP mostly consists of long planned investment projects that had not been implemented due to the shortage of funding and lacks ambitious innovative green economy projects
- Little or no attention is assigned in the plan to RRF goals such as the reduction and utilization of waste, sustainable and intelligent mobility, construction of green infrastructure. The operationalization of such goals will be a challenge as work will have to start from scratch.

COUNTRY-SPECIFIC RECOMMENDATIONS

In the main report, we identify Bulgaria as one of the EU-CEE countries falling most behind the technological frontier. The priority should be to import knowledge and capabilities in a strategic and targeted way via targeted FDI policies and greater participation in EU research and innovation networks.

- **Focus policy efforts on a selected few priority areas and/or projects where industrial technological transformation can bring tangible results, including green transition.** Establish a coherent plan of action for pursuing the objectives in the priority areas including milestones and measurable performance indicators (see policy recommendation 5.1 in the main report). As part of this plan, develop and introduce targeted support instruments and mechanisms focused on entrepreneurial innovation seeking technological transformation in the priority areas. Allocate sufficient public funding to back these instruments in the context of medium- and long-term fiscal frameworks. Review and amend innovation governance and coordination mechanisms in order to ensure efficient policy implementation. Organize monitoring of progress in implementing the plan of action and introduce corrective mechanisms and measures if needed.

- **Develop new incentive mechanisms and instruments for attracting FDI in business activities contributing to technological transformation and aligned with the green transformation goals.** These should also include the above-mentioned priority areas and/or projects (see policy recommendation 5.4 in the main report). Build on the lessons of the successful development of industrial zones to design and implement more effective and efficient policy instruments for attracting FDI into the industrial zones. Plan to transform FDI-driven industrial zones into powerful clusters which can become drivers of economic growth and technological transformation. Seek innovative approaches to the management of projects with FDI participation including through public-private partnerships and the use of blended finance.

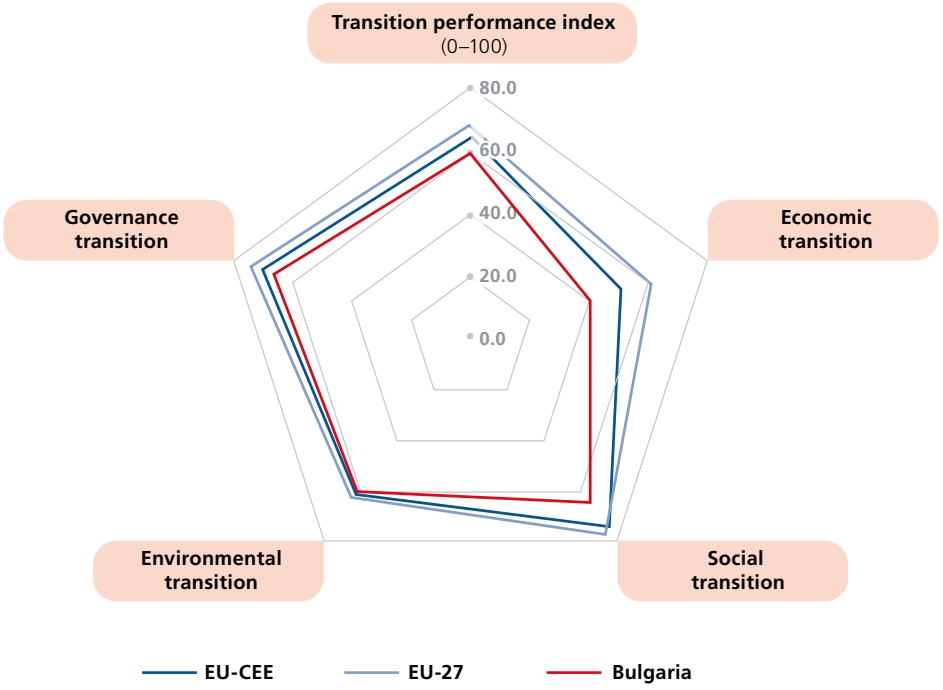
- **Develop a coherent strategy for prioritizing the future development of the ICT sector.** Develop a programme for expanding the scope of IT education and skill building with a view to increasing the pool of IT professionals as a future niche for the country (see policy recommendation 5.5 in the main report). Broaden IT awareness raising among adolescents and young people on the prospects of an IT professional career. Widen and deepen the IT curricula in secondary and especially tertiary education in close cooperation with the business sector so that to match their current and future needs. Introduce targeted support schemes for ICT entrepreneurs, startups and SMEs. Develop and introduce measures for speeding up the prevalent introduction of e-Government. Consider introducing incentives for attracting FDI in the ICT sector and the digital economy.

Industrial development – II

Sector	% of manufacturing employment
Textiles, apparel, leather and related products	17.9
Food products, beverages and tobacco products	17.7
Basic metals and fabricated metal products, except machinery	13.3
Rubber, plastics, and other non-metallic mineral products	10.5
Other manufacturing, installation of machinery and equipment	9.1

Note: 2020 values. Source: National Statistical Institute

Transition performance scorecard



Note: 2020 values. The TPI scores countries based on 4 pillars of a transition to a more sustainable, inclusive and resilient economy.
Source: European Commission

Bulgaria

COUNTRY OVERVIEW

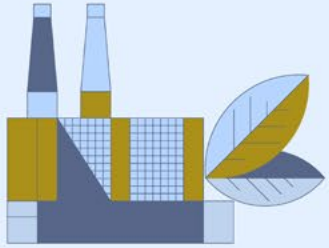
Bulgaria is at the end of most EU rankings, including those on industrial competitiveness, innovation performance, digital performance and green transition. The country also suffered a setback in its rankings on human capital development.

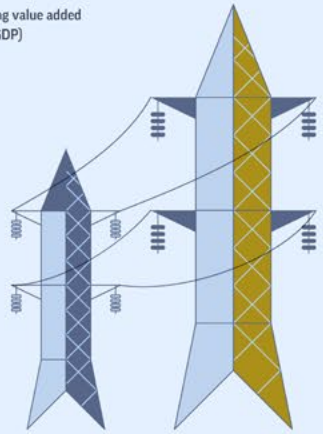
Digital transition is one of the exceptions thanks to the preservation of the tradition of good quality IT education and a relatively well-developed IT sector.

INDUSTRIAL DEVELOPMENT

	Competitive industrial performance index	Manufacturing value added (MVA) (% of GDP)
BULGARIA	0.05	12%
EU-27	0.14	15%
EU-CEE	0.10	17%

Note: 2020 values.
The CIP Index assesses the strength and complexity of an economy's industry, with Germany claiming the maximum score in 2020 at 0.42.
Source: UNIDO





INDUSTRIAL COMPETITIVENESS – SWOT

STRENGTHS

- Relatively diversified industrial and export structure.
- Industrial zones have become drivers of industrial development attracting also new enterprises conforming with the green economy.
- A relatively large ICT sector with high quality IT specialists.

WEAKNESSES

- Aging population and tendentially shrinking workforce.
- Manufacturing is dominated by relatively unsophisticated industries.
- Very low aggregate energy efficiency.
- Very low levels of R&D investment by both the public and the private sector; poor innovation performance.
- Lack of a coherent long-term strategy for green transformation.

OPPORTUNITIES

- Relatively low dependence on fossil fuels for electricity generation.
- Growth potential of the ICT sector and the digital economy, based on necessary increase of the pool of ICT specialists.
- Growing attractiveness as destination for the outsourcing of IT services.

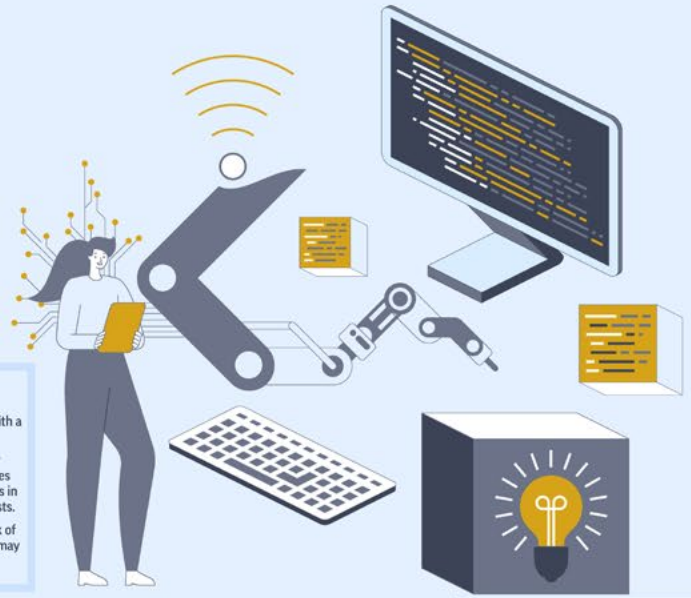
THREATS

- Skill and labour shortages coupled with a continued exodus of skilled labour.
- Recurrent populist policy motions for postponing energy efficiency measures against the background of disruptions in energy supplies and rising energy costs.
- Lingering political instability and lack of long-term policy vision and strategy may delay further the digital and green transition.

WHAT SHOULD BE DONE?

COUNTRY-SPECIFIC RECOMMENDATIONS

- **Focus efforts on few priority areas and projects where industrial technological transformation can bring tangible results**
- **Develop new incentives and instruments for attracting FDI in sectors that are contributing to technological transformation and green transformation goals.**
- **Develop a strategy for prioritizing the development of the ICT sector.** Develop a programme for expanding the scope of IT education and skill building with a view to increasing the pool of IT professionals as a future niche for the country.



IMPRINT

Friedrich-Ebert-Stiftung
Publisher: Friedrich-Ebert-Stiftung Budapest
1054 Budapest | Fővám tér 2–3.
Email: fesbp@fesbp.hu

Responsible for content and editing:
Ernst Hillebrand, Head, European Economies of the East
ernst.hillebrand@fes.de

Orders/Contact: fesbp@fesbp.hu

ISBN 978-615-6289-41-4

Design/Typesetting: pertext, Berlin
Cover photo: Nataliya Hora / Shutterstock.com

Industrial Policy for a New Growth Model: A Toolbox for EU-CEE Countries

This country briefing is a short summary of a much broader study that deals with the perspectives of industrial policies in Central Eastern and Southern Eastern Europe and the question how these countries can avoid to get stuck in a middle-income trap. The study has been authored by a team of experts from the Vienna Institute for International Economic Studies on behalf of Friedrich-Ebert-Stiftung.

The study argues that the EU-CEE countries have so far lacked a systematic approach to industrial policy in their development trajectories. They have had a very broad ranging FDI promotion policy and weak investment environments for start-ups, while the activities of state-owned enterprises have not been aligned with the greater development goals.

Hence, the growth model of the EU-CEE countries must be made fit for the future. Decarbonisation, digitalisation and a shrinking labour force require massive efforts to be made. This transition can only be managed through public investments in green technologies and digitalisation, education and infrastructure, combined with the right conditions for private enterprise to thrive.

The study includes eleven country profiles that analyse the economic and industrial structures for their strengths and weaknesses and identify possible courses of action for an active industrial policy.

The full study can be found here:
http://library.fes.de/pdf-files/bueros/budapest/20260.pdf

Industrial Policy for a New Growth Model: A Toolbox for EU-CEE Countries
Vienna Institute for International Economic Studies, Friedrich-Ebert-Stiftung Budapest, 2023, 103 Seiten, ISBN 978-615-6289-36-0

FRIEDRICH EBERT STIFTUNG