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PROMOTING FOREIGN DIRECT INVESTMENT IN BULGARIA

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Abstract:

This paper examines the factors that favor Foreign Direct Investment (FDI) in Bulgaria and recommends public policy changes that will enhance the international competitiveness of Bulgaria.

Four factors that favor an increase in FDI in Bulgaria are clearly identified. First, although the economic environment is considered challenging compared to other countries in the region, Bulgaria enjoys political stability. Second, Bulgaria offers a low-cost, well-educated labor pool, although additional public investments in foreign language training may be needed. Third, there are investment opportunities for infrastructure development through privatization in the areas of energy, information technology (IT), and transportation. Bulgaria is searching for significant partners in the renovation of the nuclear power plant in Kozlodui, IT improvements, and Build Operate Transfer (BOT) projects for the reconstruction of major highways and transportation hubs. Last but not least, Bulgaria is geographically well situated and has the potential to be an attractive tourist destination.

I. Introduction:

FDI into Bulgaria has increased considerably – from $34.4 million in 1992 to $1.1 billion in 2000 (Table 1) and comes predominantly from European Union (EU) countries, Russia, and the United States (www.bfia.org). Moreover, the percentage of FDI in the form of investment inflows (Greenfield investments, reinvestments, joint ventures, additional investments in companies with foreign participation) versus privatization is increasing, with the industrial, finance, and trade sectors attracting considerably more FDI than agriculture, construction, telecommunications, tourism, and transportation.

Nonetheless, FDI in Bulgaria is relatively low compared to other countries in Eastern Europe. In a Multilateral Investment Guarantee Agency (MIGA) survey published in January 2002, Bulgaria ranks 10th among Eastern European countries in FDI in the manufacturing and service sectors.[1] In addition, it ranks last among Eastern European countries preferred for FDI by firms from Western Europe, North America, and the Asia/Pacific Rim.

The low FDI investment is not surprising. On one hand, Bulgaria has a stable political and legal environment, a low-cost highly skilled labor force, and strategic geographic location — factors that are important to foreign investors. On the other hand, access to consumers, a well-developed transportation, energy, and IT infrastructure, as well as a dynamic market economy are even more critical factors in the location decisions of foreign investors. With a population of approximately 8 million, Bulgaria does not represent a large consumer market. The transportation network is in need of substantial renovation. The possibility of closing the country's nuclear power plant creates uncertainty about the availability of energy. And even though Bulgaria has made significant progress in its economic development, it is still considered weak compared to other countries in the region.

II. Political and Legal Climate:

Located on the Balkan Peninsula, Bulgaria is in a region that is well known for intense political and ethnic conflicts. Proximity notwithstanding, Bulgaria has not only managed to maintain its independence and avoid entanglement in these conflicts over the years but has contributed to their early resolution — for example, the recent Kosovo and Serbia crisis. In 1994 Bulgaria joined the NATO Partnership for Peace and is actively pursuing membership in NATO and the European Union (EU).

Bulgaria is a Parliamentary Republic and conforms to the Constitution of the Republic passed by the National Assembly in 1991. The Constitution provides for a separation of powers in the executive (14 Ministries), legislative (Parliament), and judicial (Supreme Courts) branches with a system of checks and balances. The President is the Head of State, and is elected once every 5 years for no more than two terms. He represents the Republic of Bulgaria in its international relations and embodies the unity of the country.

In addition, Bulgaria has well-defined foreign investment and trade laws. Foreign investment legislation covers legal and international guarantees for foreign investors, protection against expropriation, and provides for profit and capital repatriation. Two government entities oversee the FDI process. The Bulgarian Foreign Investment Agency (BFIA) coordinates the activities of state institutions in the field of foreign investment. The Advisory Council on Foreign Investment and Financing, comprised of representatives from the largest foreign investors, promulgates and adopts measures for improving the FDI climate in Bulgaria.

III. Economic Climate:

Bulgaria progressed in its economic development since the crisis of 1996-1997. Inflation decreased to a single digit rate of 4.8% in 2001 (Figure 1). Instead of shrinking, GDP grew to a positive 4.7 % as of third quarter of 2001 (Figure 2). And in December 1999, Bulgaria was invited to start negotiations for accession to the European Union – an acknowledgment of the positive economic and political changes taking place.

The economic stabilization was made possible with the assistance of international financial institutions like the IMF and the World Bank, but more importantly, by the creation of a Currency Board. The Board supervises the Bulgarian National bank (BNB), is responsible for determining the bank's aggregate amount of monetary liabilities, and ensures that the bank extends no loans to the Government or any Government agency. The financial discipline that the Board imposes on the Bulgarian Government encourages improvements in tax collection and restrains fiscal spending.

With the establishment of the Board, the Bulgarian currency (Lev), initially pegged to the German Mark (DEM), is now pegged to the Euro. Constraints on currency trading are removed. The long-term effects on the Bulgarian economy of fixing the Lev to the Euro are still unknown. However, the World Bank representative for Bulgaria, Thomas O'Brian, notes that the Euro will help bring about price transparency and lower transaction costs as well as put pressure on local producers to improve productivity levels to keep prices competitive.

A survey of 36 foreign businesses in Bulgaria indicates that only two out of five invested with the purpose of exporting their products. Three out of five companies serve the domestic market. This is puzzling because the size of the Bulgarian market is small and easily saturated. Foreign companies in Bulgaria should really direct their focus toward exports.

Bulgaria's strategic geographic location, participation in free trade agreements, established partnerships and cultural similarities with Eastern European countries provide access to a contiguous market area with over 600 million consumers (www.bfia.org). Since 1998, exports of industrial goods with Bulgarian origin into the EU are duty-free. Bulgaria is a member of the World Trade Organization (WTO) and a signatory to the Central European Free Trade Agreement (CEFTA). Bulgaria also has trade agreements with Macedonia, Turkey, and the European Free Trade Association (EFTA). As a former Soviet Bloc member country, it still maintains strong economic relations with Russia and other Eastern European countries (Dobosiewicz, 64).

IV. Human Capital:

In a recent book, Michael Porter argues that a major determinant of a country's competitive advantage is the availability of favorable factor conditions (Porter 71). Bulgaria is not rich in natural resources and raw materials. Its competitive advantage lies in a low-cost (Table 2) and well-educated labor force.

The average salary in Bulgaria of $100-150 per month translates to a wage rate between $0.63 and $0.93 per hour based on a 40-hour workweek.[2] The workforce of approximately 4.5 million has a 98 percent literacy rate with 63.1 percent of the workforce completing secondary, technical, or vocational education.[2,3] 26.1 percent of Bulgarians choose to pursue higher education in engineering, economics, medicine, and science at one of the many colleges and universities in the country (Table 3). Furthermore, many of the European languages (English, German, French, Spanish, Italian) are taught from an early age, and there are specialized language high schools throughout the country that emphasize foreign-language education.

Foreign investors do face some challenges. First, many college graduates come directly out of the universities with little or no experience. Middle and senior management lack Western experience. Second, partial or fully foreign-owned companies are not exempt from the requirements of the Bulgarian Labor Code that governs employer-employee contracts and provides excessive protections for workers. Trade unions exert important influence on employees. Working closely with the union is critical to labor productivity.[4] Last, but not least, foreign investors may have to contend with bribery practices. Although government employees are generally paid more than their private sector counterparts, approximately $150 versus $135, respectively, these wages are low.[2] Adding to this, the lack of promotion opportunities in the government sector creates conditions for corruption. To limit corruption, the Bulgarian government has adopted a national anti-corruption strategy that includes a reform of the administrative system and several newly adopted laws and regulations. The improved rating of Bulgaria in the comparative index of Transparency International is evidence that corrupt practices are under control. In 1998, Bulgaria was ranked 66th (out of 99), and in 2001, ranked 47th, approaching the status of other Central European countries.[5]

The preceding discussion suggests that the following government actions will enhance the labor market conditions in Bulgaria – increased investment in foreign language training.

changes in the hiring process, and implementation of foreign exchange and government-sponsored educational and training programs.

Even though Bulgarians are required to study a foreign language in school, not all choose to exploit this opportunity to their advantage. A significant number of university graduates and managers do not speak a foreign language. To make Bulgarian cadres more attractive to foreign investors, the government needs to ensure better implementation of current foreign language training initiatives. It can call for foreign language exams upon high-school graduation, foreign language courses and graduation exams in college, and foreign language requirements for managers. People with foreign language(s) skills should have priority when promotion opportunities arise.

As an incentive for Bulgarians to study a foreign language, the government can also create more foreign exchange programs with high schools and universities abroad. Exchange programs will make Bulgarians more accustomed to Western lifestyle and corporate culture. Government scholarships for higher education abroad are another way to make Bulgarians highly competitive. Bulgarians awarded these scholarships will bring back the know-how and Western corporate culture with them. This will facilitate the restructuring process for foreign investors interested in acquiring Bulgarian companies.

V. Infrastructure and Information Technology Development:

About 52.5 % of the assets of state-owned enterprises have been privatized, but numerous investment opportunities through privatization still exist.[6] This paper focuses on opportunities in three sectors – energy, information technology, and transportation.

A. Energy:

Bulgaria's power generation comes from nuclear, coal-fired, and hydroelectric power stations. The only important domestic energy resource is low quality, high sulfur content, lignite coal. Bulgaria relies on fuels (oil, natural gas, good quality coal and nuclear fuel) imported mainly from Russia.[7] The country imports more than 70% of its primary energy resources compared to 40% for EU countries.[7]

A primary source of power in Bulgaria is the nuclear power plant in Kozlodui (over 40%); the other is the coal-fired plant Maritza-East (30%). In 1993, the European Bank for Reconstruction and Development (EBRD) donated 24 million euro to support the decommissioning of the two oldest nuclear reactors in Kozlodui that were subsequently closed in 1999. The EU postponed its decision on the closure of two other reactors until 2006. Bulgaria's admission to the EU is, however, contingent upon the closing of these reactors. Renovation of these two reactors that currently remain in operation is yet to be addressed.

Two other factors make changes in the energy sector urgent – the high cost (approximately $0.05/kWh) and consumption of electrical power. The total energy consumption of an average Bulgarian household is three times higher than that of other countries in the region because alternative sources for heating are lacking (there is no household gas system in place), and the industrial equipment used is old.[7]

All three facts suggest the following recommendations – finding a foreign partner for the total renovation of the nuclear power plant and developing alternative sources of energy.

The Bulgarian government has limited financial ability to renovate its nuclear plant and relies heavily on foreign assistance. In 2000 Citibank provided a $77 million loan to help Bulgaria partially modernize the other two reactors.[4] In addition to seeking more financial aid, the government needs to provide a legal and regulatory framework that will facilitate the flow of foreign capital into the energy sector.

The development of alternative sources of energy is another option the government needs to explore. Bulgaria has a well-developed network for electrical power transfer inside the country and to neighboring countries. There are hydroelectric and coal-fired power plants in Bulgaria.[8] Currently 22 of the 77 hydroelectric power plants are open for privatization. The participation of US-based corporations Entergy and AES in the modernization of the Maritza-East coal-fired power plant is an example of profitable opportunities in the energy sector that foreign investors could explore.

Apart from the thermo-, hydro-, and nuclear power plants, Bulgaria has gas transfer and gas-distribution network developed for industrial consumers. Bulgaria is located at a key crossroad in Europe - the transit gas pipelines from Russia to the South pass through Bulgaria. These pipelines connect Greece and Turkey to the European network. According to the Bulgarian Department of Energy, if future gas pipelines are built from Central Asia to Bulgaria and onward to Central Europe, the country may become an alternative East-West corridor. This will diversify the dependence of Western Europe on imported natural gas. Thus foreign investors in the energy sector can benefit from Bulgaria's favorable geographic location.

B. Technology and Telecommunications:

The reliability and quality of IT is another important FDI location factor. The IT sector in Bulgaria is still in its infancy. But to develop a strong IT sector and make it attractive to foreign investors, the government needs to initiate changes in education, regulation, law enforcement, and business incentives.

If Bulgaria is to have a well-developed IT industry, the government needs to invest in technology education to ensure the development of IT specialists. The current computer classes offered during the senior year in high schools are not sufficient.

IT classes have to be available earlier and offered more frequently. For that purpose, the government needs to sponsor or find sponsors to provide computer labs in the high schools and universities. Offering higher salaries and/or university scholarships for IT professionals and specialists in the fields of mathematics and sciences is another way to encourage the development of young IT specialists.

Bulgaria has a well-defined copyright and intellectual property law. Intellectual property legislation has been amended and modernized. In April 1999, the U.S. Trade Representative removed Bulgaria from the Special 301 Watch List. However, the reality is different. Even though copyright violation was reduced from 90% to 76%, the government still needs to ensure the proper enforcement of existing copyright and intellectual property laws. Imposing larger fees and monetary punishment for violators is a possible solution. High software and technology acquisition costs contribute to the problem too. With low monthly incomes, the average Bulgarian cannot afford to pay a high price. The Bulgarian International Business Association (BIBA) suggests accelerated depreciation of technology and technical equipment that will reduce the costs of investment in new technologies, enable businesses to charge lower prices, and mitigate the incentives to violate copyright. The Bulgarian government has already taken actions in this direction. Starting on January 1, 2003, it plans to exempt the import of high tech equipment from duties, taxes, and charges.[11]

C. Transportation:

Bulgaria's strategic geographic location presents many opportunities for foreign investors in the transportation sector. A network of highways crosses the country and offers connections to Central and Western Europe, Russia, Asia, the Adriatic, the Aegean and Black Seas. The Pan European Transport Corridors crossing Bulgaria are Corridor IV, VII, VIII, IX, and X. With its geographic location and transportation network Bulgaria has the potential to become a transportation hub. Bulgaria's road infrastructure is reasonably well developed but not well maintained due to insufficient funding. However, with the financial support of the European Investment Bank (EIB) and the EBRD, essential maintenance was carried out on Corridors IV, VIII, and IX. In addition, there are development projects under the Stability Pact of South-Eastern Europe that include the construction of a road and a rail bridge over the Danube River, the renovation of ports along the Danube River, and the construction of a new terminal and a runaway at Sofia Airport.[9]

Road reconstruction grants and loans mostly cover the main road networks. However, these roads represent only 10% of the country's road network.[10] Second- and third-grade roads comprise the rest and are in poor condition. This fact suggests that the Bulgarian government should find a significant partner for road reconstruction and offer Build Operate Transfer (BOT) projects. BOT projects entitle a company that invests in road renovation to participate in the revenues generated from payments by road users. Examples of successfully introduced user-pay approaches are the highways in Serbia and Macedonia. They are in a much better condition than those in Bulgaria because they collect toll fees. According to BIBA, a well-developed toll road policy for Bulgaria could contribute $25 million — $200 million to government coffers.

The added revenue from road transport operations can also help the government increase railway subsidies to an acceptable level. Bulgarian State Railways are among the least subsidised railways in Europe and in the region.[11] Under the program for infrastructure development 2001-2005 the Ministry of Transport and Communications plans to offer railway passenger and freight services for privatization.[9] Even though the state retains infrastructure ownership, foreign investors that participate in the railway reconstruction effort can still benefit from the increase in railway traffic.

Apart from its road and railway networks, Bulgaria has two major ports – Bourgas and Varna. Both have direct connections with road and railway networks. The ports, which are being renovated, will help increase cargo capacity and provide opportunities for oil transfer from the Central Asian Republics to Europe.

Bourgas is also one of the six duty-free zones in Bulgaria. The other zones are Plovdiv, Vidin (close to Romania), Rousse (close to Romania), Dragoman (close to Serbia), and Svilengrad (close to Turkey). These duty-free zones in conjunction with Bulgaria's roads, railway network, and ports present the opportunity for turning Bulgaria into a transportation and trade hub of the Balkans and South-Eastern Europe.

VI. Geographic Location - Tourism:

The favorable geographic location and mild climate also favor the development of tourism in Bulgaria. Bulgaria is situated in the southeastern part of the Balkan Peninsula. The country has a coastline that offers recreation at the beach and surfing. The winter is cold, with significant snowfalls – a favorable condition for the development of ski resorts in Bulgaria. The mountains in Bulgaria occupy about 50% of the country.[12] This factor favors hiking and mountain tourism. In addition, Bulgaria has about 500 deposits of mineral waters with over 1,600 water sources — a natural resource that allows for the development of spa resorts.[12] The low value of the Bulgarian Lev compared to other currencies makes it generally less expensive for foreigners to spend time in Bulgaria.

The government must renovate many of the existing hotels in the country, however, to take advantage of these favorable conditions. Hotels and resort facilities need to be constructed according to European standards. For example, most of the old hotels are not air-conditioned. Partnering with the government on the hotel renovation could be a profitable opportunity for a foreign investor. For example two of the biggest resorts in the country — Golden Sands and Pamporovo AD — have been privatized. In addition, the EBRD has provided loans varying from $100,000 to $1 million for the medium-sized and small tourist enterprises.[9] This fact along with a 17.06% increase in tourists in 2001 (Table 4) suggests that there are still opportunities to explore.

For the successful exploitation of opportunities in tourism, the government needs to take several other action steps. First, it needs to design an effective marketing and advertising plan to promote Bulgaria as a tourist location internationally. Second, as noted previously, foreign language training is critical. Given that the majority of tourists visiting Bulgaria are from Eastern Europe, Russia, Germany, and the United Kingdom (Table 4), Russian, German, and English should have priority over other foreign languages. Last but not least, it has to ensure a low crime rate and high-quality customer service.

VII. Conclusion:

To summarize, if the Bulgarian government wants to attract FDI, it has to enhance Bulgaria's competitive advantage – its human capital, infrastructure and technology development opportunities, and strategic geographic location. In the area of human capital, the government needs to invest in and ensure a high quality of foreign language training. Foreign exchange programs, graduation exams, and a job and promotion selection process that rewards foreign language skills are ways by which these objectives may be accomplished. In the energy sector, finding a significant partner for the reconstruction of the Kozlodui power plant as well as exploring the alternative sources of energy (coal-fired and hydro-electric stations) available is critical. Developing IT professionals is important for starting a successful technology sector. The government needs to identify a sponsor to provide computer labs in schools and start IT education earlier. Subsidies, tax breaks, and elimination of import fees for companies involved in technology are other ways to encourage their development. BOT projects based on the user-pay approach for infrastructure construction are possible solutions for the transportation sector. Finally, Bulgaria's strategic location opens investment opportunities in the tourism sector. But to entice foreign investors, the government needs to ensure customer service and foreign language training, hotel renovation, and a low crime rate.

It is clear that the steps taken to promote FDI are interrelated. By improving the foreign language skills of the population the government will make Bulgaria's labor pool attractive to foreign investors. However, by doing so, it will also facilitate the communication process with tourists and make Bulgaria an attractive travel location. By refining the road and railway network, the government will not only help turn Bulgaria into a transportation hub, but will also facilitate tourist traveling. Adopting modern technologies and equipment, will bring improvements in the IT sector and will also result in less consumption of energy and energy resources.

Understanding that these interrelated factors affect FDI will help the Bulgarian government create strategies that make the country internationally competitive.

Endnotes:

1 www.miga.org.
2 www.nsi.bg.
3 www.worldbank.org.
4 www.bfia.org.
5 www.transparency.org
6 www.priv.government.bg
7 www.doe.bg.
8 www.nek.bg.
9 www.ebrd.com.
10 www.mtc.government.bg.
11 www.biba.bg.
12 www.bulgariatravel.org.

Books:

Dobosiewicz, Zbigniew. *Foreign Investment in Eastern Europe*. New York: Routledge, Chapman, and Hall, Inc., 1992.

Palliwoda, Stanley. *Investing in Eastern Europe*. Cambridge: Addison-Wesley Publishing Co. Inc. and the Economist Intelligence Unit, 1995.

Porter, Michael. *The Competitive Advantage of Nations*. New York: The Free Press, 1990.

FDI Survey Questionnaire:

1. How did you hear about investment opportunities in Bulgaria?
2. Why did you choose Bulgaria?
3. What other countries did you consider investing in (apart from Bulgaria)?
4. Do you invest in Bulgaria with the purpose to export your products and services or do you invest in order to serve the Bulgarian market?
5. If so, what percentage of your products do you export and what percentage do you offer to the Bulgarian market?

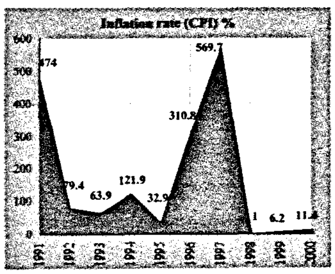
Figures and Tables

Table 1: Foreign Direct Investment by Years

	VOLUME IN USD (millions)			
Year	***Privatization***	***Other***	***Cumulative Total***	***Number***
1992		34.4	34.4	1,271
1993	22.0	80.4	102.4	2,261
1994	134.2	76.7	210.9	3,163
1995	26.0	136.6	162.6	4,183
1996	76.4	180.0	256.4	4,570
1997	421.4	214.8	636.2	4,077
1998	155.8	464.2	620.0	4,613
1999	305.7	500.4	806.1	3,590
2000	366.0	635.5	1001.5	5,153
Total	**1,507.5**	**2,323.0**	**3,830.5**	**32,881**

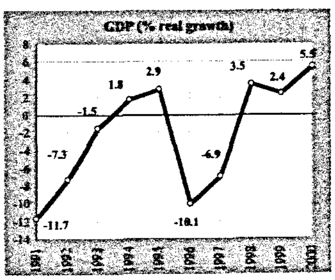
Source: *www.bfia.org*

Figure 1:



Source: *www.bfia.org*

Figure 2:



Source: *www.bfia.org*

Table 2: Labor Cost Per Worker 1995-1999

Country	**Annual Labor Cost (USD) per Worker in Manufacturing**
Bulgaria	1,179
Czech Republic	1,876
Greece	15,899
Hungary	2,777
Romania	1,190
Russian Federation	1,528
Slovenia	9,632
Turkey	7,958
Austria	28,342
Germany	33,226
Italy	34,859
Spain	19,329
UK	23,843

Source: *www.worldbank.org*

Table 3: Percentage of population in respective age category attending school

	Years			
	1996-1997	**1997-1998**	**1998-1999**	**1999-2000**
Kindergarten	66.2	62.1	65.2	66.4
Elementary	95.5	96.0	96.8	96.4
Junior High School	78.4	79.1	80.2	81.4
High School	61.5	61.3	62.1	63.1
Associate Degree	†-	0.5	0.7	0.6
College	3.0	3.0	2.7	2.3
University	21.4	21.6	22.6	23.2

Source: *www.nsi.bg*

Table 4: Arrivals with Purpose of Visit "Tourism" (January-December 2001)

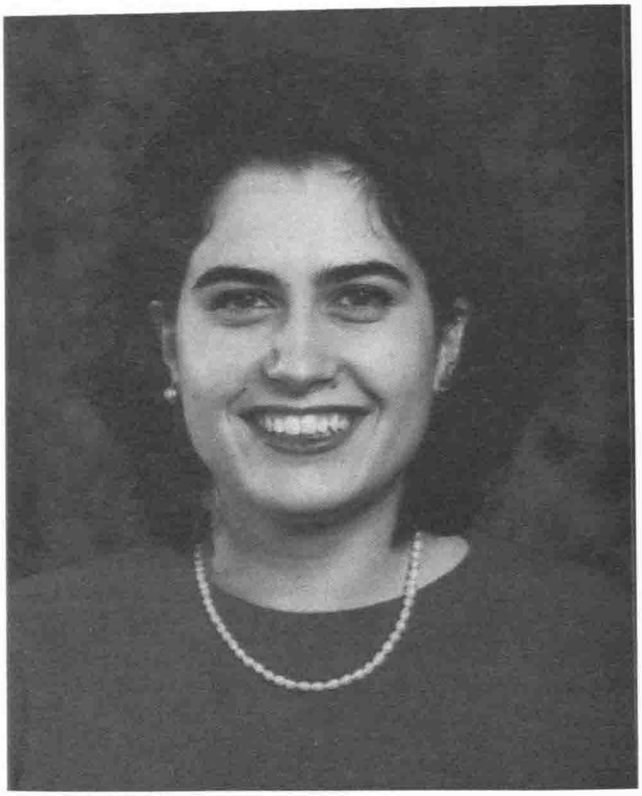
Border Statistics (Excluding Children without own passports)

No.	**Country**	**Tourists**	**% Change 2000-2001**
1	Macedonia	643,106	-2.32%
2	Germany	374,323	42.31%
3	Yugoslavia	359,467	64.59%
4	Greece	344,677	7.16%
5	Romania	227,286	11.43%
6	Russia	130,886	23.92%
7	Ukraine	70,168	18.37%
8	UK	69,202	33.15%
9	Israel	50,368	62.95%
10	Sweden	48,070	20.18%
11	Turkey	44,243	-53.70%
12	Czech Rep.	36,986	27.57%
13	Poland	31,492	66.03%
14	Slovakia	30,999	65.43%
15	Finland	29,178	51.38%
16	France	27,305	27.50%
17	Austria	27,253	225.14%
18	USA	25,560	21.89%
19	Belgium	24,946	42.56%
20	Denmark	19,372	28.85%
21	Italy	17,318	5.46%
22	Netherlands	15,422	8.66%
23	Belarus	15,386	-1.55%
24	Norway	10,485	4.01%
25	Hungary	6,818	28.25%
26	Switzerland	6,147	43.96%
27	Georgia	5,774	-10.22%

Source: *www.mi.government.bg*

Figure 3: Foreign Direct Investment by Countries in USD m (1992-2000)

Source: *www.btia.org*



Vessela Kapoulian

Faculty comments:

Ms. Kapoulian's faculty mentor, Wayne Lee, made the following comments about her work:

> In her thesis, Ms. Kapoulian identifies why foreign direct investment (FDI) in Bulgaria lags behind its neighbors and what specific actions the government can undertake to attract more investments. The amount of material that had to be read and analyzed was extensive. But she tackled the difficult and challenging task extremely well. For someone completely uninformed about Bulgaria (as I was), the thesis provides a nice, concise introduction to the opportunities and challenges of investing in Bulgaria. Though we met at least once every week, Ms. Kapoulian is very capable of independent work. I really enjoyed the interaction. It was a learning experience for me as well.

John Norwood, Director of Honors Studies for Walton College, also had complimentary things to say about Ms. Kapoulian's work:

> Ms. Kapoulian's work represents a thorough investigation of what is needed to increase the amount of foreign investment in her home country of Bulgaria. The work should be of interest to anyone interested in promoting the economic development of Bulgaria.