

## **3.3 The Southeast European States**

### **3.3.1 Bulgaria**

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#### **Introduction**

Bulgaria is a small country in the Eastern Balkans at the South-Eastern shore of the Black Sea. Its area is 108.560 square kilometers mixed terrain with fertile arable landscape in the North (Danube basin) and East, and mountainous terrain in the central and Western parts of the country (25% of the area, e.g. Rodope Mountains). Today the population of the country is 7.050 thousand inhabitants, down from its peak of almost 9 million in 1987. The change of the population is due to declining birth rates and most importantly massive outmigration. Estimations state that some 1-1.2 Million people moved from the country to other locations between 1990 and 2005, mainly young active population. This process poses serious threats for the Bulgarian economy even in the short run. Concerning the process of aging, the statistical figures already show the negative consequences: the age cohort 65+ included 21.0% of total population in 2018, meanwhile children (aged 15-18) accounted to only 14.2%. Largest cities were Sofia (1.236 thousand inhabitants), Plovdiv (343 thousand) and Varna (335 thousand). In total 74.67% of the population was urban (2017).

#### **1. Political context and quality of institutions**

Bulgaria has a rather turbulent history. The current country is the third Bulgarian state. Bulgarians lived several centuries long under Byzantine rule, then, after a brief period of independence under Ottoman rule. Both big empires left their legacy in the country. Therefore, the cultural, political and economic heritage of the country was fairly different from the “mainstream” Euro-Atlantic models (Djankov and Hauck 2016). Hence, the Bulgarian variant of the capitalist models is also very peculiar, it is a mixture of Western-type institutions in Eastern-type environment. This means that some of the standard Western institutions like property right enforcement bodies do not work here in the same manner than in core

Europe. This is also reflected in the various synthetic measures. Close ties, paternalism and cronyism marred this capitalist model. It is somewhere in between the Mediterranean and the Russian model, with much weaker state than in this later one. In fact, business-polity relationships have always been a problem area in the country, with corrupt business taking the lead over politics (Schoenman 2014). Corruption, organised crime, and the resulting state capture position (Hellman *et al.* 2000; Wedel 2001; Innes 2013) are still very problematic, and the European Union keeps on controlling Bulgarian efforts at eliminating the issues in the country (Appel and Orenstein 2018). Some progress has been achieved, but the country is by far not free of the problem (Racovita 2011).

Another important caveat of the historic development path is the area of human and social development. The mass scale migration out of Bulgaria is a very serious problem for the country (Krastev 2002), even if dissidents support their relatives through remittances that contribute to the stimulation of the economy. Yet, the steady decline of the active population has led to serious labour shortages, which is a primary impediment of future economic growth. The human endowment problem is exacerbated through the byzantine-type of society. Personal ambition, entrepreneurship but also the desire to be tapped in the most current updating of social and economic life is not strong enough in the country. Moreover, it is the more receptive young generation which moved abroad. Thus, the Bulgarian society is rather slow to join global modernisation tendencies. This is also clearly seen in the DESI (2018) figures.

Bulgaria was rather underdeveloped country compared to other socialist countries before the transition process. Forced industrialisation created important metallurgical capacities and also some other manufacturing activities were launched (e.g. in machinery industry: fork lifts production, electrical industry: types of personal computers and radio transmission devices), but the bulk of the country's industry was still specialised in garment and footwear, as well as food industries. All these industries became crisis industries already during the 1980s, before the transition process was started. Therefore, due to the lack of competitive activities quick liberalisation (70% of prices were liberalised in 1989) produced serious transformational recession in the country. This also created high inflation, that peaked by 330% in 1991 (Bitizenis 2003).

The Bulgarian governments could not avoid massive unemployment and impoverishment through other means than the subsidisation of loss-making industrial firms. The state-owned banks also continued lending and accumulated huge amounts of non-performing debt portfolio. This policy could not be maintained any longer than 1996/7, when the Bulgarian economy collapsed and inflation started to soar again (900%). The macroeconomic stability was restored with the introduction of currency board to stabilise the Bulgarian currency and tightening of the prudential regulations of commercial banks (Bitzenis 2003; Barlemann *et al.* 2002). The stabilisation program was also supported by the International Monetary Fund. IMF extended conditional loans to Bulgaria. Financial sector privatisation was to be accelerated (Pop-Eleches 2009).

As far as privatisation policy is concerned, only slow efforts were made by the 1992 funded Privatisation Agency (PA) and the responsible branch ministries. The otherwise also rather unattractive Bulgarian firms were not foreseen to be sold on open tenders. PA rather wanted to consolidate them before deciding how to privatise. The consolidation of firms was not successful since economic policy did not have any credible device during the 1990s to enforce corporate restructuring. Instead, continuous subsidisation of the loss-making companies occurred with no serious restructuring efforts. When this expensive way of maintaining jobs could not be financed any more, firms went bankrupt on a mass scale in 1997. Up till then, practically only a kind of mass privatisation effort was effectively carried out in late 1995, but this action did not change the situation of the state sector (Bitzenis 2003).

The development of the private sector did not root in privatisation but rather in misusing incompetent banks loose crediting activity. Inadequate levels of banking skills and loose prudential regulation topped by high level corruption enabled some Bulgarian would-be oligarchs to take huge loans under fraudulent conditions from the commercial banks. Similarly to the establishment of Russian oligarchy, many Bulgarian tycoons also started their capital accumulation process using illegal or at least fraudulent transactions. Although Bulgaria made some efforts to limit corruption and organised crime, and also to stabilise the economy, the most important measure of these efforts, the EU accession, was postponed to 2007 (Appel and Orenstein 2018). Even then Bulgaria had to set up appropriate agencies under the EU control to curb corruption and organised crime. Property

rights are still not well protected. The judiciary in Bulgaria's "flawed democracy" relies on legal and institutional reforms demanded by the EU accession process, but effective gains in efficiency and accountability continue to be lacking (Krastev 2002). The court system is not trusted by citizens that gives rise to "alternative dispute management practices" and criminal activities. The government's half-hearted efforts to combat corruption remained with moderate success. The policy of political conditionality pursued by the EU and the IMF negatively affected the governments' domestic power base (Simmelfenning and Sedelmeier 2005). Organised crime is heavily involved in human and narcotics trafficking and smuggling (Racovita 2011).

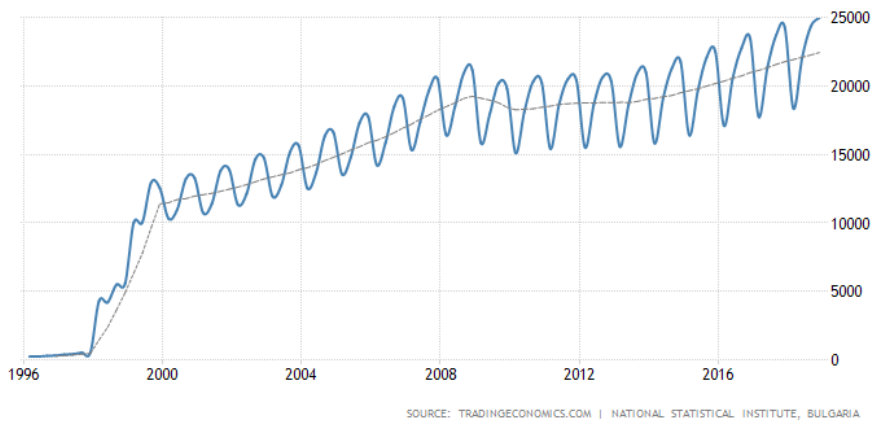
World Bank (2018) governance indicators shows mixed development tendencies in the case of Bulgaria. The country could significantly improve its position in two important indicator groups between 2007-2018. In political stability and absence of violation its ranking increased from 56 to 60. Government effectiveness improved even more significantly: from 54 to 64. Regulatory quality improved from the relatively high 71<sup>st</sup> to 73<sup>rd</sup> position. The rule of law indicator and control of corruption remained unchanged (around 50). This is bad news, because these areas have always been important bottlenecks of Bulgarian development that was criticised by global institutions and the European Union as well. Unfortunately, the voice and accountability indicator declined from 68 to 59 after 2007. This means an important decline in the perceptions of the extent to which citizens are able to participate in selecting their government, as well as freedom expression, association, and a free media.

## **2. General economic outlook**

The growth performance of the country has been rather whimsical. The World Bank (2017) database shows that during the transformational crisis that started in 1989 and lasted until 1993, GDP declined by over 25.6% only to recover rather slightly between 1993-1998 by 10%, when the Russian currency crisis pushed back the economy again by 8% (EBRD 2000). The early 2000s showed rather vivid economic growth with 4-7% annual rates, thus by the year of the country's accession to the European Union (2007) economy finally recovered to the pre-transition level of output. The 2008 global financial crisis hit the Bulgarian economy again producing 3.6% decline, which was then recovered in the following two

years. The Bulgarian economy showed more stable and significant growth in the years 2015-18 with rates between 3-4%. The 10 year average growth rate was 1.9% in 2018. GDP per capita at purchasing power parity was 49% of the EU average in 2017, up from 37% in 2006. Taking into account the relatively modest GDP growth performance of the country, the increase could be traced back to the massive decline of the denominator (declining population).

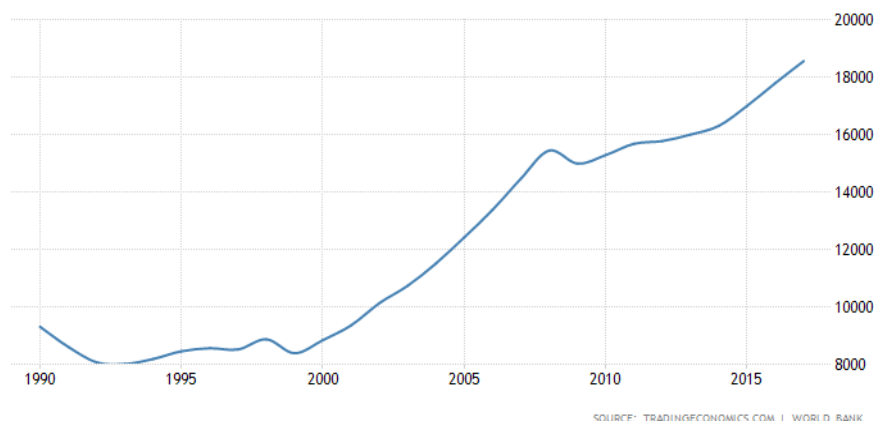
### GDP of Bulgaria (BGN Million, constant prices).



### GDP Annual Growth Rates (%).



### Per Capita GDP in USD, PPP (1990-2018).



Bulgaria used to be a mostly agrarian land. As a member of the Soviet bloc, forced industrialisation took place also in this country producing important facilities in mining and metallurgy, engineering and food industry. Much of the heavy industry collapsed during the years of transformational recession. Instead services gained importance also through the entry of multinational firms in trade, telecommunication and banking. Agricultural employment still maintained much importance employing 17.7% of the total labour force in 2018. Industrial employment remained relatively stable with 25.4% (manufacturing 19.6%). Services (including community services) employed 56.9%.

Fiscal and monetary stability have not always been primary targets of economic policy in Bulgaria. The governments during the 1990s repeatedly accumulated high state debt in their fruitless effort to consolidate ailing big business and loss-making banks. Instead of tightening fiscal discipline, paternalistic linkages have survived in a new political manner. This conflict avoiding behaviour and the accumulated high debt and hyperinflation of course strongly limited the country's chances to successfully complete the EU accession requirements. In fact, accession occurred without the full implementation of the *acquis* (Racovita 2011). The systemic weaknesses of the country required continuous monitoring, especially in the field of corruption and organised crime. Fiscal stability, on the other hand, was successfully restored and maintained throughout the 2010s.

Fiscal discipline of Bulgaria is clearly shown by the country's most recent macroeconomic data. In 2017, Bulgaria run fiscal sufficit (+1.1%), and the debt burden was also well beyond the Maastricht criteria representing 25.6% of the GDP. With these figures Bulgaria has become one of the macroeconomically most stable countries of the European Union. As it was already shown by the relatively low social expenditure, Bulgaria moderately centralises the spending of GDP, and state redistribution is not particularly high. Total government expenditure was 35.1% in 2017. Not surprisingly, inflation was also very low in the same year: 1.2%.

Bulgarian social protection system is built up in line with the acquis of the European Union. Fine tuning of the systems may of course create substantial differences in many aspects. The rather generous Scandinavian model being an extreme and the rather self-reliant Anglo-Saxon model being the other. The Bulgarian system is only moderately generous. This may also be a consequence of more cautious fiscal policy after having learnt the lesson of excessive paternalism during the 1990s. In 2017, the level of total benefits was 11.3% of the GDP. The total government expenditure directed to families as a share of total government expenditure was only 5.8%. Pension expenditure reached 8.6% (2015) and the government spent 8.2% of the GDP on health care in the same year. Inequality in Bulgaria is fairly high, higher than in other countries in the region. The Gini coefficient on incomes was 43.4 in 2018. After corrections with social transfers it declined to 40.2. This means that social solidarity cannot significantly improve living conditions of the poor.

### **3. Quality of entrepreneurship**

Entrepreneurship has little tradition in Bulgaria. Traditionally, in this mostly agrarian land much of the economic activity has been carried out in families or in unincorporated small business. Also, the centuries long foreign dominance discouraged Bulgarian citizens to launch business ventures. After the 1990 transition this situation changed and entrepreneurship was encouraged. However, high level of criminalisation paralysed business development also in this more recent period. Therefore, the level of entrepreneurship is very low in the country. Unfortunately,

criminalisation has affected government activities also very badly. All this is reflected by the entrepreneurship surveys.

The Global Entrepreneurship Monitor's spider shows adequate levels of physical infrastructure in the country. Unfortunately, this is the only measure where Bulgaria got a 4 score. Nevertheless, the country exceeded the regional average levels with scores around 3 in three aspects: entrepreneurial finance, taxes and bureaucracy (government policies) and commercial and legal infrastructure. Bulgaria lagged behind the regional average of the entrepreneurial framework conditions with regards to internal market dynamics, entrepreneurial education at post school age and also school age, government entrepreneurship programs and internal market burdens, entry regulations. These factors reflect handicaps in social institution systems (education and business support). All these barriers contribute to the very low level (2) of support, and relevance measure of government policies, as well as the similarly underdeveloped cultural and social norms. In all these aspects Bulgaria naturally also lags behind the regional average. Inadequate business support by social institutions and government policies, as well as low level of STI system both determine a rather low profile development path for the country.

The 2018 edition of WEF's Global Competitiveness Report evaluated Bulgaria to rank 51 out of 140 countries worldwide. This is a very impressive improvement from the 2009 low of ranking 76. The improvement was mainly achieved in the area of institutions (from rank 116 to 70, and infrastructure from rank 102 to 58). The country's overall performance became more balanced scoring in the range 30 to 70 (mostly around 50) in the various competitiveness pillars. Bulgaria lags behind the Europe-North America average most significantly still in the area of institutions, moreover in ICT adaptation, health, product market, financial system, business dynamism and innovation capacity; the main drivers of business dynamism. A closer look at the components of the individual pillars shows however, that the country has clear advantages in some fields and long lasting problems in some others. Efficiency of legal framework in challenging regulations (rank 134), conflict of interest regulation (121), property right enforcement (108), and judicial independence (103) show



serious weaknesses of market economic institutions, especially in the area of property rights and social control over public regulations. Another problem area is human skills and education. Ease of finding skilled employees is especially low ranked (138). This is due not only to the relatively modest level of education but even more importantly intensive outmigration. Most of the estimated 1-1.2 million migrants are young active adults. As mentioned, the cultural heritage is not favourable for entrepreneurship. Attitudes toward entrepreneurial risk (134), low level of internal labour mobility (136), as well as diversity of workforce (139) all show low level of incentives to take risks, which may be to some extent a general phenomenon in East-Central Europe.

An important feature of the social heritage in Bulgaria is risk aversion. This is also reflected in relatively low acceptance of competition. Therefore, on the one hand the Bulgarian firms have difficulties with competition, and they will rather settle market conflicts than fight back. The low interest in business participation is reflected by the relatively low number of SMEs per 1000 inhabitants (336). The OECD's product market regulation measure (2013) was 1.57 in 2013 (the only figure provided for the non-member country) that is somewhat higher than the OECD average. More developed countries' figures were in the range of 1.2-1.4. Barriers to entry related to administration is regarded high in the Institutional Profile Database (ranked 3). This gives an impression of having significant bureaucratic corruption in the country. The share of large scale distribution in the retail sector is also evaluated relatively high, meanwhile the role of foreign firms in this was most significant (4). Large national firms role is negligible or non-existent. Practices of competitors have moderate impact, competition regulation is not very strong.

The 2019 Heritage Foundation Economic Freedom ranking placed Bulgaria 37<sup>th</sup> with 69 points to the top of the moderately free countries (before other East-Central European countries). The country improved performance in monetary freedom, and fiscal health. The Foundation appreciated Bulgarian efforts at the improvement of free market conditions: "The institutional and structural reform process, although somewhat hindered by political conflicts, is gradually being implemented to complete

the transition from the centralised, planned economy to a more liberal, market-driven one. Reforms include privatisation of state-owned enterprises, adoption of favourable investment regime, liberalisation of trade, and strengthening of the tax system. Public debt has been well managed. However, corruption in public administration, a weak judiciary, low productivity, and organised crime continue to hamper Bulgaria's investment climate and economic prospects". Weak points are still property rights enforcement, government integrity and judicial effectiveness. The measure intensity of local competition in the 2017 Global Competitiveness Report was 4.8 or 91<sup>st</sup> position, which is well below the average. The number of newly registered firms per 1000 active persons was 10.69 in 2016.

#### **4. Modernisation based on FDI**

Bulgaria has never been a primary target of foreign direct investments. Its accumulated FDI stock is rather modest. The country followed cautious privatisation policy and did not sell big business and major banks to foreign investors. The Bulgarian governments maintained the subsidisation of loss-making firms rather in the hope that they would sooner or later consolidate their activity. In most of the cases this did not happen. The continuous financial unattractiveness of Bulgarian big business and the expiration of first movers' advantage (massive investment in other countries of the region) dramatically reduced Bulgaria's attractiveness as an FDI target country. Mostly market seeking investment projects were carried out in trade, communication banking and other services. The main investors were Greek and Turkish companies. The fairly weak FDI activity and the weak industrial potential delivers the message that FDI did not contribute to a massive restructuring and modernisation of the country. Unfortunately, no other (internal) sources were found to do this job. Therefore, the lack of modernisation investments in value adding activities limited the development potential of the economy.

The banking sector became dominated by foreign firms after the consolidation and sale of bankrupted state-owned banks in the late 1990s. By the year 2000, foreign share reached 74%. After some further increase it remained at 66% level by the year 2012. Parallel with this process the

role of state ownership was reduced from 70% in 1995 to 3% in 2010. Among the 500 largest companies of the CEE region only 10 operated in Bulgaria. This low figure also shows the relative underdevelopment of the country with very modest activity of big business. Out of this rather small stock there were 2 state-owned, 3 multinational companies (not from CEE), two multinationals from CEE countries, and 3 local companies. Clearly, there are not many foreign firms in Bulgaria, but the country also lacks sizeable local companies. The total inward stock of FDI in Bulgaria was 47.838 million of USD in 2017, up from only 2.704 USD in 2000. Total outward FDI stock of Bulgaria was 2.817 million USD in 2017 (UNCTAD 2018).

Investment in general remained moderate with 18.5% of the GDP in 2018, while the European average was 20.5%. Sluggish investment activity does not provide strong thrust to modernisation and reconstruction of the Bulgarian economy. Bulgaria runs a trade surplus and has therefore a higher share of exports in percentage of the GDP than imports. The 67.4% of exports and 63.7% of imports represents moderate openness. It reflects the importance of the production of basic commodities consumed domestically (high share of agriculture in the GDP). Also, the role of multinational companies' GVCs is less developed than in the Visegrad countries, let alone core Europe. Domestic consumption has an important role, therefore Bulgaria is perhaps less dependent on its foreign trade performance than the Visegrad countries.

Labour market processes in Bulgaria are determined by declining labour supply. Both quantitatively and qualitatively seen, Bulgarian labour market is shrinking due to massive migration. Excess demand and relatively weak regulation (higher flexibility) are the two important features. Due to the lack of larger scale industrial investments productivity has not increased sufficiently, therefore incomes have not yet increase significantly despite of the labour shortage. The share of wages in total GDP was 36.7% in 2017, total compensations of employees plus employers' social contributions – 49.5%. Trade unions played marginal role in Bulgaria. The trade union density rate was 18% in 2012. Due to labour market flexibility and also the massive reduction of active population excess demand curbed the

participation rate to relatively high 71.3% level (2017). It is not surprising under the given labour market circumstances that unemployment is low with 5.2% in 2018. This is a fairly low rate especially in comparison with the years 2010-2014, when it was double digit peaking in 2013 with 13%. Collective bargaining affects 29% of the employees, somewhat higher than the trade union rate, most probably because collective bargaining in the public sector with only 3.8% temporary employees rate is rather negligible. Most probably temporary employment is badly recorded thus contributing to the grey economy. Labour productivity increased by 22.9% in the period 2010-2018, very significant increase, third after Romania and Poland in the European Union. Estimations of migration vary between 1 and 1.2 million people, mostly active persons, roughly 25-30% of total active population, which constitutes a tremendous loss to the Bulgarian economy.

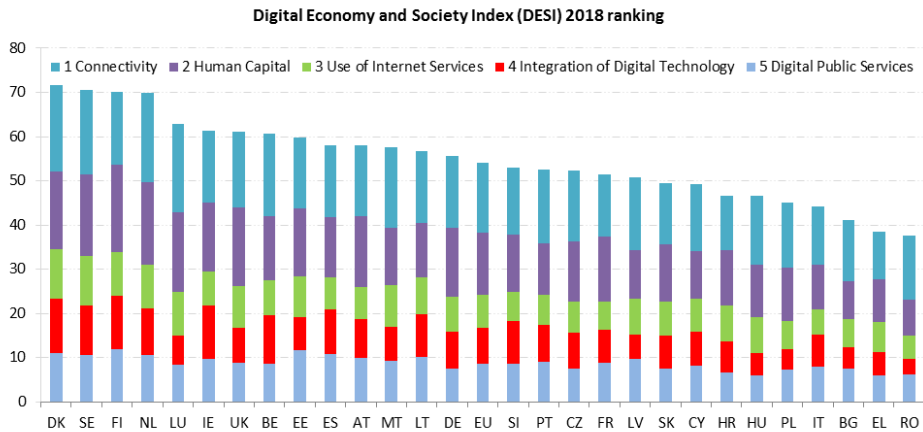
## **5. Knowledge sector**

In the traditional Euro-Atlantic capitalist model innovation is a main driver of economic development. In the Byzantine heritage of Bulgaria this driver has always been very weak. Therefore, Bulgaria is a moderately innovating country with fairly weak traditions in its STI system. Historic tradition of being part of the Ottoman empire did not create strong social institutions, and the Bulgarian governments had to make rather serious efforts to create a modern school system. Government efforts to improve education are still relatively strong. The government expenditure on education was 11.44% of the GDP (2013), a fairly high share in the region. Higher education rate was even more impressive with 36.4%. These figures of course do not tell much about the quality of education but we can expect that it is not better or worse than in other countries in the region, and then the high share of higher education enrolment could be an advantage of the country. The other sub-system of the STI sector, innovation, on the other hand is still very weak. Total R&D expenditure as percentage of the GDP was merely 0.78% in 2016. Very clearly, there is not much private (corporate) spending, and also state spending is inadequate. Bulgarian plans to increase this share to 1.5% do not seem very ambitious but given the fact that the country lacks appropriate big business this ambition still seems unrealistic. The relative

weakness of big business is also reflected in the modest share of high tech products in total exports, which was 7.44% in 2017.

Economic growth and prosperity is fuelled in the long run through technological development and innovations. The role of STI is far reaching and is not restricted to the application of modern products and technologies in the factories. It crucially determines also entrepreneurship and the level of usage of new technologies (productivity). Therefore, an adequate development level of the national innovation system can strongly support long term development of the economy and society. Unfortunately, Bulgaria seems to lag behind the European average in this regard. The 27 STI measures used by the European Innovation Scoreboard clearly reflect this situation. Bulgaria is modest innovator: only 27<sup>th</sup> among the EU member states. R&D expenditure was only 0.63% of the GDP in 2013. Both public and private spending on R&D is very low. The summary innovation index deteriorated between 2010 and 2017. This was mainly due to massive declines in the fields of finance and support, firm investments, SME innovation outputs, linkage development and the sales impact of knowledge intensive and high-tech products. Some improvement was achieved in intellectual assets and broadband penetration. Bulgaria seems to lack important institutional legs of innovation in the area of higher education and industry.

Bulgaria scores rather weak in the European Union's Digital Economy and Society Index as well. The country was 26<sup>th</sup> in 2018. The DESI country profile reported only slight improvements over the year 2017. The country lags behind the EU average in all of the covered aspects. It is relatively closest to the average with 35% level in the field of connectivity and digital public services. The use of internet services is still somewhat over 30%. Worse is the country's situation in human capital (enabling knowledge), and the integration of digital technology. The overall DESI indicator shows an increasing gap with the EU28 average. A few areas where Bulgaria was closest to the EU average were mobile broadband takeup, video calls (perhaps because of the large number of dissidents), and social networks. Significant improvements were reported in the area of digital public services for business (obligatory electronic tax declarations).



## 6. Public opinion attitude towards transformations

The EU accession process has always been a political issue. This is clearly seen in most enlargement programs. The accession of Bulgaria and Romania was not an exception either. The European Union admitted two relatively poor new member countries that did not belong to the Euro-Atlantic historical and cultural heritage, and could not transform their societies to that pattern even after several years of accession. This is clearly seen in their continuous fight with corruption and crime, very low level of legal security especially in the field of property right enforcement, the survival of the traditional crony ties between business and polity. In Bulgaria these linkages are controlled by the private business, the state is captured. This model lacks the adequate drivers for economic development. No ambition is present to excel with entrepreneurship. Career opportunities in competitive business are rather limited since property right enforcement is loose, the judiciary is weak and not independent. Also high level of corruption thwarts business development. These conditions together with economic policy mistakes reduced the growth potential of the country. Therefore it could not narrow its development gap with more developed member states of the EU. This is the main reason of very large scale outmigration, a process that deprives the Bulgarian economy from vital human resources for future development as well.

Dissatisfaction with the economy is very strong (72% in 2018 according to Eurobarometer 90). Economic problems are in the foreground of citizens' concerns: inflation/cost of living 48%, health and social security 32%, general economic situation 26%. Concerning European problems Bulgaria too sees immigration and terrorism more serious than the European average, maybe also because the country is heavily involved in smuggling. The general public clearly sees the weakness of the governments and an outstanding high share of the population does not trust the government (67%). In contrast, most people still support the European Union (53%). Public support declined from 63% in 2004 (Eurobarometer 62).

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