



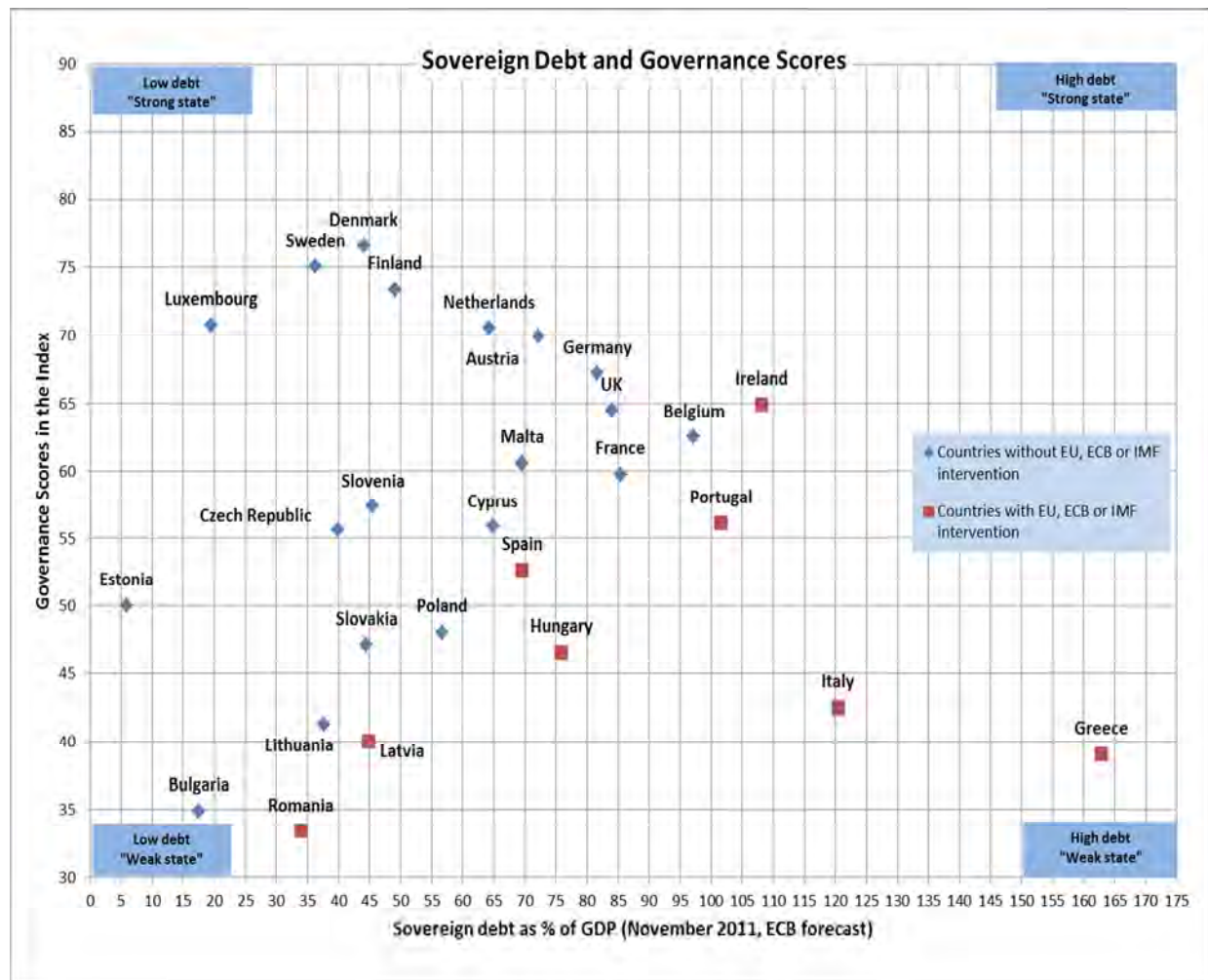
The Combo Meal that Europe Should Rethink: The Debt Crisis as a Crisis of Governance?

Marin Lessenski

- The exposure of a European country to the crisis seems to depend on both its debt level and its governance performance as there is a specific interplay of the two factors.
- The debt ceiling of 60% of GDP of the Maastricht criteria cannot be a universal measure and the safe debt level ceilings seem to be country specific, defined by particular debt to governance ratio of a country.
- Countries with poorer governance performance are closer to the danger zone even in case they have low debt levels.
- The crisis in Europe is not only a debt crisis and there are multiple forces at work here – so the responses could not include only economic and financial measures.

The exposure of a European country to the crisis seems to depend on both its debt level and its governance performance as there is a specific interplay of the two factors. The existence of such a relationship suggests that the debt crisis cannot be resolved by economic and financial mechanisms alone as the problems run deeper and will require a new perspective and a new approach.

If the country governance index estimated on a scale from 0 to 100 (please, see the methodology note) and the sovereign debt data in the EU are superimposed, the results illustrate the link between the sovereign debt level of a country and its performance in the governance category.



The red dots on the scatter plot are the countries that are currently having troubles – defined as receiving targeting assistance from the EU, ECB or IMF. Even an initial glance illustrates the point that countries with good performance in governance – such as Germany, Austria or the Netherlands – can sustain their high debt levels, while countries with lower governance scores – such as Romania, Spain or Hungary – can afford to have only low debt otherwise they risk trouble.

In other words, better governed countries can afford higher levels of debt. Conversely, badly governed countries can tolerate only lower levels of debt. The “governance vs. debt” hypothesis also helps to partly explain the ostensible paradox of why countries with higher debt levels can carry the burden and why countries with lower debt levels are in trouble with the markets.

Better governance means more policy capacity to cope with the problems (e.g. adopt and implement measures such as spending cuts, tax collection, etc.), more resilience which helps the country bounce back and more re-assurance for lenders and investors.

The “governance vs. debt” hypothesis suggests that a country can tolerate only a certain combination of debt and governance. So there should be a specific “break point” for each country, which is defined as a ratio between good governance and level of debt. If the ratio between debt and the governance level worsens, then the country plunges into a crisis.

Methodology notes

*The sovereign debt data for the EU27 is based on European Central Bank (ECB) forecasts for 2011, so the actual data may vary.

*Please, note that most of the estimates provided in this chapter are indicative approximations for illustrative purposes.

*Governance is one of the four fundamental categories of the Catch-Up Index (www.TheCatchUpIndex.eu) along with Economy, Democracy and Quality of Life. Governance is measured on a scale from 0 (worst) to 100 (best) through the following set of indicators, each with specific weight as shown in the table below. The Catch-Up Index is a forthcoming product of the European Policies Initiative of the Open Society Institute – Sofia.

| Governance Indicators | Sub-indicators | Weight |
|------------------------------|---|--------|
| Corruption | Corruption Perceptions Index – Transparency International, 2010 | 0,080 |
| | Control of Corruption – World Governance Indicators, World Bank, 2009 | 0,080 |
| Political stability | Political Instability by Economist Intelligence Unit, 2009/2010 | 0,080 |
| | Political Stability and Absence of Violence – World Governance Indicators, World Bank, 2009 | 0,080 |
| Governement effectiveness | Governement Effectiveness – World Governance Indicators, World Bank, 2009 | 0,160 |
| Regulatory quality | Regulatory quality – World Governance Indicators, World Bank, 2009 | 0,160 |
| Rule of law | Rule of Law – World Governance Indicators, World Bank, 2009 | 0,160 |
| Conflict, tensions and crime | Conflicts and tensions in the country – selected Global Peace Index indicators, 2010 | 0,080 |
| | Homicide rates per 100,000 population, United Nations Office on Drugs and Crime, 2006–2009 | 0,080 |
| E-government | E-government development index, United Nations, 2010 | 0,040 |

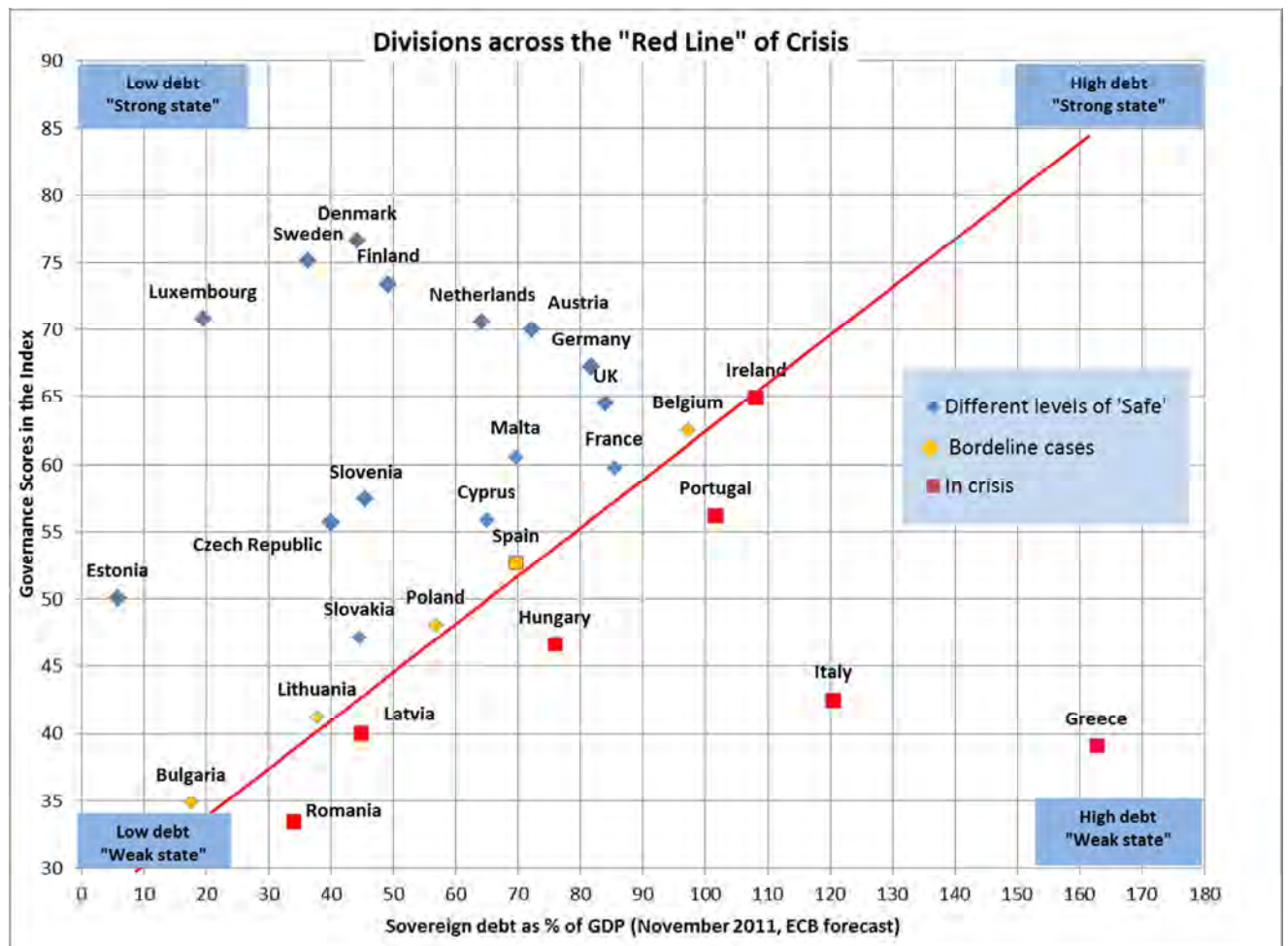
The “governance vs debt” hypothesis suggests that a country can tolerate only a certain combination of debt and governance. So there should be a specific “break point” for each country, which is defined as a ratio between good governance and level of debt. If the ratio between debt and the governance level worsens, then the country plunges into a crisis.

This model takes only two variables and isolates the rest. Of course, in real life there are also other factors that should be taken into account. For example, other economic indicators that show the resilience or the sheer size of the economy, GDP volumes, or the political influence of a country related to the ability to influence economic decisions, such as aid intervention, external perceptions, etc. – which vary from country to country and depend on the dynamic international and domestic context. But even in its simplicity – or because of its simplicity – the “governance vs debt” model provides some intuitive insights into Europe’s crisis and might suggest the responses for its problems.

The red line along the break points: the probability of crisis in a country?

The debt levels divide European countries into two big groups – those with high and those with low government debt. However, if the assumption about the debt–governance ration holds water, then the situation is more diverse and dynamic.

If the crisis is defined as an outcome of specific combinations of sovereign debt and governance, then taken together these two factors can help illuminate the state of Europe now. A Probit regression applied (the Probit model allows for calculating the probability of an event) to the data-set divides the EU members into three groups according to the probability of being in crisis. The tests show that there are statistically significant differences for the three groups, which justifies the usage and the outcomes of the method. The division of groups helps guesstimate the position of the “red line” of break points, which starts with the best positioned country in crisis – Ireland – and the slope of the line is parallel to the “borderline countries” estimated by use of regression analysis.



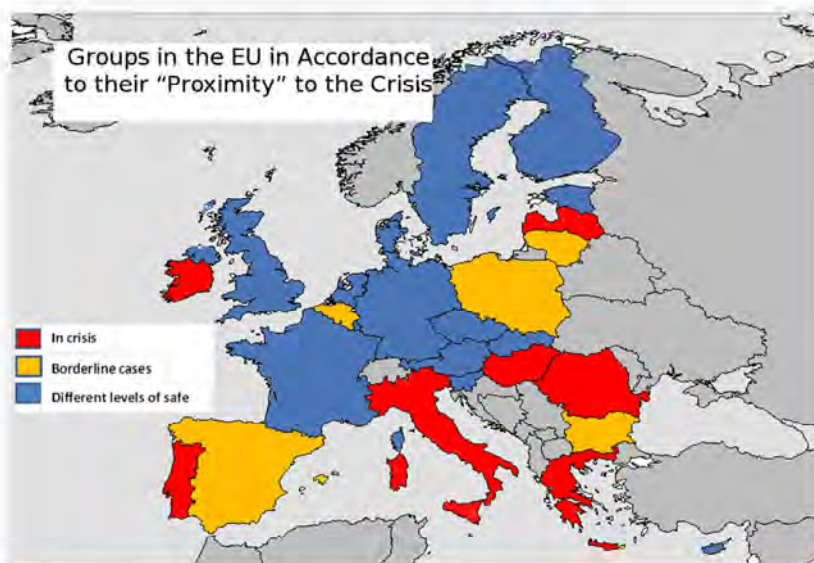
To make it clear once again – the analysis provides probabilities and not full guarantees for the events. But some of its findings are supported by empirical observations and at the same time may be quite a useful prediction instrument in policy making. For example, the “safe” countries can be assured they are on the right track, those in risk could be warned in order to take precautions and avoid disaster.

Thus, there are at three broad groups of EU countries in relation to the crisis:

- “Safe Zone” where countries that generally have both lower levels of debt and better governance performance and are on the safe side of the “break point”, where the combined influence of debt and governance can plunge a country into a crisis. There are “safer” ones such as Luxemburg, Sweden, Denmark and Finland, which are farthest from the trouble zone. The rest of the countries are less safe, but none of the countries in the group is immune to troubles. The proximity to the “break point” illustrated by the red line may define a country’s probability to enter a crisis.
- The “Borderline cases” group is a mixed bag of countries that are not in crisis, but which can go either way, depending on their policies – stay away from the danger zone or get too close to the “break point”. This is not to say that these countries will necessarily enter a crisis, but they have to be more careful about their debt, governance or both.

The presence of Spain in this group is indicative as it is considered to be in crisis (e.g. getting EU, ECB or IMF assistance). However, the Probit model ascribed Spain a place in the “borderline” less acute cases. It may mean that it has the capacity to manage the crisis, instead of being carried away by it (assuming there is not a catastrophic scenario for the entire EU). Bulgaria, Lithuania, Poland are in better shape and if they keep to prudent policies (i.e. low debt and efforts in improving governance, etc.), they can evade the worst of the crisis. But others, like Belgium, are quoted in media on the list of countries in high risk and might eventually be in need of external assistance.

- “In crisis” countries are also a very mixed bag, which supports the proposition that the path to a crisis may be driven by either high debt or poor governance or some combination of both. The group itself has three tiers. There are Greece and Italy, clearly the outliers in the scatter plot – and it can be clearly seen that they are far away from the “red line”, which separates the problematic and non-problematic countries, but Greece is visibly much more problematic. Romania, Latvia, Portugal and Ireland are not that far from the red line and have every chance to cope with the situation in a painful, but orderly fashion, either by reducing debt, improving governance, or both.



Call emergency 112: Identifying the “break point” dangerous debt levels

The question “who might be next to plunge into crisis?” is pivotal in the volatile European context. There is still not an economic and financial equivalent to the universal emergency number in the EU – 112 (that is 911 in the US) – but still the EU members can send a SOS signal and hope someone will respond.

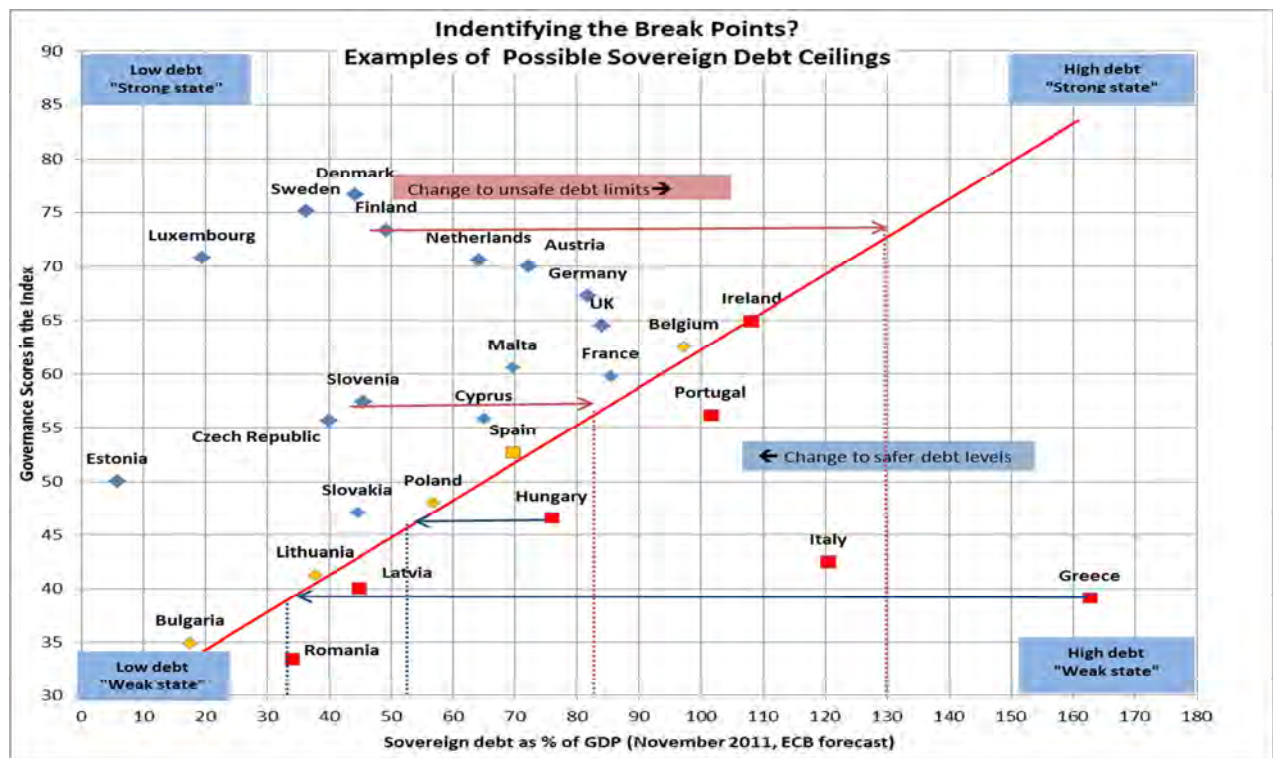
There have been nine countries already identified by the markets as being in different levels of crisis. So answering the question of who might be next could help with preventative measures in order to avoid disaster. This can happen by identifying the distances of each country to the dangerous debt levels that would push them into a crisis. In other words, these are the “break points” for the EU members in terms of debt to governance ratio. In parallel, this approach could serve to identify the countries currently in crisis, but which might be closer to recovery.

The variable in this case is the sovereign debt. The level of governance is considered constant (it is considered as less likely to change in the short term; so the estimates refer only to projected changes in sovereign debt levels.).

There are two other important notes to be made here. The first one is that these are indicative estimates for illustrative purposes, based on expert opinion and the hypothesis for the “debt and governance relationship”. This is just one possible explanation and there are of course multiple other factors that are difficult to account for in the model. The second note is that the estimates should not encourage more spending and, therefore, more debt. Their purpose is to issue a warning and help take preventative measures.

“Guestimating” break points: The country specific debt levels

“Break point” is defined here as the point where a country could enter a crisis because of a dangerous level of debt, provided that its governance level remains constant. The crisis debt level can be calculated at coordinate system of debt vs governance ratio (see the enclosed scatter plot) by the crossing at “the red line” that separates the countries in crisis from those, which are still not affected.

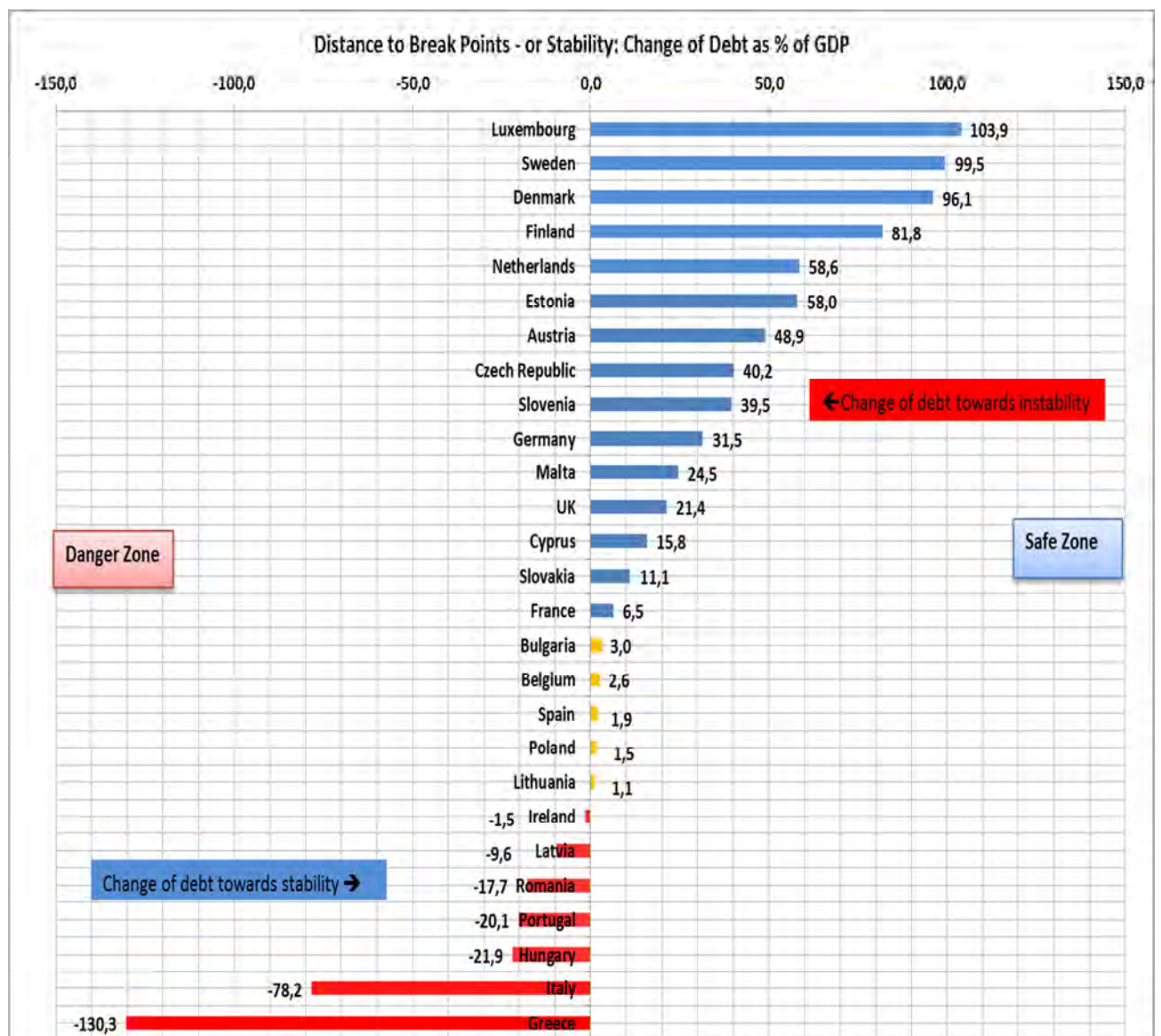


A quick guide to ruining a country: Or keeping it safe from the perils of intolerable debt

Once the maximum dangerous debt levels for each country are identified, the difference between these values and the current debt levels (in this case, the ECB autumn 2011 forecasts) will provide the “distance” of a country to a crisis. Thus, there are two sets of values that can be elicited. The first one is about:

- the maximum debt levels a country can afford before it enters the danger zone or, if it is in crisis, by how much it should reduce its debt to achieve some stability; and
- the values of debt change that a country can tolerate before it puts itself in high risk of crisis.

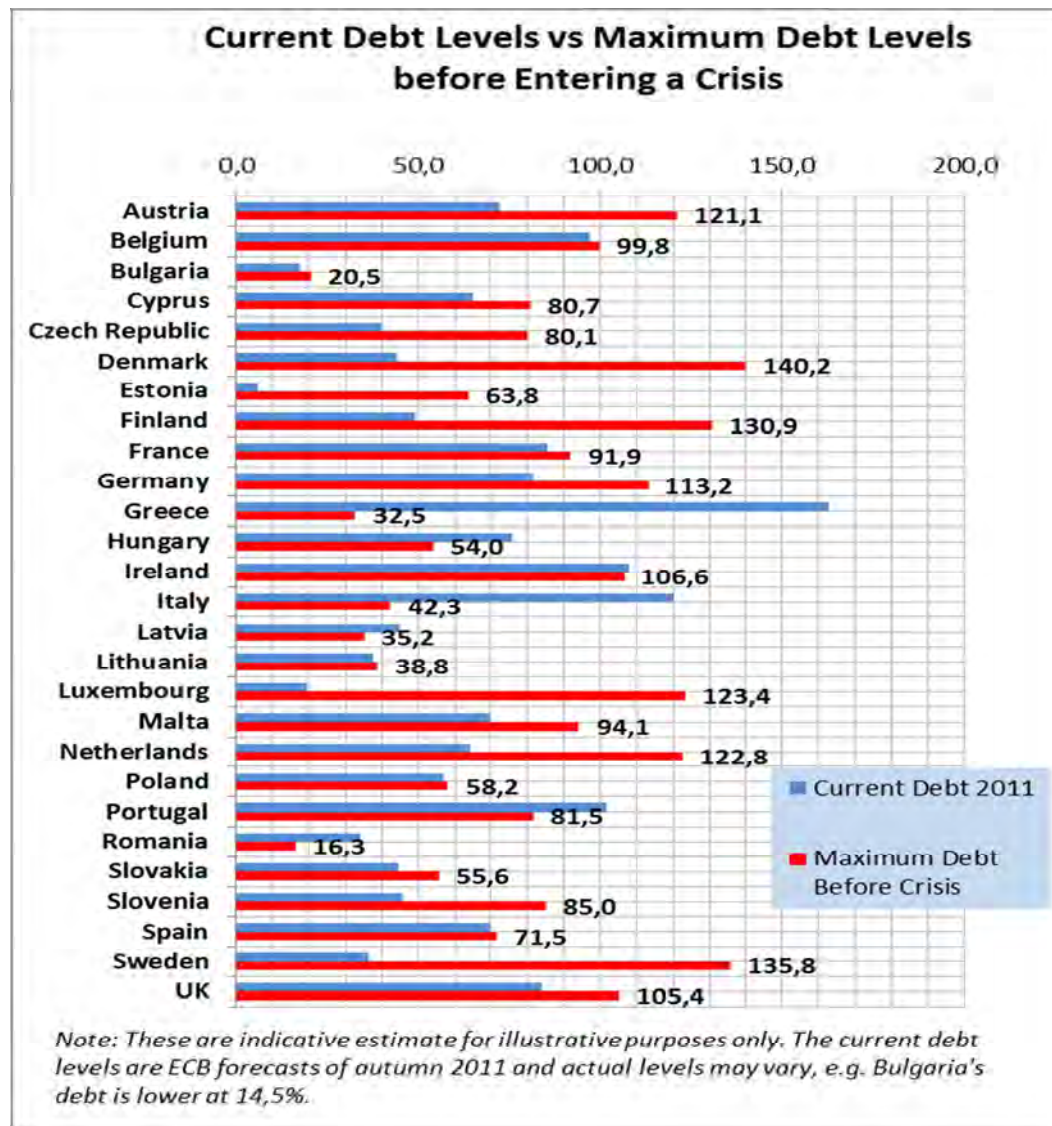
The estimates (with all reservations and precautions about the approach listed above) may be useful in indicating the ranking of countries at risk by their proximity – in terms of debt as % of GDP – to the danger zone. For example, Belgium is already a “borderline” case and it would only take a 2,6% increase of its current level of debt to increase the probability of the country entering the danger zone.



If another example is taken, if Bulgaria increases its forecasted 2011 debt by about 3%, it will be on the border of the danger zone. Thus, if Bulgaria does not improve its governance, it can tolerate about 20,5% public debt and after this point there is a higher probability that it will enter the danger zone. It should be noted, however, that the current model uses ECB forecasts for 2011, where Bulgaria has a public debt of 17,5% of GDP, but the actual debt may be lower, about 14,5%, making the country even less risky and providing more breathing space.

Alternatively, the approach can be used to identify which countries have better chances for recovery and how much they should reduce their debt levels by in order to enter a safer (yet not safe!) area.

The Distance to Break Points graph also very clearly outlines the sub-groups in terms of crisis risk. In the “safe zone” countries group, there are countries that can add some 80% to over 100% debt to its current levels before they join Greece and Italy, while other countries can take as little as 7% to 30–40% more debt before they start absorbing serious damages. For example, Germany, as strong as it is, can tolerate only slightly over 30% increase over its current debt before it risks a collapse. As it turns out, Spain, despite being considered in crisis, is slightly outside of the danger zone.



This approach also underlines the fact that countries with different levels of governance have different levels of debt tolerance. For example, Ireland can presumably tolerate high levels of debt because of its high governance score. Thus, Ireland may have about 106% of debt, while Greece should maintain about 32,5% of debt in order to be in a healthier condition.

The maximum debt levels before a country enters the danger zone of high probability of crisis are very telling. But these are not recommended levels of spending. Rather, they emphasize the differences between countries and that there is no universal yardstick of public debt – such as the 60% threshold accepted by the EU – and makes the case for country specific approaches instead of broad, “one size fits all” solutions.

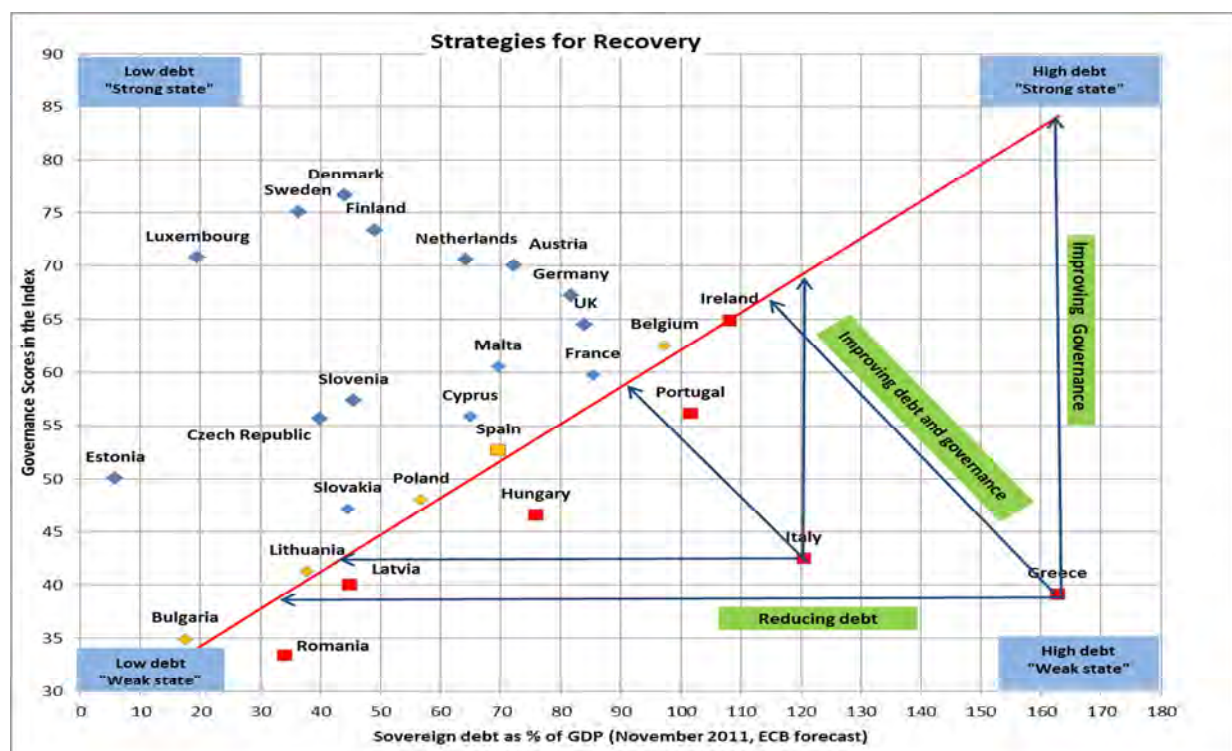
For example, some countries can tolerate higher levels of debt than countries considered in crisis – i.e. the UK’s debt is higher than Spain’s and can tolerate up to 105% until it gets into big trouble. The better governed countries in general have much higher debt ceilings, running up to 120–130% of GDP, hypothetically (these are not the advisable limits, unless someone wants to ruin a country). But countries with modest governance performance have their break point debt ceilings hovering at about 40–50% of GDP.

This assumption could certainly help shed more light on the crisis in Europe and on more inventive strategies to address it.

Reaching for a safer ground: how improving debt and governance can help

If sovereign debt and governance are related, then a country in trouble can improve its lot in three ways by following this model:

- First, by improving its governance;
- Second, by reducing its public debt, or
- Third, by improving both its debt situation and its governance.



Governance is arguably much more difficult to change in the short term as it involves complex institutional and societal changes. Debt reduction is also very difficult – in terms of social costs as seen by the protests and increased hardships that have greeted the current efforts in Europe – but still more achievable. The third way – of reducing the debt and, in parallel, improving the governance – sounds like the optimal path.

But the choice of reform path is specific for each state as it depends on the different ratios between its debt and governance. For example, if it has better governance scores but higher debt, then it should reduce its debt and vice versa. The countries with bad Governance scores and high debt should strive to improve both. In this case, there can be different proportions between debt and governance aimed at reaching the safe ground – so it might not be the perpendicular in the graph and can lean either way.

The target levels of change can be again roughly “guestimated” by looking at the projections of either debt reduction, improvement in governance or both. The results can help outline the better strategies for each of the countries (please, note that these estimates are indicative and for illustrative purposes only). In fact, the indicative results for Greece and Italy illustrate that they should take the middle path of working both on their debts and governance, as the other scenarios seem unrealistic. For example, Greece would have to increase its governance performance to about an 83 score in order to qualify – much better than the Nordics, for example. The third way will not be easy either – Greece should strive to reach Ireland’s position and exceed it – i.e. improving on Ireland’s good governance levels and its debt.

Italy, on its part, should aim to exceed Portugal and reach the position of France in order to contemplate better recovery options.

| Italy: Debt, Governance or Both? | | Target value | Metrics |
|--|------------|--------------|-------------|
| Improvement in Governance only | | 68 | Index score |
| Debt reduction only | | 43 | % of GDP |
| Equal improvement in debt and government | Governance | 58 | Index score |
| | Debt | 90 | % of GDP |
| <i>*These are approximate estimates for illustrative purposes.</i> | | | |

| Greece: Debt, Governance or Both? | | Target value | Metrics |
|--|------------|--------------|-------------|
| Improvement in Governance only | | 83 | Index score |
| Debt reduction only | | 32,5 | % of GDP |
| Equal improvement in debt and government | Governance | 67 | Index score |
| | Debt | 115 | % of GDP |
| <i>*These are approximate estimates for illustrative purposes.</i> | | | |

Tailoring recovery packages for Europe: Conclusions and Recommendations

The testing of the “debt vs governance” hypothesis has three very concrete implications:

- First, the debt ceiling of 60% of GDP of the Maastricht criteria cannot be a universal measure of identifying the dangerous levels of debt for each and every EU member states. The safe debt level ceilings seem to be country specific and depend on other factors too; in the case of the assumption on the governance. This means that the strategies for recovery or financial rules should also consider the individual debt levels that take into account the individual characteristics of the countries.
- Second, there should be no complacency. No country is immune to crisis even if its name is Germany – as seen in the graph, the economic engine and the last remaining hope of Europe (to add some drama to the numbers) is too close to the danger zone. Also, countries with low debt levels cannot be complacent – countries such as Bulgaria have very low debt levels, but their poor governance performance puts them near the danger zone.
- Third, the countries in the EU can change their lot in three ways. They can either change their level of debt or their level of governance or both at the same time. For example, Bulgaria can hardly afford much lower debt levels, so it should improve its governance while maintaining low debt. Countries like Germany have good Governance scores, but they should decrease their debt level in order to improve their situation. In the third case, debt and governance can be changed simultaneously. But proportions can vary depending on the capacity of the country and the understanding that governance is more difficult to change in the short term.

The distinctions based on the Index findings have outlined the variety of combinations between the dichotomies “high debt” and “low debt” on the one hand and “weak states” and “strong states” on the other hand.

Much of the discourse about the role of governance brings to mind the developmental paradigm usually applied to so-called “developing countries” – and not to the highly developed countries of the EU. But evidence suggests that governance matters and the EU members might have to go back to basics – measured by the high standards existing within the EU itself. Moreover, it is sort of ironic but true that the indebted EU members now are looking for countries dubbed as “developing”, such as China and Brazil, to come to their rescue.

Speaking about good governance, it would be inevitable to bring “democracy” performance to the mix, as there seems to be the high, direct correlations between democracy and governance among the EU member states (according to the forthcoming Catch-Up Index of OSI-Sofia, please see the note). So any good governance strategy should also encompass the level and quality of democracy – and take the necessary steps to improve them.

The “debt-governance” hypothesis and its initial findings lead to a rethinking of the prevailing assumptions about the “geography of the crisis” and the way the crisis is addressed, helping to illuminate the policy options for dealing with the crisis in Europe based on a diversified approach.

A few empirical observations to aid the design of recovery strategies

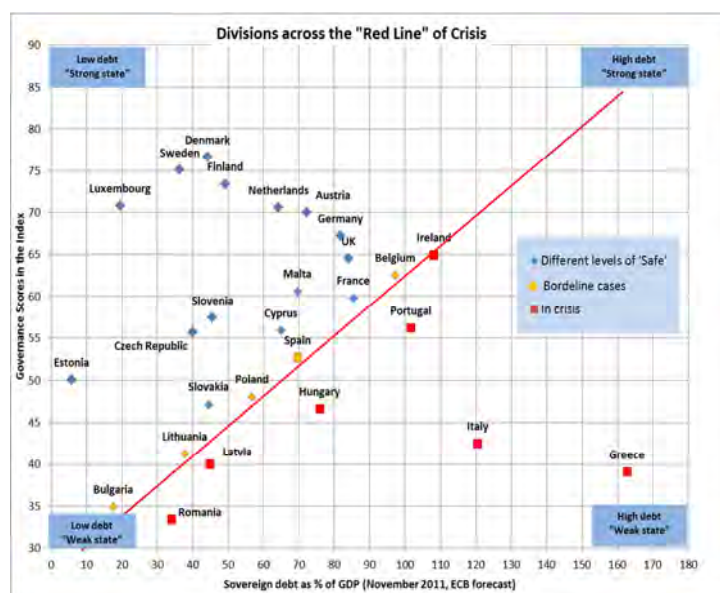
When developing recommendations, the assumption about the relationship of debt and governance in the EU should take into account other factors that were omitted from the model. These empirical observations should be considered in the “rescue packages” to address the European crisis.

The scatter plot that illustrates the debt vs governance relationship clearly shows that most of the new member states are not in deep crisis because of their low sovereign debts. Countries with some 34% to 45% (Romania and Latvia) are still considered endangered and Hungary with its less than 80% is already requesting new assistance. In their case, the threshold of a crisis situation is lower than the generally accepted 60% debt level.

Thus, the main barrier to spreading the crisis among these newer member states is their low level of public debt and the propensity of the population to accept fiscal limitations and the ensuing lower level of social security. However, if the crisis spreads to these countries too, it will have the most negative effect on their populations, which, even without a crisis, have significantly lower standards of living than the rest of Europe: the countries have much lower GDP levels and, in general, they do not have the safety cushions that their counterparts still have (though they've been diminishing too, it is far from the levels to the east).

At the same time, these countries have relatively low governance performance, so any strategy should also address this issue too (and check their democracy performance) – even as Estonia, which is a frontrunner on both indicators, is still falling behind the better developed countries. .

The South European countries are among the most affected by the crisis – or prone to a crisis should they make the wrong policy decisions. These countries share both higher levels of debt and lower levels of good governance, which explains their vulnerabilities. For example, the overcoming of the debt crisis in Italy and especially Greece could be obstructed by the relatively bad shape of their systems of governance, which are akin to those of some newer member states. The gravity of the situation in Greece even brought about discussions of Greece's exclusion from the Eurozone – or the EU, if necessary – and they were talking about an older and supposedly better integrated member state compared to newer members. Therefore, the risk of disintegration of a member state in case the situation deteriorates cannot be excluded.



Thus, the South and East of Europe retain the highest risk levels – in the case of the South because of its high debt levels and in the case of the East because the crisis has halted the catching-up process.

The North-West of Europe remains least exposed to risk because of the stable state of their governance institutions – nevertheless, many have high levels of debt, which may be even higher than some countries in crisis. Ireland is a proof, not a rebuttal, to the assumption of the Index. Even if Ireland is in a crisis and still has very high debt levels, it is performing well in governance – and we are witnessing that Ireland has much faster pace and scope of recovery than the countries that have lower governance performance.

A simple matrix for developing country specific rescue packages can be designed that has two dimensions: first, the groups of countries as defined to their proximity to the crisis and second, the specific ratio of problems along the governance/debt axis. The crisis map of Europe that has been visualized on the graph might easily help classify each country to a specific case – and a specific strategy.

In addition to that, there are ground rules – special conditions – that should be considered along with the recommendations elicited from the matrix:

| A Matrix for Developing Country-Specific Recovery Packages | | | |
|--|--|-----------------------------|-----------------------------|
| Priority problem Group | “Safe” countries | “Borderline” cases | “In crisis” |
| High debt | Maintain safe debts or reduce debts | Reduce debt | Reduce debt |
| Low governance | Improve governance | Improve governance | Improve governance |
| High debt and low governance | n.a. | Improve governance and debt | Improve governance and debt |
| Ground rule 1: | Developing country specific solutions: taking into account the specific characteristics of the countries – as country policies as well as on EU-wide measures. | | |
| Ground rule 2: | Seeking financial stability and prudent policies: Reasonable debt levels should go hand in hand with low deficit levels and financial stability measures. | | |
| Ground rule 3: | Social safety nets for the countries in need. If the country has lower quality of life, the rescue package should include also strengthening social safety nets. | | |
| Ground rule 4: | Keeping xenophobia at bay: The pressure of the crisis brings forth the issue of xenophobia and social exclusion. In the West, these are the immigrants (including EU co-nationals) targeted first, and in the East, the usual targets are the Roma. | | |
| Ground rule 5: | Keeping Europe open – i.e. an inclusive EU: This pertains to any EU master plan for getting out of the crisis. The new plans for reconstituting the Union might entail quite restrictive and closed door formats, along with the general isolationism of the more stable and affluent countries. This is a worrying trend. The EU should remain inclusive to all its members. | | |

When other possible factors are considered – such as economic potential and societal effects of the crisis – the following strategies for tackling the crisis can be identified for the different groups of countries:

In Western Europe – including also older member states in the South – the aid should be directed to saving the fiscal positions of the governments and the banks. Their populations will not be affected to the same extent as their counterparts in the East as the older member states still remain relatively affluent societies, despite the current bleak economic situation. However, poor economic prospects can help to enhance extremism and negative attitudes to immigrant communities that are not perceived as a homogenous part of society.

In the newer member states, efforts should be directed to strengthening the safety nets for the socially vulnerable groups. These countries should keep austerity policies either as the main means to prevent crisis or – if they are in crisis – as the main precondition for recovery. In any case, the austerity policies further limit the modest social security funds of these states and thus the crisis directly and painfully affects society. The EU should also increase the levels of structural and cohesion funds and ease the access of these countries to them in order to compensate for the stalled process of catching up.

The South European states have to decrease their higher levels of debt and increase the levels of good governance. In general, in the cases of the troubled South and East member states, the rescue plans have to be accompanied by programs and measures for the strengthening of democratic institutions and the principles of good governance.

In terms of the much talked about EU transformation, there could be marked differences between these groups of states. The differences in Europe are not simply between “low-debt” and “high-debt” countries, and Europe would hardly follow these lines if it changed its structure. If there is a transformation of Europe, as expected, the West and North-West countries have the advantage of higher cultural-historic homogeneity and higher levels of integration among themselves. This suggests that even in the case of economic crisis in some of these countries, they can rely on a stronger solidarity and support. They will thus be exposed to much lower risk of exclusion from any future institutional setups that may replace the current European Union as we know it.

Conversely, the countries outside of this “circle of trust” would still, in all probability, be considered periphery and other factors would trump the criteria for low debt or deficit levels. “Governance” will emerge as a pivotal yardstick for admission to this new “circle of trust”. Even though some countries may have low debt and deficit levels, if they lack sufficient good governance levels they’ll be out of the picture. Those that want to join the reconstitution of “a new EU” should be ready to prove their track record in good governance as the builders of a transformed EU are looking for greater similarity between countries across the board.

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About the Catch-Up Index

The findings in this policy brief are based on the forthcoming Catch Up Index – a project of the Open Society Institute – Sofia. (www.TheCatchUpIndex.eu).

About EuPI

The European Policy Initiative (EuPI) aims at stimulating and assisting new Member States from CEE to develop capacity for constructive co-authorship of common European policies at both government and civil society level. As a new priority area of the European Policies and Civic Participation Program of Open Society Institute – Sofia, EuPI will contribute to improving the capacity of new Member States to effectively impact common European policies through quality research, policy recommendations, networking and advocacy. The initiative operates in the ten new Member States from CEE through a network of experts and policy institutes.

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