

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY (IME CONFERENCE PROCEEDINGS, APRIL 1997)

Conference objective

IME aims at initiating a public debate on specific policies the new Parliament of Bulgaria should undertake to ensure economic stability and prosperity in a long run, assuming that a Currency Board regime will be introduced in June 1997.

Rationale

This is a historic moment for Bulgaria. Elections will take place on April, 19. April 18, is a day to stop the campaign. IME suggest thinking about economic policies that would enable growth and prosperity. Democrats have a fair chance to have a stable majority in the legislature. To date, the campaign has been focused on the immediate stabilisation policies and debates have been proceeding at rather general level. The IME conference highlights specific policies which would both support stabilisation efforts and improve Bulgaria's economic performance. We would like to hear comments on what we propose from Bulgarian politicians who would be entrusted to carry out reforms, from Western economic experts who have been advising Bulgarian and other governments, and from our colleagues from European emerging economies. We hope to gain a consensus on the most effective market based solutions for Bulgaria.

Agenda

10:00 a.m. - **Registration**

10:30 a.m. - 11:00 a.m.

Opening

Address from the President of Bulgaria, Mr. Peter Stoyanov
Mr. Stefan Sofianski, Prime Minister of Bulgaria, Opening Remarks

11:00 a.m. - 12:00 a.m.

Plenary

Economic Growth Factors in Emerging European Economies
What are Bulgarian Reforms Up To

Key Speakers: Ivan Kostov, Leader of the Democratic Coalition;
Alexander Bozhikov - Vice Prime Minister
Prof. Arye Hillman, Bar-Ilan University, Tel Aviv; President, European Public Choice Society
Prof. Marek Dabrowski, Vice-Chairman, CASE - Warsaw.
Dr. Richard Rahn, President, NOVECON
Dr. Michael Wyzan, Senior Economist, Open Media Research Institute

12 - 1 p.m.

Lunch

1 p.m. - 2:30 p.m.

Panel I

Structural Reform and Benefits of Rapid and Transparent Privatization

Key Speakers: Prof. Ilian Mihov, INSEAD
Prof. Marek Dabrowski, CASE

Domestic topics and speakers:

- Facilitate debt-equity swaps: Bradies and ZUNK's (bad debt bonds) - Rossen Rozenov (AECI) and Valentin Chavdarov (Capital Consult).
- Lifting restrictions to trade shares of the privatised enterprises - Lubomir Dimitrov (AECI)

Floor Discussion: Nevenka Cuckovic, IMO; Goran Pitic, EI&EF

2:30 p.m. - 3 p.m.

Coffee break

3 p.m. - 4:30 p.m.

Panel II

Economic Freedom, Investment Incentives and Growth

Key Speakers: Prof. Arye Hillman, Bar-Ilan University;
Dr. Richard Rahn, President, NOVECON

- Depreciation techniques - necessary amendments to the Profit Tax Law - Bozhdidar Dimitrov (Bulgarian Chamber of Commerce and Industry)
- Barriers to Free Enterprise - Dr. Krassen Stanchev (IME)

Floor Discussion: Slavica Penev, IIE; Bill Coletti;

4:30 p.m. - 6 p.m. **Panel III** ***Social Welfare Programs and Barriers to Growth: Lessons from
Developed and Emerging Economies***

Key Speakers: Dr. Michael Wyzan, Senior Economist, Open Media Research Institute
 Dr. Mieczyslaw Bak, President, Institute for Private Enterprise
 and Democracy, Warsaw

- Reduction of mandated benefits: costs and effects - Mariella Nenova, free lance consultant
- Separation of the pension and healthcare funds - Gabriella Stoyanova (AECD)
- Privatization of the pension and healthcare funds - Galina Petrova (AECD)

Floor Discussion: Jordan Christoskov; Todor Radev, Economics 2000

6 p.m. - 7 p.m. **Reception**

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

discussion paper

DEBT-EQUITY SWAPS

by Valentin Chavdarov, AECD

Government debt

The most important problem for the Bulgarian economy is the debt issue. Debt servicing absorbed almost 80% of the total budget expenditures. Large interest payments contribute to the huge budget deficit. The Bulgarian economy maintained a considerable primary surplus (deficit net of interest payments) since 1994. This indicates that non-interest expenditures are very restricted. There is no room to increase the primary surplus in order to reduce the total deficit. The only way to reduce budget deficit and inflationary pressure. is through more effective debt management

Table 1: Government debt at the end of period /bln BGL/

	31.12.95	31.12.96	28.02.97
Long-term component	260.2	828.1	2427.2
Short term component	85.2	224.7	350.3
Total	345.4	1,052.8	2,777.5

The debt burden increased more than eight times since the end of 1995. There were two important factors which contributed to this fact. First, the budget deficit financing practice. About 90% of the budget deficit has been financed by means of government bonds. The State Savings Bank and commercial banks bought the bigger part of the bonds. The balance sheets of the banks consisted primarily of short term liabilities and a lot of non-performing assets. For that reason banks demanded short term bonds with high yield. 90% of the government securities, issued in 1996, were short term. The second factor for debt increase was the soft budget constraints. The banks and non-financial enterprises continued operating under soft budget constraints and accumulated losses. In order to reduce quasi-fiscal deficits in the economy the government issued the so called ZUNK bonds which covered non-performing bank credits granted up to 1990.

The operation improved balance sheets of the enterprises and induced a higher level economic activity. The economy registered a small real growth in 1994. But the situation of the banks did not improved. They received assets which, according to the Bulgarian accounting standards, were recording in their balance sheets at nominal value. The banking system registered an "accounting profit" and paid real money as profit tax to the budget. The net result for the budget was positive. But households suffered most of all. The ZUNKs did not improved the liquidity of the banking system and did not protect their savings through establishing sound financial discipline. In the second half of 1995 the banking crisis became evident. First Private Bank was declared insolvent and a lot of people lost their savings. In its effort to calm down depositors, the Parliament passed the State Protection of Deposits & Accounts Act. According to the Law the budget accepted the liabilities of non-viable banks to the depositors.

In other words, the economic policy after 1994 was a story of shifting liabilities from enterprises and banks to the budget and increasing government debt. Now it is obvious that monetisation is the only way to service government debt. The huge monetisation at the end of 1996 was one of the reasons for the high inflation rate in 1997. The debt-equity swaps are the only way to service government debt in a non-inflationary way.

ZUNK bonds

The ZUNK bonds are 25 years government securities, issued to cover non-performing credits, granted by banks to enterprises up to the 1990. There are two types of ZUNK bonds: denominated in BGL and denominated in USD. The Bulgarian leva ZUNKs amounted to 23 bln Dollar ZUNKs amounted to 1.8 bln USD.

ZUNKs pay interest twice a year. The yield of the BGL denominated ones is equal to 1/3 of the primary interest rate in the first two years, 1/2 of primary interest in the third and fourth years, 2/3 of primary interest in the fifth and sixth years, and primary interest rate during the remaining years up to the maturity date. ZUNKs, denominated in USD pay six months LIBOR. Both kinds of ZUNKs pay principal after fifth year in twenty equal installments and are eligible for privatisation.

The Government tried to regulate ZUNK prices through restrictions on both minimal price level and privatization eligibility of the bonds. The result was a very underdeveloped ZUNK market. There are no daily bid and ask quotations and many foreign investors have no information about the possibilities that they offer.

There is no need to impose administrative restrictions on ZUNKs. The return on ZUNKs closely correlates with the return on BRADYs. No portfolio investor will buy ZUNKs at a price which give him a lower return than BRADY bonds. No strategic investor will use ZUNKs in privatisation deals if BRADYs are more favorable.

The other important factor for the underdeveloped ZUNK market is the lack of stock exchange for SOEs. The Privatisation Agency and branch ministries are authorized to sell state owned assets. The privatization process is rather unclear and the price of the capital is determined by a very limited number of sellers and buyers.

Recently the Government used ZUNK bonds to recapitalise the banking system. There were several schemes for banks' recapitalisation by means of redistributing the outstanding ZUNKs among state-owned banks. These schemes proved very inefficient. The banking system is not healthier than before the schemes' utilization. The effect on the budget was negative because of the decreased profit tax revenue from Bulbank and the transformation of long term debt into short term. The most badly affected were the households again because higher inflation tax reduced the purchasing power of their savings.

The point is to reduce the debt burden rather than to redistribute it. A modern stock exchange and simple privatization procedures are more relevant steps toward non-inflationary debt servicing rather than debt redistribution among state-owned banks. This is not recapitalisation but decapitalisation because the high inflation rate sharply decreased the value of capital stock in the economy.

Sofia, April 1997

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

discussion paper

ACCELERATING PRIVATISATION THROUGH THE USE OF BULGARIA'S EXTERNAL DEBT BONDS

by Rossen Rozenov, AECD

Bulgaria is lagging far behind the other Central and East European countries with regard to the privatised state property. Five years after the Law on Privatisation was passed by the Parliament, only 5% of the state assets have been privatised. After the last auction of the voucher privatisation this share is expected to rise to some 20% but still the majority of the enterprises will be state-owned.

The reasons for the poor performance will not be discussed here since there has been considerable debate on this topic recently. The purpose of this paper is rather to propose specific policy actions to accelerate the privatisation process. One of the means to achieve a faster change of ownership is to use external debt bonds.

I. Development of the Debt-Equity Swaps

Privatisation through Brady bonds is a sub-set of a broader set that encompasses various forms of debt-equity swaps. In the general case of debt-equity swaps the procedure is the following: A bank sells at a discount an outstanding loan extended to a country that has problems in servicing its liabilities. A private investor buys the debt paper and presents it later to the central bank of the indebted country. The central bank redeems the paper at certain exchange rate and the investor uses the money to purchase equity.

Historically the development of the debt-equity swaps began after the debt crisis of 1982 although several cases of similar transactions were recorded earlier. Many Latin American countries recognised the opportunity to deal with the debt problem and adopted relevant legislation. Brazil was the first to implement a conversion scheme, followed by Argentina, Chile, Philippines, Venezuela, Mexico and others.

The fast development of a secondary debt market facilitated to a large extent the process since loans had market value and the creditor banks could use the secondary market value to determine the discount at which to sell the loan. With the growing number of debt-equity swaps the rules and the regulations underwent major changes. The practice to allocate conversion rights and to set redemption prices through government decrees was gradually replaced by a more competitive approach based on auction systems. Some financial innovations were introduced in the late eighties like debt for trade swaps (Yugoslavia) and debt for conservation swaps (Costa Rica).

According to the definition provided above debt-equity swaps involve the participation of at least three parties: a creditor, a debtor and an investor. These parties have different interests and therefore each of them tries to obtain as much concession as possible from the others.

II. Advantages and Disadvantages for the Participants

The benefits for the creditor bank are usually associated with an improvement of the liquidity position. The outstanding loans to highly indebted countries are provisioned against losses and thus by selling a loan, the bank can invest the freed resources in more profitable assets. Banks also would prefer to diversify their loan portfolios and reduce the credit exposure that could become very high later. This is because many rescheduling agreements required new loans to finance the adjustment programs of the debtors. Since those new loans were usually extended by the creditor banks their country exposure increased. For the same reason banks often engaged in asset trading which sometimes preceded debt-equity swaps.

It is generally believed that the gains for the debtor country arise from the reduction of the debt stock. In order to avoid confusion it is essential to point out that what really matters for the debtor country is the **net** impact of the debt-equity swap on the domestic economy. For that purpose the most convenient tool to evaluate the effects of a swap appears to be the balance of payments analytical framework.

In the simple case where the redemption value is equal to the face value of the loan, the decrease in external liabilities is matched exactly by an increase in the foreign direct investment so that the foreign assets remain unchanged. The analysis becomes a little bit more complicated when the redemption price differs from the face value. The difference between the decrease in foreign liabilities and the increase in the foreign direct investment is recorded as realised capital gain. The above examples are based on the assumption that the discount value of the debt is at least equal to the redemption value. (If the reverse holds true, the investor will refuse to engage in the transaction.) Thus from the viewpoint of the net external position of a country the debt-equity swap is nothing but an exchange of one type of obligation for another. However, an important difference occurs when we consider the problem in dynamics, that is how the transaction will influence the current account of the balance of payments. In order to determine the net effect we have to compare the scheduled debt service with the factor payments associated with the investment. If the income transferred abroad is greater than the interest payments on the loan the outcome will be a deterioration of the current account and ultimately a decline in the foreign exchange reserves. In the long run there are some important benefits that can arise from positive externalities. Since the investors that buy the equity are often multinational companies, the economy benefits from the technological innovation. The purchase of equity is usually associated with additional investments which have a positive influence on the capital account of the balance of payments and increase the availability of foreign exchange.

The advantages for the investing company derive from the opportunity to buy property at terms more favourable than the company would get if it proceeds in the traditional way. Depending on the specific legislation of the debtor country, and the secondary debt market dynamics, the discounts can be quite significant.

Although debt-equity swaps can be beneficial in some respects to all the parties involved, certain problems can occur as well.

Banks might face difficulties in complying with accounting standards and local regulations.

The impact of the debt-equity swaps on the economy of the debtor country is often being assessed in relation to monetary policy. If the government and the central bank as its agent issue money when redeeming the paper, inflation may accelerate.

From the investor's perspective, the gains from the transaction may be offset by the restrictions on debt conversion operations that some of the countries introduce. Although these restrictions differ in the details they can be classified in three main groups: (1) control on repatriation of income and capital, (2) ceilings for payments with debt instruments, and (3) industry requirements. The majority of countries that engage in debt-equity swaps transactions impose some of the above mentioned limitations.

III. Country Experience

Argentina was among those countries that first passed regulations for debt conversion operations as part of a rescheduling package. According to the scheme adopted in 1984 the eligible debt was transformed into promissory notes which could be used for purchasing equity. Later the regulation was changed in a way that reduced the benefit to the investor. He was not allowed to pay with debt instruments more than 50% of the value of the investment. This requirement reflected the rising concerns of the local authorities that debt-equity swaps displace the inflows of fresh money that would have occurred otherwise.

In 1987 again the scheme was revised and the proportion of debt to fresh money was increased to 70/30 percent. Argentine's legislation imposed also limitations on repatriation of income (4 years) and capital (10 years).

Similar to the Argentinean case, in Brazil the repatriation of capital was banned for 12 years while dividends generated by the investment could be transferred freely abroad but only if they did not exceed 12% of the registered capital. In addition, foreign investors were not allowed to take control over local firms through debt equity swaps.

Jamaica's approach to debt-equity swaps provides an example of sector specific conversion scheme. In compliance with the debt capitalisation program of 1987 the Bank of Jamaica determined the "priority areas" for which investors could apply. Some of the preferred activities were construction of hotels and factories, and production or processing of export goods. The amount of the eligible debt under this program was 500 mln US dollars and the government's intention was to achieve 50% reduction of the debt stock in five years. In order to provide additional incentives to investors to engage in particular businesses, the Central bank charged different commission fees for the different projects.

The last case that will be reviewed is Mexico's debt conversion program. The experience of Mexico is relevant to our discussion because it is the first country that accomplished debt restructuring under the Brady initiative. In the general case of a debt-equity swap we assume that the creditor bank wants for some reason to dispose of a loan by selling it to an investor. Though the analytical framework presented above did not envisage explicitly the conversion of Brady bonds into equity, the same consideration is valid. The new conversion program of Mexico, enforced after the Brady deal, limited the scope of the debt-equity swaps only to purchase of state-owned companies and participation in infrastructure projects. The debt instruments that could be used in privatisation were discount bonds and par bonds. Up to 50% of the value of the investment could be paid with Brady bonds. The swap mechanism was based on auctions. Discount bonds could be converted at face value while the conversion rate for the PAR bonds was no more than 65% of the face value.

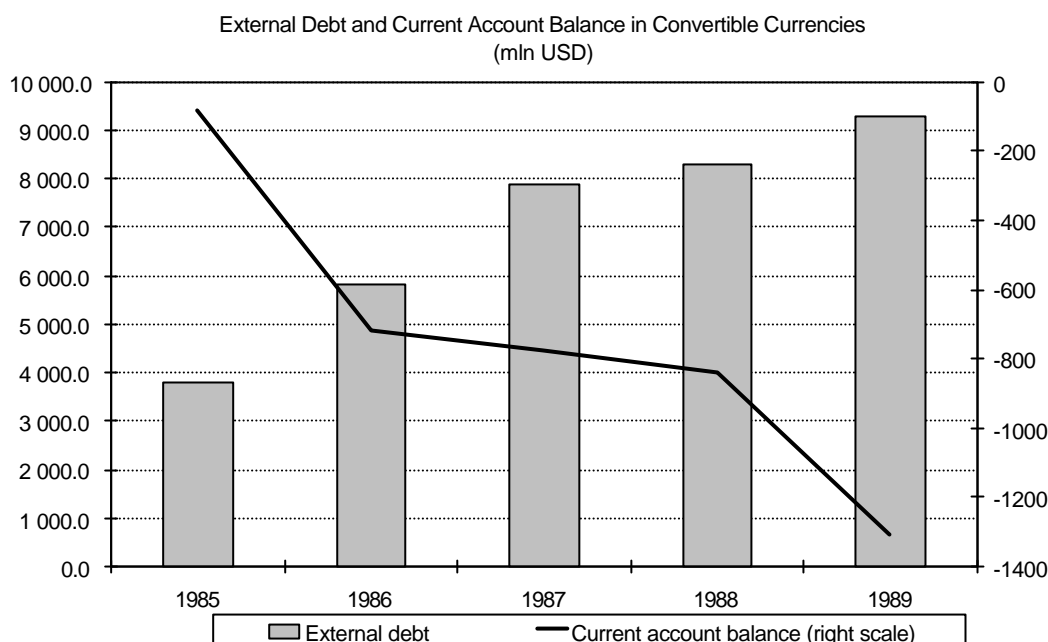
IV. Restructuring of Bulgaria's External Debt

In the period 1985-1989 Bulgaria recorded a growing deficit in its convertible currency trade. Two factors contributed most to the deterioration of the trade balance in the second half of the eighties. These are the decreased supply of Soviet oil which was previously re-exported to the OECD and developing countries, and the loss of competitiveness in the manufacturing sector.

The serious current account problems coupled with an ambitious investment program forced Bulgaria to borrow heavily from the international markets. As a result the external debt rose to 9.2 billion USD in 1989, or 272% of all exports of GNFS¹.

Chart 1.

¹IMF and World Bank staff estimates.



Source: World Bank Tables, IMF and World Bank staff estimates

In March 1990 the Bulgarian government announced a moratorium on the principal repayment after the foreign exchange reserves were depleted. It took more than three years of negotiations to come to an agreement with the foreign creditors. The deal with the London Club was finalised in July 1994 and Bulgaria resumed the debt service in accordance with the adopted plan.

The Bulgarian Brady deal covers the total amount of 8.13 billion of US dollars outstanding debt of which 6.11 bln USD principal and 2.02 bln USD interest overdue. About 300 foreign creditor banks joined the London Club. Russian banks and the National Bank of Poland which together held some 540 mln. USD of Bulgarian debt decided to arrange their claims on a bilateral basis and did not participate in the restructuring agreement.

The total debt and debt service reduction operation costs are estimated at 740 mln. USD. These include:

- 257 mln. USD for the buyback of 1.02 bln USD of debt at price 25.19% of the face value
- 219 mln. USD for the purchase of 30-year US Treasury bonds that serve as a collateral of the newly issued bonds
- 170 mln. USD for the purchase of US Treasury bonds maturing in 1995 which cover the interest payments for 1995.

The overall debt reduction of 36.8% placed the Bulgarian Brady deal among the most favourable ones achieved by debtor countries. After the restructuring the amount of the outstanding debt is 9.1 bln USD of which 5.1 bln USD to holders of Brady bonds.

Three debt instruments were issued under the agreement with the private creditors: (1) collateralised discount bonds (DISCs), (2) front loaded interest reduction bonds (FLIRBs), and (3) interest arrears bonds (IABs). Table 1 summarises the main characteristics of these bonds.

Table 1.

	Discount Bonds	FLIRBs	IABs
Date of the issue	July 28, 1994	July 28, 1994	July 28, 1994
Maturity date	July 28, 2024	July 28, 2012	July 28, 2011
Nominal value of the issue:	1 865 mln.USD	1 658 mln. USD	1 615 mln. USD
Interest rate			6-month LIBOR

Issue A*	6-month LIBOR + 13/16%	Years 1-2 -- 2% 3-4 --2.25% 5 --2.5% 6 --2.75% 7 -- 3% 8- 18 --6-month LIBOR + 13/16	+ 13/16%
Issue B**	6-month LIBOR +15/16%	the rate for issue A + 0.5%	
Interest payments	Semi-annual	Semi-annual	Semi-annual
Collateral of the principal	Zero coupon US Treasury bonds	Zero coupon US Treasury bonds	-
Amortisation	One time repayment at maturity	8 years grace period followed by 21 semi-annual installments	7 years grace period followed by 21 semi-annual installments
Face value of a single bond	250 Th. USD	250 Th. USD	250 Th. USD

* Includes bonds that replaced medium and long-term debt and 70% of the short-term debt

** Includes bonds that replaced the remaining 30% of the short-term debt

V. Debt Conversion Activities in Bulgaria

The legal foundations of the debt-equity swaps in Bulgaria were laid by Regulation No. 278 of the Council of Ministers approved on November 26, 1994. This government's act practically enforced what already had been agreed in principle with the creditors under the terms of the London Club deal . The regulation respects the important principle of non-discrimination so that any holder of eligible bonds, irrespective of nationality, can participate in the privatisation through debt conversion.

Only two out of the three instruments issued after the restructuring of Bulgaria's foreign debt can be used in privatisation. These are the discount bonds and the front loaded interest reduction bonds. Discount bonds are exchanged for equity at face value and FLIRBs at 50% of their face value. (The different treatment creates a strong bias in favour of the DISCs since their current market price is about 60c per dollar while the price of the FLIRBs is 43c per dollar par value. A possible explanation for such an approach, which violates the principle of neutrality between the different instruments, is connected with the fact that at the time when Regulation 278 was prepared the FLIRBs were twice less expensive than the DISCs. The authorities did not take into account the fact that the relative price of the FLIRBs was likely to rise with the increase of the interest rate in compliance with the debt servicing schedule.)

The leva value of the bonds is determined by multiplying the dollar value by the average central bank exchange rate for the six month period preceding the date of the privatisation contract. The backward looking approach was adopted because of the high volatility of the Bulgarian foreign exchange market. Clearly, when the exchange rate is appreciating investors lose value in leva compared to the situation when the bond is converted at the prevailing rate when the deal is made.

Regulation 278 in its initial form did not contain clauses imposing restrictions of the kind that is often encountered in other countries' debt conversion programs. There were only several cases where Brady bonds could not be used: (1) in privatisation of municipal property, (2) as a means of payment when there is a direct sale of shares, and (3) to cover penalties for breach of privatisation contracts, taxes, fees and other claims of the state.

Later however, when the socialist government that took office in the beginning of 1995, the conversion regime was revised in a way that discouraged investors to engage in debt-equity swap transactions. According to the amendments in Regulation 278 the investor must take the obligation not to repatriate income generated by the investment for 4 years and capital for 10 years and the privatisation authority cannot accept payments with Brady bonds exceeding 50% of the value of the transaction.

There is enough evidence that the introduction of a debt-equity swaps program gave an impetus to the privatisation process at the beginning. Some of the biggest privatisation deals were paid for with Brady bonds. It should be stressed that the most significant transactions took place before the restrictions on repatriation and payments were imposed.

VI. Policy Recommendations

Bulgaria is preparing for the introduction of a currency board by the middle of 1997. The currency board is expected to ensure a stable macroeconomic environment which is essential for the revival of economic activities. However, no stabilisation program, no matter how strong it may be, is likely to be successful unless it is accompanied by fiscal and real sector restructuring. The Bulgarian experience of the last two years is an outstanding example in this respect.

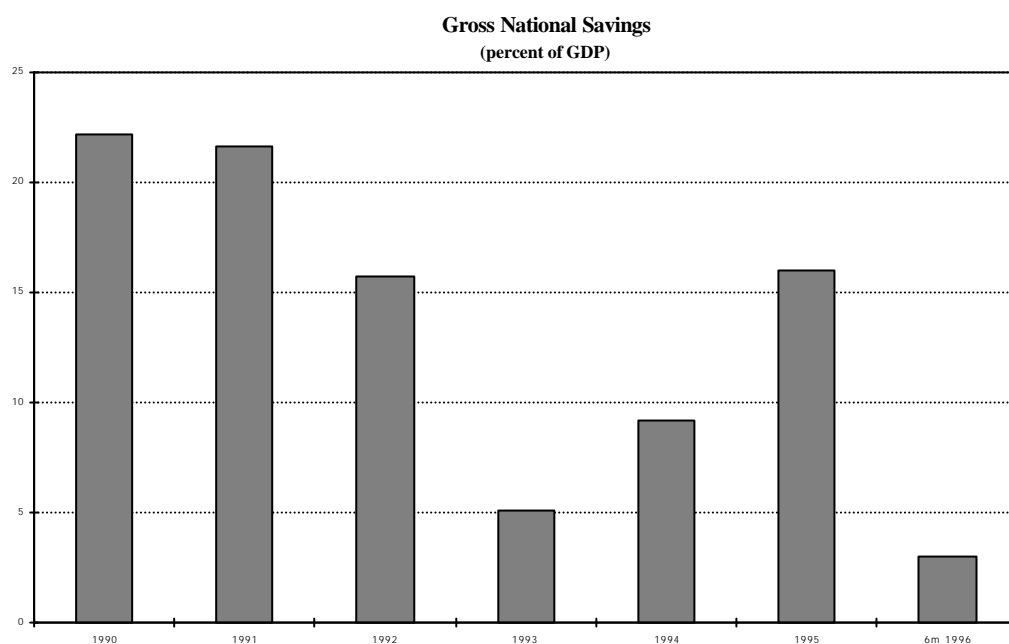
The approach to economic reforms of the former socialist countries has shown that restructuring should follow privatisation. Restructuring will hardly occur under state control of the property, or if it does, it will not be market based and could increase distortions and inefficiencies instead of abolishing them. Therefore, in order to ensure the sustainability of the currency board a massive transformation of ownership must be accomplished.

The interim government that was appointed in February declared its strong commitment to fast and transparent privatisation.

There is no doubt that supply is important but it is only one side of the market. It is equally important to have sufficient demand to match the supply. This is the key point that must be stressed upon. While the supply is entirely under the control of the authorities, the government can do very little about demand. Still it can facilitate the access to privatisation by implementing the proper policies.

The first thing that needs to be achieved is to regain the confidence of the economic agents through a strong stabilisation program. Investors, both domestic and foreign, should be convinced not to exercise the so-called "waiting option" but rather to invest their money in productive capital. But this is only the "macro" part of the story. On micro level, even though many Bulgarian investors are willing to take part in privatisation they may not be able to do so because of the shortage of resources. The recent economic developments have led to a severe reduction of the savings.

Chart 2



Source: NSI, BNB, Author's calculations

The debt-equity swaps provide a good opportunity to acquire equity cheaper as compared to a 100% cash payment. If the low level of gross national savings is taken into consideration, the clause which limits payments in Brady bonds to 50% of the value of the investment is irrelevant to the current economic situation and should be discontinued. It has to be mentioned that the legislation allows the remaining 50% to be paid in domestic debt bonds. The Privatisation Agency however has the authority to require cash payment. (This was done in 1996 but later was abandoned.) The best approach to the issue would be to restore the previous regime and leave investors to decide what combination of instruments to choose. If there are a lot of bids for a particular enterprise, the Privatisation Agency can organise auctions and choose the best terms. This will make the process transparent.

The restrictions on repatriation of income and capital are not unusual in the practice of the developing countries. Unlike the Latin America countries which enjoy enough interest from the part of foreign investors, Bulgaria faces difficulties in attracting capital from abroad. Maintaining the present regulations is counterproductive since the country risk is still high and investors require trustworthy guarantees that they will be able to get their money back.

Direct investments are essential in the restructuring period especially when the internal sources of the economy are insufficient to carry out the necessary reforms. Foreign investors often choose export-oriented industries which helps the country to improve the trade balance. The gains from the enhanced export performance can offset the outflow of income and thus the overall effect for the balance of payments will be positive.

There are a number of indirect benefits to the economy arising from the direct foreign investment like increase in employment and in the tax base. The technological innovation and better management practices that are usually associated with new investments can significantly increase the factor productivity and restore economic growth.

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Sofia, April 1997

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

discussion paper

IMPROVEMENT OF THE MASS PRIVATIZATION LEGISLATION

by Lubomir Dimitrov, AECD

The success of the governmental stabilization program depends mainly on the rapid restructuring of the ownership in the real and the bank sectors, including the mechanisms of the mass privatization. Thus, the acceleration of this process is very importance for achieving a consequent sustainable economic growth.

This presentation attempts to review in brief the progress of the mass privatization process in Bulgaria and to propose some necessary legislation amendments that will facilitate the free trade of shares. Such amendments are:

- removing the ban on acquiring more than 34% of the assets of a privatized enterprise;
- removing the ban on the free trade with the acquired shares in the first 6 months after the last auction session.

The progress in the mass privatization process: the Bulgarian experience

Until now the progress in the mass privatization process in Bulgaria may be characterized as extremely slow, overregulated and with low transparency. The Privatization Law was adopted by the National Assembly in April 1992, while the necessary amendments in this law, setting the main rules for the implementation of the mass privatization campaign, were adopted not before June 1994. One more year was needed to elaborate and pass the Mass Privatization Program (October 1995), defining the list of enterprises and the share of their equity capital to be privatized, as well as the terms of the campaign. In the period December 1995 - April 1997 other normative acts concerning the mass privatization were adopted (the Rules on the Mass Privatization Campaign, the Law on Privatization Funds, etc.). Until now the first two auctions have taken place. The third auction is to take place by September 1997.

Practically, the first wave of the mass privatization will need at least five years and a half, or 65 months, to be accomplished. This very prolonged period eliminates one of the main advantages of the mass privatization - the rapidity with which state enterprises are being sold. An example may be given with the implementation of the mass privatization in the former Czechoslovakia, which model was to a great extent applied in Bulgaria. The first wave of the mass privatization process in Czechoslovakia was carried out for only 14 months, including the registration of the participants, the licensing of the privatization funds and the carrying out of the 5 bidding rounds. Thus, on average, one large and three medium-sized enterprises were privatized per day in this period, which undoubtedly is a significant achievement. From the very beginning of the privatization in 1993 (the sale of "Carevichni produkti" - Razgrad) till February 1997, 5430 Bulgarian enterprises were privatized, but these were mainly small municipal companies.

The other main advantage of the mass privatization, namely its large scale, was also eliminated,. In the Czech Republic about 40% of the state-owned fixed assets were privatized through the mass privatization, while in Bulgaria this number is about 20% of the state-owned fixed assets. The intention of the interim government (and probably of the next one) is to accelerate the privatization process and to privatize till the end of 1997 about 40% of the of the state-owned fixed assets. This could be achieved through two ways: selling more big stakes of large state-owned firms (but this requires a relatively longer period), and accelerating and expanding the mass privatization process.

The implementation of the mass privatization campaign has been inadequate so far despite its long preparation. Only about 45% of the citizens, eligible to participate in the voucher scheme, bought

privatization vouchers. The fee for these vouchers was only about 6% of the average monthly wage in the first quarter of 1996. In the former Czechoslovakia about 80% of the citizens, eligible to participate in the mass privatization, paid registration fees which were equal to about 25% of the average monthly wage in the country.

The reasons for the failure of the registration campaign are: 1) the crash of the financial pyramids in the summer of 1995. Most of the people related it to the mass privatization process; 2) the undeveloped capital market. Practically, until now the people have not shown significant interest in investing in corporate securities. The stock exchanges failed to lay the beginning of the capital market in Bulgaria. This was mainly due to the inactivity of the state authorities which did not pass the necessary legislation and did not license the players on the capital market; 3) the delayed licensing of the privatization funds. They had to carry out the advertising campaign of the mass privatization. The best of them was licensed shortly before the end of the registration period.

The acceleration of the mass privatization depends mainly on the readiness of the government to reduce the period for the implementation of the process and to expand the range of the assets to be privatized. However, some new amendments in the existing legislation are needed.

Removing the ban on acquiring more than 34% of the assets of the privatized enterprises

The privatization funds cannot acquire more than 34% of the assets in one company under article 30, paragraph 1 of the Law on the Privatization Funds.

It is hard to judge what stood behind this decision of the legislative power. One of the possible motives may have been the prevention of the privatization funds from acquiring majority stakes in the firms. Probably, there were fears that the founders of some funds would try to initiate their artificial failure and to transfer the assets to related companies. This argument is not justified. Moreover, the restriction threatens the success of the privatization process.

The main argument of the opponents of the mass privatization is that it does not improve the efficiency of production. First, the fragmentation of the companies' capital may cause inefficient control over the activities of the privatized enterprises, especially when the key shareholders do not have the necessary skills to manage the firms in a competitive environment (this is most likely in cases of management-employee buy-outs). Second, the fragmentation of the capital may reduce the abilities of the key investors to take decisions, which will complicate solving the main problems of the privatized enterprises in the post-privatization period, such as undercapitalization; large liabilities to banks, deliverers, state budget and employees; out-of-date technologies and equipment; poor management.

The ban on acquiring more than 34% of the shares in one firm not only does not remove the main deficiencies of the mass privatization, but even reinforces them. Moreover, we should have in mind the notorious order of the Ministry of Industry, according to which the main decisions about the management of the post-privatized enterprises may be blocked by the residual stake of the state (in some cases 10%). This order aims at keeping the state influence in companies that are over 50% private.

The privatization funds were really restricted by this ban in their participation in the first auction. They bade far above the minimum acceptable prices. As a result, about 68% of the vouchers were used for the privatization of 41% of the offered assets on the first bidding round. One of the reasons for this are the undervalued fixed assets, because of the prolongation of the period between the inventory of the assets and the first auction. The second reason is that the privatization funds most probably strove to acquire the maximum allowed stake of shares in particular firms. Thus, they were forced to offer relatively higher prices.

Many of the firms whose shares were entirely sold on the first auction have been a strong competitive target for the funds. Some of the companies with the highest biddings are: “Leyar Complect” - Sofia, where PF “Doverie” and PF “Petrol Invest” have acquired the maximum allowed stake of 34% of the capital; “Unipac” - Pavlikeni, where few privatization funds bought almost all offered stake (67%) - PF “Severcoop Gumza” (26%), PF “Neftochim Invest” (25%), “Central Privatization Fund” (8.75%); “Lead-Zinc Complex” Kurdjali, where the minority stake (25%) was distributed between 4 privatization funds, etc.

According to the data about the participation of 57 privatization funds in the first auction session (the total number of the funds is 81), in about 30% of their approved offers they have acquired more than 30% of the capital in the companies. This indicator may underestimate the real efforts of the privatization funds to acquire the maximum allowed stakes because:

- 1) many of the firms (especially the largest ones, which are most attractive for the investors) are included in the mass privatization program with minority (25% or 60%) stake. Thus, acquiring a 34% stake is a very difficult or impossible task for the privatization funds;
- 2) the privatization funds have an opportunity to increase their stakes on the second auction, when the residual shares will have lower acceptable prices;
- 3) some of the privatization funds are established to participate in the mass privatization of particular firms which commonly have low offered stakes. Such examples are: PF “Slunchev bryag”, PF “Nicotiana”, to some extent PF “Multigroupelite”, etc. In all cases, the stakes, acquired through the mass privatization process, are below 20%;
- 4) co-operation between two or more privatization funds. Thus, although each of the privatization funds has acquired below 30% of the shares of a particular company, they hold together a stake of the capital which exceeds 30% and even 50%. A typical example in this respect is the co-operation between PF “Semeen” and PF “Industrialen”. which made offers for the same companies.

It may be concluded that the privatization funds have been striving to acquire the maximum stake of the capital in many companies. The privatization funds, which are an exception from such a behaviour, are PF “Akcioner Favorite”, PF “Bulgaria” and PF “Golden lev”. If the ban is not removed soon, there are two ways for evading it: 1) co-operation between the privatization funds. Such attempts are already observed; 2) acquiring shares of other privatization funds, joint or merger of privatization funds.

Removing of the ban on the sales of shares 6 months after the tenders

The shares acquired on the mass privatization auctions may be transferred only after publishing of the first balance sheet of the privatized company but not earlier than 6 months after the end of the last central auction session, according to article 51a of the Privatization Law. Thus, the acquired shares of the privatized firms may not be traded before early 1998, under the present schedule. If the restriction in article 51a of the Privatization Law is removed, the shares can be traded after mid-1997.

The hypothetical motive of the legislator was the desire to avoid the extra-supply of the shares of privatized firms immediately after their acquiring, which could cause a sharp decrease of their prices, and hence the undervaluation of the shares of many enterprises. This would favor the big investors with large investment potential. However, the delay in the free trade of the privatized shares can not cope with this problem but can only postpone it with some months.

The earlier start of the trade with the acquired shares would have a great impact on the development of the capital market in Bulgaria. The Bulgarian Stock Exchange practically stopped its activities in the end of 1995. The appearance of many small investors is an important condition for its successful future

development. The interest in the trade with the shares from the mass privatization, as well as with the preferential shares for the employees will result in interest in the overall trade of corporate securities. This will enable other companies (state or private), not included in the privatization process, to use this source of financing their activities. Until now, the sources of additional funds for the firms are commercial banks and other companies. The citizens may consider the corporate securities to be an attractive way to invest their savings.

The permission of free trade immediately after the balance sheet of the privatized firm is published will allow the large investors to consolidate their stakes as soon as possible. It may contribute to the improvement of the control and management of these enterprises in the post-privatization period which will remove the main deficiency of the mass privatization.

The delay in the free trade of shares will also have a negative psychological impact. The small investors (the citizens) will continue to consider the acquired shares of enterprises or privatization funds more as vouchers (papers with unclear economic characteristics) than as real securities. They will consider the mass privatization more as a game, than as a real process of property transition. At present, the main attractiveness of the vouchers for the people is their liquidity, but not the expected increase of their profitability in the further period. An indicator for that is the sales of voucher cards (despite the illegality of these transactions) for prices which exceed considerably the value of the registration fee. If the ban will be held, the shares will remain non-liquid for a long time and it will decrease the interest of the citizens in the whole privatization process. In the last, the main goal of the mass privatization is the privatization, in itself, but not its mass or the idea of equitable distribution of state property.

There is an existing opinion that only the trade with the shares acquired from the citizens should be allowed, while the free trade with the shares of the privatization funds, as well as with the acquired by them shares in the enterprises should be banned.

Such a decision would avoid the extra-supply in the very beginning after the last auction session. On the other hand, the privatization funds would be protected against the eventual sharp decrease of the prices of their shares because of the expected negative financial results in 1996. The founders of the privatization funds would not be able to take advantage of this undervaluation because the privatization funds will operate as closed funds in the first 5 years of their activity under article 4, paragraph 1 in the Law on the Privatization Funds.

The main deficiency of this proposal is that the majority of participants (about 85%) would not be able to trade their shares in the privatization funds. The privatization funds will have little opportunity to pay dividends in order to attract and preserve their shareholders. The privatization funds are faced with serious problems because of the lack of financial resources in the form of dividends by the privatized enterprises. The government, led by Mr. Jhan Videnov, decided to transfer all profits of the privatized firms for 1996 to the state budget. The citizens will not enjoy immediate gains from their vouchers, which may decrease their interest in the privatization process. On the other hand, the lack of financial resources (one of the few possible sources is the free trade with shares) will limit the future investment projects of the privatization funds.

The mass privatization is a way for rapid restructuring of a relatively large portion of the state-owned property. The political will and support are the main conditions for its successful implementation. Their lack caused the delay and prolongation of the mass privatization process, as well as of the privatization process as a whole. However, a hidden privatization took place and its participants remained generally unknown to the society. Probably, this is the reason for the strong resistance to the privatization process.

The mass privatization may create a large class of new owners. It may encourage popular support for the whole privatization process. It may promote the development of the capital market in Bulgaria. The task of

the state authorities is to make use of its advantages (mainly the rapid transfer of ownership from the state to individual shareholders) and to reduce its inherent vice.

Sofia, April 1997

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

discussion paper

SAVINGS, INVESTMENTS AND ECONOMIC GROWTH

by Rossen Rozenov, AECD

The primary importance of capital accumulation for economic growth is a well too known tenet of economic theory. Abundant empirical evidence corroborates the high correlation between the investment rate and income growth.

Investments both increase the production capacity of the economy (physical capital) and support technical innovation (higher factor productivity).

Savings are used to finance investments. The shortage of domestic savings is not considered to be a constraint to investments in an open economy - foreign savings presumably make up for the difference. A National Accounts identity sets the difference between gross savings and investments equal to the current account balance of the balance of payments (ex post). Hence, given a low rate of savings, investments can only expand if foreign indebtedness grows. Balance of payments deficits exert pressure on the exchange rate and fuel inflation.

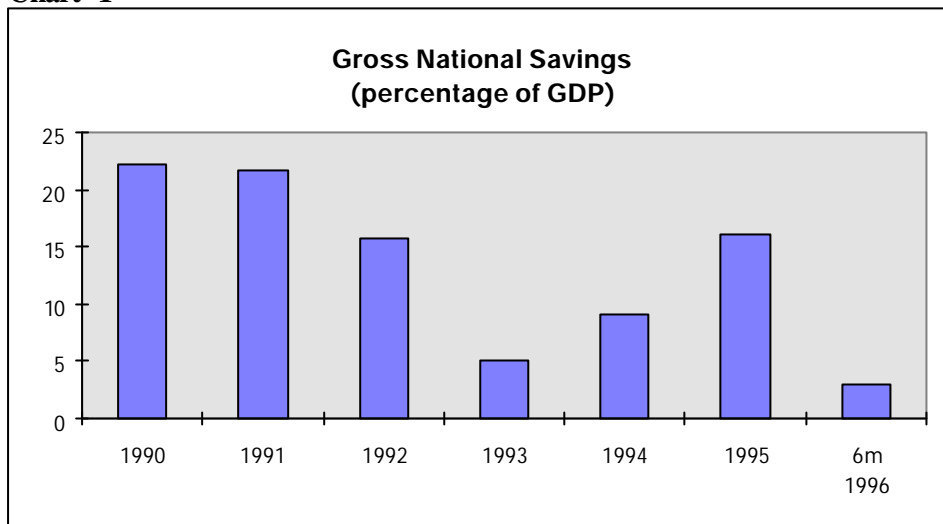
(Sometimes economic development is viewed as the outcome of the interplay of two complementary scarce resources - foreign currency and capital. The foreign currency shortage limits growth since the attainment of higher GDP levels requires higher imports.)

Foreign imbalances can be avoided if economic policies are pursued that encourage the accumulation of savings and their transformation into investments. Such policies brought about remarkable economic prosperity in certain East-Asian countries.

Savings and investments in Bulgaria

Until 1990 the savings and investments levels (share in GDP) maintained in Bulgaria were comparable to those in the developed economies. High savings rates in the 80'ies however were due to shortages of consumer goods and services rather than to autonomous decisions of economic agents who have strong preferences for future consumption. When prices and imports were liberalised (1991) and real incomes fell, the share of savings in GDP declined.

Chart 1



During the period of central planning investments resources were allocated by force of administrative decisions; no consideration was given to the return on capital. Besides, the distorted prices did not allow for meaningful assessments of such market indicators.

Investments were drastically reduced after 1992. Macroeconomic instability, low demand and delayed privatization all contributed to the slump in investments. The shortage of financial resources was another important constraint.

I should be clear that reduced investments are not an inevitable outcome of economic transition. Unlike Bulgaria, the remaining countries from Central and Eastern Europe managed to maintain a relatively high ratio of investments to GDP.

To overcome the difficulties that currently plague the Bulgarian economy, policies should be pursued that encourage savings and investments. The tax reform features among the most important policy measures.

Impact of the tax legislation on savings and investments

The share of corporate savings in total savings has stood as high as 50% in the developed economies. In Bulgaria however, the only sector that generates non-negative savings has been the households sector; (the informal sector may be another net saver but no reliable information is available). The non-financial sector has been recording negative savings in recent years, which is partly due to regulations that put at disadvantage state- and municipally-owned firms (the former Decree No.56).

Firms savings generally take the form of depreciation allowances which are not taxed, so the size and time structuring of savings strongly depend on the depreciation method adopted. With accelerated depreciation tax payments are postponed and savings accumulate rapidly in the first years of the asset's life.

Retained profits form the second component of firms savings. Retained profits depend both on tax rates and the firm's dividend policy. It is well known that higher tax rates have a strong negative impact on savings.

The incentives of the potential investors should be examined when assessing the tax policy impact on investment activity. We use here the theoretical framework provided by Musgrave, R. and Musgrave, P. (1989)

Three main factors affect the investor's behaviour, acting jointly or in their own: (1) expected net rate of return, (2) sales dynamics and its relation to existing production capacities (3) amount of internal resources, i.e. after-tax profits and accumulated depreciation allowances. Among the three variables profits are most

important for the investment decision. The higher tax burden lowers profitability. Investments are reduced whereby the amount of the reduction depends on the elasticity of the investment function. (We consider here the effective tax rate, which includes both the nominal tax rate and the tax treatment of depreciation; both components are used to derive the rate of return.)

Each firm strives to achieve high enough profits to cover the market interest rate and depreciation, i.e. the price of capital. When taxes are imposed, net rates of return depend also on the amount of the tax rate, the tax-deductible depreciation and the investment credit (if applicable). The higher the investment credit and the tax deductible depreciation, the lower the required rate of return and the higher the probability of taking up the investment. Alternatively, high tax rates push up the required rate of return and discourage investors.

Besides, investments bear certain risks that are accounted for in the probability distribution of the expected return. This factor carries an additional importance in Bulgaria due to the high macroeconomic instability.

Tax treatment of investments in Bulgaria

The Decree No.56 regulations were applied prior to the adoption of the new Law on the profits tax (July 1996). These regulations provided for a highly unequal treatment of economic units, depending on their form of ownership.

Higher tax rates were applied to state- and municipally-owned firms, their depreciation allowances were not adjusted for inflation and only 75% of interest was tax-deducted.

Private firms in turn benefited from the existing legislation. They were offered a choice between a one-shot deduction of the full purchasing price of the asset and a deduction of the principal of a loan, used to finance the investment. The preferential treatment applied however only if the amount deducted did not exceed before-tax profits, which caused troubles to small, newly created firms with no recorded profits.

It can be inferred that the former legislation did not impose taxes on investments, financed by internal resources and even provided for subsidising private investments, financed by borrowed funds. At the same time investments in the state-owned firms were discouraged, which resulted in decapitalization.

The new Law marks a significant progress by introducing equal treatment of the different forms of ownership. Another positive development has been the reduction of the corporate profits tax rate to 36% (26% for profits below 2 mln. levs). However, investments receive a worsened treatment: the one-shot deduction at asset acquisition has been abolished; a depreciation period has been fixed instead, whereby depreciation allowances are not indexed to inflation. In a high inflation economy such an approach deprives firms from internal resources (savings) and thus eliminates one of the major sources of investment financing. The changing macroeconomic environment together with a repressive tax policy will further reduce the rates of saving and investments. Unless the pending structural reform includes measures to encourage investments, the prospects for renewed economic growth may remain unclear.

Proposed legislative changes concerning depreciation

Provided that the principle that depreciation allowances are deducted during the asset's life is maintained, the law should be modified in several important respects.

First, adjustments for inflation should be introduced - high inflation makes it impossible to recover capital outlays if depreciation is based in the initial purchase price. High inflation poses the threat of decapitalization, hence the book value of the assets should be adjusted to reflect their current market price. Asset indexation requires revaluation of all balance-sheet items.

Second, the principle of “tax-neutrality” should be observed, i.e. taxes should not distort the structure of investments. A necessary prerequisite thereto is that the true economic depreciation equals the normative one - if so, the effective tax rate equals the nominal one.

Third, the annual depreciation rates provided for in the Law can be corrected according to the principle of the “best business practice” which ensures neutrality. If the principle is adopted, certain assets may depreciate at a faster rate, e.g. computers (20% depreciation rate according to the Law). A more flexible approach can be undertaken and taxpayers may be given some freedom to vary the asset’s life within certain limits. The reduced normative life of the asset will encourage investments.

Fourth, the depreciation method can be reconsidered. Only straight-line depreciation is currently applied. It may be kept for buildings, whereas the method of decreasing book value can be applied for machinery and equipment (under the latter method the present value of depreciation allowances is higher). Accelerated depreciation is usually thought to benefit investors, since the tax rate is reduced as tax payments are postponed. This is mostly true for long-term investments. (The theory of investment decisions again supports such a statement. To assess an investment one needs to compare the present value of the (before-tax) income flow to the present value of taxes due. Obviously, the faster the depreciation, the lower the present value of taxes.)

Some countries apply an “investment tax credit”. It is intended to encourage investors by tax-deducting some fixed percentage of the value of the investment. This credit resembles the accelerated depreciation but for one key difference: the latter postpones the tax payment whereas the former directly reduces it. The term of the investment should also be taken into account, since the investment credit benefits shorter-term investments. The joint application of accelerated depreciation and investment credits can be successful as well.

Given the current economic crisis in Bulgaria, a more radical approach has been proposed by Zodrow (1995) - “capital recovery during the first year”. The proposal essentially states that the sum of the present values of all future depreciation allowances should be deducted in the first year after the asset acquisition. The discount rate used should be applied for adjusting the value of losses brought forward to future reporting periods as well. The advantage of this method (which is a version of the accelerated depreciation) is seen in the elimination of the adverse impact of inflation and the increase in the firm’s free resources. Savings however can only be accumulated if income is generated from other investments.

When tax policy is devised all advantages and drawbacks of the above approaches should be assessed. A reduction of the tax rate to 20-25% is also desirable. Besides, budget revenues may not suffer from such a reduction, since part of the “informal economy” may enter the formal sector, which is particularly plausible if the tax legislation reform is paralleled by an improvement in the tax administration. The proper assessment of the fiscal effect naturally requires an in-depth analysis which cannot be undertaken in the present paper.

Sofia, April 1997

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

discussion paper

PROFIT TAX LAW - NECESSARY CHANGES

by Bojidar Dimitrov, Lawyer, Counselor of the President of BCCI

Pursuant to the State Budget Law the revenues from direct taxes for the year 1996 had to amount to about 26% while those from indirect taxes, duties and duty taxes had to be about 74% of the total. It is well known that Bulgaria's budget for 1997 has not been passed yet. Pursuant to the Budget Structure Law the revenues must comply with the laws that are operative at the moment. It is impossible to pass laws for a few weeks only and to carry out both a tax reform and a change in the ratio between direct and indirect taxes. The tendency in the relative share of taxes in the total tax revenues is connected with long-term strategy and at least for the next two years no changes of principal nature are possible therein. The tax law, which has been created for a very short time, with all its complexity of legal norms, shows the tendency of being "imposed" on the economic life, which is extremely various. Practice has proven that in these cases the law is incomplete and the tax rate is usually unacceptable. The reaction that usually emerges is one of avoiding the burdens created by the law as well as taking advantage of its incompleteness.

The comment will be limited only to the suggestions for the changes that are necessary in the Profit Tax Law (PTL). This Law has been operative since July 1, 1996 and it is in conformity with the modern corporate tax laws as far as its structure is concerned. The idea of wholly settling this tax matter by way of a law was not actually realized and a significant part of the regulation has to be provided by the Rules for Application the PTL (RAPTL). Unfortunately, the Rules have introduced some additional changes in the PTL this being a violation of Statutes Law. However, it is impossible to make the necessary revision within the short time that is left until passing the 1997 State Budget Law of the Republic of Bulgaria, or more precisely - within the remaining part of the year.

PTL was passed on the ground of motives that no tax preferences exist in EU and according to the recommendations no possibility is allowed for the tax legislation to regulate the opportunity of any tax alleviation. Finally, the PTL contains some preferences, most of them being granted to privatized enterprises, companies with foreign participation, to takeover cases of alleviation used under Decree No 56, which has been repealed, as well as to cooperatives of disabled persons. However, no preferences were granted to the hundreds of thousands of companies, which are the actual taxpayers.

It is not the global preferences under the repealed Decree No 56 that are needed, but the specific preferences are the ones that are necessary now. They have to be in accordance with the economic realities and the interests of Bulgaria. There are a number of different classifications of the types of preferences but they interweave with each other. Due to that fact I will limit my comment to specific suggestions only.

1. Fixed Assets (FA)

1.1. Depreciation Expenses:

Tax recognition of accelerated depreciation is urgently needed due to the following reasons:

a) The rates established by art. 15 of the PTL concerning the depreciation that is recognized for tax purposes are meant to guarantee the fiscal aspect and not the interests of goods producers. They do not take account of the physical and economic wear and tear in the circumstances of the rapid innovations. Even under the conditions of normal economy these depreciation rates cannot ensure the normal turnover of capital, i.e. the restoration of the initial investments in FA in their pecuniary form. Pursuant to the

Accountancy Law (AL), art. 18 and paragraph 4a of the Additional Provisions to the act, it is the "historical price" that matters. No annual revaluation is carried out considering the official statistical data about inflation;

b) The introduction of the currency board would significantly limit the inflation rate but for the time being the actual price of the FA that were acquired 3-4 years ago is approximately 10 times higher than the value on the grounds of which the depreciation expenses are calculated.

Suggestion : Paragraphs 2 and 3 of art. 15 of the PTL have to be repealed. The following is to be added at the end of art. 15, par. 1, second sentence: "... in the due order stipulated under art. 20 of the Accountancy Law".

Art. 15 can be edited again in the following sense: "Accelerated depreciation rates of FA are applied and they amount up to 50% increase of the depreciation rate recognized for tax purposes".

In any case it is reasonable to grant the companies the right to make a single reassessment of the FA and this reassessment must take the inflation into account. It is well known that since the Note of the Council of Ministers No 179/year 1991 no reassessment has been made. It is recommendable that the updating be carried out in due course established by the Council of Ministers rather than by way of expert estimates. An opportunity of this type is stipulated under art. 33 of the AL but it is for 5 years now that the Council of Ministers has not exercised its rights of carrying out this revaluation.

1.2. Buying Fixed Assets

It is necessary that a mechanism be created aimed at facilitating the process of buying FA that are intended for the industry. The orientation towards important branches of industry is possible as well. It is preferable to establish a mechanism of tax on profit, according to which no tax on profit is charged in cases where the investments are intended for production purposes, these investments being meant for creating, expanding or modernizing the machines and equipment.

Should no tax on profit be due in cases of investments for certain purposes the budget will indirectly support the development of the industry. No structural reform is possible without the development of the industry. In the long run it is through these tax alleviation that the budget revenues will be guaranteed after a short period of time. The improvements in the actual state of economy would have their effect on the national income and this, on its part, would increase both the budget revenues and the opportunities of redistribution of national income.

Expanding the production immediately results in an increase in the indirect taxes (VAT, excise).

Suggestion: Here is a possible text:

"The profit tax is not due where investments are made for production purposes according to the subject of activity. In case of impossibility of applying tax alleviation because of insufficient amount of the positive financial result at the moment of acquiring or creating the respective asset, this alleviation is used in the form of tax credit within a term of after creating or acquiring the asset.

Tax preferences apply regardless of the expenses on depreciation".

The mechanism of non-charging the tax on profit creates opportunities for controlling the expenses as well as for assessing whether the expenses are meant for creating FA. Thus an anomaly can be overcome, this anomaly having been a part of art. 87, par. 4, subpar. 2 of the repealed Decree No 56. Such expenses are recognized in Germany, the USA and other developed countries although perfect technologies are available there.

3. Current Expenses on FA

Art. 16, par. 2, subpar. 8 of the PTL, which is currently operative, states that the financial result prior to tax transformation is recognized if the expenses on improvements, modernization and reconstruction of FA are within the limits of up to 5% of their balance value. The basis is the "historical price" of acquisition reduced by the depreciation expenses. It is clear that this text prevents the owner of FA from making the expenses necessary for the normal utilization of the respective equipment.

Suggestion:

a) the percentage is to be corrected from 5 to 10-15 per cent on the basis of the updated price of the FA resulting from a reassessment (made after the Note of the Council of Ministers No 179/ year 1991);

b) art. 16, par. 2 subpar. 8 has to be edited anew in the following sense: " ... where the expenses on improvements, modernization and reconstruction bring about an increase of the value of the assets and these expenses have been reported as current expenses exceeding 50 per cent of the balance value of the respective asset".

4. The Corporation Credit under the circumstances of a currency board turns out to be extremely topical. After art. 94 of Decree No 56 on Economic Activity was repealed, art. 21, par. 1 of the PTL has been operative so far. It is under a complex of requirements that it creates the limitation on this crediting, the limit being 10 per cent of a specific value pursuant to the Accountancy Law. I suggest that this limitation should be totally repealed.

5. Salary Regulation

Paragraph 5 of the Interim and Concluding Provisions of PTL was repealed and thus the tax nature of regulating salaries was dropped off. Actually, the Council of Ministers has no rights provided by law to carry out the process of income regulation. The compromise mechanism that has been established by way of an Enactment of the Council of Ministers could be challenged on the basis of the Statutes Law due to the lack of grounds for this regulation.

The restoration of paragraph 5 of the provisions of the PTL is unacceptable under the conditions of the liberalisation, which has already started. It is even less admissible to accept the resumption of the tax scale concerning the cases where the tax limit has been exceeded. Nevertheless, it is reasonable to accept a text that should grant the Council of Ministers the right to regulate the incomes of commercial companies where the participation of the state is predominant. In 1997 the absence of limitations resulted in a turn on the labor market, the private sector not being capable to maintain the level of incomes. One of the numerous anomalies is connected with the fact that the available financial resources are used for increasing the salaries rather than for paying off the bank credits.

6. Tax Rate

The profit tax is 36 per cent; in cases when the profit does not exceed 2 million leva it is 26%. The municipal tax is 6.5%; insurance installment is based on the salary according to the labor category (the average is 44%); there are also obligatory contributions to the Professional Qualification and Unemployment Fund.

It is hard to accept both a reduction of profit tax and a simultaneous establishment of tax preferences. The very amount of a tax credit for FA is dependent on the amount of the profit tax.

My personal opinion is in favor of preserving the level of tax rates and introducing certain preferences. It turned out that the limit of 2 million leva for reduced taxation has lost its effect within the period from the elaboration of the PTL to the moment of its adoption. Less than an year after the adoption of PTL this limitation further lost its significance. The new level of differentiating tax rates should be corrected to at least 15 million leva (USD 10000).

7. Small and Medium-size Enterprises (SMEs) have still not received protection by the legislation. There is a consensus that this flexible form of production can help exiting the crisis, that it has good prospects and it is closely connected with the process of privatization and the elimination of monopolistic structures. Preferences for the SME must be regulated under the PTL but preferences should be granted at the right time. The draft law on SME could hardly be discussed prior to passing the Budget Law for the year 1997.

We hope that the Law on SME will be adopted by the end of 1997 and we do hope that tax preferences will be adopted simultaneously with the law, should this be necessary, due to the fact that the precursory changes in the PTL do not satisfy some of the tax alleviations. The PTL is the law where the alleviation should be properly and systematically stated.

8. Export Preferences would be much more easily regulated by means of by-laws - the customs regime, premiums, subsidies and other instruments. The establishment of tax preferences is a long process that takes time and it is connected with a specific complex of conceptions that have not been clarified so far and as a result they cannot be hastily included in the eventual changes of the PTL.

9. Establishing Branch Priority is a long process too, which is a result of an advanced strategy, so it could not affect the PTL at this stage.

10. Income Tax (IT) belongs to the category of indirect taxes and in 1996 its share in the total tax revenues was 13.6%. This share is high for a country with high rates indirect taxes if inflation is not taken into account and the great increase in the incomes, which is due to inflation, is not considered.

There is a direct link between the tax under art. 13 of the Income Tax Law and art. 4 of the same law. The sharp rise in inflation emerged after passing the changes and amendments to the Income Tax Law for 1997. In early May the minimum salary fixed by the Council of Ministers amounts to more than the minimum income, which is not subject to taxation. The current changes in the tax brackets would bring about some complications and this particularly refers to the level that fixes the obligation of advance taxation.

Once the principle of "tax vacation" is accepted with reference to direct taxes some changes in the Income Tax Law should be accepted as well. It is well known that the increased tax rate does not necessarily result in adequate increase in tax revenues. It is generally accepted that Bulgarian informal economy amounts to 45-50% of the gross domestic product. The relative reduction of taxes, in particular the direct ones, would result in a significant increase in their collection and this would increase budget revenues. Prerequisites should be gradually established for decreasing the relative share of the informal economy, especially as some actions of the present cabinet would inevitably bring about their results.

Sofia, April 1997

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

discussion paper

INVESTMENT INCENTIVES AND FOREIGN DIRECT INVESTMENT: the case of Yugoslavia-

by Dr. Slavica Penev

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In the transition countries, during the period of reforms, investment is important to deepen the restructuring of enterprises and the economy as a whole, and to facilitate the reallocation of existing human and material capital from lower to higher value uses while adapting the structure of the capital stock to that required by the market. It points to the necessity of investment to enable the transition process. But, the necessity of investment in the transition period will rise one of the most serious problems for transition economies, including Yugoslavia - the shortage of investment finance.

Taking into account that domestic savings are not sufficient to finance the investment in the period of reforms, the inflow of foreign capital will be of the great importance for the investment financing in the next period in Yugoslavia. It is expected that the official foreign capital will play an important role in the financing of investment growth in Yugoslavia. At the same time, official foreign capital acts as a catalyst for domestic and foreign investment by reducing uncertainty and increasing the chances that the reform will succeed, and also plays important role in fastening the development of the necessary institutional infrastructure, and in supporting the issuance of securities by enterprises in local market.

At the same time, the private foreign capital becomes an important source of investment financing in transition economies. Investment flows to these countries nearly doubled in 1995, reaching almost \$12 billion, but the predominant part of this foreign direct investment was invested in fast reforming Central European countries (Hungary \$3.5 billion, Czech Republic \$2.6 billion and Poland \$2.5 billion).

The most significant prerequisites for attracting foreign capital in the form of foreign direct investment are: the risk degree of investments, legal security, rapid economic development of the country and a continual realization of sound macroeconomic reforms, development level of financial market, the size of the domestic market, profitability of investment projects, the availability of qualified and relatively cheap labor, as well as the development degree of domestic infrastructure, the stability of the exchange rate, the development degree of the private sector and the liberalization of terms for foreign investments.

If the majority of them is fulfilled, the investment climate can be considered as favorable.

As countries increasingly recognize the importance of inward foreign direct investment for their development, they compete more and more to attract such investment. This competition takes many forms, including various forms of investment incentives.

Investment incentives are economic advantages given to the investors by a government, with the purpose to encourage them to invest in that country. Although investment incentives are not among the main determinants of foreign direct investment locational decisions, there is a strong competition among countries to attract investment through incentives. This is so because, in the situation when other things are equal, incentives can induce foreign investors to make a particular investment decision.

Incentives can increase the foreign investment rate of return, or reduce or redistribute its costs or risks.

But, abundant Incentives can introduce economic distortions, and it is not in the public interest the costs of incentives should be greater than the value of the wedge between private and social returns.

The following types of foreign direct investment incentives can be distinguished:

- fiscal incentives;
- financial incentives and
- other incentives.

Fiscal incentives' role is ***to reduce the tax burden for foreign investor***. They are the most widely used type of foreign direct investment incentive.

The main types of fiscal investment incentives used in the developing countries and Central and East European countries are:

- tax holidays, (typically available for up to 5 years)
- exemptions from import duties and
- duty drawbacks.

In the developed countries accelerated depreciation and specific deductions for corporate income tax purposes or reductions in other taxes are the main types of fiscal investment incentives.

Nearly 80 per cent of all countries in Central and Eastern Europe, including Yugoslavia, offer reductions of the standard income tax rate and tax holidays to private foreign investors.

Financial incentives involve the provision of funds directly to firms to finance new foreign investments or certain operations, or to defray capital or operational costs, government grants, government equity participation and insurance at preferential rates. They are less prominent in developing countries and in the Central and East European ***countries, although their uses*** have increased in recent years, mainly such as: subsidized loans, loan guarantees and government grants.

Developing countries make use more of fiscal incentives, probably because these countries lack the resources needed to provide financial incentives. On the contrary, developed countries ***make use more of*** financial incentives, partly because fiscal incentives are less flexible and involve more difficult parliamentary procedures for introducing them.

Sofia, April 1997

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

discussion paper

REFORM IN THE SOCIAL SECURITY SYSTEM

by Mariella Nenova
Gabriella Stoyanova
Petia Petrova

1. Structural Disposition in the Present Social Security System

1.1 *The services offered by National Social Security Institute (NSSI)*

According to the Labor Legislation in Bulgaria the Social Security System obligatory includes all workers in state, public, corporate and private enterprises and organizations or joint ventures. The type of the work, its continuation and the way it is paid for does not reject the obligation for insurance.

The social security services are provided through Social Security Fund which is run by NSSI.

The main incomes in the Social security Fund are collected trough:

- contributions to the fund which vary between the category of the labor and the risks covered.
- subsidy from the State Budget if needed
- transfers from the State Budget for special kind of pensions

The main expenditures of the fund consist of:

- benefits, monthly aids for child, pensions
- aids according Labor Legislation, Ch. III, (illness benefits, professional decease, labor hazard, pregnancy, child-birth, etc.)
- pension indexation

1.2. *Structure of incomes*

According to the National Statistical Institute (NSI), the employees for the 1995 have totaled about 3 310 884. 58,13% of them were employed in the public sector and 40,71% - in the private sector. Social security contributions into the National Social Security Institute (NSSI) budget for 1996 are given below:

CONTRIBUTIONS	PERCENTAGE
PUBLIC SECTOR	94.02
<i>ENTERPRISES</i>	76.73
<i>BUDGET SPHERE</i>	17.29
PRIVATE SECTOR	5.8

The discrepancy between the percent of employees in each sector and the related contributions could have been even bigger since the state sector enterprises are still in arrears to the social security budget with more than 27% of the total contributions they had to make. This disproportion can be attributed to the following reasons:

- the low base of the income on which the contributions are calculated by the private sector. The Bulgarian legislation limits the income on which the contributions are determined from one to eight minimum wages and the most frequently used is the lowest limit. A more detailed research over the data for 1996 shows that only about 41% of self-ensured people pay installments of 32% of the minimum wage to cover all risks, while the rest 59% make pension contributions (equaled to 22% of the minimum wage). Such a behavior is reasonable since a higher social insurance contributions do not guarantee higher pension in the future. In the same fashion if one person works at more than one job she usually

prefers to select the lowest income for insurance. The so established pension system directs much less money to the pensioners compared to the income received by workers.

- The second reason stems from the Labor Code (chapter III, article 149) according to which even if the enterprise does not pay the obligatory contributions, eligible workers receive their benefits. This encourages employers to register the employees in the social security system since the due benefits are paid automatically by the fund. This explains why only 2,5% of the private employers pay contributions to the Social Security Fund based on the minimum wage.

1.3. Structure of expenses

According to the Bulgarian legislation the insurance contributions are proportional to the received income, although the percent varies among the different labor categories due to the different retirement age. However, such installments covered not only pensions but illness benefits, labor hazards, child-birth, motherhood and so on. In the most common category of labor, the contribution consists of:

- 22% of the base insurance income for pension (56% of the total contribution²)
- 10% of the base insurance income for motherhood, illness benefits etc. (26% of the total contribution)
- 5% of the base insurance income for labor hazards and accidents (13% of the total contribution)

Structure of the National Social Security Institute (NSSI) expenses for social security activities is given below:

	PERCENTAGE OF:	
	OWN INCOMES	ALL INCOMES
A\ PENSIONS	87.23	83.28
B\ AIDS ON LC, Ch.III	8.48	8.09
including::		
<i>ILLNESS BENEFITS</i>	4.49	4.28
<i>RISING A CHILD</i>	1.62	1.55
C\ AIDS ON BRED³	7.26	6.93
including:		
<i>MOTHERHOOD</i>	7.26	6.93

The above data reveals that the pension expenditures consume almost the entire accumulated fund. Hence the contribution rate for pensions is 34% to income instead of the normative 22%. It means that the public sector is the main contributor to the Social Security Fund.

The so described mismatch explains the significant deficit in the Social Security Fund.

2. Age Structure Development and Movements in the Dependence Ratio (DR)⁴ and Replacement Ratio (RR)

The big variety of risks covered by the Social Security Fund must be separated. Due to the big part of pensions in the social payments the stress of this paper is put on the establishment of separate Pension

² The total contribution is made by two part: the first part is paid by the employer and equals either 37%, 47% or 52 % of the base insurance income according to the different labor categories. The second part is always 2% and is paid by the employee. All contributions are subtracted from taxable income.

³ Birth Rate Encouragement Decree

⁴ DR - the ratio between working people and pensioners.

Fund .The analysis of the two main ratios for the pension insurance - *dependence ratio* and *replacement ratio* is made below.

For the year 1996 the DR has been calculated to be 1,641 and the ratio between the average wage in the public sector and the average pension - 0,32. The last number is close to the so called **replacement ratio** (RR) but it is overvalued assuming that the average wage in the private sector is higher than in the public one.

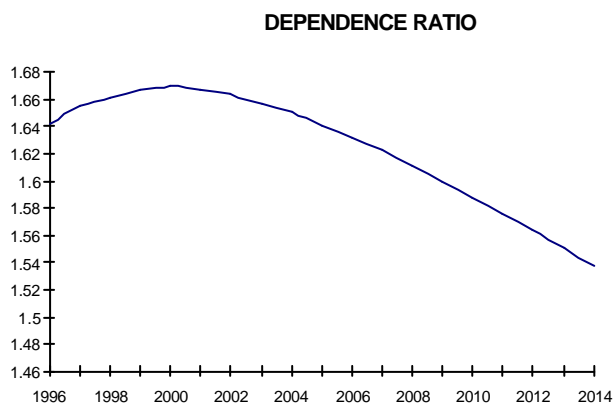
The data from NSI (for the age structure of the population) and from NSSI (for the age structure of the pensioners) have been used to make an age structure forecast of the population until the year 2014. This forecast assumes:

- all people above 18 are either pensioners, unemployed, mothers or workers.
- all working people pay their contributions to the Social Security Fund
- the average wage equals 100%
- there is only one labor category
- 12% of the population is unemployed
- the annual percent of mothers totals 4,18% of the women between 18 and 40
- the annual percent of students totals 11,44% of the peoples between 18 and 35
- 2/3 of students are employed
- a single pension contribution equals 22% of the month income
- there is only personal pensions

With the above *made assumptions* the DR for 1996 is 1,64 while for 2014 it has been predicted to be 1,54. These figures indicate the increase in the pensioners and not proportional increase in the workers. If the percent of the contribution remains fixed for the period 1996-2014 RR will decrease from 0.361 for 1996 to 0.338 for 2014. The comparison between predicted value of the replacement ratio (0.361) for 1996 and the real one (0.32) shows that according to the assumptions, pensioners should receive higher income than actual one. The reason is that not all contributions in practice are based on the average wage. As a matter of fact, the pensioners would receive even lower income if pensions are not funded from other social security sources in addition to the pension payments contributions. The sources are state Budget and the Unemployment Fund .

The movement of the DR over the years shows how the number of workers ‘paying’ for the single pensioners changes. The lower it is the higher the percentage of the pension installment should be.

Chart 1



3. The Influence of the Arrears in Social Security Fund

A more realistic forecast should reflect the existing discrepancies between the incomes and the expenditures of the Social Security Fund resources.

First, the considerably small contributions⁵ coming from the private sector will significantly influence the forecast. Some figures shows that the ratio between the average wage in the public sector and the minimum wage for the country is 3:1 for the year 1996. The number of the ensured employees (by their employers or self-ensured) in the private sector are 36% of the total number of people in the private sector. And most of them calculate their contribution on the lowest income limit.

Second, the arrears of the public sector totaled to 27% of all contributions it should pay.

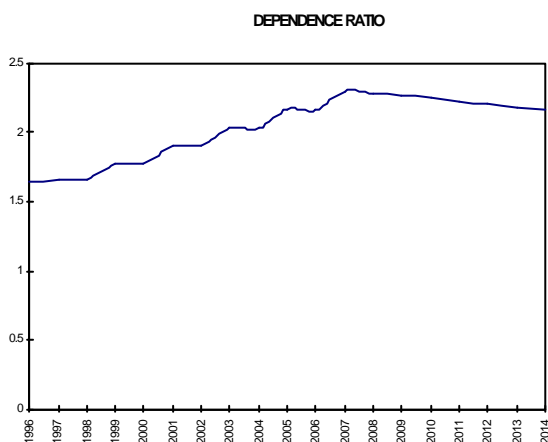
With the above consideration the RR should be 0,172 which is much lower than the RR with the assumption that all working people make installments proportional to their income. In the last case RR should be 0.361. The difference in the above figures shows that if the person is motivated to make regular contributions the pension resources would be much higher with the same installment level.

Ageing stricture worsens the pension system. In order to keep the level of the average pension the part of the contribution in the income should increase from 22% to 23,5% .

4. Investigation of the Effect of Possible Retirement Age Increase

One of the possible solutions to the negative effects of the aging structure of the population is the raise of the retirement age from 55 to 60 for women and from 60 to 65 for men. If the increase is evenly distributed over the years (retirement age increases by one year every year) the transition period will be from 1998 to 2008. The DR would improve considerably in this case.

Chart 2



If we keep the assumption that all workers pay all due contributions of 22% of the average wage, the pension level when the reform completes (in 2008) would be 0.503 of the average wage and 0.475 in 2014. If the level at 0.361 of the average pension should be kept, the part of the contribution in the income should change from 22% in 1996 to 15,8% in 2008 and to 16.7% in 2014.

When the forecast reflects the distorted flow of fund in the Social Security Fund, the change in the part of the average pension would be from 0.172 of the average wage in 1996 to 0.239 in 2008 and 0.226 in 2014.

The increase of the pension age will have medium-term effect if the aging structure continue. Another possible solution to compensate the negative impact of the aging structure is a constant increase in the

⁵ Due to the use of the minimum wage contribution calculation and the big arrears

taxes. It is important to stress that it will not increase neither the motivation of the worker nor the motivation of employer to change their behavior.

5. The Problems of Social Security System

In the light of structural reforms the reform in the social sector plays important role.

A global social security reform is under way not only in countries in transition but also in developed countries. The main reason for reforms is the collapse of the state pension systems.

The reform in the social security is a whole set of structural reforms on labor market, financial markets and public sector.

At the moment the pension reform is a central part of discussions in many countries. The main issues of the discussions are : what kind of pension system to be adopted: pay as you go(PAYG) or fully funded (FF). Should this system be run by the government or should be private?

5.1 Bulgarian Pension System

There is a PAYG system in Bulgaria. That system has many negative sides which in combination with the expected aging of population will be a real problem in the near future.

3 473 526 people have been insured at Social Security Fund in 1996. Only 359 271 persons insured themselves at their own expenses (23% or 32%).

The Social Security Fund's deficit amounts to 5206. 8 mln. BGL and is covered by the Ministry of Finance. The nature of an old PAYG system is such that it could not be financially balanced.

Spending on pensions increases exponentially as population ages. In some countries pensions are above 15% of GDP. In Bulgaria - 6.7 % of GDP.

5.2 Problems

There are two general problems, closely related.

The first problem is the decrease of the dependency ratio (number of people, which make contributions to pensioners). That problem is related from one side with the aging of population and from the other side with peoples' unwillingness to contribute to the fund. The deterioration of the dependency ratio, which is expected in many Western Countries, leads to extension of losses of PAYG system, when contributions and pensions remain the same.

The second problem is aging of pension scheme, which is caused by deteriorated demographic structure. These are the main reasons for State Fund's deficits. Such deficits create press for growing subsidies from the budget.

The need of reforms is determined by the huge and growing deficit.

5.3 Solutions

There are two approaches:

5.3.1. Reconstructing the existing system

a) increase of contribution rate

The increase of contribution rate is a measure which will not face public support. According to the data in Bulgaria the contributions are very high Therefore such variant is inapplicable.

b) restructuring of payments

Restructuring of payments could be made by creating a separate Pension Fund, Health Insurance Fund and expenses for raising a child, motherhood and etc. should be undertaken by the State Budget. Such a dividing will lead to transparency and will motivate people to make their contributions. At the moment the amount of pensions is lower than people's expectations.

The question how that Pension Fund should operate remains questionable.

Positive and negative sides of private and public insurance will be further discussed.

c) Increase of the age of retirement by 5 years step by step

The burden on the working population of PAYG system depends to a considerable extent on the dependency ratio. An alternative strategy to cutting down the level of pensions promised to be paid, is to rise the age of retirement. According to the information the idea of increased age of retirement is well accepted in many Western countries. Such kind of programs should be implemented in connection with changes in the labor market and other programs like the unemployment insurance. The application of this program may give rise to unemployment, hence, many people will not be able to contribute and to receive pension in the future.

The results from increase of the age of retirement in Bulgaria were described above.

d) Mixed variant

According to the mixed variant, the State should provide a minimal pension on the base of the period of contributions or the length of service and to leave a possibility for employees to contribute to a private funds.

Such a mixed system exists in England. State pension is only 50% of pensioner's income, and around 23% are from private pension funds.

At the moment in two-tier system is under the discussion in Hungary. All employees will be obliged to contribute 1/3 of their installments to private pension funds. The newcomers in the labor force should adopt the new system immediately. Currently working people should also contribute to private funds.

It is clear that private pension funds are able to operate successfully if there is economic and financial stability. Financial and capital markets are not very well developed in Bulgaria, which creates many obstacles for private pension funds. Therefore the need of radical pension reform is obvious.

5.3.2. Privatization of Social Security

There is an alternative to the PAYG system - Fully Funded (FF) system.

5.3.2.1 Positive and negative sides FF and PAYG systems

a) A PAYG is a mandatory social contract of transfers from workers to pensioners. A FF system provides a close link between workers contributions and benefits, which implies that the FF system is a fair one. It leads to changes in the labor market and creates a motivation for old age saving.

Under the FF system the average return on old-age saving is determined by the market interest rate, while a PAYG system provides a real return on contributions equal to the real rate of growth of the wage bill, which is lower than real return on capital. Therefore PAYG provides lower rate of return in comparison with the FF system.

b) Under the PAYG system it is possible for powerful groups to secure generous pensions from the political establishment. (Professional Trade Unions)

c) Due to the expectations for small pension under the PAYG system, a great number of people are shifting into informal labor markets, where payments for social security, as well as taxes could be easily avoided.

Here are some of the main features of a private pension system :

- individual accounts
- decentralized private management
- rivalry, individual choice
- strict supervision
- annuity or possibility for withdrawing of accrued sum

5.3.2.2 *A transition from PAYG to FF pension system.*

There are some opinions that the change of PAYG with FF will increase savings, will eliminate distortions on labor market and will sustain growth in a long run.

The transition from PAYG to FF is a long process of reforms.

a) structural changes

Privatization of social security has three elements

- workers contribute to a personal retirement's accounts, rather than to a common pension fund
- the government should create a plan to finance the transition
- the government specifies portfolio allocation, tax, bequest and withdrawal rules, which regulate the individual accounts.

WE have to take into account that there are two kinds of pensions, which should be paid:

1) pensions to the current pensioners

2) pensions, which should be paid in the future to those, who have been contributed to the PAYG.

A problem arises in family couples, with one working member. In such cases the accrued sum should be divided between them. A similar approach should be implemented in a case of divorce. Therefore the necessary laws should be created.

5.3.2.3 *Financing of the transition*

The main question is how to finance the transition.

a) debt financing

A straightforward way to finance the transition deficit is by issuing new government debt. According to Corsetti and Schmidt-Hebbel (1995) a debt financing implies that national saving and capital stock are only marginally affected.

b) tax financing

The second possibility to finance the transition deficit is by rising taxes which is equivalent to the combination of pension reform and contractionary fiscal policy.

A tax financed transition hurts transition generations and benefits future generations and in the same time encourages higher saving and capital formation, which leads to the increase of growth in the long run.

As it was pointed out FF system eliminates labor market distortions, but creates tax distortions. Tax distortions are permanent if the transition period is debt-financed. (we are considering only general taxation, not payroll one). In the same talking Kotlikoff, Smerts and Williser (1996) asserts that the most appropriate tax is tax on consumption. (when one's wealth is spent on consumption, a tax should be paid).

It should be mentioned, that the pension reform is a part of our efforts to liberalize the economy.

As it was described the Bulgarian pension system is in crisis. It is better to undertake a radical reform, than to reconstruct the PAYG system, which will deteriorate the problems, having in mind the aging of population.

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Sofia, April 1997

BEYOND DISASTERS: WHAT POLICIES ENSURE GROWTH AND PROSPERITY

discussion paper

THE CROATIAN PRIVATIZATION PROGRAM AND THE PROBLEM OF TRANSPARENCY

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I think that the issue of transparency in the privatization process is very important and is rightly chosen as one of the topics for this panel.

As can be seen from their results, in many transition countries it proved to be crucial for a rapid ownership transformation.

Transparency indeed depends on the concept of the privatization chosen. The clearer and more transparent the concept is, the more transparent are legal solutions and other rules and regulations that are supposed to guide the process.

In my opinion, this is the issue that was not well taken care of in the Croatian privatization program, resulting in a privatization that is neither rapid nor transparent.

The chronology of the ownership transformation and privatization process of socially-owned property in Croatia and the results accomplished in the last five and a half years show that the institutional and legislative framework lacked many elements. This was the key reason for lack of transparency in the process which had as a result slow privatization progress and an increase of informal economy in this field. The laws and regulations mentioned above remained dubious, incomplete and crude in a number of provisions.

The resulting irregularities were solved in practice by legislative amendments as they occurred (the initial Law from 1991 was amended six times, leading to the adoption of the new Privatisation Law in 1996).

Law-makers failed to draw up an unambiguous and precise text of the laws concerned. Some of the vagueness became visible only later on, but has never yet been satisfactorily dealt with during all the years since. An excellent example of this is the most recent controversial interpretation of the Law on Transformation concerning the quantity of discounted shares allowed to be bought. (The issue concerns a legal dilemma of restricting the subscription of discounted shares to DEM 20,000 per company or in total which as a consequence leaves dubious more than 9,000 small shareholders contracts).

The frequent changes and amendments of the original text of the Law put the new owners in an unequal position, produced feelings of legal uncertainty and created favourable conditions for many forms of the grey economy activities.

Although frequent changes may also have its positive side (correction of the distortions arising in practice), its fundamental weakness has throughout been that it was not able to establish and guarantee any lasting principles and consistency of implementation.

Its additional fault was that it continued to feed doubt and suspicion of public in the honesty and credibility of what was happening. The law-makers failed to produce stable and clearly defined regulations to make it possible for all interested to participate in the process on equal basis.

One of the factors that contributed greatly to this situation is the concept of privatisation chosen which resulted in the Law on Ownership Transformation of Socially-Owned Property (1991). It was mainly based on methods of selling on case-by-case principle with preferential treatment of formerly and currently

employed persons. According to the Law, non-privatized socially-owned property officially became state-owned property and citizens who had participated in creating that property in the first place were now represented by state institutions. As Gavin Gray has nicely put in his article on Croatia in the "Financial Times" on 30 May 1996 "This gives Croatia the dubious honour of being probably the only country to run a privatization program that has brought about an increase of the state ownership!".

The chosen model of privatization with its forms of preferential sale had at least three negative consequences: a) centralisation on the level of state administration of all decisions concerning ownership transformation and privatisation; b) state take-over of a significant part of socially-owned capital; c) selection of large buyers according to political loyalty.

The other important factor which contributed to the non-transparency was concentration of decision making in the hands of a state agency which was in charge of privatization implementation. The central role of the state in managing the entire process of privatization in Croatia had a series of undesirable side-effects.

According to the Law on Ownership Transformation of Socially-Owned Enterprises (1991), although all firms and companies were guaranteed the right to suggest their preferred privatization modes, the final decision on the privatization of a particular company was made by the Agency for Restructuring and Development (later to become the Croatian Privatization Fund, CPF). That in practice meant that it was the Agency who had the final say on who to sell and to what price. Corruption and other irregularities were some of the undesirable side-effects of the over-dimensioned role of the Agency.

The Law did not precisely establish the order of priorities or criteria for the assessment of applications for privatization. Non-transparency of criteria and the procedure itself opened up possibilities for an unusually large area of discretionary manoeuvring space for the Agency later CPF's) managing board to assess each case separately and according to ad hoc established goals. This unrestricted arbitrary decision making and the right to use own discretionary right in assessment of individual purchase offers, can be held responsible for the consequent development of numerous irregularities in the process, as it fostered expansion of the corruption and intermeshing of politics with the new private elite.

Non-transparency of conditions of selling whole companies, their stakes or shares and the adjustment of conditions to each individual case produced negative impact on the investors' decisions and immensely damaged the general perception of the privatization process in the eyes of the public. In this respect, the biggest problem was the lack of legal restrictions of the role and arbitrary decision making by the state administration in privatization process. Had the Agency not been given the role of central arbiter by Law, the problems would nowadays be far less critical.

What than could be done about neutralizing the factors that affected the speed and transparency of Croatian privatization program?

First, it is really vital to have clearer and more precise legal regulations. This will significantly narrow down the space for arbitrary decisions and discretionary interpretation of the laws and regulations by the state administration.

However, clear and predictable laws and not enough. What is also needed is a political strength of people who have authority to publicly condemn irregular activities and an efficient executive judicature, or efficient functioning of law-governed state.

Third, it is necessary to accelerate and complete the process of privatization as soon as possible, because precisely the prolongation of the process enhances the risks of corruption, fraud, bribery, irregularities and other negative side-effects which usually accompany the processes that last too long. In this respect the following steps are necessary: a) accelerating the process of privatization relying significantly on non-standard methods; b) privatization of public companies with supervision by prominent foreign supervisors;

c) clear definition of criteria and rules for direct sales so that they become mandatory and known to everybody, thus enabling their verification by all the parties interested; d) control of the work of the state privatization fund through parliament and special supervision body consisting of all political parties in the parliament.

Perhaps, some of the steps might be equally advisable for the policy-makers in Bulgaria.

Sofia, April 1997