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Bureaus, Investment and Honest Policies

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Honesty is the best policy, because it's better than any other policy. In the economy, such policies eliminate or reduce government control over prices, profits and contracts. The aggregated effect is believed to be lower transaction and contract enforcement costs and increased economic freedom. Honesty is to be sought in relations between the state, its representatives - i.e., bureaus[1] - and entrepreneurs.

Entrepreneurs, within the existing freedom of choice, aim to reduce above mentioned costs (and thus increase their profit). The bureaus also aim at maximizing their specific utility. Unlike entrepreneurs they are non-profit organizations, and they finance themselves, at least partially, through the distribution of funds collected from others (mostly taxes) and/or grants.

On the bureaus' side there is a supply of goods and services, which under normal accounting systems are reported as a share of total government expenditures. On the entrepreneurs' side lies an objective to supply of the same or similar goods and services, but not as a participation in distribution but merely as gaining a certain share on the market. An important principle in analyzing corruption is the believe that on the market both buyer and seller gives less than gets. In other words, anti- and non-market mechanisms tend to increase transaction costs, in principle.

Honest policy and freedom

Based on these reflections, at the first meeting of independent experts and the government of Bulgaria in Borovets (July, 1997)[2] I presented a list of sources of corruption stemming from intervention in setting prices, government controls over trade contracts and profit-margins, and from regulations on government appointment of state-owned enterprise management. The idea was that cabinet decrees are easy to amend or discontinue. Had it been done, current costs of doing business in Bulgarian could have been lower. As of mid-1998 everybody started discussing corruption, and the third meeting in Borovets I chaired a special debate to the issue.

It seems that the expert community believes that the basics of honest policy and freedom coincide: countries tend to rank at a similar level for indices of both economic freedom and corruption perception. Although economic freedom is measured objectively, while a corruption index measures perceptions, coincidences on the two scales show that corruption is perceived as a lack of freedom. Contrary to this conviction, at the last Borovets meeting Prime Minister Kostov declared that in Bulgaria economic

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Economic Freedom Weighted Summary Index, 1997

Index	Country (Rank)	Index	Country (Rank)
9.6	Hong Kong 1	6.2	Cyprus 63
9.4	Singapore 2	6.2	Uganda 63
9.2	New Zealand 3	6.2	Bahamas 63
9.1	Unites States 4	6.1	Sri Lanka 66
9.0	Unit. Kingdom 5	6.1	Venezuela 66
8.8	Canada 6	6.1	Barbados 66
8.7	Argentina 7	6.0	Israel 69
8.6	Netherlands 8	6.0	Malta 69
8.6	Panama 8	6.0	Ghana 69
8.6	Australia 8	5.9	Tunisia 72
8.6	Luxembourg 8	5.9	Egypt 72
8.6	Ireland 8	5.8	Jordan 74
8.5	Switzerland 13	5.7	Colombia 75
8.4	Japan 14	5.7	Zimbabwe 75
8.3	Denmark 15	5.6	China 77
8.3	Norway 15	5.6	Belize 77
8.2	Belgium 17	5.5	Brazil 79
8.2	Finland 17	5.5	P.N. Guinea 79
8.2	Germany 17	5.5	Zambia 79
8.2	El Salvador 17	5.5	Slovenia 79
8.1	France 21	5.5	Fiji 79
8.0	Sweden 22	5.5	Morocco 79
8.0	Bahrain 22	5.3	Gabon 85
7.9	Italy 24	5.3	Poland 85
7.9	Chile 24	5.3	India 85
7.9	Mauritius 24	5.2	Tanzania 88
7.9	Austria 24	5.2	Namibia 88
7.9	Thailand 24	5.2	Cote d' Ivoire 88
7.9	Costa Rica 24	5.1	Bulgaria 91
7.9	Oman 24	5.1	Iran 91
7.8	Bolivia 31	5.1	Russia 91
7.8	Philippines 31	5.0	Senegal 94
7.8	Spain 31	5.0	Mali 94
7.7	Iceland 34	5.0	Niger 94
7.7	Portugal 34	5.0	Cameroon 94
7.7	Trinidad/Tob. 34	5.0	Pakistan 94
7.7	Uruguay 34	4.8	Chad 99
7.7	Guatemala 34	4.8	Burundi 99
7.6	Kuwait 39	4.8	Nepal 99
7.6	Paraguay 39	4.7	Syria 102
7.6	Peru 39	4.7	Benin 102
7.6	Taiwan 39	4.6	Nigeria 104
7.6	Malaysia 39	4.6	Congo, Rep. 104
7.5	South Korea 44	4.4	Bangladesh 106
7.5	Greece 44	4.4	Togo 106
7.4	Mexico 46	4.3	Romania 108
7.4	Lithuania 46	4.2	Madagascar 109
7.3	Estonia 48	4.2	Algeria 109
7.2	Jamaica 49	4.2	C. Afr. Rep.109
7.2	Czech Rep. 49	4.2	Ukraine 109
7.2	Indonesia 49	4.1	Malawi 113
7.1	Latvia 52	4.1	Sierra Leone 113
7.1	Ecuador 52	4.1	Albania 113
7.0	Kenya 54	3.5	Rwanda 116
6.9	Honduras 55	3.1	Congo, Dem.117
6.9	Hungary 55	3.1	Guinea-Bissau117
6.8	Slovakia 57	2.5	Myanmar 119
6.8	Domin. Rep. 57	N/R	Croatia
6.6	Botswana 59	N/R	Guyana
6.5	Nicaragua 60	N/R	Haiti
6.5	South Africa 60	N/R	Somalia
6.3	Turkey 62	N/R	Unit. Arab Em.

freedom is being restricted in order to fight corruption. Here I would like to discuss this point in some detail.

The economic freedom index (EFI) is compiled from the following groups of indicators:

- size of government: consumption, transfers, and subsidies
- structure of the economy and use of markets
- monetary policy and price stability
- freedom to use alternative currencies
- legal structure and property rights
- international exchange: freedom to trade with foreigners
- freedom of exchange in capital and financial markets

The index for Bulgaria increased in 1997[3]. In 1995 the country was on the lower part of the table, with a freedom rating of less than 5 points. With 4.1 points, Bulgaria ranked 87th out of 115. Now Bulgaria's rating is 5.1, but it ranks 91st (together with Iran and Russia) out of 119 countries. Slovenia, which in 1995 was the only CEE country behind Bulgaria, is now ahead our country, ranking 73 with 5.9 points.

Bulgaria's progress on the economic freedom path last year is equal, in terms of speed but not in starting point, to that of Poland. Bulgaria's low rating results from several indicators, quite important for the last year: restricted liberalization of prices and international trade, high share of state property and the actual stage of development of the capital market.

What is most important is that the leading 20 countries in terms of economic freedom index are at the same time on the lower end of the scale for perceived corruption.[4] Out of the emerging CEE markets only Hungary and the Czech Republic happen to be in this group; at the same time, their economic freedom index is the highest in CEE. It is also interesting that in Romania the corruption perception index is lower than in Bulgaria, although it (together with only Ukraine and Albania) has a lower EFI rating.

If a conclusion from the above unveiled reflections could ever be derived, it would by no means be that the restriction of economic freedom might result in a reduction of corruption. It does not matter that the corruption index measures perceptions: the very feeling that corruption is a norm makes it such.

State intervention and investment process

The current level of government intervention in the economy is to great extent indirect and non-financial. The overall instability of legal framework in 1996 and 1997, economic instability and the memory of it disoriented perceptions. Among representatives of the state, the bureaus, we witness an appetite for retaining control. Entrepreneurs are left with the "shadow" economy as the realm of possible economic freedom. Dishonest policy is conducted on both sides. In a narrow definition introduced recently by the World Bank, corruption is the "abuse of public office for private gain" and appears on the side of the government official and his "bureau."

As an economic phenomenon corruption is the erosion of relations, rules and efficiency. In a single transaction the rent (price) for getting past the bureau might result in either positive or negative outcome; i.e., the transaction intermediated by the bureau either is realized or fails. For a sequence of transactions, however, the quality of the environment deteriorates due to a blocked mechanism of supply and demand of the most favorable conditions and the lowest available cost. The cumulative effect on net investment impedes growth and decreases wealth.

It might sound interesting that until 1991 in Bulgaria, as in most CEE countries, gross fixed capital formation was comparable to that in countries with developed market economies. Later the dynamics were quite different. From a level of about 30% of GDP at the beginning of the decade, gross investment in Romania, Bulgaria and Poland (from a lower starting point) fell to below 20% in 1992. In Hungary the big decline took place in 1991, and since 1994 the level has been restored to the previous 22%. In Poland the recovery took place in 1995-1996, while in Romania gross investment reached 22-23% of GDP in 1995. Major reasons for these drops were economic instability, adjustment to new markets, weak domestic demand, and for all of the countries except Hungary, delayed privatization.

Only in Bulgaria in 1997-1998 do the above-mentioned factors continue to act almost all together at once. Gross fixed capital formation fell to less than 10% of GDP in 1994, then increased to

Corruption Perceptions Index, 1998

Rank	Country	Index	Rank	Country	Index
1	Denmark	10	43	Zimbabwe	4,2
2	Finland	9,6	45	Malawi	4,1
3	Sweden	9,5	46	Brazil	4,0
4	New Zealand	9,4	47	Belarus	3,9
5	Iceland	9,3	47	Slovakia	3,9
6	Canada	9,2	49	Jamaica	3,8
7	Singapore	9,1	50	Morocco	3,7
8	Netherlands	9,0	51	Salvador	3,6
8	Norway	9,0	52	China	3,5
10	Switzerland	8,9	52	Zambia	3,5
11	Australia	8,7	54	Turkey	3,4
11	Luxembourg	8,7	55	Ghana	3,3
11	United Kingdom	8,7	56	Mexico	3,3
14	Ireland	8,2	56	Philippines	3,3
15	Germany	7,9	56	Senegal	3,3
16	Hong Kong	7,8	59	Ivory Coast	3,1
17	Austria	7,5	59	Guatemala	3,1
17	United States	7,5	61	Argentina	3,0
19	Israel	7,1	61	Nicaragua	3,0
20	Chile	6,8	61	Romania	3,0
21	France	6,7	61	Thailand	3,0
22	Portugal	6,5	61	Yugoslavia	3,0
23	Botswana	6,1	66	Bulgaria	2,9
23	Spain	6,1	66	Egypt	2,9
25	Japan	5,8	66	India	2,9
26	Estonia	5,7	69	Bolivia	2,8
27	Costa Rica	5,6	69	Ukraine	2,8
28	Belgium	5,4	71	Latvia	2,7
29	Malaysia	5,3	71	Pakistan	2,7
29	Namibia	5,3	73	Uganda	2,6
29	Taiwan	5,3	74	Kenya	2,5
32	South Africa	5,2	74	Vietnam	2,5
33	Hungary	5,0	76	Russia	2,4
33	Mauritius	5,0	77	Ecuador	2,3
33	Tunisia	5,0	77	Venezuela	2,3
36	Greece	4,9	79	Columbia	2,2
37	Czech Republic	4,8	80	Indonesia	2,0
38	Jordan	4,7	81	Nigeria	1,9
39	Italy	4,6	81	Tanzania	1,9
39	Poland	4,6	83	Honduras	1,7
41	Peru	4,5	84	Paraguay	1,5
42	Uruguay	4,3	85	Cameroon	1,4
43	South Korea	4,2			

15% in 1995, only to fall again to below 10% in 1996 and remain at this low level (11.3% in 1997 and 7.1% in the first quarter of 1998).

A comparison between investment in capital accounts during corresponding periods of 1997 and 1998 is disturbing. For the first half of 1997 these investments reached $504.4 million, while for the same period in 1998 they remained at $299.1 million. The decrease is as high as 40.7%. The difference results from the lack of foreign direct investment and the outflow of portfolio investments at the end of 1997 and entire 1998. Bank credit for the same period has been almost entirely short-term, with an interest rate on deposits of 3% and an interest rate on commercial loans of 14%. The reasons again lie in delayed privatization, underdeveloped capital market, and - probably - the fact that investment in long-term assets is taxed.

The country will (hopefully) soon conform its regulations to Art. 4 and Art. 8 of the IMF Statutes. This means that discriminatory actions against convertibility, exchange rates and capital flows would be legally impossible. Another point would be added to the country's EFI score.

Despite the latest positive macroeconomic developments, local entrepreneurs are pessimistic and foreign ones restrain themselves from coming in.

I suppose the explanation might be in the effort of the government to simultaneously enact incompatible policies: liberalization of the economy through stated intention to adjust to the practices of developed markets, and at the same time preservation of the "license-requiring state," exercising control over entrepreneurship and investment within the country via non-financial constraints.

The license-requiring state can be defined as one in which the bureaus function as agents for collecting rents. Rather than having all economic activities not explicitly prohibited by law automatically be allowed, the government sets artificial entry barriers.

In the field of privatization Bulgaria has the most complicated legislation in CEE, as well as controversial implementation and a lack of consistency. In regard to taxation, Bulgaria has maintained a confiscation regime, with no respect for the fact that people produce more when they keep for themselves more of what they earn.[5]

Currently as many as 82 laws deal specifically with some kind of licensing, endorsement or registration. Of them, 20 provide rules related to "martial-law-situations," and about 10 refer to pure administrative procedures or permits within the non-profit sector. Roughly, about 50 regulations provide "special" rules for certain economic activities. Moreover, about 150 regulations and law provisions require some sort of licensing, permit or registration.

Corruption, state-owned enterprises (SOEs) and the "rules of the game"

Contrary to the generally-spread impression, empirical studies do not prove a direct correlation between public procurement in SOEs and corruption.

In a representative study conducted by IME and the Agency for Socioeconomic Analyses (A.S.A.) in 1997 on the role of bureaucracy in SOE management, we at IME asked several questions geared toward evaluating the inclination of executive directors toward abuse of power.

How do you estimate administrative rules for enterprise operation that the State defines (one answer)?

One answer	SOEs	Private
Completely unclear	8.0	18.8
Unclear	15.9	25.0
Clear to some extent	46.6	31.3
Clear	21.6	25.0
Completely clear	8.0	0

It is interesting that the rules of the game look quite clear with regard to SOEs, while at the same time vague and obscure for the country as a whole.

In both private and state-owned enterprises, the internal rules of organization are perceived in a similar way.

The same uniformity of opinion might be observed in inclination towards general rules of the game.

Are the "rules of the game" clear in Bulgaria (one answer)?

	SOEs	Private
No such rules exist	21.3	20
Completely unclear	6.4	5
Unclear	21.3	30
Clear to some extent	39.4	35
Clear	8.5	10
Completely clear	3.2	0

One of the aphoristic definitions in the Public Choice theory, of substitution of rules of the game and abuse of power, is as follows: abuse of power is like winning a tender without having the money to participate in it - there are two ways of doing this: physical elimination of rivals or substitution of the rules of the game. Assuming that a SOE's manager has above-average political influence, IME asked the following question:

If you wanted to win a tender at any cost but you lacked the money, what would you do?

	Yes	No
I will participate anyway	72,2	27,8

I will win through:

Loan	55,6
Coalition with others	20,4
Good business plan	16,7
Corruption	7,4

It seems that the real problem in SOE management is not corruption as such, but rather in the cost of decision-making and efficiency.

Operational time and efficiency

State representatives and their bureaus do in fact have one resource at hand, which is time. A standard model for defining time efficiency might be used. We defined time cost as "high" and "low" simply by evaluating the amount of time

Time spent on coordination with the owner (percent of respondents):

Little operational time	12,5
Medium operational time	12,5
High operational time	75

spent. It turned out that 75% of CEOs spend a substantial amount of time on daily consultations with the owner (the State) about operational problems. This lack of autonomy obviously leads to wastage of time in coordinating with the owner (the State). No other institutions (labor unions, tax officers, politicians, etc.) require substantial time use.

The question is what, if not autonomy, motivates managers to keep doing their job:

Guaranteed income	39,8
Security	32,6
Contacts that allow for additional benefits	12,8
Prestige	9,1
Clear obligations	24,4
It is well-defined who takes the decisions	26,7
Comparatively low personal responsibility about issues not directly connected to the own position	31,8
Clear career prospects	13,8
Fixed working time	29,2

The most motivating factors for professionals in SOEs appear to be guaranteed income and security. Next comes the low level of personal responsibility in making decisions not directly dependent on the manager. Opportunities for additional benefits or dividend income from equity are not, however, seen as such incentives.

Obviously, the incentives cited by SOE managers are outside the enterprise as a market agent. The discontent stems not from the rules of the very operation of the enterprise, but rather from the unstable and obscure rules of the game in general. If this holds true, the sources of corruption and dishonest economic policy can be found in the system (network of relations), rather than in the SOEs themselves.

Systemic errors and deadlock

Despite their secondary role in the GDP, SOEs are still a nominal owner of the physical assets in the Bulgarian economy. De jure and de facto the owners are the Council of Ministers and the line ministries.

Relations between the owner (the State) and the SOEs are regulated by CM Decree 7/25 of January 1994, on procurement of "state property rights in SOEs."

It is barely known that these regulations have been amended 17 times in the four and a half years of their existence, mostly in sections dealing with the remuneration of managers and board members. If our empirical studies hold true, this is the least effective amendment, given that income is not a primary incentive at all. If incentives to decapitalize the enterprise exist, they obviously cannot be revealed. A lot of efforts were concentrated on restructuring SOEs' operation under the general provisions of the Commercial Code. None of the amendments succeeded in solving the major problem: the appointing of executive management with at least an element of competition or venture capitalism, for a designated period of three years.

As a result, the managers protect their places in the administration of the respective line-ministry, or on its "list" of people entitled to certain positions. It is not difficult to suggest, or even prove, that they thus maximize their personal utility. This incentive, however, coincides neither with increased profit nor with the acquisition of managerial knowledge under market conditions.

The problem is that the coalition formed by the above-mentioned alliance of interests multiplies the detrimental effects on the economy in general. As a result, loss-making enterprises are not being closed down. It also leads to political pressure for soft bank loans. It blocks privatization. It drained the commercial banks. It made Videnov's government crash. Nevertheless, five governments (two of them interim ones) maintained the same system.

There are several (theoretically) possible solutions to the problem. For instance, through formulating strict management rules for a single enterprise (or a group of enterprises) and then organizing a public tender for the managerial contract that provides autonomy and guarantees in case of default (loss). Or through privatization. Or liquidation. There are, however, no funds available for the first and the third solutions, nor human resources for the first one. The second option remains the only feasible one; this is the reason why coalitions come up with controversial privatization schemes and delay the process in order to retain control.

In general, what is good for the economy and prosperity is good for curbing corruption. The question is where this honest policy could come from. The government has a program for the formation of a "competitive economy driven by a viable private sector." This program is approved by the IMF. One would not discover anything exceptional in it; all of the measures in it have been proposed on different occasions by both local and foreign experts. No honest policy is ever possible beyond these measures; however, they were imposed by the International Financial Institutions. The question again is: to what extent have they grasped the hearts and the minds of those who sit behind the "bureaus?"

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[1] This term is broadly used by William Niskanen, Jr., CATO Institute Chairman; I use this term to underline impersonal nature of the attitudes at relations in question.

[2] In 1997 and 1998 it became a tradition all members of the cabinet and majority faction of the parliament to meet non-government experts and discuss current economic policy issues; there were two such meetings in 1997 and one in 1998; it seems that this tradition will be skipped by the government.

[3] IME is a member of the Economic Freedom Network, and co-publisher of the Economic Freedom of the World; the data below is from 1998/1999 Interim Report (editors: James Gwartney and Robert Lawson) and reflect the constellation of 1997 economic liberty factors.

[4] See Transparency International Corruption Perception Index 1998: www.transparency.de.

[5] See L. Bogdanov's article in this issue.

Transparency of Tax Regulations and Costs of Compliance

Latchezar Bogdanov, IME

"Human action is will put into operation and transformed into agency, is aiming at ends and goals, is ego's meaningful response to stimuli and to the conditions of its environment, is a person's conscious adjustment to the state of the universe that determines his life."

"Acting man is eager to substitute a more satisfactory state of affairs for one less satisfactory."

Ludwig von Mises, **Human Action**

Background

One could soundly argue that the aim of every human being (and especially one who is an entrepreneur) is to minimize costs and maximize benefits. Thus we can assume that the higher the net costs imposed by the tax system, the higher the incentive for non-compliance. Therefore, the costs of compliance with tax regulations should be examined, as well the benefits. It is quite difficult to quantify them; in some cases descriptive reasoning will be used.

In this paper I assume that tax legislation in Bulgaria encourages informal behavior among the business community. Since informality means non-compliance with tax laws, a way of avoiding penalties should exist. This might be either a lack of relevant deterrent sanctions in the law, or corruption of government (tax) officials to conceal violations. Since no empirical data on corrupt tax officials is available, we will explore the sources of informal (in terms of tax evasion) economic activity, which as noted above is closely related to corruption.

When analyzing the impact of tax legislation on informal behavior - and consequently corruption - we focus on several major characteristics of the tax system:

- First of all, it is very important that the system is stable and predictable. Important criteria are the number of amendments to tax laws, the number of regulations related to the taxation of certain activities, and the level of transparency of legislation (whether it is published or not).
- Second, we consider any possibility for arbitrary decisions by tax authorities (officials) as a potential source of corruption, which intensifies in proportion to the decrease in the rank of the official in charge
- Third, we will examine the economic incentives to maintain informal behavior.

Table 1: Stability of the legal framework

Law(s)(regulation)	First published State Gazette No	Amendments after 1991
VAT	90/1993	9
Income tax	132/1950;118/1997	17
Corporate Profit tax	4/1989 ; 59/1996/;115/97	22
Tax Administration	59/1993	3
Tax Procedures	61/1993	6
State Financial Control	12/1996	1
Accounting Act	4/1991	8
Total		**66**
Implementation rules	**First published State Gazette No**	**Amendments after 1991**
VAT	17/1994	8
Income tax	100/1994	9
Decree 56/Profit tax	15/1989 ; 109/1996	24
State Financial Control	2/1997	2
Total		**43**

Stability and predictability

The history of modern Bulgarian tax legislation began with the adoption of Decree 56 in 1989. This was an attempt to regulate emerging private sector activities, and a huge section in it dealt with corporate income taxation. Since the beginning of market reforms, and the adoption of the Commercial Code in 1991, numerous laws and Council of Ministers (CM) Decrees were introduced, to regulate the taxation of both sole proprietors and corporations.

Several things should be mentioned:

- Though very few laws were in place to regulate taxation, that does not make the legislation clear and transparent. The reason is that most of the tax laws were adopted or changed to serve short-term problems, mainly filling the gaps of the current budget. Some of them were enacted retroactively. The logical consequence was that numerous additional regulations have had to be implemented, to interpret the imprecise laws. Usually these were the so-called "implementation rules" issued by the CM to clarify the law. They do not only clarify, however, but often supplement the very substance of the law. Moreover, controversial cases are supposed to be solved through the so-called "General Tax Administration Directorate Letters" or even "Regional Tax Offices Letters," which are generally not published. Thus tax regulations end up being imprecise and controversial, and sometimes remain hidden from the taxpayers. Therefore it becomes difficult

Table 2: Number of regulations related to social insurance (as of beginning of 1998)

Laws	6
CM Decrees	5
Implementation rules	3
CM ordinances and instructions	10

to obey the "rules of the game" and consequently many choose to operate "underground."

• There are arguments that in a dynamic economic environment the tax system should also be flexible, to meet the changing conditions. A brief overview of the data above shows that major tax laws were changed 66 times during the period 1991-1998, and the respective "implementation rules," 43 times. That is equivalent to an annual average of 8.25 and 5.38 times, respectively. Altogether, amendments (or adoption of new regulations) to tax regulations occurred 16.13 times per year. That makes 1.34 times monthly! This makes long-term decisions impossible, or at least too costly, as most of the private companies can not afford them. Corporate taxation has been regulated by three different laws! At the same time there is a strong empirical evidence that business people prefer stability and predictability. The table below exhibits the opinion of entrepreneurs according to a representative survey among 101 private firms in the end of 1997-beginning of 1998, by IME and the Agency for Socioeconomic Analyses (A.S.A.) (financed by The Freedom House under the international project: Needs for Deregulation of Tax Systems in CEE: Bulgaria, Poland, Slovakia):

What in your opinion is the approximate acceptable frequency of changes and improvements to tax regulations?

Answer	%
every year	12.2
every two years	14.3
every three years	12.2
every four years	5.1
every five years	56.1

In fact, the current tax system flexibility does not fit entrepreneurs' expectations. The natural response to this is to go into the informal economy, which is at least steered by the "invisible hand" of the market and where the "rules of the game" are the results of rational action and do not change every month (see table).

The costs implied by the unstable environment could hardly be evaluated. An attempt was made in 1996, when IME and ASA studied the transaction costs of 108 entrepreneurs in the big cities of Bulgaria. According to the survey, firms rank expenses as follows: "commissions paid in cash" came first in 78.8% of answers, followed by "legal fees," "consultant services," etc. Two-thirds of firm owners (or a specifically hired person) spend up to one month of their annual working time dealing with liabilities to the Government. The average time spent for this purpose is about two months. Given the fact that accountant salaries are at least equal to the average for country, which for the period 1991-1997 ranged between $90-115 per month, we can roughly calculate that the cost of tax compliance means an annual expense of about $200.

Who makes the decisions?

Table 3: Regulations by the executive power and tax offices

Other CM ordinances, instructions 1991-1998	46
Interpretation letters of Tax Directorates (1996-1998 only)	71

When laws are obscure and controversial, some interpretation is necessary. Unfortunately, laws are interpreted by the executive power. This encourages informal behavior, and hence corruption, in two ways: first, it makes the tax system non-transparent and unstable; and second, when decisions are made by fewer people at a lower position in the administration, it becomes easier to influence them.

Since the beginning of the reform, the CM has issued 46 ordinances and instructions to complement tax legislation. Over the period 1996-1998 only, the General Tax Directorate (GTD) with the Ministry of Finance issued 71 interpretation letters. Even after the Parliament announced at the end of 1997 that the new tax laws would be clear and would need no further interpretation, the GTD has issued 14 letters in 1998.

The range of controversial regulations resolved by tax administrations during the period is immense. They start from the content of the annual tax declarations (personal and corporate income tax), through VAT treatment of option contracts, VAT refund for long-term assets purchased before VAT registration, instructions for 1991, 1992 and 1993 annual taxation (personal and corporate income tax) and even include the method of payment and the level (!!!) of corporate tax advance installments for 1998. Moreover, the Tax Procedures Code allows the head of the regional tax office to establish tax duty at to his own discretion if accounting papers are incorrect or missing, and if no tax declaration is submitted. At the same time, the procedures for tax audits are regulated by Ordinance N4 of the Ministry of Finance, accompanied by eight Letters from the GTD and four Orders from the Finance Minister!

There are several types of problems with such practices:

• The GTD letters are intended to serve other tax officers rather than taxpayers; most of them remain unpublished. Thus the rules of the game are unclear, the taxpayer never knows what the latest "Interpretation Letter" (in fact, regulation) is about, and finally it becomes easier (and cheaper) to go "underground."

• It is difficult for the Parliament to change laws frequently. The procedure is time-consuming, and more importantly, it takes the persuasion of at least half of the MPs to make an effective amendment. On the contrary, a Ministry of Finance instruction or a GTD Letter may be quickly issued, and it takes just several (in some cases, one) men to sign it. This is a dangerous state of affairs, for two reasons: first, the tax administration can change regulations virtually every week and thus make tax legislation obscure and unpredictable; and second, the level of disclosure in Tax Directorates is quite lower than that of the Parliament - while MPs should publicly motivate their proposals, tax officials in the Ministry of Finance can do whatever they feel necessary, with no effective checks-and-balances mechanism. Hence the cost of being dishonest is lower in government administration, and thus the likelihood of corruption (basically, through promoting certain interests in regulations) is higher.

Rational grounds for informal activity

By definition, taxation is the confiscation and further redistribution of private property, rather than the volunteer purchase of goods and services provided by the state. One could argue that the more taxes are paid, the more public goods are available for consumption. Or even more, that those who pay more taxes are richer, and hence benefit more from public goods such as defense, property protection, and infrastructure (e.g., those who own three cars utilize three times more road facilities than those who own just one). Both arguments are erroneous, or at least imperfect.

• First, in all democratic societies equal access to public goods is granted. Which is to say that no one can deprive you of the right to justice or police protection if you fail to pay enough taxes. It turns out that while everybody deserves police protection, only a few really pay for it; while everybody has the right to a fair trial, only a few are obliged to pay to the judge.

• As for the second argument, it assumes that those who pay more are those who actually should pay more (or, that the richer pay more than the poorer). In other words, the statement would sound like this: if there was no tax evasion, then those who pay more (the richer) would utilize more public services, and therefore they should be willing to pay more taxes. This is a logical contradiction, a vicious circle in reasoning.

In this paper we assume that, first, there is no direct relation between the amount of inputs (taxes) and benefits (public services, goods, etc.), and second, that the individual agent has the freedom to choose between paying taxes and not paying taxes.

Hence tax evasion is a result of rational choice, determined by costs and benefits. As argued earlier, the benefit from so called "public services" might be treated as fixed for everyone. Its level depends on the level of government spending, and is not related to the tax regulations. Therefore it will not be examined further in this study.

The benefits of non-compliance might be defined as those costs that would be incurred if the entrepreneur were to operate legitimately. The cost of non-compliance is the cost of missed opportunities provided by compliance, the level of any bribes, and the penalties for non-compliance.

1. Costs of compliance

If taxes are avoided, expenses saved might be interpreted as the first, most direct benefit from such behavior. The corporate income tax rates are 28% for profits below BGL 50 million and 37% (combined with municipal tax). It is useless to assess whether they are too high or not; more comprehensive analysis of what enterprises actually have to pay is necessary. In other words, we need to evaluate how the tax base is established, how revenues are accounted and which expenses can be deducted. The major hypothesis is that tax legislation in the last eight years levied costs on business that are high enough to create rational incentives for informal activity.

Impact on capital as production factor

There are several ways of capitalizing a company: reinvestment of profit, bank loan, non-bank loan, and attraction of equity investors. What is important here is that tax-recognizable returns differ significantly from cash-flow balances. For small, and especially start-up, businesses, matching incoming and outgoing cash flows is crucial for survival. Investing profit does not favor such correspondence. The cost of long-term assets can be deducted from the tax base up to the level of a linear five-year depreciation allowance (for certain assets the first quota might be 30% of value). Which means that even if the entrepreneur incurs a negative cash result after investing in certain assets, for tax purposes he realizes profit, and therefore is taxed. Similarly, companies are obliged to make monthly tax installments based upon a fraction of one-twelfth of the previous year's profit, even if they have no revenues at the moment. Another impediment to formal growth and enlargement is applying a legal rather than economic (cash) approach to accounting and tax reports. Implicitly this means that contracted and invoiced receipts are considered taxable revenues. In an unstable business environment and with troublesome contract-enforcement procedures, such regulation is a direct threat to enterprises' profitability, and yet another incentive to stay "in the shadows."

For most entrepreneurs this way of capitalizing their business is too expensive and, on some occasions, inapplicable.

The availability of bank financing is determined by fundamental economic factors, rather than by tax legislation. The outcome, however, is that almost no banks extend long-term (investment) loans, especially to emerging companies, and most firms can hardly rely on financing from commercial banks. A 1996 IME survey on transaction costs showed that 82% of the private entrepreneurs interviewed started their businesses with family savings or credit from friends.

What this table exhibits is that the private sector share of GVA has been consistently higher than the share of credit it received, until 1997. The data in the table proves empirically that entrepreneurs rely on sources of funding other than bank loans.

Non-bank loans are also unattractive because interest on such loans is not recognized as an expense, and hence is taxed.

As for equity financing, there is a fundamental principle that discourages potential shareholders. Dividends on invested

Table 4: Private Sector - Dynamics of Credit Extended and Share of Gross Value Added (GVA)

Year	1993	1994	1995	1996	1997
Share of credit extended (in % of the total)	12.4	13.9	25.9	21.21	57.49
Share of GVA (in % of the total)	35.4	39.4	48	52.5	58.8

capital are taxed at a rate of 15%, while interest on bank deposits is tax exempt. Moreover, the government-maintained state guarantee on personal bank deposits while investments in corporate equity was affected by serious default risk during that period. The outcome was a serious incentive to save in commercial banks, as opposed to investing in shares.

Summarizing the observations above, it becomes obvious that tax regulations during the last eight years discouraged private business growth and capital accumulation, which resulted in large-scale informal activity. According to the 1996 IME/ASA Survey:

• One-fourth (24.5%) of firms turned out to have "double" accounting - one for the Government and one for internal use.

• One-fifth (20%) of foreign trade businesses openly declare that they decrease or avoid custom tariff due through intermediaries or customs officers.

• In 1993, Western tobacco industries reported that about 10% of tobacco imports to the UK are illegal.

• About 43% of the sample report a level of 70-100% of cash payments within the total payment structures of the companies.

About 20% of 101 private entrepreneurs (IME/ASA Survey on Tax Deregulation, 1997-1998) believe that those who are obliged to pay at the maximum personal income tax rate save avoid paying more than 50% of amounts due.

Impact on labor as production factor

Here we pay attention to two major factors: income taxes and social insurance contributions. The personal income tax rates range between 20% and 40%. Compared to other countries, they seem quite appropriate. The problem becomes obvious when the progression in the scale is examined. Just for demonstration, for 1998 the level of annual income which is taxed at the maximum rate of 40% is BGL 15,360,000, about $700-760 a month (according to the exchange rate). Thus, even relatively small businesses are obliged to pay 40% of their income to the budget.

Formal business goes hand-in-hand with formal employment. In Bulgaria, formal employment entails obligatory social insurance contributions. A social insurance burden substantially higher than direct income tax appears to be major problem for entrepreneurs, and therefore deserves special attention. According to Bulgarian legislation the insurance contributions are proportional to the salary rate. In the most common category of labor, the contribution consists of:

• 22% of the base insurance income for pensions (about 59% of the total contribution, which is made in two parts: 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);

• 10% of the base insurance income for motherhood, illness benefits etc. (about 27% of the total contribution);

• 5% of the base insurance income for labor hazards and accidents (about 14% of the total contribution).

When added to the personal income tax, which average weight is 17-19%, a 100-leva net income for the employee requires payment of 177 levs by the employer.

Therefore, the first problem of the existing social security system in Bulgaria is due to the discrepancy between the structure of installments and the structure of expenditures. The pensions "exhaust" 87.23% of the National Social Security Institute (NSSI) revenues (or 83.28% if transfers from the central budget are taken into account). For benefits under the Labor Code (LC), Chap. III (for illness benefits and benefits for rising a child), 8.48% of NSSI revenues are spent; and some 7.26% for aid under the Birth Rate Encouragement Decree (BRED). Since pension expenditures "eat away" almost the whole accumulated fund, the 22% normative contribution rate for pensions is not sufficient, and the real rate is 34%. In other words, in the framework of the existing system the insured are not receiving the services they actually pay for.

According to the NSSI, of the 3,473,526 people included in the system in 1996, 359,271 were self-employed (contribution rate of 22% or 32%). For the same period the National Statistical Institute (NSI) reports that 56.48% of all employees were employed in the public sector and 43.52% in the private sector. A huge discrepancy between social security contributions exists, however. According to NSSI data, the public sector contributed 94.2% of the NSSI's revenues (6.73% from enterprises and 17.29% from the budget sphere), while private sector contribution was only 5.8%.

According to the Labor Code (chapter III, article 149), even if an enterprise does not pay the obligatory contributions, eligible workers receive their benefits. This encourages employers to register their employees in the social security system, since the benefits due are automatically paid by the fund. This explains why only 2.5% of private employers pay any contributions at all to the Social Security Fund, and those contributions are based on the minimum wage.

This analysis leads to two major conclusions:

• inconsistency of payments and benefits discourages payment of social insurance contributions;

• there exists large-scale evasion of labor regulations, resulting in general informal behavior in order to cover costs.

Other costs implied by the tax system

Another factor that discourages formal behavior is the high level of informal (unaccountable) expenditures. Their level is partially due to an insecure and unstable business environment, and partially due to a "chain effect" or "vicious circle" in the system, caused by the informal activities of others.

The first group is predetermined by the enormous amount of permits issued by state officials. There exist special licenses for trading tobacco and alcoholic beverages. There is no distinction as to whether certain business activity is being exercised on one's own land or real estate, all industrial-type activities (including, for instance, operation of a small caf□), require at least three permits: from the local fire department, local government architect's office, and the local section of the Institute of Hygiene (a government office responsible for monitoring in-house pollution and public hygiene). Just the official fees for these permits are equal to court registration fees, but they are special license registrations due after the registration of the firm itself. The bigger the business, the greater the number of necessary permits, and the larger the costs to obtain them. For a sole proprietor to open a caf or set up a small workshop the time necessary to collect these permits alone is at least four weeks. Submission of the permits at the local government office does mot mean that the license will be issued at a provisional deadline, but the delay does not stop the applicant from operating the activity. The smaller the venture, the less likely the immediate issue of the license by the local government office; meanwhile, the entrepreneur operates freely. All this means that entrepreneurs should either operate illegally, or find alternative ways of getting licenses. The first option means informal operation per se. This creates a reason for corrupting not only tax officials, but also other licensing bodies whose rules have been neglected. The direct consequence of the second option, that of "buying" a license, is the corruption of responsible officials. The indirect effect is that the bribe turns out to be an effective but not tax-deductible cost. In order to keep profit unchanged, the entrepreneur is "forced" not to declare at least the same amount of revenues.

2. The cost of non-compliance

Here we would explore the opportunities forgone because of operating "in the shadows," and the level of penalties. Hardly any opportunities that compliance with tax regulations provides could be found. As mentioned in the previous sections, bank credit has never played a crucial role in private-sector capitalization, and bank requirements of decent accounting papers would not touch most entrepreneurs. The prestige that could be gained seems not to be of crucial importance, whatever the reasons. As argued before, there is no direct correspondence between taxes paid and public services provided by the government. Children are not expelled from schools because their parents have failed to pay their taxes; no one is denied access to a hospital because he/she failed to pay social contributions, roads are not closed to tax criminals. Which means nothing else but a rational incentive to avoid paying taxes as much as possible.

The penalties are basically of two types. First, fines for late or missing payments or deceitful reporting. These range between DM 500 and DM 1,500 for personal and corporate income taxes, and up to DM 5,000 for VAT Law violations. This explains the relatively high collection rate of VAT. As for direct taxes, some figures are worth mentioning: according to NSI data (sample of 4,152 private enterprises with up to 50 employees), the average annual profit reported in the small business sector in 1997 (companies with up to 50 employees represent 96.9% of all firms registered) was about $5,300 *(exchange rate used: 1750 BGL/USD)*. A simple calculation shows that a decent taxpayer should have paid $1,484 in profit tax, or $1,513 in income tax (for sole proprietors). The maximum fine is $857, which is quite lower than the amount of tax due. At the same time, a kind of black market of false invoices has developed, and the price oscillates around 10% of the par value of the invoice.

The second segment of the penalty is the interest on arrears, which as set in the Law on Interest on Taxes and Other State Receipts. Its level was determined as follows: the annual Base Interest Rate (BIR) divided by 360, plus 0.1% per day. Under the current macroeconomic situation, this means 3.5% per month *(BIR of 6% annualy is assumed)*, which is a comparatively high level compared to the market ones. However, up until 1997 the penal supplement was only 0.05% a day. At the same time, the BIR was substantially higher. For 1995, *(annual BIR = 61%)* calculations show a monthly penal rate of 6.8% and a nominal lending rate of 4.9%. For 1996, *(Annual BIR = 193%)* results show a monthly penal rate of 19% and a nominal lending rate of 10.1%. Considering the risk and potential benefits of not paying taxes at all, this a good price for lending from the government

3. Some thoughts on tax administration

Here we would just like to outline several factors that facilitate informal practices and provide stimuli for the tax administration to commit misconduct in its duties

• Tax officials are poorly paid, compared to the taxes they have to collect. The Special Encouragement Fund operates inefficiently and very few of those who directly prevent tax crimes receive respective remuneration;

• A possible benefit of decent behavior could be future promotion in administration or opportunities for a better job in private business. In fact, those who "cooperate" with tax evaders usually go into the private enterprise after leaving the tax administration. A broadly-offered service (advertised even in the press) is "tax officials who do annual tax reports."

• The fear of penalties is negligible. Bribing is penalized by up to six years imprisonment. However, in order to be detected, the crime should be reported. In cases of mutual benefit neither the entrepreneur nor the tax official would alert the police. The only cases of successful bribe detection have been when either the bribe was too high, or the official failed to perform the "service."

• As a common rule tax audits of certain papers for a period is performed only once. The Accounting Act states that "tax and financial control documents should be kept until they are audited by tax officials." What this means is that it is legally allowed to destroy papers once a tax audit has been performed. As a result, almost no possibility of subsequent control exists. For the period between August 1, 1997 and September 1, 1998, only 13 out of 9,481 tax officials were laid off after internal control audits *(Source: Ministry of Finance)*.

Conclusion

Even a brief analysis of the existing tax regulations proves that there are substantial incentives to engage in informal activity. The costs of compliance with tax legislation are several times higher than the costs of non-compliance. At the same time, the "rules of the game" are unstable and non-transparent, thus imposing additional costs on private business. And finally, no incentives are provided to the tax administration to fulfill its duties.

The result is a rational escape from formal behavior.

The Russian Crisis

and its implications on Bulgarian economy

Dr. Andrey Ivanov,
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The Russian financial crisis has had a serious impact on the Bulgarian economy as well as Russia's own, although different in direct and indirect terms. The direct consequences seen have been minor, because the share (out of all exports) of Bulgarian exports to Russia in the first half 1998 was about 6.6%. Bulgarian products already have difficulty accessing Russian markets, due to both economic and political reasons. The economic reason is mainly the low level of competitiveness of Bulgarian industries, and the political one lies in high import tariffs that verge on discrimination. Hence, the collapse of the Russian market would not drastically affect Bulgarian exports to Russia, given the fact that they are not high anyway.

Imports from Russia accounted for around 28% in the first half of 1998 of all Bulgarian imports, mainly energy resources and mineral products. Since Russia is interested in achieving a stable supply of hard currency, imports would probably not be affected. According to some optimistic scenarios, some terms-of-trade gains for resource-poor countries like Bulgaria can even be expected, because Russia's external adjustment would put downward pressure on world prices for these goods. However, tough payment requirements might probably be imposed in the future. And, such gains can only be achieved if alternative suppliers are in place, which is not the case for oil imports and definitely not the case for gas imports to Bulgaria, which are regulated by a long-term agreement with a fixed price in U.S. dollars.

The indirect consequences of the Russian financial crisis have mainly been connected with their impact on the international financial markets and the feasibility of infrastructure projects. Bulgarian BRADY bonds usually follow the trends of Russian securities, with higher amplitude. This is probably due to the fact that foreign investors, driven by pessimistic expectations, are trying to get rid not only of Russian, but of Eastern European securities in general, additionally undermining their price. This seems to be the main mechanism through which the Russian crisis affected the local financial markets in transition countries that have such markets at all. This is definitely not the Bulgarian case, and hence the losses are not comparable to those of other countries with more developed financial sectors. Moreover, Bulgarian Brady Bonds prices started to recover in the recent weeks.

The most important consequence was and probably will remain the possible withdrawal of foreign investors from emerging markets, including Bulgaria. This could mainly affect possible direct investors; the Government's optimistic expectations in this respect cold prove to be wrong, which would have negative consequences for the Government's investment strategy. In the long term, facing lower-than-expected direct foreign investment activity, the Government could reconsider the limits on state involvement in the economy, keeping the state as one of the main investors. To a certain extent this was proved by the 1999 Draft Budget with its public investment program of 2.5% of GDP.

Most important for Bulgaria are the possible infrastructure projects that cross Bulgarian territory. They may become less attractive, due both to the high costs of avoiding political risk and the lack of financial resources on the Russian side for participating in such projects. It was probably not by accident that Lukoil announced that they are not interested in the Bourgas-Alexandropolis pipeline shortly after the start of the financial crisis.

Concerning banks, most Bulgarian banks hold around 50 percent of their assets in low-risk "Western" securities. The only Bulgarian bank which was heavily exposed on the Russian market was the Bulgarian-Russian Investment Bank, which has been known as a risky player. However, it managed to withdraw at the last moment, suffering only minor losses. The crisis will not, however, stimulate banks to decrease the share of their assets "frozen" in Western banks. In the long term such "safe" strategies could turn into an obstacle to investment lending.

In the most optimistic interpretations of the crisis' impact on the Bulgarian economy, one could expect that the capital flight from Russia caused by the crisis could result in increased Russian investment in Bulgaria. However, this seems quite unlikely to happen — the capital is seeking more secure markets, and Bulgaria is still not perceived to be such. One of the reasons for this perception is the "tradition" according to which Bulgaria is still located in Russia's sphere of interest, in Western perception. But even if it does happen (i.e., if capital from Russia is directed to Bulgaria) it would be in the form of direct investment, mainly in food processing, tourism and the privatization of the armaments industry (although it is disputable to what extent such increased investment is desirable in geopolitical terms, given Bulgaria's quest for NATO membership).

Instead of conclusion: the indirect consequences of the Russian crisis will be more dangerous than the direct ones. These indirect consequences are:

- lower confidence of foreign investors in emerging markets,
- re-setting of priorities, in terms of Eastern Europe ceasing to be of strategic importance;
- less optimistic perspective for transcontinental infrastructure projects involving strategic investors;
- reinforcement of the traditional perception of Bulgaria as a country in Russia's sphere of influence.

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A Letter on Mortgage Markets in Bulgaria

from Dr. Mark Riedy

Dr. Riedy is the Ernest W. Hahn Professor of Real Estate Finance at the University of San Diego. Previously, Dr. Riedy served as President and Chief Executive Officer of the National Council of Community Bankers from July 1988 to June 1992. The National Council represented savings and commercial banks and savings and loan associations before Congress and Federal regulatory agencies, and provided a broad range of educational and communicational services to community banks.

From July 1987 to July 1988, Dr. Riedy was President and Chief Operating Officer of the J.E.Robert Companies, one of the nation's largest real estate workout firms. From January 1985 to July 1986, Dr. Riedy was President and Chief Operating Officer, and a Director, of the Federal National Mortgage Association.

He currently serves on the Board of Directors of Continental Savings Bank (Seattle), AccuBanc Mortgage Corporation (Dallas), Pan Pacific Retail Properties (NYSE-listed REIT), American Residential Investment Trust (NYSE-listed REIT), and Neighborhood Bancorp., the holding company for Neighborhood National Bank (San Diego).

Dr. Mark Riedy was in Bulgaria on arrangement of IESC as a consultant on our project "Mortgage Financing Regulation for Bulgaria" and spent 4 weeks at IME in June-July 1998.

Objectives

The objective of my involvement through IESC is to assist in the development of a workable mortgage market in Bulgaria. Specifically, my goal is to help develop a conceptual framework in which both the primary and secondary mortgage markets can grow and function successfully. As I understand it, this is the goal that you and the Team originally conceived, which led ultimately to the request to IESC for someone with my experience and expertise.

Members of the Team include individuals who have been involved in drafting legislation involving foreclosures and the notariate, plus others who have invested personal time and effort into thoughts about how best to develop Bulgaria's primary and secondary mortgage markets. Team members are listed in Exhibit 1. Exhibit 2 shows the schedule of meetings in which you and I have been involved since my arrival on July 1, including Team meetings. Exhibit 3 is a schematic showing the various segments or institutions involved in the United States mortgage markets. Exhibit 3 is included for informational purposes only, in that I do not believe the Bulgarian mortgage system needs to emulate the American system.

Most of the key elements of a workable mortgage system exist in at least primitive fashion in the Bulgarian economy, but need to be more fully developed, revised, or improved significantly, if you expect your mortgage markets to function efficiently and effectively. Without these revisions and improvements, mortgages will remain excessively costly for borrowers; lending volumes will remain minuscule; investors such as pension funds and life insurance companies will miss out on opportunities to add longer-term and higher yielding mortgages to their asset portfolios; commercial banks will remain excessively conservative regarding mortgage lending and risk-taking; and the Bulgarian economy will miss out on the economic benefits of more vibrant residential construction and real estate sales markets.

It is important to keep in mind that vibrant primary and secondary mortgage markets are not the end in themselves, but only the means to an end. That is, if the mortgage markets work well, two good things happen. First, commercial banks will become more willing and anxious to make new home mortgage loans, to be held in their own portfolios as valuable assets on a risk - adjusted basis. Second, commercial banks will be able to make even more mortgage loans and sell them through the secondary markets, which will become a vehicle for attracting additional long-term capital into the primary mortgage markets - from pension funds and life insurance companies, in particular. More mortgage capital translates into lower interest rates for borrowers. Lower interest rates and a greater supply of leva available for mortgage borrowers, in turn, provide many macro-economic benefits, the ultimate goal of the program for improving Bulgaria's mortgage markets.

By macro-economic benefits, I mean increased residential construction, greater consumer spending on home furnishings and home renovations by those newly enabled to borrow for home mortgages, greater spending for construction materials, and the "multiplier" effects of additional spending (probably one-to-two times the spending initiated by new construction and the purchase of home furnishings or home renovations). In the end, the greater spending and additional home sales translate to greater tax revenues as well. Finally, by relieving overcrowded housing conditions (where families have "doubled-up", for example), by making it more affordable for families to move into bigger and/or more suitable flats or houses, and by allowing more elderly homeowners to rent out their larger flats and more into smaller units in order to supplement their incomes (by borrowing against either the larger or the smaller flat), Bulgarian families and individuals will experience improved standards of living.

In summary, improved primary mortgage markets and the creation of a secondary mortgage market will benefit the following groups and institutions:

- Consumers - improved standards of living
- Government - greater tax revenues
- Commercial Banks - greater lending and profit opportunities

• Insurance Companies - greater investment and profit opportunities

• Pension Funds - greater investment and profit opportunities

• Developers - more new construction and renovations

• Real Estate Brokers - more sales of housing units

• Bulgarian economy - spending and income increases

Bulgarian Mortgage Market at Present

We are looking at two facets of Bulgaria's mortgage market: The primary mortgage market, where home mortgage loans are made by commercial banks to individual borrowers, and the secondary mortgage market, where commercial banks would sell to other investors some or all of the home mortgage loans they have made to consumers. "Other investors" are expected to be life insurance companies, pension funds, and other commercial banks.

At present, the primary market consists largely of State Savings Bank, by far the largest lender, with approximately 32 billion leva ($17.7 million) in outstanding home mortgage loans as of the end of May 1998. Virtually all of these loans have been made since September 1997. All of the other commercial banks with whom we met during July either already are making small numbers of home mortgage loans, or desire to do so in the near future. Many impediments stand in the way, however, which is a topic to be discussed later in this paper. The banks with whom we met include State Savings Banks, Bulgarian American Commercial Bank, Reiffeisenbank, Sofia Municipal Bank PLC., Bulgarian-Russian Investment Bank, United Bulgarian Bank, and, Biochim Bank. The secondary market, as you know, does not exist.

Home ownership is widespread in Bulgaria. From my discussions, my guess is that approximately 90 percent of all Bulgarians own their houses and do not have home mortgage loans outstanding. Nonetheless, the stirrings of a strong demand for home mortgages seem to exist, not only based upon State Savings Bank's recent growth in mortgages outstanding, but also based upon conversations with the dozens of executives we interviewed during July. I believe that effective mortgage demand will grow rather significantly if the cost of funds is reduced and the availability of mortgage loans is increased. The actual amount and timing of that growth of demand should be determined by a follow-up study, but I do expect it to be significant.

Some interviewees have argued that the existence of more than a few partially completed but stalled or foreclosed housing projects is living proof of weak demand for new housing, and, therefore, weak demand for mortgage lending. Rather, I suspect that the absence or the expense of permanent mortgage financing for purchasers are two reasons for the partially completed housing projects. Further, declining incomes and employment hurt home purchasers, both those planning to pay with their own funds and those expecting to borrow via a home mortgage to supplement their own funds. Finally, developers appear to have rather heavy tax burdens; low capital bases of their own; and, in the absence of a meaningful home construction loan market, undue reliance upon pre-selling of flats to generate the cash necessary to continue work on the pre-sold flats. Moreover, I suspect that the developers also use some of the cash from pre-sales of one project to begin construction and pay the taxes and fees required on their next project. Thus, if pre-sales either do not materialize as planned, or a weakening economy causes some buyers to run short of cash to live up to their obligations in paying for a flat being constructed, the developer has little choice but to give up, and partially completed structures are the end result. A stronger, more affordable primary mortgage market will not resolve all of the developers' problems, especially in the face of a declining economy. But it will remove one major impediment to new construction if the primary mortgage market worked as it should and can operate.

Mortgage Lending Today

In that State Savings Bank is the most active home mortgage lender today, it is instructive to review its mortgage lending activity as representative of what can be done within the current framework of operational, structural, regulatory, legislative, and market-induced influences over home mortgage lending in Bulgaria. The vast majority of these influences, unfortunately, inhibit rather than enhance the performance of the primary mortgage market.

State Savings Bank (SSB) has about 32 billion leva in outstanding home mortgage loans as of May 1998, as noted earlier. According to Ivan Iskrov, Deputy Chairman and Chief Executive of SSB, none of these mortgages are negotiable (assignable or salable). Only new mortgages, with new contract terms, could be sold in the future if negotiability was added to the new contract. Mr. Iskrov added that there would be a great need for training courses in Bulgaria if the mortgage business is to grow substantially, and especially if mortgages become negotiable such that a secondary market can be created.

SSB uses its appraisers to estimate the value of flats and houses. They typically use three "comparables", according to Violeta Radeva, and then discount the appraised value by about 30 percent, just to be conservative, "at the direction of BNB Supervision", according to Ms. Radeva. The loan-to-value ratio (LTV) works out to about 49 percent after SSB limits its loan to about 70 percent of the discounted appraised value. The 30 percent discount from appraised value applies to new construction and to the purchase of existing flats. SSB applies a 50 percent discount from appraised value for renovations, which implies a LTV ratio of about 35 %. While any mortgage loan is helpful to borrowers who do not have sufficient assets to pay fully for home purchases or renovations, LTV ratios in the 35-50 percent range are onerous. Banks clearly place much higher priority on risk-avoidance than they do on making new loans. Given a weak economy and the economic history of Bulgaria over the last five years alone, this is understandable. Yet at the same time this philosophy must be overcome as better loan underwriting, more accurate and honest information, and a stronger economy emerge over time.

In addition to the ultra-conservative LTV ratios, SSB branch offices have the discretion to require borrowers to obtain personal guarantees from third parties for their home mortgage loans. As a result, guarantees commonly are required, especially because there is a general problem of identifying the stability and accuracy of the borrower's income. This is a particular problem with small business owners, whose incomes are difficult to assess. Moreover, according to Violeta Radeva, approximately half of all mortgage applicants under-report their incomes for tax purposes. Therefore, SSB looks to borrowers' other assets to try to assess their true incomes.

Other problems exist at the "front-end" of the real estate purchase/home mortgage borrowing process, according to those we have interviewed. Among the other problems are the following, in no particular order of priority:

1. Real estate agents, if and when they are involved in the purchase of a home, frequently refuse to disclose the purchase price because they do not want to share this information.

2. Home buyers under-report the value of the homes they purchase in order to reduce the impact of the two percent transfer tax.

3. Sometimes the notary simply refuses to record the information on a home purchase.

4. A central credit registry currently does not exist, so there are no public records of experience of borrowers' willingness and ability to repay their debts. Even for SSB, its specialized housing lending branch in Sofia is not tied into SSB's central credit registry. For mortgage lending, therefore, they have to take the borrower's word for his or her credit worthness (willingness and ability to repay the loan), according to Violeta Radeva. Further, according to Anna Staneva, Legal Consultant for SSB, the Bank never can be sure that its mortgage is a first mortgage on the property. SSB does not rely completely upon the credit registry that it has, even when it is accessible. Yet SSB will not require a borrower to sign a statement verifying that it is a first mortgage subject to a fraud lawsuit if the borrower lies. Bulgarians are known in a cultural sense to place great emphasis on honoring their debts, but this generalized statement does not help the commercial bank in any specific loan application.

5. The registry of land/property is not clear enough to verify titles with 100 percent assurance by the notaries, whose responsibility is to check the published information, but apparently not to be liable for errors or omissions in the registry. Moreover, until about 1990, all land/property records were done by the owner's name (not by the location of the property) and (usually, but not always) registered where the property owner lived. Therefore, pre-1990, it is extremely difficult to track down a "chain" of ownership to verify the title on property/land. The new registry system is just now being developed, and will register property where it is located. In practice, however, property frequently is registered elsewhere, and there is no nationwide electronic registry to allow the necessary checking. The Ministry of Justice is thinking about a central registry for the country in conjunction with the law for the private notariate this year. The foregoing information about title issues was provided by Nasko Atanassov, President of the Managing Board, and Marinella Roussinova, Executive Officer, of the National Real Property Association.

6. Because commercial banks (including SSB and others) have short term liabilities, it is considered excessively risky for them to have more than a very small portion (less than five percent, I expect) of total assets invested in home mortgage loans. With no outlet yet for selling the mortgages, commercial banks will not generate enough mortgage loans to satisfy the demand that would exist (be "effective") if mortgage interest rates were below their current 14-16 percent range, with 5-9 year maturities. Both the short maturities and the high interest rates are major impediments to an active mortgage market, both from the point of view of borrowers and of the banks. The banks, for example, will not invest a great deal of time, effort, training, and money in a program (home mortgage lending) where they perceive total lending volume to be small. Therefore, it is critical that the commercial banks gain an outlet for selling most if not all of the home mortgage loans they produce – the secondary mortgage market.

7. According to Violeta Radeva, under Article 43 of the prior banking law, a land owner could mortgage the land to build on it. She stated that the current regulations eliminate this opportunity. "Even though you own land, you cannot use it as a down payment on a loan to construct flats on it." The law now says "no". In her view, there needs to be an entire new law dealing with loans to physical persons. Apparently, home mortgage lending currently falls under corporate credit laws, which do not accommodate the unique aspects of lending to persons.

8. Bulgarian National Bank (BNB) Supervision is responsible for supervising commercial bank mortgage lending. Yet BNB supervisors' experience and training all revolves around corporate credit, not consumer lending, including home mortgage lending. Therefore, supervisors tend to be unnecessarily conservative because they do not understand the risk in home mortgage lending. BNB supervisors need specialized training in how to assess the risks of mortgage lending, which is a proper commercial bank activity. They should encourage responsible home mortgage lending, not burden it with so many conservative rules that it discourages the banks and makes the costs and terms nearly prohibitive for borrowers.

Creation of a secondary mortgage market, one in which pension funds, life insurance companies, and even commercial banks could invest in individual home mortgages or securities collateralized by home mortgage loans, would put pressure on banks, regulators, and the Parliament to reduce or remove the current impediments at the front-end of the real estate sales/mortgage financing process. Another major impediment exists at the "back-end" of the mortgage lending process. That is, bankruptcy and foreclosure laws, as they are enforced, create excessive delays in allowing creditors to recover amounts owed them as a result of defaults on home mortgage loans. Moreover, the "order" of recovery on loans collateralized by mortgages is "first-come, first-served", meaning that first mortgage holders should be paid off first following the sale of property in foreclosure by an executive judge. But sometimes the executive judge pays off second mortgage holders first, or delays excessively (ignoring legal deadlines) the sale of a property in foreclosure.

The creditor, not the executive judge, has the greatest incentive to expedite home mortgage foreclosures and should be given the right to sell the property and evict tenants, as necessary, within legal guidelines, but without the direct involvement of the executive judge. This change will become even more important when the secondary mortgage market develops, because then the creditor (commercial bank) may well be acting as an agent (loan servicer) for a third party investor in the mortgage being foreclosed. Investors will not want receipt of their money due to a foreclosure to be delayed by the arbitrary behavior of an executive judge. Rather, they will be paying the creditor (commercial bank who is servicing the loan) a fee to handle the foreclosure and sale expeditiously, and to minimize their loss on the foreclosed loan.

Another impediment to efficient primary and secondary mortgage markets is the lack of third-party guarantees against losses through loan foreclosures on home mortgage loans. Third-party guarantees provided either by government-related funds or private financial guaranty companies, on either individual mortgage loans and/or securities collateralized by mortgages, provide protection for investors at a reasonable cost, paid by the borrower (on individual loans) or the creditor (on securities they sell to investors). With such protection, investors are willing and able to reduce the rate of return they demand for the mortgage loans and securities in which they invest, which in turn should reduce the cost to borrowers.

In my judgment, another major impediment to a larger-scale, highly competitive home mortgage market is the fact that still 75 percent of the commercial banking system's assets are controlled by state-owned banks. In a market-driven economy driven by strong profit incentives, the commercial banking industry must be privately owned. My understanding is that privatization of the commercial banking sector is behind schedule, with prospects of greater delay rather than a timely conclusion to privatization the most likely outcome. To some significant extent, the delays in commercial bank privatization apparently are caused by the poor financial condition of the banks' balance sheets. According to Ken Walker, Senior Advisor to BNB, foreign banks should be the appropriate banks to acquire the Bulgarian banks in line to be privatized. Yet foreign banks prefer new charters in Bulgaria in order to avoid dealing with the social (layoffs, management changes), economic (bad loans), and infrastructure problems of taking over an existing banks. Moreover, interviewees have mentioned also that BNB refuses to merge or close more banks, or to sell off pieces of existing banks that might be attractive to outside investors. All in all, while privatization of the remaining 75 percent of the commercial banking industry's assets may seem far afield from the development of a framework for efficient primary and secondary mortgage markets, it is not. Indeed, it may be the largest single impediment, because it minimizes the profit motivation of the banking industry versus other incentives (political or otherwise). Profit motivation probably will become the strongest factor unifying the commercial banking industry into working cooperatively to develop the standardized forms, policies, procedures, and infrastructure needed to make the mortgage industry work effectively.

In reference to the bad loans still on the books of commercial banks, Ken Walker pointed out that banks do not charge off bad loans. Rather, they provision heavily. They do not want the borrower to know that they have charged off a loan, became the borrower then will feel no pressure to try to pay off the loan. Nonetheless, typically a bank employee will inform the delinquent borrower of a charge off, if it occurs. Thus, delinquent loans on the commercial banks' books are extraordinary large because the bad loans are not charged off. Investors performing "due diligence" in assessing whether or not to acquire a commercial bank see through this charade and reduce the value of the bank accordingly - another reason privatization of banks has been so slow, and unattractive to foreign investors. At least one interviewee claimed that SSB has many such bad loans still on its books, which will become "charge-offs" during the next economic downturn and cause serious harm to SSB's reputation. I did not verify this claim independently.

Costs are also a significant impediment, in the sense of taxes and fees paid by borrowers and lenders. Effective October 1, 1998, the notary fees (really taxes, today, because they mainly go to the State) will be reduced by at least 50 percent from their current level of two percent for contractual mortgages and one percent for legal mortgages. The new fees, which will accrue primarily to the notary, will be set on a sliding scale, with a minimum of 5,000 leva and a maximum of 3,000,000 leva. The new fees do not seem unreasonable, especially in that under the new act a notary will have personal liability and needs to buy errors and omissions liability insurance, whereas in the past the notary was considered a state employee and not personally liable. The new system is better than the old, but because the notary still is not liable for imperfections not shown in the existing records, it is not an absolute guaranty of clear title - nor is it title insurance - for the person acquiring the property. As a postscript, under the current law, notary fees when you cancel a mortgage (pay it off) are one percent, for both legal and contractual mortgages. Now that, under the upcoming (Oct. 1, 1998) law, this fee will be paid to the private notary rather than to the State, Team members believe that this fee will be easier to abolish. It is excessive and burdensome.

Regarding other costs, what I have been able to identify are the following: When you transfer title to a property, the local transfer tax is two percent. In a foreclosure, at the time of a forced sale of a property, the two percent transfer tax still would apply, as in any other transfer of title. Generally there is no such transfer tax in the United States, as it is regarded simply as a tax revenue generator that would inhibit real estate sales if imposed. The transfer tax is one more burden on already heavily burdened real estate and mortgage markets. Its removal should be encouraged.

There are conflicting views about fees or taxes that would apply if banks exchange or sell mortgage contracts. Borislav Belozelkov, a Team member and a judge, says that his review of the law suggests only a small fee, perhaps one-tenth of one percent, would be applied. Mr. Belozelkov claims that no VAT or similar high charge would be applied. On the other hand, our meetings with others provided these views: Andrey Nikolov, Chief of the Credit Management Division of UBB, stated that UBB already sells (problem) loans to real estate companies that specialize in this area, and VAT applies.

He specifically said problem loans, not problem real estate. Next, George Alexander of IFC said that when banks transfer contracts (including the selling of mortgages), the sale is subject to a 22 percent tax. It is commonly referred to as a VAT, but technically it is not a VAT, though it still is a tax. Finally, in a meeting on July 15 with four senior representatives of BNB, my notes indicate that one of them said that if a bank sells a mortgage to another bank, there would be a 22 percent VAT imposed, plus other fees and/or taxes.

I have raised this issue with Borislav Belozelskov several times, and he insists there is no such tax. Time does not permit me to pursue this issue further, but it needs to be resolved, and if Borislav is correct, the others need to be asked the source of their views. A 22 percent fee, VAT or otherwise, imposed on mortgage sales would be a deal killer, in my judgment.

Additional charges identified are as follows: There is a small fee for the Executive Judge handling a foreclosure (amount or rate not known). Also, Anna Stanchev (SSB) stated that any assignment of mortgages (the loan with the mortgage) would require re-registration of the mortgage by a notary and taxes (probably one percent) would have to be paid again. Also, Andrey Nikolov (UBB) mentioned that UBB currently charges a one percent fee annually on its mortgages. I see no reason for the re-registration fee of one percent for a simple assignment of a mortgage and note. Similarly, a one percent annual "servicing" type fee on mortgages outstanding sounds excessive. U.S. mortgage lenders collect, on average, about one-quarter of one percent as a servicing fee if they service loans for other investors, and they charge no explicit fee if they hold the mortgage loan in their portfolio. In effect, the "servicing" fee for loans banks hold in their portfolios is simply part of the interest rate they earn. It is not an "annual extra". If the mortgage market in Bulgaria becomes competitive, this annual fee charged by UBB and possibly by other banks will disappear over time. It is excessive.

No lender discussed the fees it charged to a borrower as part of the loan application process, such as appraisal fees, credit reporting fees, processing fees, application fees, etc. Nor did any bank indicate whether it charged discount points at the time of loan closing, in addition to the interest rate. Further, I do not have a clear picture regarding how interest rates are determined for home mortgage loans, or whether they are primarily fixed or adjustable. I know some are adjustable. It sounded to me as if SSB's mortgage loans were adjustable at the discretion of its Managing Board, rather than being tied to some independent index. In the U.S., lenders may not adjust interest rates on their outstanding mortgages on a discretionary basis. Adjustments, if allowed at all, are tied to an index beyond the direct influence of any one lender, such as LIBOR, or three-month U.S.Treasury bill rates. These issues bear additional research and clarification.

The last issue regarding taxes involves capital gains taxes upon the sale of a house. According to Borislav Belozelkov, if an owner-occupied home is held for more than three years, there is no tax on capital gains. If the house was held (owner-occupied) for less than three years, a 36 percent capital gains tax would apply. Moreover, if it is not your primary residence, the capital gains taxes would apply no matter how long you owned it. Further, the tax authorities have the unilateral right to impose their own "fair value" on the property and subject it to capital gains taxation if they believe it was undervalued by the buyer and seller.

Observation on the Primary Mortgage Market

The analogy that occurs to me with respect to Bulgaria's primary mortgage market is as follows: If you give a swimmer a few small stones to carry while swimming, he or she will be able to swim just fine. However, if you give the swimmer enough small stones, he or she will drown. So, too, with Bulgaria's primary mortgage market. There are so many impediments, the mortgage market is more a hope than a reality. Moreover, I do not get a strong sense of cooperation, either among banks, or between the banks and BNB, or even within the Association of Commercial Banks. Loan syndications do not occur, bankers think they know what other bankers either are or are not doing, but really don't know. In the end, with respect to lending in general, and home mortgage lending, in particular, not much of anything is being done. Cooperation and communication are sorely lacking, and must be improved.

The fact that everyone knows one another and seems to get along socially is not a good substitute for actually working on common goals. Even the mortgage market Team with which we worked suffered from less than full attendance, although you, I , Ivaylo Botev, and Borislav Belozelkov were faithful attendees.

The Secondary Mortgage Market

Given the constraints of the primary mortgage market, it's surprising that you have had the foresight to think about developing a secondary mortgage market. It is important to develop secondary market legislation for adoption by the Parliament and implementation by the appropriate regislatory agencies. Secondary market legislation will add pressure appropriately to primary mortgage market participants, who need to address all of the impediments noted above in order to facilitate the interaction of the primary and secondary mortgage markets and to allow each to function successfully.

As you know, but included here for the record, when I arrived at the beginning of July, the Team was considering only a "Mortgage Bond" security, which in fact would be a general liability of the commercial bank issuer, backed by all of the bank's assets. The proposed legislation you were considering included great detail about how the bank's mortgage holdings would indirectly (but not really) reduce the risks of foreclosure and bankruptcy for Mortgage Bold holders. As we held more Team meetings, I introduced the concept of a mortgage pass-thru security, which actually allows the commercial bank issuer to move the mortgage loans to off-balance-sheet status and shifts the risk of foreclosure/bankruptcy to the pass-thru security holder. By the Team meeting of July 22, we were only considering the pass-thru concept, which I agree is the best type of mortgage-related security to pursue.

While the likely title of the proposed secondary market legislation will include "Mortgage Bonds" as well as the "Pass-Thru" concept, I urge you only to address the pass-thru concept in the legislative language. Also, it is important for IESC and the IME to note that, at the urging of the Bulgarian American Enterprise Fund representatives, the pass-thru legislative language allows not just home mortgage-related securities, but the sale of any asset-backed receivable by a commercial bank. This is an issue of legislative strategy, not one of substance. My focus has been on the home mortgage market and trying to help create the structure of a secondary mortgage market - not secondary markets and securities for all types of commercial bank assts. I agree that it makes good business sense for banks to be able to create securities collateralized by all types of assets. My main reservation is that somehow members of Parliament who did not fully understand the proposed legislation would be led to believe they were only allowing home mortgage loan-backed securities, when in fact the assets being securitized would cover a much broader range.

Many issues remain to be resolved in the pass-thru legislation. Commercial banks will need to negotiate with regulatory authorities and with potential investors in home mortgage loan-related securities regarding the terms and conditions under which the securities will be issued; forms to be used; disclosures to be made; how and when cash flows collected from borrowers are to be "passed-thru" to investors; fees to be charged for "servicing" the mortgages underlying the securities (to be collected by the commercial bank as the mortgage loan "servicer"); the procedures for dealing with delinquencies and foreclosures (for example, how many months of monthly payments will the bank have to continue paying to investors even if the borrower is delinquent? Does the bank have the right to recover any or all costs of handling a foreclosure on behalf of the investor, including advances of monthly payments, even though they were not collected from the borrower?) As a transitional step, should mortgage securities be sold to investors with recourse to the bank in the event of default? This would "use up" some of the bank's capital, if it still remained liable to cover foreclosure losses to investors, but at least the bank still could sell the loans to regain the liquidity it used up in making the mortgage loans in the first instance. There is no obvious, clear-cut answer to these questions…no necessarily right or wrong way to proceed. Each is important, but resolutions of these questions will have to come in wide-ranging negotiations involving all relevant government and private participants in the process.

A Conceptual Framework: Putting the Pieces Together

Many elements of the conceptual framework for a fully functional primary mortgage market exist in Bulgaria, some only as concepts to be developed and implemented later, other as existing elements of the infrastructure, but only developed to a primitive level. The greatest barrier to progress is Bulgaria's continuing dominance of State-owned banking institutions and the lack of progress in their privatization. Improvements in the primary (and secondary) mortgage markets will accelerate only when the entire (or at least the vast majority) of the banking industry's assets are privately owned.

The second greatest potential "deal killer" would be either a VAT or taxes and/or fees equal to the VAT being applied to the sale of mortgages or mortgage-related securities by banks. As noted above, there seems to be much confusion on this issue. If it is true, it will make mortgage and/or mortgage security sales prohibitively expensive.

A third major issue is the tax deductibility of interest payments on home mortgage loans. Interest is not tax deductible at present. Nor are property taxes. Like any favorable tax treatment, the deductibility of interest payments would be an added incentive for individuals to take advantage of home mortgage borrowing to acquire or renovate a home or flat. The question of property tax deductibility does not affect individuals' interest in borrowing on a home mortgage loan, so it is not directly relevant to their project. Nonetheless, in that the deductibility of property taxes does ease the financial costs of home ownership, it may be a topic worthy of consideration at a later date.

Now, as to the conceptual framework for a fully functioning primary mortgage market, the areas we have identified as needing to be developed and implemented, or improved if they already exist but only in a primitive stage of development, include the following:

1. Credit register. BNB is working on it. Theirs will not include information such as when and why someone has applied for credit and been denied, which should be included. The private sector should develop its own central credit registers - two or more, in competition with one another. Disclosures by private credit registers may be illegal, however. At a minimum, the commercial banking industry, in organized fashion, should work with BNB to develop the central credit register quickly, and with all the relevant information banks will need to make informed credit judgments. The data base must allow credit information from multiple sources to be tied back together to the individual consumer, so that a complete credit history can be presented. Individuals should have access to their own credit files at BNB, and have the right to correct any errors they find in their files, as well as the opportunity to explain any true but adverse credit information about themselves.

2. Land/property register. Essential for a well-developed mortgage market. New property registry records property by location, not by owner's name, as at present. It may take 50 years of running parallel systems, but the registry by location is critical. Also, the new law on the private notariate improves lenders' and home buyers' assurances that the notary has checked the record carefully, which probably is an improvement over the State-notariate system. Nonetheless, clear titles still cannot be assured with 100 percent certainty, which will continue to pose at least small risks for mortgage lenders and investors, as well as for home buyers.

3. Accurate, honest information still is a problem regarding its availability. The true market value of a flat or home purchased may be difficult to discern, despite the best efforts of appraisers. They may be given inaccurate information about comparables, for example. Home buyers and sellers may reduce the actual reported sales price to minimize transfer taxes and other fees. I have received conflicting information about the following statement: There is no law prohibiting the provision of fraudulent information by borrowers in the loan application process. The borrower should be required to sign a certification, under penalty of law, stating that the information he or she provides is accurate to the best of their knowledge.

4. The bankruptcy and foreclosure laws and procedures are disadvantageous to the mortgage lending industry, rather than supportive of creditors' rights (balanced evenly with debtors' rights). The appeals process, especially as administrated in practice by executive judges, is too long and weighted too much in favor of the debtor. This is an area of great, legitimate concern to lenders and to would-be investors in home mortgages.

5. The mortgage industry - lenders, BNB supervision, capital markets regulators, life insurance company representatives, and pension fund investors in mortgages and mortgage securities - need to get together and work cooperatively on the following:

a. standardized information and forms on credit; loan applications; title information; loan underwriting; loan processing procedures; forms for the registration; documentation, and sale of mortgages and mortgage securities. Fannie Mae has most of this information readily available, and one or more Bulgarian banks already have begun to utilize Fannie Mae's assistance.

b. training for all relevant employees at BNB, commercial banks, capital market regulators, life insurance companies and pension funds. The terms and conditions, and even the language of home mortgage lending, not to mention the risks, all are unique. Yet risk-taking is the source of profitability, so BNB supervisors need to allow banks to take reasonable risks in making, selling, and servicing home mortgage loans. Banks' mortgage departments and information flows need to be integrated fully into the banks' overall operations, to assure communication and cooperation, and to provide access to all relevant information needed by the mortgage department as well as by bank management.

c. laws need to be checked to make certain that banks clearly have the right to sell mortgages and mortgage securities, and that pension funds and life insurance companies have their right to buy them. I was told by one interviewee that a new pension law prohibits investment in mortgages and mortgage securities, and only allows investments directly in real estate. In the law, it may be necessary to distinguish between "making" mortgage loans (the bank-consumer relationship in the primary mortgage market) versus buying (investing in) mortgages and mortgage securities (the bank-investor relationship in the secondary mortgage market). This is so because only banks can "make" mortgage loans, which is fine. Investors would not deal directly with consumers even if they owned the mortgages or mortgage securities. The bank, as servicer of the mortgages, always stands between the consumer and the investor.

Reactions of Those Interviewed Toward Mortgage Market

All commercial bank representatives favored a more active and functional mortgage market as well as the idea of a secondary mortgage market. In fact, everyone with whom we visited either supported the concept or expressed an open mind to its development, despite the nearly overwhelming impediments facing a successful primary mortgage market.

George Alexander of IFC discussed with us the idea of a loan guaranty fund. As you know, he stated that IFC works along the path of least resistance. That is, it does more in countries farther along toward a functioning market economy, although they do play a more limited role in "developing" economies.

Mr. Alexander said that IFC might be able to look at a loan guaranty fund as a developmental effort or concept, subject to several conditions, as follows:

a. IFC would only consider a guaranty fund when the mortgage market is ready to work well in the near future, not three-to-five years out. They need to see quick results.

b. IFC wants to see an exit strategy, to earn a profit and privatize the operation (build, operate, and transfer strategy).

c. IFC would want to see a partner, a private partner with at least 51 percent ownership.

I suggested a possible strategy of IFC partnering with SSB to create the guaranty fund, with the exit strategy being their spin-off of the guaranty fund at a profit several years hence. George Alexander's response was that a State-owned SSB would not qualify as a private partner, but that if legislation absolutely mandated SSB privatization on a firm schedule, it might work. He also questioned whether SSB had enough capital to help finance a loan guaranty fund. Alternately, he suggested that IFC might find a foreign investor as a partner, which would be his preference, or a local private investor. But he also stated emphatically that IFC would not want to be actively involved in the management of such a guaranty fund.

Could IMF joint venture a loan guaranty fund with the IFC? It seems to me, further, that Bulgaria is too small an economy, without adequate geographic and economic diversification, for a loan guaranty fund to work profitably. I think such a fund would enhance greatly the profitability of success of a secondary mortgage market because it would protect investors against losses caused by foreclosures on the underlying mortgages.The guaranty fund could provide whole or partial coverage against foreclosure losses. Perhaps it would require banks to provide for partial recourse with the guaranty fund supplementing that recourse, as a transition step. However, to obtain the risk-diversification I consider essential to allow a loan guaranty fund to be profitable, I would suggest that the fund provide coverage in many countries simultaneously. Rather than one fund for each (relatively small) country and economy in Eastern Europe, for example, why not one fund for six or eight countries?

Conclusions

I believe most interviewees understand pieces of the puzzle called a mortgage market, but few understand what the whole puzzle will look like if and when the pieces come together. You are well along the way to that understanding and have proven to be a quick learner during my time here. Bill Foerderer seems to appreciate fully the dimensions and difficulty of pulling together all the pieces and making them to work. He has great access to Fannie Mae materials from his prior experience, as do you, and I would encourage you to utilize them - especially their standardized forms, documentation, and procedures.

Your challenge is to continue to be the driving force, pulling disparate groups of lenders investors, regulators, legislators, real estate brokers, developers, and notaries and others, to forge a consensus on how to proceed. The work of the last month, plus this document, should give you a roadmap worth following. Training will become an issue at some point in time, but it is not the issue today. Checking out all laws cited above; seeing if investors have the legal right to invest; building their interest and enthusiasm; working with BNB supervision to assure that they understand the unique opportunities - not just the risks - in mortgage lending and a secondary market; addressing all of the impediments we have identified; getting the commercial banking industry privatized more rapidly; convincing Parliament to adopt the mortgage pass-thru legislation as well as tax deductibility for mortgage interest payments; and, working with the IFC, IMF, and perhaps others to create a loan guarantee fund; these are your major and most immediate challenges.

Krassen, with your Team and the support of the IME, Association of Commercial Banks (who should be members of the Team, by the way), and perhaps future I.E.S.C. volunteer executives who have experience in the day-to-day operations, policies, and procedures of the mortgage markets, you are uniquely positioned to make a real, positive difference in the quality of life in Bulgaria. A more vibrant mortgage market, at more affordable fees, taxes, and interest rates, will do much to increase economic activity and incomes and improve the standard of living for countless Bulgarian families.

Your task is extremely complex. It is a large puzzle with many pieces. In my judgment, a reasonably functional primary mortgage market is at least two years away, and a reasonably functioning secondary mortgage market is three-to-five years away. Attack both markets simultaneously, however. That is, all primary and secondary market issues are interrelated. Whatever the issue, ask yourself the question, if we proceed in this direction, what are the implications for both the primary and the secondary mortgage markets?

It has been a tremendous pleasure and source of satisfaction to work with you, your staff, and the Team you assembled. Thank you for this opportunity, and for the hospitality and the adventures you provided so generously. I will be keenly I nterested in maintaining ongoing communications regarding your progress. It goes without saying that you are invited to e-mail or call me with any questions and to discuss any decisions under consideration. I wish you great health, good fortune, and a vibrant Bulgarian mortgage market.

28 July 1998
Dr. Mark Riedy

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I.M.E.

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General information

IME is the first independent economics think-tank in Bulgaria (non-profit corporation Reg.# 831344929, March 15, 1993, 729/XI/VI, p. 169). IME's mission is to formulate and advocate market approaches to the problems Bulgaria is facing in its economic transition. For three years IME has been producing a weekly economic policy talk-show, "Live Money," in cooperation with the largest radio broadcasting company, Darik Radio.

IME's 1998-1999 Priorities

- ✓ Credit and Capital Markets Development, Mortgage Financing
- ✓ Decentralization, Regional Development, Private Provision of Public Services
- ✓ Public Procurement and Competitive Business Environment
- ✓ Applied Economics Research, Improvement of Economic Information
- ✓ Regulation Impact Analysis and Legislative Corrections Studies

International

✓ IME is an initiator and co-founder of the Balkan Network of public policy institutes, set up to study fragmented capital and finance markets, quasi-fiscal subsidies and informal labor markets, and impacts of different crisis situations and embargoes, and to disseminate ideas on regional cooperation and exchange.

✓ IME is a co-founder of the 3-E-Net (Emerging European Economies Network), a joint venture of seventeen policy institutes from eleven countries in the region, set up to advocate market reforms.

✓ IME is a member of the Economic Freedom Network and co-publisher of Economic Freedom of the World Annual Reports.

Pioneering Research

✓ Responding to the need to maintain a market orientation of the reforms and develop arguments to support this orientation, IME was the first institution to carry out research in the following areas:

- ✓ Bulgarian Business Associations and Their Services
- ✓ Transparency of Capital Markets
- ✓ Private Sector Transaction Costs
- ✓ Informal Employment
- ✓ Informal Credit Markets in Poor Regions
- ✓ Public Procurement Impact on State Enterprises
- ✓ Creation of Competitive Clusters
- ✓ Border Crossing Procedures and Transport Costs

IME Advocacy

- ✓ In coalition with other organizations or independently, IME has contributed to the following:
- ✓ Information Disclosure and Anti-Fraud Provisions in Securities Regulations
- ✓ Introduction of the Currency Board
- ✓ Deposit Guarantee Act
- ✓ Tax Reforms in 1997 and 1998
- ✓ 1998 SME Strategy
- ✓ Competition Defense Act
- ✓ Draft Mortgage Bonds Act
- ✓ 1998 Reduction and Fairness of VAT and Social-welfare Taxation

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Bulgaria: Selected Macroeconomic Indicators (monthly data)

Real sector

Output	**04.98**	**05.98**	**06.98**	**07.98**	**08.98**	**09.98**	**10.98**
Receipts from sales of industrial output							
% change over corresponding month of previous year, comparable prices	-5,0	-11,0	-4,0	-14,0	-15,0	-23	-19
Unemployment							
Registered unemployed, end of month							
level, thousand	497,7	463,7	434,7	422,6	413,6	410,7	423,1
% change over previous month	-5,0	-6,8	-6,3	-2,8	-2,1	-0,7	3,0
% change over corresponding month of previous year	-14,9	-18,3	-19,7	-22,2	-22,6	-22,7	-17,5
Unemployment rate, end of month							
% of total labour force*	13,0	12,1	11,7	11,1	10,8	10,7	11,1
Wages and Prices							
Average monthly wage in the public sector							
nominal level, BGL	192830	192511	199473	194532	193554	208456	201556
nominal growth, BGL							
% change over previous month	1,1	-0,2	3,6	-2,5	-0,5	7,7	-3,3
% change over corresponding month of previous year	56,9	35,1	26,7	29,1	27,3	21,3	21,1
% change, cumulative from the beginning of respective year	11,0	10,8	14,8	12,0	11,4	20,0	16,0
nominal level, USD	106,1	108,5	111,4	108,1	108,2	121,9	123,0
nominal growth, USD							
% change over previous month	1,6	2,3	2,7	-2,9	0,1	12,7	0,9
% change over corresponding month of previous year	33,4	16,7	18,1	28,3	31,2	27,1	30,0
% change, cumulative from the beginning of respective year	10,8	13,4	16,4	13,0	13,1	27,4	28,5
real (CPI deflated) growth, BGL							
% change over previous month	1,0	1,0	1,1	1,0	1,0	1,0	1,0
% change over corresponding month of previous year	22,2	10,6	6,6	14,3	19,9	14,9	15,7
% change, cumulative from the beginning of respective year	3,1	4,1	5,2	6,3	7,4	8,5	9,5
Average monthly wage in industry							
nominal level, BGL	251096	259161	273377	265544	263111	287803	273986
real (CPI deflated) growth, BGL							
% change over previous month	0,9	1,0	1,1	1,0	1,0	1,1	1,0
% change over corresponding month of previous year	18,5	20,1	14,4	22,6	28,4	20,8	20,7
% change, cumulative from the beginning of respective year	3,1	4,1	5,2	6,3	7,3	8,5	9,5
real (PPI deflated) growth, BGL							
% change over previous month	0,9	1,0	1,1	1,0	1,0	1,1	1,0
% change over corresponding month of previous year	29,2	25,0	18,3	29,7	31,9	26,0	26,3
% change, cumulative from the beginning of respective year	4,0	5,1	6,2	7,3	8,3	9,5	10,5
Producer prices in industry							
% change over previous month	0,4	0,1	-0,1	-1,0	1,0	0,2	-0,3
% change over corresponding month of previous year	17,7	17,3	15	6,8	3,4	1,2	0,0
cumulative PPI, March 1992 = 1	75,4	75,5	75,4	74,7	75,4	75,5	75,4
% change, cumulative from the beginning of respective year	1,9	2,0	1,9	0,9	1,9	2,0	1,8
*Consumer prices***							
% change over previous month	0,1	0,5	-1,9	-1,5	-0,9	3,0	-0,3
% change over corresponding month of previous year	28,4	22,2	18,9	13,0	6,1	5,5	4,7
cumulative CPI, December 1990 = 1	1444,3	1451,5	1423,9	1403,0	1390,2	1432,2	1427,9
% change, cumulative from the beginning of respective year	3,8	4,3	2,3	0,8	-0,1	2,9	2,6

Sources used: Bulgarian National Bank, National Statistical Institute, Ministry of Labour and Social Assistance - various publications.

* *Women on maternity leave not counted*

*** NSI announced November inflation to be -0,9%*

External Sector

Gross Official Reserves*	04.98	05.98	06.98	07.98	08.98	09.98	10.98
level, mln USD, end of month	2614,6	2878,4	2913,6	2911,2	2724,5	2788,3	2842,8
% change over previous month	1,7	10,1	1,2	-0,1	-6,4	2,3	2,0
% change over corresponding month of previous year	128,2	132,0	116,7	87,4	57,2	24,9	19,8
Exchange Rates							
Nominal							
BGL per 1 USD, monthly average	1818,1	1774,5	1790,6	1799,2	1789	1709,6	1639,0
% change over previous month	-0,5	-2,4	0,9	0,5	-0,6	-4,4	-4,1
% change over corresponding month of previous year	17,6	15,8	7,3	0,6	-3,0	-4,6	-6,8
% change, cumulative from the beginning of respective year	0,1	-2,3	-1,4	-0,9	-1,5	-5,8	-9,7
BGL per 1 USD, end of month	1798,0	1782,4	1800,0	1769,0	1806,8	1673,2	1647,5
% change over previous month	-2,0	-0,9	1,0	-1,7	2,1	-7,4	-1,5
% change over corresponding month of previous year	22,5	13,7	4,7	-4,1	-0,1	-5,1	-4,2
% change, cumulative from the beginning of respective year	-0,6	-1,5	-0,5	-2,2	-0,1	-7,5	-8,9
Real (CPI deflated)							
BGL per 1 USD, monthly average							
% change over previous month	-0,6	-2,9	2,9	2,0	0,3	-7,2	-3,8
% change over corresponding month of previous year	-8,4	-5,2	-9,7	-10,9	-8,6	-9,6	-11,0
% change, cumulative from the beginning of respective year	-1,6	-4,5	-1,7	0,2	0,6	-6,7	-10,3
BGL per 1 USD, end of month							
% change over previous month	-2,1	-1,4	2,9	-0,3	3,1	-10,1	-1,2
% change over corresponding month of previous year	-358,9	-55,8	-213,8	-274,4	-224,1	-446,0	-79,2
% change, cumulative from the beginning of respective year	-2,4	-3,7	-0,9	-1,1	1,9	-8,4	-9,5
Real (PPI deflated)							
BGL per 1 USD, monthly average							
% change over previous month	-0,9	-2,5	1,0	1,5	-1,6	-4,6	-3,9
% change over corresponding month of previous year	-0,1	-1,3	-6,7	-5,8	-6,1	-5,7	-6,9
% change, cumulative from the beginning of respective year	-0,9	-3,3	-2,4	-0,9	-2,4	-6,9	-10,5
BGL per 1 USD, end of month							
% change over previous month	-2,4	-1,0	1,1	-0,7	1,1	-7,5	-1,3
% change over corresponding month of previous year	4,1	-3,1	-8,9	-10,2	-3,4	-6,2	-4,2
% change, cumulative from the beginning of respective year	-1,6	-2,6	-1,5	-2,2	-1,1	-8,6	-9,7

* Monetary gold not included; SDRs and nondollar currencies converted into USD at their respective end-of-period exchange rates

Fiscal Policy - Consolidated State Budget

		04.98	05.08	06.98	07.98	08.98	09.98	10.98
Revenues:	bln BGL	2563,8	3171,7	3849,2	4547,9	5151	5801,7	6473,0
	% of GDP	11,0	13,6	17,2	20,3	23,0	25,9	28,9
Expenditures:	bln BGL	2164,6	2823,8	3687,7	4213,7	4723,9	5241,6	5853,0
	% of GDP	9,3	12,1	16,4	18,8	21,1	23,4	26,1
Surplus (+)/Deficit(-):	bln BGL	399,2	347,9	161,5	334,2	427,1	560,1	620,0
	% of GDP	1,7	1,5	0,7	1,5	1,9	2,5	2,8
Foreign financing, net	bln BGL	37,8	27,3	28,4	27,8	-325,7	-461,7	-491,5
	% of budget deficit	-9,5	-7,8	-17,6	-8,3	76,3	82,4	79,3
Domestic financing, net	bln BGL	-437,0	-375,2	-189,9	-362,0	-101,4	-98,3	-128,5
	% of budget deficit	109,5	107,8	117,6	108,3	23,7	17,6	20,7
Securities financing	bln BGL	57,9	38,1	-65,0	-99,4	-99,8	-96,9	-210,3
	% of budget deficit	-14,5	-11,0	40,2	29,7	23,4	17,3	33,9
Bank financing	bln BGL	-70,7	-71	-98,4	-120,7	21,8	-5,5	79,5
	% of budget deficit	17,7	20,4	60,9	36,1	-5,1	1,0	-12,8

Monetary Policy

Broad money, end of month	04.98	05.98	06.98	07.98	08.98	09.98	10.98
level, bln BGL	5959,0	5884,4	6029	6130,9	6300,4	6103,5	5999,6
currency outside banks	1305,1	1323,7	1418,9	1498,8	1557	1475,4	1440,9
demand deposits	814,6	758,7	808,6	806,6	832,3	825,2	850,6
time and savings deposits	1073,0	1036,4	1037,1	1072,4	1064,3	1036,6	1027,1
foreign currency deposits	2442,9	2435,7	2412,3	2428,4	2530,7	2461,2	2378,2
% change over previous month	0,0	-1,3	2,5	1,7	2,8	-3,1	-1,7
currency outside banks	1,5	1,4	7,2	5,6	3,9	-5,2	-2,3
demand deposits	0,3	-6,9	6,6	-0,2	3,2	-0,9	3,1
time and savings deposits	0,4	-3,4	0,1	3,4	-0,8	-2,6	-0,9
foreign currency deposits	0,1	-0,3	-1,0	0,7	4,2	-2,7	-3,4
% change over corresponding month of previous year	88,6	68,4	50,3	29,2	24,1	19,1	14,2
currency outside banks	248,9	207,1	156,6	92,0	69,6	52,6	42,1
demand deposits	270,8	175,4	144,1	57,9	41,1	35,9	37,9
time and savings deposits	76,5	63,3	49,3	25,4	16,5	11,4	8,0
foreign currency deposits	37,3	23,9	8,8	1,9	4,3	2,8	-2,7
Domestic credit, end of month							
level, bln BGL	4339,3	4227,6	4205,3	4207,4	4374,1	4370,3	4369,6
net claims on government	919,2	742,7	748,4	771,3	809,1	827,7	730,1
claims on nonfinancial public enterprises	1107,2	1103,2	1026,4	952	959,8	952,6	929,3
claims on private sector	2312,9	2381,7	2430,5	2484,1	2605,2	2590,0	2650,2
% change over previous month	-7,1	-2,6	-0,5	0,0	4,0	-0,1	0,0
net claims on government	-21,2	-19,2	0,8	3,1	4,9	2,3	-11,8
claims on nonfinancial public enterprises	-1,8	-0,4	-7,0	-7,2	0,8	-0,8	-2,4
claims on private sector	-2,8	3,0	2,0	2,2	4,9	-0,6	2,3
% change over corresponding month of previous year	11,9	9,0	-15,2	-21,2	-17,8	-14,3	-11,9
net claims on government	-25,5	-36,1	-65,5	-66,8	-63,2	-57,7	-57,2
claims on nonfinancial public enterprises	3,6	0,7	4,2	-11,3	-17,4	-17,8	-23,6
claims on private sector	46,8	46,8	34,5	27,9	33,1	30,4	30,8

Monetary Policy

Interest rates, end of month	04.98	05.98	06.98	07.98	08.98	09.98	10.98
*Nominal deposit rate**							
monthly rate	0,23	0,23	0,23	0,24	0,27	0,27	0,27
annual effective rate	2,77	2,75	2,75	2,98	3,31	3,31	3,30
cumulative from the beginning of respective year	0,95	1,19	1,42	1,65	1,93	2,21	2,48
*Real (CPI deflated) deposit rate**							
monthly rate	0,12	-0,23	2,14	1,74	1,19	-2,67	0,57
annual effective rate	1,45	-2,73	28,93	23,00	15,25	-27,73	7,10
cumulative from the beginning of respective year	-2,76	-2,99	-0,92	0,81	2,01	-0,71	-0,15
*Nominal lending rate ***							
monthly rate	1,14	1,20	1,12	1,09	1,04	1,06	1,11
annual effective rate	14,60	14,51	14,30	13,90	13,21	13,44	14,13
cumulative from the beginning of respective year	4,59	5,85	7,04	8,20	9,33	10,48	11,71
*Real (CPI deflated) lending rate***							
monthly rate	1,03	0,74	3,05	2,60	1,97	-1,91	1,41
annual effective rate	13,08	9,25	43,41	36,07	26,38	-20,66	18,31
cumulative from the beginning of respective year	0,75	1,49	4,58	7,30	9,41	7,33	8,49
Base central bank rate							
simple annual rate	5,40	5,25	5,15	5,20	5,15	5,09	5,14
monthly rate	0,45	0,44	0,43	0,43	0,43	0,42	0,43
annual effective rate	5,54	5,38	5,27	5,33	5,27	5,21	5,26
cumulative from the beginning of respective year	1,93	2,37	2,81	3,26	3,70	4,13	4,58

** One-month time deposit rate, average for commercial banks.*
*** Short-term lending rate, average for commercial banks.*

The Trade Deficit - A Threat to the Currency Board Or Inevitability?

Latest trade balance release of the Central Bank might spoil the bright picture of economic recovery. For July-September merchandise exports shrank by 20% to USD 1016 m as compared to same period of 1997. The decline in imports was more modest, about 10%, and the third quarter ended in a trade deficit of USD 40,1 m. The current account balance was also negative - USD -3,8 m, basically due to positive balance of transfers - USD 40,5 m.

On January - September basis the trade balance was USD -72,5 m, and the current account recorded a deficit of USD 42,1 m. Merchandise exports fell to USD 3 230,6 m, a drop of 12,6%, while imports have slightly increased by 1,8% to USD 3 303,1 m.

The projected level of the current account deficit is USD -92 m for 1998 and USD 449 m for 1999. To factors will continue to "shape" Bulgarian foreign trade in the short term - low international prices of major export products such as fertilizers and base metals, and at the same time increase in real incomes which combined with trade liberalization is about to boost consumer goods' imports.

In the third quarter of 1998 the capital account turned negative to USD -95,5 m, and the balance for the first 9 months of 1998 is only USD 99 m. As a comparison, for the same period of 1997 it marked a surplus of USD 403,4 m. Foreign direct investment fell from USD 404,7 m to USD 152,1 m, while portfolio investment dropped from USD 187,4 m to USD -200,2 m as of 9m of 1998.

Nevertheless the Central Bank forex reserves increased by another USD 314,2 m for the 9m of 1998 m, and the **reserves/ monthly imports** *ratio reached 6,1.*

Latchezar Bogdanov