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Bulgarian Energy Market

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Heritage

Bulgarian electricity production and supply networks have been established according to beginning of the century model (huge plants grids, constructed by the government which has the monopoly to sell it to consumers). In addition, the model had a Soviet type design based on the conviction that artificially cheap improves economic efficiency and increases productivity. The system required "cheap" resources, so domestic energy production and supply has been linked to the COMECON "division of labor," grids attached to Russia and Central Europe, but not as part of immediate (e.g. inner-Balkan) infrastructure.

Transition background

Adjustment of electricity prices, originally scheduled for the second half of 1991, has actually taken place in 1997. This distorted the entire price system of the economy and fixed a tradition of using the electricity prices as major venue of quasi-fiscal subsidization.

The general economic and political consequences were:

- frizzed structure of the economy and the power sector;
- export led by energy-intensive sectors and non-competitive adjustment to the international markets;
- intentions to retain monopoly power, poor corporate governance, and populist rhetoric creating false consumer expectations;
- omitted revenues and opportunities.

Meanwhile, Poland, the Czech Republic, Hungary embarked upon deregulation pattern, and in 1992 they and Slovakia established an inter-government coalition to get linked to the West-European electricity transmission network (which was accomplished in 1995); Hungary and the Czech Republic have started privatization of their utility sectors; Poland recently announced its program, and in 1997 Russia’s electricity monopoly has been set for deregulation with the assistance of Arthur Andersen, Brunswick Brokerage, and Salomon Brothers.

Bulgaria and other Balkan countries have hardly thought of energy market liberalization and did not test the waters at all for negotiations on electricity transmission reorientation and inner-Balkan links.

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Current ideas

The government strategy is based on the so called "single producer/buyer model" (SBM). Respective regulations are being discussed on inter-ministerial level. No outside criticism had motivated any re-thinking of this strategy. Besides "insuring energy independence of the country", no other argument in favor of SBM has been

communicated to the public.

The strategy consist of three stages:

- introductory (by 2000);
- opening the retail market (by 2005);
- "reduction" of the government property rights (by 2010).

The current concept is that after 2010 the government retains its ownership over the grid-lines.

Challenges ahead

For the time being using grants from EU and applying for loans before IFI's are envisaged as sources of financial backing (and borrowing). There is no expertise and/or skills in securing projects' multi-source financing. The cabinet's expectation is that the World Bank would provide technical assistance for the implementation of the entire strategy. In addition, there is no macroeconomic assessment of the provisional impacts of the selected strategy. Given the currency board arrangement, sovereign borrowing is expected to be limited.

Regulations which are going to introduce SBM have not been a subject of any impact assessment.

The strategy seems to create tensions in the area of public procurement. The case in point here is monopoly regulations. According to the existing Bulgarian anti-trust laws and the draft competition defense bill (passed recently on the first hearings), "natural monopolies" are being controlled and regulated by government designated bodies and there is no third-party access to these bodies and respective procedures.

Recent Developments & Events

Achieving macroeconomic stability, budget surplus and curbing inflation, the government focused on improvement institutional framework of the Bulgarian economy. The ultimate objective is to foster structural reforms and economic growth. Although properly targeted, institutional reform efforts have not been evenly successful. Delayed adoption of number of draft bills (on State Saving Bank, Deposit Guarantee, etc.) postponed disbursements of fourth and the fifth trench of the IMF stand-by agreement. The problem, however, is not with the latter but likely delays in negotiations of Extended Fund Facility (EFF).

✓ Since late December when Moody's assessed Bulgaria's creditworthiness at "B2", key government officials repeatedly stated that they would consider an offer to review it to "B2+". In April, IBCA awarded "B+" to Bulgaria, which is equivalent to Moody's B1. At the same time, it is not clear whether the government or businesses are ready to borrow; the government's foreign debt policy in a long run is still obscure. The development on this front (before this issue went to print) is that:

✓ In late February finance minister decided to postpone Eurobond issue; in early April the cabinet finalized documentation for US $ 80 million SPAL from the World bank and the Parliament ratified the consolidation of the ex-GDR debt as sovereign debt (DM 359 m); Italian and Spanish debts are next to be consolidated (about $120 m total). Sofia City Council selected BANQUE PARIBAS as an intermediary for US $ 50 million bond issue. Meanwhile, domestic debt market remains tin and no agency or municipality tried to attract resources.

✓ In March, the government started talks with IMF and representatives of the World bank on EFF. According to their responsibilities, government agencies attempted to outline next three years priorities. The entire concept seems not yet properly knitted, some parts do not take into account the integrity of the program, some do not recognize hard budget constrains and fail to envisage proper financing schemes.

✓ From the broad range of negotiations, public at large and labor unions paid attention mainly to the income policiy. Minimum salary has been raised to DM 50.94. The average salary is expected to grow to US $ 120 by the year end (from its current level of, roughly, US $ 97). But one of the strong unions requested 75% increase of salaries in the budget (and state enterprise) sector; another threatened to skip its support to the currency board and the government if such an increase fails. If we assume that the government has an income growth policy based on productivity growth, it is failing to communicate it to the public.

✓ The cabinet is expected to resume EFF talks with IMF later in May or early June, by when legislators are expected to adopt necessary regulations.

The most important institutional developments in the first quarter of 1998 have been in the following areas:

✓ End of March was the deadline insurance companies to submit applications to the Insurance Supervision (a body formed earlier) in order to be licensed. Consolidated 36 (of previously registered 130) companies applied, most of them expected to obtain license and continue operation.

✓ In the field of FDI, the cabinet adopted implementation rules for the 10-year 50% corporate tax relief (i.e. Article 18 of the Foreign Investment Law in conjunction with Article 44 of the Corporate Tax Law which provide for a tax-concession of locally registered foreign investment of more than US $ 5 million in structurally underdeveloped communities, creating at least 100 new jobs.) which identified 94 municipalities where foreign investment would enjoy these tax benefits.

✓ Amendments to the Securities, Stock Exchange and Investment Companies Act were adopted in order to give a definition of public joint stock companies facilitate trade of privatization funds and other public companies.

✓ Entirely new Competition Defense Act has been passed on first hearings, similar is the case with deposit guarantee and State Saving Bank bill. But latter acts were approved by the cabinet in February and are the ones on which adoption IMF insists upon.

Foreign Debt And Fiscal Impact on the Currency Board's Operation

By Viktor Yotzov,
BNB, Strategic Research and Forecasts Directorate

1. Foreign Debt Impact

The currency board's introduction created conditions for an overall change in the economic situation in Bulgaria. The Bulgarian National Bank (BNB) prevented itself from maintaining a monetary policy. The government cannot rely on direct financing by the Central Bank any longer. Commercial banks should forget about refinancing as a means of covering non-performing loans. The short-term goal is financial stabilization; the long-term one is the establishment of the preconditions for dynamic economic growth. Financial stabilization (at least during the first year of the currency board's operation) is possible only together with massive foreign financing, which is estimated to reach $1,000 million for 1997, and $500 million for 1998. This apparently leads to an increase in the size of foreign debt and the cost of its servicing.

1.1. Size, Structure and Problems Connected With Foreign Debt and Capital Outflows

The foreign debt problem emerged in the late 1980s. Neither its size nor its servicing used to cause any trouble. In the mid-80s it was slightly above $1,000 million, while at the end of the decade it exceeded $10 billion.

The reasons for the fast increase in foreign debt are both internal and external. Among the external ones, political factors were of the greatest importance. Despite the proclaimed "Crusade against communism" at that time, the countries of the Soviet bloc had easy access to both private and official credits. The low interest rates after 1994-1995 were an additional incentive for the increase of the debt. On the other hand, the obvious economic disturbance in the socialist countries and progressively decreasing access to cheap resources from the Soviet Union forced most of the countries to borrow actively, hoping to delay the economic collapse of the system. Bulgaria, Poland and Hungary were to suffer most. The internal factors were the fundamentally mistaken economic policy, unrealistic exchange rates, a decrease in hard currency incomes, aggravated "terms of trade" due to the unfavorable foreign trade product structure — import of processed goods and export of agricultural products. Another reason for the fast accumulation of debt was that the money borrowed was not invested properly in order to make its repayment possible. The loans were not used for the development of production of tradable goods but for maintaining the living standard (mainly covering the budget deficits) — i.e. they were "consumed." Part of them has probably gone back abroad[1], leading to additional problems:

- The potential for economic growth declines — the level of domestic investment shrinks, and at the same time the connection between savings and investment is cut. Kept abroad, that capital is not used for import, which under certain conditions could induce growth.
- The tax base contracts and budget revenues decline; therefore, the ability of the government to invest and to service the debt also decreases.
- The contraction of the tax base is usually followed by an increase in tax rates, which additionally de-stimulates economic activity.

1.2. Macroeconomic Impact of Foreign Debt Servicing

The important question now is whether Bulgaria can service its debt, and if yes, at what price. Also, is it recommendable to increase it further, and are there any dangers of default?

The Table below shows some calculations which estimate the ability of the state to service its debt. The figures do not stand as a concrete forecast, but rather as a basis for the evaluation of trends in analyzing the problem.

The total amount of payments on the foreign debt will be $3,000 million by the year 2000, varying between $1,000 million and $1,200 million annually.

In 1999, when the loans contracted after 1990 start to mature, the burden will reach its highest level. All new loans will additionally increase the servicing. The unsettled debt to Polish and Russian banks act in the same way. Fluctuations on the international credit markets will also influence the cost of debt servicing.

In compiling Table 3, we take into

[1] There is a problem with the definition of "outflow of capital." The same process is being addressed differently in developed and developing or transition countries. The outflow of capital in developed countries is considered to be investment abroad, while in developing countries and transition economies it is considered as escape of capital. It is obvious that a precise distinction between investment abroad and capital outflow should be made. In the first case, what happens is maximization of profits while in the latter , it is escape, due to political and/or economic instability, corruption, etc., aiming at hiding capital rather than at maximizing profits. Empirical evidence proves it is quite natural that capital flows from countries with excessive financial resources to countries where they are deficient. Therefore, in a case of capital flows from a developing or transition country to a developed country we have escape of capital rather than a normal investment. Another argument in favor of this statement is the fact that countries with a huge level of capital outflow usually undertake programs stimulating and attracting foreign capital.

Table 1. Gross Foreign Debt

	1991	1992	1993	1994	1995	1996	1997/*
Gross foreign debt (A+B)	**22301.1**	**13857.7**	**13889.4**	**11411.4**	**10229.2**	**9595.6**	**9741.8**
A. Long-term debt	**2676**	**3167**	**3256. 6**	**9267.9**	**8841.3**	**8555.0**	**8411.0**
State or guaranteed by the state	2274	2658	2740	8755	8499. 7	8319.7	8302.0
Non-guaranteed	402	509	516. 6	512.9	341.6	235.2	109.0
I. Official creditors	1872	2256	2338	3216	3084. 6	3188.5	3273.8
1. International financial institutions	744	1099	1157	1825	1657.1	1983.9	2220.2
International Monetary Fund	401	590	632	941	716. 7	584.6	934.9
World Bank	142	152	155	396	410. 6	455.8	540.4
European Union	201	357	357	444	460. 6	495.5	286.4
Other (incl. EIB, EBRD)	0	0	13	44	69. 2	448.1	482.1
2. Bilateral credits	1128	1157	1181	1391	1427.5	1204.5	1030.1
Paris Club and non-prolonged debt	1128	1095	1100	1240	1237. 6	1034.5	877.9
Other bilateral credits	0	62	81	151	189. 9	170.0	152.2
II. Private creditors	804	911	918. 6	6051.9	5756.7	5366.4	5137.2
Brady Bonds	0	0	0	5137	5005. 4	4984	4924.4
Bulbank Bonds	402	402	402	402	409.7	147.2	80.8
Commercial Banks	402	509	511	479	273. 3	155.9	47.3
Other private creditors	-	-	5.6	33.9	68.3	79.3	84.8
B. Short-term debt**	**9625.1**	**10690.7**	**10632.8**	**2143.5**	**1387.9**	**1285.9**	**1354.3**

Source: BNB
** Preliminary data*
*** Including deposits of non-residents in local commercial banks, T-Bills and overdue debt*

account the following assumptions:

• The GDP dynamics by 2000 will be positive. This will happen if favorable economic and legislative conditions for export are in place, given the inevitable increase in imports. Under the contemporary macroeconomic situation, the decline in invested GDP (compared to GDP spent) should be stopped, without decreasing consumption once again. A gradual increase in accumulation should begin, together with an increase in foreign direct investment.

• Inflation, measured by CPI, is expected to fall, but by the end of the century it will be probably above the levels in Germany, given the fact that the reserve currency in Bulgaria is the deutschemark. The GDP deflator will also decrease and by year 2000 it is expected to reach 8-9%.

• The budget deficit will also gradually decline, and by 1999 a balanced budget can be expected. This will require expansion of the tax base as well as increase in tax collectibility, after the tax rates are decreased (starting from 1998).

• The nominal exchange rate against the DEM will remain unchanged, and given the higher domestic rate of inflation, the Lev will appreciate. Labor productivity should therefore increase faster than the appreciation rate, in order to stimulate exports

• The export growth rate will be almost double the GDP growth rate. If stagnation and chaos in trade with the CIS and CEE countries continue, and the EU doesn't change its import policy, these rates will be put into question. A great national effort will be needed to accomplish that goal.

The features in Table 4 suggest the following effects on foreign debt servicing:

First, foreign debt servicing seriously aggravates the ratio between GDP produced and GDP consumed. It is obvious that during the next couple of years the country will have a significantly trimmed GDP for domestic spending. This means restricted capabilities for maneuvering in all issues connected with consumption and capital accumulation. There is no other solution to that problem than mitigating the consequences through reasonable political and macroeconomic decisions. **This requires modesty in new long- and medium-term borrowing.** By the end of the decade, new loans

Table 2. Debt Indicators

Year	1991	1992	1993	1994	1995	1996
Debt/GDP	161. 9	161.1	131	118.9	78.7	99.1
Debt/Exports (goods and services)	297.4	275.7	283.6	219.8	151	158.8
Debt Servicing/GDP	3. 2	5.1	4.0	15.1	7.3	10.8
Debt Servicing/Exports	5. 8	8.8	8.7	27.9	13.9	17.2

Source: BNB

Table 3. Foreign Debt Servicing and Selected Macroeconomic Indicators by Year 2000

	Unit	1997	1998	1999	2000
1. Foreign Debt Servicing	USD mln.	897	980	1150	1200
2. GDP at current prices	BGL bln.	16880	23200	27000	30900
3. Exports	USD mln.	4878	5087	5376	5797
4. Debt Servicing/GDP	%	10.9	8.6	7.8	6.7
5. Debt Servicing/Exports	%	22.4	21.4	22.1	20.5
6.Interest Expenditures/					
Budget Expenditures	%	26.3	15.2	16.2	15.7
- domestic debt	%	17.9	5.8	5.5	5.3
- foreign debt	%	8.4	9.4	10.7	10.4

Source: BNB, Bulbank, commercial banks, IMF, estimations of the author

Table 4. Foreign Debt and its Servicing by Year 2000

Years	1994	1995	1996	1997	1998	1999	2000
Foreign Debt (right scale)		10230	9571.4	10300	10505	10200	9800
London Club banks	249	275	262	327	327	332	336
Paris Club banks	36	204.7	157	81.9	153.7	216.5	225.4
IMF, WB, G-24	156	0	326.7	314.8	584.9	638.6	502.5
Other	57	0	303.1	280	159.3	151.7	134.5

Table 5. Foreign Debt Servicing

Years	1995	1996	1997	1998	1999	2000
as % of GDP	4.4%	9.4%	10.9%	8.6%	8.9%	7.1%
as % of exports	11.2%	24.6%	22.6%	21.6%	23.7%	20.2%

should not exceed the payments on servicing the old debt, given stable growth in foreign direct investment.

Secondly, the share of consumption in GDP falls. Bulgaria has no other choice than to "force" investment activity in the second half of the decade, as well as during the following decade, through structural and technological renovation of the production capacities. This will, of course, happen in the framework of domestic spending of GDP, and will increase contemporary consumption in order to increase it in the future. The distribution of GDP by spending is not related to the foreign debt only at first sight. The foreign debt influences the base for distribution. Besides, without settling the pending foreign debt a massive inflow of foreign capital is hardly probable. Also, the country will remain in isolation on the international commodity, credit and capital markets. Under such isolation an economic revival and GDP growth will be impossible during the following couple of years.

Thirdly, debt payments will seriously affect the ability of the state to implement significant social programs. The stabilization of real incomes will be further hindered. A serious increase in real incomes is hardly to be expected by the end of the century, unless in the case of an extremely positive coincidence of circumstances.

Fourthly, the share of GDP spent on servicing the debt is relatively high (Table 5). During the following couple of years a significant improvement in that ratio can hardly be expected.

Fifthly, the share of debt servicing payments of export revenues is also very high. While in 1991-1993 it ranged between 1.5 and 6.0%, in 1997-2000 it will reach 20 - 23%. A slight decline is expected after 2000, but it will remain 13 to 14%. In 1991-1993 that ratio was 15% for the developing countries, and 12.6-14.8% for the CEE countries.[2]

Sixthly, the share of debt servicing in the total amount of budget expenses remains high. Until 1994, the share of foreign debt payments in the budget expenditures was negligent. The reasons are well-known. However, after the country resumed servicing its foreign debt, the share of those expenditures rose significantly. Moreover, at present the payments to the London Club consist only of interest. After 2001, repayment of the principle should start, causing difficulties to the state budget. The problem becomes more complicated when the domestic debt is added. During the next couple of years its size will be determined by controversial factors. On the one hand, negative real interest rates will diminish its real size and therefore, the cost of its servicing. The basic interest rate (BIR) will fall, together with a decrease in inflation (hopefully), which will also act in the same direction. On the other hand, it is not impossible that the non-performing loans accumulated in the economy after 1991 will be converted into government debt some day.

Regardless of all of the indicators mentioned, the period of 1998-1999 is crucial for the servicing of the foreign debt. Under the current repayment schedule, the Bulgarian economy is unlikely to bear that burden. Some may argue that the problem can be resolved through new loans to cover the peak payments, but this is possible only with a normally functioning economy. It is not a solution for the immensely indebted Bulgarian economy.

It is obvious that the country has reached the potential to pay its foreign creditors. It is possible that adding payments on new loans, it what could be even exceeded. Going into the same situation as the moratorium of 1990 would be disastrous for the economy. These problems presuppose that relevant solutions will be found before the critical moment occurs. They might be:

- Negotiations for rescheduling the debt.
- New borrowing to finance payments on

[2] IMF, World Economic Outlook, Part I. Main Report, p.57

old debt — there is a strong probability of entering a vicious circle.

- Accelerating debt-equity swaps.

1.3. Pros and Cons of Debt-Equity Swaps.

The absence of any foreign property in Bulgaria until the last few years left the impression that foreign property ownership is dangerous for the independence of the country.[3] The international experience, however, has proved that such practice is not so frightful. The swap operation has been unjustly underestimated, and deserves a more serious attitude.

Debt-equity swaps leave all agents better off. Bank creditors regain part of their claims by selling them on the secondary market, or become owners, if they also act like investment banks. For the debtor the main advantage is a decrease in obligations and an increase in investment. That leads to improvements in the respective indicators in the balance of payments, both in the current account — because of the decreased interest payments, and in the capital account — because of the decrease in principle. On the other hand, by decreasing the debt, most of the factors repelling foreign investors will disappear. Another important advantage is a "boom" in investment. Experience has proved that after swap deals, investment in new or already existing companies increases significantly. This itself leads to modernization of technologies and improvement in management skills, and opens the door to new markets and sources of financing. Apart from that, the list of advantages may be continued:

- Debt-equity swaps are a good solution to the problem of capital outflows.

- A successful start in the debt-equity swap program leads to an increase in the price of debt bonds on the secondary capital market. This improves the country's creditability and stimulates the inflow of "fresh" money.

Together with all of the advantages mentioned above, there are also a number of shortcomings of this technique. The positive effect on the balance of payments can be exhausted. Sooner or later, foreign investors should start to repatriate their profits, and, in some cases, the whole capital. When dividend payments exceed the interest payment avoided by the scheme, the current account will worsen, without that effect being compensated for by an adequate improvement in the capital account.

The positive impact of debt-equity swaps should not be exaggerated.[4] Their low efficiency in solving the debt problem, when compared to other instruments, is due to the fact that the largest part of profit stemming from the discounted price of the bonds on the secondary market goes to investors or intermediaries, while under other techniques it goes to the country-debtor.[5] Another inconvenience is the possibility of legalizing illegally evaded capital. The opportunities for corruption and speculation should also be taken into consideration. There are a number of cases of illegally exported capital being used for buying bonds on international markets and then converted into equity, using the preferential regime.

There is a common belief that debt-equity swaps should be avoided when the probability for "fresh" investment exists — i.e., new money is always better than settling old obligations. Some critics even argue that these operations are unprofitable for the country because if an investor is willing to do business in the country, he will do so with or without using foreign debt bonds. This might be true for countries attracting huge investment interest, with high credit ratings. Unfortunately, Bulgaria is not among them. This can be proven even by the amount of foreign direct investment during the last 4 years as compared to that in Poland, the Czech Republic or Hungary. Therefore, the debt-equity swap program will make it possible for foreign investors to rediscover our country.

Another unfavorable factor is the possible increase in inflation caused by an increase in money supply. This could be avoided by competent operations with T-Bills. And, finally, the debt-equity swaps program could face strong resistance by local entrepreneurs because of the different starting conditions for investment for different categories of potential investors. The only solution to that problem is to allow local persons to participate, but as mentioned above, that might be quite a risky enterprise.

During the past three years, different governments showed explicit interest in the matter and made the first steps to regulate the process. According to the Regulation adopted by the caretaker cabinet, lead by Reneta Indjova, foreign debt bonds could be used in the privatization of state-owned enterprises, no matter who their holder was. The BGL equivalent of the bonds is calculated using the average BGL/USD exchange rate over the last six months, before the privatization contract is signed. The restrictions are: obligations for investment, forfeits on privatization contracts, and taxes are not allowed to be paid with foreign debt bonds. Municipal property could also not be bought against bonds. When a public offering of shares of a SOE is initiated, payment may not be made with foreign debt bonds. No restriction on the repatriation of profits and capital after a debt-equity swap is made by the law. This is quite favorable to investors, but is hardly successful for the country.

Another point of interest is the access of local persons to the Brady bond market. The principle here should be equal treatment for all participants. That, however, is impossible, for two reasons: (1) though illegal, the export of hard currency abroad is possible, and, (2) local persons can set up an off-shore company, which according to the law is foreign person, absolutely legally.

Zhan Videnov's government made some amendments to the regulations:

- Only 50% of the price of the deal could be paid in Brady bonds. The other half might be paid in cash or ZUNK bonds (bonds issued by the government to settle the non-performing loans of state-

[3] A question worth answering is whether it is worse for economic independence to swap equity for debt, or to implement programs written abroad.

[4] Only one single country in the world,Chile, managed to significantly decrease its foreign debt through debt-equity swaps, about 15-20%.

[5] One should never forget that in debt-equity swaps, the foreign debt is bought for the national currency, while otherwise it should be paid in hard currency.

owned enterprises extended before 1990).

• Unpaid interest on Brady bonds is accepted for payment, despite the fact that there is no explicit condition for cash payment.

• Profits may not be repatriated for a period of 4 years after the privatization deal is signed, and capital may not be for 10 years.

Without any doubt, the restriction implied in the new regulations[6] did not cheer foreign investors, especially those with speculative intentions.

The introduction of the currency board and the signs of financial stabilization, as well as the agreements with the IMF and the World Bank, have changed the investment climate in the country. Confidence is coming back, though very slowly. From that point of view, amendments in the regulations for privatization through foreign debt bonds are absolutely necessary.

The basic provisional changes are as follows:

• increase (from 50% to 75%) in the share of payment through FLIRBs;

• clarification as to whether or not the second half can be paid in ZUNKs;

• abolishment of any restrictions on the repatriation of profit and capital.

These amendments are aimed at attracting more investors. The increased percentage (from 50% to 75%) provides better opportunities for those owning FLIRBs. They would be able to buy more property for the same price, other things being equal. Given the overall appreciation of Bulgarian Brady Bonds, this amendment is quite necessary. Moreover, the still remaining country risk and further increase in prices will make investment less profitable. As for the restrictions on the repatriation of profit and capital, the problems are more "tricky." The grounds for them lie in the very essence of the Bulgarian Brady deal: according to the agreement with the London Club, Bulgaria received a 7-year gratis period for the principle repayment of FLIRBs and a 30-year gratis period for DISCs. They make no sense if the investor can immediately repatriate the capital — i.e. the principle.[7] The outflow of capital will by all means negatively affect the balance of payments in the country. The question here is whether it will be compensated for by a higher increase in foreign direct investment (FDI), which usually follows any privatization deal. If the restrictions were to be amended, this should be followed by strict regulations providing that the enterprise not be immediately liquidated and the capital repatriated. Otherwise, they will only facilitate speculative operations without a relative restructuring in the real sector. The prolongation negotiated with the London Club should by all means be used. Moreover, there are reasons to believe that a lot of local entrepreneurs are interested in privatization through Brady Bonds, which makes all restrictions on repatriation meaningless. As for foreign investors, these restrictions can hardly repel them, if they come with long-term intentions. From that point of view, it is reasonable that only the restriction on the repatriation of profit be abolished, and the restriction on repatriation of capital be decreased to 5 years.

Debt-equity swaps, however, are not a panacea for economies in debt crises. They cannot, and should not, be used in lieu of other stabilization instruments, but rather in addition to them. A national program is needed for their successful execution, not a chaotic sale. The elements of that program should at least answer the following questions:

1. Which debt category is applicable for debt-equity swaps?

2. Which category of investors will be attracted?

3. In which sectors should the program be directed?

4. What share of payment will be accepted in bonds?

5. Should there be any restrictions on the repatriation of profit and capital?

6. Should there be specific tax treatment for investment through debt-equity swaps?

Of what has been said, one can conclude that the execution of a balanced debt-equity swaps program will positively affect the economy for quite a long time, without threatening its political and economic independence.

1.4. Some Conclusions

Resolving the foreign debt problem is a long and complicated process. It is only a part, though a significant one, of the revival of the whole Bulgarian economy. It is obvious that without real GDP growth — and especially export growth, without curbing inflation, and without a reasonable state budget, the country will hardly be able to meet its debt obligations without new loans. The idea of new borrowing to cover old debt payments always ends in a vicious circle.

The analysis so far proves that the Bulgarian Brady deal had to be signed, but only as a part of a larger agreement for debt consolidation.

The most important proof of the necessity for reduction and restructuring of the debt with official creditors lies in the currency board regulations in the country, and the real possibility for Bulgaria to achieve not only a financial stabilization, but sustainable economic growth as well. The chance to escape the vicious circle "high debt -> new loans -> higher debt" should not be missed once again. This is the only way to partial compensation for the losses stemming from the Gulf War and the UN embargo on Yugoslavia.

2. Fiscal Influence

The changing macroeconomic environment in the country after introducing a Currency Board vitally influenced the cash performance of the state budget in 1997. The process of financial stabilization that started restoring confidence in the banking system, accompanied by increased liquidity, presenting the macroframe and the draft budget for the next year on time, had a positive influence on the performance of the 1997 budget. This way efforts in the fiscal sector are concentrated on finding an optimal solution guaranteeing government securities development (through carrying out an adequate issuing policy that by this

[6] In Council of Ministries' Decree (CMD) N278 of November 25, 1994, new regulations for debt-equity swaps through foreign debt bonds were adopted, and amended later in CMD 41 of February 20, 1995.

[7] Brady Bonds can be bought at a lower than the face value, while in privatization they are accepted for payment at par. Therefore the repatriation of capital will also be at par value.

moment became a major instrument of regulating banking system liquidity), while at the same time ensuring the fiscal reserve indices obligatory for the country, included in the IMF Memorandum, and not allowing unjustified increases.

The radical change in the inflation index during the present year influences the state budget's monthly income dynamics. Analyzing the data without taking this factor into consideration shows, that budget returns are more significant in 1997 compared to previous years. Also, it is to be mentioned that taxes are being collected more effectively as a result of measures undertaken by the government. Monthly incomes in the second half of this year (around 289 billion BGL) remained comparatively steady, despite the rapid decrease in inflation. Keeping inflation at a low level was marked by fluctuating and decreasing monthly incomes (monthly average 132 billion BGL) during the same period. The conclusions drawn were confirmed by the successful performance of the state budget.

At the same time, if there are no additional expenses, the budget year will end with the retrenchment of expenses calculated in the 1997 state budget. By June 30, 1997, Bulgaria's expenses in comparison with those calculated were 39%, 78.2% by November 17, as of the 95.3% expected by December 31.

These comparatively low expenses were a result of both the government-guided restrictive fiscal policy and the decreasing interest payments in the budget. Introducing the Currency Board and the measures undertaken by BNB towards stabilizing the banking sector, accompanied by closing non-vigor banks, as well as low regulations envisaged for sanctioning and licensing bank managers and leaders, led to a clenching of banking activity. In this environment, investments in state securities that are guaranteed by the government and carry minimum risk became a preferred form of utilizing free resources. The big demand for state securities and the low supply led to a decrease in their profitability, and respectively (by the methodology of defining basic interest rates), to a decrease in the basic interest rate. This directly mirrored the size of budget expenses to interests, thus decreasing their share of the general expenses to 61.1% by June 30, 1997, and 53.8% by September 30. By the end of 1997 it reached 40%.

After the Currency Board's introduction, a steady trend of increasing general credit demand could be observed. For the purpose of this analysis we consider excluding budget deposit from credit demand to be appropriate, for unlike other elements it can be used as a financing resource. The data compiled after eliminating this influence shows that the credit demand increase is a result mainly of the fact that most of the payment dates for state securities come during the first half of the years, whereas state securities were 7-day issues, that were rolled over.

2.1. Budget Deficit Financing

The Law of the State Budget for 1997, unlike in previous years, envisaged positive net external financing amounting to 133,247.8 million BGL. The real size of external financing by 31 December 1997 was negative, amounting to -205,4 billion BGL.

Central government budget net internal financing by 31 December 1997 amounted to 872 billion BGL.

The main sources of cash deficit internal financing are state securities operations and credits, according to Act. 45 of the Central Bank Law. Issuing state securities is considered a more dynamic element, which the Ministry of Finance can use to implement its policy and more effectively regulate the fiscal reserve, because credits under Act. 45 of Central Bank Law depend on IMF Agreements and are of defined-in-advance size and dates of receival. The net financing with state securities by 31 December 1997 amounted to 568.5 billion BGL, or 119.8% of the planned amount in the budget.

In view of issuing state securities a regulatory role, we consider it necessary to submit to the market a bigger variety of state securities, both in terms of maturity and profitability. Realizing different kinds of issues can indicate investors' expectations, in both the short-term and long-term. Being familiar with these will allow optimally motivated management decisions regarding issuing policy and budget deficit financing. We think that the third quarter of 1997 could have realized a greater size of long-term state securities, if they had been issued with a profitability matching better market conditions.

Surveying the state securities market shows that it is still unstable, and any rumor of changing macroeconomic indicators can influence it. By our judgment it is evident that after announcing a publicly average basic interest rate for 1998 of 10% (that is now considerably lower), a subtle increase in state treasury bond profitability, formed on sell auctions, should be observed. The bonds with a validity of two years offered in the period have not been realized, in spite of their small amount. Additional conclusions about the market can be drawn based on the results of sell auctions of the announced two-year state securities on November 20, with interest payments of six months, whose profitability is formed on the profitability reached at the auction of six-month state securities, prior to the respective interest period + 1 point. Of the 5 billion BGL nominal value of securities issued by Ministry of Finance, some 1.35 billion BGL were sold. Obviously, investors are not inclined to make long-term investment without being clear about the possible profit they can receive from it.

The above confirms our view of the necessity of developing and publicly announcing an issuing calendar, that would support effectiveness of management and regulation of banks' system liquidity and stabilization of the financial market, as well as investors' confidence, because based upon these, they can make grounded decisions regarding managing assets.

In order to limit inflationary bank financing of the budget deficit, we consider that government measures should lead to creating incentives for increasing non-bank financing. Through supporting a proper state securities issuing policy, the government can compensate for the depreciation of individuals' savings due to the low interest rates that commercial banks render to loans. This is basically because of their weak credit activities (except for state securities issued as a guarantee for consumer loans, thus promoting banks that render them).

The dynamics of expedient issues sales

aimed at individuals and non-financial institutions for now have no steady trend. This can be explained by investors' confidence in the banking system. We consider it important that for the last quarter a decrease in state securities sales is evident. We think this is due to lowering their profitability in comparison to profitability during inflational periods. The restriction imposed by the Ministry of Finance in September, on buying back these securities, also had an influence. The purchases of state securities are mainly made by small investors in possession of limited assets, in fact they will probably need cash at any time, and so they prefer to invest money in time deposits in commercial banks which have a lower interest rate but more liquidity. Another reason for the decreasing sales of these specific securities is insufficient advertising after the implementation of the Currency Board. Practice shows that the public needs to be precisely informed of the advantages and disadvantages of every investment. Besides, the individuals willing to invest, want to know the exact size of profitability to be achieved, before actually buying.

Another main source of budget deficit financing are direct credits from the BNB, corrected with expenses for servicing old debt. Taking into consideration the process of restructuring government debt according to the BNB balance sheet into debt denominated in Special Drawing Rights, net direct bank financing by June 30 amounted to 65,304.7 million BGL, by September 30 to 29,659.6 million BGL. By the end of 1997 it to reached 523.89 billion BGL, including credit already granted amounting to 62.2 million SDR for November, as well as provided transfer for December amounting 62.2 million SDR.

2.2. Fiscal Reserve

Favorable development of the macroeoconmic environment during the second half of 1997 allowed for the forming and supporting of a comparatively big fiscal reserve which remained above the IMF-agreed limit during the whole period. By June 30 the fiscal reserve amounted to 1 115.4 billion BGL, by September 30 to 1 099.2 billion BGL, and by the end of the year it reached 1 405.5 billion BGL.

The availability of a big fiscal reserve during this period laid the effective management problem aside. The big share of loans in the reserve requires control both over budget expenses on servicing these obligations, as well as interest rates proceeds that are received on relevant accounts.

Effective fiscal reserve management also requires limiting its wrongful increasing. This is achieved by developing exact recounts of expected budget incomes and an expenditures schedule, based on which a strategy is developed for providing financing sources, and respectively for issuing policy.

The question of an optimal time limits within which to buy all necessary SDRs for the country arises from the above. A conclusion arises that it would be more advantageous for the country if the schedule of IMF trenches coincide with payments for servicing government debt. In case a change in this schedule is impossible, we think that it is expedient to decide first whether it will be more appropriate when buying new SDRs to direct them toward SFRD accounts, the same way it is done with CCFF. This will stimulate the government to manage reserves more effectively, while at the same time BNB will not bear losses because of a negative interest differential.

3. Monetary Aggregate and Interest Rate Dynamics Under the Currency Board

Since the introduction of the Currency Board, Central Bank activities are limited to supporting national currency stability through full coverage of monetary reserves (BNB liabilities) with foreign currency on a fixed exchange rate to the DEM. The BNB's potential for intervening in the banking system with monetary instruments is considerably limited to a single available instrument — minimal obligatory reserves (MOR) and is rather of strategic importance. Referring to this, the main influence of the BNB over commercial banks is performed through bank control. Responsibility for financial stabilization under the Currency Board is directly connected to government fiscal and revenues policies.

3.1. Monetary Aggregates

Under the Currency Board, the BNB has no opportunity to control monetary supply. Financing the budget deficit and refinancing commercial banks is no longer a source for increased monetary reserves, as well as (through money multiplier) to broad money. From this viewpoint, increasing monetary aggregate could only be related to a rise in real monetary demand due to recovering confidence in the banking system.

3.1.1. Prerequisites for Monetary Aggregate Dynamics

• Velocity of money (GDP/broad money correlation) in 1998 will increase, which means that with an assigned value of GDP, the necessary money for normal functioning of the economy will be less, in comparison with previous years. After the dramatic changes in 1997, money demand volume still cannot be restored. Real sector development, which is the determining transaction motive in money demand, does not imply a considerable money demand increase. Probably, after all the shocks that have been survived, economic agents have changed their attitudes toward money; therefore, new standards of inter-relations between GDP and money are introduced. This way, any comparison with previous years cannot be used as a starting point, and even less as a goal. Monetary turnover pace can be influenced by different factors: inflation , interest rates , informal economy share , payment system development. Forecasting this rate will be difficult, because of the contradiction of factors influencing it. It can be assumed that after 1998 this rate will be stabilized with a slight trend of reduction, due to general economic and financial stabilization.

• Money multiplier is expected to increase. After the introduction of the Currency Board, the share of money in turnover to attracted deposits is showing an increase as well. In the previous four years this share was limited to between 10-12%, and by the end of 1997 it reached 28%. The basic reason for this can be found in the decline of deposits' amount as a whole, due to the bank system confidence crisis, as well as the rapid decrease in interest rates. Economic agents decide to keep most of their money in cash, thus increasing money in turnover, rather than deposits. This brings a lowering of the money multiplier. Nevertheless, this trend is opposed by a decrease of the bank reserves/attracted deposits correlation.

The above can be expected mainly because of declining commercial banks' reserves.

• Net BNB foreign assets will increase due to expected growth of international foreign currency reserves, pledged in the balance of payments. Because of the small real sector, this forecast includes an increase of commercial banks' assets for 1998. This means capital outflow and the convulsion of domestic crediting capacity. Interest rate stabilization is expected, leading to stabilization of the real sector, which in turn can stimulate commercial banks to allocate more credits toward the domestic market and reduction of assets. It should be stressed that every delay in structural reform will postpone the retrieval of Bulgarian capital back to Bulgaria, as well as a convulsion of domestic crediting capacity (especially for the non-governmental sector), which finally leads to a slower economic growth pace.

• Low budget deficit provided in the Law of the State Budget for 1998 (around 2.7% of GDP) and the possibility of financing being carried out only by incomes from privatization and external financing, brings an environment in which government claims will decline, thus re-allocating resources for crediting the non-governmental sector. This forecast includes our viewpoint that the government will not only stop accumulating claims, but will decrease the domestic debt through issuing negative state securities. This way, it will help commercial banks' liquidity. For 1999 and 2000, a well balanced budget is foreseen to accelerate the above process.

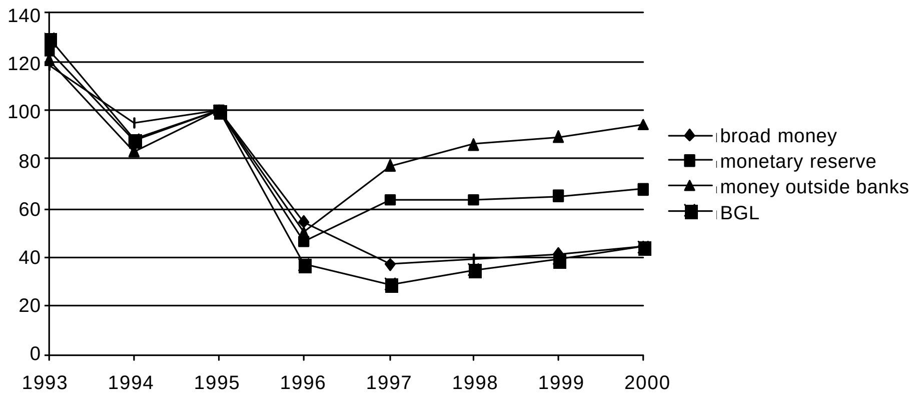
• No change in the BGL/DM exchange rate is to be expected, as all forecasts are based on the fixed BGL/USD exchange rate.

3.1.2. Basic parameters for year-2000 money report

• Nominal expression of broad money growth until the year 2000 is foreseen to be more than the accumulated inflation for the years studied. This way, a real increase in money supply is ensured, which will catalyze the process of re-monetarization of the economy that started after the Currency Board's introduction. The process that was commenced is slow and steady: the real growth of broad money is at ana average 6% annually, and the average annual share of broad money to GDP grows by 1 percentage point per year. By the end of period studied, this correlation will reach about 32%, while in 1993 and 1994 it was more than 60%, and by the end of 1997, 25% .[8] The slow pace of re-monetarization is determined from both the money turnover trend, and the BNB's responsibility to cover all monetary obligations with gross foreign currency reserves, emanating from Act. 28 of the Central Bank Law. The limited opportunities of the BNB to increase monetary reserves through re-financing commercial banks and through lending direct credits for the government results in limiting monetary aggregate growth. Increasing monetary aggregate (the share of broad/reserve money) cannot compensate for the above-mentioned factors' influence, hence, re-monetarization of the economy will probably slow down.

• Monetary reserve growth is determined by the Currency Board rules. In real measurement, the growth is 1 to 4% per year, as the only source for it are foreign currency reserves, followed by balance of payments' development. Government claims from BNB they will decrease both, in nominal and real terms, resulting from the introduced fiscal discipline and low budget deficit. Balancing the budget is based on the reduction of interest non-payment, as well as the decline of interest payments on servicing domestic debt based on a drastic decline of the basic interest rate. No movement in commercial banks claims to the BNB is calculated, which means that no banking administration deposit is to be used for re-financing banks with liquidity problems. Nevertheless, it is possible to use this instrument in order to avoid any further financial crises.

Graph 1. Monetary Aggregates Dynamics; 1995 = 100



• Increasing net foreign assets is determined both by the balance of payments, and by commercial banks' behavior. The expected development in the balance of payments for 1998 and commitments toward international financial institutions, gives grounds for increasing the BNB foreign currency reserves by $440 million. Regarding the calculated current payments deficit, this increase will be totally due to the positive balance on the capital account, resulting from foreign investment (from privatization, around $400-500 million), credits from international financial institutions — the IMF, World Bank, European Community — approximately $600 million. Commercial banks' behavior after the Currency Board's introduction and the hyper-reserves accumulated give reason to assume that in 1998 they will increase their foreign deposits (by approximately $300 million), which will contribute to net foreign assets growth. In the following two years, along

8 As was stressed above, after the economic crisis and hyperinflation, money demand convulsed and brought a new balance point between money and production - i.e. neither can money turnover get back to values of 1.26 - 1.27 (as of 1993 and 1994 respectively), nor can broad money exceed 60% of GDP.

with real sector stabilization, this trend will probably break, as commercial banks will allocate more resources for crediting production. With an expected increase of BNB foreign currency reserves in 1999 and 2000 of about $250 million, net foreign assets will slow their growth, and in real terms will even decline 1% per year.

• Domestic credit in 1997 showed a radical decline of 60% in real terms. In 1998, this trend will even be harder to overcome, as it is expected to have a further 11% reduction due to a real decrease in government claims, estimated at 45%. For the next two years domestic credit growth is projected at respectively 3% and 8% annually. Along with changes in nominal real terms, a prompt restructuring process of domestic credit is assumed, as the bigger share of it will go to the non-governmental sector. As a comparison, the credits aimed at government sector agents correlated to credits for the non-government sector were as follows: 1993 - 104%, 1994 - 96%, 1995 - 124%, 1996 - 123%, and 1997 - 49%. For 1998 this correlation is estimated to reach around 26%, and by the end of 2000, 8%. A non-governmental credits increase is a prerequisite of vital importance for reviving the economy and sustaining a steady pace of economic growth. Provided that a negative balance of current payments is calculated, the assumed GDP increase for 1998 is 3-4%, and could only be reached if investment rapidly grows, at the same time keeping a slow and steady pace of domestic consumption growth. For the time being, foreign investment is aimed mainly toward privatization, i.e. no new production capacities are created, there is an ongoing process of changing ownership. This means that a very important source for reviving the economy remains domestic investment, expressed in a growth of credits for the non-governmental sector. The forecast includes a real increase pace, respectively, of 5%, 12% and 14% per year, sufficient for the calculated GDP growth. It should be mentioned that during the last few years, credits for the non-governmental sector have been steadily reducing in real terms, even during years with GDP increases (1994 and 1995). During these years, however, there was noted a process of accumulating inter-company liabilities — bad credits — which became an indirect form of financing. If this negative process ends, credit growth assumed for the non-governmental sector will in real terms mean credit expansion, with all its consequences. Commercial banks will face an ordeal. From one side, accumulated hyper-reserves and limited state securities emissions will urge them to grant new credits. From the other side, bad memories of the recent financial crisis, limitations by the Banks law, low capital adequacy and unwillingness to undertake risks will prevent them from lending more money. Related to the above, not only does the responsibility of the commercial banks become enormous, but also that of the BNB to control and monitor all transactions and limit credit expansion before it turns into another financial disaster.

Table 6. Domestic credit - real changes; 1995 = 100

Year	1993	1994	1995	1996	1997	1998	1999	2000
domestic credit	184.6	113.8	100	77.1	29.2	25.9	26.7	28.8
government sector	202.2	129.9	100	77.4	21.4	11.8	7.7	4.6
non-government sector	170.3	100.9	100	76.9	35.5	37.3	42.1	48.2

Table 7. Domestic credit as % of GDP

Year	1993	1994	1995	1996	1997	1998	1999	2000
government sector	42.9%	57.6%	32.0%	28.4%	11.5%	5.8%	3.4%	1.6%
non-gov. sector	64.0%	50.2%	36.1%	36.4%	17.6%	16.8%	17.9%	22.8%

• Resulting from the financial crisis and radical reduction of confidence in the banking system in 1996 and 1997, deposits amount decreased in real terms, by respectively, 45% and 41%. The nation still has a suspicion toward banks. Public opinion polls show evidence that almost half of those interviewed (46%) have no confidence in the banking system. Apart from introducing the Currency Board, recovering this confidence will be a slow and difficult process, limiting deposit amount growth. A limiting factor will be the income policy which assumes no sharp changes in view of supporting competitiveness of exports under a fixed exchange rate. The real growth of deposits is estimated at up to 57% per year, as BGL deposits will forestall foreign currency deposits both in terms of size and pace. The process of currency substitution will subside as the foreign currency/broad money correlation will gradually decrease to 30%.

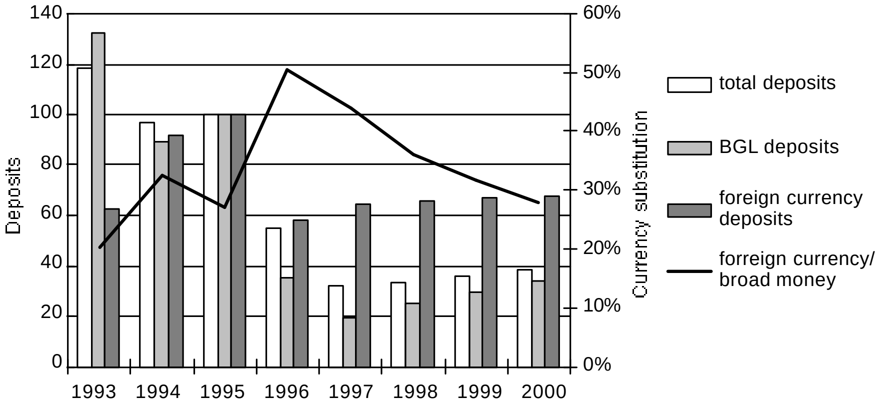
3.2. Interest Rates

The main goal of the Currency Board is to remove all negative expectations, accelerate investment activity, and assure economic growth. With a fixed exchange rate, the basic interest rate (BIR) is a single macroeconomic instrument to determine the main economic agents' behavior. By forming and changing it, the real situation in the monetary sector, the economy as a whole, and investment, can be observed. *The only function of the BIR, which is only announced by BNB, is to be an indicator of the economic situation, improving economic agents' rationality.* Incompatible levels of interest rates, based on improper methodology for their determination, as well as frequent fluctuations, can turn into a crisis of the banking system, as it almost always lies in other countries' systematic crises. Under a currency board such systemic crises are very hard to overcome, and this can badly compromise the future development of the country.

In countries with currency boards, there is no BIR. These are Argentina, Estonia and Lithuania. Article 35 of the Central Bank Law does not allow this in Bulgaria. Serious thought on removing this article is worthwhile.

In developed countries, the inter-bank market interest rate on money turned over is used as a base. In Bulgaria, this market is underdeveloped, albeit ending BNB re-financing policy. The slow development of the inter-bank market is an indicator of low confidence in the general economic environment. As a whole, the

Graph 2. Real Change of Deposits (1995 = 100) And Currency Substitution



money market is segmented, there is no correspondence between different segments and it is difficult to formulate a profitability curve. This way an easy transfer from one asset to another is impeded, and possibilities for prompt arbitrage and liquidity are limited. Developing and motivating the inter-bank money market is urgent; serious administrative and economic measures are of vital importance.[9]

The present determination of the BIR, based on three-month auctions of state securities profitability, shows the dynamics only of the money market segments, and cannot be used as a representative indicator of money price. Lack of BNB intervention instruments, used to adjust bank system liquidity, forces the Ministry of Finance to carry out some non-inherent money-related functions. Through state securities emissions, the Ministry is trying to solve both the budget and liquidity problems. This brings contradiction, because if possible, the Ministry of Finance will aim (mostly with these emissions) at minimizing new state securities emissions profitability, thus solving future problems with dividends payments on emissions related to the BIR. Looking at the issue from this point of view, the BIR is not quite market oriented (if "market orientation" can be used here at all, because state securities supply is a monopoly of the state itself). The BIR depends on cash budget deficit dynamics, which make it fluctuate. It is obvious that with the present methodology, servicing domestic debt is relieved, but the BIR does not display demand and supply of money, but demand and supply of state securities (only three-month emissions), which is only one segment of the money market. Even more, under the Currency Board, the interest rate should react fast and effectively on inflow and outflow of foreign capitals in view of stabilizing liquidity. If not, Currency Board principles can easily be compromised.

After ending repo-operations of the BNB, commercial banks' hyper-reserves are curtly increased. Commercial banks in the current environment with no refinancing will probably keep bigger reserves in the BNB, because of the hazard of liquidity problems. Lack of data far enough back in time, however, does not allow the estimation of hyper-reserves of banks under the Currency Board and the possible indirect influence on determining the BIR. The underdeveloped interbank market still does not determine the BIR based on real interest rates.

All of the above brings us to a conclusion that the methodology for determining the BIR will obviously not be changed soon, which also means that the BIR will remain low and fluctuate within the limits of 6-8% on annual basis.[10] This actually proves that no earlier than the year 2000 can the interest rates level be expected to become positive. Real negative interest rates are profitable for investors, but savers must once again bear losses. It is obvious, though, that this abuse of ordinary savers' patience cannot carry on forever. In previous years, nominally high interest rate levels on deposits in fact hide the truth about their real depreciation. After the Currency Board's introduction and the proclaimed financial stabilization, it will be even more difficult to explain why each BGL deposited in a bank is "diminishing," rather than "multiplied."[11] The commercial banks still form their interest rate policy following BIR dynamics, without being forced, either administratively or economically, to adopt such a policy. Moreover, a trend for big banks to announce the same interest on deposits can be observed, i.e. competition on attracting sources is omitted. Under these circumstances, competition should show up in banks' active operations, which in a similar environment narrows the interest spread.

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[9] The Association of Commercial Banks proposal that views possibilities for guaranteeing the inter-bank money market with the latter's reserves kept in BNB, is worth consideration.

[10] In view of expectations for low budget deficit and stable fiscal reserves, the reason for sharp growth of BIR could only be reduction in state securities demand, caused by increased commercial banks' investment abroad process.

[11] This can lead to deposit amount erosion. If money moves toward the stock exchange, i.e. direct to real sector, without commercial banks as intermediaries, there will be no negative effect on the economy.

New Tax Legislation And Business Environment

Latchezar Bogdanov, IME

Analyzing a tax system one should be concentrated on two general questions: Does the system stimulate economic growth and entrepreneurship? Or is it designed solely to provide funds to the government which will be further centrally distributed, under state supervision and control?

A whole new set of tax laws was adopted at the end of 1997. The major principles introduced in the new set of laws are: neutrality (gone are the tax exemptions and reliefs), yearly taxation of income and property, self-taxation (every taxpayer is personally responsible for declaring his obligation to the state), and a tendency towards smaller differentiations in rates. Both local and foreign persons are subject to taxation, with the latter obliged to declare incomes earned in the country.

The New Law on Corporate Income Tax

The basic tendency in the corporate tax system has been to abolish tax exemptions and reliefs. However, nominal tax rates have remained relatively high — 30-40% until July 1996, 31-41% between July 1996 and December 1997, and 28-37% since 1998 began.

Here we shall mention several features of the new LCIT:

• All legal persons, both local and foreign, are subject to taxation by Corporate Income Tax. Local persons are also taxed for profits earned abroad.

• Taxable profit differs from accounting profit. The way it is adjusted is provided in the LCIT.

• Corporations are taxed 10% municipality tax and 30% or 20% central budget tax on the remaining part of the taxable profit. The criteria for the above differentiation is the level of annual profit for taxation, with a cut-off point of BGL 50 million.

• Income on government securities and interest on bank deposits are not taxed for local persons. However, foreign persons are taxed on such incomes at 15%.

• Dividends and other capital incomes are taxed at 15% when they are distributed.

• There are no tax allowances on investment purchases. Depreciation is treated as expenditure only within the scope defined in the Profit Tax Law.

• Expenditures on car maintenance are taxed at 20% when the vehicle is not used in the primary activity of the corporation.

• Risk provisions on receivables are taxed at 30%.

• Tax declarations must be submitted once a year. However, companies pay monthly advance installments, calculated on the basis of 1/12 of their profit the previous year.

• Overpaid tax is not refunded. The taxpayer can only redeem it from further tax obligations.

• Corporate income tax is not collected from corporations which employ disabled people (30%-50% of the total number of employed).

Tax incentives for newly privatized enterprises which were provided under the old regulations were also canceled. The direct impact of this amendment is questionable, but in the context of the government's aim to accelerate privatization, it could raise serious doubts about the "honesty" of such an intention. The "hostile" message of the State might make entrepreneurs cautious about expanding and hiring new employees.

No reliefs on investment purchases are envisaged under the new law. This hinders the accumulation of investment resources to induce growth. For start-up businesses this is fatal. The natural response from entrepreneurs is to stop expansion or to "go into the shadow economy." The direct consequence is not just lower-than-expected employment as a result of lower-than-expected economic growth, but also the negative consequences from this boost to the informal sector, in the form of employment without social security obligations, lack of support from trade unions and weaker bargaining power for the employee.

Also, taxes on representative expenses, (25%), social expenses (20%) and car maintenance (20%) have been introduced. What is dangerous here is that the tax, once withheld, is deducted from the personal income of the recipient. Thus the final goal — to eliminate tax evasion — will not be achieved. On the contrary: the rate that is applied is lower than the general one, so it becomes more attractive to distribute profit through "social" benefits, pay 20-25% of them, and then enjoy non-taxable personal income as an individual.

The LCIT tries to establish a so called "fair market price" of transactions. A price (or interest, in the case of credit contracts) is "unfair," i.e. "non-market," when it differs by more than 25% from the so-called "market" price. The aim is obvious: to eliminate transfer of income. In an unsettled market such as the Bulgarian one, however, no one can really tell what the "market" price is — except maybe from the tax administration, which is entitled to calculate what the "fair" revenues/expenditures should be in such cases and afterwards use these calculations for tax purposes. The possibility of arbitrariness by the authorities when dealing with tax issues always provokes suspicion. It tries to impose the idea that economic agents are not free to establish their own relations in the way they believe is best for themselves. Instead, the state determines what revenues they should earn and what costs they should have. Otherwise, they are "punished."

A certain group of corporations and sole proprietorships is subject to so-called "lump taxation." Companies with an annual turnover of less than BGL 75 million that are engaged in certain fields of activity, such as accommodation and hotel business, restaurant business, retail trading, a number of handicrafts (tailors, hairdressers, plumbers, carpenters, etc.) are obliged to pay a fixed annual tax. The whole list of activities is explicitly detailed in the Law on Personal Income Taxation

Though lump sum taxation is understood as a tax incentive for small businesses in various countries, the situation in Bulgaria is quite different. The problem is that most of these businesses used to avoid taxes at all. Also, entrepreneurs still misinterpret patent fees as being supplemental to income taxes, and therefore try to conceal revenues and disregard accountancy procedures. As a result even a low lump sum tax is perceived as an increase in tax obligations to the state, and induces suspicion against government institutions.

Until December 1997, advance payments were made either monthly or quarterly, on the basis of the accumulated profit since the beginning of the year. This demanded accounting efforts at the end of each period. The quarterly/monthly declarations were complicated and time consuming. But that system had one major advantage: advance tax contributions were based on the actual amount of the income earned during the period.

With the new LCIT, the procedure was fundamentally changed. Since the beginning of 1998, firms should pay monthly contributions calculated on 1/12 of the profit for the previous year, or the year before the previous one during the first. Tax declarations are submitted once for each calendar year, by March 31 of the following one. Overpaid tax installments are not refunded but may be exempted from further tax dues. This means that firms must wait for years to effectively regain the overpaid installments. The synthesis of this principle is found in the anonymous quote: "once paid to the state money never comes back." The reason, as declared by the government, is to simplify tax procedures and save both time and cost on accounting for entrepreneurs. What actually happens is the simplification of the tasks of the tax administration, and regular revenues for the budget. In the extremely unstable macroeconomic conditions in Bulgaria, it is very important for economic agents to match incoming and outgoing cash flows. In other words, it might happen that one should pay taxes in advance even if not having earned a penny for months. Thus the business is obliged to credit the state through the tax system. The very idea of a citizen crediting the state on the grounds of legal obligation is unacceptable. Civil society requires a certain symmetry of rights and obligations, and shared confidence between citizens and the State.

Compared to the previous law, which was in place until the end of 1997, the new legislation seems to be relatively neutral and restrictive. Over the last couple of years all tax incentives and exemptions were gradually abolished. Unfortunately, nothing was provided to compensate for those incentives and thus win supporters for a modern neutral tax system. As a result, the general feeling in Bulgarian society is that the tax "loop" is continuously tightening and nothing can be done - except to avoid it.

Value Added Tax

In Bulgaria Value Added Tax (VAT) was introduced in April 1994.Its initial level was 18%. In July 1996 the rate was increased to 22%, mainly due to fiscal problems and pressure from the IMF.

Generally, Bulgarian VAT system is relatively simple and harmonized with EU legislation (Sixth VAT Directive). There exist only two rates: 22% and 0% for exports. Effective from January 1, 1998, new regulations on registration and tax refunds have been implemented.

The VAT was introduced after a long political debate. Its opponents claimed that the new indirect tax would discourage entrepreneur initiative. The previous system of "turnover" taxation embraced only final consumption deals. Thus it could easily be avoided, simply by declaring that the good or service would be used in production. The VAT, however, is levied on all transactions. To avoid multiple taxation, a system of tax refunds was introduced. VAT refunds could (and still can) be claimed only by those registered according VAT Law.

From a fiscal point of view, the VAT (together with personal income tax) was the easiest way to collect money for the budget. Through the system of VAT refunds, companies were forced to demand VAT invoices from their partners, thus obliging those partners to declare and pay VAT, and vice-versa. Moreover, it adjusted automatically for inflation. Given the single-rate VAT in Bulgaria, it was also very cheap to control the application of the regulations.

The major characteristics of the new VAT regulations are as follows:

• only companies with turnover for the last 12 months exceeding BGL 75 million (or BGL 50 million export turnover) can register and become subject to the VAT regulations. Non-registered companies cannot retrieve VAT paid on inputs;

• a single rate of 22% is applied to all "taxable" transactions;

• financial, insurance, health care, legal and educational services, sale of enterprises as a whole, betting and gambling, and rent, are not subject to VAT taxation;

• tax declarations and the respective tax payments are made monthly;

• VAT is refunded as follows:

a) the registered taxpayer subtracts it from the tax amount he owes as he has declared it in the tax declarations submitted during the following 6 one-month tax periods; should there remain a tax sum due to the state after the deduction, it must be paid within 14 days after the tax period elapses;

b) if the six-month deadline expires and there remains an amount to be refunded, the tax authority is obliged to make an audit; the tax authority includes the remainder in other discovered payables to the state or returns it within a 30-day period starting from the date of entry of the last tax declaration. Any trader registered with the VAT Law, whose exports for the last 12 months exceed 50 percent of all deals concluded and which have no debts to the state, is entitled to receive the difference with the tax credit within 45 days from the date of the entry of his informative declaration.

One of the major features of the old VAT legislation was the so-called "volunteer" registration. This means that all companies with a turnover exceeding a certain sum (it varied with inflation during the years) were obliged to register for VAT, while others could choose to do so or not. Even small companies which made exports were able to reclaim VAT paid on inputs.

Another important provision in place before the last amendments concerned the VAT refund. Overpaid VAT on purchases was refunded not later than 3 months after the refund declaration was submitted (15 days for exporters).

With the new regulations, these provisions were completely altered. The assumption was that the old regulations provided good opportunities for tax evasion. The following are just a few of the reasons that the abolishment of "volunteer registration" would negatively affect business activity in the country:

• the regulation nullifies a significant export stimulus;

• the intention to reduce fictitious deals harmful to the budget may inflict additional harms to an unlimited number of honest small exporters, many of them losing the chance to grow.

What is dangerous in these changes is not the fact that small companies — especially those who export — will not be able to recover VAT paid on input purchases itself, but the reasons of the government for making it so. It simply declared that VAT refunding is by its nature a source of fraud, and the easiest way to avoid it is to nominally decrease the number of VAT-registered companies, and to delay as much as possible VAT refunds to those who remain registered. No significant economic reasons for doing so have been disclosed by the government thus far.

Personal Income Taxation

Bulgarian personal income tax is based on the domicile principle. Local persons are taxable for their worldwide income, while foreign persons are taxed on income earned in Bulgaria. The definition of "local person" is based on a term in excess of 183 days annual residence in the country. Local persons, once taxed abroad, may recover the tax paid on income in the other country up to the limit of their obligation according to Bulgarian legislation.

Personal income taxation is based on annual calculation of gross income received.

Tax obligations are due at most 30 days after the deadline for the submission of the annual tax declaration, i.e. April 15 of the next year.

The new income taxation system is relatively neutral, with no or very few incentives. It is, however, quite progressive. The ratio between the maximum and the minimum tax rate is 2:1 (40% vs. 20%). The problem during the last several years was not the level of the maximum rate; there was almost no debate as to whether the 40% tax rate was too high or low. The issue has always been at what level of income this rate should take effect. When taking into consideration the average wage as reported by the statistics — about $100-120 monthly — it seems appropriate to tax monthly income levels above $700 at the maximum tax rate of 40%.

Statistics, however, do not disclose the real income differentiation in the country. Employees in the government sector fall well within the so-called "average income," and are taxed at generally acceptable tax rates of 12%-14%. In the real sector, however (both public and private), the situation is quite different. The problem lies in levels of differentiation. There is a certain group of profit-making enterprises whose wage levels differ significantly from the average. Thus, for example, an ordinary worker in a chemical plant is obliged to pay the maximum tax rate of 40%. Such rates are interpreted as punitive, and therefore are applied to people considered "rich" in general terms. The chemical worker does not perceive himself as a member of the "rich" stratum of society. This inevitably causes unrest and non-compliance.

In Bulgaria as in other countries, the question of who is "rich" is both a matter of self-perception and the perception of the tax authorities. The two perceive this question quite differently.

This results in the everyday occurrence that an owner of a 90-square meter apartment and a 10-year-old, second-hand "Volkswagen" is classified as "rich," because that is exactly what a $700-earner can afford. However, the income-earner must recognize himself as being "rich and thriving" in order to voluntarily deprive himself of 40% of his consumption. All these implications provoke a negative attitude toward the income taxation system, and what is more dangerous, among the most economically active part of the population — successful entrepreneurs, managers, qualified workers, etc.

Another cause of disturbance in contemporary Bulgarian income tax system is the principle of not taxing interest income; i.e., savings in bank accounts. While income from dividends and other capital gains is taxed at 15%, interest payments received on deposits in commercial banks registered in the country are left to the disposal of the recipient. At the same time, the government is proudly declaring its intention to develop an active capital market. This looks at the very least controversial; as long as bank deposits are privileged compared to stock investments, not a single rational human being would seriously consider the opportunity of acquiring equity — unless he has the possibility to avoid taxation. Which is quite rare for most potential investors who have no experience or legal background.

Another argument in favor of progressive income taxation is the common belief that the "rich" utilize more public goods than the "poor" do. The evidence is quite self-explanatory; the more property you own, the more police and court protection you engage; the richer you are, the more road and infrastructure you make use of (by using more cars, planes, trains, etc.); the more you consume, the more garbage you "produce," ergo the more you enjoy garbage collection; the higher living standard you enjoy, the more pollution you cause; the list may be continued. Unfortunately, this is hardly the situation in Bulgaria. The so-called "well earning and prosperous" Bulgarian citizens suffer the most from car theft, burglary, bad roads, a poorly functioning court system, a lack of police protection, and a lack of contract enforcement provisions.

The only justification for the steep tax scale remains the vague idea of social justice, defined as the "moral" obligation of the rich to devote part of their income to the poor. Or, in other words, progressive taxation in Bulgaria is interpreted as "compulsory charity." Which is by default a contradiction — charity is always defined as voluntary action.

What are we paying for, after all?

A major problem in societies worldwide, is the way taxpayers money is spent. In other words, the taxpayer always needs to witness a certain result from his taxes, even if he is not directly compensated by the state. At least he should see a new hospital, school, shelter for the poor, highway or railway, or less pollution. Or a modernized police service. Or a secure fire brigade. Or, at least, an illusion of "national security."

Nothing of the kind, however, can be observed in Bulgaria. The figures in the table represent central government spending during the last 4 years (in BGL millions):

Table 1. Central government spending 1994-1997

Central Government Budget	**1994**	**1995**	**1996**	**1997***
Revenues, total	133,112	197,294	349,979	2,647,650
Tax revenues	102,308	160,108	287,279	2,265,930
Non-tax revenues	30,804	37,186	62,700	381,720
Expenditures	167,156	255,219	540,848	3,586,621
Current	86,527	140,745	374,235	2,768,363
incl.: interest payments	70,674	123,927	343,958	1,547,321
other	15,853	16,818	30,277	1,221,042
Capital Investments	692	837	1,693	90,258
Transfers	79,936	113,637	164,920	728,000
Deficit	34,044	57,925	190,869	938,971
Ratio of interest payments/tax revenues	**69%**	**77%**	**120%**	**68%**

**preliminary data*

The figures in the last row speak for themselves. The predominant share of tax revenue is spent to service the government debt. Even more striking is the paradox in 1996, when all tax contributions happened to be insufficient to cover interest expenditures. It is obvious that nothing, or almost nothing, goes back to the taxpayer. Of course, the current government is not to be blamed for debt accumulated during previous periods, especially for the huge foreign debt incurred before 1989. But it is very difficult to convince the average taxpayer that he should voluntarily pay for debts used or consumed years ago. It could be expected that one would have to pay for results that he will enjoy at the moment, or even in the foreseeable future. But no one is willing to pay for vague and doubtful benefits enjoyed in the past (probably). Especially if he believes that those who benefited at the time were the "bad guys."

The macroeconomic stabilization achieved after the introduction of the currency board in 1997 and the significant decrease in inflation and interest rate levels made the trend change its direction. The interest payments vs. tax revenues ratio as planned for 1998, is 30%, which means that 70% of taxes paid will go back, in one form or another, to the taxpayer. If that trend is sustainable, we can expect attitudes toward taxation as such to evolve.

The tax reform - what did it change? A conclusion.

Various interpretations can be made of what the economic consequences of the tax reform may be. One could argue that the reform introduces neutrality, more simplicity, and decreases the opportunities for tax evasion. Or even more, that for the first time in years, the various tax laws to a great extent correspond to one another. But for the average taxpayer the reform will bring:

• new tax declarations (once again), with all the annoyance caused by them;

• the notion that whatever the government does, the tax burden never decreases;

• the feeling that the taxpayer is still treated as a hostile object by the state;

The problem is that the ultimate goals implied in the tax reform are correct, while the likelihood of success at the implementation stage is dubious. What the government still lacks is good "advertising." Also, the state should start to treat taxpayers as citizens, rather than subjects. Otherwise, every effort will merely remain just a good intention.