

**In this issue:**

**Dr. Krassen Stanchev**

**George Stoev,**

on pension reform in Latin  
America and Central and Eastern  
Europe

**on p. 1 - 4**

**Dr. Diana Kopeva,**

**Docho Mihailov**

on business opportunities in  
regions with ethnically mixed  
population

**on p. 5 - 9**

**Dr. Georgi Ganev**

on the elusiveness of Bulgarian  
economic growth

**on p. 10 - 20**

**Also Inside:**

A supplement with selected  
macroeconomic indicators

Editor-of-issue: *Andrey Ivanov*

English editor: *Carolina de Ramos*

## **Pension Reform Models In Latin America and Central and Eastern Europe**

**Dr. Krassen Stanchev**

**George Stoev**

### **Introduction**

There is no clear-cut solution to the problems involved in different individual pension reforms. However, thanks mostly to the Latin America's experience there is little doubt as to which measures of these reforms work and which do not.

A workable solution to the pay-as-you-go system in most cases is found in the following three features of the reforms:

- private administration of the pension funds,
- capitalization, and
- individual accounts.

The challenges facing reforms based on the market and privatization approach have been identified in the prospect of market failures in the cases of:

- adverse selection, or cases when the highest risk groups buy private insurance, and if the premium is based on the average risk, only people of average or higher risk would purchase life insurance policies;
- moral hazard, or cases of deliberate actions of not caring about specific risks once people have insured themselves;
- incomplete markets encounter downturns, inflation and other sorts of "environmental" risks.

The first two of the above types of market failure are attributable to a large extent to pension systems based on life-insurance schemes rather than those based on schemes of accumulation and investment. The last type of failure is related to any type of pension system, and there are different ways of tackling these failures:

- intergenerational transfers in the pay-as-you-go system,
- tracking individual behavior in the life insurance system, and
- techniques to diversify risk in the investment/accumulation system.

### **Lessons Learnt in Central and Eastern Europe**

There are only few CEE countries that have copied that Chilean model. Most of these employed a mixture of the pay-as-you-go system and the capitalization based system, or a combination of these two plus different compulsory insurance schemes. Thus, most reforming CEE systems resemble the Argentine system, in which pensions are administered by the government and private pension funds.

In Poland, the capitalization of the system occurs through transfers to the individual accounts of younger and mid-career workers, while contribution rates remain compulsory for them. The deficit in the pay-as-you-go system is covered through privatization proceeds.

The Hungarian, or the most detailed and articulated reform, currently being implemented, is based on three pillars:

- compulsory social security pension,
- compulsory private pension,
- voluntary pension obtained via insurance.

Those beginning their careers have no choice but to turn to the private pension system, and currently middle-aged workers are expected to choose whether to

stay with the old system or go into the private one. In the two compulsory systems, i.e.:

- social security based (1),
- and compulsory private (2),

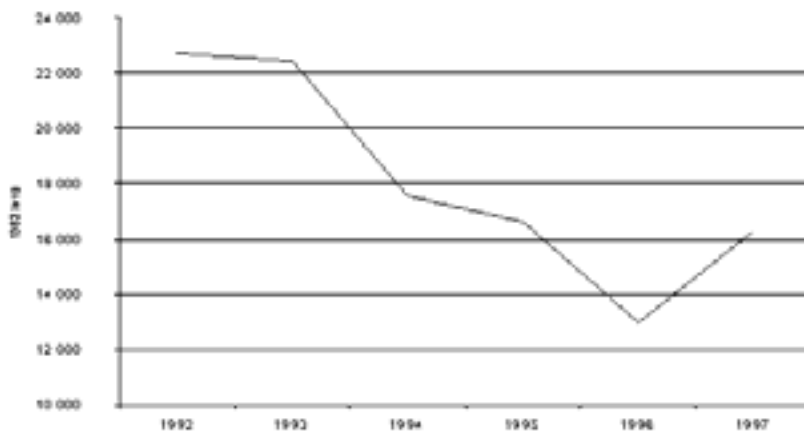
the pension payments differ as follows:

- 1) = to the social security pension in the old pay-as-you-go system;
- 2) = reduced social security pension (3/4) + private pension.

**Table 1**  
**Social Insurance**  
**Contributions**

| country        | employer contribution | employee contribution | total |
|----------------|-----------------------|-----------------------|-------|
| Hungary        | 48.2%                 | 11.5%                 | 59.7% |
| Czech Republic | 35.3%                 | 13.3%                 | 48.7% |
| Bulgaria       | 46.8%                 | 2.9%                  | 48.5% |

**Figure 1**  
**Average Monthly Wages in Bulgaria, in 1992 BGL**



Contributions are:

- in 1) 24% from the employer in 1998, 23% in 1999, and 22% from the year 2000 onward; and from employees: 7% in 1998, 8% in 1999, and 9% from the year 2000 onward.
- in 2), employees on the mixed system contribute 1% to the social security fund from 1998 onward.

Hungarian private pensions are financed on a compulsory contribution basis as well. Employees pay a 6% "membership fee" in 1998, 7% in 1999, and 8% in 2000 and thereafter.

The starting points of the pension reforms look different in the different countries:

The highest contribution to a pay-as-you-go system of an EU member country is in France: 62.1% (37.8%

from the employer and 24.3% from the employee).

### **Peculiarities of the Bulgarian Reform**

Bulgarian pension reform is a rather shining example of how such reforms should not be implemented.

As it is scheduled for the time being, it is based on pillars similar to those in the Hungarian, and to some extent the Argentine, system:

- the old system, which is expected to allocate 40-45% of the wages before retirement as pension benefits;
- compulsory additional pension financing; an individual account which is expected to equal 15-20% of the net salary before retirement as pension payments;
- additional volunteer pension insurance, financed by contributions from both the employer and employee, expected to equal 15-20% of the net wage before retirement as pension payment.

### **Logistical problems**

#### **Background issues**

Since 1994 the pensioners-to-workers ratio in Bulgaria is around 80%.

In 1996 — six years after the initial attempt to implement market-based stabilization in Bulgaria — the economy fell into a deep crisis, which heavily affected Bulgarians' standard of living. In 1996 the share of households with incomes below the subsistence-minimum rose to 54% of the total number of households, an increase of 30 percentage points compared to 1990. In addition, the share of households with incomes below the poverty threshold as defined by the Ministry of labor and social affairs increased, from 41% in 1990 to 73% in 1996. The inequality of income distribution deepened in recent years; the ratio of the incomes of the wealthiest to the poorest groups in Bulgaria rose from 3.5 in 1990 to 5.8 in 1996.

Bulgarian household incomes have declined by 65.6% since 1990. The share of wages and pensions in total household income remained predominant, and was approximately 70% in 1996. Property income and income from entrepreneurship, which are the only sources of income without real erosion, continue to be only a small part of total incomes (6% in 1996), and cannot change the overall negative tendency.

Wages and pensions were seriously eroded by inflation in the last years. The average monthly wage in real terms in 1996 was just 42% of its 1990 level. The sharp depreciation of the lev in 1996 and the first months of 1997 drastically reduced wages in dollar terms. From about \$110 in 1995 the monthly dollar wage fell to \$20 in the first months of 1997. (Its level was almost the same in February 1991 when initial price liberalization took place.). With respect to the monthly dollar wage in 1996, Bulgaria ranks last among the transition economies and is the only one to have had such a sharp reduction. The average monthly pension has declined by 65% over the 1990-1996 period. In the beginning of 1997 its equivalent in dollars was just \$10.

The decline in income was directly reflected in the deteriorating structure of household expenditures. Food purchases as a share of total expenditures grew

from 36.3% in 1990 to 47% in 1996. The relative shares of expenditures on clothing and footwear, education and leisure declined during the above mentioned period. The structural changes in household expenditures adversely affected the amount and quality of final consumption.

The sharp reduction in 1996 in real GDP (around 10%) had a negative impact on employment. The unemployment rate started to rise in mid-1996, and reached 12.5% in December, among the highest in the transition countries. Taking into account the needed structural changes to restore long-term economic growth, it will be not surprising if the unemployment rate in 1997 continues to increase.

The severe drop in the standard of living in recent years is reflected in the demographic indicators — the death rate increased and at the same time the birth rate fell. As a result the natural increase of the population worsened from -0.4 per 1,000 in 1990 to -5.0 per 1,000 in 1995.

### 1991-1997: Reduction Stage

Domestic demand in Bulgaria has decreased dramatically in recent years. This is due to the decreased purchasing power of the main consumer groups: citizens, the government and business consumption (intermediate consumption).

Since 1991, the real incomes of citizens have decreased. As result of this, the purchasing power of the population was almost halved over the period between 1992 and 1996. The reduction is more dramatic if data on the 1990 purchasing power of households (on the eve of the economic reforms in Bulgaria) and that in 1996 are compared. Thus, the purchasing power of households has decreased by a factor of 2.3 to 4, if measured by the purchase of particular goods.

### Household Consumption

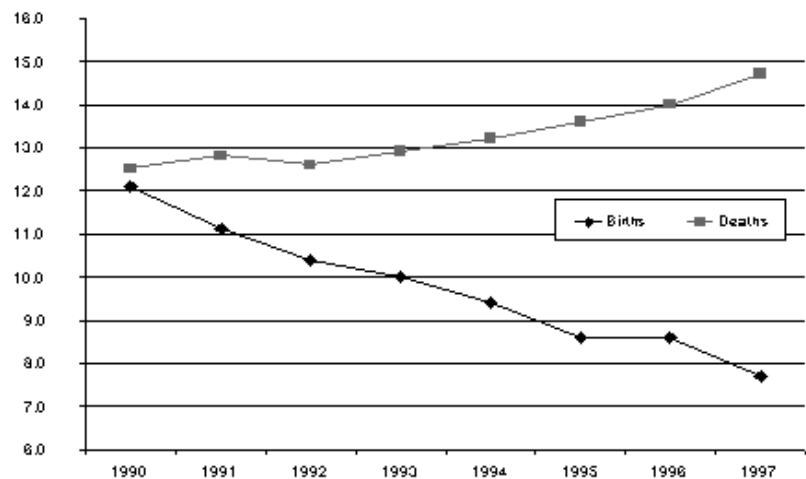
All of this has caused changes in the structure of household consumption. The structural change in household demand is more important than its reduction in volume, in spite of the fact that these are closely connected. The character of domestic demand has a much greater significance than its size. The share of foodstuffs in the total amount of consumption increased from some 36% in 1990 to about 45% by the end of 1996. That share achieved the extremely high level of 55% of total household consumption in the first months of 1997, when real incomes were extremely low. At the same time, in the 1993-1996 period, the share of clothes and shoes in total consumption decreased from some 9% to about 7%, while the consumption of other goods (electric appliances, etc.) decreased from about 35% to 29% by the end of this period. At the end of 1996, some goods were almost impossible to buy for citizens with average incomes. In 1996, a person earning the country's average annual wage could only have bought two refrigerators, or two television sets, or three washing machines.

### Investment

The change in the structure of domestic demand concerns not only household demand, but intermediate business demand as well. This is especially true for Bulgaria, where 70% of companies registered are sole

proprietors. (They report their income once a year and are not required to keep double entry books; thus, their financial (tax) reporting position is similar to that of households.) The demand for investment goods, which are mainly high-end products, reached extremely low levels in 1995 and 1996. The share in the GDP of expenditures on the acquisition of tangible fixed assets decreased from 18.3% in 1991 to 10% in 1996. It was 11% in 1997 and 1998. Thus, the most science-intensive manufacturing branches, such as electronics and electric appliances, the machine-building industry, etc., registered the greatest drop in their output in comparison with the end of the 1980s. On top of this, reduced investment activity by firms diminishes their ability to be competitive on the world market. In the case of business demand, the huge decrease in demand for high-end products is of crucial importance, because it does not contribute to the development of clusters for the production of sophisticated final commodities. Sophisticated business demand allows close contact

Figure 2  
Births and Deaths per 1000 of population



between firms in the development process, and furthermore, creates opportunities for them to engage in a joint-development process.

### Government Debt

Government demand has also decreased remarkably. It fell by a factor of more than two in the 1993-1996 period alone. Government borrowing for the first half of 1998 is zero. This tendency is determined by the government's huge debt burden to be serviced. It can hardly be expected that the volume and structure of government demand will be able to contribute to the improvement of the whole economy's competitiveness in the near future.

The decline in living standards led to the erosion of the credibility of the Government and vast political instability in the beginning of 1997. The ability of politicians, led by President Stoyanov, to avoid widespread unrest and to revive people's confidence in government institutions is encouraging evidence for the depth of the democratic process in Bulgaria.

Our assumption is that the real GDP in BGL will show growth of 3.5-4.5% until 2005. We forecast a gradual

increase in growth, starting from 3.5 and gradually increasing. The reason for this is the slow process of the structural reform at the beginning of the period. The expectations show that sustainable growth will be reached after the year 2001. Real GDP per capita in BGL shows a stable trend of increase, caused by the GDP growth and the population decrease. The same

**Table 2**  
**Bulgaria in 2005: An IME Forecast**

| Year | Real GDP* | GDP growth % | Real GDP** | Population | GDP*** per capita |
|------|-----------|--------------|------------|------------|-------------------|
| 1997 | 17,134    | -            | -          | -          | -                 |
| 1998 | 17,734    | 3.5          | 10.43      | 8,600,000  | 1,213             |
| 1999 | 18,354    | 3.5          | 10.80      | 8,587,500  | 1,257             |
| 2000 | 18,997    | 3.5          | 11.17      | 8,575,000  | 1,303             |
| 2001 | 19,757    | 4.0          | 11.62      | 8,556,000  | 1,358             |
| 2002 | 20,547    | 4.0          | 12.09      | 8,537,000  | 1,416             |
| 2003 | 21,369    | 4.0          | 12.57      | 8,518,000  | 1,476             |
| 2004 | 22,330    | 4.5          | 13.14      | 8,499,000  | 1,546             |
| 2005 | 23,335    | 4.5          | 13.73      | 8,480,000  | 1,619             |

\* 1997 BGL, billions

\*\* 1997 US \$, billions

\*\*\* 1997 US \$

Assumptions:

1. BGL/USD exchange rate used: 1,700:1

2. Long-term decrease in population: according to NSI

indicator in USD should begin to grow after 2001, at a much slower rate. Given the above assumptions for GDP growth, significant GDP per capita growth is not to be expected until 2002.

### **Decrease in the State Share and Capital Market Development Determine the Success of the Pension Reform**

1. The low efficiency of the pay-as-you-go (PAYGO) system is obvious. The opportunity cost of the pensions that come from the mandatory schemes is the imaginary pension that would have been received if the installments were made in another type of social insurance mechanism – fully-funded schemes (FFS). A simple hypothetical model developed by the Institute for Market Economics, which assumes gradual future increases in pensions, as well as an annual rate of return of the pension funds of 10%, proves the obvious inefficiency of the PAYGO system. The PAYGO system provides for future pensions by taking in more than 35% of wages. The hypothetical model shows that the future pensions would have been the same if the people made their contributions in a FFS.

2. The first pillar of the pension system should have a small share and be fully funded, if possible. The first pillar of the pension system, i.e. the basic mandatory social insurance, is in its current condition one of the main obstacles to the development of additional social insurance. Its share has to be lowered in order to let the people decide freely between the other two pillars – the

additional mandatory and voluntary funds. It is clear by now that the pension reformers in Bulgaria have no intention of leaving the PAYGO mechanics in the first pillar. Thus, this scheme's share should be lowered, and should remain low as the other two pillars are introduced. The transition from a PAYGO system to an FFS or mixed one will open a financial gap, which should either be filled by privatization payments or foreign financing should be found for it.

3. The second pillar should be given to private companies. The second pillar is the additional mandatory social insurance. There is no doubt that it will be of the FFS type. Moreover, the funds serving this scheme should be privately managed. There are at least two reasons for this:

- A private company will manage the funds better than state;
- The problems in a pension scheme managed by the state immediately become fiscal problems, and therefore macroeconomic problems.

4. Voluntary pension insurance in Bulgaria is just another experiment so far. Additional and voluntary social security will be the third pillar of the system. The first law regulating the pension reform is the Law of Additional and Voluntary Social Security. The law introduces the most important institutional investors — pension funds — for the first time in Bulgaria. Because of the huge resources that they could accumulate they are viewed as panacea for the Bulgarian capital market. The fact is that they can in part solve the problems on the demand side of the market, but this will not be sufficient. Some of the biggest international institutional investors already operate on the Bulgarian financial markets, and if the problem were low demand, it would have been solved. These foreign companies prefer investing in our Brady debt, which is very liquid and has a market capitalization of about US \$5 billion. The problem lies rather in the small stock supply, which is closely connected to the privatization process in Bulgaria. Therefore the existence of the pension funds will hardly have an effect on capital market development. Furthermore, the underdeveloped capital market will be a big obstacle to the development and functioning of the pension funds.

5. Mass privatization vouchers will hardly become "live" money. The possibility of making pension contributions to separately established pension funds with mass privatization vouchers cannot increase the chances of higher pensions in the future. The reason for this is not the merging of pension reform and the privatization process, but the concrete conditions of the second "wave" of mass privatization in Bulgaria. Most of the enterprises included are small and have no clear prospects for the future. If there is, however, a bit of attractiveness in some of them, it is wiped out by the fact that only small stakes of up to 5% will be sold that way. Thus the pension funds will hardly receive any cash dividends or generate any capital gains, which means that most of the vouchers will simply turn into stocks that have no value.

# Agrarian Reform, Regional Development and Business Opportunities

## in Regions with Ethnically Mixed Populations

Diana Kopeva, Ph.D.  
Docho Mihailov

A decade after the transition to a market economy started Bulgaria, there are still severe obstacles to the development of the country's regions. Significant regional disparities exist, and economic and human factors are highly stagnant. People still tend to rely on the state as the primary source of both economic security and opportunities.

This generally applicable statement is especially valid for regions with ethnically mixed populations. These regions used to rely solely on the state as the main provider of employment opportunities. After the state sector collapsed, economic development there showed extraordinary decline. Poverty and unemployment, combined with ethnic divisions, could become a source of ethnically based conflicts.

Due to the issues of the ethnic conflict potential in those regions, its probability and the feasible business strategies there are important from both a research and a practical point of view. They were approached in a study of the interdependence of the business environment, the progress of agrarian reform and possible ethnicity-based conflicts, conducted by the Institute for Market Economics under a project funded by the Friedrich Naumann Foundation of Germany. The project seeks to deliver a framework for economic and political relations in regions with ethnically mixed populations and use it for identifying possible centers of ethnic conflict, as well as opportunities for defusing them.

The study is based on the assumption that ethnic conflicts are manifestations of other conflicts which for one reason or another have acquired an ethnic character. Among these, economic relations and especially conflicts as to property rights play a leading role. Therefore, solving existing or potential ethnic conflicts should start by attacking the real cause: economic tensions. After the general theoretical framework of ethnic conflicts and minority nationalisms in the Balkans, the pace of agrarian reform in the ethnically-mixed regions was analyzed. Against this background, representative sociological research in three municipalities with ethnically mixed populations (Kurdzhali, Omurtag and Targovishte) was carried out by the Agency for Social and Economic

Analyses. In the previous issue, the theoretical framework of minority nationalisms in the Balkans was presented (Andrey Ivanov, "Minority Nationalisms in The Balkans - The Bulgarian Case). Here we continue presenting the main findings of the economic and sociological segments of the study. The whole report can be accessed on IME's World Wide Web site (<http://www.ime-bg.org>).

### Agrarian reform and its influence on regional development

The transition to a market economy is a complex process. Agrarian reform in Bulgaria is based on the restitution of property rights over land, liquidation of the former collectives (TKZS), privatization of non-land assets (buildings, machinery, equipment, animals), liquidation of the monopolistic structures downstream and upstream of agriculture, and the establishment and development of a private sector in agriculture, adapted to the market economy. Therefore, agrarian reform in Bulgaria includes two major processes carried out in parallel: land reform and structural reform.

As a result of the land reform program in Bulgaria, the socialist bi-modal agricultural structure — large state cooperatives (TKZS) and small household plots — has been destroyed. It has been replaced by a new structure, in which new farms evolve. However, the new agricultural structures will be influenced by the old, and thus the pre-reform structure should not be ignored.

The key objective of this paper is to identify the main factors that have had an influence on the transformation period, and to analyze the outcome of land reform and farm restructuring on a regional level in three municipalities inhabited by different ethnic groups: Kurdzhali, Sliven and Omurtag.

Land reform causes a radical change of the ownership structure. Society has been stratified along ownership criteria. Two major groups emerged: the landowners and the landless. According to the latest census (1992), the prevailing part of the landless have ethnic minority identity. This fact is critical in making possible policy decisions concerning eventual ethnic conflicts on the basis of the lack of ownership of land and non-land assets. This was one of the factors that determined the choice of these three municipalities.

*Ethnic conflicts are manifestations of other conflicts which for one reason or another have acquired an ethnic character. Among these, economic relations and especially conflicts as to property rights play a leading role*

### *Pace of Land Reform*

Some 1.7 million applications were made, almost all from individuals resident in Bulgaria, with only about 0.4 percent from so-called legal entities, such as churches, monasteries, agricultural schools, municipalities, and the government. Of nearly 5.7 million hectares available for restitution, 91 percent was claimed by individuals, 1.4 percent by the government, 5.1 percent by municipalities that held communal land before collectivization, and 2.4 percent by other legal entities. The land area subject to restitution in real boundaries [Article 18g(1)] accounted for only 18 percent of the total area of all land subject to restitution. In total, 863,819 final decisions for restitution of land ownership within real boundaries were issued, accounting for some 1.133 million hectares. In contrast, nearly 1.7 million decisions were handed down for restitution under land reallocation, accounting for 69 percent of all land subject to restitution. These include nearly 540,000 decisions under Article 18i, for temporary use, which covers almost 1.45 million hectares. In addition, some 1,222,902 decisions were issued under Article 27, whereby plans for land reallocation are completed and their provisions implemented, covering 3.16 million hectares. An estimated 67.2 percent of all claimed land had been returned to recognized owners or their heirs by the beginning of November, 1998. Of the total, it is known that at least half was being farmed. It must be remembered, however, that restitution is formally complete only when the final legal title to land is issued. By the beginning of November, 1998, a mere 383,669 notary deeds had been issued, for a total of only 982,557 hectares or 15.3 % of all land subject to restitution. (National Statistical Institute's reference on the pace of land reform, March 26, 1996). Without deeds, there is no legal foundation for trade in land.

Land restitution in the surveyed municipalities is close to the picture for the whole country. The level of land restituted varies from 47% in Sliven to 50% in Omurtag and 62% in Kurdzhali. The biggest share of issued notary deeds and arable land covered by them is in Sliven. Landowners have issued notary deeds for 17.6% of the restituted land within the TBS. The picture is different in Omurtag and Kurdzhali, with 6.15 percent and 3.1 percent, respectively.

The new structure of ownership over land has influenced the structure of operating units in agriculture. The newly emerged structures are individual private farms and farming companies. By the end of October, 1998, newly established cooperatives in Sliven covered 46.8% of agricultural land subject to restitution. This percentage is much lower in the other two municipalities: 20.3% in Kurdzhali and 6.7% in Omurtag. All of the newly emerged cooperatives in Sliven and Omurtag are registered under the current Cooperative Act. Just the opposite is the case in Kurdzhali, where only 20.3% of newly emerged cooperatives are registered.

### *Possible Conflicts*

Different options for proving ownership rights were based on the widespread public concern of giving peo-

ple who live outside Bulgaria and don't have Bulgarian citizenship the opportunity to apply for land. This issue was much more politically sensitive in regions with ethnic minorities, especially in Kurdzhali. In fact, this "public awareness" has been disproved by the latest statistical data. For example, in Kurdzhali 427 people of Turkish citizenship have applied for the reinstatement of property rights over land, and the percentage of land they are applying for is 0.5% of the land in the TBS.

### **Existing attitudes toward business-related issues in regions with ethnically mixed populations**

#### *Business environment*

The study found that 14.5% of respondents in the three municipalities have tried to start their own business, and most of them (8.9%) have failed. Business activity is tangibly higher among ethnic Bulgarians (19.0%), compared to 6.1% among ethnic Turks. Of all of the opportunities for private business, trade has the largest share (6.6%).

The high prices of suppliers/inputs is identified most often as the chief impediment to private business (71.9%), coming ahead of monopolist and unfair competition (64%) and the high VAT rate (60.3%). The fewest complain about lack of support from the government (42.9%) and the municipality (46.7%).

The opinions of local elites confirm the attitudes of the general public. Only one out of all of the respondents (in the structured polls) said that there are no obstacles to private enterprise. The hostile macroeconomic environment, poorly operating market mechanisms and restricted access to loans also seem to be major obstacles to developing a private business in the regions in question. Next come high taxes and red tape. Also, sluggish and clandestine privatization puts off foreign investors while favoring circles close to the local authorities according to the respondents.

#### *Business intentions*

A total of 9.8% of respondents in the three municipalities plan to launch their own business. The bulk of people (45.5%) believe that trade offers the best prospects. This matches the existing distribution of sectors in private business, both in the regions covered by the study and in the country in general. Only 0.2% of town dwellers in the three municipalities plan to start a production-oriented business. The general preference for trade is hardly a matter of values and attitudes — it can be put down to available means. The low level of credit resources leads to intentions to start a small trading enterprise with a minimum of investment.

The motivation for launching a private business, however, is negative and more connected with efforts to avoid unemployment rather than with a desire to increase one's income. This negative motivation seems to be predetermined rather by the overall macroeconomic situation in the country than by local municipal factors. This is why the attitude toward the local (municipal) conditions for starting and developing a pri-

*The motivation for launching a private business is negative and more connected with efforts to avoid unemployment rather than with a desire to increase one's income. This negative motivation seems to be predetermined rather by the overall macroeconomic situation in the country than by local municipal factors.*

vate business is very similar across the different municipalities and ethnic groups. Still, conditions in the Kurdzhali municipality are found to be relatively less favorable. The explanation for this unfavorable comparison is to be found in market factors: there are more consumers/ rich people in the other two municipalities.

The predominant intention for launching a micro-business with a minimum of investment is upheld by the fact that only 27.6% of those planning to start a business are ready to use their own housing to secure loans. The majority of future entrepreneurs are more willing to pledge cars and land. Curiously enough, the psychological value of land is lower than that of buildings. On the other hand, plans to pledge a vehicle in order to get a loan demonstrate poor awareness of the terms offered by lending institutions.

The amount of the planned potential credit is 5 to 6 million on the average, with an annual interest rate of 10%. Where the business experience is the poorest and the business intentions the lowest (Kurdzhali, ethnic Turks), the admissible annual interest is the highest: 10%. The business plans of those hoping to get a loan of over 5 million levs are connected with construction (57.1%) and transport (50%). These two sectors seem to be the most lucrative and reliable in the minds of the respondents. Figures for agriculture show that where there are intentions for seeking loans, they go along with hopes for a much lower interest rate compared with those for other sectors.

However, the business intentions connected with agriculture are negligibly low (1.2-3.0%). Where they exist, they have to do with trade in farm produce (1.2%). The unattractiveness of farming is particularly striking in the villages. There are still people among the town dwellers (4.1%) who believe that with unemployment remaining the only alternative, agriculture can still bring a profit. We get a different picture in villages (1.2%), where people are fully aware of the state of domestic agriculture.

The results of the research confirm the assumption of a predominant intention for starting micro-businesses with minimum of high-risk investment. Trade seems to account for most of these intentions and agriculture for the least. The few planning a more serious undertaking have their interests in transport and construction, but there the fear of monopoly and unfair competition is the biggest.

### **Agricultural production**

A total of 56.9% of all households produce agricultural products. The percentage is highest in Omurtag (77.9%) and lowest in the Sliven municipality (49.6%). The problems in the agricultural reform, low purchase prices, land restitution and market chaos are frequently identified as problems by the local elite. The lack of soft-term loans and turnover capital are other impediments to agriculture, as well as the highly fragmented farmland in this semi-mountainous region and the small size and self-sustaining character of most farms. Despite the regional specificities, almost everywhere people complain of a vicious circle: delayed agricultur-

al reform —> lack of investment and turnover loans —> chaos on the market for farm produce.

The bulk of agricultural output (75.7%) goes for the consumption of the producers themselves. Agricultural production involves a minimum of expenses: 91.5% of respondents have no expenses for buildings, 87% for labor and 71.2% for land. In the majority of cases it is production within the household with its land and labor, where all expenses go for preparations, animal feed and seeds.

Very few households produce for the market, because of which it is difficult to obtain a valid picture of the sale structure by type and efficiency. And yet some observations are not impossible: the households that do the most farming sell animal products (milk, cheese, eggs, etc.). This observation matches the intentions of households for future agricultural production, where livestock breeding dominates over land cultivation.

Understandably enough, the sale of tobacco dominates in Kurdzhali, where 82.7% of people selling any agricultural produce are selling tobacco. It is interesting that tobacco growers are relatively younger and have a lower level of education: 64.4% of them are aged 36 or younger and 54.3% have only a secondary education or lower.

The figures show greater fluctuations of expenses in the production of grain and vegetables compared to those for other crops. Over 87% of grain producers have expenses for water, electricity, fuel and preparations. Together with meat producers, they have the highest expenses for hired labor and land. Fluctuations are less pronounced in the expenses reported by producers of animal products (milk, cheese, wool, eggs, etc.), most of whose spending goes for animal feed (92.5%), preparations/medicines (73.1%) and water (73.1%). The picture is similar with tobacco growers, most of whose spending goes for machines (77.6%) and preparations (69.9%).

These figures lead to an assumption of greater efficiency in the production of animal products and tobacco in the regions under analysis. Indeed, 87.9% of tobacco producers and 67.2% of producers of animal products say that they make more than they spend. But the general rule is that profit, where it exists, is the result of minimized expenses.

The amount of profit can be deduced from the fact that most agricultural producers can live for about 3-4 months on what they earn from the sale of a year's output. Thus 87.8% of respondents are unable to save. This figure is particularly high in Kurdzhali (91.3%).

Producers say the biggest problems come from traders (middlemen) of farm produce. The administration (both municipal and central) is not seen to have any direct link with the problems in farming. Curiously, ethnic Turks are the least critical of traders, institutions, suppliers and end-buyers.

### **Property rights and possession of land**

Land restitution is often identified by local elites as a precondition for solving the problems in agriculture. A

*Business intentions are dominated by the desire to avoid long-term (and hence - high-risk) investment. Trade seems to account for most of these intentions and agriculture for the least.*

*The bulk of agricultural output (75.7%) goes for the consumption of the producers themselves. Agricultural production involves a minimum of expenses. In the majority of cases it is production within the household with its land and labor, where all expenses go for preparations, animal feed and seeds.*



total of 40.1% of the respondent households possess farmland other than their private gardens. The percentage is highest in Sliven (41.5%) and lowest in Kurdzhali (34.5%). Nearly identical shares of ethnic Turks and Bulgarians (42.9% and 46.7%, respectively), but only 7% of Roma people, say they have arable land. A total of 35.1% say they have not had ownership restored. The percentage of unrestored ownership is highest in Sliven (54.3%) and lowest in Omurtag (8.5%).

Only 23.7% of land owners have incomes from the sale of farm produce and only 23.4% from leased land. The structure of incomes of landowners is close to that for the whole sample. Here most incomes come from pensions, farm produce and land leasing. On the other hand, landowners more rarely have incomes from wages from private companies and welfare benefits.

The figures for land ownership restored to ethnic Turks and Bulgarians vary over a wide range: 80.2 percent for the former against only 36.7% for the latter. This is probably attributable to the concentration of ethnic Turks in the municipalities with a high share of restored land ownership: 49.7% of ethnic Turks covered in the study live in the Kurdzhali municipality and

60.93% (relative share) of the households in the municipalities that have the government as an income source. Second come incomes from personal activities (19%), including private business, sale of farm produce, land leasing and rents. Income from wages in the private sector make up 15% (relative share).

The structure of income sources by municipalities and ethnic groups matches the general picture. The following groups are identified: Villages with high incomes from pensions (43.2%) and farm produce (27.1%); Kurdzhali (15.9%) and Omurtag (18.1%) with a relatively higher share of incomes from the sale of farm produce; Sliven with a high share of incomes from pensions (42.4%); ethnic Turks with the highest share of income from the sale of farm produce (25.8%); and Roma people with the highest share of income from unemployment benefits (30.6%).

**Ethnic identity**

A total of 29.2% of the households covered by the survey have family members living in Turkey. This indicator of migration is understandably the highest among ethnic Turks. The distribution by municipalities is proportional to the share of ethnic Turks in the total population.

**Table**  
**Structure of ethnic self-identification**

| Percentage          | Total | Sliven | Kurdzhali | Omurtag | Bulgarians | Ethnic Turks | Roma | Villages | Towns |
|---------------------|-------|--------|-----------|---------|------------|--------------|------|----------|-------|
| Bulgarian-Christian | 59.6  | 84.5   | 51.6      | 20.6    | 97.8       | 0            | 0    | 22.5     | 80    |
| Bulgarian -Muslim   | 1.3   | 0.9    | 2.5       | 0       | 2.2        | 0            | 0    | 1.2      | 1.4   |
| Turkish             | 31.7  | 3.3    | 43.6      | 71.4    | 0          | 100          | 0    | 67.4     | 12    |
| Roma-Christian      | 5.1   | 10.1   | 1.1       | 1.5     | 0          | 0            | 69.4 | 6.9      | 4.1   |
| Roma - Muslim       | 2.2   | 1.2    | 1.1       | 6.5     | 0          | 0            | 30.6 | 2        | 2.4   |
| Other               | 0     | 0      | 0         | 0       | 0          | 0            | 0    | 0        | 0     |

45.8% in Omurtag. Whatever the reason, ethnic Turks in the regions under analysis possess farmland almost as frequently as Bulgarians, and do not have problems with the legal status of ownership.

Only 17.8% of respondent households cultivate all their land by themselves. The percentage is highest in the region of Kurdzhali (29.2%) and among ethnic Turks (28.3%), and lowest in Omurtag (7.5%). Not a single Roma household cultivates the whole of its land by itself. Tobacco growers are those who most often use only their own labor. Next come producers of animal products (24.5%) and meat, against only 9.5% of grain producers

The study shows a lack of motivation to cultivate farmland. A few (43.3%) would drop land cultivation if they had other sources of income. Those willing to try their hand at land cultivation are mostly town dwellers with no experience in farming. The majority of landowners (47.4%) would lease their land, given the chance, rather than cultivate it.

**Structure of household incomes**

State-owned companies account for 28% (relative share) of the income sources in the municipalities under review. Together with pensions (25.4%), welfare benefits (5.44%) and grants (2.44%), they add up to

Compared to the aspirations for Turkish cultural and language identity programs (supported by 88% of the ethnic Turks interviewed) the likelihood of emigration is negligible. Only 24.5% of ethnic Turks are likely to take a final decision to move to Turkey. The figures show an awareness of the economic rather than ethnic motivation for migration to Turkey. Despite the motivation, a majority of 37.1% would not leave the country even for a short time and even if there was a chance.

Figures show that 3.9% of people with Turkish ethnic identity have Bulgarian names, while 1.8% of all people with Bulgarian names have Turkish ethnic identity. In reverse proportion, 0.2% of Bulgarians have Turkish names and 0.3% of all people with Turkish names have Bulgarian ethnic identity.

We can assume that 3.9% of the people with Turkish ethnic identity kept their Bulgarian names after the changes or have adopted such names anew.

A total of 45.2% of ethnic Turks and 4.7% of respondents with Bulgarian identity can speak Turkish. These 4.7% are most probably people who have kept their Turkish names. Command of the Russian language is almost as strong an ethnic identifier as the Bulgarian language, with 29.7% of Bulgarians and 9% of ethnic Turks saying they speak

**Assets ownership coincides to a certain extent with ethnic affiliation, which can bring an ethnic scent to the economically-based conflict. Two ethnic minorities have been identified as having no (or only very limited) ownership of land: Roma people, or gypsies, and Pomaks (Muslims who are ethnically Bulgarian).**

Russian. Elderly Turks have a better command of the Turkish language.

A total of 36.6% of all respondents are supportive of having Turkish-language programs broadcast by Bulgarian National TV. By municipality, the share rises with the increase in the percentage of ethnic Turks in the population. The idea fetches the support of 88.4% of Turks, against 9.9% among Bulgarians. Taken at face value, the figures are indicative of potential ethnic tension. Study of the Koran in optional classes is supported by fewer ethnic Turks (71.3%).

The weaker support for study of the Koran among ethnic Turks is indicative of the prevalence of language and cultural over religious identity. It is further upheld by the fact that a sizable share of ethnic Turks (18.5%) observe Bulgaria's March 3 holiday marking liberation from Ottoman rule. Similarly, 10-12% celebrate Christmas and other Christian holidays. Those who observe the rules prescribed by the Koran are much fewer than those supporting Turkish-language programs on the National TV and Turkish classes in the schools. The religious nucleus of the Turkish ethnic identity, if it ever exists, is in the range of 21 to 35%.

#### **Inter-ethnic relations**

The question "Would you mind if your child had a .... for a close friend" (Question 33) seems to represent most clearly the potential for ethnic isolation. While 25.6% of Bulgarians would oppose their child's friendship with a Turk, only 1.9% of ethnic Turks would oppose their child's friendship with a Bulgarian. There is an even higher tendency among Bulgarians for preferring isolation from Roma people. While not a single Roma minds his or her child having a Bulgarian as a friend, almost half of Bulgarians (42.1%) would be unhappy with their child having a Roma friend. It is interesting to note, though not as prevalent as with Bulgarians, a preference for isolation from the Roma people exists even among ethnic Turks: 36.1% of them do not want to see their children having a Roma friend while only 1.4% of the Roma people share an identical attitude to them.

The figures lead to the general conclusion that Bulgarians are more inclined toward isolation from the other ethnic communities, in comparison to the others' attitude toward Bulgarians. This is why if any action is to be taken for reducing potential intolerance and ethnic isolation, the target group should be Bulgarians rather than ethnic Turks, and even less Roma people.

Only 2.9% of ethnic Turks identify ethnic tension. Nearly twice as many Bulgarians (5.5%) and many more Roma people (16.7%) say there is ethnic tension in the region where they live. These figures give rise to a hypothesis about ethnic inferiority, feelings of tension and minority inferiority complexes dominating among Bulgarians and Roma people rather than among ethnic Turks. But to put it bluntly, while nobody wants to be integrated with Roma people (to play with them) and Roma people do not want to be isolated, everybody wants to be integrated with

Bulgarians, while they place themselves in isolation.

These are all more or less potential trends rather than actually existing ethnic tensions. Over 70% of all ethnic groups believe that ethnic tension is not present in the region where they live; that is, neither artificially created nor actually existing. This attitude can be interpreted as a display of pragmatic philosophy, with both Bulgarians and ethnic Turks becoming aware that potential ethnic tension can be overcome primarily through economic development.

#### **Conclusions**

The starting point of the analysis was the assumption that access to factors of production (land, buildings, capital) is a core issue in terms of regional stability and potential for ethnic conflict. The results of the study confirmed the initial hypothesis, that the potential for ethnic conflicts as such is weak and the ethnic dimensions of the existing contradictions are of secondary significance. The level of inter-ethnic tolerance is still significantly high. However representatives of different ethnic affiliations reveal different levels of tolerance, with Bulgarians being the most intolerant.

In terms of business attitudes, the results cannot be assessed as optimistic; business is perceived as an element of the survival strategies. Avoiding unemployment is one of the main motives for starting a private business. The level of business activity, however, is not lower than in other regions of the country. Still, business intentions connected with agriculture are negligibly low. The results of the research confirm the assumption of a predominant intention to start micro-businesses with a minimum of high-risk investment; mainly small-scale trade.

One of the obstacles in this respect is the advance of agrarian reform. The study proves the fact that assets ownership coincides to a certain extent with ethnic affiliation, which can bring an ethnic scent to the economically-based conflict (in this case, over the possession of land). Two ethnic minorities have been identified as having no (or only very limited) ownership of land: Roma people, or gypsies, and Pomaks (Muslims who are ethnically Bulgarian). One of the possible ways to avoid their "marginalization" is by access to factors of production. For that purpose, special regional programs and strategies should be developed.

It would be a truism to say that economic growth is necessary in order to avoid ethnic "blurring" of the existing economic conflicts in regions with mixed populations. The problem is: what can the indigenous sources of such growth be, and what can the competitive advantages of those regions be. In the short term government subsidies cannot be avoided, but they should be growth-oriented, directed to investments in the regional infrastructure in order to provide the necessary conditions for growth. Such a local focus will probably turn out to be a winning strategy for the local elections in the autumn of 1999.

***It seems that Bulgarians are more inclined toward isolation from the other ethnic communities, in comparison to the others' attitude toward Bulgarians. This is why if any action is to be taken for reducing potential intolerance and ethnic isolation, the target group should be Bulgarians rather than ethnic Turks, and even less Roma people.***

# Reflections on the Elusiveness of Bulgarian Growth

*Paper presented at The Second Economic Workshop of the Institute on South-Eastern Europe: Growth Prospects of South East European Economies in Transition; Central European University, Budapest, September 4-5, 1998*

**Dr. Georgy Ganev**  
Center for Liberal Strategies

## Abstract

*This paper will try to explain Bulgaria's poor performance during its transition from a planned to a market economy by looking past the difficulties associated with concrete policies and concentrating on the deficiency of Bulgarian society in its ability or desire to adopt the market system and its heavy requirements.*

*Modern economies rely on complex intertemporal monetary exchange. While this mode of exchange greatly improves economic performance, it also involves information problems, which bring uncertainty in the economic environment and play a major role in the decision-making process of the society as a whole.*

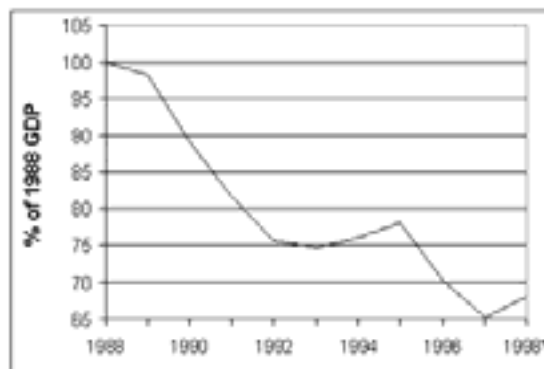
*If these problems are inefficiently resolved, the economic system becomes fragile and subject to chronic crises, which suffocate any growth potential.*

This paper is an informal discussion, starting from the institution of indirect exchange. Indirect — especially intertemporal — exchange is linked to the general economic environment, and from there to the macroeconomic performance of the economy — especially to the principle of effective aggregate demand. This paper tries to show the interaction between the level of uncertainty in the economy and indirect exchange, and suggests some margins in which investment in human and social capital may dominate other kinds of investment. In this sense, the conclusion is that the foundation for a functioning market economy still remains to be built in Bulgaria, and that is why the country's economy has not been able to grow so far.

## 1. Introduction

Over the period of transition from a planned to a market economy and from command to democracy, the Bulgarian economy has performed poorly. This can be immediately illustrated by a look at the Bulgarian real GDP chain index, displayed in Figure 1.

Figure 1  
Bulgarian Real GDP Chain Index, 1988=100



Note: Data for 1998 is a forecast

Data source: National Statistical Institute (NSI)

The observations in Figure 1 take 1988 as a base year.

That was the last year of socialist growth, recorded at least on paper, before the political (1989) and economic (1991) changes started. The chart shows very clearly the peculiarity of the dynamics of Bulgaria's economic output. As in most other post-communist economies, Bulgaria experienced a steep initial drop in GDP, associated with the transition between fundamentally different political and economic systems. This was followed by a somewhat feeble recovery in 1994 and 1995, but instead of solidifying it, as its fellow European economies in transition managed to do, Bulgaria plunged into what by now has become an internationally notorious example of reform failure and catastrophe during transition. It is important to mention that the catastrophe was brought about by a government that was elected with a landslide victory, received a clear mandate for socially friendly reforms and began its rule with a very high degree of public support and trust.

There are many possible explanations for the inability of the Bulgarian economy to reform and grow, but almost all analyses converge around the opinion that the major reason is the lack of real structural reforms. This led to the economy's inability to adapt to the international market, and consequently to a sustained fall in the standard of living and a loss of perspective, both on the micro and on the macro level. This development had a very logical reflection in the share of the different components of GDP. A clear demonstration of the drop in living standards is the growth of non-government consumption's share, which shot up from 59% in 1988 to 82% in 1993, and has been around 80% ever since. A clear demonstration of the loss of perspective is the drop in real investment: gross capital formation has fallen by more than two-thirds in real terms between 1989 and 1997. Figure 2 shows the changes in the shares of the non-consumption components of the Bulgarian GDP during the transition.

The least interesting of the components is government consumption. Its share, after slowly and steadily declining down to approximately 6% of GDP, has remained there for the past 3 years. At the same time, investment fell dramatically and unevenly. There are two clear nadirs in 1994 and in 1996, followed by relatively significant increases. As will become obvious in the following sections, an expla-

nation for this behavior of investment and its share in GDP is the core for understanding Bulgaria's growth problems.

The component of GDP that is probably the least noted and the most idiosyncratic for Bulgaria is net exports. Observations show both positive and negative values without any visible trend, which means that over the period of observation, Bulgaria had a more or less balanced trade in goods and services with the rest of the world, which makes it a significant outlier in comparison to other European transition economies. This suggests that the underlying structure of the Bulgarian economy for the present moment favors balanced trade, or even a trade surplus.

Overall, a look at the components of the Bulgarian GDP confirms the depth of the economic crisis, and helps identify the most serious symptom of the sickness of the Bulgarian economy: the drop in investment. It is by far the component of GDP with the most dynamic downward direction, and has experienced an astounding decrease in real terms. Its behavior indicates a trend towards decapitalization, which leads to decreasing productive capacity and falling competitiveness, and at its present levels dooms any perspective for growth. In short, it seems that the most serious problem of the Bulgarian economy is that there is no investment. The rest of this paper will attempt to explain the sickness behind this symptom.

## 2. Looking further at the data

### 2.1. Some more graphs

The observations in the introductory section on the dynamic structure and behavior of Bulgarian output during transition is not enough to give a clear picture of the processes in the economy. The two other macroeconomic indicators which are traditionally widely used around the world for describing the health of an economy are unemployment and inflation. In a transition economy, there is also a fourth important macroeconomic indicator: the share of the private sector in the economy. Looking at the behavior of these additional variables may be helpful for understanding the processes in the Bulgarian economy.

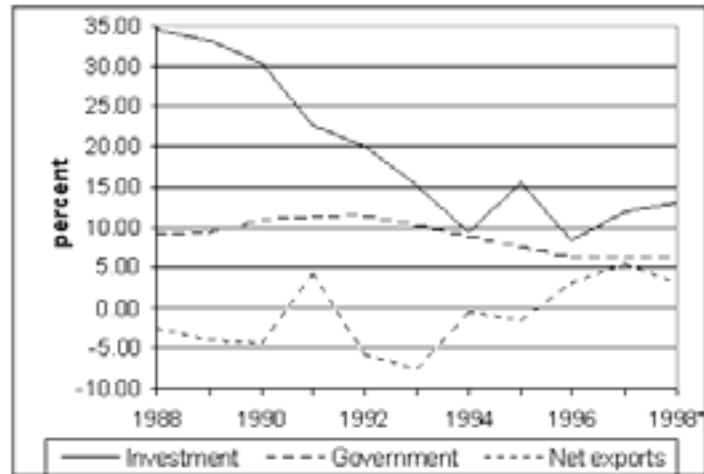
In Bulgaria the unemployment rate, shown in Figure 3 in monthly observations, confirms its reputation of a good lagging indicator of economic activity.

There was a steep initial rise in the number of unemployed people, due to the start of economic reform and the loss of many jobs in the ineffective state-owned enterprises. After peaking in January 1994, the unemployment rate reached a minimum of less than 10% in June 1996 — at the very beginning of the second meltdown of the Bulgarian financial system. Then it increased sharply, with the dramatic decrease in economic activity over the following 10 months, and then began dropping again when financial stabilization became a fact and a new package of reforms was introduced under a currency board.

Overall, the unemployment rate has been following, with a little lag and less drama, the dynamics of output.

Even if long-term, hidden and unmeasured unemployment are taken into account and hidden and gray employment are ignored, unemployment has never been high enough to become a policy-shaping factor, except in some regions. As such, it is hard to find in it a cause for the

Figure 2. Some Components' Share in the Bulgarian GDP, 1988-1998

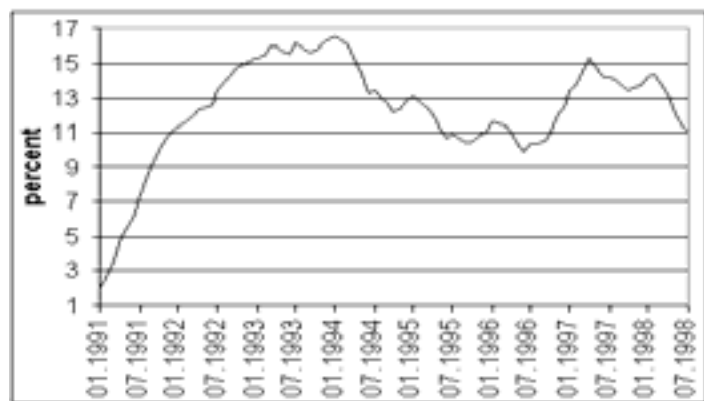


lack of growth in Bulgaria.

*Note: Data for 1998 is for the first quarter.*

Inflation, on the contrary, gives much more food for thought and reflection on the elusiveness of Bulgarian economic growth during the first decade of transition. Over a period of transition from a planned to a market economy, inflation is a very interesting object of observation, because it reflects much more than sim-

Figure 3. Bulgarian Unemployment Rate, Monthly, 1991-1998

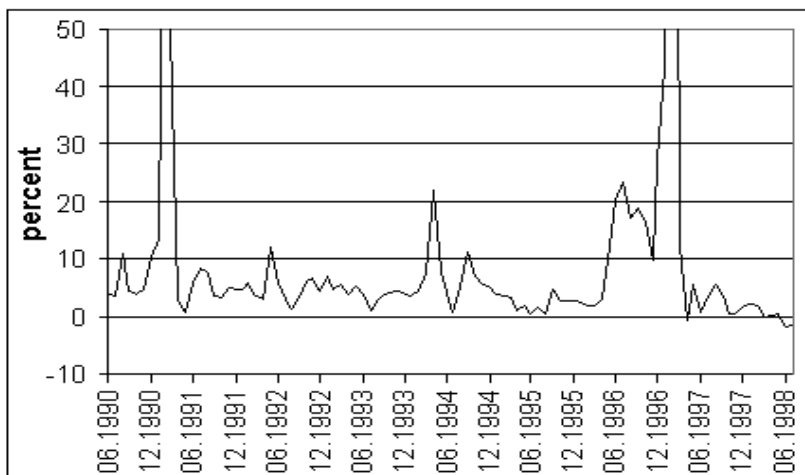


ply the monetary policies of separate governments. It captures the combined effects of actions of previously non-market oriented economic agents. It is highly conditional, hinging on the overall behavior of financial intermediaries and the level and quality of bank regulation and control exercised by parliaments and central banks. During a transition, inflation is influenced not only by the dynamics of one or another monetary aggregate or by the problems of the state budget (both of which remain important factors), but by the liberalization<sup>1</sup> of different prices, by the continuing existence of monopolies created during socialism, by the actions of newly established criminal groups,<sup>2</sup> and by the mental models and the culture of every economic agent. Inflation both reflects the problems of the economy

and is a part of what causes them. In the case of Bulgaria, inflation, as opposed to unemployment, has been influencing the economy both directly and indirectly by becoming a major social — and from there, political — issue. If it were not for the social prominence of the issue of permanent high inflation throughout the period of 1990 to 1997, the introduction of a currency board, which is by far the major brick in the foundation of the present package of Bulgarian reforms, may not have been possible. The simple fact of chronic inflation deprived the opponents of the currency board, both the bona fide and not so bona fide ones, from any electorally, and

obvious that reforms were failing. Even when these observations are omitted, it is obvious that the inflation rate in Bulgaria up until 1998 is both high and highly variable. The geometric average of the CPI inflation rate is 8.12% per month with, and 6.02% per month without, the two hyperinflationary months. The arithmetic average is 9.89% and 6.29%, and the standard deviation is 27.69% and 8.03%, respectively. Figure 4 clearly shows that there are significant fluctuations in the CPI inflation from month to month consistently throughout the period of observation. So the problem in the economy is not only that inflation has been high,<sup>3</sup> but that it has been highly variable and unpredictable.

**Figure 4. Inflation in Bulgaria: Monthly CPI, 1990-1998**

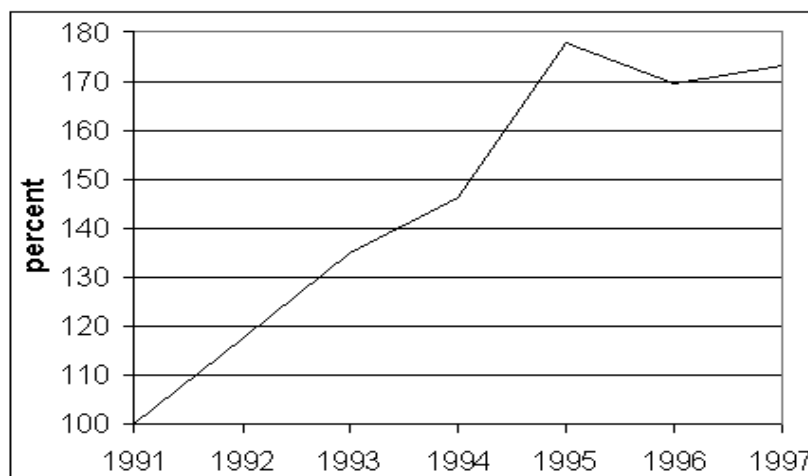


from there politically, valid arguments.

Inflation, represented by the monthly rate of increase of the CPI, is shown in Figure 4.

The missing observations (the graph is scaled so that the variance in the inflation rate can become more

**Figure 5. Growth of the Bulgarian Private Sector, Chain Index, 1991=100**



obvious) are for February 1991 (122.95%) and February 1997 (242.71%). They are associated with the initial liberalization of some prices at the beginning of the first reform package, and with the hyperinflation that crowned the financial meltdown when it became

One of the main characteristics of an economy in transition is the ongoing process of privatization. Privatization is one of the major aspects of structural reform, aimed at introducing the incentive structure associated with private property into the previously command systems and creating the basis for the growth of markets, productivity and output. Therefore, when evaluating the macroeconomic performance of a transition economy, it is important to keep track of the behavior of the private sector. In Bulgaria the private sector started being measured, albeit quite imperfectly, in 1991. Since then, as Figure 5 illustrates, it has grown by close to 75% in real terms.

The growth of the private sector has been very robust, even when the effects of privatization, which is a transfer of assets from the state to the private sector, are accounted for. In every year since 1991, the private sector has significantly outperformed the overall GDP, and as a result its share in total output has increased. This is illustrated in Figure 6, for the share of the private sector in gross value added (GVA), and in GDP.

It is not easy to evaluate the performance of the private sector of the Bulgarian economy. On one side, it has grown impressively in real terms, except for 1997. On the other side, its share of GDP is just slightly above 60% at the moment, and in comparison with the other European economies in transition this is too little, too slow. However, such a conclusion does not take into account the gray sector of the Bulgarian economy, which is mostly private and according to different estimates of the National Statistical Institute, constitutes between 20% and 40% of national output. With respect to the future, however, the important thing is that the private sector will most likely continue to grow faster than the economy as a whole, especially if the present reforms manage to convince some of its gray sectors to become fully legal and they start to be included in the routine measures of output. Thus, the expectation that the Bulgarian economy will become more than 75% private in the following two to three years, even without privatization, is not an unreasonable one. The main question is about the quality of the economic environment and about the ability of the incentive structure of the economy to foster growth. This makes analysis of private sector dynamics over the period of transition informative.

According to Figure 6, there are two clearly visible

slowdowns of the growth of the private sector share in the Bulgarian economy: in 1994 and in 1996. They are closely associated with sharp increases in the rate of inflation, dramatic drops in the share of investment in GDP,<sup>4</sup> foreign currency crises and the corresponding fiscal disasters. A more important factor, however, seems to be the plummeting public confidence in the respective government's dedication to genuine economic reforms preceding the crises. In each case the crisis followed 10- to 15-month periods of a lack of fiscal discipline, slow privatization, draining of state-owned and private banks and firms, and non-introduction of hard budget constraints. The same two years coincide with the lowest values of the share of investments in GDP. On the other hand, whenever a new government with a new level of social trust, with clear parliamentary majorities and enthusiastic reform promises has come to power, as in January 1995 and May 1997, the private sector has responded with robust growth, inflation has been moderate to low and the share of investments in GDP has increased considerably. The data suggest that there is a close link between the political and economic processes in Bulgaria. This observation gives food for further thought.

### 2.2. An interpretation of the data

Of course, the validity of the observations in the preceding paragraph and of the inferences based on them cannot be statistically confirmed, due to the small number of observations. Therefore the analysis is based on the data observed and its interpretation.

There are two specific features of the Bulgarian economy which may lead toward an explanation of its bad performance and may help in coming up with some conclusions as to what can be done in terms of policy to resolve the country's growth problems. The first feature is the lack of investment, and the second is the link between the economy and politics.

The lack of investment can be attributed to the unsuccessful policies of the government, the lack of specific incentives, the inability of politicians to attract foreign investors, and so on. All these explanations have their valid points, but they fail to explain the persistence of the problem. After all, in a normal market economy with private property, more than eight years should be enough time for entrepreneurs to identify investment opportunities and for the economy to recover from a crisis, even if there are no specific policy actions, the legislation is confusing and inconsistent, and there is no access to capital markets. The problem with Bulgaria, compared to the other transition countries, is that it is still not a normal market economy with private property. In such an environment, before any meaningful discussion of specific policy actions, provision of investment incentives, and attempts to influence the economy through the means of monetary and fiscal policy can start, the whole system needs to be reformed. It was precisely the reform of the economic system with all its structural components that was successfully carried out in other ex-socialist countries, but failed in Bulgaria. And since the reform process in a democracy is political, there is a close connection

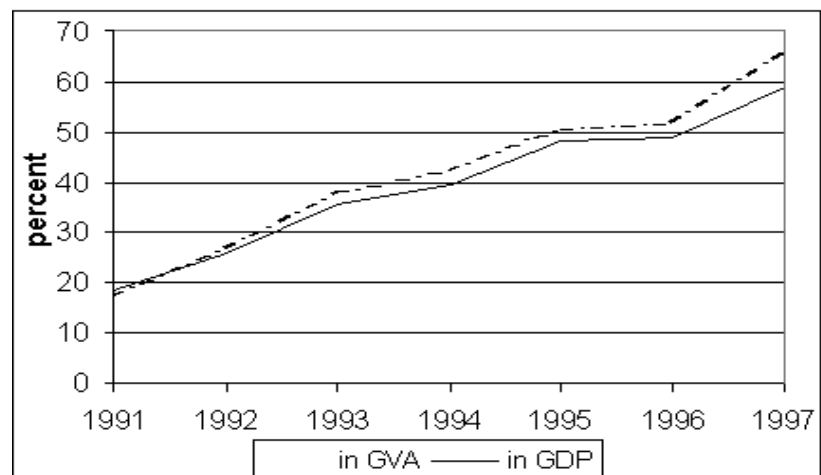
between politics and economic performance. It is by now a clear fact that no effective reform, at least until the reform package of the present government was introduced, has taken place in Bulgaria. And every time the promise for reform is shattered by the government, the economy has responded by plunging even further into crisis.

There are, of course, many possible explanations for the lack of reforms. It is beyond the scope of this paper to make a contribution in this direction. Put in a most abstract way, the reason for the Bulgarian failure is that something fundamental to the health of a market economy is missing. What is missing can be described as a critically necessary level of social capital, of ability of the society to make and enforce decisions. This involves culture, democracy, experience in intertemporal and impersonal interactions and the overall level of trust in the workings of the market system. This point requires some theorizing.

### 3. Indirect exchange and investment

In the concluding remarks of his General theory,<sup>5</sup> Keynes argues that government intervention can help an economy escape the problems of insufficient aggregate demand and approach full employment. This would include intervention on many margins, and "a

Figure 6. Bulgarian Private Sector Share, 1991-1997



somewhat comprehensive socialization of investment," as the basic cure for the downsides of capitalism due to the problems that private incentives create alongside all the benefits. Whether such intervention is possible — and if possible, desirable — has been one of the fundamental questions in macroeconomic theory and practice ever since Keynes suggested it. It is quite obvious that the recent plans of the Ivan Kostov government in Bulgaria for a comprehensive investment program, aimed at jump-starting economic growth, were inspired by it.<sup>6</sup>

Exchange in a modern economy is very complex and involves many economic agents, long time horizons and complicated contracting, creating relationships and financial links that last for long periods of time — often decades. In such an environment of significant intertemporal transfers of value, the level of uncertainty is a very

important factor. One way to show how the principle of effective demand<sup>7</sup> works is through the role of uncertainty. The existence of the link between uncertainty and effective demand has numerous implications for the social rates of return on investment in different types of capital. It also has implications for economic policy and for the relevance of short-run policy actions. This section discusses the link between the nature of exchange in a modern economy and the principle of effective demand, and draws some conclusions about possible types of social investment with potentially high social return.

### **3.1. Money and indirect exchange**

One of the main points of Adam Smith's economic theory<sup>8</sup> is that specialization leads to higher productivity and that increases in specialization are the foundation of economic growth. The process of exchange, which may be defined as the transfer of goods and services or simply of value, between economic agents, is crucial in achieving such increases in specialization. Thus the broader and deeper the reach of this process (or, to use Smith's terminology, the greater the extent of the market), the better the perspectives for economic growth.

Since in the process of exchange economic agents basically give value and get value, information about the value they give and get is crucial in their decision as to whether to engage in exchange or not. In the real world, this information is never perfect or complete, and economic agents are faced with two types of problems: problems of availability, and problems of the processibility of the information. The first type of problem is analyzed by Alchian (1977), and involves a lack of information (or erratic information) about the real value of the product an agent will obtain in exchange for his or her product. Acquiring such information involves costs that may impede exchange. The second type of problem<sup>9</sup> involves the fact that agents are bounded rational and cannot process the vast amounts of information generated by the economic system. These problems impede the process of exchange by introducing uncertainty into the environment in which agents make their decisions.

As argued by North (1990), in order to cope with the uncertainty caused by the informational problems of the economic environment, agents resort to specific rules of behavior, or to institutions. Applying this insight to the problems of the process of exchange discussed above, anything devised by society in order to reduce these problems can be viewed as an institution. Therefore, for example, money, which, as King and Plosser (1986) point out, "exists in societies because it serves to reduce the informational requirements of exchange," can be defined as an institution. However, if we define money itself as an institution, there may be a confusion between the cash and the rule of behavior behind it. In a certain sense, defining money as an institution may lead to a categorical mistake,<sup>10</sup> in which the different pieces of paper, gold, silver, diamonds, or what-not, are confused with the whole complex social interaction for which they are only a tool.

As a way to avoid the problems discussed above, a more precise view of the institution in question is suggested here. The social convention, or institution, that has been described as money, consists of the following rule of behavior:<sup>11</sup> "every economic agent will accept in exchange for his or her goods, services, or promises for future goods or services, something that is not the goods or services or promises he or she ultimately wants in exchange, but which all other agents will later accept in exchange for their goods or services or promises." This rule is hereafter referred to as "the institution of indirect exchange," and money is its instrument. The institution of indirect exchange has great economic importance, because it is the pattern of behavior that enables agents to escape from the requirement of double coincidence of wants and uses the tool, or medium, of exchange, which will minimize losses due to the information problems.<sup>12</sup>

### **3.2. Intertemporal monetary exchange and effective demand**

The main insight resulting from the definition of indirect exchange is that it allows the economic system to escape the stringent requirements of barter, and greatly increases the set of trades available to the economy in the goods-agents-distance-time space. The effects of indirect exchange in the time dimension of this space are of special interest here.

By separating the two steps in the exchange of value, the institution of indirect exchange enables economic agents to transfer abstract value through time.<sup>13</sup> This ability has two sides. First, it does what it is advertised for: it gives economic agents a significant degree of freedom in making and implementing intertemporal decisions; it expands possible trades, increases the margins on which economic agents are able to optimize, helps specialization and improves the overall performance of the economy. Second, it introduces the future into the present, vastly expanding the set of information relevant to decision-making. This second aspect of indirect, in this case intertemporal, exchange, is closely related to Keynes' principle of effective demand.

Briefly stated, the principle of effective demand is that the volume of actual employment in the economy will be the one and only volume that equates the aggregate supply function and the aggregate demand function.<sup>14</sup> This principle is a logical consequence of recognition of the fact that in contemporary economies, Say's Law doesn't have to hold. Keynes claims that the intuition behind Say's Law is wrong, because social decision-making is based not only on resource and technology constraints, but on human wants as well.

Intertemporal exchange is a very strong argument in favor of such a claim. By making possible the transfer of value between time periods, intertemporal exchange introduces the future into the present. Plans, expectations, and future human wants become relevant today. The decision-making process becomes very complex and subject to uncertainty,<sup>15</sup> errors, and coordination failures. Because of the intricacies of indirect exchange, an act of saving does not have to be an act of increasing pre-

*Since in the process of exchange economic agents basically give value and get value, information about the value they give and get is crucial in their decision as to whether to engage in exchange or not. In the real world, this information is never perfect or complete, and economic agents are faced with two types of problems: problems of availability, and problems of the processibility of the information.*

sent demand through investment. One reason for the lack of such coordination has been pointed out by Leijonhufvud (1981). Indirect exchange allows value to be transferred inter-temporally in the form of money; i.e., of an abstract representation of purchasing power. No decision as to the exact form into which this "liquid" purchasing power will be "poured" has to be made by the saver at the first step of indirect exchange — savers do not have to commit to a concrete future consumption stream. At the same time, an investor now has to invest (mostly) in very concrete capital and equipment, and thus to commit to the future supply of concrete goods and/or services. The reason for this is the nature of the production process: most technologies are time consuming, and the time period between making a decision to produce and the finishing of the final product is often substantial, especially if new production facilities have to be put in place. Usually, these production facilities are not very flexible in order to respond to unpredicted realizations of the abstractly transferred purchasing power from previous time periods.

The important point in this discussion is that the great expansion of trade due to the adoption of the institution of indirect exchange comes at the cost of introducing the unknowns and uncertainties of the future in present-day decision-making. Namely, intertemporal monetary exchange introduces a wedge between abstract future demand (implicit in a saving decision) and concrete future supply (implicit in an investment decision). Whenever at a future moment the abstract demand takes on a concrete form that is different from the plans and expectations on which future supply is based, excess effective demand may turn out to be different from zero in some markets. When this happens, the inherent instability of the financial system due to the debt-deflation effects of failures in any market<sup>16</sup> creates conditions for aggregate effective demand to be insufficient for full employment.

The financial fragility of the economic system which relies heavily on intertemporal monetary exchange has been the subject of a significant and growing theoretical and empirical literature<sup>17</sup>. On a more abstract level, the economic system may be viewed as moving toward and along the boundary between structural stability and structural instability.<sup>18</sup> In such an environment, especially when the time dimension of trade is greatly expanded due to indirect exchange, it may pay to increase the economy's capacity to deal with uncertainty, rather than to try to decrease uncertainty or alleviate its consequences. Completely unexpected and unpredictable things happen constantly to the economy. To stop them from happening is impossible; decreasing uncertainty may be more costly, at least after some point, than developing the ability of agents and of society as a whole to make decisions and implement actions that are optimal in the existing environment, given some set of criteria for what is "optimal."

### 3.3. Dealing with uncertainty

One way to deal with the problems of potential discrepancy between demand and supply discussed in the

previous section is to invest in types of capital that are flexible enough to respond to different specific realizations of inter-temporally transferred abstract demand.

Using Ostrom's definitions,<sup>19</sup> three major types of capital can be distinguished. The first is physical capital, comprised of all material productive resources. The second is human capital, consisting of individual knowledge and skills used by economic agents in their productive activities. Personal knowledge, education, health, motivation, leadership and qualities for teamwork are important aspects of human capital. The third is social capital, which is "the shared knowledge, understandings, and patterns of interaction that a group of individuals brings to productive activity" (Benham, Benham, and Merithew (1995)). Trust, credibility of commitments, clear definition and enforcement of property rights, and the stability and efficiency<sup>20</sup> of the existing economic and political institutions are all important elements of social capital.

In the context of the theoretical framework outlined up to now, there is a close link between social capital and the efficiency of the institution of indirect exchange. Indirect exchange cannot work without social confidence in the workings of the institution, without dominant expectations that contracts will be enforced at an acceptable cost and obligations will be honored, and without the presence of cooperation based on trust. Also, indirect exchange cannot work without confidence in money, and therefore, without the trust of every economic agent in the universal acceptance of money and the adequacy with which it represents value.<sup>21</sup> Due to this, trust in the institution and in the workings of its instrument is crucial to the effectiveness and efficiency of indirect exchange. Intertemporal monetary exchange is "...possible only in social groups closely knit by mutual guarantees for protection from external, and especially also from internal, dangers" (Frankel (1977)). Indirect exchange both liberates people by breaking the chains of barter, and makes them more interdependent, with the requirement for social trust. Thus trust is an important part of social capital, which means that the institution of indirect exchange supposes a certain level of such capital in a society.<sup>22</sup> Every time a monetary authority consciously tries to affect the economy by monetary policy actions, knowing that these actions will lead to unpredictable changes in the value of money, it fosters uncertainty and mistrust, and destroys part of the social capital of the economy. Also, every time the government reneges on a promise, it destroys social capital. Every time a businessperson fraudulently realizes a profit, or a corrupt state administrator or magistrate impedes the process of normal business activity or of the enforcement of justice, social capital is destroyed.

Another important illustration of the role of social capital is the presence of hard budget constraints. For both firms and the government, in both the economic and political spheres of society, the presence of hard budget constraints is an aspect of social capital. In this case it means clear delineation and enforcement of

***Indirect exchange cannot work without social confidence in the workings of the institution, without dominant expectations that contracts will be enforced at an acceptable cost and obligations will be honored, and without the presence of cooperation based on trust. Also, indirect exchange cannot work without confidence in money, and therefore, without the trust of every economic agent in the universal acceptance of money and the adequacy with which it represents value***

responsibility for every action of every agent. This enables society to react promptly to inefficient and harmful behavior, and decreases the probability of major disturbances due to the compounding of opportunistic, inefficient decisions in an inherently unstable system.

Uncertainty, besides the possibility for meaningful long-term contracting and exchange, is another margin in which the returns to human and social capital may be significantly higher than the returns to physical capital. Human and social capital are as abstract in their capacity to be productive in supplying different goods as inter-temporally transferred purchasing power is abstract in its capacity to transform itself into concrete, effective demand. Essentially, human and social capital enhance the ability of the economy to react to signals from the environment, unforeseen and unforeseeable as they often are. This creates the right incentives and provides tools for individuals and for society as a whole with which to make decisions more efficiently, leading to, on average, efficient allocation of resources. It can be used, with relatively small adjustment costs, in order to increase productivity in any specific sector that is favored by effective demand over any specific period of time.

It is important to note that the claim here is not that physical capital is completely inflexible. Rather, it is relatively more inflexible, given its nature, or put in another way, its flexibility is more costly than the flexibility of human and social capital. Also, it is not claimed here that investment in human and social capital is a panacea for all of the problems of coordination and uncertainty facing the economy, but rather that the problems associated with intertemporal monetary exchange represent one more margin in which investment in human and social capital may have higher returns (at least at existing levels) than investment in physical capital. Social and human capital help the economic system to expand exchange, decrease the adverse effects of inefficient behavior, and deal with unexpected realizations of effective demand.

#### 4. Reflections on the operationalization of the implied hypothesis

The general reflection on the problems of Bulgaria's economic development and on some seemingly relevant aspects of modern complex indirect exchange brings with it the possibility of formulating a hypothesis, with which to explain the lack of economic growth in Bulgaria since its transition to a democratic market economy began. It must be noted that the discussion here is bound to remain mostly a theoretical speculation, based on loose and stylized empirical observations. The data necessary for the rigorous empirical testing of the possible hypotheses that can be derived from this theoretical reflection do not exist, and it is beyond the scope of this paper to successfully deal with this problem.

The goal of the discussion in this section is, drawing on the Bulgarian experience, to formulate a viable hypothesis and outline some basic steps toward putting it into operation, with the hope that

future research will tackle the data problems and will lead to empirical results, based on the study of a panel of transition and other emerging or less-developed economies.

##### 4.1. The hypothesis

Observation of the facts of the Bulgarian transition, and the theoretical considerations that try to explain the facts by focusing on the lack of investment, that were outlined in the preceding two sections, lead to a relatively well-defined hypothesis. Stated in the briefest possible way, the hypothesis claims that the main reason for the consistent failure of the Bulgarian economic reforms in the period 1991-1997 is the lack of a critically necessary level of social capital.

Actually, the hypothesis, as formulated above, consists of two separate claims. The first is that social capital matters for economic development. The second is that there is a critical level, or stock, of such capital, below which sustained development is unachievable no matter what the levels of other types of capital or the quality of economic policies, and that Bulgaria is below this level.

The concept of social capital is central to this hypothesis and therefore requires further study, for which the definition given in Section 3.3 can only serve as a beginning. There are other definitions of social capital that may clarify its meaning and suggest possible ways to model and measure it.

Among the early definitions of social capital is the one given by Coleman (1988), who defines it as "the variety of different entities that consist of some aspect of social structures and facilitate certain actions of actors within these structures" (Coleman (1988), p. S98). Putnam (1993) lists some concrete features of social organization to which the concept of social capital refers: "networks, norms and trust, which facilitate coordination and cooperation for mutual benefit" (Putnam (1993), pp. 35-36). Ostrom (1994a and 1994b) adds to this list "shared relationships, ... , knowledge and understanding," and claims that social capital is an arrangement, a sharing, of human resources, which, like the other forms of capital, is aimed at improving future income flows.

The last definition puts social capital in a well-defined position relative to the other forms of capital — physical and human. Physical capital can be defined as an arrangement of material resources (Ostrom (1994a) following Lachman (1978)), and human capital as the "knowledge and skills" brought to the solution of any problem. As with both physical and human capital, social capital is productive and serves to achieve goals that would not be achievable in its absence, and can be activity and goal specific. What distinguishes it from the other two forms of capital is its relational nature. Social capital is contained only in the structure of relationships between actors. Its domain is not a physical entity or a human being, but the relational space between actors, be they individuals or groups. Social capital structures this space in one way or another by defining, constraining and prohibiting relationships.

There are several ways in which social capital helps to achieve goals and is thus valuable, according to

*Essentially, human and social capital enhance the ability of the economy to react to signals from the environment, unforeseen and unforeseeable as they often are. This creates the right incentives and provides tools for individuals and for society as a whole with which to make decisions more efficiently, leading to, on average, efficient allocation of resources.*

Coleman ((1988), p. S101): it increases the level of trust between actors, and thus the flexibility of their mutual arrangements; it provides fruitful information channels; and it effectively sanctions behavior according to known norms. In general, all this contributes to a decrease in transaction costs, and thus enhances the productivity of the other forms of capital.

#### 4.2. Ways to model social capital

It is quite obvious that no matter what the working definition of social capital, it is a concept that is difficult to model, both theoretically and empirically. The main reasons for this are the imperfect theories of institutional change and of human learning, which could help explain and understand the ways in which actors develop social capital in the form of "rules used by self-governing communities" (Ostrom (1994b)). The first two ways to model social capital are discussed by McClennen (1998). Naturally, since social capital concerns the relationships between agents during their interactions and exchanges, one way to model its significance is in a game theory context. This idea relies on the observation that the realization of social capital takes the form of cooperation between agents, and proposes to study the social factors that may influence such cooperation within groups of agents or within whole economies.

The second way to model social capital is via evolutionary economics. This approach is based on the idea that the presence and utilization of social capital is embodied in a certain group behavior, and that the traits of this cooperative behavior will be selected in an evolutionary manner as more efficient in the long run. Each of these approaches has a lot of merit and some deficiencies. The most serious one is that empirical game theory and evolutionary literature have not reached a stage advanced enough to allow for an immediate application of a model to the realities of transition or less-developed economies.

A third way to approach the modeling of social capital has been suggested by North and Wallis (1994), and recently strongly advocated by Eggertsson (1998). It rests on the observation that the production process of any economic good involves not only physical, but legal transformation, as well. In other words, any good is not only physically transformed from raw materials into a final product, but is also transferred in terms of ownership, possibly many times over the whole process. Thus, production has two aspects and includes both physical transformation and social transaction. Without either of these aspects of production, a modern economy is unthinkable. To deal with these aspects of production, Eggertsson (1998) suggests, society has developed two distinct kinds of technology: one to deal with the physical transformation, and the other to deal with the transaction.

This approach can be easily and immediately integrated into traditional neoclassical modeling and econometrics, since all it does is simply redefine and slightly complicate the production function, introducing a new argument: social capital. Using such a framework of thinking, for example, it is easy to

derive the claim that low levels of social capital may make the other stocks of capital unproductive, and that the possible social rate of return on social capital is very high.

It should be kept in mind, however, that this way of introducing the concept of social capital into formal theoretical or empirical models immediately encounters at least three problems. The first is that it is likely that social capital will exhibit a sort of "non-neoclassical," or non-convex, behavior. As Putnam (1993) puts it, "its supply increases rather than decreases with use, and becomes depleted when not used." The second is that the impact of social capital on the productive capacity of the economy may have a discrete nature; namely, there may exist a critical level above which social capital becomes self-reinforcing and accumulating, and below which the other forms of capital become relatively very unproductive. And the third is, of course, the problem of measurement.

#### 4.3. Suggestions for the measurement of social capital

Measuring something as difficult to define and detect as social capital is a serious problem, even after the concept is streamlined in a way that allows it to be included in a neoclassical production function. It is especially difficult because the concept refers to relationships, and it is embedded deeply in interactions influenced by many other factors and is not readily revealed.

In a way, macroeconomists are already utilizing something that may be seen as a measure for social capital; namely, the "rule of law" index used by Barro (1997), wherein they analyze the factors relevant to long-term economic growth. Law enforcement is certainly important, as are other possible measures of contract enforcement, such as time and costs of obtaining what one is owed, the share of long overdue arrears in the total amount of arrears, etc.

Another important group of observable phenomena that can be linked to social capital are societal norms — both formal and informal. Analysis of the nature of the set of rules that assign responsibilities and allocate benefits may lead to a conclusion about the level of social capital.

A third group of factors, relevant for the measurement of social capital, is focused around trust. Trust in the banks (bank vs. mattress deposits), trust in the government and in the political system, perceptions of the degree of corruption in the bureaucracy and of fraud in the private sector, are all important indicators of the level of social capital.

Fourth, social capital is readily detectable by looking at time horizons. The length of contracts between agents, the length of business relationships with specific counterparts, and the presence of groups of agents who have been able to develop and take advantage of relationships based on cooperation and supported by long term interests, are all possible measures that can serve to gauge the level of social capital. Another tool would

***Measuring something as difficult to define and detect as social capital is a serious problem, even after the concept is streamlined in a way that allows it to be included in a neoclassical production function. It is especially difficult because the concept refers to relationships, and it is embedded deeply in interactions influenced by many other factors and is not readily revealed.***

be to look at and analyze the visions for the future of economic agents.

## 5. Implications for Bulgaria

Even without the benefit of a formal measurement and testing, it seems that Bulgaria is scoring very low in most of the criteria mentioned in Section 4.3. Since the whole literature on social capital strongly suggests that social capital may be extremely important for long run economic growth,<sup>23</sup> this fact of the present-day Bulgarian status quo should not be ignored, especially when economic policy decisions are being made.

The nature of indirect exchange in a market economy, the principle of effective demand and the potentially high relative returns on investment in human and social capital have direct implications for the situation in Bulgaria over the period of transition.

Economic policy is conducted by governments, and consists of sets, or sequences, of actions through which different policy instruments are manipulated in order to achieve, directly or indirectly (through the effects of the instruments on some operating targets), some ultimate goals. These goals are usually both economic and political: price stability, full employment, social justice, social security, equality and fairness, economic and social stability, etc.<sup>24</sup>

One fundamental problem with all these goals, and especially with the policy means for achieving them, is that they cannot be achieved if the political and economic system lacks the ability to implement decisions, and if the culture and the mental models of the agents involved run contrary to the implicit models of the economy underlying any policy decision.

Another fundamental problem with all these goals is that they shift through time, their relative importance changes with the changes in economic and social conditions, and many of them are substitutes for rather than complements to each other. And economic policy guided by such shifting goals is bound to vary with their shifts and with the changes in their relative importance. Shifting economic policy, even if it is able to achieve its goals in the short run, ultimately results in increased uncertainty, reduced efficiency of indirect exchange and lower growth in the long run. For example, Lucas (1987) studies the effects of policy actions aimed at decreasing the magnitude of business fluctuations, and finds that achieving this goal at the cost of higher inflation and lower long-run growth can reduce overall social welfare. In Bulgaria, one clear case of shifting goals was the increase in the importance of inflation and its consequences for living standards in the minds of the public throughout 1996, at the expense of concerns about the social acceptability of reforms and the preservation of jobs in large state-owned enterprises.

There is a trade-off between short-run goals and long-run welfare. Whenever governments act in order to achieve some short-run objective, they implicitly sacrifice long-run growth. Regardless of whether the short-run objective is achieved through fiscal or monetary means, the overall level of trust in government

decreases, and uncertainty increases. Such an environment ultimately results in high inflation,<sup>25</sup> which destroys the existing patterns of cooperation between economic agents and prevents the creation of new ones, hurts long-run contracting and intertemporal exchange, and increases the potential for an insufficiency of future aggregate effective demand due to the higher fragility of the financial system. This is true even if the short-run goals are achieved by the government in an efficient manner, which is usually not the case. Developments in Bulgaria between 1991 and 1997 can serve as a glaring example of the validity of this point of view. All governments during this period were unable or unwilling to implement structural reforms, to introduce and enforce hard budget constraints, to invest in the judicial system so that property rights are protected and responsibilities enforced, or to consciously undertake actions aimed at increasing social trust in the newly-established democratic political system. Every time there was a choice to be made between a short-term oriented expedient action and a behavior fostering long-term objectives, expedience won. By the hyperinflationary month of February 1997, the overall time horizon of Bulgarian society as a whole was less than a quarter of a year, and most of the economic and social agents were just trying to survive from month to month. There were firm beliefs that property rights are not protected, that prices are unpredictable, and that any investment is a lost cause. To a lesser degree, such opinions have been representative throughout the transition so far.

In other words, the general argument here is against the micro-management of the economy by the government. This doesn't mean that the government has no role in the economy. Government remains essential in providing public goods and services to society. Investment in human and social capital can be regarded as such a public good, due to the externalities associated with these types of capital, especially in the case of social capital. Increases in the stock of human and social capital improve society's overall understanding of the nature of its economic processes, enhance its ability to respond efficiently to changes in environment, and enable it to devise "policies that have minimally inefficient side-effects."<sup>26</sup>

Investment in human and social capital is not a short-term policy tool, but rather a constant activity of the government. The returns on this activity, especially in terms of long-run growth and welfare, are very high, and often underestimated by policy decision-makers. Sacrificing it in favor of some short-run economic or political goal is bound to result in welfare loss. Investment in human and social capital cannot play the role of "socialization of investment" suggested by Keynes (1936), and cannot be used as a means for intervention and increasing aggregate effective demand. The important aspect of this investment is the improvement of the overall "immune system" of the economy. Even though this does not insure that the economy will never catch a cold or get the flu, investment in human and social capital may be an opti-

***Economic policy is conducted by governments, and consists of sets, or sequences, of actions through which different policy instruments are manipulated in order to achieve, directly or indirectly (through the effects of the instruments on some operating targets), some ultimate goals. These goals are usually both economic and political: price stability, full employment, social justice, social security, equality and fairness, economic and social stability, etc.***

mal course of action, because the "medicines" so far developed by economic theory and practice have not historically been very effective in curing the problems, while most of them can be shown to have significant and potentially damaging side-effects; namely, the destruction of social capital.

## 6. Conclusion

Modern monetary economies are based on indirect exchange. This mode of exchange permits a significant expansion of trade, with the resultant increases in specialization, trade and wealth. However, it also increases the set of information necessary for making decisions, and this creates coordination problems between abstract future demand, inter-temporally transferred in the form of money or money-denominated agreements, and future supply, which by the nature of the production process is to a large extent pre-committed. One way to deal with this possibility of insufficient effective aggregate demand is to invest in flexible capital, which can be used to respond to different realiza-

tions of the abstractly transferred demand and to restore the link between saving and investment. Human and social capital can be seen as such flexible types of capital, and may serve as a means to cope with the problems of effective demand. Due to the externalities involved in these types of capital, investment in them may be made by the government as an alternative to the presently used short-run oriented economic policy actions, aimed at achieving some short-run goal and usually having adverse side-effects.

The explanation for the poor performance of the Bulgarian economy during its transition from a planned to a market economy so far is sought in the lack of a necessary level of social capital. It is precisely the deficiency of commitment to the market, to the protection of private property rights, and to the enforcement of hard budget constraints within a democratic political system, that has doomed any attempt of the economic system to recover and regis-

## References and Footnotes

- Alchian (1977): Alchian, Armen, "Why Money" in Armen Alchian, *Economic Forces at Work*, Liberty Fund Inc., Liberty Press, Indianapolis, 1977, pages 111-123; reprinted from *Journal of Money, Credit and Banking*, 9 (1), Part 2, February 1977, pages 133-140.
- Barro (1997): Barro, Robert J., *Determinants of Economic Growth: a Cross-Country Empirical Study*, The MIT Press, Cambridge, Massachusetts, 1997.
- Benham, Benham, and Merithew (1995): Benham, Alexandra, Lee Benham, and Michael Merithew, "Institutional Reform in Central and Eastern Europe: Alternative Paths with Incentives and Information" study, International Center for Economic Growth, April 1995.
- Brunner and Meltzer (1971): Brunner, Karl, and Allan H. Meltzer, "The Uses of Money: Money in the Theory of an Exchange Economy," *American Economic Review*, 61 (5), December 1971, pages 784-805.
- Coleman (1988): Coleman, James S., "Social Capital in the Creation of Human Capital," *American Journal of Sociology*, Volume 94, Supplement, 1988, pages S95-S120.
- Eggertsson (1998): Eggertsson, Thrainn, "Order, Organization and Performance: the Role of Culture," paper presented at the Second Conference of the International Society for New Institutional Economics, Paris, France, 17-19 September 1998.
- Fazzari and Variato (1994): Fazzari, Steven M., and Anna Maria Variato, "Asymmetric Information and Keynesian Theories of Investment," *Journal of Post-Keynesian Economics*, 16 (3), Spring 1994, pages 351-369.
- D. Fisher (1992): Fisher, Douglas, *Money Demand and Monetary Policy*, The University of Michigan Press, Ann Arbor, 1989, printed 1992.
- I. Fisher (1922): Fisher, Irving, *The Purchasing Power of Money*, 1922, reprinted New York, Augustus M. Kelley, 1987.
- Frankel (1977): Frankel, S. Herbert, *Two Philosophies of Money*, Basil Blackwell, St. Martin's Press, New York, 1977.
- Friedman (1973): Friedman, Milton, *Money and Economic Development: the Horowitz Lectures of 1972*, Praeger Publishers, New York, 1973.
- Gertler (1988): Gertler, Mark, "Financial Structure and Aggregate Economic Activity: an Overview," *Journal of Money, Credit and Banking*, 20 (3), August 1988, part 2, pages 559-588.
- Heymann and Leijonhufvud (1995): Heymann, Daniel, and Axel Leijonhufvud, "High Inflation," *The Arne Ryde Memorial Lectures*, Oxford: Clarendon Press, 1995.
- Jevons (1878): Jevons, W. Stanley, *Money and the Mechanism of Exchange*, New York: D. Appleton and Company, 1878.
- Keynes (1936): Keynes, John Maynard, *General Theory of Employment, Interest and Money*, London: Macmillan, 1936.
- King and Plosser (1986): King, Robert G., and Charles I. Plosser, "Money as the Mechanism of Exchange," *Journal of Monetary Economics*, 17 (1), Jan. 1986, pages 93-115.
- Lachman (1978): Lachman, Ludwig M., *Capital and its Structure*, Sheed Andrews and McNeel, Kansas City, Missouri, 1978.
- Leijonhufvud (1981): Leijonhufvud, Axel, *Information and Coordination: Essays in Macroeconomic Theory*, New York: Oxford University Press, 1981.
- Lucas (1987): Lucas, Robert E., Jr., *Models of Business Cycles*, Oxford, Basil Blackwell, 1987.
- McClennen (1998): McClennen, Edward, "Trust and Market Exchange," paper presented at the Second Conference of the International Society for New Institutional Economics, Paris, France, 17-19 September 1998.
- McNees (1992): McNees, Stephen K., "A Forward-Looking Monetary Policy Reaction Function: Continuity and Change,"

- New England Economic Review, Federal Reserve Bank of Boston, Nov./Dec. 1992, pages 3-13.
- Mill (1848): Mill, John Stuart, *Principles of Political Economy*, 1848, reprinted New York, Augustus M. Kelley, 1963.
- Minsky (1975): Minsky, Hyman P., John Maynard Keynes, New York: Columbia University Press, 1975.
- NSI (1997): National Statistical Institute, *Main Macroeconomic Indicators 1991-1996*, Sofia, NSI Press, 1997.
- NSI (1998): National Statistical Institute, *Statisticheski Spravochnik, 1998* ("Statistical Reference Book, 1998"), Sofia, NSI Press, 1998.
- North (1990): North, Douglass C., *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990.
- North and Wallis (1994): North, Douglass C. and John J. Wallis, "Integrating Institutional Change and Technical Change in Economic History: a Transaction Cost Approach," *Journal of Institutional and Theoretical Economics*, 150, 1994, pages 609-624.
- Ostrom (1994a): Ostrom, Elinor, "Neither Market, Nor State: Governance of Common-Pool Resources in the Twenty-First Century," Workshop in Political Theory and Policy Analysis, Indiana University, Bloomington, Indiana, 1994.
- Ostrom (1994b): Ostrom, Elinor, "Constituting Social Capital and Collective Action," *Journal of Theoretical Politics*, 6 (4), 1994, pages 527-562.
- Putnam (1993): Putnam, Robert D., "The Prosperous Community: Social Capital and Public Life," *The American Prospect*, No. 13, Spring 1993, pages 35-42.
- Radford (1945): Radford, R. A., "The Economic Organization of a P.O.W. Camp," *Economica*, 12 (48), Nov. 1945, pages 189-201.
- Schofield (1995): Schofield, Norman, "Chaos or Equilibrium in a Political Economy," *Chaos and Society*, A. Albert, ed., IOS Press, Amsterdam, 1995, pages 193-209.
- Smith (1976): Smith, Adam, *An Inquiry into the Nature and Causes of the Wealth of Nations*, The University of Chicago Press, Chicago, 1976.
- program a "neo-Keynesian" one.
7. It is one of the centerpieces of Keynes' General Theory. See Keynes (1936), p. 25-29.
8. See Smith (1976), Volume 1, Book 1, Chapter 1.
9. This type of problem has been traditionally discussed by any inquiry into the problem of why money exists: see Smith (1976), Mill (1848), Jevons (1878), I. Fisher (1922), Brunner and Meltzer (1971).
10. Described by Frankel (1977) with the example of the difference between a university as a separate entity, and all the different people and buildings, etc., that comprise it.
11. The wording presented here does not pretend to be definitive — the goal is to convey the basic idea rather than to strictly define a norm of social conduct.
12. Which is the equivalent of maximizing the "net value after exchange," using Alchian's terminology; see Alchian (1977).
13. This is different from transferring value through the storage of goods to be consumed later, and if they are stored in order to be exchanged later, then they actually play the role of money.
14. See Keynes (1936).
15. Both fundamental uncertainty and uncertainty in the other agent's behavior due to asymmetric information; see Fazzari and Variato (1994).
16. A feature of the economy first stressed by Keynes (1936) and further studied by Minsky (1975).
17. For an extensive review of this literature, see Gertler (1988).
18. See Schofield (1995).
19. See Ostrom (1994a). The discussion here is based on the compact summary in Benham, Benham, and Merithew (1995).
20. Following North (1990), the efficiency of an institution is defined by the balance between the degree to which it decreases transaction costs and enhances the performance of the economy, and the static and dynamic costs associated with the enforcement of a constraint on behavior.
21. Agents exchange value for value. Money represents value adequately when the value it can buy in the second step of the indirect exchange is exactly the value the agent had in mind when he or she entered into the first step of the exchange. This feature becomes very important when the exchange of value is intertemporal, and money facilitates it by serving as a store of value.
22. This is precisely what was meant by "a crucially necessary level of social capital" in Section 2.2.
23. Even without specifically dealing with social capital, Barro (1997) finds that the "rule of law" index, which may be seen as a measure of social capital, is significantly positively related to growth.
24. Among the many statements of some or all of these goals, see McNees (1992), D. Fisher (1992), Friedman (1973), and Frankel (1977).
25. An argument fully developed in Heymann and Leijonhufvud (1995), who conclude that the fundamental reasons for high inflation are uncertainty, lack of fiscal restraint and thus, of government credibility.
26. See Lucas (1987). A similar argument can be found in Friedman (1973).
- 
1. Price liberalization is a one-time proposition in theory, only. a more careful look at the process of price liberalization shows that many very important prices in the transition economies were liberalized in several stages and over significant time intervals. Thus, liberalization has been fueling inflation throughout the transition. In Bulgaria, a very good example is energy prices, which still must rise by more than 20% in the following two years according to the Bulgarian agreement with the IMF for the next three years.
2. Mainly racketeering and creation of local monopolies based on the use of force.
3. If the observations after the introduction of the currency board are omitted, the average inflation rate and its variability are even higher. So the Bulgarian data completely fit the criterion of consistently high inflation, which is defined by monthly rates between 5% and 50%. See Heymann and Leijonhufvud (1995).
4. See Figure 4 and Figure 2, respectively.
5. See Keynes (1936), Chapter 24, Section III, p. 378.
6. Actually, the prime minister himself called the investment