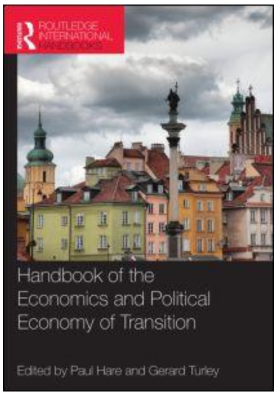

Handbook of the Economics and Political Economy of Transition

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BULGARIA AND POLITICAL ECONOMY OF TRANSITION

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Introduction and conceptual framework

Economic and political transformation in Bulgaria has been rather uneven and often changed direction. Compared to the countries in central Europe, it took much longer to define the course of reforms and until 1997 Bulgaria was a laggard in the reform process. In 1996–97 the deepening macroeconomic imbalances escalated into a severe financial crisis combining a crash in public finances, a run on the banks and a collapse of the currency, all of which gave rise to a hyper-inflationary hike in early 1997.

However, after 1997 the situation changed radically: the course of economic and political reforms was firmly set and the policy orientation towards a pluralistic democracy and market economy gained support among a wide majority of the society. In political terms, this was a definitive shift in values embodied in a firm orientation towards EU membership. In terms of economic policy, the emphasis was placed on fast macroeconomic stabilization (based on a currency board arrangement) and acceleration of structural reforms. There was a remarkable turnaround in economic performance: inflation rapidly fell to low single digits, public finances were brought under firm control and the economy grew steadily at a relatively rapid pace, which allowed for the recovery of real incomes and private consumption. The successful institutional reforms culminated with EU accession on 1 January 2007—which is also the end point of the narrative in this contribution.

Bulgaria's economic and political transformation has been the subject of extensive research. An overview of the political developments during the first phase of transition at the onset of transition can be found in Koford (2000). The initial stop-and-go reform effort, its policy rationale and macroeconomic outcomes are analyzed in Bristow (1996) and Jones and Miller (1997). The policies and the sequence of events that lead to the crisis are addressed in Avramov and Sgard (1996), Dobrinsky (1994, 1996), OECD (1997). Minassian (2001) addresses Bulgaria's relations with the IMF and summarizes the outcomes of the Fund-supported programmes. The nature of the crisis itself and its various facets are analyzed in Berlemann and Nenovsky (2004) and Dobrinsky (2000). The change in the policy course in the post-crisis period is analyzed in Dobrinsky (2001) and Nenovsky and Hristov (2002). Nenovsky and Rizopoulos (2003) analyze different aspects of the political economy of the regime change in this period. A few studies have attempted a synopsis of longer periods in Bulgaria's transition: Mihov (2001) provides an overview of the economic policies and changes during the first decade of transition. Miller and Petranov (2000) look at the process of privatization in Bulgaria and its outcomes.

Bulgaria's peculiar path towards the market economy reflects, *inter alia*, the intricate and strenuous political economy of the process of transformation. This contribution presents a concise overview of the political economy of the transition in the country focusing on the motivation and driving forces of Bulgaria's reform process.

The political economy of the transition has been about the political decisions on reform policies: How do these decisions take shape? What motivates such decisions? What are the driving forces (and actors) behind the decisions on reforms (or non-reform)? How are reforms implemented? When implemented, how successful are the policies in achieving their objectives? Why are some attempted reforms successful while others fail?

The theoretical literature also provides clues to some of these questions. Oddly enough—and somewhat disappointingly—the transition from plan to market *per se* did not motivate many new developments in the theoretical political economy literature. Most of the theoretical essays in this area were based on the application of already existing theoretical models of the political economy of economic reforms or their extensions.

Roland (2002, 2000), following Rodrik (1993), distinguishes between two main strands in the related literature: normative (which seeks to rationalize the decision-making problem of reformers subject to political constraints) and positive (which looks at the reform process as the outcome of a clash—or a deal—among interest groups).

A key specificity of the recent literature is the understanding of the endogeneity of the political process in a situation of a dynamic political equilibrium. It has been pointed out (Krueger, 1993) that, on the one hand, market responses to economic policies affect the political equilibrium and can induce changes in policy; on the other hand, economic interests are often a function of past policies.

Another key notion in the literature is that of political constraints, which by and large determine the space of feasible reforms as well as the degrees of freedom of policy makers. Roland (1994, 2000) points to the need to distinguish between *ex ante* political constraints (political factors that may block the adoption of reforms) and *ex post* ones (possible reversals after the reforms are implemented and their outcomes are known).

Another important feature of these models is the focus on the re-distributional nature (related to costs and benefits) of most economic reforms which gives rise to 'winners' and 'losers' of the reforms (Fernandez and Rodrik, 1991).

Notably, theoretical models are often put forward with the benefit of hindsight. In reality, most transition reforms were performed as trial and error. The same applies to the related political process which at best was promoted by visionary politicians and at worst, was captured by interest groups (Hellman *et al.*, 2003).

We illustrate some of the above concepts and the dynamics of transformation reforms with the case of Bulgaria, one of the most intriguing cases of the political economy of the transition from plan to market.

The political economy of non-reform leading to crisis (1989–97)

The context

Several major factors shaped the course of reform policies in Bulgaria: the specificity of the context; the acute political constraints at the onset of transition; the controversial process of stakeholder formation; a peculiar institutional dynamics; inefficient external anchors.

The specificity of the context played an important, if not a dominating, role in the initial phases of Bulgaria's reforms. A multiplicity of contextual factors—such as the extremely difficult initial economic conditions compared to other former communist countries (Dobrinsky, 1997), specific cultural and historic legacies, unfavorable geography, low state capacity, etc.—entailed path dependence and *de facto* acted as deterrents to market reforms. Importantly, in the case of Bulgaria, the inherited large macroeconomic imbalances were coupled with a severe foreign debt problem which led to a default in 1990.

The start of transition was marked by a collapse of the previously existing institutional structures. The speed of institutional destruction in Bulgaria by far exceeded the speed of creating new institutions. Ironically, the attacks on the public institutions of the communist state often degenerated into an attack on the institutions of the state *per se*. This forced retreat by the state resulted in an 'institutional hiatus,' with severely negative consequences for the reform process (Kozul-Wright and Rayment, 1997). It bred perverse incentives at the micro level, giving rise to adverse side effects such as financial indiscipline, rent seeking, and corruption.

The first phase of transition was characterized by amorphous and unstable stakeholder groups as well as by frequent changes of government representing different sides of the political spectrum. The short planning horizon essentially pre-empted polices targeting the medium or long-term horizon as a rational choice for politicians.

External factors also strongly affected the dynamics of Bulgarian reforms. The only important external actor in this period was the IMF. But the IMF as an institution was unprepared for the unprecedented challenges of the transition from plan to market. Being dominated by the spirit of the 'Washington Consensus,' the first IMF-supported programmes put too much emphasis on neo-liberal macroeconomics and too little on the context and the institutional environment and structural issues (Rodrik, 1996). These policies did not enjoy sufficient support from the Bulgarian government bureaucracy and were largely mistrusted by the Bulgarian public (Minassian, 2001). Programmes largely missed their targets and goals and as a result none of the four consecutive funding agreements subject to IMF conditionality between 1991 and 1996 was brought to a successful end (Table 18.1).

Lasting political polarization pushed the reform agenda in different directions, with dismal outcomes. On the macroeconomic front little was done to address the underlying causes of macroeconomic instability. No significant structural and institutional reforms were initiated in this period. Little progress was made in privatization (Figure 18.1) and enterprise restructuring. Soft budget constraints took various forms (Schaffer, 1998) leading to an escalating bad loans problem (Dobrinsky, 1994; Dobrinsky *et al.*, 2001).

Delayed reforms as a rational choice

At the start of transition, Bulgaria was facing the combination of a complex reform agenda and an extremely painful adjustment effort, compounded by the default on the foreign debt. Political support for the needed reforms was weak, indeed absent, due to high uncertainty about their distributional outcomes. Different interest groups feared, and were unwilling to accept, a disproportionate share of the costs of reforms. The political incentives for reforms were further reduced by the short lifetime of governments. The needed adjustment effort was hardly marketable to an electoral constituency as it involved painful measures with uncertain outcomes in a highly polarized society with heterogeneous stakeholder groups. One of the main societal failures in this phase was the inability to establish a core agreement on a coherent reform programme addressing both the adjustment effort and the basic market reform agenda. In the technical sense this was equivalent to a co-ordination failure among stakeholders and politicians.

Table 18.1 The two periods in Bulgaria's transition

	Reform failure	*Reform success*	
	1990–1997	*1998–2003*	*2004–2008*
Real GDP growth, average annual rate, %	-4.5	4.4	6.5
Real gross fixed capital formation growth, average annual rate, %	-10.8	18.7	18.6
Growth of total employment, average annual rate, %	-3.7	0	3.2
Rate of registered unemployment, period average, %	13.3	15.5	9.1
Growth of industrial labour productivity, average annual rate, %	0	4.7	4.6
Consumer prices inflation, average annual rate, %	174.7	7.7	7.7
Growth of average real wages, average annual rate, %	-15.2	5.4	5.7
Average share of food expenditure in household budget expenditure, %	47	42	38
BNB basic interest rate, %	99.6	4.2	4
Average short-term commercial lending interest, %	130.4	11.8	9.4
Commercial rate on (one-month) time deposits, %	71.8	3.1	3.4
Consolidated government balance (deficit), % of GDP (period average)	-6.3	-0.5	2.7
Total public debt, % of GDP (period average)	139.8	70.4	24.7
FDI annual flow, % of GDP (period average)	1.3	5.6	19.6
Share of private sector in GDP, % (period average)	46	69	75
'Progress in transition', EBRD (period average score)	2	3	3.38
Memo: Best performing country 'Progress in transition' (period average score)	3.01	3.79	3.9
IMF funding agreements brought to a successful end (number)	0 (out of 4)	3 (out of 3)	–
Average term in office of governments (years)	<1	4 (as law)	4 (as law)

Source: Author's calculations on the basis of national statistics, EBRD Transition Reports.

The required reforms in this period can be broken down into two broad categories: macroeconomic stabilization and systemic reforms. Without looking into the aspect of sequencing, we try to interpret the rationale for delayed reforms in the context of some theoretical models.

One of the key related questions is why it took so long—compared to other countries with similar starting positions in the reform process—to introduce and sustain policies guaranteeing macroeconomic stability. The 'war of attrition' model suggested by Alesina and Drazen (1991) provides a rational explanation of delayed stabilizations in a similar macroeconomic setup. One of its results is that macroeconomic stabilization can be delayed because of significant distributional implications of the needed policy reform. In a heterogeneous society, when

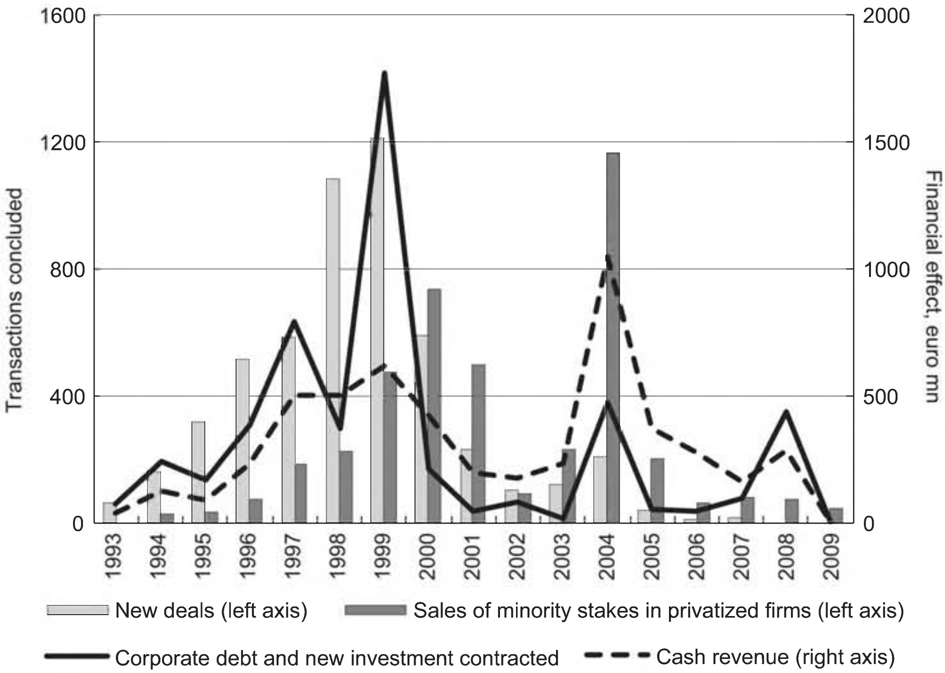

Figure 18.1 The process of commercial privatization in Bulgaria and its financial effect, 1993–2009
Source: Bulgarian Privatization Agency.

certain socio-economic groups may have to bear a disproportionate share of the reform burden, each group attempts to shift the burden of stabilization onto other groups ("war of attrition") and this delays the implementation of the reform.

As to systemic reforms, the prevailing socio-economic and political environment in Bulgaria in that period was consistent with the framework of the model of resistance to reform in the presence of individual uncertainty developed by Fernandez and Rodrik (1991). According to this model, some reforms that would have been popular *ex post* may not enjoy support *ex ante* depending on the uncertainties regarding the identities of the gainers and losers from the reforms.

In principle, the reform package facing Bulgaria's policymakers combined trade liberalization (as in the original Fernandez-Rodrik model) with enterprise restructuring and restructuring of foreign debt. All these policy measures were expected to affect post-reform relative prices and can thus be interpreted in the framework of the above model. The main theoretical outcome is that a situation when the individual gainers or losers of the reform cannot be clearly identified in advance is likely to be associated with the inability to form a voting majority in support of the needed reform. Hence, the likely policy outcome in this situation is preservation of the *status quo*.

While looking at the reform agenda from two different angles (that of their implied uncertainty and that of their distributional consequences) both models provide a rational interpretation of the reluctance of policy makers to go ahead with the needed reform agenda.

In fact, the socio-economic and political context in Bulgaria, the policy course, and the observed outcomes of (the lack of) reforms are also consistent with other models in this strand of the literature. Thus, Cukierman *et al.* (1992) derive the result that political polarization (very pronounced in Bulgaria in this phase) increases the probability of blocking the reforms. Similarly, Murphy and Sturzenegger (1996) arrive at the result that the more ideological the political parties are (another typical feature of the Bulgarian political system at the time), the more likely it is that reforms would be blocked (as indeed happened).

The outcomes

The uneven course and piecemeal nature of Bulgarian reforms in the early phases of transition is reflected in the country's dismal economic performance in this period (Table 18.1). Bulgaria experienced one of the worst transformational recessions in Eastern Europe. The first phase of transition was characterized by a chronic large fiscal deficit (Figure 18.2), persistently high inflation and very high unemployment. The toleration of non-payments among economic agents (an important institutional failure) instigated widespread financial indiscipline in the economy. Ultimately, the negative consequences of non-reform accumulated in the banking system in the form of an escalating stock of bad loans. The banking system itself was institutionally weak: bank supervision was poorly designed and not endowed with sufficient power to enforce prudential banking regulations and practices (OECD, 1997).

The situation with banks' portfolios rapidly deteriorated: at the end of 1995, some 75 per cent of the outstanding commercial bank loans were classified as sub-standard or non-performing. Public confidence in the banking system started to erode in late 1995. The panic gradually escalated with the subsequent closure of several banks and towards mid-1996 took the form of a full-scale run on the banking system. The collapse of the banking system provoked massive currency substitution and capital flight, exerting a strong downward pressure on the currency and causing a drain of official forex reserves. Money supply was out of control. Attempting to save the banking system, the central bank increased uncollateralized refinancing of the commercial banks. Finally, a special law was passed in December, obliging the central bank to

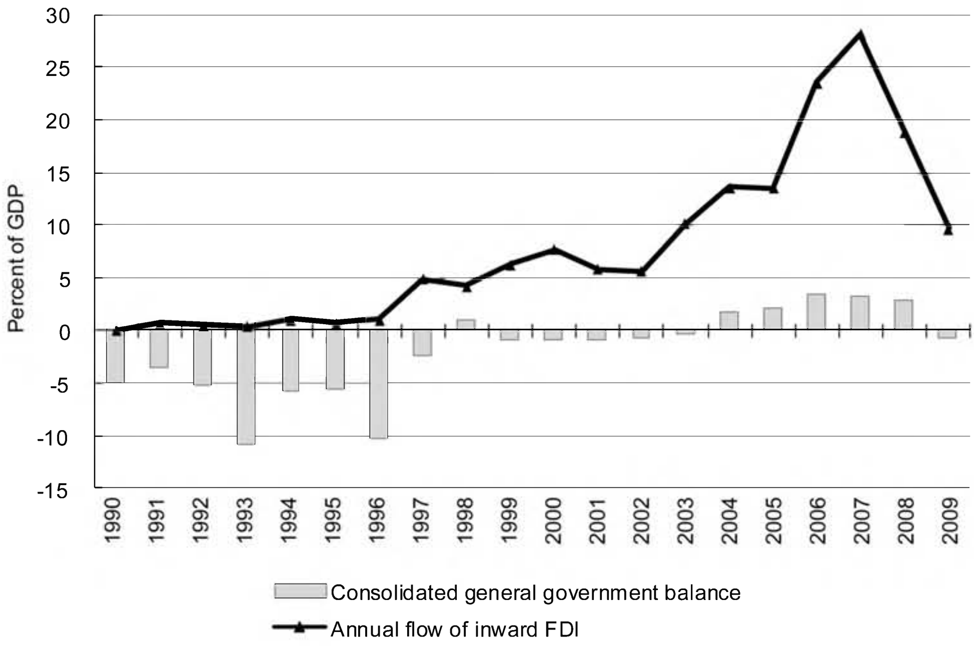

Figure 18.2 Fiscal deficit and inward FDI in Bulgaria, 1990–2009 (per cent of GDP)
Source: Author's calculations on the basis of national statistics.

extend a huge credit line to the budget (equivalent to 45 per cent of GDP in 1996). This enormous monetary injection spurred a hyperinflationary hike at the turn of 1996.

The chaos in the financial system, as well as in the economy as a whole, the eroding real incomes and the steadily deteriorating expectations triggered a plunge in economic activity: the cumulative GDP drop in 1996–97 amounted to some 15 percent. The crisis resulted in a significant loss of financial wealth for a great number of people and provoked mass street riots. In January 1997, the ruling government was forced to resign. A caretaker government took office to prepare early parliamentary elections, which were held in June 1997.

The political economy of successful reforms (1997–2007 and beyond)

The new context

The 1996–97 crisis was a dividing line in Bulgaria's reforms. It resulted in further impoverishment and deepening of the social stratification, and brought about widespread frustration with the policies pursued during the first phases of transition. The biggest losers were the low- and middle-income classes, those who had held assets and savings in domestic currency. By the time of the crisis and during its course, many of them lost a major share of what they had to lose, in terms of both wealth and jobs.

The general disillusion with the previous policy stance translated into broad public support for a radical change in the course of economic reforms. The reform drive was supported by a process of consolidation of stakeholder groups. During the course of transition, small entrepreneurs gradually emerged as one of the most influential stakeholder groups. Foreign investors and the emerging class of big domestic entrepreneurs and executives also gained in importance. Private entrepreneurs had a vested interest in a stable and predictable economic environment, transparent policy, and political stability.

Equally important, significant changes took place in the country's external environment. In the first place this was the IMF, which intervened during the crisis offering financial support, but under the conditions of a clear role in macroeconomic management. The other major external agent that entered into play was the EU. The actual turning point in the relations with the EU was the decision to start accession negotiations with Bulgaria in 1999. These important external signals provided a powerful support for those domestic political forces with a pro-market political orientation.

All these changes in the context amounted to a 'structural break' in the driving forces of Bulgarian reforms in the sense of a major change in the underlying structural relations that drove the reform process and determined its direction.

The political economy of policy change

The political economy of this second phase of transition can also be interpreted within the strand of literature on the positive economics of policy reform. The models of Drazen and Grilli (1993) and Drazen (1996) suggest rational choice theoretical arguments why major economic crises may serve as catalysts of reforms. They conclude that the welfare losses associated with crises mobilize societies to put in place measures that would otherwise be impossible to enact. In such a framework, if there is no consensus between interest groups over the reform path and the distribution of the costs and benefits associated with it (as was the case in Bulgaria), a crisis may be the only way to induce necessary policy changes. Put differently, in a situation of a crisis, the costs incurred by the population, including the interest groups most affected by reforms, become comparable to the costs of reforms and political support for reforms starts to grow. The Drazen and Grilli interpretation is fully consistent with the situation in Bulgaria at the peak of the financial crisis in 1996–97. It was the deep economic and financial crisis that finally motivated a political agreement on the future reform course.

Taking into consideration the endogeneity of the policy process in a situation of a dynamic political equilibrium (Krueger, 1993) adds another nuance. As noted above, in such a framework, both policies and the political equilibrium (support of or resistance to policies) can change endogenously over time. In the case of Bulgaria, the attitude of the main interest groups, including those that resisted reforms most fiercely in the first phases of transition, were rapidly changing during the crisis as they were beginning to realize that past policies of non-reform were leading to a catastrophe. This was equivalent to a major shift in the political equilibrium in the country towards reform-oriented policies.

And finally, one cannot ignore the importance of the external agents in legitimizing the change in policy direction and in providing an anchor to local reform-minded politicians after 1997. The IMF had a prominent role in instituting policies of fiscal restraint under extremely harsh economic conditions, which has been the key factor of macroeconomic stability after 1997. In turn, the realistic prospects for EU membership (regarded by local politicians as an impending reward for policy success) and the disciplining role of accession negotiations have been a crucial vehicle for pushing through a broad institutional, legislative and regulatory reform agenda. It would be fair to say that the risks of abandoning the reform course and slipping back into policy havoc would have been much greater in the absence of these strong external anchors.

The outcomes

The key component and instrument of the policy approach towards macroeconomic stabilization in Bulgaria was a currency board arrangement (CBA) which started operation in July 1997 with the nominal exchange rate fixed against the Deutsche mark (subsequently to the euro). Under this arrangement, there was no room for sovereign monetary policy: the central bank was banned from open market operations and refinancing of commercial banks.

Under the CBA the instruments of fiscal policy, in principle, remained available to policy makers; however, in practice, the degrees of fiscal policy freedom were limited by long-term fiscal sustainability concerns (Dobrinsky, 2001). Indeed, Bulgaria's fiscal policy under the CBA was set up under a medium-term fiscal framework that would guarantee fiscal sustainability (Horvath and Székely, 2003). This framework was a major technical innovation in Eastern Europe and its implementation proved a success.

A major focus of the accompanying reforms was placed on institutional strengthening. New technical criteria regulating risky exposure of commercial banks and very tight capital adequacy requirements as well as stringent requirements on bank reporting to the supervision authority were put in place.

During the years that followed, a number of important structural reforms were also given a start. These included a tax reform whose main direction was towards lowering the tax burden as well as reforms of the pension and health care systems; other components of the social security system were also reorganized.

Privatization was finally given a solid start. Sales to strategic foreign investors were declared as high priority targets and this period saw several landmark sales of large SOEs. The years between 1997 and 1999 were the period of most intensive ownership transfer combining commercial privatization (Figure 18.1) and several waves of mass privatization that mostly involved small and medium-sized SOEs (Miller, 2011; Miller and Petranov, 2000). Bank privatization was also assigned high priority and by 2004 all state-owned banks had been privatized to strategic foreign investors.

The process of accession negotiations with the EU which started in 1999 played a very important role in speeding up market reforms, especially in their institutional aspect. This preparation of EU accession involved negotiations on the 30 'chapters' which make up the EU's *acquis communautaire*. EU accession implied a considerable widening and deepening of the reform process with the goal, within a relatively short historic time span, to upgrade market institutions to a status typical of a mature market economy.

In the period after 1997, Bulgaria's macroeconomic performance improved considerably, especially when compared to the preceding period (Table 18.1). The major improvements in the fiscal system brought about a remarkable consolidation in public finances (Figure 18.2) and a sharp fall of public debt as a proportion of GDP. Macroeconomic stabilization was finally achieved. The initial stagnation that accompanied enterprise restructuring was followed by years of strong growth.

The fast reform progress in these years is also evidenced by EBRD's assessment of 'progress in transition' (Table 18.1). In these assessments Bulgaria moved from being one of the laggards in reforms before 1997, to one of the more advanced reformers in the period thereafter. Another sign of positive change has been the surge in the flow of inward FDI after 1997, in contrast to the anemic inflows prior to that (Table 18.1 and Figure 18.2). Foreign investors 'vote with their feet' and this change was a clear indication of the improvement in the investment climate and the business environment in general.

Concluding remarks

Bulgaria's experience in economic and political transformation is one of failure and success: a first phase characterized by a series of failures and relatively successful reforms in later stages. Political economy factors played a key role in the dynamics and outcomes in both phases of Bulgaria's transition. Moreover, Bulgaria's experience in both phases is consistent with the theoretical predictions of a number of models of the political economy of economic reforms.

A variety of intertwined factors and developments (from context, to institutions, to design, to political constraints, to implementation) undermined Bulgaria's first reform efforts. This experience confirms that disregarding or underestimating the importance of any of these components can drive a reform effort to failure. From a political economy point of view reform failure in this period highlights the role of uncertainty about the outcomes of reforms and their distributional implications. Such an analytical insight helps to understand better why policies that worked in other transition economies turned out to be unsuccessful (or non-starters) in Bulgaria: while a number of countries attempted similar reform programmes at the start of transition, the outcomes were very different due to a different context and/or country-specific structural and institutional characteristics.

The reform programme in the second phase of transition owes much of its success to the fact that it addressed some of the institutional failures of the first phase of transition: both institutional strengthening and improving governance were important factors for the acceleration of the ongoing structural reforms. From a political economy point of view reform success in this period underscores the role of a major crisis as a catalyst of reforms. Bulgaria's experience in the second phase also suggests that in a situation of amorphous and unstable stakeholder groups external anchors can substitute as a co-ordinating factor in the design of reform policies.

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