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FOREWORD BY THE EDITOR

This edition is a collection of article from very different areas of economics and economic policies, and also some of them reflect of different periods of recent and contemporary policy making.

Bertrand Lemennicier's article first appeared more than ten years ago and was updated and edited for this publication two years ago but goes now into print just in the week when the 1987 Intermediate-Range Nuclear Forces Treaty between USA and USSR is put on hold, a treaty that had an end to the cold war. Professor Lemennicier helps us understand the economics of nuclear weapon controls and agreements, and one can find in his paper an explanation of the challenges such agreements face and are doomed to face.

Dr. Tatala's interview, which first appeared in the Capital Weekly some six months ago in Bulgarian, explains not only 30 years of Poland's success in reforms from central planning to market economy but makes a review of the challenges his country is now facing in the area of the rule of law, challenges that emerged in the last two-three years to almost everybody's surprise.

Ruta Vainiene, Professor Hanke and Dr. Ganev's article deal as if with different areas of monetary and fiscal policies, respectively – Lithuania's entry into the Eurozone, the success of Bulgaria's currency board arrangement (CBA, while the country is currently aspiring to join the Euro) and the fiscal stimuli during economic recession in Bulgaria that happened about ten years ago. In fact, however, these three authors discuss the impacts and (especially fiscal) risks of the strict rule-based monetary policy such as CBA in the transition to other type of rule-based monetary policies, the ones of the European Central Bank. These three papers demonstrate how up to date is the research outline of Professor Tanev into the "political economy of the currency boards". (Professor Tanev is current and Fulbright Scholar with Professor Hanke.)

This volume starts with a Gia Jandieri's review of the Georgia's most radical reconstruction during the period from 2004 to 2012, a prompt and that far-reaching reform that event Poland cannot match. This review, not surprisingly, is a dialogue with above four articles because it demonstrate how important is the overall philosophy and general framework of economic policies that are likely to ensure both prosperity and rule of law.

The discussion of the possible developments of a very specific fiscal policy of food-vouchers in Bulgaria by Panchev, Sharkov and Stanchev gives an example of how obvious to economist beneficial and Parretto-optimal policies fail to make its way into real life for more than a decay.

In 2019 we plan to publish a series reports and articles, both in Bulgarian and English, on the 30-year anniversary of the collapse of central planning and the Berlin Wall in a special rubric: 30 Years of Reforms. Some of the material will be selected from 11-12 of April Conference on 30 Years of Public Governance Political Reforms in Central and Eastern Europe: The Next Horizon, the call for papers for which is open at: Conference information on: <http://phls.uni-sofia.bg/article/details/114#tab2840>. In this volume we reprint a brief reflection of Crackdown of the Prague Spring, the invasion of Czechoslovakia by the Warsaw Pact in 1968 – an act that has become one of the key motivator of the opposition to Communism across what is now New Europe.

Dr. Kuzyakiv's, of the Institute for Economic Research and Policy Coordination in Kyiv, paper gives us an opportunity to take a look at the reforms in a country like Ukraine, from the perspective of an empirical test of allegations of corruption, an allegation that most often hampers the country's image.

A great ex-Yugoslav, Serbian economist, social philosopher and a friend, Professor Miroslav Prokopijevic, passed away unexpectedly in January this year. We republish here, In Memoriam, his path-breaking 2007 analysis on Why Foreign Aid Fails.

This volume would not have been possible without the commitment of the authors and the members of the Advisory Board, and without the hard work of Dr. Simeon Petrov who helped me editing it and who coordinates the entire work on the Journal.

I am sure our readers and students will find the individual papers interesting and useful for further research and deliberation of economic policies.

Krassen Stanchev, Responsible editor

ECONOMY, POLITICS, POLICY

GEORGIA – FREE MARKET IDEOLOGY OR PRAGMATISM

Gia Jandieri¹

Abstract

Georgia attempted the most radical reconstruction during the period from 2004 to 2012. There were made several pragmatic economic decisions together with implementing of state assistance programs for the most vulnerable. The assistance and subsidies had increased together with improvement of the economic performance and raise of state budgetary revenues but also strongest push of populist agenda by political rivals of the government.

Economic performance of Georgia in the period was remarkable. The country improved its macroeconomic and business conditions by major reforming of business climate and economic freedom. The Economic Liberty Act of 2011 was a major step for guarantying and stabilizing of this environment but the simultaneous introduction of some interventionist measures made initiated and supported by internal and foreign stakeholders limited the ability of the economy to grow faster resulted in losing of popularity and inviting to the political agenda leftist players.

Majority of the politicians who supported the radical reforms in the middle of 2000s found themselves in a trap of promises abandoning little-by-little small government agenda - to have chances to keep the support they had. For them so-called libertarian fashion lost its attractiveness and resulted in the shift towards left. They found a new pragmatic vision based on the belief that maybe more economic freedoms are good for business but this does not give immediate relief to poor who expect more responsibilities of the government for their living conditions.

This paper is an attempt to analyze if the policy of economic freedom was maintained in its full range in Georgia and to show that more economic freedom is the only pragmatic way to improve economic conditions in the long-run.

The Past

Current economic performance of Georgia is tied to its past – to the major tendencies in its development in the periods before Russian annexation of the country, during Russian Empire period of from early 19th century to the beginning of 20th, Soviet and post-soviet periods.

The period before 19th century has to be divided into two parts of progress before Mongol invasions in 13th century and decline after it. The first period is illustrated in development of architecture, poetry, science, government institutions etc; Georgia is proud of constructed that time church buildings and philosophy. All this needed of course good economic background which was based mostly on trade as the country was located at the crossroads of west to east and north to south.

¹ Gia Jandieri is the founder and vice president of the New Economic School of Georgia in Tbilisi, Georgia. Mr. Jandieri is one of the most prominent Georgian economists and commentators who took part in the design, advocated and promoted the country's remarkably successful economic reform after 2004. The New Economic School is a combination of an economic school and a think tank that was instrumental in educating about 15 thousand young Georgian, Armenian and Azeri student in the principles of sound economics, economic policies and the basics of public choice theory.

The period started from 13th century can be characterized as permanent wars and invasions. Started with Mongols and continued by Ottoman and Persian, ended by annexation by Russian Empire; most important impact could have fall of Constantinople in 15th century which meant earthquake kind of shake of the economic and political system of the region, losing of the major strategic partner and military ally, the intellectual, cultural and religious leader and center, resulting in a major philosophical shift.

In 19th and 20th centuries Georgia was a peripheral region of Russian Empire and then Soviet one. Russian/and soviet governments made all possible to eliminate any kind of economic autonomies, despite of promises to keep them. For instance, both in the beginning of first decades of life in the Russian Empire and then in the first decade of Soviet Union, Georgia kept right of issuing and using in circulation of Georgian coins and banknotes but then they were abolished.

Pure colonial direction of policies and rules made Georgian economy (sectors, investments, supply and trade) serving strictly interests of the metropolis; moreover, Soviet Union shut opportunities international trade to Georgian producers. No direct trade was possible with foreigners and few indirect ties developed via Moscow – center. All postal or transportation services were available strictly through Moscow or by its authorization. This developed a strong dependence on the central bureaucracy, abuse of power by it, super-regulation of the economic activities, parasitical behavior and relationship between the center and the periphery.

This tendency was strengthened by soviet authorities because of their strong will to keep the political unity of the country. Georgia was among those Southern republics of the SU which, distanced from the entire world and international trade was forcefully integrated in the complete bureaucratized, centralized and protectionist economic system without private property.

Soviet Period

Economy of the Soviet Union was centrally planned one. What this meant to Georgia was that central authorities needed to plan all the production and consumption, decide what was necessary to produce and where, by whom and where to be consumed, or use for future production goods.

By the idea economy of the SU was centralized to maintain full control of the economic process and try to use resources most effective ways. The central authorities were given power to distribute and redistribute resources, maintain prices, overprice one sector of the economy at the expense of underpricing of other, subsidizing production, groups and even territories, republics of the SU.

The monetary system was a part of centralized decision-making, which in fact (among the other functions) was another instrument of subsidizing of poor performing parts of the nation by better performing and wealth of natural resources.

It is uneasy to guess what would be the real quality of economic performance of different parts of the SU in the situation of market prices, if they would need any subsidies. Clear is one that central government first forced peoples (factories, agrarian production, cities, republics etc), to follow its own pricing decisions, then it was itself obliged supporting some of them who failing; then, even maybe understanding negative consequences of subsidizing, kept the system for political reasons only. Most of the agriculture goods were under-priced in exchange of overpricing of the industrial and consumption goods (like cars, TVs, etc).

Economic activities were corrupted and parasitized, resources wasted, institutes disorganized and people de-motivated. Corruption was widespread and reached greatest scales, criminalization of economic activities rose simultaneously with deficits of consumer goods, starvation and poverty.

Georgia was one of the strong evidence of wrong economic system and incorrect policies. This applies to the centralized and *one size fits all*, collectivist policies against powerful individualistic nature of Georgians. In many cases they looked for private opportunities, even illegal ones, or, in

others, they instead parasitized on collectivist institutions, using common resources, receiving easier funds from Moscow authorities in exchange of bribes.

Moscow authorities heavily subsidized soviet Georgia, even well understanding of parasitizing character of this action but thinking this would strengthen uniting attitudes (in fact parasitizing) and calm down separatism. Subsidies were available for the government and industrial factories, agrarian sector (though buying lower quality production) and also culture sector.

Soviet Georgia counted around 900 industrial manufacturing companies, fabrics and factories, around 10 of them with more than 5 thousands of employees. The quality of their production was so low that in many cases buyers (obliged by the authorities) were trying to reject accepting them. Simultaneously, running for plan results Georgian authorities made possible to falsify statistics permanently and pushed falsified ways of fulfilling of the plan. This kinds of policy made further harm to the quality of goods; this tendency was also very much strengthened by lack of international trade – no direct import or export of goods was possible even from the SU's satellite countries in Eastern Europe. Consequently, quality of Georgian labor corresponded to the low quality of goods and services, despite of high level of literacy.

Very important is to mention also what real values represented by the soviet companies: these were mostly land and other real estate assets but for sure some qualifications of labor which could be still above the level of developing nations.

This was the environment in which Georgia met new life of independence.

Post-soviet time

Georgian economy made a major collapse in the first few months and years of independence. The major reasons of the crash were closed economy, with no trade ties and low quality of goods made impossible to find chances for exporting goods, to keep industries to work but also to import essential consumer goods and food. For long months Georgia faced total deficit of automobile fuel. Remaining working companies were busy mostly with selling of scrap metal which staid a major export commodity for more than a decade.

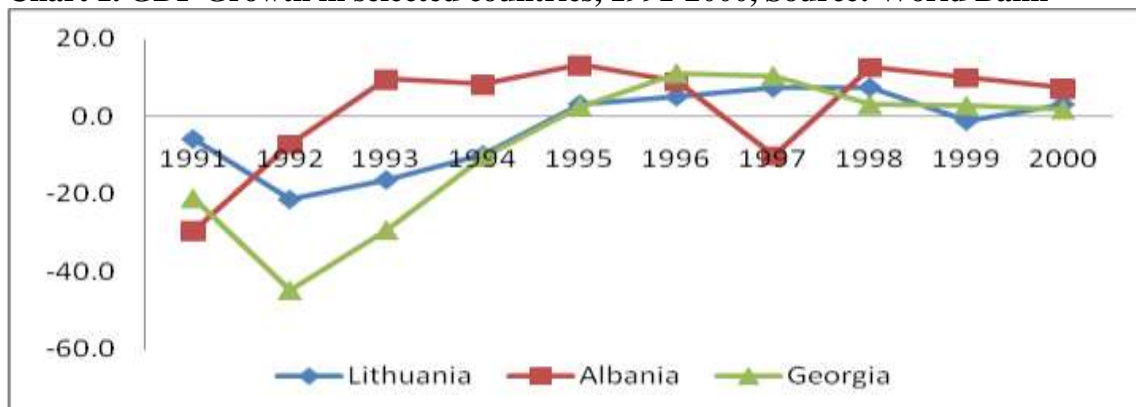
Very first year of independence was quite controversial. In parallel with very promising attempt of highest autonomy from already collapsing soviet economy, new Georgian government of the first president Gamsakhurdia made several crucial mistakes (for instance making barriers for trade with Russia and ordering price ceilings for food), which damaged first commercial attitudes for next long years.

Later, from 1993, electricity and natural gas blockade stopped operations of all remaining working industrial companies (except of those which were owned by Russian energy companies). People faced very tough winters, shortages of electricity and major food supply which lasted next several years.

First State Budget for Georgia after the collapse of the SU was only adopted in 1995 and it was less than 1/50 of the current budget arrangement.

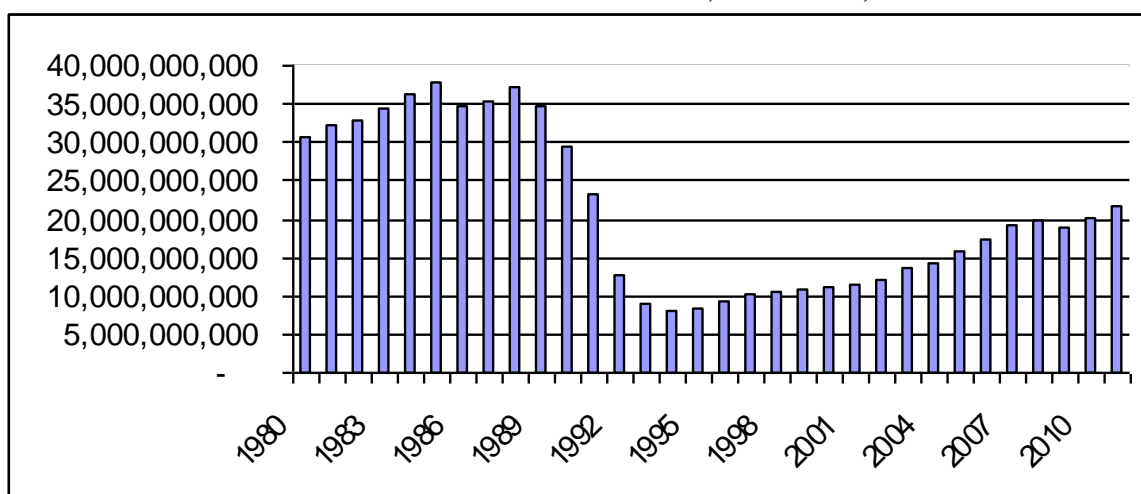
Independent Georgian economy suffered one of the worst among the ex-communist nations. In the middle of 1990s its GDP fell under 30% of the levels of 1980s and never had recovered back. The next graph illustrates the economic trends in three different nations.

Chart 1. GDP Growth in selected countries, 1991-2000, Source: World Bank²



Another chart shows well the deep failure of the Georgian economy after losing guaranteed soviet market.

Chart 2. GDP in constant 2005 International dollars, 1980-2011, source: World Bank³



Monetary System:

Monetary policy of first years of ex-soviet Georgia was a story of lack of experience combined with abuse of power and incompetence. In 1993 Russian Federation Central Bank decided to stop supplying Georgia with Russian rouble. In April of 1993 Georgian newborn Central Bank issued coupons to circulate in parallel of still remaining in the country roubles. This attempt was mostly connected with two major goals:

- a. create first state budget and
- b. start collecting taxes using local currency.

Unfortunately this attempt could have some other reasons which were backed by some interest groups for first increase artificially debts of public companies but also decreasing of real value of the assets for future privatization. This made acceptable inflating the Coupon t the levels of hyperinflation from initial rate of USD1=500 to USD1=1,000,000 coupons.

² <http://data.worldbank.org/>

³ <http://data.worldbank.org/>

In 1995 Georgia adopted new laws on National Bank and National Currency – Lari, from the position of USD1=GEL1.3. Since that time Georgia's monetary policy went through several inflation and deflation periods, with flexible, pegged and inflation targeting experiments, which made their serious impact on the development.

Fiscal and Tax Policy:

First tax laws in Georgia were adopted in 1994 in substitute of the soviet tax code which itself was implemented at the end of the SU. VAT was first implemented instead of sales tax among the other taxes on incomes, properties and consumption.

Georgian Parliament adopted state budget in 1995 in effort to cover some of the most important tasks (for instance elections) and expenditures (renovation of parliament building after it was destroyed by the civil war in 1991-1992).

The budgetary revenues collection started improving during the next years but hindered by Asian/Russian financial crisis in 1998. By that time collection of taxes reached the level USD400-500m (from almost zero in 1994) but the expenditures also increased the same speed due to implementation of several government functions and institutions.

Georgia was one of the ex-soviet nations which implemented so-called *Tax Code of the Republic of Taxastan*⁴, recommended by the IMF to these nations. Since 1998, local interest groups, politicians and other lobbyists organized a great press on the government and tax code was more than 100 times amended with more than 2000 minor and major changes. Every somehow powerful business was pushing its own privileges and relieves; having more than 20 kinds of taxes, most of them were using several different rates for different businesses and sectors of economy. From 1998 Georgia adopted a law freeing a farmer from taxation if the land parcel was less than one hectare. This decision made a very wrong impact on the agrarian sector.

This environment made business very unstable, impossible to fulfill obligations and rules, impossible to organize collection work. It created an informal relationship between taxpayers and authorities, paying taxes not by formal rules but by agreements making business illegal, tax collection based on bribery, lie and hiding of taxable operations.

In 2002, government, in cooperation with private experts attempted a major exercise to adopt new tax code but neither administration nor the business was ready for such a big change. This was just too late - there was a need of full shake of entire political system.

Government revenue collection declined after 1998 crisis then almost restored to the level of 1997 only in 2003. Between these years Georgia's government was sometimes unable to adopt state budget law for the year for long months, ministries and departments had huge arrears of salaries (especially to school teachers, pensioners) and liabilities to suppliers of electricity and office supplies.

The tax system contained several mistakes and loopholes, useful for powerful groups but dangerous for smaller companies. With the choice of paying up to 40% of taxes on labor most of the employees instead were hiding real volumes of salaries, but frequently paying dividends instead salaries to employees. Falsification of VAT documents was one of the ways to keep alive in the market. Meanwhile this system adapted only very risky or connected with the powerful politicians business; others tried to be distanced from the in-advance-criminal activities, the total number of registered companies was around 50,000 but only around 1/5 of this number companies were operational.

Dissolution of Soviet Union (Georgia lost its share in the Soviet pension fund) and crash of economic activities in Georgia, particularly, inability of tax collection, total unemployment created a long-run stoppage of contributions to social, health and pension funds. Restoration of the tax/social contribution collection was only possible in the second part of 1990s but in very

⁴ <http://www.imf.org/external/np/leg/tlaw/2000/eng/stan.htm>

limited frames. Economy was still very weak and heavy taxation made most of existing private employment hidden – major part of the contributions to the social funds were coming from public institutions, or returning amounts paid by the state budget.

This period, was characterized with total collapse of health care services – privatization of medical institutions was slow due to ongoing speculations. The pensions were flat (with some exceptions for military and police ex-officers) but never exceeded USD15 per person per month. State social funds became another big corruption sphere. Despite of very small pensions and all efforts to collect taxes funds accumulated huge arrears to pensioners, sometimes reaching several months and years.

Privatization and industrial structure

First minor privatization attempts in ex-soviet Georgia were made already in the period of still alive SU, in 1991. The major success of privatization before 2004 was connected to the voucher method which woken up entrepreneurial mood among Georgians despite of rather. The major big factories stayed in state ownership mainly because of soviet type patriotic political campaigns serving the interests of the former administration leaders of those companies – the red directors. The only exception was privatization of electricity distribution company of the capital Tbilisi which suffered from shortages for long periods.

Red directors, those who participated in soviet centrally organized economy, using their powers to make money from by any possible illegal way now became organizers of strikes and manifestations in defense of their dear factories – the nation's dignity. In fact, with this way they continued use of assets, in many cases just selling them as scrap, accumulating debts at the expense of the state and avoiding paying taxes. Simultaneously, government implemented negative to liquidation bankruptcy law mainly to support dying state owned factories only for the benefits of the general managers who continuously speculated at the expense of poor employers. This had also negative impact on visions of Georgians towards entrepreneurship – for them businessman was a synonym of a thief, a liar and a falsifier.

Adoption in 1994 Law on Entrepreneurs and the Civil Code gave a strong push to entrepreneurship, but state remained the major owner of assets, including of the land. Land privatization started in early 1990s but first real effort was possible only with adopting new legislation on land ownership. Government granted small parcels of land to the farmers issuing to them registration papers but those parcels remained without surveys which remained a major problem for best use of the resource. Land ownership was limited to Georgian citizens although possible for foreign companies. But privatization was very slow due to very bureaucratized and corrupted practices. This limited very much economic progress and chances for private entrepreneurship.

Regulations

Georgia of 1990s and beginning of 2000s became heavily regulated economy. First and second parliaments after adopting in 1995 new constitution made a great effort to create legislation counting totally of 900 laws and administrative acts by the executive branch. This first of all increased number of public offices and officers, especially of inspections and inspectors, all to have their strong mandate to check if all the rules, licenses and permits were used by businesses correctly, in fact collecting small to large sums as bribes. Regulatory legislation, backed by several small interest groups, made easy selection of those businesses who were ready pay bribes in exchange of getting licenses but simultaneously limiting others. Very uneasy was for instance to receive permission for constructing of new buildings, for which a company would need several permits but also bribing certain authorities of different levels – in fact impossible and/or very costly. A small business could have several different guests from different inspections sometimes for just collecting bribes – contributions for not auditing them.

Other problem of the implemented regulations was that they were adopted in a hurry to satisfy demands and recommendations of several international donors and advisers, sometimes just translated from mainly German or other EU nations. With this Georgian government tried to harmonize its legislation as close as possible to the EU without looking in its own institutional and human capacities, experience of using the democratic governance tools, responsible individuals. This created a huge opportunities of abuse and corruption but also heavy burden on the economy and business. Complicated regulations and totally corrupted bureaucracy became strong barriers to business.

Some other Challenges:

Property: Ethics and Protection

Private property had been recognized by constitution but lack of experience and wrong experience of soviet past created new atmosphere where everything was allowed in parallel of lack of responsible and ethical behavior. In combination of very corrupted state institutions and especially judiciary, this made impossible of protect private property from fraud and contracts from breaching.

Government was very weak to protect individuals from robbery and stealing, moreover, criminal gangs had more power than police; they controlled smaller criminals and had very strong ties with several politicians. In many occasions police itself was acting like a criminal – robbing the small businesses, mostly during their delivery and transportation activities.

Police was one of the most corrupted institutions together with customs and some inspection services at the border. Procedure of crossing of the border for importers especially was a nightmare and impossible without direct bribery of the officers. Any effort to avoid bribe payment would cost into long delays of customs procedures, losing of market competitiveness – in comparison to those who just bribed and paid much smaller amounts as taxes, or just smuggled their goods through borders.

Apart to corruption schemes of appointment of servicemen of police, customs and tax departments (similarly to all public institutions) were paid very low salaries from 20 to 30 US dollars. This made the system working mostly for self-sustainable goals and serving the interests of powerful political groups.

In fact, several years after gaining of independence, “best” businesses in Georgia were fraud, robbery and breaching of contracts.

Advantages and Disadvantages, Regional, Political, Geo-political, etc

First separatist movement in Georgian regions of Abkhazia and S. Ossetia were organized already in the beginning of its independence. Not to fall in a discussion what and how happened, it is still very important to say that this confrontation has been only useful to Russian authorities and none of the sides gained anything from the conflict. But problem has remained and its impact on the Georgian economy is countless.

Other real influence on the economic situation in Georgia and the region has made a conflict between Georgia’s direct neighbors Azerbaijan and Armenia. This made impossible to cooperate especially in the toughest period of 1990s, trade and exchange was very limited – everybody lived for own-survival.

Fragility of the economic environment was also several times increased by bigger conflicts in the region, directly neighboring – like Chechnya, or distanced like Iraq. All the counted and other threats to peace contributed to a pessimism of investors.

In late 1990s Azerbaijan decided to change its oil industry policy, inviting western companies to develop but also cooperate with Georgia and Turkey on construction of two major pipelines to pump oil and natural gas to Europe. This revived global political interest to the region in the beginning of 2000s.

Labor quality:

As it was mentioned above the quality of labor in Georgia was not very competitive. It was somehow better in comparison to developing nations but looked less professional in comparison with developed nations but disoriented from global markets. Collapse of the SU and post soviet crash of the economy stopped operations of the factories, agriculture and services; this meant a long period of mass unemployment, further degradation of labor quality, no local competition, no attempts to improve skills in the times when the world continued improving, especially in the emerging markets. This made Georgians even less competitive and losing of even comparative advantage increasing importance of intensification of competition for rapid improvement of labor skills, quality and culture.

Inherited from the SU labor legislation was formally to put severe regulations to restrict employers but they almost never had any impact on the labor relations in Georgia. Even though together with heavy tax burden on labor they hindered competition and distanced potential investors for whom quality of labor in Georgia was a kind of big secret, hidden in soviet university diplomas and scientific degrees.

Another big problem with the labor market for Georgia was immigration of at least one 1/5 of population, maybe most active and skillful workers who found their business or employment opportunities up to as far as the US, living and working there mostly illegally. They worked hard in their new places sending money to support their family members back in Georgia, contributing to Georgia's economy sometimes up to 10 per cent of GDP.

Energy Supply

Georgia during SU was fully dependent on the soviet system then inherited by Russian Federation. This made not only very powerful the system itself but also possibility of Russian authorities to use energy supply system as a weapon for punishing rebelling neighbors. Shortages of electricity supply in winter lasted up to 2005, before it was possible to restore ordinary commercial relations in the sector instead of much politicized one. But shortages of 1990s after long decades of permanent supply during soviets brought a total shock and pessimism in Georgian cities but especially countryside where electricity was already a surprise.

Energy sector control was monopolized either by politicians or criminals who had direct corruption based ties to the suppliers in Russia. Attempt of the US owner of Tbilisi distribution company – AES, to arrange best commercial relations was also unsuccessful due to political trap they got in. Natural gas supply in Georgia was totally monopolized by Russian companies Gazprom and Itera. They dictated their policies, prices and rules but despite of this, corrupted nature of this trade made impossible provision of natural gas enough for Tbilisi until 1999 and to other places in the country even up to 2004.

International Assistance

International assistance started to come to Georgia immediately after its formal recognition by UN and world nations. Volumes of financial aid and loans increased especially during financial crisis of the end of 1990s. Assistance money corrupted and parasitized further government leaders. Trapped with hopes to receive as much assistance as possible they had forgotten about real life and need for improvement of business climate. Georgia's public debt reached 45-50% of GDP.

In many cases reports showed a total abuse and wasteful spending of the financial assistance and loans. Foreign experts, following to the aid resources frequently advocated policies which created further misuse of the resources, in many occasions granted finances were used for hiring individual or group advisors from abroad whose advices were just to increase public spending and regulatory burdens on businesses.

The IMF and World Bank, together with other donors made an effort to create anti-corruption and poverty reduction programs for the government. Georgian agreed with donors a reducing poverty with economic growth direction but implementation of this way was already late and rather impossible.

Short Conclusion

Post-soviet economy in Georgia was a total chaos, corruption, waste of time and resources, incompetence and inability to arranging of business friendly institutional framework. Economy was growing slowly despite of huge barriers created by government. Georgia was fluctuating in between of 90th and 102nd places in the Index of Economic Freedom of the Heritage Foundation, held lower than 130th position in Transparency International Corruption Perception Index and among autocratic nations in the Freedom House surveys.

At the end of 2003 people were very exhausted with corruption, poverty and stagnation, demanded a major change which then converted into the Revolution of Roses a great hope.

After the Revolution of Roses

Revolution of Roses – public peaceful revolt against falsified results of the elections in November 2003 brought a new reality to Georgia. Power was taken in its hands by young politicians in effort to modernize the country, finish with corruption, abuse of power and improve economic conditions of life for people.

From the very beginning of revolutionary era government has very unclear understanding and visions what was needed to restart economy. Most of the efforts were directed towards fighting corrupted officials, illegally or wrongly privatized assets and other violations of legislation. Only from the summer of 2004 the government announced about some of the new ideas to decrease of tax and regulatory burden, reform totally the police and other enforcement agencies, improve the quality of judiciary and public institutions.

Reforms of 2004-2012. The core foundations for the reform which sometimes were called Singaporisation⁵ - were De-bureaucratization, Liberalization and Privatization, that meant:

- Decreasing of taxes and government size
- High speed of Privatization
- Deregulation of economic activities
- Anti-corruption measures
- Decriminalization measures
- Openness

Tax reform

As it was mentioned above the tax system in Georgia before the Revolution of Roses was both disorganized and bureaucratized. The tax audits were organized by five different offices, some of the independent from the Revenue Service office (Social Taxes) and even from the Ministry of Finance (Road Tax). Therefore, a taxpayer could have been attacked by any of these offices (including VAT, Excise and Big Taxpayers Divisions). One of the main tasks government announced in 2004 was to allow only one institution to have inspection/auditing,

This kind of change first of all needed to reorganize the tax code and the revenue service itself. After long-run discussions it was decided to eliminate all secondary and special taxes (except social tax which was abolished later in 2007).

One of the directions of Tax Reform was decrease of rates for all remaining taxes after. Some of the rates decreased gradually and some had decreased in one step:

1. Personal Income tax decreased from 20% top rate to flat 12%, from 2005

⁵ For instance: Thomas de Waal in his *Georgia's Choices* actively advocated for Georgia to take Europeanization instead of looking for making Georgia another Singapore.

2. Social Tax from 31% - to 20%, from 2005
3. VAT from 20% to 18% later, in the second part of 2005
4. Corporation/profit Tax from 20% to 15%, 2005
5. Dividend and Interest Tax (part of the Personal Income Tax) from 10% to 5%
6. Social Tax merged into Personal Income Tax, in 2007 with rate of 25%, which decreased to 20% (flat) from 2008, becoming on of the first nations abolished social/wages taxes, meaning stoppage of social contributions and government liabilities to population.

Total number of taxes in 6, including of Import Tax

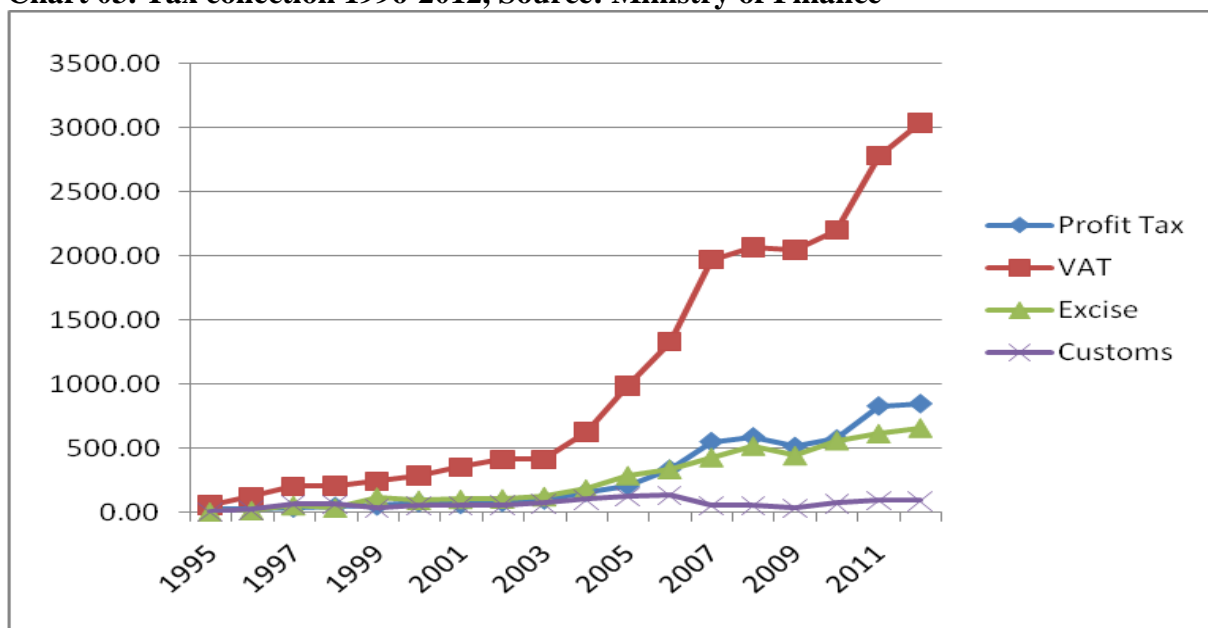
It would be uneasy to calculate what impact made the Tax Reform on the economy because of several other factors – reforms in many other spheres. But indirect positive impact can be observed in the dynamics of tax revenue growth:

“The growth in nominal tax collection between 2003 and 2011 was remarkable across all taxes, with the largest increases in the profit tax (up by a factor of six), VAT and excise tax (up by a factor of more than five), and income and property tax (up by a factor of three). This expansion of the tax base was particularly striking given the sharp reduction in tax rates.”

(Fighting Corruption in Public Services, Chronicling Georgia’s Reform, WB, 2012)

The first chart below demonstrates absolute positive trend of tax collections – a supply-side effect of the tax reduction (please note: customs tax rates have been radically reduced in 2007).

Chart 03. Tax collection 1996-2012, Source: Ministry of Finance



Very impressive was the reform of customs. First of all, simplified customs procedures are allowing importers to cross the border in few hours. But most effective news was elimination of customs duties to most of the imported goods from 2007 and decreasing the top rates of up to 32 % down to 12%. Here is the table to visualize Georgia’s trade policy openness in comparison to other nations in transition and the EU average:

Chart 04. Border Protection in the EU and partner nations 2009 (Source: An Appraisal of the EU's Trade Policy Towards Its Eastern Neighbors: The Case of Georgia (Groupe D'Economie Mondiale, Sciences Po, Center for European Policy Studies, 2011)

	Applied tariffs (%)		
	All goods	Agriculture	Industry
European Union	5.9 ^a	13.5 ^a	4.6
Countries under accession negotiations			
Croatia	4.9	10.7	4.0
Turkey	9.7	42.9	4.8
Macedonia	7.3	13.4	6.4
Countries with signed or ongoing DCFTA negotiations			
Korea	12.1	48.6	6.6
Ukraine	4.6	9.7	3.8
Countries willing to open DCFTA negotiations			
Armenia	2.8	6.8	2.2
Georgia	1.3	7.7	0.3
Moldova	4.6	10.7	3.7

It is also important to mention total improvement of tax and customs services. All tax procedures including of declaring and payment of taxes now are made through internet based software - taxpayers have no direct contact with the tax administration personnel. Very important was also to maintain very tight monitoring for the customs department offices which are now done with several special displays at the offices of Ministry of Finance and Revenue Service.

Social System Reform

The initiative of the government to eliminate social tax or contributions was both long- and short-run practical decision. For the long run Georgia avoids huge liabilities of the government that makes its fiscal future very stabile. But for the short-run this attempt had a very pragmatic reason – government tried to avoid any fiscal difficulties but simultaneously stopped any speculations on the theme – who deserves more. The last was very important because any attempt to find a fair way to pay pensions and for medical services would be trapped in miscalculations and political accusations.

Therefore government's decision on keep flat pension system, gradually increasing the rate, according to the fiscal capacities was the only correct solution. The same time means-tasted social assistance program was also implemented to support the families with no or low incomes, with the medical insurance vouchers for pension age people.

Deregulation

The Revolution Government promised to eliminate any kinds of barriers and obstacles to for making business in Georgia. In spring of 2004 it announced about lifting off the burden of inspections and checking of the fulfillment of regulatory requirements. It was clearly understood that this kind of functions of the government offices had no positive impact but simply making business difficult – many businesses were shutting down just because impossibility of following the rules and paying bribes.

After a year long discussions government in 2005 adopted new legislation regarding licensing, competition, labor, electricity production and supply. 800 licenses (85% of all⁶) and permits out of almost a thousand were just abolished. New rules of competition (Fair Trade) prohibited any

⁶ <http://issuu.com/freedominstitute/docs/20120227-dis-fins-why-georgia-has-succeeded>

governmental intervention which could result in artificial monopolizing in the market – instead of investigating and punishing of the businesses. Legislation in energy sector allowed vertical integration, unregulated pricing and exporting opportunities.

Deregulation and commercialization brought total improvement of the situation in the energy market which after a decade of shortage nightmare became in 2007 exporting sector. The next table illustrates trend of electricity export and import during the last decade:

Table 1. Georgia’s Electricity Export-Import Trends, Source: Ministry of Energy Web-Site⁷

YEARS	2007	2008	2009	2010	2011	2012
Export	633.9	679.4	749.4	1,524.3	930.6	528.2
Import	433.5	649.2	255.0	222.1	471.0	614.6
Balance	200.4	30.2	494.4	1,302.2	459.6	-86.4

Very effective was the deregulation in the sector of pharmacy sector. Here, government made three important steps: 1) eliminating most of the licenses, 2) total opening of the market to the medicines produced and licensed in OSCD nations, and 3) allowing vertical integration. Production of medicines was also deregulated that supported the sector’s development and competition. In the result of the reform total number of acting in this sector companies increased 10 times, number of chain pharmacies increased from three to six, eight new producing companies were created, all these resulted into: “In 2012 standard treatment price is 50%-60% less compared to 2009” (Curatio International Foundation survey, 2012).

Another strong effort for supporting business environment was made in eliminating obstacles to start business. By new rules starting of business procedures decreased to two within maximum two days.

The deregulation story in Georgia would not be full (although there were countless other improvements) without major labor reform. In 2005 government adopted new labor code of Georgia which made employment relationship based totally on contracts. This measure was very essential for Georgia because of a long stagnation period and before disoriented by artificial economic system labor force the country needed a very free labor environment with highest degree of competition.

Together with the decrease of labor costs (taxes on labor) this reform made the country one of the leaders in labor freedom (evaluations of the World Bank, Fraser Institute and Heritage Foundation).

The labor freedom and decrease of tax burden on the labor, together with the government downsizing measures resulted in a great shift in the employment:

The Reform of the Police

The police system in Georgia was a direct successor of soviet militia. Its main real function was to serve the interests of the authorities but not of the people. Simultaneously it was the most corrupted public institution in the country, taking bribes in any situation, robbing drivers in the streets, and it was also the most violent – having a big number of kidnapping, robbery, theft and victims every year.

The revolutionary government decided to finish with this problem using several different tools: a) firing all corrupted policemen. b) hiring new, well trained policemen, c) reorganizing of the system, implementing transparency and openness, d) implementing civilized methods of functioning, respecting individuals but strictly fulfilling their legal obligations. Most effective step was made was firing all the traffic police in one day – this eliminated bribing robbery of

⁷ <http://www.minenergy.gov.ge/en/Statistic>

drivers at once. The other very effective measure was building of new offices of the police – all made of glass, transparent and friendly. But major step for fighting crime was zero tolerance low – or stopping any kind of cooperation with criminals (higher rank criminals to control the lower.) Announced by the government zero tolerance to crime policy together with the police reform made Georgia one of the safest nations in the world. The following table illustrates a big success of the police reform.

Table 2. Victimization over last five years, per cent of the population, 2011; Source: Georgian Crime Trends in an International Perspective⁸, Jan Van Dijk and Tea Chanturia

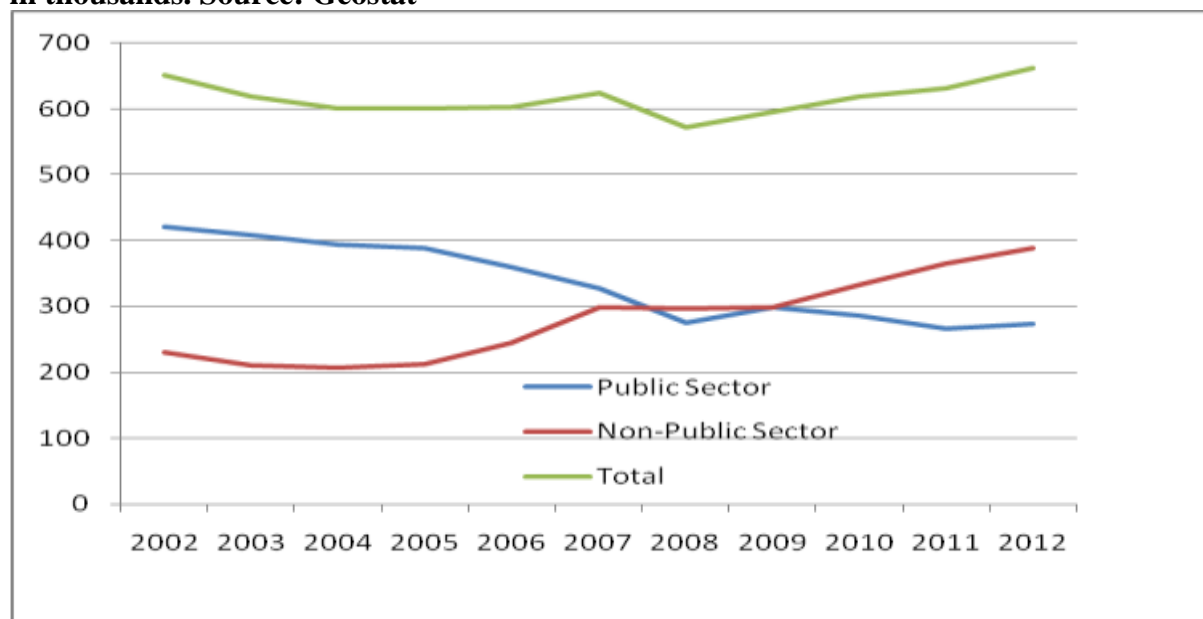
Crime types	0.2	1.2	2.2	0.4	1	0.1	1.1
Car Theft							
Theft from and out of cars							
Burglary							
Robbery/Armed Robbery							
Theft of other personal property							
Sexual incidents against women							
Assaults and threat of violence							

Anti-corruption reform

Anti-corruption agenda of Revolutionary government included first of all a campaign against bribery practices, including of firing hundreds of public servants. From the beginning everyday news was full of investigation and arrest stories of former government officers.

Then government decided to completely reorganize public services by downsizing, decreasing of the number of institutions and employees of remaining offices. This wave of downsizing of the government decreased number of employees from 400 thousands to 280 thousands, including of Ministry of Agriculture in which number of working public servants was diminished from almost six thousands to 400 (the number of employed doesn't include self-employed).

Chart 5. Number of Employed in Georgia, 2002-2012, total, public and non-public sectors, in thousands. Source: Geostat



⁸ Remarkable Case of Georgia, Georgian Crime Trends in an International Perspective, Secondary Analysis of the 2010/2011 Crime and Security Surveys in Georgia, Jan Van Dijk and Tea Chanturia, (Ministry of Justice publication)

Government made a special effort also for moving public institutions from their huge buildings in to smaller outside of the center of the capital. Some of those buildings were privatized to international hotel chains (Intercontinental, Kempinski)

Another anti-corruption direction was establishment of fair payment for the employees (average salaries increased 10 times and more) with the more open and transparent hiring rules it was already possible to invite honest and well-trained individuals to the public service.

One of the most important anti-corruption directions was indeed the implementation of new procurement system. The new system took full control (except of some state secret purchases) of all government tenders and contracts but also fully changed to methods of purchasing. Now, since 2010 all procurement (including of municipal) is based on the Internet based software and all procedures are done via this system of the State Procurement Agency (www.spa.ge). Any user, registered in the system can observe the process and the results. Worth to mention also the dispute mechanism of the SPA: it is a group of individuals selected from non-government organizations and business associations. EBRD recognized Georgian public procurement (both the legislation and the system) as “A model for improving public procurement regulation”.⁹

It is not very big surprise globally now, but still, for the country with soviet past, implementation of e-government, electronization of the public services and procedures, using Internet-based services in several spheres like: taxation, civil registration, real estate registration, vehicle registration, national exams, etc. In the Justice House – individuals can obtain all kinds of documents, buy, sell and register properties, etc – in a very short time, with the principle of one window. No more lines and bureaucratic problems or bribes.

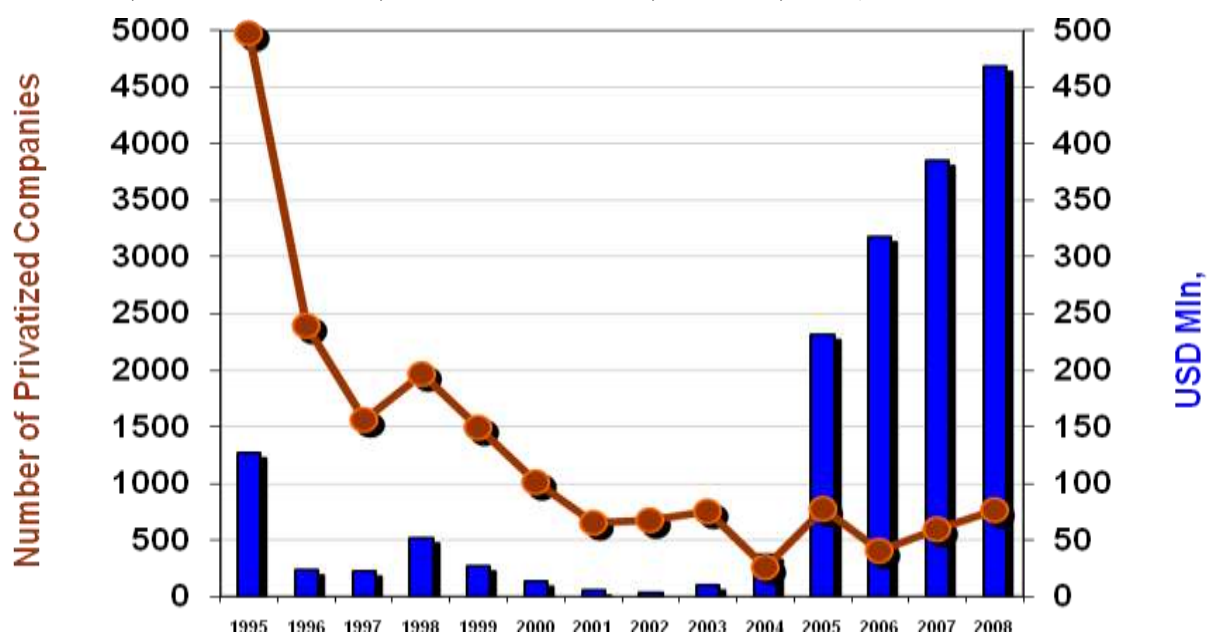
PRIVATIZATION

After long years of efforts to privatize state owned factories and land 2004 Georgian government met with a huge task to make major steps forward. The Voucher Privatization in the middle of 1990s was successful in the meaning of involving millions of population into privatization process, understanding that private ownership of former state property was normal event.

In 2004 new government, and particularly Minister of Economy (in future – State Minister of Reforms coordination - the major intellectual figure of economic reforms in Georgia) Mr. Kakha Bendukidze announced about full scale privatization “we are going to sell everything except of our honesty”. The agenda of the government included privatization of thousands of state owned factories as well as to restart privatization of the land. Very important was the second wave of the land privatization – in 2005 government adopted amendments to the legislation which eliminated some discriminations of farming land ownership. Major privatization efforts included the sectors of electricity generation and distribution and natural gas distribution, sea ports and heavy industries like metallurgy.

⁹ Seventh Regional Public Procurement Forum May 16-19, 2011, pg. 10-17

Chart 6. Privatization of state owned factories (Left, line pattern, number of factories privatized; Right, columns, revenues from privatization in mln USD) Source: Why Georgia Succeeded, Larisa Burakova, OOO United Press, Moscow, 2011)



From the same Source we learn that: “The European Bank for Reconstruction and Development (EBRD) noted a significant improvement in privatization of large enterprises in Georgia, raising the associated indicator from 3.3 in 2003 to 4 in 2007.”

Openness

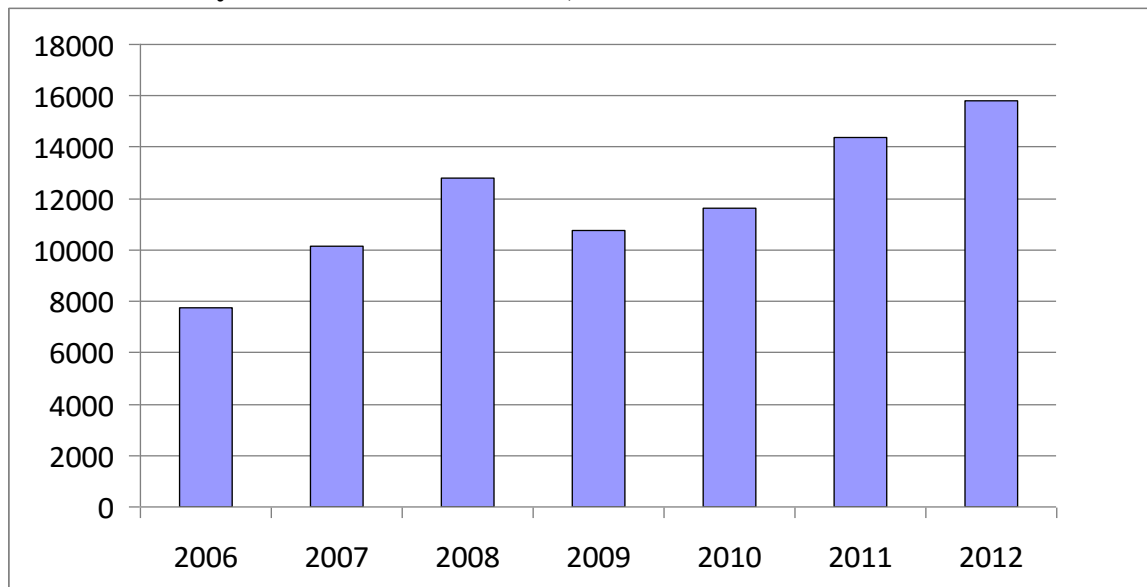
Georgian government made a very special effort for opening the country to any foreign economic activities and people. If looked at the four general freedoms from which European integration started in 20th century - freedom of movement of human and financial resources, investments, goods and services, Georgia can be recognized one of the world champions. A member of the WTO from 2000, Georgia from 2007 opened its borders to any goods – most of them are not taxed when imported, but the tariffs are kept at maximum of 5% and 12% for other goods. Georgia also has no quotas and any other limitations for imports.

More impressive can be visa regime and even more labor requirements for foreigners in Georgia. First of all, nationalities of 88 countries do not need visa to enter and stay in Georgia for a quarter of the year, all others can obtain a visa while crossing border with a simple procedures.

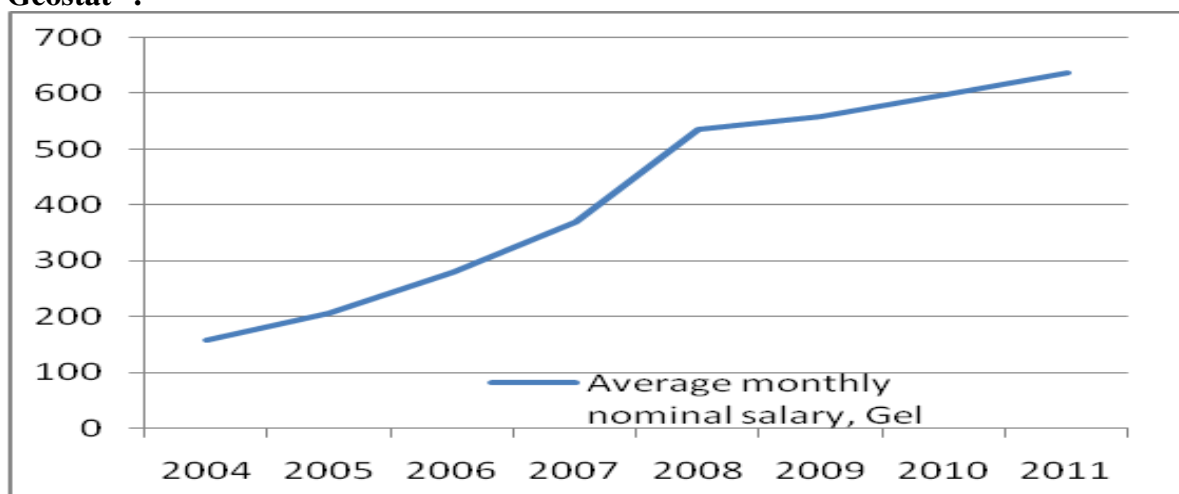
Employment rule is as primitive as having just a permanent legalization in the country.

RESULTS OF THE REFORMS:

There are several facts to illustrate the positive impact of the reforms. Let’s look first at economic growth. In real current US dollars GDP of Georgia during the years of reforms from 2004 to 2012 more than doubled (it is worth to remind this growth happened despite of several tough challenges like: economic, energy supply and trade blockade by Russian Federation from 2006, the War with RF in 2008, Global Economic Crisis from 2008, etc):

Chart 7. GDP by millions of current USD, Source: Geostat¹⁰

Average salaries in Georgia increased four times – reasons can be various: economic growth, legalization of labor costs, increase of salaries especially in the public sector and inflation but all of them were the results of the reforms.

Chart 8. Dynamics of average monthly nominal salaries, Georgian lari, 2004-2011, Geostat¹¹.

Another strong witness of well-performance of the economy during the reform period is for instance increase of volume of bank operations – the next table shows that it boosted eight times:

Table 3. Revenues of Commercial Banks 2003-2012, Source: web-site of the National Bank of Georgia

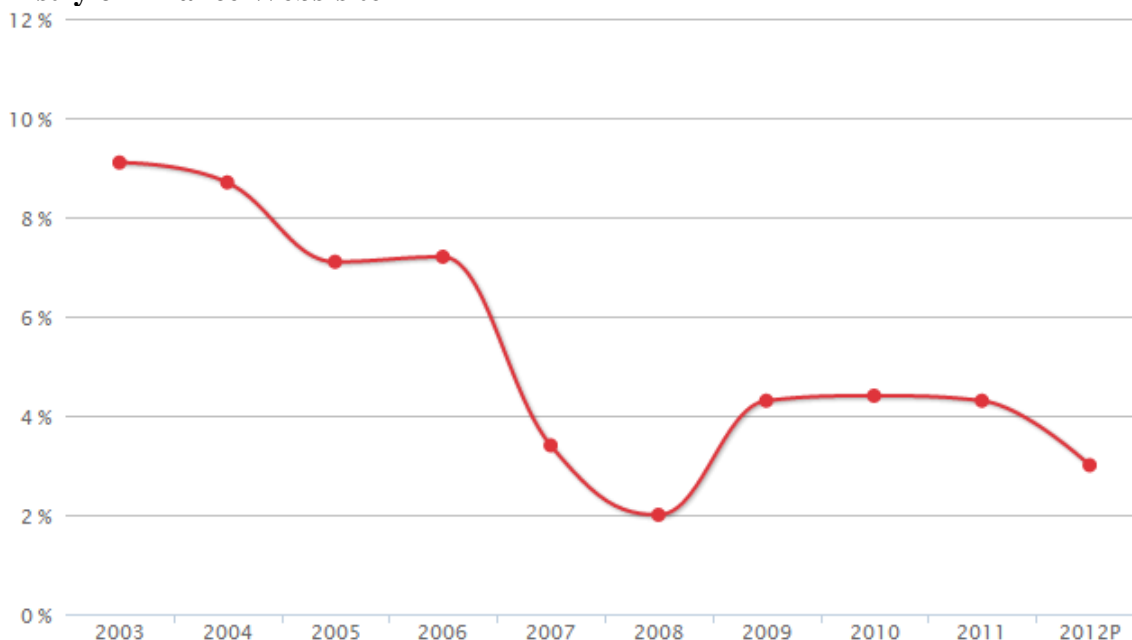
YEARS	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Bank Revenues	251,400	276,338	395,970	575,327	949,335	1,555,232	1,377,283	1,553,053	2,037,738	2,143,095

¹⁰ http://geostat.ge/index.php?action=page&p_id=119&lang=eng

¹¹ http://geostat.ge/index.php?action=page&p_id=149&lang=eng

Very important for the economy and country was a decline of public foreign debt ratio to the GDP - from 40% to 25% but more important was a sharp decline of ratio of the annual payments from the state budget for the foreign debts. It decreased from 9% to below 3% level despite of the War in 2008 and global crisis.

Chart 9. Ratio of repayments for the foreign debt to state budget, 2003-2013, Source: Ministry of Finance Webs-site¹²



With high speed of growth and declining of need in borrowing Georgian government made very good steps to take whole responsibility over the economic situation and growth. In the Spring of 2008 major projects of the World Bank were finishing their activities in Georgia, and in May the office of the IMF was closed down. Only War with Russia in August after few months made it turning towards international borrowing and assistance.

Very spectacular is the number of registered companies which increased from 50 thousands in 2003 to 400 thousands in 2012.

Georgia became one of the leaders of economic reforms (WB, Doing Business) and kept this recognition for years. Different studies of economic and business liberties found Georgia as one of the best in the region and world. By now Georgia is:

- 21st in the Economic Freedom of the World, by Heritage Foundation evaluation
- 42nd Index of Economic Freedom, by Fraser Institute study
- 9th In Doing Business, World Bank survey.

*Georgia has emerged as a global leader in deregulating businesses and improving its business environment*¹³. By DB 2013 Georgia is No 1 in the World in Registering Property, 3rd - Getting Construction permits, 7th – Starting Business.

Very inspiring was as it was mentioned above, the anti-corruption reform after which Georgia improved its position of 124th in the world (out of 133) in 2003 to 51st (out of 176 nations) in 2013. Surveys like *Life in Transition* by EBRD found that: “77% of citizens agreed that corruption has fallen last four years. 87% of population assessed police performance as good or fairly good; 0.4% of cars were stolen last five years (Crime and Security Survey, GORBI, EU, 2011).

¹² <http://www.mof.ge/en/DebtFinance>

¹³ Fighting Corruption in Public Services, Chronicles of Georgian Reforms, 2012, IBRD/WB

Economic Liberty Act

In 2011, after long discussions Georgian government adopted constitutional Law: Economic Liberty Act. It prohibits government to have:

- Public spending over 30% of the GDP,
- State budget deficit upper than 3% of the GDP, and
- Public Debt more than 60% of the GDP.

The Economic Liberty Act also restricts government to impose a new tax or increase tax rates without public consent by referendum. The law came in force in 2013 for the time when all the requirements of it were already kept. This law has very important meaning in the situation when Georgia already has new government which is limited with the Liberty Act, though had promised lots of spending initiatives.

Another significant recognition of the reforms was a great number of visitors to Georgia to observe and study why country was so successful and how it happened. These were delegations from neighboring Azerbaijan, Armenia, Ukraine, Moldova, Kyrgyzstan, Kazakhstan, even from as distanced as

Problems Remained and Some Controversy:

After a very strong free market push – President Saakashvili declared that Georgia’s way was “Not by closing the economy, but by giving it maximum transparency and by implementing free market principles.”¹⁴, from 2007 Government made its approach more moderate. Though most of the pillars of the reform were kept political leadership made some important decisions to try to calm down the rising political opposition and some disappointment of population (maybe mainly because of increase of competition). From 2008 government started implementing social programs of more assistance to poor, to unemployed, health care insurance for pensioners etc. The table below describes the fast growing social expenditures (and this is without education spending and subsidies to farmers).

Table 4. Public Social Spending in Georgia, Millions of Lari, Information: Ministry of Finance of Georgia

YEARS	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Social Expenditures	382.99	434.04	558.10	762.40	851.00	1378.60	1505.90	1623.60	1655.57	1857.57

Volume of Subsidies in the state budget increased five times from 105 m lari in 2003 to GEL514 in 2012. Among the subsidies, only after 2008 appeared support to farmers article, in 2012 government made one of the biggest mistakes during all post-revolutionary times: bought all the harvested grapes from farmers.

Backing of these new policies they thought could have found permanent support from the population, especially during the election periods. The same affair with grape purchasing was a simple attempt to keep engaged by opposition (political opposition strongly demanded direct budgetary support of the agrarian sector and farmers) farmers at least neutral in their political choice.

The faith into free market solutions was also strongly shaken by several international institutions demanding from Georgian government to implement more restrictive regulations especially in the labor, food safety, and competition policies. ILO, EU Commission, USTR and many other international institutions were directly involved not only recommending but also dictating to Georgian authorities to change their liberalizing attitudes (for example EU Commission’s prolonged pre-negotiations about the Free Trade Agreement, described in a study by Science Po

¹⁴ From the President M. Saakashvili’s speech to the Parliament of Georgia, October 6, 2009

and CEPS¹⁵). Still, nothing said in this text can discredit the chosen by the government, very brave path to improve Georgia's economic situation with free market rules.

One of the challenges to economic improvement was the monetary policy. In 2010-2011 inflation again reached double digit size. Here, it is very important to note in favor of the Georgian National Bank leadership that after the high inflation they maintained more careful monetary policy which reduced the inflation to zero levels in 2012. But the experience of most successful in monetary policy nations in transition like Estonia and Bulgaria shows that implementation of the system of Currency Board would be better solution both for economic and political reasons. In fact Georgia was very close to this decision in 2007 when after Dr. S. Hanke visited Georgia and convinced many decision-makers about benefits of the Currency Board. (This is especially essential now when Currency Board could be another strong limiting instrument for the new government).

There were several criticisms for slow process of improvement of judiciary in Georgia. In fact there were many steps to improve judiciary independence: there were 76.4 % surveyed in the country in 2012 who believed that bribes were not taken by judges, and up to 84% trusted the courts, and quality of services by the courts was evaluated 4.5 out of 5¹⁶. But, still, it seems that to achieve more confidence, there should be harder work but lifting out political mentorship (maybe somehow needed at the first stage to ensure implementation of reforms but also avoiding corruption.)

This good result and very best and safe system of property registration had a very weak influence on the situation with property right in Georgia. This applies especially the eminent domain cases where government abused its confiscatory powers. The Heritage Foundation Economic freedom 2013 Index also states slight improvement of the property freedom in Georgia from by 5% to 45%, remaining the lowest rate among 10 subcomponents of the Index for Georgia¹⁷.

Some other problems the reformist government was not able to improve were decreasing of budgetary deficit and stabilizing the business legislation. Some government leaders were also too much excited by the success, forgot about their support to the small government idea. Very important was also to ensure that revenue service rules would not make a taxpayer automatically guilty and the rules to fit the constitutional requirements. A problem of low quality of the labor will remain a challenging press on the next generations of the decision-makers.

Conclusion

The economic reforms of Georgia of 2004-2012 was one of the greatest attempts to improve economic situation and take responsibility on economic policy and development. Despite of the several warnings from abroad and opposition in the political scene in Georgia free market direction was chosen as a major engine of the reforms. The hesitations and political pragmatism after 2008 made impact on the decisions by which it was never achieved the level of double digit growth of 2007, and or level of investments of the same year of USD2 billion.

Government tried its best to walk between free market ideology and political pragmatism but rising dissatisfaction with results made possible softening of the reforms character and moving towards more socialized spending. Government simultaneously made a greatest step to ensure sustainability of the reforms by the Economic Liberty Act but hesitated to fulfill its promise to decrease further tax rates and soften administrative burdens. International organizations hailing Georgian reforms the same time pushed to the agenda some spending initiatives and regulatory obligations which have never helped country's business and economy. But political pragmatism dictated to be involved or to lose their potential support if needed.

¹⁵ An Appraisal of the EU's Trade Policy Towards Its Eastern Neighbors: The Case of Georgia (Groupe D'Economie Mondiale, Sciences Po, Center for European Policy Studies, 2011)

¹⁶ Court Services' Quality Survey 2012, Applied Research Company, Council of Europe, and others

¹⁷ <http://www.heritage.org/index/country/georgia>

It is very uneasy to anticipate what situation Georgian people would have if not the War with Russian Federation in 2008. But if implementing the Currency Board and keeping all the free market reforms, Georgia could very much count on foreign direct investments and double-digit growth. This could increase GDP to the rather higher level than it happened to have in the reality and bring this growth to every individual and family. This is exactly the major lesson from the Georgian experience: the political and international environment puts a government of a transition nation in front of the choice: either self-responsible policy or obeying to global powers, accepting their rules and assistance, pushing short-sight based huge social programs to satisfy current needs of population, instead of ensuring of quick development and sustainable future. Georgia's experience was a good lesson to the politicians in Georgia and in the World; the success of the reforms was a very good reason for following them in the direction of more liberalization. There was a need to decrease further tax rates, eliminate remaining custom duties and reorganize further tax rules, maintain strict fiscal and monetary discipline and at last, implement inviolability of private property environment.

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LITHUANIA'S DECISION TO JOIN THE EURO ZONE IN 2015: CORRECT AND TIMELY?

Rūta Vainienė¹

Abstract

Being a member of the European Union Lithuania has an obligation to join the European Monetary Union. The first attempt to meet Maastricht criteria was done on the 1st of January, 2007. However Lithuania failed to fulfill the inflation target. Recorded inflation for March of 2006 (as it was the reference period) was 2.72 percent, given that the criterion was 2.66 percent (if using the CPI data provided by the Eurostat with two digits precision). So, Lithuania had 0.06 percentage point bigger inflation that was required. It was considered as a huge failure of economic policies as the major impact to the raising inflations was made due to the rise of the regulated prices of energy and transportation. In 2009 the major economic crisis hit, followed by the increase in the public debt and raising fiscal misbalances. At present Lithuania would not meet the criterion on fiscal deficit, the inflation could also be an obstacle.

The critics of the Lithuanian economic policies are strengthened by the fact that being in the worse condition in 2007 (did not meet criterions by the larger extent), the other Baltic State – Estonia - managed to meet the criterions and joined the euro zone as of the 1st of January, 2011. As Baltic States are competing for the investment, the euro in Estonia is considered as a big advantage for the investors, creating larger stability and credibility. Both countries had very strong links between national currency and the euro through the currency board arrangement, meaning the fixed exchange rate and 100 % reserves of foreign currency. That was considered as very similar starting positions.

Estonia joined the euro zone probably in the worst period for the euro itself. The stability of the euro is threatened by the debt crisis in Greece, Italy, Portugal, Spain and unsustainable social security policies in all EU countries. Newcomer in the Euro zone is the most disciplined country – Estonia has balanced the budgets and demonstrates the best economic results. Being a member Estonia will have to contribute to the Financial Stability Fund to bail out economies that were performing loose fiscal policies. Tax payers of responsible countries are paying for irresponsible and that creates moral problems in addition to financial. Moral hazard is encouraged.

The opaque future of the euro as a stable currency raises the question if the countries outside the euro zone should seek joining the EMU. The paper analyzes major benefits and drawbacks of the being inside and outside the euro zone, given the risks for the euro zone itself.

In 2012 Social Democrats won the parliamentary elections in Lithuania and formed the center-left wing coalition government. Among the priorities parties decided to seek euro adoption since 2015. That raised many questions to the politicians, economists and general public such as whether the decision is correct in principle and timely given the turbulences in the Euro zone itself. General public is mainly afraid of the rising prices that followed the introduction of the euro in most euro zone countries. Economists are concerned about the financial cost –benefits issues. Politicians argue that Lithuania is committed to join the euro zone by the EU agreement.

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The political decision is mainly driven by the fact that Estonia has adopted euro since 2011, and Latvia is adopting it since 2014. However, the commitment is not defined in terms of time, but in terms of meeting Maastricht criteria. Thus, the main discussion follows the time issue – is the timing appropriate for the country. This paper is looking at the monetary zone issues from the broader prospective. Is the union viable as such and is membership justifiable from the moral principles and values of liberty.

Introduction

Being a member of the European Union Lithuania has an obligation to join the European Monetary Union. The first attempt to meet Maastricht criteria was done on the 1st of January, 2007. Lithuania failed to fulfill the inflation target. Recorded inflation for March of 2006 (as it was the reference period) was 2.72 percent, given that the criterion was 2.66 percent (if using the CPI data provided by the Eurostat with two digits precision). So, Lithuania had 0.06 percentage point bigger inflation that was required. It was considered as a huge failure of economic policies as the major impact to the raising inflations was made due to the rise of the regulated prices of energy and transportation. In 2009 the major economic crisis hit, followed by the increase in the public debt and raising fiscal imbalances. At present (compliance period - March 2012) Lithuania would not meet the criterion on fiscal deficit; the inflation could also be an obstacle. The Government declared the membership as its priority therefore has already made efforts to limit the budget deficit. However, inflation criterion will be under the question for the coming compliance period – March 2014. Government incited business community to contribute to the achievement of this strategic goal and not to raise prices. This undermines the influence of market forces in the pricing process and therefore should be treated as soft intervention into it.

Neighboring Baltic country - Estonia - became a member of euro zone since 1st of January, 2011. This was considered as a huge achievement and a demonstration of having the national political priorities. Estonia joined the euro zone probably on the most complicated moment for the euro zone itself. Public debts in several member state of the euro zone created dangers for the stability of the monetary union. Different scenarios are under consideration: from Germany exiting the euro zone to Greece being thrown out of it.

Latvia took a decision to adopt the euro since 2014 and it is now obvious that Latvia succeeds in achieving that. However, Latvian case is different to that of Lithuania. Latvia has big and risk exposed banking sector, thus his main argument for joining the Euro zone is more of mercantilist. After establishment of the European Financial Stability Mechanism countries with weak financial sector may be eager to join the union in order to safeguard the stability of its weakening financial sector.

Why multinational monetary union?

Multinational monetary union is close cooperation between monetary authorities of independent countries based on the fixed exchange rate or the use of a single currency. There are national monetary unions that operate within the borders of one state, which historically had several currency issuing banks (for example, British monetary union, Federal reserve banks).

Many multinational monetary unions were created in the history of global economic life. There are three main reasons for creating the monetary union (and interaction of these reasons):

- 1) political reasons;
- 2) economic reasons;
- 3) and cultural reasons.

(1) If the political unification takes place, the unification of monetary systems eventually follows. As a rule, the adoption of one currency is imposed by political bodies and even a

discussion on whether the union should be created or not is not admissible. The best example of the politically created monetary union is the ruble zone that was created for the 15 soviet republics, members of the soviet union.

- (2) The facilitation of free trade is the main economic reason that is advocated for the creation of monetary unions. Politically free countries surrender their currencies seeking closer economic integration. The reductions of the transactions costs comes as the first exposed benefit of the monetary union presented to people and businesses. However, the architects of the monetary unions foresee much deeper effects of the monetary union for the countries. These are the control over the inflation and unification of interest rates among the monetary union states. As there is a constant pressure from politicians, as well as from vested interest groups, particularly exporters, on the national central banks to keep the inflation higher than in export destination countries, this creates a kind of unfair competition, or currency wars, that at the end harms all countries involved. The interest rates require some single basis (basic interest rate set by the single central bank) due to free movement of capital. If this is not the case, capital dis-balances may occur.
- (3) Cultural reasons, such as language, history and religion also play an important role, however it mostly goes as an additional argument to the previous reasons. Culturally similar countries better adapt to a single monetary regime if some moral/cultural argument is attached to the economic and political ones.

The history demonstrates the comparatively little viability of multinational monetary unions created by political rather than market tools. Here needs to be mentioned that the only multinational monetary union that was market created is use of gold and silver to facilitate exchange. Gold and silver were chosen by people engaged in exchange by choosing: preferring the commodity that performs its monetary function and rejection the commodity that performs worse. Gold and silver were voluntary, not institutionalized monetary union, the most long-lasting: people used gold and silver money for approximately 3000 years.

I contrast to this, most of the artificially (by political decision) created unions dissolved much sooner. The major reason for monetary disintegration became the political disintegration (Soviet Union, Austro-Hungarian Empire, Yugoslavia and Czechoslovakia). There are also examples of the fall of monetary unions due to economic reasons. For example, the Bretton Woods, the “monetary union-like” system collapsed, because regulations and restrictions created huge economic imbalances.

EMU

European monetary union is an example of multinational three-tier monetary union, from European exchange rate mechanism (ERM) II to a single currency. The euro was created as a single currency not only to facilitate exchange and to reduce transaction costs, but also to end the economic conflict conducted by the European countries in the currency arena. After the fall of Bretton Woods’s system in 1971, Central banks of Western European countries lost the control over the money supply. Huge exchange rate fluctuations harmed international trade and capital movement. German exporters (especially automotive companies) were most unsatisfied with the strong Deutschmark. Something had to be done to stop the currency wars, and Europe opted for the euro. The founding fathers of the euro understood that economic rivalry among countries may be moved from the currencies arena to the debt arena. That is why the criteria to adopt the euro, the Maastricht criteria, were designed to prevent countries from manipulative games in the single currency field. However, since there are no legal or economic consequences for the countries that break the Maastricht criteria (only the existing mechanisms, such as EU excessive deficit procedure, were applied, but in very soft way, only Hungary received stricter penalty, also said, due to other reasons, mainly Constitution), the fear of fiscal wars became the present reality.

While countries lost the possibility to issue unlimited amount of national currency, they engaged in large scale borrowing, and single currency euro even facilitated this.

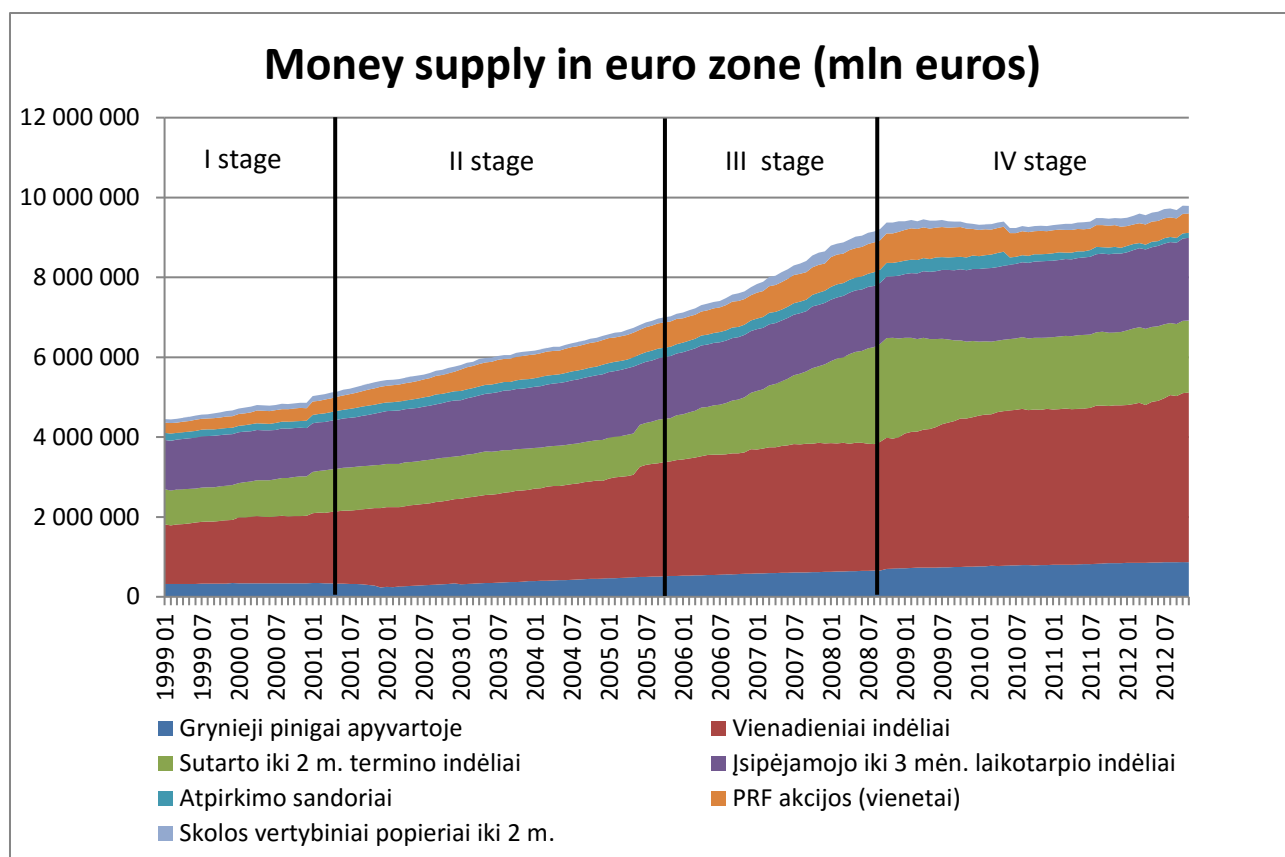
Today the euro has been weakened by attempts of some irresponsible governments to cover public deficits or to finance public debt via monetary means, i.e., to monetize the debt. Irresponsible fiscal policies create huge public debts which cannot be repaid, thus put pressure on governments and central banks to monetize these debts. Currently, there is no direct monetization; instead, monetization is being conducted indirectly through the lending facilities of the European Central Bank (ECB) and emergency lending facility of the central banks that belong to the ECB system. Commercial banks have huge incentives to lend to the governments since sovereign bonds are less risky assets and they can use these bonds as collateral with the ECB. This is indirect and, of course, quite limited way to monetize the debts, therefore irresponsible countries would demand larger scale of intervention. This process increases the supply of money and thus weakens the euro's purchasing power.

Monetization of debt means that disciplined countries take the burden of undisciplined ones, and that the citizens and businesses of disciplined countries bear the burden of decisions made by undisciplined governments. This redistribution takes many forms but in addition to its economic outcomes causes moral hazard and public dissatisfaction. Such a system is not sustainable from a more general point of view than just the economic ones.

In addition, the official public debt figures hardly capture the scope of the present debt problem because they do not include the long term obligations of the state social security (welfare) systems; this is invisible debt. This debt will reveal itself in the years to come as its obligations come due. If current policies continue, economic tragedy is inevitable: the euro will lose value, or government will default on their debt instruments and social security obligations, or both.

The single currency also allowed large scale international cross-subsidizing and redistribution to emerge. The euro provided credibility to economically weaker countries, allowing them to cheaper finance their public deficits. That created an illusion that economic prosperity can be easily achieved by cheaper financing alone. Essential economic reforms of welfare systems and the improvement of the business climate were not addressed in a timely manner. These unsolved tasks will inevitably require attention as the monetary means for stimulating economic growth have already been exhausted. Economic prosperity can only be achieved by effective production, by competitiveness that is reached through production rather than redistribution.

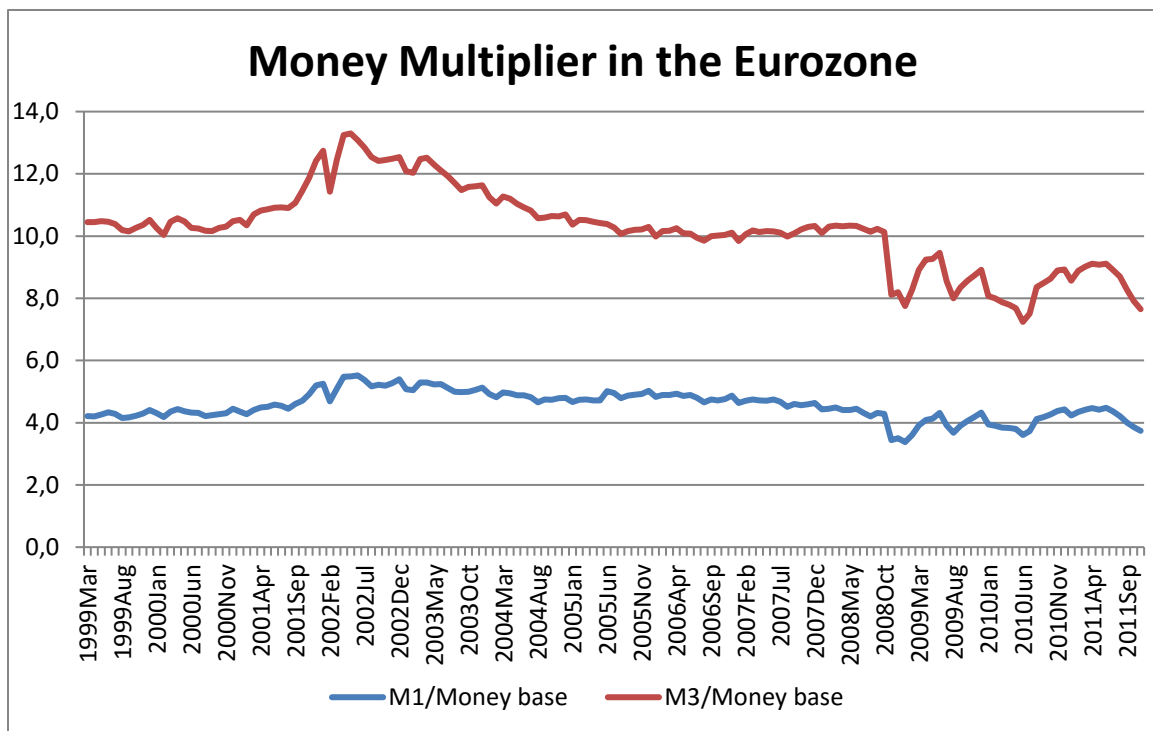
The public debt component in the euro crisis is crucial; however it should not overshadow the other weaknesses of the euro, i.e. credit expansion and fractional reserve system that creates the money multiplier. The ECB issues euros by granting credits to commercial banks at an arbitrary interest rate (which is misleadingly called the "basic interest rate"). That creates an increase in the money supply which damages the economy due to monetary and general price inflation, redistribution of wealth and by malinvestment. Despite the fact that the ECB monetary policies have been more disciplined than the Federal Reserve's it is still engaged in monetary expansion. The ECB's has increased the money supply more than 2 times since its single monetary policy began in 1999. See the graph below.



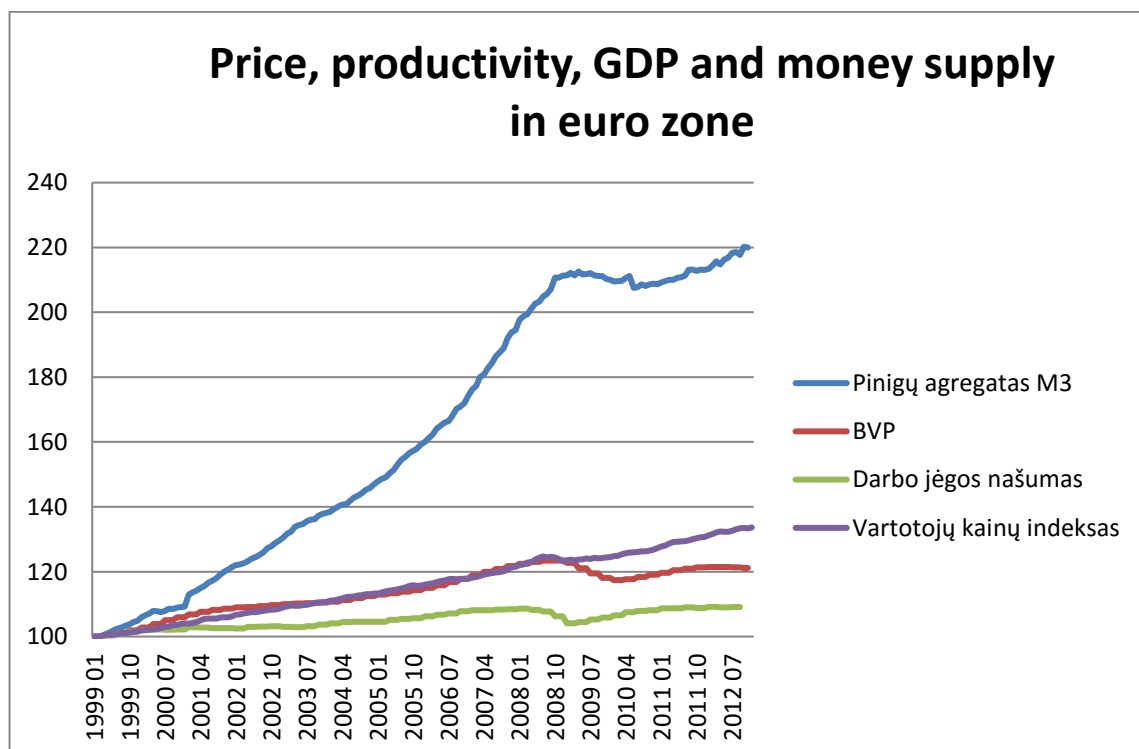
Source: ECB² (Cash in circulation; Term deposits up to 2 years; Repo; Debt securities up to 2 years maturity; One day deposits; Deposits up to 3 years; Shares)

After money is issued, commercial banks can increase the money supply through the fractional reserve system. The ECB required a minimum reserve on only 2 % for demand deposits and that allows the money supply to multiply, in theory, by a maximum of 50 times. Moreover for the first time in the euro history ECB lowered required minimum reserve ration down to 1 per cent and that cause the release of 1 trillion euros in the banks’ balances. The actual money multiplier in the euro zone is 3.7 for M1 and 7.7 for M3. See the graph below. The constantly deteriorating purchasing power of money depreciates savings and income and thereby encourages society to indulge in “fast living”. People tend to spend their money as fast as possible (to consume), and neither people, nor businesses should be blamed for that. These processes are not country specific; they are general and fundamental reasons in choosing the monetary regime.

² <http://sdw.ecb.europa.eu/browse.do?node=2120791>



Source: ECB³



(money aggregate M3; GDP; Labor productivity; Consumer price index)

The euro is facing problems now not because the euro zone’s 17 countries are too different to have a single currency. The world is much more diverse than the euro zone, but most of the globe

³ <http://sdw.ecb.europa.eu/browse.do?node=2018810>

was once comfortable with single currency - gold and silver. The Neither does the euro zone suffer from its lack of financial integration (as proponents of financial integration point to the euro zone's lack of single budget, harmonized taxes, Eurobonds, etc) as well. Economic integration comes from free trade, free movement of people, capital, goods and services. If someone wants more integration, they should focus on these 4 liberties that were initial goals of the EU. If euro crisis is solved in a timely manner, then real European integration, based on free trade, can proceed.

In sum, the main reason for the euro crisis is that the single currency is no longer scarce and this harms the current membership. The constantly increasing supply of euros redistributes wealth among member countries and generations, destroys prices and savings, and causes malinvestment which leads to the consumption of capital and, in the long run, - the general impoverishment of the euro zone society. The euro's problems stem from its lack of the anchor, that European nations lost after the fall of Bretton Woods system in 1971 (which, it should be acknowledged wasn't a perfect system either).

Currency board arrangement

Within the EU there are currency board-like systems, in Lithuania and Bulgaria, which issue national currencies with the peg to euro. Estonia began a currency board system when it introduced the Estonian kroon (EEK) in 1992. Lithuania followed Estonia's lead and introduced a currency board system on April 1, 1994. The IMF initially opposed the introduction of these systems, but later could not deny the success of the Estonian currency board. The IMF extended a credit to the Bank of Lithuania to strengthen its reserve base before pegging Lithuanian national currency Litas to the US dollar. Lithuania successfully repaid the debt. At present, after more than 19 years of existence of the currency board, the amount of Litas in circulation is covered by over 120,1 % with foreign reserves and gold at the end of April 2013⁴.

Currency board-like systems protect the market from the domestic source of inflation; however they suffer from the inflationary policies of the reserve currency countries. Currency Board allows the national currency to have the same qualities of the peg currency; however, there is a safe distance to watch if the anchor currency still meets the requirements of stability. If the peg currency is quickly losing its value, there is a possibility to re-peg national currency to a new anchor unit. For example, Lithuania re-pegged the Litas from the US dollar to the euro on February 2, 2002 without causing any problems to the market. (In this case Lithuania re-pegged national currency due to political reasons, i.e. joining the EU.) Therefore, currency board arrangement is a balanced monetary regime for those who want to avoid internal inflation, to have a credible peg, especially in times when the anchor currency is under uncertainty.

Benefits and disadvantages of being in euro zone

The main benefits that are usually presented in favor of euro zone are the following:

1. Smaller transaction costs to businesses, easier price comparisons for consumers. As EU trade integration is rather deep, the main trading partners are members of the euro zone (for Lithuania – 1/3 of total exports in 2012⁵), businesses would have costs savings due to absence of currency exchange operations. They will also avoid exchange rate risks and costs related to the risk management.
2. Cheaper debt financing. If the country used to be carrying additional risk related to inflation and monetary expansion, which was expressed in risk premium on loans, euro zone integration will eliminate the risk and make loans cheaper to

⁴ Data source: The Bank of Lithuania, http://www.lb.lt/stat_pub/statbrowser.aspx?group=7269&lang=lt

⁵ Data source:

<http://www.verslilietuva.lt/uploads/file/PREKI%C5%B2%20eksporto%20tendencijos%202012%20%28gruodis%29%20PRIEDAI.pdf>

businesses, as well as to government. Cheaper debt financing is not an advantage as such. It is a short sighted advantage from the investor's view. However, it may lead to more risky projects and finally to malinvestment. Interest must be based on market conditions, not on expectations that somebody will cover the debt. Lower interest rates are even damaging for governments, as it creates excessive borrowing incentives.

3. Increased competitive advantage and additional FDI. It used to be considered that euro increases competitive advantage due to the first 2 reasons and attracts more investment. The first 2 advantages being correct, there are realistic doubts if the euro is the crucial criterion to choose the country for investment. Investors look at small corruption, favorable general business conditions, and predictable, stable and small taxes, good infrastructure. Therefore, this advantage should not be overestimated. It is only an additional reason to much bigger scope of reasons that investors consider.
4. Reduced political risk of national currency devaluation and inflation. As ECB follows the comparatively strict monetary policy, joining the euro zone provides for lower inflation and comparative stability. The currency board allows achieve the same task, however the risk that the currency board arrangement itself may be eliminated, or the national central bank may change the fixed exchange rate remains under the currency board system. Being a member of the euro zone fully eliminates the domestic inflation factor and this is definitely the biggest advantage of being in the euro zone.
5. The goal to joint euro zone creates more fiscal discipline, as countries must comply with Maastricht criteria. However, the fiscal discipline can be achieved without joining the euro zone.

The main disadvantages that are usually presented in favor of euro zone are the following:

1. Uncertainty of the euro zone related with undisciplined budgetary policies of member states, as well as discretionary monetary policies of ECB. Euro is *fiat* currency which supply is defined by the decisions of the ECB. ECB sets the base interest rates, engages in open market operations and that keeps constant stability risk.
2. Moral hazard. Single *fiat* currency creates room for moral hazard, i.e. irresponsible behavior of national governments and free-riding. Even most disciplined countries, like Germany, failed to meet Maastricht criteria. See the table below.

Deficit as Percent of GDP 1999-2011⁶

Euro zone countries	Years of compliance	Years not in compliance
Germany	6	7
France	6	7
Italy	4	9
Non-euro zone countries		
U.S.	7	6
Britain	5	8
Japan	2	10

3. Additional costs related to the contributions to European Financial Stability Facility. Given the budgetary constraints in each member state, and given the local needs, each contribution to EFSF will create an additional pressure on national public finances.

⁶ Source: The Washington Times. Dec 13, 2011

Taxpayers of responsible countries cover the bills of irresponsible ones. One can hardly find any justification to that. As P. Bagus notes, “While it is still unclear where future developments will lead the EMU, the costs and risks of remaining within the system are already immense and rising. The risks of the project keep increasing day by day”.⁷

4. Transfer of the decision making from national to the EU bodies due to Treaty on Stability, Coordination and Governance in the Economic and Monetary Union.
5. More incentives for price increase. As P. Bagus notes “The euro is a misconstruction as several independent governments can finance their deficits through one (central) banking system. The incentive is to run higher deficits than other states of the EMU. The setup of the euro system made interest rates converge and enabled monetary redistribution. Due to its incentives there is a tendency for price inflation”.⁸

The single monetary unit reduces competition among currencies. Competition of currencies is needed when the currency is produced by the state central bank and the money issue is discretionary. Therefore, the competition provides broader choice of currencies for those who demand stable money.

Conclusions

Gold used to be single global money; however global single paper money is a different issue. The contemporary paper money is issued exclusively by governments (state central banks) and therefore is money chosen for people, not by people. The main advantage of being in the euro zone is the abolishment of the national inflation component and national political risk of devaluation (under the currency board monetary regime). The euro may be like leading-rein for undisciplined central banks. However, as we experienced from Greek example, loose discipline is exercised on the budgetary field then. Advantages, such as cost savings and easier price comparisons are minor, therefore are inadequate to ground the need for a single currency. The advantage of better investment climate is poorly grounded, as the investment climate is much broader understanding. Besides, stable national currency may be achieved through other means and ways.

Main disadvantage of being a member of euro zone stems from the opaque future of the euro and euro zone itself. A country like Lithuania, having euro as an anchor currency, is in a close, but safe distance to observe the developments in the euro zone. If euro is failing to serve as stable reserve money, the country may escape from the zone of trouble within short period of time.

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USE OF THE BTS METHODOLOGY FOR MONITORING OF BUSINESS PERCEPTIONS TOWARDS CORRUPTION IN UKRAINE¹

Oksana Kuziakiv²

Abstract

Ukraine is perceived as highly corrupt country where political, grand and petty corruption has become an integral element to social interaction. Corruption causes losses to both the State and its population due to inefficient use of budget funds and low level of government services as well as piles uncertainty in the environment where economic agents and households function. Excessive regulation is one of the key contributors to corruption at enterprise level. International studies demonstrate that excessive regulation of business activity promotes corruption. The more procedures a business needs to go through and the longer these procedures take, the more likely it is that the level of corruption in the country is high. This assumption is backed by findings of the 2009 World Bank Investment Climate Research Study³. The cause and effect link here works in both directions: government regulation of business generates corruption, and corruption can lead to the government introducing a regulation promoting one company or sector at the expense of others or at the expense of the population in general⁴. That is why deregulation is an important tool in the anti-corruption framework, as it reduces the possibilities for abuse. Developing instrument for monitoring and evaluating the business climate, regulatory environment identification of barriers to business development to compile a list of top-priority economic, legal, and regulatory reforms based on feedback from business as main stakeholder of reform is among key priorities of public policy agenda in the country. In the article, we describe of our experience in construction of corruption perceptions' indicators, present the indicators based on results of last decades BTS survey. In addition, we try to compare the indicators of regulatory climate and corruption perceptions (Annual Indicator of Business Environment Burdens and Annual Corruption Perception Indicators) with IER Industrial Confidence Indicator and IER Index of Business Condition that based on BTS data. It is important to check the hypothesis that in complicated regulatory climate the corruption perceived by enterprises as way to solve a problem of excessive, unclear and complicated regulations, and not as single problem. It is important message that should be taken into account when anti-corruption measures are developed in the country. In terms of real policymaking

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³ <http://blogs.worldbank.org/psd/restrictive-regulation-is-positively-correlated-to-corruption>

⁴ M. Bédard, Less regulation and more competition to curb corruption, MEI May 2016, https://www.iedm.org/sites/default/files/pub_files/lepoint0816_en.pdf

process in Ukraine such message means that measure aimed at deregulation of economy should be successfully completed.

Key Words: *Business Tendency Survey, Expectations, Confidence Indicators, Business Climate Index, Business Conditions Index, Corruption Perceptions, SME, Ukraine*

1. Introduction

Ukraine is perceived as highly corrupt country where political, grand and petty corruption has become an integral element to social interaction. Corruption causes losses to both the State and its population due to inefficient use of budget funds and low level of government services as well as piles uncertainty in the environment where economic agents and households function. Excessive regulation is one of the key contributors to corruption at enterprise level. International studies demonstrate that excessive regulation of business activity promotes corruption. The more procedures a business needs to go through and the longer these procedures take, the more likely it is that the level of corruption in the country is high. This assumption is based by findings of the 2009 World Bank Investment Climate Research Study⁵. The cause and effect link here works in both directions: government regulation of business generates corruption, and corruption can lead to the government introducing a regulation promoting one company or sector at the expense of others or at the expense of the population in general⁶. That is why deregulation is an important tool in the anti-corruption framework, as it reduces the possibilities for abuse. Developing instrument for monitoring and evaluating the business climate, regulatory environment identification of barriers to business development to compile a list of top-priority economic, legal, and regulatory reforms based on feedback from business as main stakeholder of reform is among key priorities of public policy agenda in the country. Business tendency surveys (BTS) are the source of information about the state and future progress of selected economic indicators based on the enterprise managers' opinions and expectations and can serve as such tool of monitoring.

The Institute for Economic Research and Policy Consulting used the BTS to tracing business perceptions on different topics. Based on more than 20 years' experience on conducting business tendency survey the IER has designed several instruments that allowing to monitoring of business expectations and attitudes toward the main economic issues as well as measure the quality of business climate including corruption related issues. Perceptions of corruption based on informed views of relevant managers and their actual experiences with it are sometimes the best way to gather the information about corruption.

IER business tendency survey is conducted quarterly. In each quarter, the questionnaire consists in two parts. The first is the regular questions regarding enterprises performance and expectations about future change of the performance. In this part, there is question about impediments to business development, where the corruption is among other 15 options of impediments. We use this variable of corruption as single indicator as well as part of composite indicator "quarterly regulatory climate". The second part of the IER BTS questionnaire consists in questions regarding so called special topics that vary from quarter to quarter. The questions regarding different aspect of business and investment climate including perceptions regarding corruption⁷ are asked on annual base in the 1st quarter survey since 2003 in April. As result, the

⁵ <http://blogs.worldbank.org/psd/restrictive-regulation-is-positively-correlated-to-corruption>

⁶ M. Bédard, Less regulation and more competition to curb corruption, MEI May 2016, https://www.iedm.org/sites/default/files/pub_files/lepoint0816_en.pdf

⁷ We use adopted for Ukraine questions based on approach describe in Hellman et al., Measuring Governance Corruption, and State Capture, 1999 <http://siteresources.worldbank.org/INTWBIGOVANTCOR/Resources/measure.pdf>

set of indicators that describe the business climate and corruption was developed. The list of indicators with periodicity in brackets is below:

1. Corruption as impediment to business development (quarterly)
2. Quarterly regulatory climate (quarterly)
3. Annual Indicator of the Institutionalization of Corruption (annually, data collected in April)
4. Annual Corruption Perception Indicator (annually, data collected in April)
5. Annual Indicator of Regulatory Burdens (annually, data collected in April)
6. Security of property rights (annually, data collected in April)
7. Annual Indicator of Business Environment Burdens (annually, data collected in April)

At the same time, quarterly, the IER collect data and calculate Industrial Confidence Indicators (which is calculated as the arithmetic average of the balances (in percentage points) of responses on questions about production plans, the assessment of order books and stocks of finished products (the latter with inverted sign). In addition, we produce the Index of Business Conditions (which is calculated as the arithmetic average of assessment of current business situation at the firm and expected change of it in 6 months perspective).

In the next sections we have briefly describe the indicators of corruption and regulatory environment, show there fluctuations and try to test several hypotheses about relations between different indicators.

2. IER approach to monitoring of corruption perceptions

2.1. Quarterly indicators

1. CORRUPTION AS IMPEDIMENT TO BUSINESS DEVELOPMENT. We ask firms' managers about the most limiting factors to the growth of their business, where corruption is included as one of the limits. Corruption is one out of 15 options of impediments to business development. Single variable "corruption as impediment to business development" allows understanding how problematic is corruption for the doing business for Ukrainian enterprises against the background of other barriers. For example, such as "economic" impediments as demand, capital, labor force etc or institutional ones as political instability, stability (predictability) of legislative environment etc.

2. QUARTERLY REGULATORY CLIMATE. Variable "corruption" is part of composite index named "regulatory climate". The composition of index based on experts' assessment of the regulatory climate in Ukraine. In particular, it is important to take into account enterprise managers self-assessment of regularity pressure, predictability and certainty of legislation environment and assessment of impact corruption on doing business. As result, this index consists of three components: (1) high regulatory pressure. (2) frequent changes in legislation and (3) corruption and reflects the proportion of respondents who chose at least one of the factors from list of impediments to business development (see Annex 3).

2.2. Annual indicators

(3) ANNUAL INDICATOR OF THE INSTITUTIONALIZATION OF CORRUPTION has been constructed and calculated since 2003 until now. Constructing the annual indicators, we proceeded from the assumption that corruption is a reaction to excessive regulation. That is, entrepreneurs, in order to reduce their administrative costs in a regulatory environment that has internal contradictions, is

complex and confusing, it creates a "cooperative" with government officials. Who, in turn, perceive their service as a business of providing services for their own enrichment. Under such conditions, corruption acts as a parallel institution that helps "solve the issue" quickly. In this case, the more reliable such "parallel system", the clear rules in it. That is, the phenomenon is widespread, tariffs for "services" are known and service recipients are sure of the result. This suggested that indicators could be found to measure in what extend corruption could be perceived as a social institution. So the idea of building an indicator of institutionalization of corruption arose. We have been looking for suitable dimensions for a long time, and then, after having studied literature, interviews with experts, interviews with business representatives, we have identified four variables: (3.1) absolute level of corruption, (3.2) unpredictability of unofficial payments, (3.3) uncertainty about the consequences of a corrupt act and (3.4) informal relationships with representatives of government. These variables are reflect the following data:

- % of firms that admit paying bribes by themselves or say that this is typical for their sector,
- % of firms that are unsure about the outcome (result) of bribe,
- % of firms that consider bribe sum unstable,
- % of firms that admit importance of informal relation with at least one authority from list (implicit corruption).

All variables are measured by score from 1 (not important) to 5 (very important).

To be test the possibility to combine the abovementioned variable we have applied principle component method. The simple correlation analysis supports the thesis, the existence of a link between the widespread of corruption and the extent to which the bribe is stable and how bribe-giver is sure of the outcome. 3 of the 4 variables have an upper level correlation with a "hidden" variable (see details in Annex 2). While the "importance of informal relations" has a quite low correlation. However, given the meaningful importance of this indicator, we decided to keep all variables in the new indicator. We present these data in form of in form of geometrical figure rhombus (see Annex 2) and calculate the value of Indicator of the Institutionalization of Corruption as square of rhombus divided by 100.

Table 1. Some results of factor analysis (INDICATOR OF THE INSTITUTIONALIZATION OF CORRUPTION)

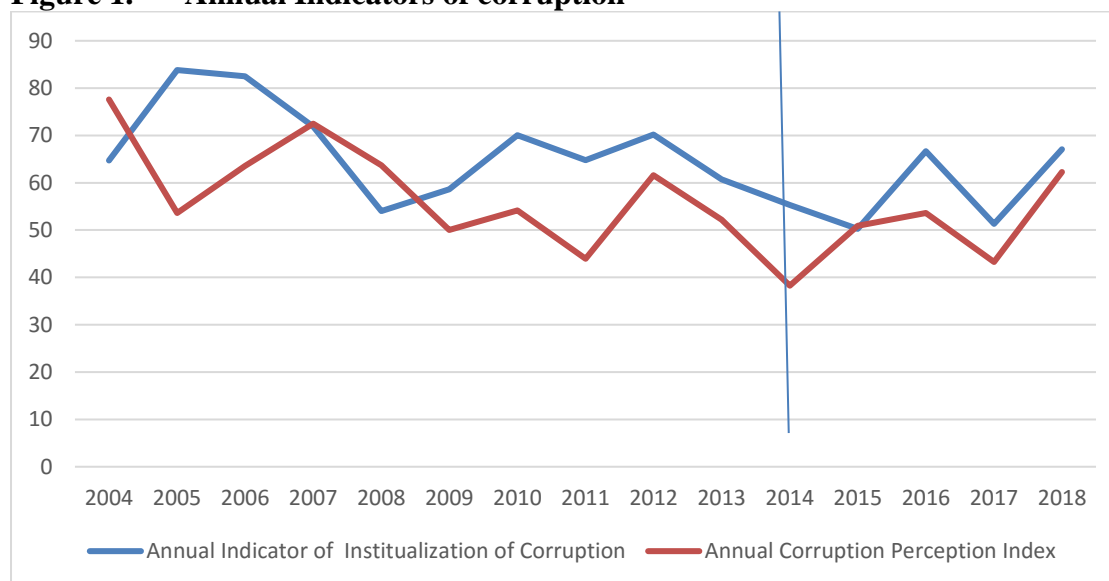
INDICATOR OF THE INSTITUTIONALIZATION OF CORRUPTION	
Name of variable	Correlation with "hidden" variable
Absolute level	-.900
Uncertainty of corruption outcome	.750
Unpredictability of bribes size	.897
Unformal relations	-.418

Extraction Method: Principal Component Analysis.

Another annual indicator of corruption is (4) ANNUAL INDICATOR OF CORRUPTION PERCEPTIONS that describe how corruption is widespread according to enterprise manages opinions. It is calculated as the arithmetic mean of two variables: absolute level of corruption and informal relationships with representatives of government. First variable is results of answers on question "Is that corruption is typical for such enterprises as yours?", the second variable is answers on question "Is that important for get success in business in our country to have

unformal relations with representatives of the state bodies. The both variables are measured by score from 1 (not important) to 5 (very important).

Figure 1. Annual Indicators of corruption



Source: IER BTS

In addition, we ask about the share of bribes in the overall turnover of the enterprise. However, given the high fluctuation of this response and the different responses in different years, this indicator is not used for regular analysis.

The next indicators (indexes) are describe the regulatory environment. It is important to measure the business opinions respecting this issue due to our assumption that corruption is reaction on improper regulation.

(5) ANNUAL INDICATOR OF REGULATORY BURDENS. We investigate regulatory burden across the following variables⁸: 1) level of indirect state interference (% of enterprises that indicate the interference of the state in operating activities), 2) predictability and clarity of regulations (% of enterprises that consider economic legislation unclear and unpredictable), and 3) time tax (% of managers' time spent on interaction with government officials).

To test the possibility to combine the abovementioned variables we have applied principle component method. In contrast to Indicator of the INSTITUTIONALIZATION OF CORRUPTION, the result of factor analysis shows the respectively high correlation of these variables with “hidden” variable. As result, we decided to calculated indicator as arithmetic mean of abovementioned single variables. In table 2 the some results of factor analysis for the both composite indicators are presented. The more details are in the Annex 2 and Annex 3.

Table 2. Some results of factor analysis (ANNUAL INDICATOR OF REGULATORY BURDENS)

ANNUAL INDICATOR OF REGULATORY BURDENS	
Name of variable	Correlation with “hidden” variable
"Time tax"	.610
Unpredictability of legislation	-.855
State interference	.927

Extraction Method: Principal Component Analysis.

⁸ In our survey, we avoid from looking at the changes in registration procedures and quantity of regular/irregular controls by regulatory bodies, since progress in this area is well recorded by other analysts.

(6) SECURITY OF PROPERTY RIGHTS indicator is calculated as arithmetic mean of two indicators: 1) assessment of ability of judicial system to ensure enforcement of commercial contracts; 2) assessment of ability of judicial system to protect personal security and security of business entities against criminality

Finally, the (7) ANNUAL INDICATOR OF BUSINESS ENVIRONMENT BURDENS is calculated as the arithmetic mean of such components:

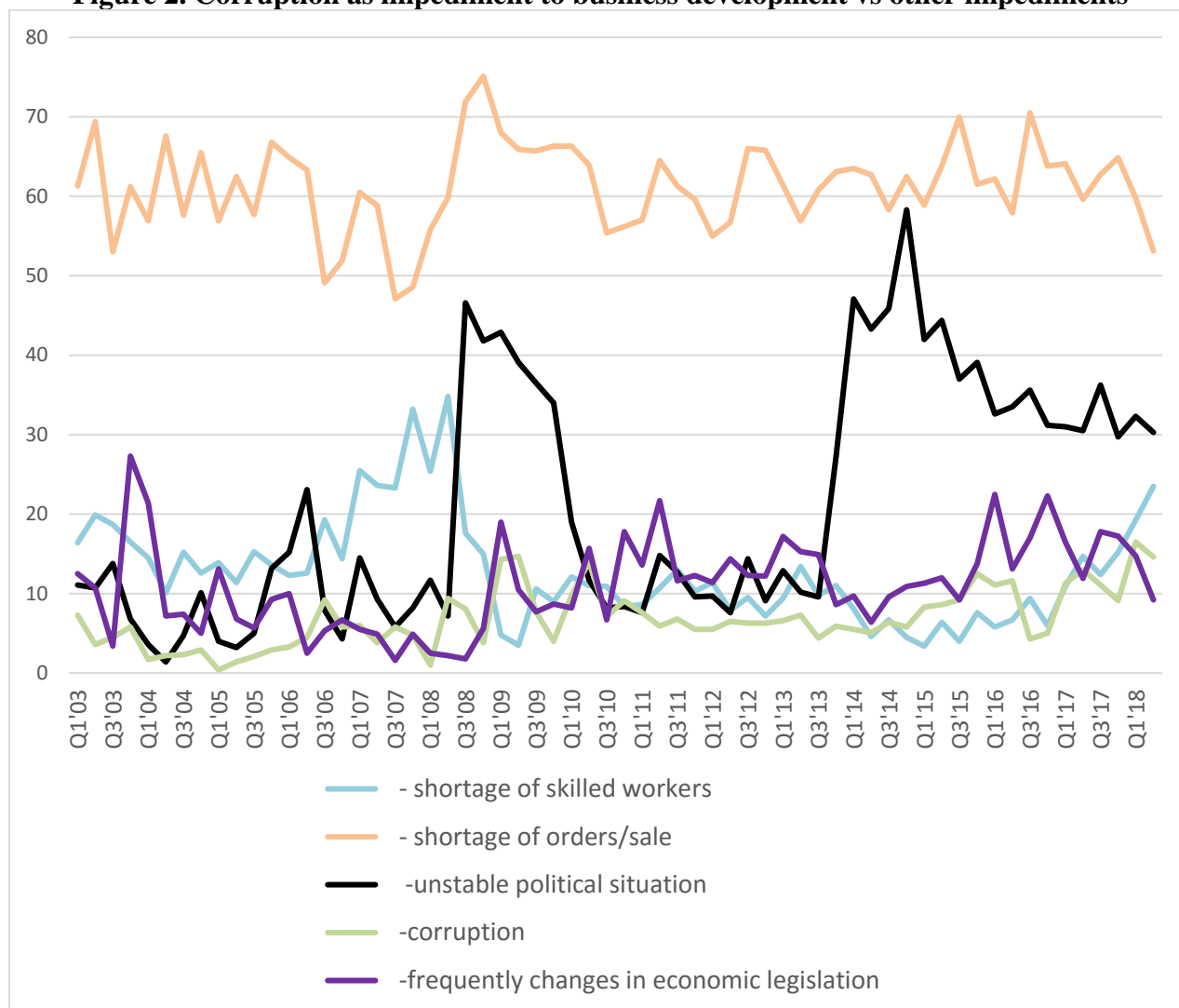
- Security of property rights
- Annual Corruption Perception Indicator
- “Time tax”
- Unpredictability of regulations
- State interference
-

Annual INDICATOR OF BUSINESS ENVIRONMENT BURDENS is measured on a scale from 0 to 100, where 0 is no burdens and 100 is completely burdened environment. Therefore, the lower values the indicator the better business climate.

2.3. Analysis of quarterly indicators

Corruption as an obstacle to the growth of production has never been one of the main obstacles. The list of obstacles traditionally led by such barriers as insufficient demand, liquidity problems and other purely economic factors. In the period of 2014-2016, the top three leaders of the rating included a factor characterizing the instability of the political situation. This is due to Russia's military aggression against Ukraine. However, since 2017, the weight of this factor is decreasing. Corruption ranged from 12 to 8 among 15 possible factors. The figure 1 presents the dynamics of the factor "corruption" and other factors characterizing the regulatory environment in comparison with the factor leading the list of barriers "lack of demand", and an important factor of "shortage of labor". The data obtained in July 2018 indicate an increase in the predictability of the business environment (the value of the obstacle "frequent changes in legislation" has diminished) and the reduction of the weight of obstacles to corruption for enterprises. The regulatory climate in the quarterly dimension is improving.

Figure 2. Corruption as impediment to business development vs other impediments

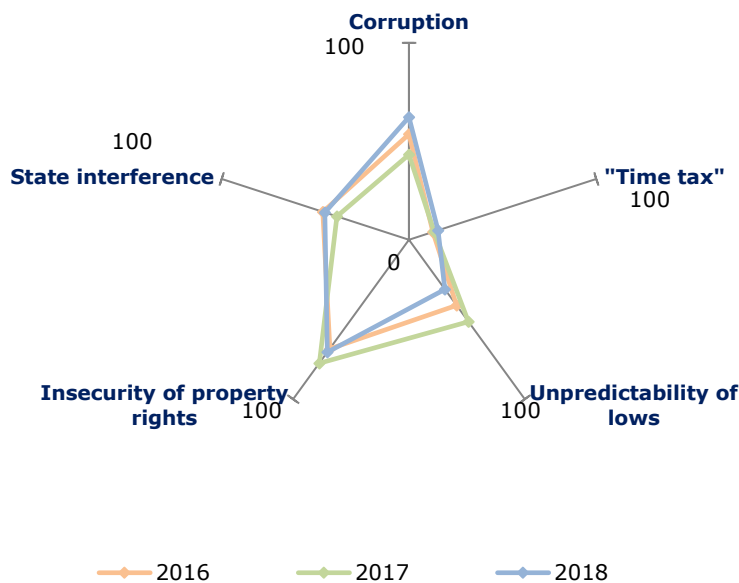


Source: IER BTS

2.4. Analysis of annual indicators

The overall picture of the problem of the business environment is presented in the star chart in the Figure 3 where the axis reflects the indicators. In 2018, the level of corruption, the level of state interference and time tax have increased in comparison with 2107. At the same time, there are two important improvements. The issue of non-compliance with property rights has decreased. Legislation that affects the activities of the company has become much simpler and more comprehensible. These two opposite trends led to the fact that the value of the indicator of business environment burdens did not change in comparison with last year and was 44.9 (44.8 in 2017).

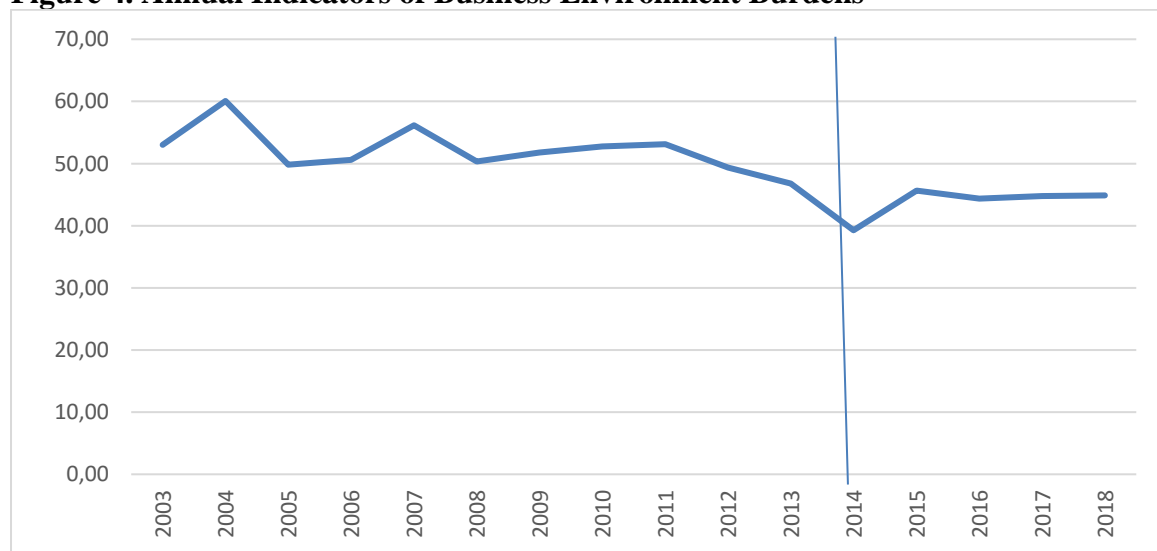
Figure 3. Annual Indicators of Business Environment Burdens in the star chart



Source: IER BTS

Analyzing 15 year’s trends, we can see the decrease the level of regulatory burdens. See figure 4. In the next studies, we are going to look for the real statistic data that can be correlate with this trend.

Figure 4. Annual Indicators of Business Environment Burdens



Source: IER BTS

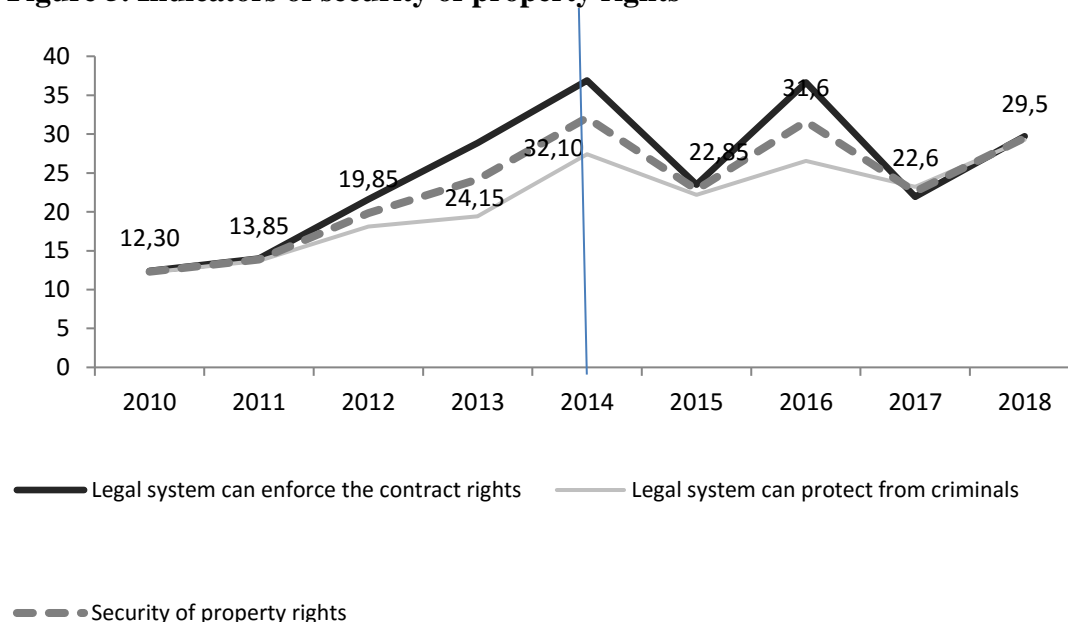
In the chapters below, we analyze the fluctuation of components of the Annual Indicator of Business Environment Burdens during recent years.

2.3.1 Security of property rights

In 2018, entrepreneurs note improvement of the situation with the security of property rights: after the rapid fall of the indicator in 2017, in 2018 its value increased from 22.6% to 29.5%.

This concerns both the assessment of the ability of the legal system to ensure compliance with contractual rights and the ability of the legislative system to protect business from criminality. In 2018, 29.3% of managers believe that the legal system will provide protection against organized crime and 29.7% of managers believe that the legal system will ensure compliance with contractual rights. In 2017, the figures were 22.1% and 21.4%, respectively. The larger the size of the enterprise, the greater the share of managers believes that the legal system ensures compliance with contract rights. Similarly, the change in the indicator depends on the size of the enterprise. The share of respondents who believe that the legal system for enforcing contract rights among small businesses has doubled - from 13% in 2017 to 26% in 2018, for medium enterprises - from 22% to 29%, respectively. For large enterprises, the share increased by only 1.7 pp, from 36.4% to 38.1%. The value of providing a legal system for protection against crime virtually does not depend on the size of the enterprise. Among small businesses, 28% of managers believe that the legal system will provide protection against organized crime, among medium and large - 31% and 29% respectively.

Figure 5. Indicators of security of property rights



Source: IER BTS

2.3.2. Regulatory burdens

Direct state interference in the operational activities of enterprises. The level of state intervention in entrepreneurial activity is considered by respondents to be high. In 2016, this indicator reached a record high of 46%, dropped to 38.5% in 2017, and in 2018, it rose again to almost 2016 and was 45%.

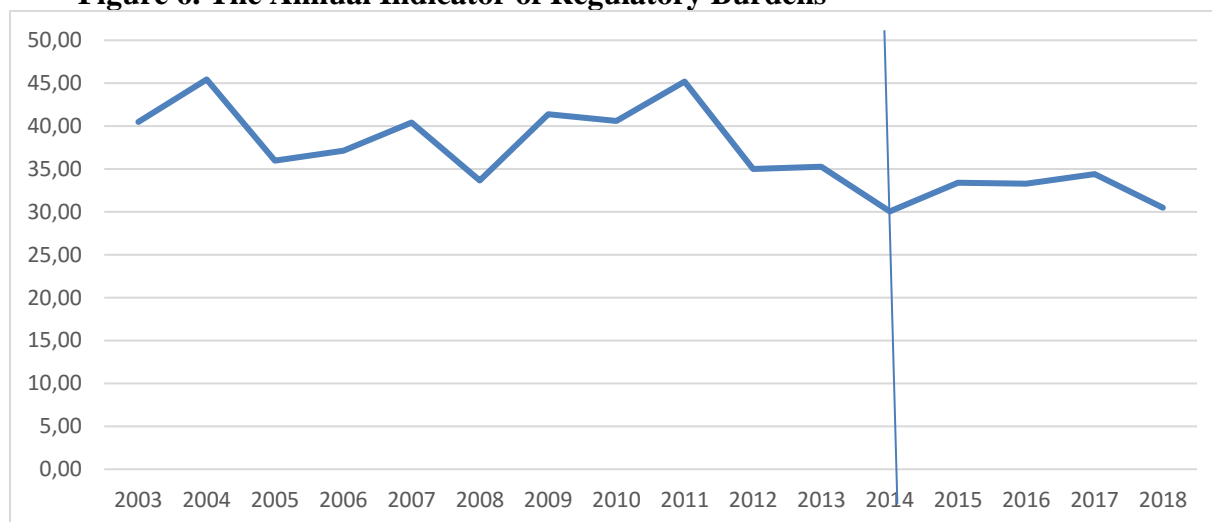
Predictability and clarity of regulatory acts. Assessment of predictability and clarity of legislation has improved. The share of respondents who consider legislation to be contradictory and unpredictable has decreased from 51.3% in 2017 to 31% in 2018. The share of respondents who consider the legislation to be contradictory and unpredictable among small enterprises has decreased the most, the smallest decrease for large enterprises. For small businesses, the value dropped from 48.4% in 2017 to 24.7% in 2018, for large from 54.5% to 39.6%, respectively. For medium-sized enterprises, the value dropped from 53.8% in 2017 to 32.8% in 2018.

"Time Tax". It is estimated that in 2018, managers spend 15.6% of their working time on interacting with government officials on the interpretation and application of laws. The value of

this indicator increases for 4 years in a row, in 2015 the value was 11.4%, in 2018 it increased to 15.6%. For comparison, the minimum time spent on communication with government officials was recorded in 2010 - the time tax on average was 9.4% of the time, and the maximum - in 2011 and was 19.9%. The larger the size of the enterprise, the more time managers spend on interacting with government officials on the interpretation and application of laws.

As results, the Annual Indicator of Regulatory Burdens has decreased from 34.4% in 2017 to 30.5% in 2018. In 2018, the reduction of the regulatory burden is characteristic for enterprises of all sizes. For small, medium and large enterprises, the indicator has decreased, compared with 2017, by 3.9, 4.2 and 3.7 percentage points in accordance.

Figure 6. The Annual Indicator of Regulatory Burdens



Source: IER BTS

2.3.4 Indicators of corruption

Absolute level of corruption. The level of corruption in Ukraine remains high. Respondents were asked whether unofficial payments were payable to companies such as them to deal with problem situations. In 2018, the share of managers who replied that for such enterprises as them, the payment of unofficial payments has become widespread to 78.5% (in 2017, 59.3%). This value is the highest for all years of research. A similar high value was in 2004 (76.8%). Most often, corruption is faced by small businesses - 85%. For medium and large enterprises, the level of corruption is 71.9% and 72.4% respectively.

Uncertainty about the consequences of a corrupt act. (Impossibility of payers of unofficial payments to provide the desired results). The share of respondents who are uncertain or after payment of an unofficial payment will be provided with the necessary "service", as was stipulated before, decreased in 2018 compared to last year - from 59% to 52.3%. The most unpredictable consequences of corruption acts for the third year are for medium-sized enterprises (63.9%), for small and large indicators it is 46.2% and 51.7% respectively.

Unpredictability and instability of unofficial payments. In 2018, the size and the situation in which unofficial payments are unpredictable for more than half of the enterprises. The unpredictability rate of unofficial payments remained almost unchanged at 57.8% (59.8% in 2017). However, for small and medium enterprises, the value of this indicator has changed. For small businesses, the value increased from 46.9% in 2017 to 52.3% in 2018, while for average it decreased from 85.7% to 60%, respectively. Value for large enterprises increased by 1.2 percentage points. and accounted for 67.9%.

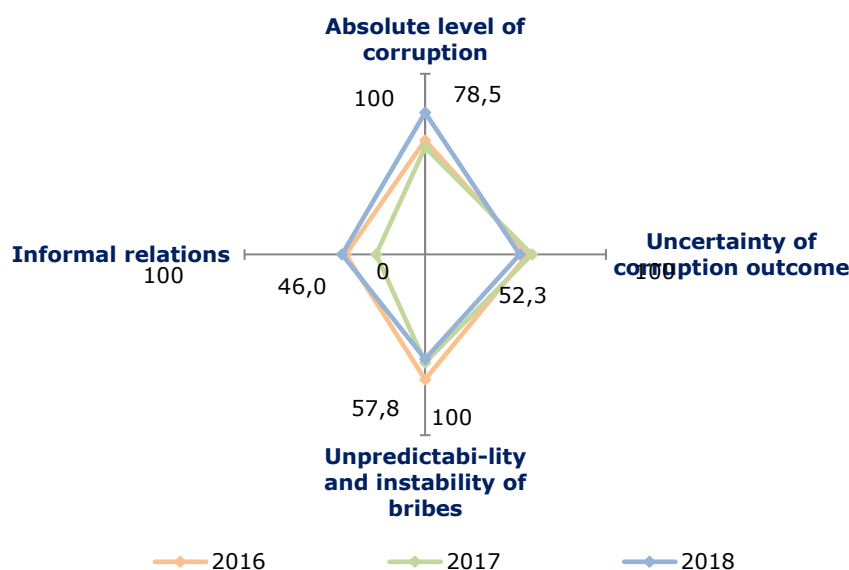
Informal relationships (implicit corruption). In 2018, compared with 2017, entrepreneurs estimate the importance of informal ties with state authorities much higher. Thus, 46% of managers consider the presence of informal connections as an important factor in the success of their economic activity, while in 2017 their share amounted to 27.2%. This year, entrepreneurs rated the importance of informal ties for the last five years, the lowest in 2014 and 24.8%. The greatest increase in the importance of "friendly relations" with state authorities is characteristic for small enterprises (24 pp), and the smallest for large enterprises (10.5 pp). For medium-sized enterprises, the importance of informal ties increased by 17 percentage points.

The general picture of corruption is presented in a star chart, where the axes reflect the following indicators:

- % of companies that recognize the payment of unofficial payments;
- % of enterprises unsure of the consequences of a corrupt act;
- % of enterprises considering the size of unofficial payments unstable;
- % of companies that recognize the importance of informal links with at least one public authority.

The star chart in the Figure 7 as well as fluctuation of Index presented in the Figure 1 shows a worsening of the situation with corruption in 2018 compared to the previous year for the sample as a whole. In 2018, the absolute level of corruption increases and the importance of informal contacts with government officials for successful business, the size and situation of informal payments are almost unchanged, and the results of corruption are becoming more predictable.

Figure 7. Annual Indicator of the Institutionalization of Corruption presented as star chart



Source: IER BTS

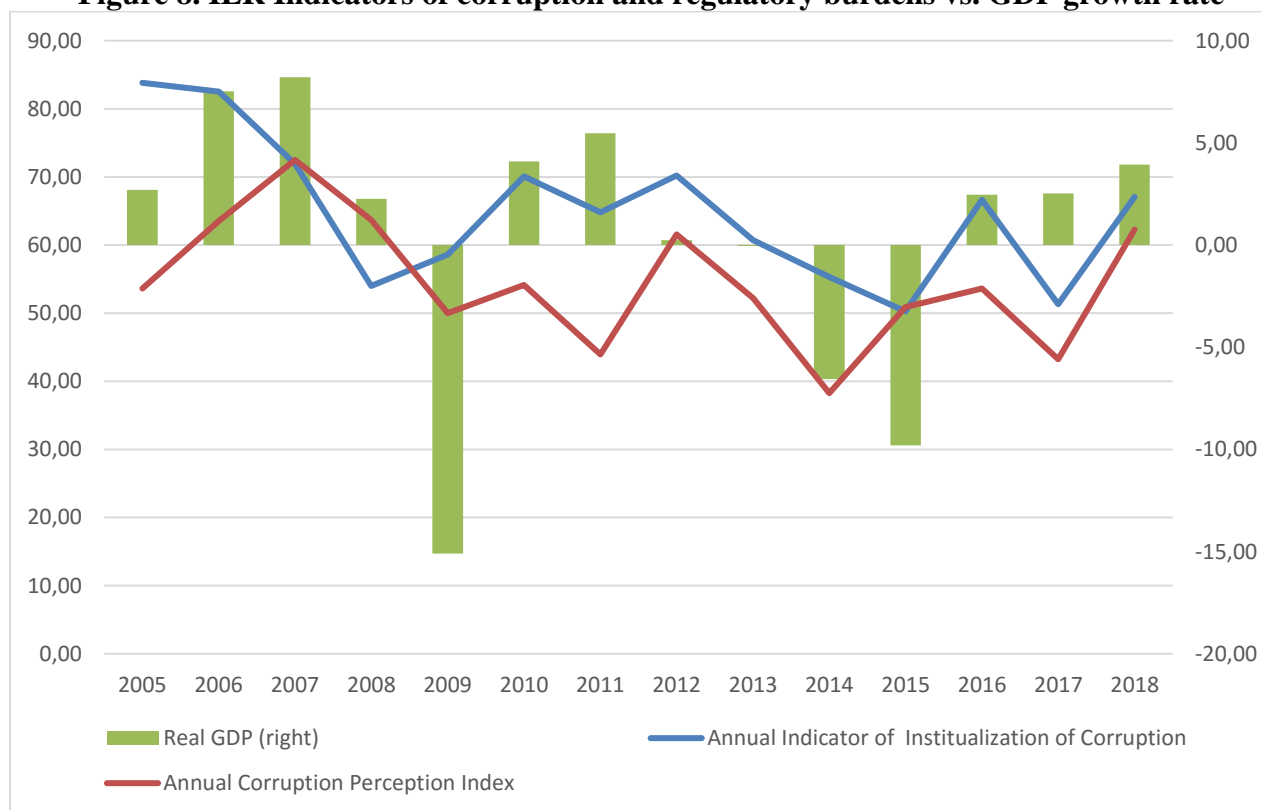
2.5.Relation between indicators of corruption/regulatory environment and BTS indicators

At the stage of designing the research, we have expected to find the relations between the corruption indicators and other indicators. Annual indicators of regulatory climate and corruption were compared with quarterly indicators of the economic situation (IER Industrial Confidence Indicator and IER Index of Business Condition). Taken into account that the annual figures were collected during the first quarter (April / May) wave of the survey, the quarterly indexes for the

relevant period were taken into account. At this stage of our research, no statistically significant relations are recorded. The coefficient of correlation is low than 0.2. Therefore, we will continue to work at this issue.

At the same time, the simplest correlation analysis (Pearson correlation) shows the moderate level of correlation between year over year GDP growth rate and Annual Indicator of the Institutionalization of Corruption (details see in the Annex 4. The coefficient of correlation is - 0.57. This result is significant at the 0.05 level (2-tailed). At the first glance, this correlation can be spurious. Nevertheless, it push to think. If we assume that corruption is a reaction on improper regulation, and entrepreneurs optimize their costs (behavior) in order to get the best result with less resources. In this case, this correlation can mean that, indeed, corruption has a certain institutional role, better than a regulatory system. In addition, the result shows that the root of the problem of corruption is still a disadvantageous regulatory environment.

Figure 8. IER Indicators of corruption and regulatory burdens vs. GDP growth rate



Source: IER BTS

If we go beyond the goals of this work, then the question is raised and what is generally corruption in the understanding of business representatives. Moreover, here we will note that corruption is a movement from both sides. On the one hand, an official may demand a bribe, on the other hand, often the business is ready to pay extra in order to accelerate one or another process. This can be adjusted by directing funds not into the bribe, but the state (local) budget, through the creation of a corresponding "legitimate" service. This has already been used in the implementation of Ukrainian reforms. In particular, it was about administrative services for citizens. All services can be obtained by paying a state fee, but if someone wants to get the service faster, then there is an appropriate procedure for additional funds. When it comes to reducing opportunities for corruption in the economy, we usually talk about reducing the role of an official through the digitization of services. However, it can be said that the "speed service" will have to pay and business.

From the point of view of political recommendations, there is no alternative to deregulation on the one hand and the establishment of a system of proper regulation in Ukraine. Given that this is an important part of the Association Agreement between Ukraine and the EU, the same implementation of the Agreement in the areas of creating a favorable regulatory environment - one of the important measures to reduce corruption.

3. Conclusion

1. IER has developed a system of indicators that tracking business attitudes towards corruption and some aspects of regulatory climate. There are quarterly and annual indicators. They collected in frame of conducting business tendency survey.
2. Developed IER indicators measure business attitudes to various aspects of the regulatory environment, including corruption. In the future, it is necessary to conduct research to compare the indicators of the business climate and corruption with the indicators of real economic statistics. Although we are aware that such indicators may not be found.
3. The result of analysis presented in this article support the thesis that corruption is reaction on overloaded and unclear regulation. While the more quantitative studies are demanded.
4. The result of the studies have policy implications and can be used as additional argument in developing policy recommendation and monitoring reforms implementation in Ukraine.

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Annex 1. Questionnaire of BTS. Section «Corruption»

Annually asked questions (Survey wave of April)

1. In your opinion, what percentage of total annual sales do firm like yours pay in the form of unofficial payments to public officials? _____% on average

To what extent do you agree with the following statements? (scale: 1 - completely disagree, 5 - completely agree, 6 - do not know):

2. The level of unofficial payments and the situation in which they are paid are stable and predictable 1 2 3 4 5 6

3. Interpretation of law and regulations that affect your business do not contradict each other and are predictable 1 2 3 4 5 6

4. There is a need from time to time in "unofficial payments or services" in order to conduct business properly for the enterprises of your industry 1 2 3 4 5 6

5. I am sure that the services for which I pay informally will be executed in accordance with the agreement 1 2 3 4 5 6

6. If the actions of a civil servant do not meet the established rules, you can apply to a senior official to correct the situation without using unofficial payments 1 2 3 4 5 6

7. It is believed that companies in Ukraine are forced to evade tax payments. In your opinion, what percentage of the official tax is paid by enterprises involved in the same area of commercial activity as yours?

<10%	11-20%	21-30%	31-40%	41-50%	51-60%	61-70%	71-80%	81-90%	>90%	Don't know
<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6	<input type="checkbox"/> 7	<input type="checkbox"/> 8	<input type="checkbox"/> 9	<input type="checkbox"/> 10	<input type="checkbox"/> 11

8. When it comes to public procurement, in your opinion, what percentage of the contract value of an enterprise in your industry (such as yours) are willing to offer in the form of an unofficial payment to guarantee the receipt of a contract?

0%	<5%	6-10%	11-15%	16-20%	>20%	Don't know
<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6	(<input type="checkbox"/> 7)

9. In your opinion, how is it important to have informal relationships with representatives of different levels of government for doing business in the same volume as yours? (1 - not important, 5 - very important, 6 - I do not know)

10. How do you think, to what extent the change in the management of various levels of government influence the process of doing business in your enterprise? (1 - not important, 5 - very important, 6 - I do not know)

9. Informal relationship in.....

10. Government influence

<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6	Regional authorities	<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6
<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6	Central government	<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6
<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6	Local government	<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6
<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6	Police	<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6
<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6	Tax authorities	<input type="checkbox"/> 1	<input type="checkbox"/> 2	<input type="checkbox"/> 3	<input type="checkbox"/> 4	<input type="checkbox"/> 5	<input type="checkbox"/> 6

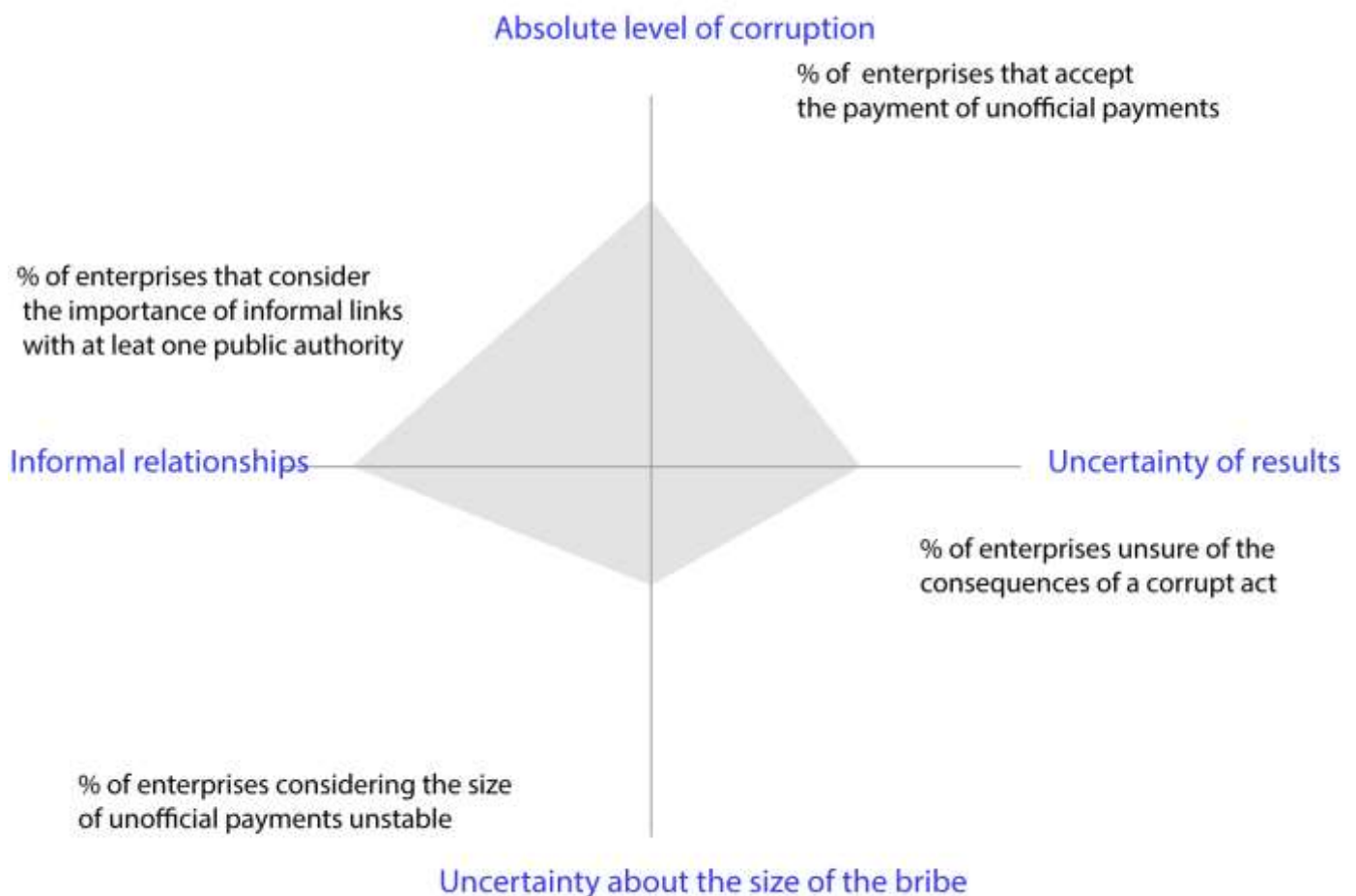
Quarterly asked questions

12. Are there factors limiting the growth of your business? IF yes, choose no more than the most important factors of the following.

READ OUT, MULTIPLE CHOICE (NO MORE THAN 4)

1.	Shortage of energy	High regulatory burden (unclear legislation, bureaucracy, inspections)	9.
2.	Lack of qualified workers	High tax rates	10.
3.	Lack of orders/sales volume/ insufficient demand for products/services	Outdated technology	11.
4.	Lack of raw materials	High interest rates	12.
5.	Liquidity problems	Frequently changes of economic legislation	13.
6.	Unstable political situation	High competitive pressure	14.
7.	Lack of capacities	Corruption	15.
8.	Low availability of loans (access to credits, complex loan requirements and procedures)	Other _____ _____	16.

Annex 2. The Indicator of the Institutionalization of Corruption



Factor Analysis (Principal component)**Correlation Matrix**

		Absolute level	Uncertainty of corruption outcome	Unpredictability of bribes size	Unformal relations
Correlation	Absolute level	1.000	-.581	-.834	.079
	Uncertainty of corruption outcome	-.581	1.000	.427	-.255
	Unpredictability of bribes size	-.834	.427	1.000	-.338
	Unformal relations	.079	-.255	-.338	1.000

Communalities

	Initial	Extraction
Absolute level	1.000	.810
Uncertainty of corruption outcome	1.000	.562
Unpredictability of bribes size	1.000	.804
Unformal relations	1.000	.175

Extraction Method: Principal Component Analysis.

Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	2.352	58.794	58.794	2.352	58.794	58.794
2	.945	23.629	82.424			
3	.608	15.210	97.633			
4	.095	2.367	100.000			

Extraction Method: Principal Component Analysis.

Component Matrix^a

	Component
	1
Absolute level	-.900
Uncertainty of corruption outcome	.750
Unpredictability of bribes size	.897
Unformal relations	-.418

Extraction Method: Principal Component Analysis.

a. 1 components extracted.

Annex 3. The Annual Indicator of Regulatory Burdens**Factor Analysis (Principal component)**

FACTOR

```

/VARIABLES VAR00001 VAR00002 VAR00003
/MISSING LISTWISE
/ANALYSIS VAR00001 VAR00002 VAR00003
/PRINT INITIAL CORRELATION EXTRACTION ROTATION
/CRITERIA MINEIGEN(1) ITERATE(25)
/EXTRACTION PC
/CRITERIA ITERATE(25)
/ROTATION VARIMAX
/METHOD=CORRELATION.

```

Correlation Matrix

		"Time tax"	Unpredictability of legislation	State interference
Correlation	"Time tax"	1.000	-.224	.426
	Unpredictability of legislation	-.224	1.000	-.740
	State interference	.426	-.740	1.000

Communalities

	Initial	Extraction
"Time tax"	1.000	.372
Unpredictability of legislation	1.000	.731
State interference	1.000	.860

Extraction Method: Principal Component Analysis.

Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings		
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %
1	1.963	65.436	65.436	1.963	65.436	65.436
2	.810	26.985	92.421			
3	.227	7.579	100.000			

Extraction Method: Principal Component Analysis.

Component Matrix^a

	Component
	1
"Time tax"	.610
Unpredictability of legislation	-.855
State interference	.927

Extraction Method: Principal Component Analysis.

a. 1 components extracted.

Annex 4 Correlation between selected indicators and GDP growth yoy

		Correlations						
		Absolute level	Uncertainty of corruption outcome	Unpredictability of bribes size	Unformal relations	Institutionalization of corruption	Annual Corruption Pr Index	GDP% yoy
Absolute level	Pearson Correlation	1	-.507	-.814**	-.089	-.322	.519	.136
	Sig. (2-tailed)		.064	.000	.761	.262	.057	.642
	N	14	14	14	14	14	14	14
Uncertainty of corruption outcome	Pearson Correlation	-.507	1	.242	-.015	.551*	-.314	.329
	Sig. (2-tailed)	.064		.405	.960	.041	.273	.251
	N	14	14	14	14	14	14	14
Unpredictability of bribes size	Pearson Correlation	-.814**	.242	1	-.155	.105	-.617*	-.322
	Sig. (2-tailed)	.000	.405		.596	.721	.019	.262
	N	14	14	14	14	14	14	14
Unformal relations	Pearson Correlation	-.089	-.015	-.155	1	.784**	.805**	.462
	Sig. (2-tailed)	.761	.960	.596		.001	.001	.097
	N	14	14	14	14	14	14	14
Institutionalization of corruption	Pearson Correlation	-.322	.551*	.105	.784**	1	.482	.570*
	Sig. (2-tailed)	.262	.041	.721	.001		.081	.033
	N	14	14	14	14	14	14	14
Annual Corruption Perception Index	Pearson Correlation	.519	-.314	-.617*	.805**	.482	1	.477
	Sig. (2-tailed)	.057	.273	.019	.001	.081		.085
	N	14	14	14	14	14	14	14
GDP% yoy	Pearson Correlation	.136	.329	-.322	.462	.570*	.477	1
	Sig. (2-tailed)	.642	.251	.262	.097	.033	.085	
	N	14	14	14	14	14	14	14

** . Correlation is significant at the 0.01 level (2-tailed).

* . Correlation is significant at the 0.05 level (2-tailed).

NUCLEAR WEAPONS: PROLIFERATION OR MONOPOLY?¹

Bertrand Lemennicier²

Abstract

The problem of nuclear proliferation is an old one dating back to the first offensive nuclear detonation in 1945 when the United States used nuclear weapons on Japan³. The problem resurfaces each time a new nation develops nuclear weapons: the Soviet Union in 1949, the UK in 1952, France in 1962, China in 1964 and India in 1974. Israel claims to have nuclear weapons. Brazil, South Africa, Egypt, Argentina could but have stopped development; and Iran, Iraq, Libya, North Korea, Syria and probably others have express the desire to have them. The development of a nuclear black market is well known over the past four decades. Iran and to a lesser degree India remain active customers by using procurement networks to supply its nuclear programmes via the private sector notes the International Institute for Strategic Studies (IISS)⁴

If nuclear weapons in the hands of governments present a real or perceived threat of intrusions or invasions among neighbors, we can expect smaller nations to move to protect their territory and political independence through nuclear weapon production or acquisition. The French government used this last argument against the American nuclear program when Charles De Gaulle came to power in 1958. At the same time technological and political changes have reduced the cost of acquiring weapons. Further, the technological progress should make possible the miniaturization of these weapons. Small organizations could someday have access to them. This possible proliferation is currently considered as a curse, not as a blessing. Why? Mainly because everyone fears that such a proliferation of weapons of mass destruction combined with advanced means for their delivery intensifies "the problem of ensuring global security" as Dagobert Brito and Michael Intriligator⁵ wrote recently in *Economic Affairs*.

This claim that the proliferation of any weapons- small or large, in the hands of the ordinary citizen or politicians- is a general threat is, in fact, the first step in the centralization and monopolization of power. It is through the argument, that proliferation itself is dangerous, that individuals, in being forbidden to own weapons of their choice, have been deprived of the basic right of self-protection by (and from) the tyrants governing their own countries.

¹ Editor's remark : This paper is a revised (in November 2012, for a publication and translation into Bulgarian, by the electronic journal *Public Policy.bg*, of Sofia University) version of an earlier article published as chapter 4 of: Hans-Herman Hoppe (editor), *Defense Myth: Essays in Theory and History of Security Production*, Auburn, Alabama, Ludwig von Mises Institute, 2003, pp. 127-144. It was amended by the author, following his lecture on "Liberalization of Nuclear Weapons" held in Sofia on October 17, 2012, sponsored by the Institute for Market Economics and Friedrich Naumann Stiftung (which motivated the author to add a new paragraph on "*Nuclear weapons: Unjust «in Bello», just «ad Bellum»?*" » and make other updates reflecting the international experience after first publication. It is reprinted here with the kind permission of the Ludwig von Mises Institute (www.mises.org) and Professor Lemennicier.

² Emeritus professor, University of Paris Sorbonne (Panthéon-Assas)

³ Remember that the US government of the time uses the nuclear bomb twice Hiroshima and Nagasaki.

⁴ *Nuclear Black Markets : Pakistan, A.Q. Khan and the rise of proliferation networks. A net Assesment*, IISS Strategic Dossier 2 may 2007.

⁵ D.Brito and M.Intriligator 1997 "Deterring nuclear weapons proliferation" in *Defence Economics* , Economic Affairs IEA (December)

Part of the problem is fear instilled in others when one possesses weapons. Imagine a situation in which miniature nuclear weapons with great power are available and affordable for ordinary citizens. I could give the French government an ultimatum as they sometimes do with other government. My ultimatum might be: “if you take my resources through taxation and invasion of my property, I will destroy Paris”. Or worse “The residents of Paris must pay me a tribute or face annihilation”⁶

Facts and common sense contradict this simplistic argument. In France, in 2010, there were 4936 arrests for possession of illegal arms, and only 437 homicides. Knowing that a third of homicides is committed with guns, shotguns or hand-held weapons, the probability of use of restricted weapons is low – around 3 percent, and knowing arrests involve only a fraction of persons carrying or possessing legal or illegal weapons, the real probability of forbidden weapons being used is very low. And of course, the only time in the history where the nuclear weapons were used was when the United States was able to do it without fear of retaliation.

In this paper we will challenge three following views usually held by experts and the public opinion: 1) Proliferation increases the probability of a global nuclear war; 2) nuclear weapons are unjust means used to reach a just end: ensuring global peace; 3) the fight against proliferation is a good thing.

Proliferation and the Probability of war.

To challenge the first view, we need to establish a correlation between arms possession and the number of assaults. Does legally or illegally arming additional people increase the probability of aggression, or decrease it? Does the probability of nuclear war increase when additional countries develop nuclear weapons? Brito and Intriligator through a cardinality theorem, tried to show such a correlation⁷. Their thesis was traditional in that the dominant factor was not the proliferation of nuclear weapons *per se* but the increase in accidents or inadvertent launches by those possessing them. Alternatively, the nonproliferation case often focuses on the irrationality of the marginal actor who can destroy the “terror equilibrium of nuclear weapons”—a classical argument used to justify a cartel.

Imagine there is only one armed person. The temptation for aggressive behavior instead of peaceful conflict resolution for this person would be strong—because he has a comparative advantage. Now imagine two similarly armed people (or States). The fundamental question is whether either will use an aggressive (Hawk) strategy, or a cooperative (Dove) strategy, in a conflict. If the use of weapons will lead to a deadly war in which both sides likely will lose not only their property but their lives, an aggressive strategy is not the preferred one. If we suppose that both are rational entities, they will adopt Dove behavior over Hawk behavior only if the expected gains from using the Dove strategy exceed those of the Hawk strategy. The complication is that future gains from either strategy for one player depend on the behavior of the other player. There is a nonzero probability of armed conflict, though this probability is much lower than in the case in which a party faces no risk of retaliation.

In that case, the Hawk strategy would dominate for the armed player.

Let's formalize⁸ this interaction between John and Peter, two individuals or princes representing their countries, both possessing nuclear weapons:

⁶ Of course, at present, only governments, through massive taxation, are able to afford nuclear weapons

⁷ D. Brito and M. Intriligator. "Proliferation and the Probability of War." *Journal of Conflict Resolution* (March 1996): 206-14.

⁸ This model is a variant of the Hawk and Dove model of modern game theory first developed by J.M. Smith, *Evolution and the Theory of Games* (Cambridge, U.K.: Cambridge University Press, 1982).

		Peter			
		$1-\lambda(2)$		$\lambda(2)$	
John		Dove		Hawk	
Dove	$\lambda(1)$	V/2	V/2	0	V
Hawk	$1-\lambda(1)$	V	0	(-C)	(-C)

V measures gains from a conflict. C is the cost of war. If they both use the Dove strategy, they divide gains, V/2. If there is a balance of power, nuclear weapons make war very costly. When both make war, the use of nuclear weapons imposes only losses, -C for John and for Peter. In the case that John has a monopoly in nuclear weapons, he has no fear of retaliation: here, there are only gains (V > 0) for John and no losses or gains for Peter, as he surrenders.

If John has a monopoly, the dominant strategy for him is the Hawk strategy⁹ In the case of a balance of power, each party will adopt the Hawk strategy if and only if he is sure the adversary will play the Dove. If both play the Hawk strategy, losses are the only outcome. If John plays Hawk and Peter plays Dove, John will get the totality of gains, V. In the opposite case his gain is zero. The game is symmetric since both sides have the same weapons. We can see that the Hawk strategy is not the most attractive behavior as the outcome (-C) is negative. But the Dove strategy is dubious since $V > V/2$. Thus, John plays Hawk only if Peter plays Dove. In the absence of perfect foresight, John has to predict Peter's behavior. From John's perspective, $\lambda(2)$ is the probability that Peter will adopt the Hawk strategy and $1-\lambda(2)$ that Peter will adopt the Dove strategy. And for Peter, $\lambda(1)$ is the probability that John will adopt the Hawk strategy and $(1-\lambda(1))$ the Dove strategy.

Future expected gains for John in adopting the Hawk strategy are:

$$(1) E(U)_H = (1-\lambda(2))V + \lambda(2)(-C)$$

If he plays the Dove they are:

$$(2) E(U)_D = \{1-\lambda(2)\} \cdot V/2 + \lambda(2) \cdot 0 = (1-\lambda(2)) \cdot V/2$$

Thus he plays the Dove if and only if

⁹ Asymmetries, imbalance of power, and hierarchy of political forces are usually the sources of political power. In the analysis we assume perfect symmetry of forces as a result of the spread of nuclear weapons: Military technology is available or accessible at a certain price for individuals or groups. Let's drop this hypothesis. We introduce asymmetry between John and Peter. Costs and gains for them are divergent. The matrix looks as follows:

		Peter	
		Dove	Hawk
John	Dove	V/2, v/2	0, v
	Hawk	V, 0	(-C), (v-c)

We give Peter an advantage in aggression, $v-c > 0$. John is aware that Peter will play Hawk due to this advantage. Because Peter definitely will play Hawk, John's strategy will be to surrender to Peter, since $0 > -C$. Peter beats John. This interaction will lead to domination by one party, which strangely is praised by political scientists. The origin of such domination lies not necessarily in asymmetry itself, but in the belief in it on John's part. This helps highlight the role of misinformation as military strategy as well as the role of technology in multinational conflicts

$$(3) E(U)_D = (1-\lambda(2)) \cdot V/2 > E(U)_H = (1-\lambda(2)) \cdot V + \lambda(2) \cdot (-C)$$

and he will play Hawk when:

$$(4) E(U)_D = (1-\lambda(2)) \cdot V/2 < E(U)_H = (1-\lambda(2)) \cdot V + \lambda(2) \cdot (-C)$$

He will be indifferent between the two strategies when:

$$(1-\lambda(2)) \cdot V + \lambda(2) \cdot (-C) = (1-\lambda(2)) \cdot V/2$$

that is when

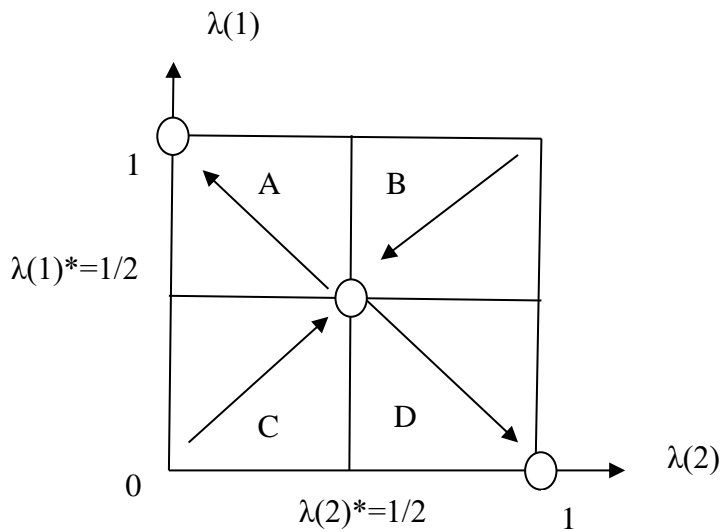
$$(5) \lambda(2)^* = V/(2C + V)$$

The interpretation of the ratio $V/(2C + V)$ is straightforward: It is the relation between the gain of the Hawk strategy, V , when the other plays Dove; and the opportunity costs of war $(2C+V)$ ¹⁰ when the other plays Hawk. If John estimates that the probability, $\lambda(2)$ that Peter will play Hawk is less than this ratio, $\lambda(2)^*$, John will play Hawk. Otherwise, if he estimates that this probability is higher than the ratio, John will play Dove. We also notice that as the damage from war compared to gains increases, the more likely John (or Peter) will adopt the Dove strategy, as the threshold probability is lower. If the ratio of gains over costs, from the war, approaches zero, which is the case with nuclear weapons, then the probability of peaceful conflict resolution increases drastically. Now, as the game is symmetric, we have $\lambda(1)^* = \lambda(2)^*$.

In such an interaction, $\lambda(2)$ and $\lambda(1)$ are key variables in the decision to enter a nuclear conflict. Assume that John is convinced erroneously by a third party, Paul, that Peter will play Dove, or that Peter is very likely to play Dove (while Peter in fact is ready to play Hawk), Then John will adopt the Hawk strategy based on incorrect information. Nuclear war is then the outcome of this incorrect information. This explains why governments have developed direct communications between those who have the power to start a nuclear conflict, protecting themselves against such erroneous decisions, But as players are rational, they anticipate difficulty in predicting the behavior of others. A natural consistency requirement is that expectations are also rational.

The convergence of anticipations between John and Peter is crucial. Consider the following figure 1.

¹⁰ $(2C + V)$ measures for both players the sum of the direct cost of war, C , and the loss suffered by each player in losing the gain of the Dove strategy, $V/2$. $2(C+V/2) = 2C + V$.

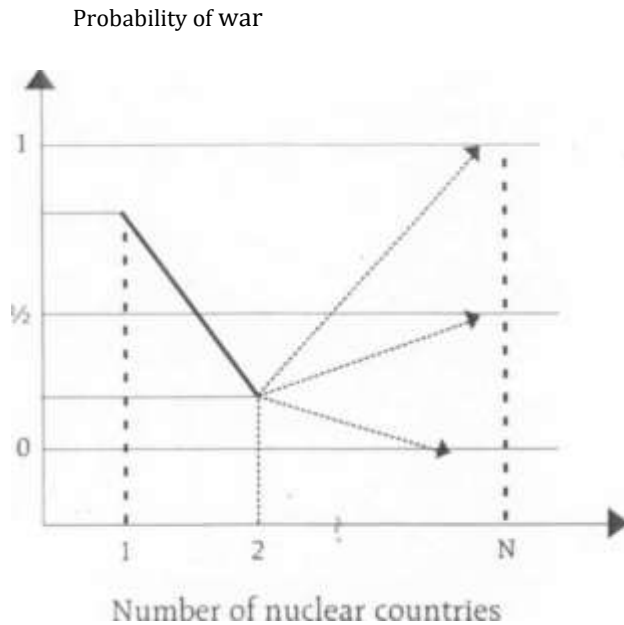


On the horizontal axis, we plot John's expectations of Peter, $\lambda(2)$, while on the vertical axis we plot Peter's expectations of John, $\lambda(1)$. Assume we are in zone A, in that case, $\lambda(1) > \lambda(1)^*$, while $\lambda(2) < \lambda(2)^*$. This means Peter should play Dove as the best response to the behavior of John, as John rationally plays Hawk. For expectations in zone A, a stable strategy is the couple $\lambda(1) = 1, \lambda(2) = 0$; John plays Hawk and Peter plays Dove. In zone D, we have the opposite, $\lambda(1) = 0, \lambda(2) = 1$; John plays Dove and Peter plays Hawk. There are two pure strategies: Either John dominates or Peter dominates. In regions B and C, both Peter and John play the same strategy, either Hawk or Dove, as $\lambda(1) > \lambda(1)^*$ and $\lambda(2) > \lambda(2)^*$ (zone B), or $\lambda(1) < \lambda(1)^*$ and $\lambda(2) < \lambda(2)^*$. The mixed equilibrium $\lambda(1)^* = \lambda(2)^*$ is not in fact stable in regions A and D. But when C increases drastically, as with nuclear weapons, the value of $\lambda(1)^* = \lambda(2)^* = V/(2C+V)$ approaches zero, such that regions of peace A, B, and D increase in size. This means an increase in the probability that the outcome of the interaction is peace.

Consequently, the arms race between two nuclear countries to establish a power equilibrium should decrease the odds of an armed conflict. The more deadly the weapons become, the more they are dissuasive. The next question is: Does the introduction of additional participants increase, decrease, or leave unchanged the probability of conflict? Refer to the next figure: 2.

On the vertical axis is plotted the probability of war and on the horizontal axis the number of countries or governments with nuclear weapons. With a monopoly the probability of war approaches 1. With two players the probability nears zero. Adding participants either lowers this probability to zero or increases it until we reach pure uncertainty¹¹ (the probability of war is $\frac{1}{2}$) or pure certainty (the probability of war approaches 1).

¹¹ Brito and Intriligator recognize the monopoly and duopoly cases, but they argue that an increase in the number of players will increase the probability of errors. In that case the probability of conflict increases to .50—that is to complete uncertainty.



Adding one player to the interaction implies a new game with three players, each always having two strategies to play, Hawk or Dove:

Patrick	Hawk ($\lambda\{2\}$)		Dove ($1-\lambda\{2\}$)	
Peter	Hawk	Dove ($1-\lambda(3)$)	Hawk	Dove ($1-\lambda(3)$)
John	$(\lambda(3))$		$(\lambda(3))$	
Hawk $\lambda\{1\}$		-C.-C.-C		V. 0. 0
Dove $1-\lambda(1)$	-C.-C.-C	o. v. o	-C.-C.-C	V/3.V/3.V/3
	-c.-c.-c		o. o. v	

Patrick plays either Hawk or Dove. Then Peter plays either Hawk or Dove, conditional on whether Patrick has played Hawk or Dove. Then what is John's strategy? In a nuclear conflict, if two players play Hawk the destructive power of nuclear weapons is such that the other actor who plays Dove may be destroyed as well¹². In fact, gains occur for one or for all when only one actor plays Hawk while the others play Dove, or when all play Dove. Consequently, knowing this matrix, John will calculate the expected value of adopting the Hawk strategy versus the Dove by anticipating the aggressive behavior of the two other players.

Hawk strategy:

¹²One thought is that the third party who does not take part in the nuclear conflict will be the last survivor and will profit from the destruction of his competitors in the fight for resources. Actually, this strategy moves the third player to autarky, which implies losses compared to the present situation of no conflict. Further, we can add an externality problem-collateral damage-with nuclear war due to the destructive power of nuclear weapons.

$$(6) E(U)_H = \lambda\{2\}\lambda(3)(-C) + \lambda(2)(1-\lambda(3))(-C) + (1-\lambda(2))(1-\lambda(3))V$$

Dove strategy:

$$(7) E(U)_D = \lambda(2)\lambda(3)(-C) + (1-\lambda(2))(1-\lambda(3))(V/3)$$

John will play Hawk when

$$(8) E(U)_H = \lambda(2)\lambda(3)(-C) + \lambda(2)(1-\lambda(3))(-C) + (1-\lambda(2))(1-\lambda(3)).V > E(U)_D = \lambda(2)\lambda(3)(-C) + (1-\lambda(2))(1-\lambda(3))(V/3)$$

He will be indifferent when:

$$(9) E(U)_H = \lambda(2)\lambda(3)(-C) + \lambda(2)(1-\lambda(3))(-C) + (1-\lambda(2))(1-\lambda(3)).V = E(U)_D = \lambda(2)\lambda(3)(-C) + (1-\lambda(2))(1-\lambda(3))(V/3)$$

As the game is symmetrical, and knowing that expectations are rational (that is each player's expectations of the others coincide with actual choices the others intend to make), we can write: $\lambda(1) = \lambda(2) = \lambda(3) = 3\lambda$ where 3λ is the threshold with three players. Solving equation (9) for 3λ , we find:

$$(10) 3\lambda = V / (3C + V)$$

The threshold on which John bases his strategy is lower with three players than with two. Adding N players in this game leads to a threshold on which all players base their strategy:

$$(11) N \cdot \lambda = V / (NC + V)$$

Increasing N to infinity reduces the threshold to zero. Each nuclear power will be incited to play Dove. Adding N players implies N pure strategies where one is dominant (that is. plays Hawk while all others play Dove) and one mixed equilibrium $\lambda(1)^* = \dots = \lambda(N)^* = V / (NC + V)$. In the N-dimensional space of the $\lambda(i)$, the corresponding C area in the two-dimensional space shrinks to zero, insuring high stability of peace.¹³

To an outside observer, the frequency with which a nuclear conflict can emerge is given by

$$(12) f(H) = \sum N \lambda + \prod (N \lambda)^N$$

Looking at the matrix with three players, we see there are three cases with two players at war and one case with all players at war. But the product of a probability raised to the power N is negligible. Then the frequency of a nuclear war in a matrix of N players is reduced to:

$$(13) f(H) = \frac{NV}{NC + V} = \frac{V/C}{(1 + V/NC)}$$

¹³ The underlying idea is simple: if k players anticipate that (N-k) players will play Dove, $\lambda(i) < \lambda(i)^*$. then their best strategy is to play Hawk. But if they all play Hawk at the same time, the outcome is a generalized conflict and their own disappearance due to the externalities of a nuclear conflict. Knowing that each of the k players anticipates that the (k-1) other players will have the same bet, they will play Hawk only if they are sure that all others will play Dove. This possibility diminishes drastically as the number of players increases.

As N approaches infinity, the frequency of nuclear war is the ratio of gains V over the cost of war C . With nuclear weapons, C is very high compared to V , which predicts that the frequency of nuclear war will approach zero. The lesson from this formal analysis is that the more armed players there are, the more the threshold probability to have armed conflicts depends only on the ratio V/C . The more dissuasive the means is, the less the chances for conflict. Formalization can always be suspect of rhetorical trickery, and the present demonstration is no exception. At least, the formal model appeals to reason and not passions. If the model is correct, then it is important to liberalize the right to have extremely dangerous weapons and accept their dissemination among nations or individuals.

Nuclear weapons: Unjust «in Bello», just «ad Bellum»?

In a society where the individuals are free, the organization of the protection of individual rights is in the hands of each one, since each one has full sovereignty on himself. The organization of this protection has only one purpose: the protection of the self-ownership and of the goods an individual acquired "in a just way". For reasons of compatibility of the individual rights, this protection cannot use violence or the principle of aggression or coercion to reach its private ends. The principle of non-aggression or non-coercion is the base of a theory of the personal freedom and thus also of a theory of the just war. That implies two things: on one hand the only purpose of an "offensive" war is restitution of physical goods or private territories "unjustly" appropriated by the attackers and/or the compensation for the damages caused by them. On the other hand, a military organization which respects a general principle of non-coercion recognizes the possibility for each individual of ensuring his own defense as he thinks is the best for him. When this individual joins others to protect his fundamental rights, he joins a political society, and does this in the spirit of article 2 of the French Declaration of the Rights of Man and of the Citizen of 1789:

"The purpose of all political association is the preservation of the natural and inalienable rights of man. These rights are liberty, property, security and the resistance to oppression"

This point is crucial in answering the question of who must say when a war is just or not. It goes without saying that in this approach, there will be neither a national government, whatever its political regime (dictatorial or democratic), nor a cartel of governments under the cover of an international bureaucracy that dictates the terms of a "just" war. When this individual has weapons or pays men-at-arms, it does it to ensure the protection of these fundamental rights and not to ensure the timelessness of a government in place. He accepts to die to preserve his freedom, his life or his property as the freedom, life and property of those whom he loves and not to preserve the life of the members of a particular group of individuals in power. He might even wage a "just" war against his own government. In this vision, the victims or their entitled beneficiaries will require compensation, not in an arbitrary way but through a private system of justice. Thus, the judges or the referees will dictate what will be a "just war" and the principle which emerges from this system is the self-defense and restitution.

The Principle of Self-Defense: "Jus ad bellum"

Using the armies implies protection against an aggression. This aggression is characterised by a failure in the obligation to respect the fundamental rights of the individuals (for example plundering a territory which is the property or the joint ownership of the individuals who live there), by creating a measurable damage and connecting the failures to respect the obligations to the damages. The first - *the failure to respect an obligation* - must cause the second - *the damage*. This excludes the "aggressions" like the attack on the honor, the insults, and the injustices other than those implying a violation of the individual rights. That excludes the wars

whose aim is to impose a spiritual, social or religious ideal. That also excludes any intervention under the only pretext that the supposed attacker would have the intention to attack others or would have dangerous weapons. The army intervenes in self-defence, and if there is damage, it goes after the aggressors to obtain reparations. There, for example, we have a simple and unambiguous answer to the intervention announced by the USA in Iraq in 2003 compared to that of 1991 called "desert storm" following the 1990 invasion of Kuwait by the armies of Saddam Hussein. For the moment Iraq neither "aggressed" nor caused any damage to U.S. citizens contrary to the case of the Twin Towers. The army's mission is simple and clear. It's a body of professionals specialised in a particular protection: protection against the predators who would come in mass and who couldn't be stopped otherwise. The other types of threats call upon other professionals in charge of the security and protection of the individuals' fundamental rights or to the abolition of a the state interference in the economic and social life. The principles of self-defence and pursue of the aggressors responsible for the damage are the pillars of any military intervention. This is why the decision of a military intervention should be put in the hands of judges and not in the hands of politicians ready to use an army to satisfy the private interests of those who helped them to be elected and to consolidate their own political power. The "judge" or the "referee" and the insurers dictate the terms of the "just war" and the compensation. There is no difference between an ordinary crime and an aggression made by the statesmen.

This question raises another point : what is the responsibility of the politicians who start the aggression or who finance wars ? They do not act by themselves but they order, give commands. Is this a full responsibility or is it partially or entirely put in the hands of those who carry out their commands? The answer is that this responsibility is entirely in the hands of those who execute the commands and not in the hands of those who give orders. Those who carry out orders should be sanctioned because they are responsible for their acts and they should disobey the orders when these violate the individual rights of innocent third parties. Civil or military disobedience is the rule that the individuals must follow to prevent a government from starting an "unjust" war.

The Limits of Self-Defence: "Jus in bello"

From the general principles, "jus ad bellum" one can go by to the practical rules of the use of weapons, "jus in bello". Things are never as simple as we would like them to be wrote E. Mach¹⁴! The use of an army is never as selective as it would be wished. An army on active service is not a gun with sights. Is it acceptable to kill innocents (or to threaten to kill innocents), who have nothing to do with the conflict, to fight (or to dissuade) the aggressors?

The use of a nuclear bomb, (or the threat of using it) as of any bomb, even if the bomb was used by a "terrorist" has collateral effects on the innocents. Can one kill the Iraqi soldiers who would invade our land knowing that they were enlisted by force? Aren't they also innocent? Can one make a preventive military intervention as the United States did it, against the Iraqi and Libyan dictators as some would have wished it, a posteriori, against Hitler's Germany? Can one sacrifice all the moral principles with the only aim of winning the war? Can one torture the aggressors, the accomplices or the innocents to obtain informations supposed to be vital for continuing the combat? Can one execute his own soldiers if they refuse to obey like the French commander in chief have done in the First World War? The self-defense is a response to an aggression against goods and/or people. It is a question of preventing the aggression or of pursuing the aggressor so that he repairs the damages caused to the victims.

¹⁴ E.Mack 1995, " Rights, Just War, and National Defense" in *Liberty for the 21st Century*, ed. T. Machan and D. Rasmussen, Rwoman & Littelfield, Inc.

The first moral constraint imposed by the self-defense is *proportionality* in the response. Imagine Australia invading Tahiti. The Australians decide to act because they had enough of our nuclear tests in their sphere of influence. Can the French Army use the atomic bomb on Sydney, to protect Tahiti from the Australian invasion? The second moral constraint imposed by the self-defense is that the response should not strike innocent persons. This is the *discrimination principle*. The victim of an aggression cannot be held responsible for the unforeseeable collateral effects induced by his response but can be held responsible if these effects are foreseeable. It is obvious that if you know that in the counterattack, you can wound or to kill somebody, an innocent, you become aggressor. The principle of self-defense applies only to the aggressors. The self-defense will be unjustified. However, if the victim of an aggression must put in balance his life and that of an innocent or if the aggressor seeks impunity, like the Hamas, attacking in the vicinity of innocents, the decision to counterattack or not, remains in the hands of the victim. When the aggressor seeks this impunity, he takes in hostage the innocents. The hostages, the innocent third parties, become victims¹⁵. But can one take a hostage in order to dissuade a possible aggressor to act or a real aggressor to continue his aggression? Who attacks whom? Can one threaten a tax inspector to poison his children so that he ceases his permanent aggressions on the wallet of the taxpayers? Can one take hostage the entire population to dissuade the terrorists to act? The answer seems clearly negative. When the Germans take hostage the French population to dissuade the resistance to act and to kill the German soldiers, their behavior is immoral because they are the aggressors. If the French government took hostage the Moslem population to dissuade the Talibans to put bombs in the Parisian subway, the French government would be the aggressor. And if the Moslems took French hostages to release their imprisoned companions, they would behave like aggressors with regard to the population. The nuclear dissuasion resembles much to this type of dilemma. The victims - those who are taken hostages - are in a state of self-defense. Therefore, they can answer back to the aggression.

This is why the armaments, and their use, must be selective. These weapons must strike the aggressors as much as possible. Using nuclear dissuasion in a strategy oriented against the inhabited areas is immoral. Bombardments at high altitude too. From this point of view, the military technology made huge progresses because a bomb can strike a ministry in a town like Belgrade without any collateral damages. But what is worth this ethical approach towards a predator who thinks the human beings can be treated like animals and killed as the chickens or the cows are killed in the name of protecting the consumers or the people, a race or a religious ideal or a social class? Then it seems difficult to reject a consequentialist argumentation, state the partisans of dissuasion. The self-defense *must* be effective i.e. to lead to the desired result: *the protection of the individual rights*. And if the only way of stopping the aggressor is to take hostage the innocent thirds, must one deprive oneself of this radical instrument in the name of a certain professional ethics? The characteristic of a ethical argumentation is to prohibit the use of an instrument which, even if it is very effective, violates the self-ownership of innocents. However, it remains to be demonstrated that nuclear (or some other type of weapons) dissuasion violates the rights of innocents. Let us return to taking hostage an individual, third party in the conflict (the children of the tax inspector or the Muscovites in nuclear strategy oriented against the inhabited areas during the cold war). The principal characteristic of dissuasion by the hostage-taking is that the victim, who seeks to be protected from the aggressor, announces that he has the *conditional intention* to kill millions of innocents, if the aggressor acts. But to have the conditional intention to commit a crime, does not mean to commit the crime. What is wrong, is to commit the crime, not to have the intention of doing it.

¹⁵ E.Mack (op.cit.)

When the victim, to put an end to the aggression, takes hostages innocents that the predator is very fond of and that his threat is credible, he points out to the aggressor the real opportunity cost of his act of aggression. He also points out to the hostages having a link with the aggressor that it is up to them, to discipline the aggressor with which they have links. This dissuasion is there to prevent a violation of individual rights, not to cause it or to threaten the life of the hostages. It announces in advance the price which will be required to the aggressor as compensation for the created damage. It will be noticed that the hostages in question are not innocent third parties. They are third parties who accept predators among them or who agree to put their destiny between their hands. Therefore, there is not necessarily incompatibility between the deontologic morality and efficiency of the development of nuclear weapons.

Nuclear Proliferation is a Blessing and not a Curse: the Cartel Hypothesis

Yes it is. Why? Because things that are good for us are good for others. The terror equilibrium was a guarantor of peace in Europe during the cold war. Without it, the Soviets might have been tempted to invade Europe. When there are no nuclear weapons there are classic wars, which can result in massacres comparable to those seen with the use of conventional weapons in the world wars. The Iran/Iraq war is a case in point: If both sides had had nuclear weapons, they might have hesitated to enter the conflict, saving millions of lives.

Possession of nuclear weapons by all players is a good and not a bad. Indeed, the more countries possess such dissuasive weapons, the wider will be the territory of peace and stability as experienced in Europe throughout the cold war. There have to be serious reasons to prohibit certain countries from owning such means of dissuading potential aggressors.

This sort of support of nuclear arms proliferation is natural for economists but heretical for non-economists. The countries who are members of the nuclear club form a cartel that is looking to protect its monopoly in respect to other countries. They even use violence in order to prevent countries they do not like from obtaining nuclear technology. If nuclear weapons reduce the possibility of armed conflicts, i.e., protect human lives and territory from external invaders and violence, it means nuclear weapons possession is efficient.

Nuclear weapons possession will become more necessary as the costs of nuclear technology decrease. Competition between countries to defend themselves against external aggressors will lead to the proliferation of nuclear weapons. The cartel of members of the nuclear club (Russia, England, France, China and the United States) will fail as more countries develop weapons. There are two major forces in this process. Club members have reason to cheat by giving nuclear weapons to other countries (e.g., France and Iraq, China and Iran); and other countries can enter the market on their own (e.g., India, Pakistan, Israel, Iran, Iraq, North Korea). Remember also that Kazakhstan, Belarus, and Ukraine inherited nuclear weapons from the USSR even if Kazakhstan restitutes its nuclear weapons to Russia in exchange of aid. South Africa, Japan, Germany, Brazil, and Argentina could, in the near future, have nuclear weapons if they do not already have it by undertaking covert nuclear weapons development despite of being part of an agreement not to develop such military programs.

This point of view is increasingly shared by Western military strategists, many of whom believe countries willing to obtain such weapons should be helped and not considered outlaws. An article by J. Fitchett in the International Herald Tribune notes this change in opinion among military advisers. But Fitchett claims that if proliferation prevails, the risk of conflict increases due to everyone's inability to control everyone else's dissuasion. Pentagon experts note that when communication between the USSR and the U.S. was limited, it minimized provocative behavior. Fitchett continues: With territories like Asia and the Middle East, nationalistic passion and irrational behavior are reality. Those leaders frequently are autocratic and are ready to destroy their countries in a nuclear conflict just to satisfy their interests or territorial appetites.

Even though the 1991 Iraq conflict showed the opposite (Saddam Hussein did not dare use chemical weapons under the nuclear threat of Israel and the U.S.), we cannot extrapolate this to a world where nuclear weapons are commonplace. We should not forget that nuclear conflict is not local and it can affect, as did the Chernobyl nuclear disaster, uninvolved third parties. This argument is not new—it is similar to the one used by French medical doctors, who in the name of protecting consumers are impeding the sale of drugs in supermarkets. Another argument holds that competition in airline services leads to an increase in accidents due to airlines' failing to invest sufficiently in safety under the pressure of competition. This has proven to be false. All defenders of monopolies and cartels use such arguments, including the one concerning nuclear weapons.

It is difficult to believe that a taxi drivers' monopoly protects consumers. But when a medical board announces that a monopoly benefits consumers, the public is persuaded. Indeed, reasoning is distorted when the arguments relate to our lives. In this manner, when we think about nuclear weapons we often lose our ability to think clearly.

Let's return to the economic argument. Before 1989 there was nuclear parity between the USSR and the U.S. We can regard this situation as a Cournot bi-polarity. The essential question of that time was the arms race in nuclear missiles. For a given level of Soviet armament, U.S. production of missiles, to match it, was profitable, measured in dissuasion capacity. The same way, for a given level of American offensive capacity matching it with nuclear warheads in the USSR was advantageous.

The intersection between these two functions is the Cournot equilibrium. The number of missiles being produced was very high. It was possible to improve outcomes for both adversaries through mutual arms reduction. If both parties agreed to reduce their arms while retaining dissuasion capacity, it would have been optimal for them not to miss the opportunity. From the beginning of the cold war we witnessed conferences on arms reduction and treaties on nonproliferation. Each side in such an agreement would have maintained a certain quota of missile production or brought stockpiles down to a level that maximized profits for both parties.

All those conferences between superpowers were simple agreements to optimize the tradeoff between costs and dissuasion. The failure of such agreements is intriguing. Why did they fail? Because agreements have to be respected. The majority of such treaties not only gave exact details concerning quotas but also the means to verify whether the quotas were respected. In other words, the issue of agreement or cartel created a prisoner's dilemma. An advantage was gained by the one who cheated while the other respected the agreement. This incentive not to respect the agreement explains the continuous failure of such agreements. The cold war was characterized by missile production at the Cournot point with attempts to reduce these arms, at the equilibrium point. Only the disappearance of the USSR ended this strategic interdependence—the bi-polar structure disappeared.

Two Directions of Future Development

The U.S. retains a monopoly on nuclear dissuasion and plays the part of world enforcer, excluding international exchanges for countries seeking nuclear weapons. Such a position is costly, and the U.S. has no legitimate claim to such a role.

We should allow more and more countries to develop nuclear weapons. The first lesson of history is that in the absence of an enforced monopoly, no agreement or cartel, even one organized by States, can survive. One of the best known examples is the oil cartel. The second lesson is that competition is the means by which we maximize our exchange profits. Nuclear arms possession is the most efficient defense of territory because it produces fear. It reduces armed conflicts and does not require many personnel. Such technology, as it becomes more affordable, will face increasing demand from countries with fewer resources. Such democratization is the result of competition.

I use the term "democratization" rather than "dissemination" to make a point. For many, "democratization" has a positive connotation. If a poor Iraqi or Pole can benefit from such protection it is "democratization." For a rich Frenchman or American it is "dissemination." For an economist it is competition.

The argument that an Iraqi, Pole, Iranian, Syrian or Libyan is more irrational than a Frenchman is fundamental. This is the argument used against nuclear arms proliferation. It was evoked during the Gulf War. Saddam Hussein is not one of us, he does not share our values, and he is a murderous dictator, but he is not irrational or crazy. But those who share this point of view insist that we cannot extrapolate from Saddam Hussein's case. Yet if we follow their logic we will have to demonstrate that non democratic political systems constantly have as their leaders irrational and crazy persons. There is no proof of this. It would also have to be proven that democratic systems are immune to such phenomena. Hitler and National Socialists came to power through democratic mechanisms. Thus, this argument fails also.

We can link this theory to the one that prohibits citizens to carry firearms. The problem with this prohibition is that citizens are defenseless and the only armed persons are police, who often do not know how to shoot, or turn their arms against innocent civilians; or gangsters, who use their arms against citizens who have been disarmed by the State. We also see that within any given territory, relaxing gun laws leads to a reduction in crime. The mechanisms proposed to account for this trend, shown most notably by John Lott are the same ones I propose will decrease violent multinational conflict, like in the middle-East, following the free proliferation of nuclear weapons.

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STUDY ON THE FOOD VOUCHERS MARKET IN BULGARIA

Stoyan Panchev, Arkadi Sharkov, Krassen Stanchev¹

Abstract

This Study gives a macroeconomic, socioeconomic and fiscal evaluation of the potential liberalization of the food voucher system in Bulgaria. It takes into account the developments in the country after 2012, notably the dynamics of the household income, wages and labor market and updates the justification for liberalization of the system. It assesses and analyses the direct and indirect benefits and costs of the system's operation in its present form, from the perspective of both government budget as well as the economy and household budgets. For better accuracy and comprehensiveness of the analysis, it also takes into consideration the impact of food vouchers on the informal economy, the value added generated in the domestic economy and intra-family redistribution.

The study outlines three sets of reasons – economic, fiscal and social-political - why we can expect positive developments if monthly voucher allowance is increased and the quota principle is replaced by market-based use of the system.

On the macroeconomic side, the growth of wages and productivity resulted in decrease of the value of the monthly allowance of the vouchers (BGN 60) since the system was introduced in 2007. The devaluation is about 3 times, inflation is not the key factor but the developments in wage income, minimum wages, employment and productivity.

The use of FV is associated with higher productivity, improved diet and consumption, while food expenditure as a share of household budget declines. This leads to **positive effects on the fiscal side.**

Indirect effects resulting from increased corporate and households' disposable income, and expected job creation effects that liberalization is likely to produce offset the direct shortfall of budget revenues. Depending on the scenario that will eventually materialize, the probable indirect effects are the following for the first three years:

- The number of **new jobs created connected to food voucher consumption vary from 1,679 to 2,068;**
- The direct budget revenue shortfall will most likely be compensated by **indirect (non-VAT) fiscal proceeds from income tax and social contributions, of an amount between BGN 11 and 15.7 mln.** Additional positive development would materialize from household income allocation to non-food consumption.

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Socio-political grounds for liberalization are associated with improved household budget structure and gains from improved social policy efficiency on enterprise and country political level.

Previous studies show that almost 85%² of companies increase the salaries with the cost of the vouchers competing for qualified labor and most of them consider FV as an essential part of their corporate social responsibility policy³.

According to the study of the International Labor Organization, Food at Work⁴, the food voucher system benefits employees, companies and governments alike by increasing purchasing power, improving health and working conditions, enhancing productivity and reducing the informal economy. Out of 19 EU member states who have implemented some form of social voucher system, Bulgaria remains the only country in the EU with FV system based on the quota principle. The following study looks at different scenarios for market liberalization of the system following the steps of all other countries that have implemented a food vouchers social policy and assesses the impact of such liberalization on the state and the users of food vouchers.

Assessments in the report use conservative assumptions on initial values of parameters. The key source here is the social and economic analyses of food vouchers and the (latest) field surveys of the system conducted by KS2 Ltd and Industry Watch in 2010 and 2012.

Arguments in Favour of Liberalization of the Quota Principle

Historical justification

From all 42 countries in the world with existing social voucher system, only in Bulgaria allocated annual quotas limit the use of food vouchers. When the country introduced food vouchers **in 2003, the overall socioeconomic situation was very different from today**. Back in 2003, and ever since 2003, the Ministry of Finance or the legislators did not undertake any detailed impact assessment or justification of the quota principle. However, the general economic reasoning is applicable and validates both the cautious approach to the innovation of 2003 and the reasons to put an end to the use of this principle in 2018.

Fiscal background

On the fiscal side,⁵ any tax preference in 2003 would have been risky in terms government (foreign) debt management. The following chart gives the dynamics since the beginning of this century to 2017.

² The Use of Food Vouchers in Bulgaria: A Field Survey Report

³ FV A/B/C National Scale Survey, B2B Trade Nets, June – August 2017

⁴ Wanjek, C., Food at work: workplaces solutions for malnutrition, obesity and chronic diseases, Geneva, International Labour Office, 2005

⁵ On the situation with the government debt in 2003, see: Ministry of Finance, Government debt Management, Sofia, September 2003, pp. 38-42.

Chart 1: Overall fiscal situation: government debt

The consolidated government debt in 2003 was 55.8% (down from 77.6% in 1999), of which the foreign debt was 49.1% of GDP. The situation in 2018 is significantly better: in May 2017, the debt was at the level of 27.1% of GDP, **in May 2018 – 22.6%.**

On the government spending side, the dynamics is also positive: government expenditure in 2017 were 35.2% of GDP, while their average level in the last 22 years was 37.7% of GDP.

Socioeconomic developments⁶

In 2003, according NSI data and reports by the Ministry of Labor and Social Policy, **the unemployment rate was almost 18%, in 2018, it is three times lower - 5.7%** (while employment rate improved from 40% to 52% for the period, and is the highest in the last 20 years).

Chart 2: Unemployment dynamics: 2008-2018⁷

FV typically have positive impacts on junior employees, not at least because they are new entrants to the labor market, start from relative low wage level, close to the minimum wage, and because vouchers increase social mobility.

⁶ All data on employment and wages is available from NSI and EUROSTAT in somewhat more condensed form.

⁷ All graphs from Trading Economics use latest NSI data.

For the last 17 years, the dynamics of youth unemployment was uneven, but it decreased since 2013, from 28.7% of the total unemployment to 10.5% in August 2018, while its all times peak rate (in 2001) was 38.6%.

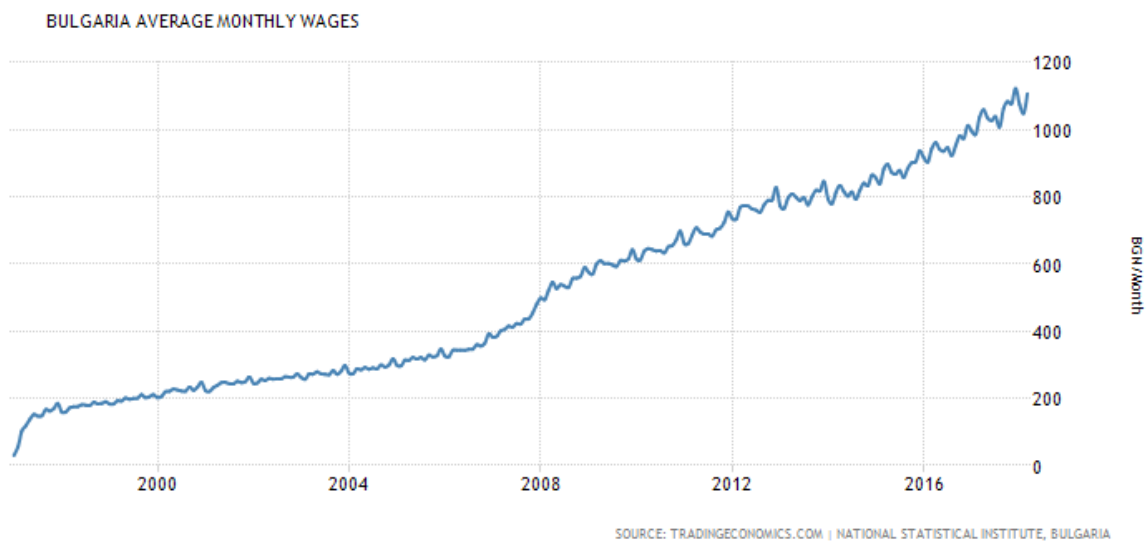
Chart 3: Youth unemployment in Bulgaria: 2000-2018



Socioeconomic conditions of the FV also developed in a direction that allows for liberalization of the system without negative side effect for the state budget.positive direction.

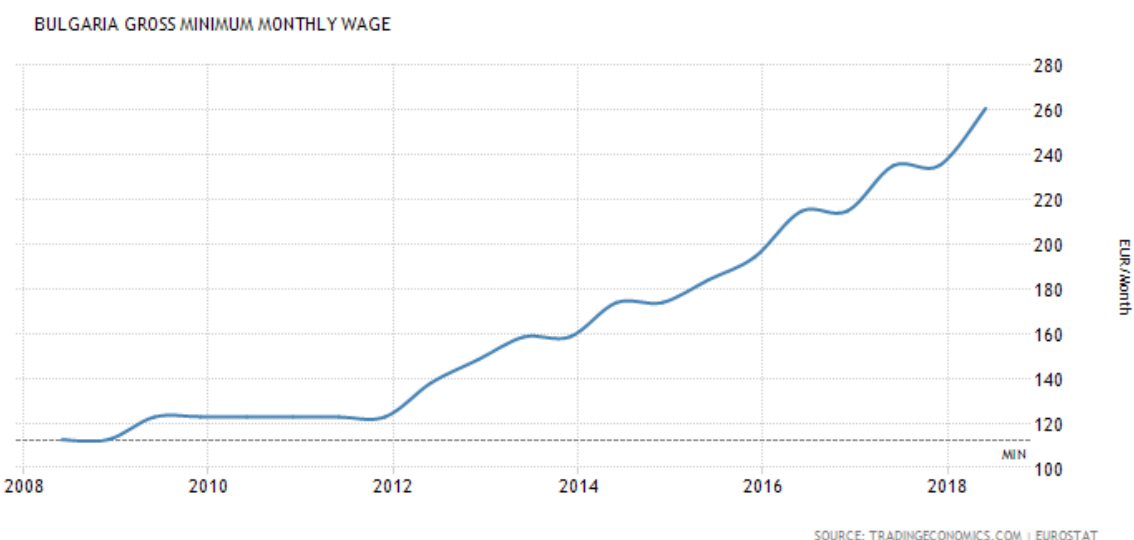
- At the time of its introduction, the monthly FV allowance represented 13.9% of the average monthly salary and 15% of the average monthly insurance income; in April 2018 it stood at 5.8% of the monthly wage and at 6.7% of the insurance threshold; the improvement is 2.4 and 2.2 times respectively. The comparison for a twenty-year period finds that the BGN 60 monthly allowance was equal to the average monthly salary of 1997.

Chart 4: Twenty-year increase of the average monthly wages



- When the introduction of the system, the monthly FV allowance was conditional to the amount of the minimum wage (MW), and fixed at a three times lower threshold, or the allowance was 33.3% of the MW in 2007.
- In 2018, it is 11.2%; almost three times less. The following Graph shows the dynamics of the MW. Since 1999, the minimum monthly wage had grown by 870%.

Chart 5: Minimum monthly wage dynamics (2008-2018)



The unit labor costs index increased from 75 in 2007 to 153 points in 2017 while productivity went up from 80 to 137 index points for the period.

All these factors led to an overall decline of the real value of the food vouchers, which leads to diminished effects of their use as a type of a social policy.

In 2003, presumably, there could have been a concern about the risks to the overall tax collection from households, since **the food expenditure per person stood at 40.4% of the household expenditures**.⁸ This led to the assumption that, due to the high food and beverages share in family budget, larger than BGN 60 tax allowance will diminish VAT and other revenues to the state budget. This assumption was not justified: food share in the household expense went down, social mobility (poverty dynamics, etc.) improves, and the budget revenue increases due to overall economic performance since 2011.

After 2015, the households' food expenditure, relative to non-food goods, is not the lead item in household payments. Even eight years ago, in 2010, the spending on food per person was relatively high – 37.2%, in 2017 it was 30.1%, this year it is likely to go further down to about 29.5% of household expenditures per person. In the meantime, mirroring the growth of the family income, household expenditures increased by 62.8% for the period, while **the VAT revenue from food purchased by households went up by 29%** (according to our estimate).

Simultaneously, food consumption also increases: in 2016, compared to 2010, Bulgarian households could buy larger quantities of all basic food products; the highest is the growth of pork (51%), eggs (43%) and rice (42%), and the smallest - feta cheese (21%), milk butter (12%) and yellow cheese (8%).⁹

Liberalized FV system is likely to increase social mobility and quality of the diet for the lowest income strata of the population: due to low education levels, job opportunities for this stratum are limited to low-skill job openings and close to MW monthly income. This is the most socially

⁸ All data used in this paragraph is from NSI regular Households Surveys.

⁹ <https://www.infograf.bg/article/1492600326000>

stagnating social group, which comprises 60% of those at poverty risk (below 60% of the median household income), with poorest quality of the diet.¹⁰

Previous findings and the Romanian experience

In 2012, a special field survey of the system proved that provisional concerns that the food vouchers would be used by employers to economize on wage costs were not justified: almost 85% of the companies, in fact, increased the salaries with the cost of the vouchers (competing for qualified labor). As the above data on employment suggests, such concerns in 2018 are completely unjustified as unemployment is at all times low and companies are competing for ever less available talent.

Since 2003, the liberalization of the system was discussed at least four times, each time the reform was supported by detailed impact studies that articulated the above and other arguments (benefits related to shrinking-shadow-economy effect, advantages vis-a-vis other social policies, minimum and/or average wage ratios, ratio to annual “fiscal losses” as assessed by the ministry of finance, etc.)

In 2004, out of 19 EU countries using food vouchers only Bulgaria and Romania still applied the allocation of quotas.

The experience shows that, in Bulgaria, quotas regularly exhaust by September- October each year. Presumably, similar developments along with concerns that the benefits of the system (for the state budget, income growth and market transparency) remain unutilized, while admin costs of running the quota-based system increase inefficiencies, motivated Romania to abandon the quotas in 2004. The reform was justified by a macroeconomic and fiscal impact survey that applied the same reasoning as in the Bulgarian discussions.¹¹

Two years after cancelling the quota, a comparative study by Accase found that “meal vouchers are the main benefit Romanian workers get” and that the original modest and, then, more substantial increases of the value of the vouchers (approximately by 30%, since 2017) have had no negative fiscal impacts.¹²

Net shortfalls and benefits for government revenue (scenarios)

If the total quota is liberalized, and assuming that the use of food vouchers increases by respectively 30%, 10% and 10% annually in the next three years, the **shortfall for the budget will be relatively insignificant.**

As it is demonstrated in the below calculation of effect of different scenarios, here we shall mention the following effects. In the ‘zero’ year scenario with an increase of the total quota from BGN 280 to BGN 340 mln, the shortfall for the state budget will vary from BGN 26.5 mln in the ‘zero’ year, through BGN 34.5 mln in the first year of liberalization (30% increase) to BGN 38 mln in the second year after the liberalization.

This budget revenue shortfall is calculated on gross basis, and is significantly lower than the total amount of losses from tax breaks on various items, according to the methodology of the Ministry of Finance.

Calculated on net basis, i.e. taking into consideration the effects on the shadow economy (with an assumption of 10% and/or 15% reduction¹³) and additional value added that is generated in the domestic economy (BGN 0.20-0.25 per each Lev), budget shortfall will be even more insignificant.

¹⁰ See details: <https://ime.bg/>

¹¹ See: *Macroeconomic Impact of the Prospective Increase of the Nominal Value of Meal Vouchers in Romania*, Bucharest, Geastrategy & Consulting, 2013.

¹² See: [Benefits granted by Romanian employers compared to practices in the region](#), Bucharest, Accase, 2015, pp.: 8-14, and, for the latest developments:

¹³ *The Use of Food Vouchers in Bulgaria: A Field Survey Report*, KC2 Ltd, 2012.

For example, under the ‘zero’ year scenario the increase of the total quota will amount to BGN 60 mln compared to 2017. This will mean that the relevant additional VAT revenues should reduce gross shortfalls. Because of additional domestic value added, they would be BGN 2–2.5 mln, and thanks to bringing into the light the respective turnover in the economy by 10% – BGN 1 mln or BGN 1.5 mln in case of 15% reduction of the shadow economy. The expected higher consumption and family income redistribution, amounts to an additional revenue of BGN 2.6 mln.¹⁴

As the shortfall results from increased companies and households’ disposable income, the expectations of job creation resulting from the reform are likely to increase the fiscal benefits. The number of jobs vary from 1,679 to 2,068 for the period. The associated fiscal proceeds from income tax and social contributions vary between BGN 11 and 15.7 mln within three years period.

Taking into account direct and indirect budget paybacks from job creation, increasing the disposable income of households, bringing shadow economy into the light and the generated additional value added, the net effect of the reform is actually positive. Depending on the scenario considered, it varies from **BGN 13 to 22 mln per annum within three years.**

Historical basis of liberalization

The average annual increase in the total quota was little more than 4% in the period 2009-2017, amounting to 41% for the whole period. **No negative effects were registered so far. The loss of revenue for these years due to use of food vouchers was less than or around 1% of the corporate tax revenue.**

Economic trends and dynamics

The unit daily value of food vouchers in the country is relatively low – BGN 2.7 per business day and less than BGN 2 per calendar day. This value of **food vouchers is at the level of the World Bank’s absolute poverty line measure**¹⁵. This amount and the dynamics of household incomes since 2004 gives grounds to assume with greater probability that, **first, the saturation of the demand for vouchers will be a relatively quick process and second, it will help reduce the poverty level.**

This is due to the **relatively high share of food expenditures in household budgets in Bulgaria** – around 30%. The fact that the introduction of a social policy system using food vouchers coincided with the tax reforms towards reducing and simplifying direct taxes, does not reduce the benefits and incentives of using vouchers, both for the government budget and for the companies and beneficiaries. This is so because:

- **The growth of the disposable income of households results in an increase in absolute terms of food expenditures in household budgets; these amounts (if vouchers are used) increase the registered turnover and indirect tax revenues;**
- **Companies have only a partial incentive for tax optimization: what is important for them is competition, i.e. optimization of unit labour cost (including the so-called social taxes, which become difficult to estimate in the medium-term) and providing additional (compared to their competitors) benefits for their employees.**

The liberalization of the system will not result in substitution of food vouchers for salary income. This is so, as:

- **vouchers constitute a relatively small share of labour costs of companies and are**

¹⁴ See for details below the paragraph on Reduction of the shadow economy.

¹⁵ Global Poverty Line Update, FAQ, World Bank Website:

<http://www.worldbank.org/en/topic/poverty/brief/global-poverty-line-faq>. In 2011, the share of Bulgarian population living under USD 1.9 per day was 2%, see: List of countries by percentage of population living in poverty, Wikipedia: https://en.wikipedia.org/wiki/List_of_countries_by_percentage_of_population_living_in_poverty .

- used in combination with other social benefits;
- as mentioned above, there is a general **downward trend of food expenditures as a share of household incomes**, and as a share of total household expenditures;
 - the household expenditures on other items have an effect of replacing food expenditures with savings, healthcare, education, leisure, travel, etc.; i.e. there is another positive spill-over effect of food vouchers¹⁶;
 - This is not a trivial effect in the medium term: together with the drop in food consumption as a share of household budgets, **non-food consumption increases**, as mentioned above by almost 63% for the last seven years;
 - Simultaneously, as already mentioned the **purchasing power of households for most food products also increases** in 2016, compared to 2010.¹⁷

Regulation of the Food Voucher System in Bulgaria

Legal Framework

The use of food vouchers regulated by the Corporate Income Tax Act (CITA), Income Taxation of Natural Persons Act (ITNPA) and Ordinance No.7 of 9 July 2003 on the Conditions and Procedures of Issuance and Withdrawal of Authorizations for Operating as Food Voucher Operator and Carrying out Activities as Operator. Pursuant to Art. 209, paragraph 1 of CITA, no tax shall be due on the social expenses amounting to up to BGN 60 per month, provided in the form of food vouchers for each employed person, if several conditions are met. The person's negotiated basic monthly remuneration for the month, in which a voucher is provided, is not lower than the person's average negotiated monthly basic remuneration for the preceding three months. Operators authorized by the Minister of Finance provide the vouchers.

Pursuant to Art. 24, paragraph 2 of ITNPA, the taxable income of natural persons does not include food vouchers received within the amount of 60 BGN and under the procedure of CITA. In addition, no social security contributions are due on this amount.

Pursuant to Art. 12, paragraph 1 of Ordinance No.7, the total annual quota for issuance of food vouchers is approved in the State Budget of the Republic of Bulgaria Act for the relevant year. Pursuant to paragraph 2, the Minister of Finance determines the amount of the individual quota and the total number of individual quotas for the relevant year. The procedure of granting individual quotas allows for reporting on demand and supply of vouchers, and enables control on transactions implementing individual quotas.

The social vouchers system exists in 42 countries worldwide, including 19 EU member states. In general, social vouchers are instrument to implement social policies at local level, according to a specific context and national objectives often leading to a combination of tax and/or social security preferences that are limited to some monthly/daily amount. Except for Bulgaria, total quota limitation existed only in Romania since 1999. At that time, this was a precedent in the almost 50-year old practice of using food vouchers. In 2004, Romania removed the quota limitation as inefficient and unjustified.

In some countries, there are automatic increase mechanisms in place, e.g. the monthly amount is tied to the minimum salary, an economic growth index or an inflation index. No matter how imperfect these mechanisms are, they do not result in unlimited increase of food voucher users and in uncontrolled consequences for the government budget. Currently, only in Bulgaria the system still uses the quota principle.

There are a number of regulatory requirements for food voucher operators and supplier commercial outlets, and for the companies employing the beneficiaries, such as:

¹⁶ See: The Use of Food Vouchers in Bulgaria: A Field Survey Report. See also below the paragraph on "Conclusions from previous studies".

¹⁷ <https://www.infograf.bg/article/1492600326000>

- issuers' capital and capacity;
- voucher securitization;
- and obligations:
 - a. for VAT registration of commercial outlets accepting vouchers,
 - b. employers to be correct payers to the budget
 - c. of bank payment (ensuring traceability of nominal values traded),
 - d. to use the funds paid by employers only for payments in commercial, VAT registered outlets (securing system's liquidity and sustainability, etc.).

These features of the Bulgarian system are among the best worldwide and provide for transparency and stability of the system. It is also worth noting that these characteristics of the Bulgarian legal framework are fundamental for both its positive effect on the shadow economy as well as the relatively quick tracing of demand and supply of food vouchers.

On the other hand, vouchers facilitate employers' competitive positions in the labour market, increase beneficiaries' disposable income, and assist bringing the economy into the light (in terms of VAT and direct taxes).

Bulgaria a country with tradition in home making food. Since even under communism 85% of the urban residents had a house or a slot of land (and close relatives), 60 to 65% of the households had the habit of canning food and home (meat, vegetables and fruits). It was called "Ikonomika nd Burkanite" ("a Jar Economy", in English). This tradition was sustained during the difficult years after 1989, especially prior to 1998. There no detailed survey of this household economy in the recent years. But it is obvious that FV system limits the incentives for the "jar economy", create jobs owing to the positive effects on consumption and the improves nutrition quality.

For Bulgaria, these effects are evident since the introduction of the system. In 2010, a study by KC2 and Industry Watch (led by the author, and including a nationally representative poll of companies and employees), identified the impacts on the shadow economy (2011) and, in 2012, updated the values of fiscal, social and economic effects.¹⁸

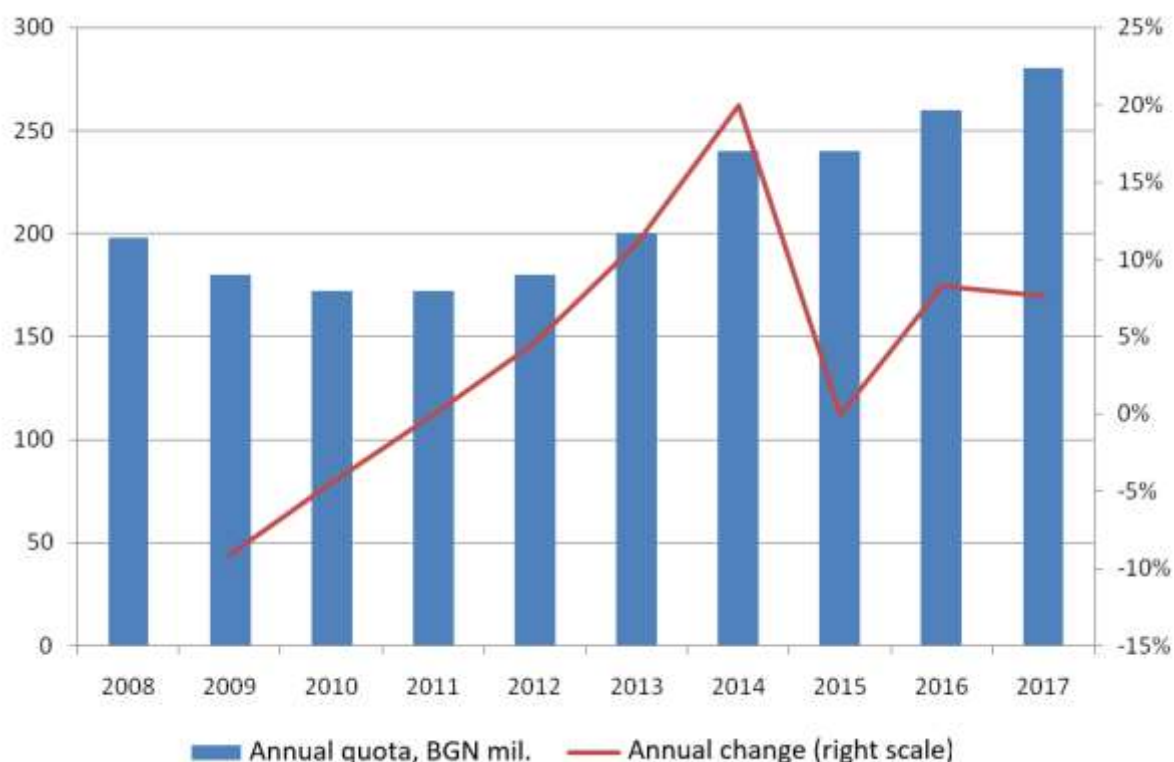
The System in 2017: elements of inefficiency

After freezing the overall food voucher quota in 2015 at its previous year level of BGN 240 mln, two consecutive years with a BGN 20 mln annual increase followed, thus reaching BGN 280 mln in 2017. The number of individual quotas has remained unchanged since the start of the program – BGN 2 mln, so the overall amount is allocated into 140 individual quotas. Food voucher operators, depending on their market presence, quantitative and qualitative characteristics of employers using vouchers, utilized them on an ongoing basis.

Higher demand

Subject to the regulatory requirements, until the end of 2017, the voucher system is available to almost 389,000 employees out of 3 mln working population. This is below the level of demand, as the set quota exhausted in August, which led to shortage in the last four months of the year. If the rate of demand of the period January-August 2017 were to remain throughout the remainder of the year, this would have resulted in a deficit of supply of food vouchers of about BGN 93 mln.

¹⁸ Some of these findings are summarized below.

Chart 6: Amount of the food voucher quota (BGN mln) and annual change (%)

Source: Ministry of Finance

On the chart, three periods can be discerned – slight contraction and freeze of the quota in the period 2009-2012, followed by moderate growth.

Regular depletion of the overall quota

In 2009-2012 the decrease of the ceiling can be accounted for by the onset of the economic crisis and then the economic rebound, although the policy during this period was only consistent with the state of the government budget, rather than with the need of additional social expenditures, given the deteriorating condition of the labour market. After the budget stabilized, a gradual increase in the food voucher quota commenced, and in the period 2013-2017 it has been increasing with average annual rate of around 9%.

Even in good fiscal years, such as 2016, when the year closed with a budget surplus of approximately BGN 1.5 bln, and 2017 when the budget surplus amounted to BGN 845 m the quota was exhausted earlier (end of August). The depletion of the total quota in the current and previous years is due to the quota principle of organization.

Macroeconomic Parameters

The adverse effects of the quota organization of the system exacerbated in 2017 as incomes and the economy grew with the highest rates since the 2009 crisis, utilization of capacities in enterprises was at a record high level¹⁹, and the employment rate reached its pre-crisis levels. The total amount of the quota typically depletes at the end of the third quarter every year, due to the following macroeconomic circumstances.

- In nominal terms household incomes increased by about 46% in the period 2009-2016²⁰,

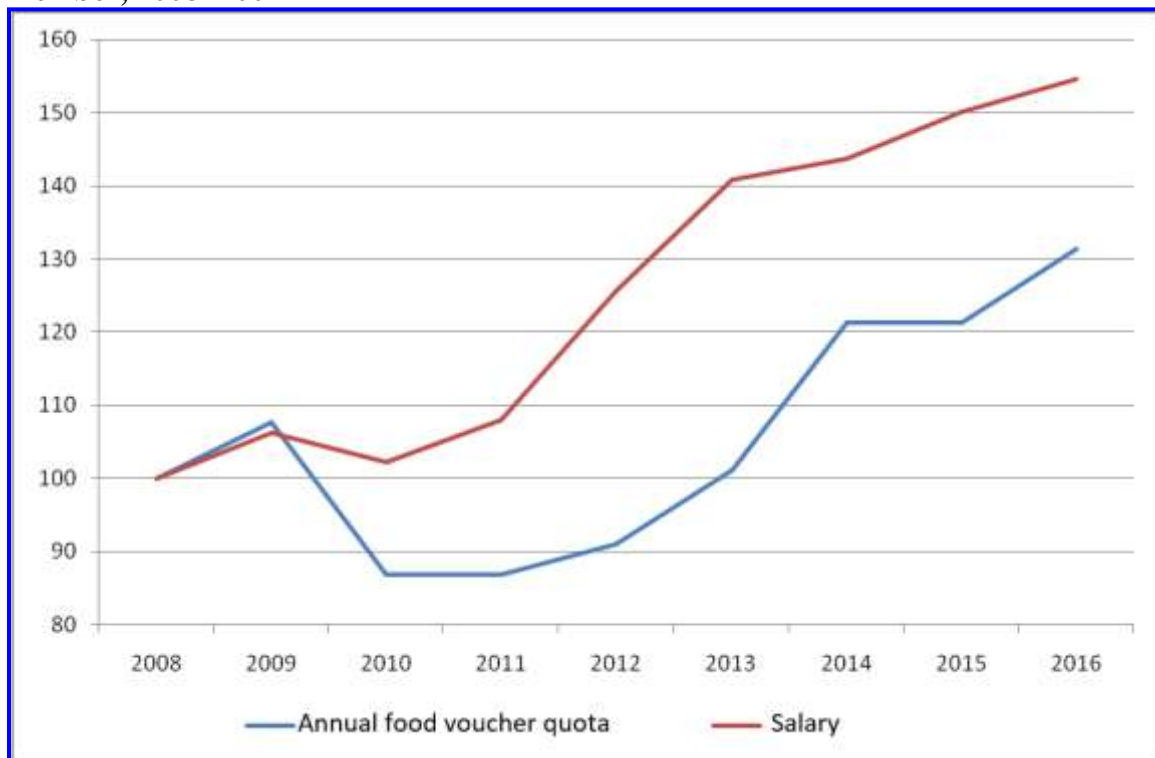
¹⁹ NSI, statistics of business observations

²⁰ Pre-2008 data are not comparable due to a change in the methodology.

while the food voucher quota increased by 31% annually in the same period;

- Incomes from salaries per household member increased by around 55%. As seen from Chart 2, after an adjustment in 2010, the salary income has been growing in each year of the period under consideration, while with regard to the food voucher quota, both a slower growth and periods of no growth, as in 2011 and 2015, are evident.

Chart 7: Index of the annual food voucher quota and salary income average per household member, 2008=100



Source: NSI, own calculations

- On micro level, the tax break for individual users has remained at the level of BGN 60 per month since 2009, but its relative value (weight in the incentives for using vouchers) has decreased, thus accelerating the process of demand at the beginning of the year, increasing the number of entities interested to be included in the system. This regularity emerges from the changing ratio of voucher value to gross and the minimum wage. For example, in 2010 (the last year of contraction of the economy), the tax break accounted for around 9% of the average gross salary for 2010²¹ and approximately for 25% of the minimum salary, while in 2016 the same 60 levs are already 14% less than the minimum salary and about 6% of the average salary.
- Another microeconomic factor is the average spending on food and non-alcoholic beverages per household: it decreased by 1/7 as a share of total household spending from about 34% in 2008 to about 29% in 2016.²²
- Households, however, still allocate a significant part of their budgets for consumption of food and non-alcoholic beverages, which remain as a stable cost item in household expenditure, higher than any other individual item. In other words, any policy aimed at

²¹ NSI, Annual statistics of employment and labour cost

²² NSI, Households income, expenditure and consumption

reducing consumers' costs and increasing their disposable income should aim, primarily, at spending on food and non-alcoholic beverages.

To put it another way, it becomes clear that the total quota is insufficient, its positive effects on household consumption decrease in time and its depletion is an annual practice.

In the conditions of chronic deficits of supply of food vouchers, due to the quota principle, both beneficiaries (employers and employees), and licensed food voucher operators, as well as the state budget incur losses. Furthermore – the existing situation creates conditions for limiting the access to vouchers, as companies with higher annual turnovers, respectively high levels of available resources, have the capacity to purchase large quantities of food vouchers before other companies. Thus, small and medium companies turn out to be at a disadvantage.

Identifying the effects on the government budget: direct and real impacts

Conclusions from the reports of the Ministry of Finance

*Table 1 shows the shortfall for the state budget; the data is from publicly accessible expenditure reports of the Ministry of Finance.*²³

There are some peculiarities, which help interpreting this information. The shortfall for the state budget as summarized in Table 1 does not represent any firm pattern of correlation between the tax breaks provided and “the loss” of tax revenues, which vary from 4.6% to 10%, and between the quota increase and the loss of revenue related to it. Obviously, the budget revenue performance results from real economy dynamics, business cycle and market conjectures. Thus, it is not clear why a decrease of the quota in 2010 has resulted in an increase of the loss of revenue. The same applies to 2011, when the quota remained unchanged, but the Ministry of Finance reported higher loss of tax revenues. In the period 2008-2016, the total amount of the food voucher quotas amounted to BGN 1.8 bln. The “loss of tax revenue” associated with it amounted to around BGN 135 mln, or around 7%.

Table 1: Allocated annual quota of food vouchers and loss of tax revenues related to it in the period 2008-2017, BGN million

	Food voucher quota	Loss of tax revenue	Change of quota vs previous year	Share of the loss of revenue in the food voucher quota	Change of revenue vs previous year
2008	198	9.2	110	4.6%	6.2
2009	180	13.3	15	6.2%	4.2
2010	172	13.4	-41	7.8%	0.1
2011	172	17.3	0	10.0%	3.9
2012	180	13.4	8	7.4%	-3.9
2013	200	19.0	20	9.5%	5.7
2014*	240	11.5	40	4.8%	-7.6
2015*	240	12.7	0	5.3%	1.2
2016	260	25.8**	20	9.9%	13.1
2017***	280	18.2	20	6.5%	-7.6

*The assessment of the loss of revenues in the MoF report includes food vouchers, additional social security contributions and life insurance premiums and costs of transport of employees

²³ Ministry of Finance, Tax Expenditures Report - <http://www.minfin.bg/bg/175>

and persons employed under management and control agreements, and the values shown in the table are results of own calculations based on historical data from MoF reports.

**As the amount stated in the MoF report is unreasonably higher than in previous years, we presume it includes the loss of tax revenues due to exemptions from additional social security contributions and life insurance premiums and costs of transport of employees and persons employed under management and control agreements. The value in the table is an own calculation based on historical data from MoF reports.

***There is no detailed breakdown of the losses of revenue by specific tax measure, and the values shown in the table are results of own calculations based on historical data from MoF reports.

Source: Ministry of Finance, own calculations

Quota and corporate tax revenues

Compared to other preferential tax measures, the loss of revenues due to the total quota exemptions for food vouchers are rather modest.

The 2016 report of the Ministry of Finance indicates that the relative share of shortfall from the tax exemption of food vouchers is around 1% of corporate tax revenues, while the possibility of carrying over of tax losses resulted in loss of revenues amounting to nearly 11% of corporate tax revenues.

Effects on the shadow economy

Due to the specifics of the sectors producing and marketing foodstuffs, food vouchers have more shadow economy reduction effect than other tax breaks. As the Edenred (one of the major food voucher operators on the market) national scale consumer and customer survey from 2017 shows, for close to 30% of merchants, food vouchers represent between 10-30% of turnover, which is a non-trivial size for this particular effect.

Vouchers free resources for consumption, including having positive effect on family consumption; the resources thus freed are used in the tax-transparent section of the market and fall within the context of the decreasing share of household expenditures for food.

The average expenditures for food and non-alcoholic beverages per household decrease, as a share of total expenditures, from around 40% in 2003, to 34% in 2008, to around 29% per household and 30% per individual in 2017²⁴. Besides lowering trend of food expenditures and the fact that after 2015 they are the second expense after the group of non-food goods bought by households,²⁵ the food expenditures are still significant. This means that the role of the food vouchers as a social policy makes a difference and is likely to remain a significant factor supporting household welfare.

Companies using the food voucher system and paying partially or fully the salaries of their employees informally, transfer to the officially reported economy when they participate in this system. Therefore, the system provides an incentive for replacing informal cash payments, up to the amount of the allowable BGN 60 per month, with voucher use. This is particularly important for companies whose official employment contracts are at the level of the minimum wage or the minimum insurable income thresholds and pay the rest of the employee salary “under the table”. In other words, the marginal tax preference has a direct positive effect on not only employers and employees, but also, indirectly, on the economy as a whole. The shadow-economy reduction-effect is in the range from 15% to 25%²⁶ of the total amount of the food voucher quota. This means that more transactions and funds appear in the formal economy (tax)

²⁴ NSI, Households income, expenditure and consumption

²⁵ Georgi Ganev first revealed this important change in the household situation, see his blog at CLS website: <https://www.cls-sofia.org/blog/>.

²⁶ This amount is established by a previous survey – ‘The Use of Food Vouchers in Bulgaria: A Field Survey Report’

reports, thus the National Revenue Agency collects more VAT revenues and the so-called social taxes into the state budget. The table shows this effect by year, calculated based on the actually allocated total quota.

If we compare the shadow economy reduction effect even under a conservative assumption of only 15% reduction with the reports of fiscal “losses” (for the years where data is available from Ministry of Finance reports on the “losses”), **we will see this effect does not simply set off the losses, but it also brings benefits.**

Table 2: Reducing effect of the total quota on the shadow economy (in BGN mln)

	Real amount of the quota	15% reduction	25% reduction
2008	198	29.7	49.5
2009	180	27.0	45.0
2010	172	25.8	43.0
2011	172	25.8	43.0
2012	180	27.0	45.0
2013	200	30.0	50.0
2014	240	36.0	60.0
2015	240	36.0	60.0
2016	260	39.0	65.0
2017	280	42.0	70.0

Source: MOF, own calculations

With regard to household budgets, using food vouchers leads to higher gross income, higher disposable income and higher food consumption.

Almost 90% of respondents of the 2017 survey confirm that food vouchers lead to positive changes in their consumption patterns - while for 40% they produce greater purchasing power options, for 20% of respondents vouchers bring improvement in the quality of food purchased.²⁷ Although probably less significant, there should also be effects in relation to other items of the budget behaviour of households (consumption of non-food products, savings and investment in property, education and health).

NSI and BNB statistics indicate positive dynamics of these expenditures. For example, after the recession ended in 2011, household food expenditures declined by 6.4 percentage points (p.p.) as a share of total household expenditure, while transport, leisure time and various goods and services expenditure has increased by 2.2 p.p. during 2011-2017 period. During the same period, there is also a 4.2 p.p. increase in the tax and social contribution expenditures. In 2017 household banking deposits have reached BGN 49.5 bln, which is a 76% increase compared to BGN 28 bln in recession 2010.

Experience from the year with the smallest quota increase.

The experience of 2012 is interesting, as this is the year with the smallest total quota increase. Nevertheless, the impacts are significant. From a statistical perspective, the typical household behaviour allows for the assumption that the marginal use of food vouchers generates around 7% higher food consumption²⁸ and household benefits. All other conditions being equal, in 2012 this means, for example, additional foodstuff consumption of around BGN 12.6 mln, which generated over BGN 2.1 mln additional VAT revenues.

Food vouchers impact income distribution within the family – if one of the household members

²⁷ FV A/B/C National Scale Survey, B2B Trade Nets, June – August 2017

²⁸ The Use of Food Vouchers in Bulgaria: A Field Survey Report

receives a voucher, this voucher frees part of the household income for other purposes and thus increases disposable income. Under the World Bank's assumption of around 25% redistribution of income within a family²⁹, the BGN 180 mln quota in 2012 freed around BGN 45 mln of income. NSI data indicate that household consumption accounts for around 77% of household spending, which means additional consumption of BGN 34.7 mln can be expected, and the VAT on this consumption would amount to BGN 5.8 mln.

Around 89% of the value added in the Bulgarian economy comes from the price of foods.³⁰ Therefore, the positive impacts support (*ceteris paribus*, and in a relatively stable market conjectures), first and foremost, national producers. For every BGN 1 worth of food vouchers, the domestic value added increases by BGN 0.20 to 0.25. Hence, in 2012 the additional valued added from domestic sources ranged from BGN 36 to 45 mln, and VAT on it was in the range of BGN 6 to 7.5 mln. The tradeoff of budget revenue shortfall from granting tax exemption for food vouchers amounting to BGN 13.4 mln resulted in higher revenues from consumption at a monetary value of BGN 13.9 to BGN 15.3 mln.

The situation in 2017 looks quite similar and is characterized by expected higher food consumption amounting to BGN 18.2 mln, redistribution in the family – BGN 50 mln and additional value added from domestic sources ranging from BGN 52 to BGN 65 mln. **All this brings BGN 20-22 mln additional VAT revenues into the budget, compared to a shortfall of tax revenues of around BGN 25.7 mln.**³¹

Popularity and Attitudes to the System

The effect of the economic crisis (2007-2010)

In 2007, in an economic situation of record high foreign direct investment and expected economic growth rate of above 6% of GDP and effective budget surplus of more than 3% of GDP³², the total food voucher quota was BGN 90 mln and could be used for tax exemption of BGN 40 per beneficiary (employee) per month. The amount was sufficient for around 183 thousand beneficiaries. The real increase of the quota in the next 2008, which also featured GDP growth, provided benefits for 412 thousand employees.

In 2008, the total quota was increased by 125%, and in 2009 – in a totally opposite economic situation with almost tenfold contraction of foreign direct investment – there was a 7% increase to a total voucher quota of BGN 180 mln (to BGN 213 mln), and the monthly income threshold for food vouchers was raised to BGN 60. There was a more than 28% decline in the number of beneficiaries compared to 2008.

In April 2009, the National Center for the Study of Public Opinion established that:

- 60% of enterprises do not intend to increase the salaries of their employees;
- 34% plan making redundancies;
- 85% of food voucher users were satisfied with their use and – in spite of the total decline of salary income in real terms – wish to receive such.³³

In 2009, the Association of Food Voucher Operators expected a rise in the number of users to 280-300 thousand, but this did not happen. As already mentioned, the reason was the quota voucher management system, which did not allow for meeting the demand and created –

²⁹ Bulgaria: Poverty During the Transition, Report No. 18411-BUL and Bulgaria: Poverty Assessment, October 29, 2002 (World Bank Report No. 24516-BUL, available at: http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2002/12/06/000094946_02112204044990/Rendered/PDF/multi0page.pdf)

³⁰ Food vouchers in 2015 System behaviour, socio-economic impacts and reform outlook, Sofia, KC2 LTD, 2015.

³¹ We note again that in Table 1 the value from the Ministry of Finance report seems rather high.

³² From the introduction of the system in 2003, effective budget surpluses were approximately 2% of GDP per annum, the most significant ones being in 2007 (3.5%) and 2008 (3%).

³³ See: <http://www.karierist.com/news/bulgaria/novi-100-hil-rabotnici-vzimam-vaucheri-za-hrana>

intentionally or not – problems with compliance with the regulatory framework of the budget management of food vouchers.

Conclusions from previous studies

In 2010, KS2 Ltd. and Industry Watch³⁴ conducted a representative survey among participating companies of the reasons, benefits and views to making changes in the food voucher system in Bulgaria. Random interviews by telephone calls in 2015 and the applications for inclusion of new companies into the system indicate the main conclusions from the 2010 survey can be still considered valid today.

More specifically, it is a matter of the following:

1. Social vouchers are perceived as an employee loyalty program and facilitate access to specific goods and services for employees;;
2. The tax exemption is an important (39%), but by far not the only factor for participation in the system; other factors include employee motivation (30%) and corporate social responsibility policy (18%)
3. Companies participating in the system provide other benefits to their employees – both in-kind and in the form of paid services (additional health insurance – 40% of the companies, preventive medical examinations – 78%, and expenditures for security at the workplace – 60%); it should be noted this circumstance is characteristic for companies' behaviour, and not for the food voucher system;
4. Only around 20% of the employees in the companies using food vouchers were employed at the minimum wage – and the minimum wage itself is not of great importance in using vouchers: **for 80% of the companies it is way of complimenting the wage contracts and compete with rivals on the labor market.**
5. The benefits in the form of vouchers are as a whole less than 1% of the annual turnover of the companies;
6. Benefits as a whole are up to 2% of the costs of labour;
7. Generally, the use of vouchers results in an increase of the total salary remuneration;
8. The average effect of increase of the gross salary is by BGN 30-40 per employee;
9. Provided the monthly allowance in vouchers is increased, 24% of employers would unconditionally add the amount to the salary; 24% would use the increase to cut other benefits in kind, and 45% would use them for partial increase of the gross salary; It can be assumed that around 70% of employers would increase employee remuneration in one form or another; It is safe to assume that these attitudes are valid presently, too, as they were in a crisis year such as 2010;
10. Satisfaction with the system is observed in more than 90% of employers and employees; they support the extension of the total quota, and increasing the amount of personal exemption,
11. Extending the total quota by BGN 10 mln would result in net fiscal gains in the amount of BGN 440,000 per annum;
12. Generally, food vouchers are preferred by employers as the most efficient form of corporate social policy;
13. These attitudes prove realistic and probable if one considers the data from the annual reports on “budget losses” of the Ministry of Finance: shortfalls from the voucher system are negligible in comparison to other “losses” and the system is a more effective social policy tool than conventional social policies.

³⁴ The Use of Food Vouchers in Bulgaria: A Field Survey Report

Economic Consideration for Liberalization of the Quota Principle

The unit daily value of food vouchers in the country is relatively low – BGN 2.7 per business day and less than BGN 2 per calendar day. This value of food vouchers is at the level of the World Bank's absolute poverty line measure.

This amount and the dynamics of household incomes since 2004 gives grounds to assume with greater probability that, first, the saturation of the demand for vouchers will be a relatively quick process and second, it will help alleviating the poverty level.

The extensive growth of the voucher market by increasing the number of customers would be relatively limited if the quotas are removed because the removal of the quotas will have only partial effect of replacement of salary incomes with food vouchers, since:

- vouchers constitute a relatively small share of labour costs of companies and are used in combination with other social benefits;
- there is a general downward trend of food expenditures as a share of household incomes, and as a share of household total expenditures;
- the expenditures for other household budget items (healthcare, education, leisure, travel, etc.) are increasing.

This effect can be found in large and medium enterprises, with the amount per person being limited in the range from the minimum salary (BGN 460 in 2017) to the average gross salary per month (BGN 1,060 in 2017).

On micro (household) level, the calculus of this limit is obvious from the following idealized nationally average estimate per household:

$BGN\ 1,060 * 2\ household\ members * 29\% \text{ food expenditures} = BGN\ 615 - BGN\ 460\ (\text{quota allowance}) = BGN\ 155\ (\text{per household}).$

This is a potential and theoretically constructed maximum limit, which would reach the effect of substitution in case of elimination of the quotas.³⁵

This effect is applicable to enterprises with wages around the country average salary. This helps calculating the total economic effect of saturation of food voucher demand. The experience of the counties with no quotas for food vouchers proves that similar regularities are common everywhere.

Another limitation would arise from the circumstance that staff working on employment contracts would agree only to a partial substitution of income, although they would benefit from it, as the increased share of food vouchers above negotiable thresholds would be perceived as a salary decrease.

This perception arises from the circumstance that employers are competing with other employers in attracting talents, and employees – with other employees. As indicated by the above-mentioned field survey, the food voucher system is part of competition and bargaining for remunerations and benefits in the labour market.

At the time of the increase from BGN 40 to BGN 60 years ago, around 80% of employers availed of this increase for their employees, thus the number of beneficiaries did not grow in de facto linear proportion to the increase of the monthly value.

Based on these microeconomic dependencies, the conclusions are the following:

- Increasing the monthly limit of food vouchers per employee is logical. The amount of BGN 60 was set long time ago. Applying inflation for the period (which is used on an ongoing basis for indexation of other remunerations – from those of notaries and attorneys to collective bargaining agreements), the adequate amount would be BGN 75-80 or 25-33% higher than the current limit. This will likely result in the same

³⁵ Food vouchers in 2015: System behaviour, socio-economic impacts and reform outlook.

percentage growth of the voucher market as a whole.

- Due to the above considerations, and in line with the experience from previous years, particularly 2012, increasing the quotas will bring into the light part of earnings, although vouchers are likely to be used mainly in large companies, and they are already in the open. Shadow economy reduction will probably come also from household consumption, intra-family redistribution of income, positive impact on other household expenditures.
- The realistic monthly increase per one beneficiary up to BGN 80 may be allowed with no adverse spillover effects for the government budget only on account of the inflation for a 15-year period.
- The growth of the economy frees resources in large companies for increasing personnel expenditures compared to incomes, and part of this growth made in the form of vouchers. Salary expenditures represent a percentage of total incomes of companies in the economy. If we assume that the percentage remains unchanged or changes at a relatively slower rate, probably another natural limit for the use of vouchers would be established up to a percentage of beneficiaries in a jurisdiction – likely not more than 25-30% of employees, as is the case in the countries without quotas.
- Due to the competition in the labour market, the average remuneration in the private sector has been increasing by over 8% per annum in the period 2015-2017, a rate that may be expected to remain unchanged in medium term; sometimes this is also reflected in the employer-employee contracts (particularly in the quickly developing industries). Part of this growth will be likely rechanneled into free quotas and/or food vouchers (provided the liberalization of the quotas), as it will provide tax savings to both parties.
- However, this increase will not be more than double – $2 \times \text{BGN } 60 = \text{BGN } 120$, as the idea is not just to purchase food, but to ensure the worker's normal performance and satisfaction with the conditions of the contract.
- The base vouchers of minimum BGN 2 per employee per day under Ordinance 11 are exactly such – for food when working under hazardous working conditions. The other employers' idea is also to provide for an employee's nutrition during work.

Fiscal Costs and Benefits of Liberalization of the Quota Principle

Main Assumptions

- The share of informal economy is 20%³⁶ of the reported economy – in the food production and sales industries (excluding catering establishments) it is a little higher than the average for the economy;
- Regarding tax and social security contribution rates, a 1 percentage point increase of retirement social security contributions is envisaged as of the beginning of 2018 and they will remain at these levels over the period 2018-2020;

³⁶ The minimum share of the informal segment of the Bulgarian economy can be calculated using the most reliable quantitative method, known as “contract-intensive money” (CIM) introduced by Christopher Clague, Philip Keefer, Stephen Knack and Mancur Olson in 1997. According to our calculations based on BNB momentary statistics, CIM for Bulgaria is around 17% in the period since the introduction of the system. CIM is determined as the ratio of money kept outside banks to the so-called broad money. See: Christopher Clague, Philip Keefer, Stephen Knack and Mancur Olson, Contract-Intensive Money: Contract Enforcement, Property Rights, and Economic Performance, Working Paper No 151, University of Maryland at College Park, IRIS, 1997, p. 8. However, the CIM method does not take into consideration incomes in kind, estimated by Anton Marinov in 2007 at 25-30%, of Bulgarian households in rural areas (see Anton Marinov, *The Shadow Economy in Rural Regions of Bulgaria*, Springer Verlag, April 2008).

- We have made no assumptions after 2020, as this is the time period with which the Ministry of Finance works;
- The calculations of the net effect on the government budget are made under the assumption that employers' labour costs are equal where vouchers are used and salaries are paid in pecuniary form;
- The real GDP growth in the period 2018-2020 is expected at 3.9% per annum;
- Employment growth in the period 2018-2020 will be in the range from 0.2% to 0.6% annually;
- The use of food vouchers will grow by 21%, 10% and 10% respectively on annual basis in the period 2018-2020; i.e. the steepest increase will be in the first year and the total quota will rise to BGN 364 mln in absolute terms, after which it will grow to BGN 400 and BGN 440 mln, respectively;
- The market potential is related to the number of employees in large and partially in medium-sized enterprises (excluding small and micro enterprises for the purposes of the simulation). Thus, the maximum addressable number of possible users (employees) is around 978 thousand.

'Zero' year scenario – BGN 340 mln quota

- Under this scenario the quota amount is increased in the first year to BGN 340 mln (21% increase of the quota compared to 2017), and then the quota is removed.
- As a result, the market size in the second year will increase by 30% compared to the previous one – BGN 442 mln, and in the third it will grow by 10% compared to the previous one – BGN 486 mln;
- The shortfall for the government is mainly from uncollected taxes, which directly increase the disposable income of the private sector of the economy. As a result, consumption and investment are generated, calculated by applying a ratio based on regression analysis of historical data of the Bulgarian economy, which indicate that approximately 97.6% of every additional unit of income in the economy is used for consumption and investment;
- Consumption and investment, on their part, are a basis for generation of tax revenues. The analysis of historical data indicates that from every additional lev of income in the economy the state manages to collect approximately BGN 0.25 tax revenue. By applying this ratio, we come to the additional effect for the government budget, as a result of creating and keeping new jobs.

Gross costs and benefits for the state budget

Table 3: Impacts on the economy and the state budget at BGN 60 monthly non-taxable amount, BGN 340 mln quota in the ‘zero’ transition year and removing it thereafter

Scenario (increase vs previous year)	0 (21%)	1 (30%)	2 (10%)
Total amount of food vouchers, BGN mil.	340	442	486
Loss of tax revenue (7.8% of the amount of food vouchers), BGN mil.	26.5	34.5	37.9
New jobs resulting from the reform, in thousand	1,679	2,026	2,068
Additional revenue from taxes and social security contributions on labour	11.0	14.3	15.7
Indirect benefits	31.9	41.4	45.6
Net effect of the reform	16.3	21.2	23.3
Number of new jobs resulting from growth of economy, in thousand	15,349	10,294	5,168
Tax and social security revenues (excluding consumption) resulting from new jobs, BGN mil.	84.0	60.7	32.8
Total net impact for the government budget, BGN mil.	113.8	94.1	68.4

Source: Updated medium term budget forecast for the period 2018-2020, NSI, own calculations

Under the ‘zero’ year scenario with an increase of the total quota from BGN 280 to BGN 340 mln, the direct losses for the government budget vary from BGN 26.5 mln, through BGN 34.5 mln in the first year of liberalization (30% increase) to BGN 38 mln in the second year after the liberalization. However, the loss of budget revenues means an increase with the same amount of the disposable income of the companies, which opens prospects for new job creation and/or investment.

Table 3 shows the effect of this – creating from 1,600 to almost 2,100 new jobs, which may result in growth of revenues from income and social security taxes between BGN 11 and almost 16 mln. Thus, the initial negative budget shortfall effect is substantially mitigated.

In addition to the direct benefits, the indirect effects, such as those on the shadow economy can be added (assuming 10 and/or 15% reduction) and some value added generated in the domestic economy (20-25%).

For example, in the case of a ‘zero’ year, there will be a BGN 60 mln increase compared to 2017, which would lead to BGN 6-9 mln increase in turnover, with 10-15% reduction of shadow economy, resulting in additional VAT revenues of BGN 1-1.5 mln. The additional domestic value added would amount to BGN 12 to 15 mln, with expected additional VAT revenue of BGN 2-2.5 mln.

In other words, **the direct losses for the budget will be fully compensated by the direct benefits from new job creation and the indirect benefits from increasing the disposable incomes of households, reduction of shadow economy and the additionally generated value added.** Therefore, it is likely that **the net effect of the reform will be positive - from BGN 16 to 23 mln in the three-year period.** (The data presented in Table 3 use a conservative assumptions of 20% additional value added and 10% shadow economy reduction.)

The effects of the expected growth of the economy and new job creation in the next three years should also be added. As can be seen from Table 3, the total net effect for the state budget is positive throughout the period under consideration, owing to the expected increase of the number of employed, and hence – of the additional revenues from taxes and social security contributions on labour.

*No transition year scenario***Benefits and costs for the state budget and the economy****Table 4: Impact on the economy and the state budget at monthly non-taxable amount of BGN 60 and removing of the quota from the next year**

	0 (33%)	1 (10%)	2 (10%)
Total amount of food vouchers, BGN mil.	373	411	452
Loss of tax revenue (7.8% of the amount of food vouchers), BGN mil.	29.1	32.0	35.2
New jobs resulting from the reform, in thousand	1,843	1,882	1,921
Additional revenue from taxes and social security contributions on labour	12.0	13.2	14.6
Indirect benefits	30.3	32.3	35.5
Net effect of the reform	13.3	13.5	14.8
Number of new jobs resulting from growth of economy, in thousand	15,349	10,294	5,168
Tax and social security revenues (excluding consumption) resulting from new jobs, BGN mil.	84.0	60.7	32.8
Total net impact for the general government, BGN mil.	97.3	74.2	47.7

Source: Updated medium term budget forecast for the period 2018-2020, NSI, own calculations

Under the no zero year scenario and liberalization of the market as early as next year the effects are similar, however brought forward in time. That is due to earlier increase of food voucher demand, which will increase during the first year from BGN 280 mln to BGN 373 mln – 33% and it will increase by 10% in each of the next two years. This results in a loss of budget revenues in the range of BGN 29 to 35 mln, and accordingly, to the same amount of increase of disposable income of companies. That could result in creating 1,840 to 1,920 new jobs.

It should be noted that new jobs created under this scenario are by about 130 less compared to the foregoing scenario, but a greater number of them would be created in the first year of the period under consideration. This means that the welfare created will be higher under this scenario, since its positive effects appear earlier in time. The other effects from the expected economic developments are the same as in the foregoing scenario.

The indirect effects resulting from the expected reduction of shadow economy and additional value added generated in the domestic economy resulting from the increased food voucher demand during the first year by BGN 93 mln should also be added to those effects.

Shadow economy reduction may lead to increase of reported turnover in the range of BGN 9.3 mln to BGN 14 mln, and hence, to additional VAT revenue in the range of BGN 1.6 mln to BGN 2.3 mln. The additional value added in the economy would amount to BGN 18.6 – 23.3 mln, and hence, to BGN 3.1 - 3.9 mln additional VAT revenue.

This means that in the first year, the direct shortfalls for the government budget would be additionally compensated by gross benefits from the reduction of shadow economy and additional consumption in the range of BGN 4.7 to 6.2 mln.

Finally, we can also add the expectations for higher household consumption – about 7%, and the results from the World Bank study on intra-household redistribution of about 25%. That would lead to additional household consumption of about BGN 24 mln and additional VAT revenue of BGN 4 mln.

Thus calculated, the initial net shortfall of budget revenues due to the reform, amounting to BGN 29–35 mln for the three-year period again will be compensated by the expected direct and

indirect benefits for the government budget. Thus, the net effect from the elimination of the quotas will be positive and will amount to BGN 13–15 mln. Adding the expectations for additional direct effects from the growth of the economy in the next three years shows that the government budget not only can afford to change the present system built on quota principle, but this would not entail any loss for the government budget.

Technical arguments for liberalizing the quota principle

Updating the quota in the first year of the reform by 21% will allow for meeting the currently emerging demand and may serve as a basis for a transition period to a system without quotas from 2019 on. The following arguments continue and substantiate of the above-mentioned theoretical and economic reasoning.

The calculations use conservative assumptions of the positive impacts and maximum expectations of adverse impacts. In the computations that direct losses are set off to a significant degree by the positive effects. According to estimates, the net effects are by about 22%-29% lower than the gross ones.

In the first year of the reform, the system coverage would be about 472,000, in the second year – 614,000 and in the third – 675,000.

According to NSI data and expectations for labour market developments of the Ministry of Finance, in the next three years this could mean system coverage of 13%, 17%, 19% of the country's labor force. The last percentage is close to the limit of saturation of the system in other countries.

Due to the nature of the system, the specifics of accounting and tax transparency of relations between suppliers and users of food vouchers, removing of the quota principle would not result in further administration costs of the authorities of the Ministry of Finance. In the past, such increases did not show any negative impact on the economy and on the state budget.

The full version of the calculations shows that the benefits of the new system to a great extent offset the costs also over the years in which those were monitored, and in the forthcoming period without implementing a quota principle.

The present system may be kept in the segment of allocation of funds for tax breaks. As mentioned above, the procedures allow for the supply to follow the demand for food vouchers. It is technically possible for liberalization to be implemented without any increase of the monthly allowable tax break, and to consider its increase thereafter.

Fiscal impacts from increase of the monthly preference of BGN 60

Explanation of scenarios

- Three scenarios of increase of the monthly amount of BGN 60 not subject to taxation have been considered: no-change of BGN 60 amount (or “0-scenario”), an increase to BGN 80 (“scenario 1”), and to BGN 100 (‘scenario 2’) under the same assumptions, used in the analysis of impacts of elimination of the quota principle.
- As the increase of the monthly preference may lead to increase of demand, which we cannot project, we use assumptions in the transition year scenario, where the consumption increases by 21%, thereafter followed by increases of 30% and 10%, respectively.
- The effects are presented in Tables 5 and 6 and may be summarized as an increase of the loss of benefits by 1/3 under a scenario with BGN 80 monthly amount and by 2/3 under a scenario with BGN 100 monthly amount, in comparison to the base scenario described above.
- At the same time, direct and indirect benefits for the state budget resulting from creation of new jobs, growth of disposable income of the households, and hence, of consumption,

reduction of shadow economy and additional value added fully compensate the loss of budget revenues due to the reform. The net impact of the increase of the monthly limit to BGN 80 is positive, and is in the range of BGN 13 – 16 mln in the three-year period under consideration.

- The increase of the monthly limit to BGN 100 has also a positive net impact on the state budget, in the range of BGN 15 - 22 mln.

Results under various scenarios

Table 5: Impact of quota liberalization under transition year scenario and increase of monthly limit to BGN 80

	0	1	2
Monthly limit in BGN	60	80	80
Increase of demand vs previous year	21%*	30%	10%
Total amount of food vouchers, BGN mil.	452	588	646
Loss of tax revenue (7.8% of the amount of food vouchers), BGN mil.	35.3	45.8	50.4
New jobs resulting from the reform, in thousand	1 679	2 026	2 068
Additional revenue from taxes and social security contributions on labour	11.0	14.3	15.7
Indirect benefits	37.7	47.6	50.9
Net effect of the reform	13.4	16.0	16.1
New jobs resulting from economy growth, in thousand	15 349	10 294	5 168
Tax and social security revenues (excluding consumption) resulting from new jobs, BGN mil.	84.0	60.7	32.8
Total net impact for the general government, BGN mil.	97.4	76.7	49.0

Source: Updated medium term budget forecast for the period 2018-2020, NSI, own calculations.

Note: approximately 1/5 increase of the demand.

Table 6: Impacts of removing of the quota under a transition year scenario and increase of monthly limit to BGN 100

	0	1	2
Monthly limit in BGN	60	100	100
Increase of demand vs previous year	(103%)*	(10%)	(10%)
Total amount of food vouchers, BGN mil.	568	569	570
Loss of tax revenue (7.8% of the amount of food vouchers), BGN mil.	44.3	44.4	44.5
New jobs resulting from the reform, in thousand	1 679	2 026	2 068
Additional revenue from taxes and social security contributions on labour	11.0	14.3	15.7
Indirect benefits	48.6	49.6	50.6
Net effect of the reform	15.2	19.5	21.8
New jobs resulting from economy growth, in thousand	15 349	10 294	5 168
Tax and social security revenues (excluding consumption) resulting from new jobs, BGN mil.	84.0	60.7	32.8
Total net impact for the general government, BGN mil.	99.3	80.2	54.7

Source: Updated medium term budget forecast for the period 2018-2020, NSI, own calculations.

Note: approximately a doubling of the demand.

Conclusions

- Positive development in the overall economy, wages and productivity, household budget, disposable income of companies and households alike have had an impact on the value of the food vouchers: the real value of the monthly allowance of the vouchers (BGN 60) declined about three times. The inflation rate, typically used as argument for indexation, is not the key factor;
- These are positive effect of the overall being. They, however, speak of:
 - a. The fact that there is little to no risk liberalizing the entire system, and increasing the monthly allowance;
 - b. Retaining the reporting practice, the use of vouchers will thus become self-regulated;
 - c. The lead factor in the process will be already existing rivalry between employers for qualified labor, and the independent from employers macroeconomic factors as propensity to consume and save of the public at large;
 - d. Bulgaria will be no different in this respect other EU member state, using food vouchers;
- Macroeconomic precautions and fiscal conservatism of the period before the introduction of the system are still valid policy considerations today as principles of fiscal discipline but their conditions of the time – high government debt to GDP ratio, outstanding government debt obligations, relative low wage income, minimum wages, high employment and low productivity – today do not constitute a challenge;
- There is little to no justification for government budget revenue shortfall as an illusionary result from the liberalization of the quota principle, and from increase of monthly tax exemption per beneficiary;
- Furthermore, the direct shortfalls are inevitably compensated by the expected indirect fiscal benefits from developments in the economy, labour market, consumption substitution, and higher income and social tax revenues;
- Macroeconomics of the process implies that there are natural limits of saturation of the liberalization. Under the developed scenarios of 30-10-10 percent increase in the first three years (while keeping the monthly exemption per person), the workforce covered will be about 19% in the third year;
- These expectations are confirmed by the NSI statistics and by international comparisons.

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ECONOMIC ACTIVITY, FISCAL, AND CAPITAL FLOW DYNAMICS IN BULGARIA 2007-2012: FISCAL MULTIPLIER THEORY VS. “OTHER THINGS”

Georgy Ganev¹

Abstract

When towards the end of 2008 the leading world economies found themselves in the grips of a severe global financial and economic crisis, their governments felt compelled to react. Most of them, especially in North America and Europe, did so by dramatic increases in government spending with two main goals: to bail out failing financial systems and to substitute dropping private demand with pumped-up public demand as a general support for the aggregate. At the same time central banks made large injections of liquidity to pump up the monetary base and thus counteract the severely contracting money multipliers – at the cost of putting on their balance sheet assets of less than prime quality and thus in effect debasing the currencies of the respective economies.

1. The logic of fiscal multipliers as a “general theory”

When towards the end of 2008 the leading world economies found themselves in the grips of a severe global financial and economic crisis, their governments felt compelled to react. Most of them, especially in North America and Europe, did so by dramatic increases in government spending with two main goals: to bail out failing financial systems and to substitute dropping private demand with pumped-up public demand as a general support for the aggregate. At the same time central banks made large injections of liquidity to pump up the monetary base and thus counteract the severely contracting money multipliers – at the cost of putting on their balance sheet assets of less than prime quality and thus in effect debasing the currencies of the respective economies.

All of these steps constituted an almost point-by-point execution of the standard Keynesian policy proposal for times of slump: make money as easy as possible, and prop up government demand through deficit and accordingly debt-accumulating spending.

Many people, subscribing to the standard Keynesian logic of economic policy, would argue that it is precisely this swift action on the part of governments which is the sole reason why the world avoided slipping into a depression at least as deep and long as the Great one. Some prominent economists, including Nobel laureates Paul Krugman² and Joseph Stiglitz³ continue to defend and promote the proposition that when the trough of the crisis seems to be behind most of the world, any attempts to cure budgets and consolidate public finances will inevitably cause a second dip into recession. Given the difficulties in the economic recovery, especially in Europe where a second dip of the recession is in fact occurring at the end of 2012 and the beginning of

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² See his regular comments in his blog: <http://krugman.blogs.nytimes.com/>

³ An explicit statement of his argument was made in front of Bloomberg: <http://www.bloomberg.com/news/2010-08-24/stiglitz-says-government-cuts-set-to-push-europe-into-double-dip-recession.html>

2013, ultimately the IMF also reevaluated its position to claim that policies aiming at curing public budgets and debts while the economic crisis was still in the air have had a detrimental effect on the dynamics of economic activity.⁴

The main proposition made by all the above mentioned economists rests on two related, but not equivalent, claims. The first one is that fiscal stimuli help avoid depressions and shorten recessions. The second one is that fiscal consolidation causes recessions. In economic parlance, the claim is the following: the fiscal multiplier is large in both directions.

One can easily imagine the theory behind this claim, and it would include the standard argument that the fluctuations of overall economic activity are causally led by fluctuations in aggregate demand and the fiscal stance is an important determinant of aggregate demand. However, as is the fate of almost any other theory in the realm of social sciences, it can be realistic enough in specific contexts which are a strict subset of the overall set of specific contexts in the world and may lose a lot of its pertinence in other specific contexts. Thus, if a given country's government is to make a political decision on a course of policy action, the important question is the one about the theory's empirical validity not in general, but under the country's specific circumstances.

2. A set of specific and unique circumstances

The case of Bulgaria over the last business cycle offers such a very peculiar set of circumstances, which can help throw light on the first part of the claims of the general theory that fiscal multipliers are large in both directions.

The set of Bulgarian circumstances in the first business cycle of the 21st century is indeed peculiar. This set includes, among others, five characteristics, which alone are enough to demonstrate the uniqueness of Bulgaria, but which also have – separately and combined – specific and significant economic meaning. This meaning is significant for the Bulgarian economic reality, but it is also significant for the theoretical and empirical question about the role of fiscal multipliers.

Bulgaria is a small, open, catching-up, member of the EU operating under a currency board arrangement.⁵

Small means that its size is negligible relative to world flows. Open means that it has active goods and services exchanges with the rest of the world. The combination of these first two characteristics means that the trade flows between Bulgaria and the rest of the world are large relative to its domestic size.

Catching-up means that its domestic rates of return are relatively high, so that in normal times it is highly attractive for capital, even though its smallness limits this attractiveness and prevents Bulgaria from having any significant role as a safe haven for capital during bad times, so it is to be expected that during a global or domestic downturn capital will tend to leave despite attractive rates of return. EU member means completely open current and, especially, financial accounts. Bulgaria is subject to free movement of factors of production. The combination of this second pair of characteristics means that not only trade, but capital flows between Bulgaria and the rest of the world are free and large relative to its size, and, which is probably even more important, only a small portion of those flows depends on domestic policies.

Bulgaria operates under a currency board regime, meaning that there is a highly institutionalized fixed exchange rate to the Euro and almost complete lack of autonomous domestic monetary policy – the central bank has no control over the monetary base and is not allowed to hold any

⁴ See more specifically Blanchard, Olivier, and Daniel Leigh, "Growth forecast errors and fiscal multipliers", IMF Working Paper No. 13/1, January 2013, at: <https://www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf>.

⁵ There is only one other country sharing these characteristics with Bulgaria, namely Lithuania. Of course, it is easy to show differences between the two in other important dimensions and thus that they are completely unique, but this is beside the main argument pursued here.

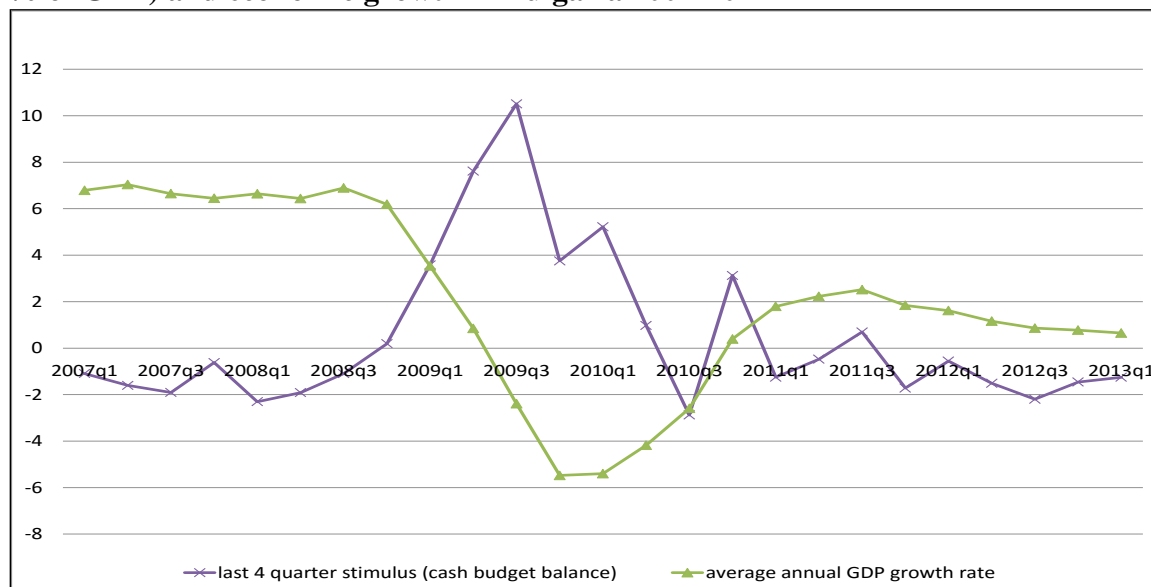
form of Bulgarian debt, including government paper and loans to Bulgarian banks. For this reason the stability of the monetary regime requires fiscal prudence, and the country has actually recorded a decade of fiscal surpluses which have been piled up into the government's fiscal reserve.⁶

3. A test of the “general theory” in the specific circumstances

After a decade of fiscal prudence, when the global crisis knocked on Bulgaria's door in late 2008, the country had ample reserves, as large as 20 % of annual GDP, stacked in a highly liquid form, ready for spending. It is important to note that to start spending Bulgaria did not need issuing new debt and raising all kinds of problems with the private sector feelings and expectations about the future servicing of this debt, which plague many countries in the world. Bulgaria had ample fiscal reserve, cold cash stashed abroad, ready to be spent without crowding out anybody's access to credit or desire to spend.

And Bulgaria did spend it. At the end of the first quarter of 2013 the size of the fiscal reserve, measured as a percent of GDP for the last 4 quarters, is less than a third of its size in September 2008. Measured through the change in the government net debt position, in order to clear away effects of changes in government debt, the Bulgarian government has stimulated the economy in each of the 17 quarters starting with the first of 2009,⁷ in some cases by as much as 4 to 6 % of current GDP. One would imagine that, given such support, the Bulgarian economy should have avoided a recession altogether, or at least seen a very mild one. The facts, as illustrated in Figure 1, however, are a bit different.

Figure 1. Fiscal stimulus (measured as change in consolidated state budget on cash basis as % of GDP) and economic growth in Bulgaria 2007-2012



⁶ The prudent fiscal policy in this period is a characteristic of Bulgaria, which is qualitatively different from the other five enumerated in this section. The difference is that the size and the position of a catching-up country are reflections of the natural, inherited state of affairs and cannot be changed at will. Openness, EU membership and the currency board are elements of the institutional setup of the country and can be changed, but such a change would involve all the intricacies of macroinstitutional change and have a very complex social dynamics. The budget balance, on the other hand, is a matter of current policymaking and is very much subject to the whims and preferences of the current government. The fact that four consecutive governments chose to, by and large, follow a prudent policy, is very interesting in itself, but is not part of the natural characteristics or the fundamental institutional setup of the country.

⁷ As of the moment of writing this streak continues.

Figure 1 shows that in each of the first seven fiscally stimulated quarters the dynamic Bulgarian economic activity worsened – either slowed down or contracted, in some cases between 5 and 6 % annually. To put things in comparative perspective, the 2009 Bulgarian recession was a bit deeper than the overall EU-27 recession, while the economy was stimulated by about 4 % of GDP. From another perspective, over the period from late 2008 to mid-2010 Bulgaria saw half of its huge fiscal reserve gone with nothing to show for it. No multiplier effect seems to be visible here.

On the contrary, if we look at the simultaneous dynamics of the fiscal stance and the overall economic activity, it is very easy to see that in the case of Bulgaria while fiscal consolidation was happening (2007-2008, and 2011-2012) the economy was growing, and while a very large fiscal stimulus was applied, the economy contracted and continued to stay depressed for several quarters in 2009 and 2010. The Bulgarian data and experience for 2009-2010 put a serious empirical obstacle to the claim that fiscal stimuli soften recessions. The Bulgarian data and experience for 2011-2012 put a serious empirical obstacle that fiscal consolidation necessarily leads to recession.

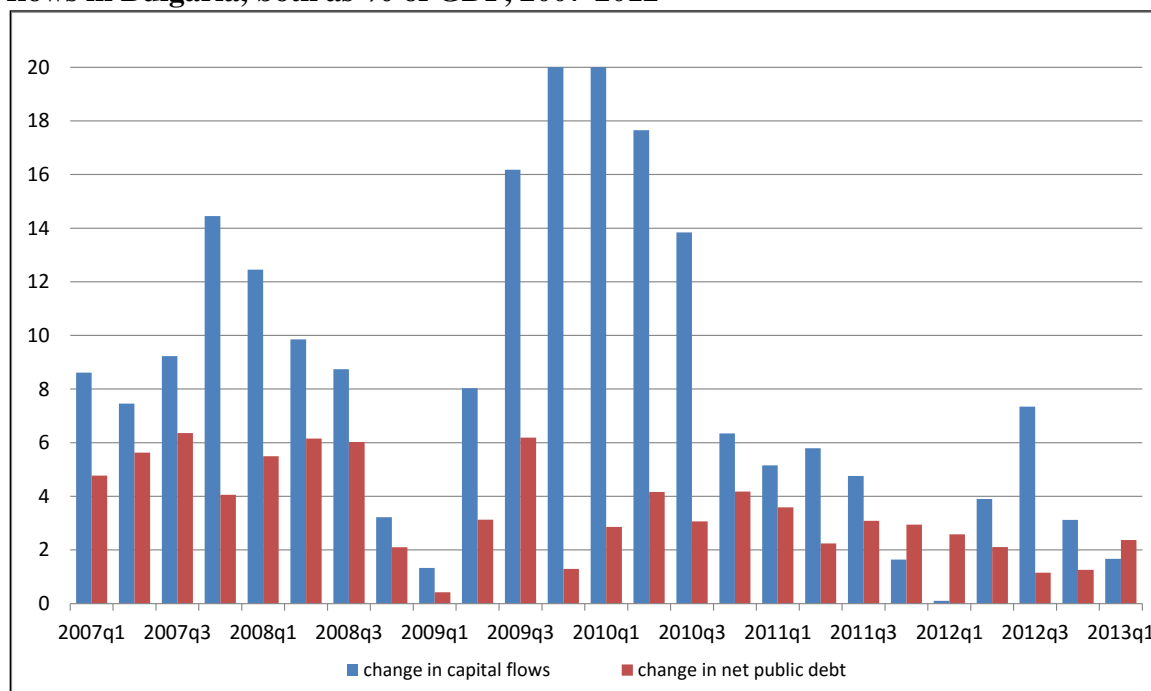
4. Can the fiscal multiplier general theory survive the Bulgarian facts?

A natural counter-argument from the point of defense of the fiscal multipliers theory would be that fiscal stimuli work with a time lag, so that the improvements in economic activity dynamics in Bulgaria after mid-2010 are a response to the stimuli of early 2009, implying a one to one-and-a-half year response time. This is a valid hypothesis. But there are some serious empirical arguments against it, and also there are other valid hypotheses explaining the same growth dynamic without fiscal multipliers and without necessity to rely on assumptions about long lags. One empirical argument against it is that Bulgaria, being small, should not exhibit long lags. Another is that the improvement of the overall economic dynamic came primarily from a very fast increase in exports, reflecting a rise in final demand not so much in Bulgaria, but abroad – and there is no way the Bulgaria fiscal stimulus can affect demand abroad.

Of course, this development has another ready theoretical explanation in the specific features of the Bulgarian economy mentioned above – it is small, open, catching-up in a huge market of freely moving capital. And this explanation is centered on the fact that under these circumstances the capital flows into the country in globally good times and out of the country in globally bad times are dwarfing the otherwise large changes in the fiscal position. To illustrate this, Figure 2 shows very similar data as the one used to illustrate the fiscal stimulus, only now it shows the change in government net debt position in comparison with the changes in net capital flows to and from the country. The Figure uses absolute values, so that the comparison is only in size.

Figure 2 starkly demonstrates the fate of a small, open, catching-up EU economy. The fiscal movements of its government, and they were large indeed by any measure, were almost always several times, in some cases orders of magnitude, smaller than the relevant capital flows. For only three of the 25 observations in Figure 2 the change in the fiscal position was larger than the change in the capital flow. During the good times of the business cycle these flows create domestic demand.

Figure 2. Fiscal stimulus (measured as change in net government debt position) and capital flows in Bulgaria, both as % of GDP, 2007-2012



During the bad times they depress domestic demand. There is nothing, beyond a trifle, that the government of this small economy can do to substitute for these flows in the bad times, and under the EU it is legally forbidden to block their entry during the good times. Paul Seabright's⁸ metaphor about politicians sailing a boat in a storm is spot on in this case:

“Politicians are in charge of the modern economy in much the same way as a sailor is in charge of a small boat in a storm. The consequences of their losing control completely may be catastrophic (as civil war and hyperinflation in parts of the former Soviet empire have recently reminded us), but even while they keep afloat, their influence over the course of events is tiny in comparison with that of the storm around them. We who are their passengers may focus our hopes and fears upon them, and express profound gratitude toward them if we reach harbor safely, but that is chiefly because it seems pointless to thank the storm.”

Of course, it has to be recognized immediately here that all these are not formal econometric tests of the validity of the fiscal multiplier versus the other potential theories explaining the Bulgarian facts. It may very well be that such a test will prove that a fiscal multiplier does in fact exist, in the “statistical significance” sense of the word, in Bulgaria. It may also prove that this multiplier is not only statistically significant, but even large in international comparison. None of the abovementioned facts and alternative hypothetical explanations refutes the fiscal multiplier general theory conclusively. Other thing equal, as is the tradition of stating theories in economics, the fiscal multiplier in Bulgaria may exist and may indeed be relatively large, we do not know.

5. Some important qualifying considerations

The whole problem with the fiscal multiplier general theory in the case of Bulgaria, however, is to be found in this traditional qualification, which we economists seem to have developed a habit of not noticing any more: “other things equal”. In fact, we do know other things are never equal.

⁸ Paul Seabright, *The Company of Strangers: A Natural History of Economic Life*, Revised edition, Princeton, Princeton University Press, 2010, p. 10

In the case of small open economies they are simultaneously both never equal and always important.

From the point of view of pure economic theory, it might be extremely important whether there is a fiscal multiplier and whether it is large. From the point of view of actual, real-life policy-making this is not the relevant final question, but just a preliminary one. If it is recognized that policy-makers face, as every other economic agent, the reality of scarcity and the necessity to choose between alternative uses of the scarce fiscal resources, then the only policy relevant question is not whether the fiscal multiplier is large, but whether it is larger than “other things” in the respective specific and unique country context.

In a sense this consideration follows the logic of Ziliak and McCloskey (2008)⁹ in claiming that for real-life policy-making statistical significance is essentially useless and the only thing that matters is economic and social significance.

In the case of Bulgaria, even if there is a fiscal multiplier and even if it is large, there are also “other things” which not only do change, but have two other important characteristics. First, they very probably depend, even if in a roundabout and indirect manner, on the fiscal stance of the government. Second, they are large relatively to the fiscal multiplier effect.

The most important such “other thing” is the international capital flows to and from Bulgaria. As suggested by Figure 2 most of the time these flows have an effect on aggregate domestic demand in Bulgaria which is several times to an order of magnitude larger than any change in the fiscal position. If the fiscal policy of the government has an influence on these flows, and if this influence requires fiscal policy measures which are different from the measures implied by the logic of the fiscal multiplier theory, then the government faces a genuine policy choice which cannot be resolved on the basis of the simple claim that fiscal multipliers exist in theory and may be of specific size in reality. The government has to constantly ask itself which – the fiscal multiplier effect or the “other things” – will be larger.

6. Summary and a policy suggestion

As many other countries, Bulgaria met its recession of 2009 with a very substantial fiscal stimulus in an attempt to substitute depressed private demand. Unlike most other countries, Bulgaria had used the good times before the recession to behave in a fiscally responsible manner and had piled a large fiscal reserve in highly liquid, ready to spend assets so that government spending could immediately be expanded without simultaneously causing the usual complementary problems of crowding out and aggravating expectations.

The fiscal stimulus in Bulgaria did not prevent recession, even if it might be argued that it may have softened it a bit. Later, when the fiscal reserves were depleted and the government began a process of fiscal consolidation, this did not cause a second dip of the recession. It seems that the effectiveness of fiscal policy and thus the economic significance of the fiscal multiplier both in the direction of stimulus and in the direction of consolidation have been weak over this particular episode.

This is possible under two scenarios only, First, the fiscal multiplier does not exist or is very small in Bulgaria. This first scenario seems unlikely and it is not the contention of this study to claim any such finding.

Second, and much more policy-relevant, the fiscal multiplier exists and is relatively large, but other things are more economically and socially significant and trump its effect. The most important candidate for a member of set of these important “other things” is international capital

⁹ Ziliak, Stephen T., and Deirdre N. McCloskey, “*The Cult of Statistical Significance: How the Standard Error Costs Us Jobs, Justice and Lives.*” Ann Arbor: University of Michigan Press, 2008. See also the especially enlightening exchange between Thomas Mayer and Ziliak and McCloskey on the pages of the September 2012 and January 2013 issue of the online journal Econ Journal Watch: <http://econjwatch.org/articles/>.

flows. This is especially true given the five fundamental characteristics of the Bulgarian economy: small, open, catching-up, member of the EU, under a currency board.

Thus international capital flows trumping the fiscal multiplier seems exactly the experience of Bulgaria in the period 2007-2012. And, if we extend Seabright's metaphor, the best strategy to navigate a small boat in a big storm is to pay attention to the storm and its flows. In the case of Bulgaria this would mean to actively manage not domestic demand, by trying to substitute government spending for it, but to actively manage the way in which the huge international capital flows treat your particular country. Under such a strategy the fiscal reserve, this fruit of reasonable fiscal austerity during the good times, still has a crucial role to play, but in a possibly dramatically different way. Rather than being spent in order to substitute the un-substitutable, it may serve as a lever to make the international capital a bit more willing to enter and a bit less quick to exit. This strategy can hardly ever be much more than a hope, but what else is there for a small bark in the storm?

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CURRENCY BOARD

THE POLITICAL ECONOMY OF CURRENCY BOARDS *Theses about the political environment of fixed national currency flow*

A Methodological Essay

Todor Tanev¹

Abstract

This paper presents methodological theses for a non-standard study of currency boards performance in terms of their political dimensions. These theses refer to the domestic and foreign policy frameworks of the creation, management and termination of the currency board arrangements. The theses are designed as to allow the best possible comparison between countries with different currency arrangements. This essay does not set as many hypotheses as it seeks to provoke reflection and dialogue within the scientific community for the exploration of important phenomena in today's globalizing world.

- The political economy of currency boards is an uninvestigated phenomenon. There exist many purely economic studies on currency boards that explain their narrow economic role. At the same time, their political nature remains unexplored.

- It seems that the approach to currency boards from the perspective of political economy does not conflict with the Keynesian view of the government's positive role in creating economic trends, with the Central bank being a priority. Currency boards are just the same, though bearing the opposite sign: they suggest a positive role for the government as well, however not relying on the Central bank, but on the contrary, self-restraining itself by restricting the Central bank's actions to curb hyperinflation and its consequences. Thus, the government is active in the Keynesian tradition by making a choice of “lesser evil” – better without a fully functioning Central bank rather than with hyperinflation.

- Why is the topic of political economy of currency boards important -- this is an open question. It is important to determine the focus of the political study of currency boards: the Board, or Politics, is the independent variable determining the other? Which of the two will explain the other, or there is something “third”? The notion of “economy” usually refers to a narrow study of the economy without other political and social considerations, while the term “political economy” is a separate approach containing many more aspects (political, legal, cultural, sociological) whereby it is not economy that defines politics but rather the opposite --

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politics determines economy (and without this happening necessarily in a revolutionary situation or other emergency where politics typically precedes economy). Political economy most often refers to interdisciplinary research based on economics, sociology and political science aimed at the explanation of how the political institutions, the political environment and the economic system interact one with the other. It should be kept in mind that, as opposed to pure economic approach, political economy deals with three particular themes: (1) the role of governments and power relations in the allocation of resources, (2) the economic impact of international relations (international political economy) and (3) economic models of political processes. Each of these thematic circles is central to the study of currency boards as a political phenomenon.

- Currency boards as a political phenomenon are directly related to the political sphere, to law (law), culture (public values, habits, traditions). In other words, currency boards reflect many other things -- culture, history and social psyche, politics, power and governance, internal and external politics. The adoption of the bill of currency board in Bulgaria is a good example – all different aspects are reflected in the debates, in the claims for authorship of the Board, etc. The obedience of all political forces all the time of existence of the Bulgarian currency board to the idea of a “future after the currency board when joining the common European currency” discloses a feature of the national character of a sense of inferiority, as if “Europe is watching at us”.

- The political economy approach to currency board analysis reveals the transition from the borders of the nation state out to the supranational space, though the latter space is limited to a system of two economies - a “donor” and a “acceptor” of stability.

- Currency boards are a tool for politicians to use (especially the ruling, but not only). When successful they compete with claims to be its founding fathers. Currency boards should be seen as an instrument of political survival, means in inter-party collisions, a matter of political strategy extended beyond current mandates, etc. The common and different between countries that have adopted the Board (for example, Bulgaria and Argentina) would serve as source of inferences in that overall context.

- The main political question is what is the attitude of political institutions and the rest of elements of the political systems (parties - ruling-opposition, big-small, conservative-radical, democratic-ultranationalist, etc.; parliaments, the government-president binom) and their attitude to crisis management through currency boards.

- From the point of view of political analysis, it is important, above all, who the stakeholders are (with their managerial, power, etc. potential), their position and even more their intentions (whom they conceal or clearly defend in rejecting or supporting the currency board in a clear or hidden way). Stakeholders can be found in all three sectors – the private, state and civil – respectively: private sector – small, medium and big businesses, gray / shadow economy or overt economy, foreign or local capital; state sector -- political parties and opposition, political forces supporting or opposing the Board, foreign political interests, external influences, the clash or cooperation between government and presidential institution; civil sector - poor-rich, young-old, citizens-peasants,

- A second major political question is what is the relationship between the currency board and international politics, supranational political and financial institutions. In this sense, the main political question is the so-called “Cross-border effect”: one currency is “hooked” to another because an economy, but also a society and government is more unstable than another economy, society and state (mostly politics, i.e. the independent variables are mostly the political actions, the cultural factors and, to a lesser extent, and economic ones to the least). There is a cascade overflow of stability (sustainability, hence socio-political consent as a consequence). If boards

exist only in donor-acceptor of stability “pairs” this effect will be maximum; if, conversely, (the ultimate option -- the existence of a world currency which obscures who are the donors and who are the acceptors) -- the effect of the “coupling” of national currencies would be minimal. In this sense, it is important to make a comparison with the effects of the German mark in a situation of united Germany with its single Central bank -- how are they merging and how is stability in the economy in the East of the country secured? How does the Euro stand in Greece as opposed to Germany?

- An important though not fundamental political question is what are the main political and quasi-political arguments (usually expressed in economic form) in support or rejection of the Board arrangement? Do they differ in different cases of currency board? The arguments in support of the CB arrangement are related to the significant anti-inflationary effects: hyperinflation disappears everywhere in the very first few months or years after the adoption of the currency board and is kept at a low level afterwards. Obviously, the reason for the sharp fall of inflation is due mainly to the confidence in the currency board. However with regard to gross domestic product, we can see also positive consequences in the form of a general trend of growth that varies between countries depending on political stability and the commitment to economic reforms and a healthy macroeconomic environment.

- Another political question is to examine the timing of the Board and, respectively, the stages that determine the different consecutive types of political decisions: first comes a crisis (caused by internal policy failures often in relation to the external circumstances that lead to an economic crisis) → a decision to adopt a currency board (internal political debates on the outcome and the choice of tools to tackle hyperinflation as well as the direct impact of external political and economic factors on domestic politics, such as international banks, foreign governments) → decisions concerning the government in all public areas resulting from the CB → decision to terminate the CB (once again the influence of internal and external political factors).

- Other political issues are: Which / what (internal) political actions typically lead to an unmanageable crisis that requires the introduction of a currency board and how that rate of instability is generated, what are the steps leading to that state? Which foreign policy influences typically initiates / catalyzes / encourages the introduction of a currency board -- like reports by global financial institutions, international banks, but also some specific foreign governments? Where from (source) comes the decision to end the currency board arrangement? Is the Bulgarian Board an orthodox one and are there orthodox Boards at all, or is it only an ultimate theoretical ideal?

- The results of a currency board’s functioning are politically attractive. As a rule, CB leads, besides limiting inflation, to rising real GDP growth rates, and also to a sharp fall in government bond yields, resulting in a huge reduction in government spending and a better redistribution of government resources. CB cuts the two major hyperinflation channels – the Central bank’s loans to government and commercial banks. In this way the state is hampered by excessive behavior, the Central bank under the conditions of the CB imposes strict discipline on banks which altogether leads to limiting hyperinflation. A central bank that can fight inflation can commit more credibly by fixing the exchange rate. When workers and corporate managers have low expectations of inflation, they set their wages and prices accordingly. The result is that the country is able to achieve a lower level of inflation for any given level of output. Bearing in mind that the currency board is the most credible form of the exchange rate, according to the postulates of economic theory, it should be expected that the countries under this arrangement have the lowest rate of inflation. This has been confirmed by a number of empirical studies.

Schuller (1992) concluded that inflation has generally been lower and GDP growth per capita higher under currency boards than under central banks. However, comparative economic research shows that the nominal rate of exchange rate fixation is very efficient in terms of hyperinflation or high inflation, while its efficiency is lower at lower rates of inflation.

• The political influence of CB is also evident from its “Placebo” effect: in that regard it is interesting to mention that inflation in Bulgaria decreased significantly in April 1997, i.e. after the decision to introduce a CB was made but two good months before its official introduction. The reason for this is most possibly the currency board's impact on the increase in financial discipline which is reflected in curbing money supply growth and increasing confidence that affects the inflation expectations built into the expected rate of return after the announced cash (Beck et al., 2003). Generally, in its full form, CB is an outcome of crises of several types:

- The transition from war to peace economy,
- The transition from planned to market economy and
- The transition from the status of a former dependent state to an independent state.

It is no coincidence that the transition to CB in Bosnia and Herzegovina was fixed in a political document of paramount importance - the Dayton Peace Accord, which is a political document that sets above all a political outcome from a dramatic socio-political crisis.

• CB is an exclusive state and not other type of regulation. CB is a specific part of regulatory economy (or economy of regulation). In principle a large part of it deals with the implementation of the law by the government agencies for various purposes, including the elimination of market failures and variants of more or less centralized management of the economy in order to change existing economic behavior. In the case of currency boards the state regulation exceeds by far the standard for every other government regulation like the sale of alcohol or prescription medicines, food controls, control over housing conditions, public transport, construction, television, and so on. As measures, it also transcends standard forms such as state licensing, standardization or state inspection of some kind. Thus, currency boards are passive and automated regulatory government policies. Such should be their definition in their political-economic research.

• The axiom is that only politicians take the strategic decisions about the currency board: decisions about its introduction, its management, its termination, the choice of currency to which the national currency is attached, decisions to carry out the domestic political struggles in order to withhold the CB arrangement, decisions related to the future after the Board, etc. Political is the question of negotiations between the parties -- above all between the government and the Central Bank – covering themes such as the strength of the currency board (its proximity or distance from the ultimate form of an orthodox currency board) with a view to securing some degree of fiscal policy (see, the negotiations in Lithuania in 1994 - (Alonso-Gamo, et al., 2002) - where, as a result of political negotiations with the government, the Central Bank managed to retain the function of a lender of last resort and the function of money market operations controls the liquidity of the country's financial system). Unlike political strategists, economic agents (from the Central Bank, etc.) make, above all, tactical (technical) decisions following from strategic decisions. Economists, unlike politicians, think in rational schemes of “if-then,” and a premise in all their judgments is rational behavior; however, behavior is not such in the actual life -- there is both irrationality as well as value rationality which largely differs from instrumental rationality on which economists emphasize. However, remoteness from the hard-line version of CB leads to problems (see, for example, Lithuania where some concessions have been agreed, the board has led to a fall in inflation relatively quickly, but then other important

issues remained as a result of the CB's reserved policy). In a nutshell, political is the question of the slow or insufficiently rigid financial reforms, as well as the residual paternalistic behavior of the government towards the economy. Political is the question of the CB as an instrument for imposing discipline preventing private banks to distribute bad loans as a matter of politics (Bulgaria in the 1990s).

- CB is a possible political norm in small and emerging economies facing macroeconomic crisis due to slow, timid or improper attempts at financial reform. In the past, it was only a fiscal policy of a domination (mainly the British Empire) over colonies. It is the inflationary pressure that occurs in such small countries as a result of price liberalization after the transition to a market economy, the lack of automatic macroeconomic balance of supply and demand, the problem of chronic shortage of money, the loss of the bulk of the export market (for example, the loss of exports to the CEA for the former Soviet bloc countries). When the economic crisis is particularly large and parallel with a political crisis, governments are looking for internationally recognized and accepted means such as CB. At the same time, CB offers a so much desired by politicians in troubled economies quick “instantaneous” solution when it comes to emerging from a deep and unsolvable crisis. All of this is catalyzed by the failure of other stabilization attempts made before the introduction of a CB.

- Historically, given the fact that currency boards have been established in territories under British domination, as a reaction the desire in the past was for an independent central bank, imposed as one of the key aspects of newly acquired independence and separation from the colonial past. Today, however, CB's role is reversed, often aimed at promoting political independence. For example, in the Baltic countries (first Estonia), the role of the Boards is obviously both economic and a matter of foreign policy. Since 1991, all these countries have sought to insure themselves against Russian influence. All of these are simultaneously political as well as economic factors for the existence of CB.

- In some sense, after politicians bring by their actions a deep crisis that leads to the introduction of a currency board, it happens when they “have lost their teeth “ -- for example, the introduction of the CB in Bulgaria took place under severely reduced political activity -- no functioning parliament, a provisional government, while at the same time the political crisis has exhausted political opponents. However does this same happen everywhere while introducing a CB? Does this also have to be the condition under which the decision to end with the currency board arrangement is made?

- When is a board successful from a political point of view: presumably when its economic, social and, above all, political consequences last after it has ceased; if the positive consequences quickly pass, politicians cease to recognize the CB as a success and as their own achievement.

- What are the criteria for introducing a board (still, this is clearer) and terminating its mode (that's less clear)? The beginning (possibly the end) of a Board is a matter of political situation, respectively the phases of the situation, with the “joint constitution of meaning” followed by an allocation of roles and eventually the corresponding automated action from this moment on.

- The research on the currency board has a direct relationship with theory of risk and uncertainty (overcoming the uncertainties of the future). It is possible to gradate the degree of uncertainty that leads to the decision to introduce the Board.

- The fact of the existence -- or absence -- of an alternative possibility of a stable national currency throughout the existence of the currency board arrangement is of paramount importance, as is the case with Bulgaria. Bulgaria faces the possibility of being accepted in the Eurozone, a fact that influences strongly all political forces at any moment of existence of the

currency board in the country; respectively, the lack of prospect of monetary stability “after” the CB is the same factor bearing the opposite sign. The word is about the presence or absence of additional factors, such as financial discipline, political consensus, national unity regardless of political opposition ...

- What is the Model of Exit from the Board arrangement (or is the Board once introduced to be “eternal”?) -- what is the basic point of view and what are the auxiliary points of view: whether this is an ideal, for example, extracted by theory, or the basis for the solution is to achieve what is “good for all citizens” (how such a state is defined in terms of the Condorcet’s Paradox, etc.) or, rather, good for the small or the big business, the local or the foreign one, the overt or the shady business, the politicians, for the political consensus, for the government (whatever it is) ... is there a state that is “good for all” made possible by the currency board?

- The currency board is a matter of national security: the currency is a pillar of statehood, but not necessarily the national currency – currency flow stability whatever the currency alone secures legitimacy to the state (preventing people “trampling gold coins in jars”); the currency board is an instrument of trust, and for the formation of a civil society.

- The currency board policy is related to the issue of distributional justice.

- The board is above all a tool for reaching socio-political consent within a society fragmented by a economic crisis and creates socio-political and economic comfort. However, the board hinders some of the business (certain business segments) and hence the question arises about the balance between the two sides -- public-political consent and economic circles self-isolated from that consent?!

- Currency independence has a different level of success for small and large countries. It can be assumed that success in smaller ones is more guaranteed.

- The CB is protected from political pressure, while an acting central bank, on the contrary, is a highly politicized body, this is why CB policy leads to depoliticizing the macroeconomic framework of the national economy. The government refuses to finance through central bank loans and to gain by creating inflation, against which it gains predictability, credibility, and, above all, fast and efficient financial reform.

- The political price of a currency board: this is the rejection of other instruments of financial governance (internally against the opposition and externally against superpowers who do not support the government).

- Possible parts of a future study of the political economy of currency boards: Political institutions and the CB; Currency board ideologies (i.e. whether it is important to have free national currency flow and to what extent and in what respect, for smaller or larger countries); The state, private and civil sectors and the CB, and so on.

- Important is to compare not only between government policies in countries with a currency boards but also between government policies in countries with different currency systems -- on the one hand currency board countries and on the other at fixed exchange rates, managed float, and free floating.

Fixed exchange rate arrangements (currency board being the most rigid form) lead to overestimation of national currencies over time, which could stimulate imports and discourage exports. Therefore, based on theoretical assumptions, it will be reasonable to expect that countries in the currency board arrangement will have a higher external current account deficit (expressed as % of GDP) compared to countries with the free floating exchange rate arrangement in place. Namely, in the CBA, the exchange rate is a not variable that the state can use in order to

depreciate undesirable developments in the balance of payments, therefore, the appearance of the current account deficit is imminent in this monetary arrangement.

The currency board arrangement is usually introduced when the current monetary arrangement does not give satisfactory results, especially in the form of low credibility and high inflation. This arrangement, which has a long history, is applied now to four European economies in transition. This arrangement has proved very efficient when it comes to lowering high inflation. Therefore we can conclude that in the period of its introduction, this arrangement achieved good results in all four observed European transition economies.

Given the fact that the European economies in transition continued to apply this arrangement for many years after the lowering of inflation, there is a question of whether it is efficient in a relatively stable environment, that is, whether an “exit option” should be pursued.

Some authors have concluded that the application of this arrangement in the long run leads to overvaluation of national currencies and thus the current account deficit is almost twice as big as that of countries with the fluctuating exchange rate. As for the inflation rate, it turned out that countries in this arrangement have almost 1.5 percentage point higher rate of inflation than countries under the floating exchange rate arrangement. One can therefore conclude that the currency board arrangement is less efficient in stable conditions.

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BULGARIA: FIFTEEN YEARS LATER¹

Steve H. Hanke²

Abstract

The first of July marked the anniversary of a momentous day in Bulgarian history. On that day, fifteen years ago, Bulgaria installed its currency board system (CBS), finally ending its hyperinflation, which had peaked with a monthly inflation rate of 242%, in February 1997. But, I am getting ahead of myself.

As the Soviet Union and allied communist countries began to collapse, I anticipated that a big issue facing the newly-liberated, former communist countries would be inflation, and the instability associated with it. In consequence, I shifted the emphasis of my research program from privatization to currency reform. For me, this was a big shift, since I had been President Ronald Reagan's chief White House adviser on privatization, in the early 1980s, and had a great deal invested in developing that policy agenda. By 1990, I was operating as the personal economic adviser to Živko Pregel, the vice president of the Socialist Federal Republic of Yugoslavia. Yugoslavia had been plagued by very high inflation rates for many years. As I reflected on Yugoslavia's problems and the inflation storms which were gathering in the former communist lands, I concluded that currency board systems were the best monetary arrangements for stopping inflation and establishing economic stability. I also embraced the idea that, while stability might not be everything, everything is nothing without stability. Early on, it became clear that Bulgaria would face the curse of hyperinflation. So, thinking Bulgaria was fertile

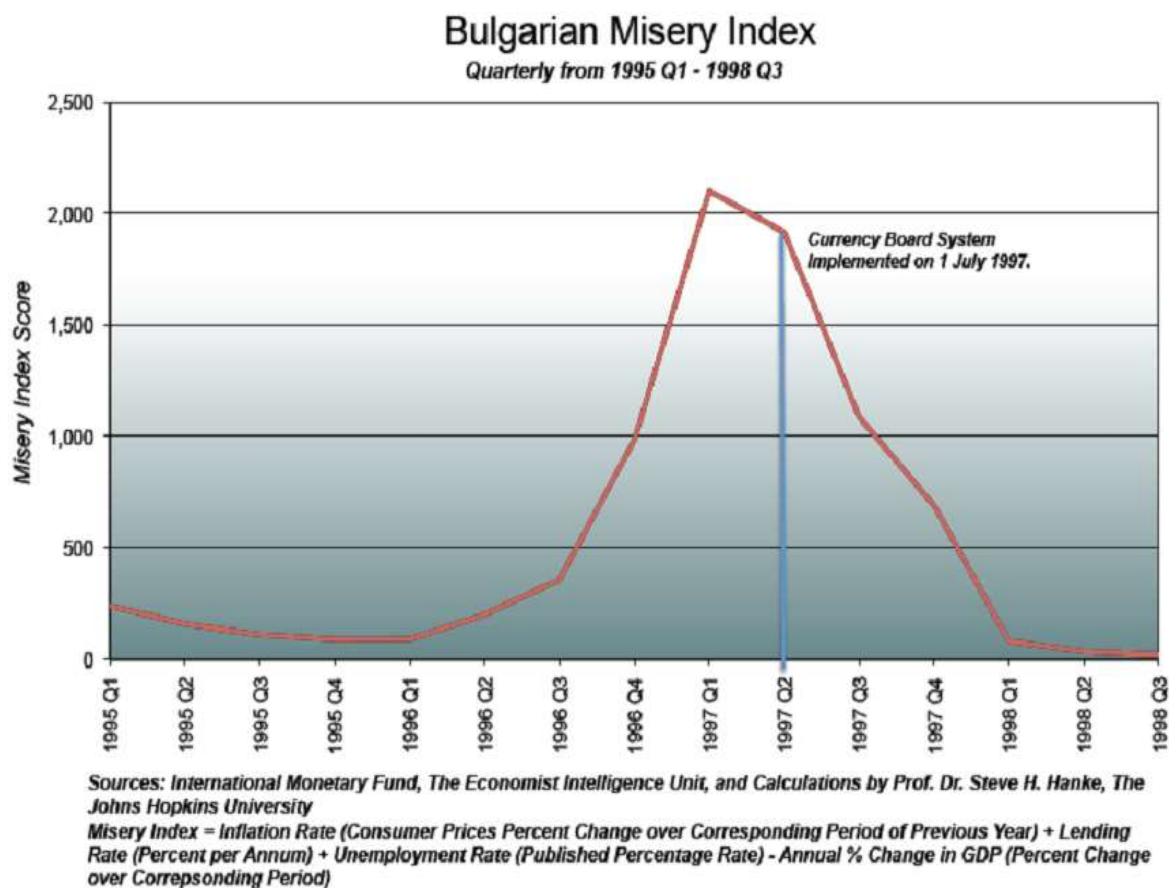
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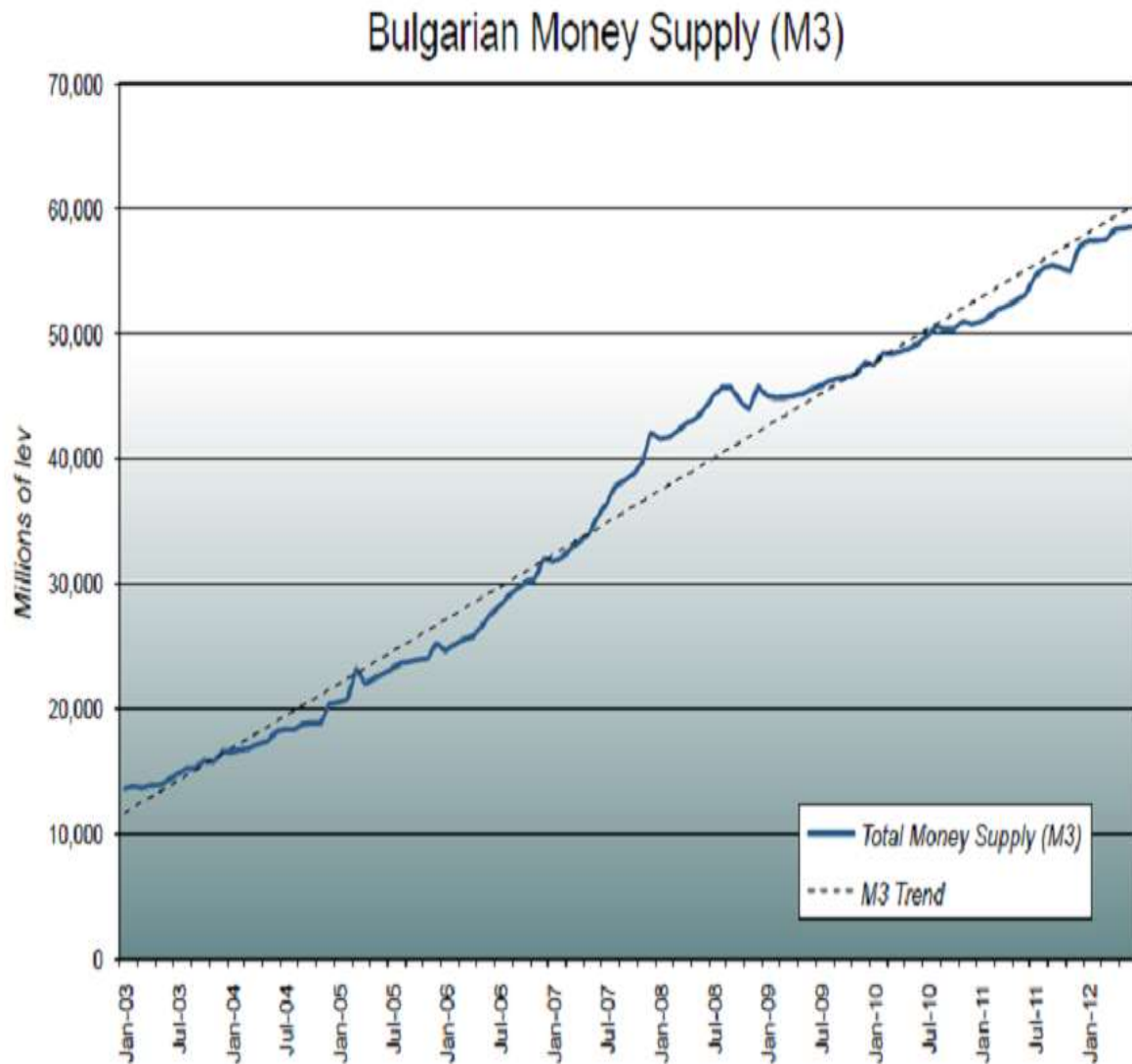
ground to plant the CBS idea, Mrs. Hanke and I traveled to Sofia in 1990. Our objective was to present the CBS idea to Bulgarian officials, intellectuals, and the general public. After our initial trip, we concluded that Bulgarian economists had never heard the words “currency board” and had no idea how such a monetary regime would work. To remedy this, I developed a blueprint for a Bulgarian CBS, which I incorporated into a book that I co-authored with Dr. Kurt Schuler: *Teeth for the Bulgarian Lev: A Currency Board Solution* (1991). Armed with that book, Mrs. Hanke and I made several subsequent visits to Bulgaria. Even though the CBS idea generated genuine interest in certain circles, the official response was negative. The often-repeated refrain of the respected former Governor of the Bulgarian National Bank, Prof. Dr. Todor Valchev, was typical of government officials: thank you for your proposal and interest in Bulgaria, but we know the realities of the local situation and have everything under control.

Once hyperinflation broke out, in 1996, resistance to the CBS idea vanished. In December 1996, the Bulgarian Ambassador to the U.S. requested that I present my CBS ideas in Washington, D.C. That same month, a pirated version of the book Dr. Schuler and I co-authored (in English) was translated into Bulgarian and reached the top of the best-seller list in Sofia. Two months later, Mrs. Hanke and I traveled to Sofia, and President Petar Stoyanov invited me to become his adviser. He requested that I draft a currency board law for Bulgaria, and explain to the Bulgarian people, and their politicians, how such a system would halt hyperinflation.

After the currency board was installed on 1 July 1997, inflation and interest rates plunged immediately. I can recall the genuine pleasure (and, perhaps, relief) that President Stoyanov displayed when he congratulated me on the outstanding results produced during the first few months of the CBS. He then admitted to me that, while he had hoped the CBS would kill inflation, he was initially somewhat skeptical. Indeed, he was amazed when the CBS worked even more rapidly than I had predicted. Much later, President Stoyanov confided that, without the stability created by the CBS, Bulgaria would have had much more difficulty entering NATO (2004) and the European Union (2007). To illustrate just how dramatically the CBS improved life for Bulgarians, I constructed a Misery Index for the 1995-98 period (see the accompanying chart). The index is the sum of the inflation, interest, and unemployment rates, minus the annual percent change in the gross domestic product (GDP).



With the establishment of the CBS, Bulgaria's hyperinflation crisis came to an abrupt halt. Since then, Bulgarians have strongly embraced their currency board. This embrace has forced all political parties in the past 15 years to practice monetary and fiscal discipline. The result has been stability, even in the face of the Russian ruble crisis of 1998 and the current economic implosion in neighboring Greece. On the fiscal side, Bulgaria's annual fiscal accounts have been closer to balance than those of almost any other EU country. And, Bulgaria's debt is one of the lowest in Europe. As for the money supply, Bulgaria's has registered stable growth, and the total money supply is very close to the trend rate (see the accompanying chart). By contrast, most other EU countries are witnessing huge money supply deficiencies and deflationary pressures.



Sources: Bulgarian National Bank, IFS, and calculations by Prof. Dr. Steve H. Hanke, The Johns Hopkins University.
 Note: The trend line for the total money supply is calculated over the period from January 2003 to June 2012.

The CBS delivered Bulgarians from the crisis of 1996-97. But, crime and corruption remained a persistent plague. Because I was an adviser to the President – and an independent one – many foreign companies alerted me to the problems they were facing. To underscore just how big the corruption problem was, I reached into my briefcase, during one meeting Mrs. Hanke and I had with President Stoyanov, and pulled out proof that a Bulgarian minister was demanding bribes from an American company. I soon advised President Stoyanov that his next step should to mount a campaign to end Bulgaria’s rampant corruption, as it stood in the way of more healthy economic growth. Sadly, little has changed since then.

For evidence of this, just look at where Bulgaria ranks on two “corruption indices” – Transparency International’s Corruption Perception Index and the World Bank’s Ease of Doing Business Ranking. The accompanying table illustrates how Bulgaria compares to other countries which currently (or until recently) employ(ed) CBSs.

"Corruption" Rankings for Selected CBS Countries		
	Corruption Perception Index Rank (2011)	Ease of Doing Business Rank (2012)
Hong Kong SAR, China	12	2
Estonia	29	24
Lithuania	50	27
Bulgaria	86	59
Bosnia and Herzegovina	91	125
Source: Transparency International and the World Bank.		
Note: For both indices, countries are ranked from best (1) to worst (183).		

For those who might be skeptical, just consider Singapore, where the Finance Minister earns €1.2 million per year. This first-class salary has indeed generated first-class results – for the past two years, Singapore has held down the top position in the Ease of Doing Business Rankings, and corruption is almost non-existent. Armed with a currency board system, Bulgarians overcame the hyperinflation crisis of 1996-97, and finally began to realize stability and economic growth. Now, it's time to get serious about Bulgaria's biggest problem: corruption.

30 YEARS OF REFORMS

PRAGUE SUMMER: 1968 INVASION OF CZECHOSLOVAKIA IN A HISTORICAL DETAIL

Krassen Stanchev¹

Abstract

The invasion of Czechoslovakia was an extraordinary event in the history of the Warsaw Pact but not because it was not a repetition of sorts of the 1956 crackdown of the Hungarian Revolution of 1953 Berlin strikes and riots. It chanced the history of the ex-Communist countries: it was a technical “success” of the Soviet army, the other members of the Pact had played just a marginal role. The real victor was the generation of on the 1960’s that dismantled the central planning and the only party dictatorial regime and dismissed the Warsaw Pact.

Introduction

50 years ago, in August 1968, armies of the Warsaw Pact invaded Czechoslovakia, out of fear she liberates itself from the Communist Camp, a liberation that was under way in the cultural, religious and social life of the country, not so much in the economy. By mid-1960, the Communist failed to oppress the Church and intellectual quest for freedom of expression, a quest that penetrated all walks of society, from pop music and Scout movement, from vigorous defense of religious and human rights by priest, to high literary circles and some honest, though naïve, individuals in ranks of the Communist party. This Liberation become known as Prague Spring, the August 20-21st invasion attempted strangling militarily these embryos of freedom, deferring the liberation for another 20 years.

Lessons from that Czechoslovak summer seem today forgotten, even in former Warsaw Pact nations – including young Czechs and Slovaks – seem to have forgotten this invasion.

Between 250,000 and 500,000 soldiers of the Warsaw Pact (WP) armies stood on high alert, massed and ready to attack at the border of the nation then known as Czechoslovakia. The soldiers came from Bulgaria, Hungary, Poland and the Soviet Union. (East German forces opted to provide only logistical support.) A total of 27 divisions had at their disposal 6,300 tanks; 2,000 cannons, and 800 airplanes. However, this belies the army’s diversity. The military might was overwhelmingly Soviet. Some 85 to 90 percent of the forces deployed – as well as 100 percent of planning, logistics, communications, and leadership – were also Soviet. Two Soviet divisions just “forgot” to leave the country after end-July WP exercises. The role of the other armies was rather to help with some task and legitimize the military intervention, augment the propaganda. The top brass of KGB, not the generals, had final say throughout the invasion.

This was the largest military operation in Europe since the Second World War. The task was “to capture all important state institutions” in order to support “people’s power organs suppressing

¹ Krassen Stanchev teaches Macroeconomic analysis and Public choice theory at Sofia University. The author expresses his gratitude to Angel Nikolov (Filchev), a historian and former student in Prague and a participant in the street riots against invaders in August-September 1968. His book, “Hot Summer of 68: Prague Spring and Brothers’ Help”, published in Bulgarian in 2013 (by Zelyo Zelev Foundation) is a unique for its panoramic view of the events, written by a witness, participant in the opposition to the invasion, historian and still an outsider, an objective observer. (The second updated Bulgarian edition has just appeared under title “The Crashing of the Prague Spring”(CIELA Publishing House and is currently being translated into Czech.) Mr. Nikolov helped me checking new archives and shared his latest findings with the author.

counterrevolutionary forces.” The 130,000-member Czechoslovak Army had orders to stand down – orders they gladly followed.

Before the Prague Spring, there was a Prague Autumn

On the surface, the formal reason for the invasion was the “Prague Spring,” a common name for a new kind of socialism dreamed up by the naïve majority at the top of the Communist Party of Czechoslovakia between December 1967 and January 1968. They were forced by the events to seek something called He planned to adopt an action plan making this phrase a reality in September 1968, at the next Communist Party congress.

The “human face” metaphor was a name for a It came as a sincere reaction to events of October 11, 1967. Students, irritated by power shortages in a region of Prague, held a demonstration in front of the president. Though police dispersed the rally by force, the students continued to demonstrate more. (In general, students’ protests in Eastern Europe, from 1945 to 1989, were always to protect individual liberty and human dignity, not to promote Communist ideas as in, e.g., 1967-1968 France.)

In an attempt to calm down the situation, the Soviet leaders sought to replace the secretary of the Communist Party, Antonín Novotný, with the poet-and-journalist-turned-Communist boss Alexander Dubcek. Dubcek was educated and lived in USSR. An honest, good-natured, and naïve believer that mankind is basically benevolent (no observer denies these characteristics), in January 1968 Dubcek proposed his own counterpoint to Novotný’s policies, which he called “socialism with a human face.” The very title of the proposed program shocked Communist leaders. Brezhnev is said to have commented off-the-record to Dubcek, “If your socialism has a human face, what is the face of ours?”

The program was modest and cosmetic. It promised separation of the Communist Party from the executive branch of government; political equality of all parties in the People’s Front, which had ruled under Communist domination since 1948; equality between Czech and Slovaks; a federation; decriminalization of small private businesses and meritocracy in the huge government sector; abolishing censorship and easing the freedom of association. It was never implemented, but the very promise sparked a strong, grassroots liberty movement.

The role of the Church

This is rarely talked about. 76% of Czech and Slovaks have been and still are Catholic believers, 10-11% were Czech Hussites. After 1948, the Communists authorities attempted to impose atheism on the society, and to blame the priesthood as cleric-fascists, to split the Church between the two nations, and between coopted “New Catholics” (young priests, who pretended to support Communism) and bishops, who opposed it and were bold guardians of religious liberties and human rights.

By early 1960s, the New Catholics lost their public appeal. Dubcek had no choice but to liberalize the nation’s religious life by ending the persecution of, and tacitly lifting the ban on, Catholic priests and other Christian clergy. Prior to 1968, the Byzantine Catholic Church was prohibited, though bureaucratic toleration extended to Orthodox Christian priests. Prior to the invasion, Cardinal Frantisek Tomasek was one of the key defenders of liberty, after 1968 he reaffirmed his role as human rights and freedom fighters, along with Vaclav Havel and other intellectuals, until 1989.

The invasion

The plan to invade Czechoslovakia started as early as on April 8, 1968. The objective stated above, to “to capture all important state institutions” of the country is from an order of the minister of defense to the Chief of the General Staff of the Soviet army. The plan was ready by mid-April. It was based on the assumption that “Zionist, revisionist, and counter-revolutionary

elements” had undertaken “a major assault on socialism.” It arranged for “liquidation of Zionist and enemy forces” and recommended, as parallel line of action, and elimination of all Zionist elements in the Czechoslovakian Communist Party. The most often quoted “Zionist” organization was the Simon Wiesenthal Center in Vienna, some targeted people were not even Jewish...² Between April and August 20, the Pact armies conducted five military exercises on the borders of and, the last one within Czechoslovakia.

In July 1968, the Red Army simply forgot to go home.

Between January and late July, the Communist leaders met eight times to discuss how to harass Dubcek and his fellows, while the KGB organized (read: bribed and threatened) the opposition to his rule; their formal call for an invasion was written in Moscow. In the meantime, they also brainwashed their own military personnel. KGB chief Yuri Andropov, the key organizer of the invasion of Hungary in October 1956, played the key role in providing disinformation.

On one hand, from a military perspective, the invasion was overkill. As the Czechoslovak Chief of Staff said, it was an “operation to kill a fly with a sledgehammer,” especially given the fact that the army had been under Pact’s command, and the Pact had no other military strategy than that devised by the Red Army. On the other hand, the capture of airports went smoothly, due to no resistance and experienced commander.

“The Master of Invasions”

General Makrelov, who led the operation, cherished first of all cooperation with KGB (mastered in WWII) and was previously involved in the invasions of Poland (1939), Finland, the Baltics (1939-1940), and Hungary in 1956. His biography is one of the contemporary army myths of Russia. Monuments of him are still being erected around the country (the most recent in April 2018). For his 1968 “victory,” he became “a hero of USSR,” and between 1969 and 1985 was decorated with more than a dozen top-medals from WP countries (four of them from Czechoslovakia, five from my native Bulgaria).

Logistics and victims

Indoctrinated soldiers did not meet armed imperialists, in fact no single shot was fired against them by any army or police officer. In some big cities, the locals used homemade amalgam to ignite fire, or street cars and buses to block streets. Some of the soldiers were surprised to realize that Czech and Slovak ladies were no whores (as they were “informed”), that Czech and Slovak way of life was much richer, and especially cleaner than what they knew as a “superior Soviet life” back home.

Logistically, the invasion was next to a nightmare. KGB squads and one airborne infantry division captured the airports and post offices because no one guarded them. But ground troops were puzzled: Maps were more than 20 years old towns and villages often had new names, and the locals changed or painted over the street and railway signs. Poor logistics, disinformation, and culture shocks greatly contributed to the decline of soldiers’ morale. Often invaders were ashamed even to appear in dirty attire before the locals, not even thinking of talking to them – out of natural inferiority complexes.

This situation led to countless irrational shootings, suspicion and paranoia among invaders: there are many instances of tanks crashing shops, attacking barefoot protesters or street cars, or simply shooting against walls and militarily insignificant buildings, like museums and schools.

Czech sources report 137 Czechs and Slovaks died as a result of the Soviet-led invasion of Czechoslovakia in 1968, and 400 between then and 1989. The public went out on the streets on August 21, built improvised barricades, stopped tanks with human chains, and refused to

² One of the excuses for this Anti-Semitic attitudes was, perhaps, the fact that in 1967 the Soviet sponsored and equipped Arab invasion of Israel ended up in a complete failure. The rhetoric of the plan aimed at motivating decision about Czechoslovak operation by the Soviet and WP authorities.

cooperate. The latter, besides random shooting³ in the air, was the most often reason for incomprehensibly cruel killings of innocent, unarmed individuals, teenagers and young women. The most organized resistance was around the building of National Radio in Prague, which continued broadcasting real life news for about a week. (The Soviet invaders lacked the technical knowledge to stop it.) Then the radio went underground, and illegal newspapers flooded the nation.

On the invaders side, 98 were killed, most of them in automobile or equipment accidents, including the inexperienced use of firearms. Five committed suicide in the first month of invasion. Eleven Soviet soldiers are believed to have been killed by locals. One Bulgarian soldier there was either killed in a drunken quarrel while attempting to desert, or killed by border guards while trying to flee into West Germany.

”The Oak Out, KGB Stays,” Ice Hockey Episode and Human Torches

Police deployed heavy troops, including tanks patrolling the city, on the first anniversary of the invasion: August 21, 1969. The Soviets sent 130,000 troops, ready to intervene. The locals named it “The Day of Disgrace.” Despite threats of violence, about 100,000 went to Prague’s main square that day.

In the rear mirror, many backward changes took place in one year. Here is brief account of the events.

By the fall of 1968, the unarmed resistance was already fading away. In order to wake up the nation, on January 16, 1969, Jan Palach (21) set himself on fire, leaving a message “I burn myself in order to wake up the people of this land.” It caused anger in Moscow: Kremlin cabled Dubcek to “stop politization,” he failed to deliver “appeasement.” Unfortunately, human torches started burning one after another – six young men and one young woman set themselves on fire and died in the following month, 26 were saved by medical intervention; three protesting torches perished in Poland, Hungary and Latvia. The letters they left were, in substance, the same: I burn myself not for fame, but as a sign of protest against the invasion.”⁴

Alexander Dubcek (whose last name may be translated into English as “Oakson”). The order given by Brezhnev to no other than Marshal Andrei Grechko: “Oak – out, KGB stays.” As a result of the [Hockey Riots](#) Dubcek was dismissed in April 1969, served for two years as ambassador to Turkey, and then until retirement as a clerk as ministry of forestry. He was replaced by the KGB loyalist Gustaf Husak, who ran the country until 1987. Since his last name means “goose,” the Czechs and Slovaks dubbed the regime “socialism in a goose skin.”

What really horrified the Soviets was the fact that Czechoslovakian ice hockey team defeated the USSR in the world championship in March 1969 in Sweden. They did it twice, in the run offs and in the finals, making no secret they played for the national dignity.

The Soviet animosity against Czechoslovak Ice Hockey had a long history. After WWII their team was the best in the world – at no excuse for vassal country. In 1950, Soviet KGB and partners staged a beer brawl between some of the champions and unnamed hooligans downtown Prague, as a result the entire team was arrested and convicted of a lack of loyalty, treason, and espionage; sentenced to a combined 77 years of prison and forced labor; and sent to the uranium mines. (The most famous champion, the goalkeeper Bohumil Modry, was not involved in the brawl but received the longest jail-term and died soon after his release.) By the mid-1960s, the

³ Random shooting at buildings happened most often. One of the houses that “suffered” was that of the National Gallery. The students named its walls “Frescoes by El Grechko” (after the name of the de facto commander of the invasion, Marshal Andrei Grechko, defense minister of USSR, former commander in chief of the Soviet ground troops in East Germany and until 1967, commander in chief of the WP armies).

⁴ Here are the names: Jan Palach, Jan Zajic, Evzen Plocek, Josef Hlavaty, Miroslav Malinka, Blanka Nachazelova, Michal Lefcik, and Ryszard Siwiec (in Poland), Bauer Sandor (in Hungary) and Elijahu Rips (in Latvia)

Czechoslovakian team was again one of the best in the world, their victory in March 1969 was celebrated everywhere in Eastern Europe. I was then 14 years but still vividly remember the joy this victory caused in Sofia.

Why did this happen?

Besides some theoretical reconstructions of the events preceding the invasion, the reasons for the discontent were not immediately economic. Power shortages were regular phenomena in ex-Communist Europe, as the shortages of everything, as Ludwig von Mises predicted in 1922.

Beside post-WWII reparations by Soviet Russia (irrespective of the fact that Czechoslovakia and Poland were victims of the German invasion, the Red Army confiscated key industries in both countries), the economy of Czechoslovakia was the most competitive Communist economy, their cars were far superior than those produced in USSR or East Germany, their shops offer better food and non-food goods, and by the end of the 1980s the country traded “only” 55-56 percent of its output with Soviet Union (Poland and Bulgaria – over 80 percent).

Most of the reasons for invasion were both historic and symbolic.

“The Evil Empire” was exporting Communism since the founding of the Comintern in 1919-1920. In 1922, it exported the Bolshevik system to the Caucasus, and financed a rebellion in Bulgaria in 1923. In 1939-1940, it occupied West Ukraine, Bessarabia, and the Baltics. And from 1944 to 1950, the Soviet system reached East Germany, China, and North Korea. These nations were held at the point of a gun – in East Germany in 1953, in Hungary in 1956. The invasion of Czechoslovakia was more “business as usual”: deadly, nasty, and fundamentally unjust, but also typical.

Because the system could not work by itself economically, without private property and free trade, the peoples and individual must be kept within it by force. For individuals, there was an Iron Curtain, for peoples – there was the Warsaw Pact under Soviet, and KGB, command.

For the West, the invasions were an internal Soviet affair. No one would risk another war or a nuclear standoff in the 1960s because of distant country about which they “know nothing” (as Neville Chamberlain said of Czechoslovakia three decades earlier). This argument is thoroughly analyzed in the literature. The Soviets risked no worsening of relations with the West. And attempted both expansion and retaining the control over the WP countries and other friendly regimes until 1989. The Russian military base in Syria is a legacy of those years.

Today, the Russian Federation keeps the tradition alive, with KGB tactics, first of all USSR countries, less strongly in New Europe and elsewhere. This is the key motivation for the post factum glorification of the deeds of the Red Army and embellishment of the activities of “masters of invasions” like Margelov.

The invasion produced three major losses.

- Life. The number of casualties from the invasion remains a top military secret of the Russian Federation.
- Greater religious liberty.
- Greater economic and personal liberty.

Those three freedoms – religious, economic, and personal – rise, or fall, as one.

The Prague Spring was suffocated by military force, a generation lost the hope for instant liberation. But the flashes of discontent with the Communist-Soviet rule that sparked across Eastern Europe did not cease to exist. 1968 generation of our countries, to which I too belong, had put an end to that rule in 1989. The remembrance of the misdeeds of the Warsaw Pact and the USSR is a precondition of not repeating similar crimes in the future.

INTERVIEW

INTERVIEW WITH MAREK TATALA¹

Svetlomira Gyurova - interviewer²

1. Poland's economy has grown for 26 consecutive years and the country seems on track to be formally recognized as a developed economy. Why is Poland the first from the CEE region to pass that mark? What is the Polish economic recipe? What are the key policy moves that have facilitated Poland's developed market status promotion? Can any one administration realistically claim responsibility and the benefits of this development?

Poland can be regarded as a success story of transformation. For over two decades Poland was developing at a pace exceeding an average of 4 per cent a year, faster than other countries of Central Europe. Per capita income, adjusted for differences in price levels, increased from 29% of income per capita in Germany in 1992 to 55% in 2015. The economic and political reforms initiated in 1989 in Poland enabled economic growth and peaceful institutional transition. Comparative research of the ex-Communist countries in Europe shows that rapid, "big-bang" reforms at the beginning of transition led to better economic and social outcomes than gradual approach or lack of necessary reforms. Poland took the rapid, radical path in 1989, including the so called "Balcerowicz plan" and it contributed to the radical economic improvements.

What has been also important is continuation of the pro-reform path by the consecutive governments and institutional improvements, e.g. in the areas of monetary policy and financial supervision, so the economic growth in Poland has not only been rapid but stable. Finally, it is important to remember that the political transition since 1989 was also smooth and peaceful. Different political parties ruled and changed in power after elections without any violence. Domestic efforts and external incentives such as EU and NATO admissions have all led to significant improvements in the institutional framework.

Developed market status is a result of the accumulation of many policies and their outcomes that led to economic development.

The rapid reforms in the late 80s and early 90s enabled Poland to move quickly towards the market-based economy. Radical pro-market policies and stabilization triggered a broad transfer of technology and pro-efficiency structural changes. Liberalization and privatization of the economy enabled several million workers to leave agriculture and outdated, inefficient state-controlled industry and to find work in more efficient services and private industrial enterprises. Structural reforms and economic openness which stimulated the inflow of foreign direct investment contributed to dynamic growth in exports and improvement of its structure.

¹ Marek Tatala, Vice President and Economist at the Civil Development Forum (FOR), a think tank from Poland founded by Professor Leszek Balcerowicz. Graduate of the University of Bristol, Warsaw School of Economics and Atlas Leadership Academy. His research interests include law and economics, rule of law, justice system reforms, populism and economic freedom.

² Bulgarian version -

https://www.capital.bg/politika_i_ikonomika/sviat/2018/10/19/3329503_marek_tatala_politikata_na_polskoto_pravitelstvo_e/

Thanks to parallel institutional improvement, which finally enabled Poland to join the EU, Poland also avoided problems with oligarchs capturing control over certain economic sectors like in some other countries of the region. Corruption has been much smaller problem for business and citizens in Poland than in other CEE countries. Finally, stability of the economic growth is owed to a large degree to weaker growth of credit and of current account deficit than in most EU countries and in the region. Tightening of monetary and fiscal policy broke the boom associated with the accession to the European Union so these imbalances did not reach such a large size as elsewhere.

2. Poland has registered both high investor confidence in its equity markets and steady economic progress, but suffers from continued demographic outflow. Is a slowdown due to labour shortage to be expected and to what extent can we expect developed market status to alleviate that?

Demographic changes in Poland are one of the biggest challenge for the policy makers and entrepreneurs as the Polish society is aging rapidly. Labour shortage is nowadays mentioned as one of the top barriers to growth by business representatives and it may worsen in the future while number of people in a productive age will fall. It will also increase the costs of the pension system as a burden on the working population.

Developed market status is unable to solve these problems alone. What is needed are labour market and pension reforms. Poland has still quite low employment rate, in comparison to many other EU countries, among certain groups – younger (18-25) and older people (55+), women of various age. Therefore, labour market reforms should target barriers to employment among these groups, including unnecessary restrictions in the labour code or social traps discouraging people from working. Minimum retirement age should be increased again to 67 years for both men and women and it may require future adjustments connected with the growing life expectancy. This important reform undertaken by the previous PO-PSL government was unfortunately reversed by PiS. What can also alleviate labour shortage is better immigration policy to facilitate economic immigration from Eastern Europe and other directions to Poland. At the same time the key to discourage emigration from Poland or attract Poles who left Poland after the EU accession is to lower the gap in standards of living between Poland and Western Europe. It requires rapid and stable economic growth in the future.

3. How immediate can we expect the benefits of market status upgrade to be? What further operations of reindexation and restructuring are left for Polish equity markets?

The potential benefits depend not only on the status but also on the government policies and perception of foreign investors based on these policies. So far many of the policies by PiS, especially connected with the rule of law and economic nationalism, have been criticized by the foreign institutions and media. Better PR is not enough. The government should also change its policies as they do not only harm Poland's economy and legal system but also weaken good image of Poland which has been built since 1989 transition.

Weakening of the role of private pension funds, which played an important role in the financial market, by the previous PO-PSL government had a negative impact on the development of the capital market in Poland. Therefore, development of some new elements of the pension system e.g. Employee Capital Plans (PPK) might become a new boost for the stock exchange as long as the market is dominated by private entities and not investment agencies controlled by the government and focused on political interests.

One problem of the financial market in Poland is its politicization. 12 out of 20 enterprises in WIG20 index are controlled by the government which causes that their performance and the index itself are too much dependent on political decision. Poland should continue privatization initiated after 1989 but the current government is unwilling to do so.

4. Are the policies of the PiS government a threat to the to steady growth in Poland? Many experts are warning PiS could derail growth by meddling in the private sector and trying to fulfill costly populist promises. Are these concerns justified? Can Poland's ongoing conflict with European institutions over its judicial reforms rcreate perceived barriers to market access / slow down of market restructuring?

Policies of the PiS government are a threat to steady growth in Poland. Firstly, they increase vulnerability of the Polish economy to external shocks. Public expenditures on various new social programs have been increased but majority of revenues growth is very dependent on the cyclical factors. Relatively good times in the global economy, as observed today, should be used to repair public finance and generate surpluses. Why general government deficit in Poland in 2018 might be low from a historical perspective it will still exceed the levels in many of the EU countries. Moreover, policies like lowering the minimum retirement age to 60 for women and 65 for men will be costly for this and future generations and stimulate demographic outflow.

Secondly, economic nationalism and populism are harmful for economic freedom in Poland. We observe new sectoral taxes (e.g. on banks) and regulations. Moreover, the slogan of "re-Polonization" is used to increase the government presence in the economy. It has been used for example in the banking sector where growing state ownerships generates new risks for the future connected with politicization of banks and credit.

Finally, PiS policies do not respond to key challenges connected with demography, productivity growth and investment rate so apart for increasing the vulnerability of the economy the government is also weakening chances to catch up with the West. The upcoming elections in 2019 and 2020 may stimulate even more populist policies harmful for Poland's long-term development.

One of the key topics in the public debate about Poland in the last three years was the rule of law. It has also become an important issue in

the foreign media and institutions, including the European Union. It is important to remember that the EU's reaction is a direct consequence of three years of the government policies that have damaged the rule of law, through attacks on the Constitutional Court and independence of judiciary. Many of PiS policies have been unconstitutional attempts to change or circumvent the Polish Constitution and even without any criticism by the European Union or foreign institutions, these policies should be opposed as a violation of the rule of law and institutional achievements of Poland since 1989. The justice system in Poland in 2015 was far from being perfect but instead of real reforms, beneficial for citizens and business, the ruling party has been building much worse system with high risk of using politicized judiciary to fulfil political interests. This process will be gradual but it may hamper longer-term economic growth, diminish Poland's credibility abroad and, what is the most important, significantly weakens quality of democracy in Poland.

5. An aspect of developed markets is consistency and predictability – how has the business world reacted, if at all, to the news of waning judicial independence in Poland? To what extent do perceptions of the rule of law influence the capital and foreign exchange markets in Poland?

If all of the PiS policies in the justice system are finally implemented despite local and EU opposition it will significantly weaken the rule of law. Therefore, despite status of a developed market weak rule of law will be one of the negative characteristics of Poland. Foreign and local investors will have to take it into consideration.

Dziennik Gazeta Prawna, Polish daily newspaper, has recently done a poll among the biggest law firms. 82 per cent responded that foreign investors express interest in the state of rule of law in

Poland and as a result 40 per cent of the lawyers experienced situation in which investors preferred to use other legal jurisdiction in their contracts.

6. Could you elaborate any future barriers to the development and deepening of the Polish growth that are as of yet unresolved?

Apart from challenges connected with demographic changes in Poland two other things should be mentioned. Firstly, productivity growth in Poland has been rapid since 1989 as Poland was moving away from the inefficiencies of the socialist past. Nevertheless, the rate of productivity growth has been slowing down and additional reforms are needed to release available reserves. Therefore, the government should encourage competition and continue privatization. Moreover, there are still too many people employed in agriculture, the least productive sector of the economy. Many of them are kept in the agricultural sector due to various subsidies and regulatory barriers which should be reduced or removed.

Secondly, investment rate in Poland is much lower than in many other CEE countries and far from the government target of 25% of GDP. An important question might be too what extent institutional and legal instability contribute to low investment rate despite relatively good performance of the economy. It is still difficult to give a clear-cut answer. Moreover, we observe some structural weakness of the Polish economy e.g. high proportion of micro and small enterprises whose performance lags behind the performance of other companies more than in any European Union country and that invest little.

Unfortunately, it is very difficult to indicated any policies of the ruling party which can be regarded as a serious attempt to minimize the above barriers to the development in Poland.

7. Poland's use of EU funds is a major source of growth. Yet PiS has picked a number of fights that threaten it. What is the risk that the awakening from Poland's sweet economic dream turns rough?

First of all the EU funds role as a source of growth is often exaggerated and there are other more important benefits from being part of the European Union, including participation in the Single Market and institutional improvement stimulated by the accession process. It is why Poland should be in the EU and should aspire to be present in the core of decision-making processes.

Nevertheless, the future inflow of the EU funds to Poland depends on the negotiation skills of the government and Poland's position in the EU. PiS policies in the area of the rule of law and some other fights with the EU institutions (e.g. only Polish government opposed appointment of Donald Tusk, former Polish prime minister, for the second term as the President of the European Council) weaken Poland's role in the EU. Moreover, the discussion about linking the EU funds with the rule of law is still in progress and this ideas has been triggered mostly by developments in Poland and Hungary.

IN MEMORIAM

On January 20th, 2019 we lost an extraordinary thinker, philosopher and economist, Professor Miroslav Prokopijevic, and I lost a friend and fellow Scorpio with whom I was making plan for joint university courses and events just days before he passed away to a more distant, calm and better world of our memories about him, his writings and simulating research.

Miro was a Principal Fellow of the Institute for European Studies and was teaching for about 30 years Public Choice, European Studies and Economics at several universities in Germany, Italy, Montenegro, Serbia, USA. His background in Philosophy and Economics allowed him to make contribution into all these fields of knowledge and publish outstanding books on Rationality and Understanding, Transition Towards Market Economy, UN Economic Sanctions, European Union, Constitutional economics, Market Democracy, Political Markets, European Monetary and Applied ethics. Here is reprint Prof. Prokopijeci's analysis on foreign aid, which is used in Sofia University classes in economics for political scientists.

WHY FOREIGN AID FAILS¹

Miroslav Prokopijević

Summary

The main point of this paper is that foreign aid fails because the structure of its incentives resembles that of central planning. Aid is not only ineffective, it is arguably counterproductive. Contrary to business firms that are paid by those they are supposed to serve (customers), aid agencies are paid by tax payers of developed countries and not by those they serve. This inverse structure of incentives breaks the stream of pressure that exists on the commercial market. It also creates larger loopholes in the principle-agent relationship on each point along the chain of aid delivery. Both factors enhance corruption, moral hazard and negative selection. Instead of promoting development, aid extends the life of bad institutions and those in power. Proposals to reform foreign aid – like aid privatization and aid conditionality – do not change the existing structure of the incentives in aid delivery, and their implementation may just slightly improve aid efficacy. Larger improvement is not possible. For that reason, foreign aid will continue to be a waste of resources, probably serving some objectives different to those that are usually mentioned, like recipient's development, poverty reduction and pain relief.

Key words: *Foreign development aid, Planning, The structure of incentives, Aid inefficiency, Reform of foreign aid.*

¹ The paper is reprinted here with the kind permission of Panoeconomicus (<https://panoeconomicus.org/index.php/journal/issue/archive>), a quarterly journal in economic theory, policy and history published by the Vojvodina Union of Economists, with an Editor-in-Chief Kosta Josifidis. The link to the original publication is: <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.430.5871&rep=rep1&type=pdf>

INTRODUCTION

Foreign aid has not existed throughout history as it is plasticized today, aside from a few sporadic events that may have resembled it. Countries in need looked to commercial credits rather than to have waited on aid. Foreign aid emerged as a part of the post WWII order, as one of the instruments to promote development, relieve pain and alleviate poverty.² The emergence of aid on the international scene is inseparable from the popularity of the heavy hand of state in the domestic economy of relevant states. When planning, regulation and social engineering became the instruments in internal economic policies of larger developed states, it was a natural step to implement the same tools on the international scene. Institutions for such programs were missing, since the WWII wiped out international organizational infrastructure that had existed before. The epidemic in designing international organizations after the WWII was motivated by creating international means for interventionist policies rather than by sheer reestablishment of their rare pre-war equivalents. In addition to international development agencies like the World Bank, IMF (International Monetary Fund)³, EBRD (European Bank for Reconstruction and Development) or UNDP (United Nations Development Program), all larger countries established their own agencies for implementation of development aid.

It seemed easy to make the case for foreign development aid in the post-war institutional environment. Developed countries could help non-developed countries largely at a negligible cost, it was stated⁴, if they allocate a very small piece of their GDPs. By getting foreign aid, non-developed countries will probably not catch up, but at least they will avoid larger troubles and speed up development.

This idyllic picture of foreign aid prevailed during several decades after the WWII, and it started to pale just recently under the influence of articles and studies that called into question the nature, justification and efficacy of aid. On the one hand, it took a long time to collect empirical evidence, and, on the other, it took some time to get the courage to attack something that was considered to be a sound part of the international order, which was not before seen as objectionable. For eminent economists over the past several decades, foreign aid was not an interesting topic. Academic economics has ignored the subject because it seemed to be of a practical rather than of an academic interest. With rare exceptions, first class economists began to deal with foreign aid just recently when the shift in its understanding was already on the way. If any particular contribution to this shift is to be mentioned, it would be the work of the late Peter Bauer⁵. While dealing with foreign aid for his entire life, he was the first to write systematically on the weaknesses of aid delivery. There is hardly a single argument questioning the rationale of foreign aid that was not mentioned by Lord Bauer. After Bauer, it is easier to see that foreign aid is ineffective because it resembles central planning. The contribution of this paper is not in declaring a similarity of aid to central planning, since we have seen such statements by Bauer, Easterly, Friedman or Lal. I will try to go further in two directions. First, I will compare the structure of incentives for market operations to those for aid and planning. My question is what are the incentives for aid workers to get things done. Second, I will suggest that foreign aid is not just inefficient – it is also counterproductive.

Types of foreign aid may be very diverse, and I do not have all of them in mind when writing this paper. Excluded are the types of aid like those covered by a humanitarian intervention, diplomatic and political aid, the aid through trade and preferential agreements, and debt service

² “There was no development aid until President Truman’s Point Four in 1949. That led to foreign aid and that led to development economics”. Peter Bauer in: IEA 2002, 35

³ The IMF initially had a role of policing monetary order and in 1970ies it assumed its development role.

⁴ “Foreign economic and humanitarian assistance programs make up less than one half of one percent of the U.S. budget. This small contribution by the United States makes a big difference around the world.” Cf. Atwood, 1995.

⁵ For example, Bauer 2000. See also Brumm 2003, IEA 2002

write offs. My article is focused on foreign development aid in its narrow meaning where one constituency helps another by granting goods and services, financial transfers and technical assistance. The total amount of foreign aid was more than \$ 2,3 trillion over the last five decades.⁶ The size of the aid in the narrower sense in the world is estimated to be \$60bn per year at the beginning of XXI century. This amount is equal to some 20% of foreign direct investment in non-developed countries.

Despite the fact that foreign aid accumulates significant means and that it has been practiced for decades, there is a growing attitude among researchers that the aid has no tangible, long-term impact on economic development. In conveying this result, some authors are more refrained (Swenson & Dollar; Easterly 2003) while others are very outspoken (Boone 1994; Lal 1996 and 2005; White 1992; Martens et al. 2002; Easterly 2006, Djankov et al. 2006).

Facts are the driving force in this change of attitude. William Easterly⁷ led a larger research using the data for 88 countries supported by the World Bank and found that in just six cases, aid had some positive visible influence on growth. More specific in its conclusion was the single largest donor – the U.S. – when it concluded the following, after reviewing its long history as a donor: “The U.S. has granted \$ 144bn in inflation-adjusted dollars to 97 countries in the period 1980-2000. These 97 countries had a median inflation-adjusted per capita GDP of \$1,076 in 1980 but only \$ 994 in 2000, a decline in real terms”.⁸ Among these 97 countries “...37 averaged zero or negative growth in per capita GDP from 1980 to 2000. Another 27 averaged marginal growth rates between 0 and 1 percent over the span. And only 33 averaged growth in per capita GDP over 1 percent from 1980. to 2000, of which only three (St. Kitts-Nevis, South Korea, and China) averaged over 5 percent”.⁹ Djankov et al. go a step further and state that aid has a negative impact on recipients: “... foreign aid has a negative impact on the democratic stance of developing countries, and on economic growth by reducing investment and increasing government corruption”.¹⁰ All three researches are based on large samples and all state that there is no long-term positive influence of foreign aid on growth and the standard of living. Under the pressure of such results, the U.S. decided to reshuffle its aid programs in such a way that the aid inflows are related to reform efforts in the recipient country. This program is called Millennium Challenge Account (MCA). The UN commission, chaired by Jeffrey Sachs, has developed the MDG (Millennium Development Goals), a close relative to the MCA. I will comment the proposed changes at the end of this paper.

MARKET VS. PLANNING

The majority of studies on aid was focused on the effect of aid in the recipient countries. These studies have pointed out the lack of institutional infrastructure, different social habits and low level of development as the main obstacles to efficient aid delivery. Some among these studies sound reasonable and well grounded. It may be that these factors from the recipient side contribute to the inefficiency of foreign aid. Contrary to common wisdom, I will focus on the side opposite to recipients – on donors. I do so because it is irrelevant what happens at the recipient side if the instrument on the donors' side is misconceived. If so, the responsibility for its ineffectiveness rests solely on donors and there is nothing recipients can do to change the situation. We will also see that it is the nature of operation of aid that implies a particular

⁶ According to Easterly 2006.

⁷ Cf. 2003, p. 32-33

⁸ Cf. Schaefer 2002, p. 1.

⁹ Schaefer, 2002, p. 3. Korea has grown due to liberalization of the tradable sectors, while China has grown due to a combination of de facto privatization of agricultural land and larger liberalization in the free trade zones. The case of St. Kitts-Nevis is poorly researched.

¹⁰ Djankov et al. 2006, 2.

structure of incentives that causes its inefficiency. In order to realize the former statement, let us compare the operation of the market, i.e. the business firm versus aid delivery.

A business firm opening a branch office in a foreign country may face a different business and social environment, but its main objective remains the same throughout the landscape – making profit. The functional structure of a business firm is performs as usual; business people get revenues from those for whose goods they are supposed to produce. Microsoft serves customers around the globe and gets revenue in exchange for services. In doing so the firm needs to survive competition – to pass the test of the market. A firm’s headquarter continues to check the operation of its branch office in a foreign country in the same way in which it controls its domestic offices. Market pressure does not allow a business firm to relax its monitoring and controlling activities. Any relaxation of usual controls may result in loss of revenues and profits, and this would impose damage to a firm’s owners.

Consider now the case of foreign aid. Its main objective is to provide development assistance to some foreign country. Voters from the country providing means for aid are not those that profit from aid. Donor’s voters may feel some moral satisfaction for offering aid to people in trouble, or enjoy some externalities from a poor country’s development, but they are not the beneficiary of aid. Aid workers are not paid by those for whose benefit they are supposed to work. By serving some population aid agencies, contrary to business firm, get nothing but gratitude in exchange. They grant rather than sell. They serve the population of some troubled country, but they are paid by tax payers of developed countries – an inverse structure of compensation compared with that of the business firm.¹¹ By not being paid by and dependent on those served, aid workers are relaxed from the operating pressures in the same way in which planners were relaxed from those “those who were subjects of the plans”.

When one buys a Fiat, he does not need Audi, GM or any equivalent car. On the contrary, when one gets aid from the agency X, this does not exhaust the place for aid from the agencies Y, Z or W. In other words, market demand is limited by financial means available, while aid absorption capacity is not. More precisely, it may be limited only by a donor’s readiness to grant aid rather than by any trait of the recipient. Aid has a cost next to zero for the recipients, and they take it all.

A business firm is very interested whether customers are satisfied, while aid workers do not have incentives to care whether aid recipients are satisfied. Aid workers need not care about recipients’ satisfaction because they are sure that recipients will always accept aid when it is offered, due to its low cost. Neither aid nor planning are exposed to competition, and this indicates that they are mutually similar as non-market phenomena. Like central planning, aid is centrally collected and allocated according to the plan created in advance, regardless of circumstances in the recipient country and regardless of its effects. Plans for aid are tailored by one entity, while the costs are born by another. Planners and aid agencies are paid by governments (donors) rather than by customers. Consequently, customer satisfaction (aid recipients) is irrelevant for the government (donor), and there is no need for proper feedback information. Instead, there is a feedback loophole that is also typical for central planning. Contrary to a business firm where feedback information is important because it informs producers on how products are accepted in the market, an equivalent feedback information in the case of aid is useless, since all aid is accepted due to its low cost rather than its quality. This completely frees the hands of those reporting on aid delivery.

Having all that in mind, it is not surprising that foreign aid fell under doubt as an endemic trace of the past after collapse of communism. “Seventeen years after the fall of the Berlin Wall, there is just one major area of the world in which central planning is still seen as a way to achieve

¹¹ This inverse structure has nothing to do with the type of ownership. Nothing would be different if donor organizations were private instead of state owned. Just exceptionally aid is collected and allocated by private, for profit firms. Private firms are, however, frequently involved in consulting and other subcontractual deals.

prosperity – countries that receive foreign aid”.¹² Milton Friedman witnesses that central planning was deliberately introduced rather than organically emerged. “Again, conventional wisdom in the development community was that you needed central planning. If the underdeveloped countries were going to get anywhere, it would only be through central planning”.¹³

Ineffectiveness of aid does not mean that all development aid operations must fail. Some aid operations were and are successful or partly successful. This means that they have achieved their objectives and improved the situation. However, this does not prove the case for foreign development aid, because successful operations are not numerous. Under central planning some successful firms also existed due to different factors – like protection by the state, insufficient competition, limited supply of the good produced, etc. But they were just a small fraction of the economy and unable to reverse the fate of the whole order.

Similar to central planning, the profile of aid delivery is complicated because it reflects the complex organizational structure and correspondingly creates a complicated, inefficient structure of incentives. A state, represented by politicians and bureaucrats, decides on behalf of its voters to grant aid to some foreign country. By doing so, the aiding country uses some specialized agency for aid delivery and the specialized agency eventually engages subcontractors for the execution of the aid program. Since the state with its agencies is not exposed to the pressure of market forces, other mechanism of control is needed. In the standard scenario, politicians issue commands and they should control and monitor how commands are obeyed. The absence of market or other equivalent pressure, owing to the structure of incentives, allows weakening of the command and monitoring mechanisms that cause significantly different results of foreign aid when compared to foreign or domestic private investment. This distortion occurs along the chain of command from voters of the granting country to voters of a beneficiary country. Aid workers and agents in general are supposed to work in a certain way, although the structure of incentives allows quite another action. Aid workers, like planners, may have good intentions, but they are not really motivated to implement them. Even if they were personally motivated, they would face an inappropriate structure of incentives. Aid workers launch plans and raise expectations but do not bear responsibility (consequences). Like managers in state-owned firms, they do not bear responsibility for their choices because enforcement and monitoring cannot reverse incentives nor repair the damage. They engage in creating additional deception in order to present a rosier picture that everything goes well.

Along the chain of aid delivery, there is an uneven, asymmetric relationship of competence and information, again similar to central planning. As a rule, actors located lower in the chain (beginning with voters and politicians in the aid granting country and ends with local agencies, aid suppliers and voters in a recipient country) are privy to significantly better information compared to actors located higher in the chain of aid delivery. While taxpayers and politicians in the aid granting country depend on second-hand information provided by media and their intermediaries, aid agencies, subcontractors and local agents have first-hand information because of their day-to-day involvement in project implementation. Nevertheless, competencies in planning and decision-making concerning vital questions of aid are concentrated at the other end of the chain. They are placed where the information is poor – in the hands of politicians of the aid granting country. All important questions – like the nature, size, type, objectives and duration of aid – are decided by politicians and aid agencies, i.e. those that are inferior in information compared to their subordinates along the chain. The same happened under central planning – planners were not interested in real circumstances and how those affected by planning feel and what they need. The above has at least two important consequences. First, decisions related to aid

¹² Easterly 2006, 2

¹³ M. Friedman in: Friedman & Sowell 2005, 442

supply can not be optimal or adjusted to the situation. Second, there is no proper feedback information.

In addition to these incentive and information problems with aid delivery, foreign aid in the world has undergone a change that enhances the space for manipulation. When the World Bank was established, its main objective was to promote investment, growth and development in poor countries. Socialism was popular in the East and in the Developing world, while in the West, the atmosphere was friendly to increasing government regulation, and welfare state policies. So many of the Bank's activities moved around direct investment in poor countries in infrastructure, factories and farms. The results were much poorer than expected. Over the years, the Bank has redefined its main objective from promoting development to "fighting poverty" or "poverty reduction". The shift occurred in 1980s with the focus on institutional reform rather than on investment. Other larger world donors have followed the Bank by redesigning their aid programs.¹⁴

The reasons for this fundamental change were twofold. First, growing awareness among donors that poor countries lacked a suitable business environment and that investment under present circumstances was equal to squandering resources. One may wonder how it was possible that aid and other authorities in developed countries were not aware of the problem before or shortly after the aid programs started and why they wasted resources for decades before discovering that such programs were failures.

Secondly, by shifting away from the prevailing belief in planning to belief in market forces, investment activity of state and non-market funds was progressively considered non-productive. This redefinition of the Bank's role, followed by other larger aid agencies, clearly indicates the failure of the development philosophy from the early period. With the demise of donors' role in development, which was clear despite its basis on irrational expectations, donors shifted to institutional reform. However, this is not only more difficult but also a much less clear task. Development was relatively easy to measure via conventional data. But how can one measure "institutional development" or "building institutional capacity"? This change of strategy toward ever-increasing vaguer objectives is not original. Central planners did the same. When one strategy collapsed, they proclaimed another fuzzier one, thus buying additional time at a lower cost.

It is straightforward to realize that donor actions after the change of strategy were exposed more at will than before, what has again additionally freed the hands for manipulation of all actors along the aid granting chain. Post-contractual uncertainties rose sharply, risks of moral hazard and adverse selection became higher, corruption opportunities were enhanced, while monitoring and evaluation got new ground for "creativity". "Creativity" consists in depicting disasters as success stories. In a word, the whole game of granting aid became less accountable than before.

THE CHAIN OF AID DELIVERY

Voters and politicians.

Similarly to central planning, the means for aid are first centralized and then disbursed. When politicians in aid granting countries, acting on behalf of their voters, decide to grant aid to some country, they both prima facie believe that this will improve the situation. There are a variety of reasons behind this conviction. One may feel that aid contributes to growth. Others may believe in improving the institutional structure of the recipient country. Many would like to relieve suffering among the population in a country. Taxpayers in developed countries, when confronted with pictures of the poor, may feel compassion, solidarity and prepared to help the poor. Additionally, aid suppliers and consultants would like to get new contracts and to earn additional money on external market. Finally, politicians may like to export values and home products by

¹⁴ Some aid programs, like Phare and Tacis, that were launched in 1990s by the European Union, were institutionally focused from their inception

distributing aid. Whatever the reason, a decision to grant aid is hardly objectionable. Readiness to help others is not just legitimate but even desirable. However, good intentions and desires do not necessarily lead to good results. In order to make a nice generosity translate into a good result, one needs the appropriate instruments. This is precisely what is missing in the aid delivery chain because of the structure of incentives.

Political room to maneuver with information on domestic transfers is relatively restricted since some voters are beneficiaries of transfers, while the rest of voters may at least sporadically monitor what is going on. There is no such feedback when it comes to foreign aid. Beneficiaries of transfers are foreign citizens. If it holds that politicians, above all, focus on their domestic interests, the interest for foreign aid may be merely instrumental, and if there is no opportunity to present the case for domestic purposes, foreign aid may be worthless for politicians. Politicians are controlled by their domestic terrain, those actions that they take on the behalf of voters, but this is largely much too difficult to account for in their actions abroad. Instead of pursuing voters' preferences, politicians may deviate from expectations and advance their own interests. Politicians also may have some information about target country that is not available to voters and manipulate it against voters' interests. Aid may be used to simply shift attention from painful topics of internal policy toward foreign policy. Aid may be used as a pretext for a humanitarian or military intervention, to support or suppress some political forces, and that again may be different from voters' preferences. Politicians may travel to a distant target country pretending that they care about aid delivery. It is costly for voters to find out the truth about such trips that abound in corruption opportunities. In the end, aid may be used fairly to help those in need, but this depends more on the aid agency and not the politician.

Politicians and aid agency.

Contrary to private, for-profit firms that have only one objective – profit – aid agencies usually have multiple and hard-to-define objectives. There are umbrella objectives and specific objectives and both are vague and multiple. Under umbrella objectives are to be found: pain relief, development promotion, combat poverty, building institutional capacity, strategic planning¹⁵. Specific objectives range from supplying food, building hospitals and schools, graveling roads, preventing disease, supporting institutional change (like privatization or legislation proliferation), supporting entrepreneurship, enhancing education, etc. The structure, timing, priorities and ways to conduct such actions may be very different. Multiple objectives and different opportunities for aid delivery weaken both the connection of aid delivery with umbrella (political) objectives and the procedures of monitoring and evaluation of aid delivery.

Unlike a business firm, it is difficult to establish an efficiency measure of the aid agency's activities. Multiple objectives often operate against each other and weaken each other, so that aid may end up serving none of its multiple goals particularly well. An aid agency may obfuscate its objectives and manipulate results (performance) in order to avert investigation and prevent insight into real achievements. In order to cover multiple and frequently conflicting objectives, administrations and aid agencies label these programs with slogans like "aid, not trade", "Beautiful Bulgaria", "first things first", "alleviate poverty", "Serbia on the right path". This merely focuses the public's attention away from real problems and troubles in execution of aid programs.

The wider the range of political principles and interest groups to which the politicians and aid agency have to respond, the vaguer will be the aid mission, the weaker the constraints and the more diversified and complicated the structure of incentives will be. International aid organizations, such as the UNDP, World Bank or EBRD, have an additional problem of reaching consensus over objectives, due to their joint delegations. These usually result in costly

¹⁵ After demise of central planning, strategic planning became its replacement applicable at the regional and local level.

negotiations and mutual concessions that, as a rule, end with even weaker and fuzzier objectives than in the case of national donors. The control of international programs is also weaker than in the case of national ones, again due to the joint delegation of responsibilities.

Aid agency, subcontractors and consultants.

One may feel that there would be fewer problems as the implementation goes down the chain, from politicians via aid agency to subcontractors. This expectation is unfounded since the problems continue to persist. "Following Gresham's law, 'bad suppliers will drive out good suppliers'. On average, suppliers who take more risks and make less effort to achieve project objectives, stand a higher risk of being found out. But that risk becomes verifiable ex post of contract signature only and often ex post of project implementation, when it is too late and/or very costly to correct implementation problems. There are basically two ways to reduce these post-contractual risks: to invest more in ex ante information on the quality of the bidders or make it exceedingly costly for them to take implementation risks".¹⁶ However, both hopes for improvement fade away as one takes a closer look. In order to get better suppliers, additional research is needed. The more one invests in additional research of this type, the more accurate information he will receive. It also holds, the more investigation conducted on aid delivery, the more interest subcontractors will have to

invest in order to distort the information, by presenting themselves and their works in a better light than they de facto are. Negative selection sometimes makes additional research pointless. Frequently one gets just two or more bidders that are good or bad to a similar degree. Their only interest is to get the job and to acquire profit, this time in exchange for nothing, since aid agency is short of incentives to check how subcontractors operate. Even if it appears to be an honest bidder, the reality is that there is nothing like this because such a bidder has already been expelled from the business as a disruptive factor that has a higher operation costs and lower profit. This would merely unsettle the aid agency because it raises the risk of honest reporting, which again may shed undesirable light on the whole aid operation, i.e. on its ineffectiveness.

Another option for an aid agency would be to improve performance evaluation. This may include several different measures like reducing implementation uncertainties and implementation risk, close monitoring and reliance on a really independent evaluation. This is going to be not only exceedingly costly but also undesirable, as I will show later on by discussing the evaluation risks. It is sometimes said that aid officials quickly rotate out which minimizes the effects of the learning-by-doing process. Such fast rotation may play some role in explaining aid results but just to some modest degree. The salary policy offers a much better starting point for the performance explanation. Salaries in aid agencies are fixed because it is impossible to measure aid performance. They are fixed extra high because such salaries are considered to be a "hardship allowance"¹⁷, although in reality there is nothing hard or dangerous. As a rule, salaries in aid agencies are much higher than that of the staff in local administrations, where they are fixed as well. This means that international aid agencies would be able to save a lot of money spent on salaries, but they are not interested in such a saving strategy. This again indicates that salaries are present rather than compensation for work effort. Fixed salaries do not encourage risk taking and work ethics. When pay is not related to performance indicators, it is impossible to improve incentives for a better performance by shifting salaries up and down. Local bureaucrats may be additionally discouraged to facilitate execution of aid programs having seen that aid officials are

¹⁶ Martens, 165.

¹⁷ I met in Belgrade in 2002 an official of one larger international development organization, aged 29. His mission was to visit Bosnia and Herzegovina, Serbia and Kosovo. He was simultaneously paid \$ 1500 per territory per day, what means \$ 4500 per day, plus one daily allowance of \$ 1000, exceeding five times the accommodation costs. For 28 days of his „mission“ he collected \$ 146,000 and all that was tax free. It was against the rules of that organization to get more than one honorarium of \$ 1500 per day.

paid several times higher¹⁸ than the y are for a work that local officials consider as a useless squander of money by careless, arrogant, ignorant and sometimes even insolent persons. Nothing would change if aid workers were ordinary people with exception of disappearance of non-necessary irritation. Aid workers are short of motives for work effort and of instruments to induce local authorities and other stakeholders to assist aid programs, with exception of those domestics that are net beneficiaries of aid, and these are rare. Central planning was inefficient in enforcement although it disposed over heavy instruments to discipline subordinates like the communist party, regular and secret police. Constitutionally constrained government granting aid is short of such instruments. By lowering the price for offenses, the threat of sanctions is undermined. News about the criminal prosecutions of politicians and aid workers for the misuse of aid funds is so rare that it deserves to enter the headlines.

Target country, local agencies and target groups.

Among the justifications for foreign aid, the “vicious cycle of poverty” or “poverty trap” are the most popular and have been championed for a long time.¹⁹ Poor countries are poor because they cannot generate capital. Consequently, they cannot develop, thus keeping them poor. The current trend of thinking to believe that only way to eliminate this poverty is to bring capital from the outside. If one assumes that this is so, how can be explained that once poor countries, which are now developed, have ever developed? The main problem is not whether some country is poor or developed; the question is does it have the institutions that encourage capital formation, investment and entrepreneurship. The problem of the African countries is not that they are poor or that they do not get aid enough. Their problem is that they rely on socialism rather than capitalism, and with foreign aid they receive more socialism.

Lord Bauer and many others wonder why governments pursuing anti- market policies that economically cripple their countries get aid. The above explains the paradox. Aid based planning comes in support of its domestic ally, resulting in a stagnating or deteriorating situation. For that reason, aid agencies cannot indicate any improvement over decades, as the World Bank cited in reports in footnote no. 32. The solution for poor countries is to rid themselves of foreign aid and to enforce property rights, freedom of contract and open their markets.²⁰

Another prejudice is the myth that aid is a win-win strategy. Donor country or agency asks a recipient to do something what is in the recipient’s interest in exchange for getting aid. It seems that recipient profits twice. It profits once by doing something that is in its’ interest, the other time by getting aid. This win-win strategy seems to be predestined to succeed.

This requires shedding more light onto the idyllic win-win strategy. Let us go back to the beginning and ask: who decides what is in recipient’s interest? This is usually done by donors in a similar way in which central planners operated. They estimate what is supposed to be in the recipient’s interest. Donors select what is in recipient’s interest, although they do not bear the consequences of the ir choice. Planners also decide on others’ fates without being affected by the consequences themselves. The cost for central planning is borne by state budgets or foreign creditors; the cost for aid is borne by the taxpayers of rich countries and the recipient. No wonder the recipient, when struck with such an uneven structure, is frequently either indifferent or against such imposed choice. Recipient may reject donor’s choice even when it is a reasonable one. Rejection may be caused by a different perception of priorities and different interests. It may

¹⁸ Sometimes salary differentials are offending. The chief of one international program for South Serbia 2001-2005 had a monthly salary 52 times higher than the Serbian average. His deputy (local staff) had 24 times higher salary than average, local activists 10-12, drivers 6 times, coffee girl 5 times – the lowest salary in the local office.

¹⁹ Although this justification has been discredited for a long time, Sachs (2005) and the UN MDG-program are based on it.

²⁰ As Mart Laar succinctly said citing Peter Bauer – “Trade, not aid”

reject objectives and accept aid. It may accept both the objectives and aid, which again does not guarantee a successful implementation of the aid program.

All Central and East European countries (CEECs) after the collapse of communism were populated by the same density of foreign aid workers delivering technical assistance. All of these countries suffered from the same disease. In every case, the advice was the same – do some kind of pro- market reform. Due to the fact that CEECs' situations were similar, one would conclude that the post-reform outcome should be similar, too. This would be wrong. Although the situation and density of experts were similar, the outcomes were widely divergent. Some countries did fast, deep and consistent reforms and became reform champions. Others have seen moderate reforms, and the third ones were the latecomers. The conclusion is straightforward – foreign expertise has no greater positive impact on reform in CEECs. The reform exclusively depends on the domestic political elite and given circumstances. Only insiders may be a factor of reform. Not only has foreign technical aid not contributed to reforms in the CEECs latecomers, it may have actually slowed down reforms in reform champion CEECs by suggesting welfare measures, bureaucratic interference into economy, slow pace liberalization, and control instead of competition.²¹ For example, all candidates for the European Union from the CEE were urged by the European experts to raise their income and corporate profit taxes in order to finance the welfare measures comparable to those in over-regulated EU15. Instead of home-grown regulation and central planning, a similar imported process developed under umbrella of “technical assistance”.²² Instead of getting rid of the socialist past, technical and other aid slowed down the change of the rules of the game and in some countries, even repaired and fixed the already shaken socialist heritage. As in the case of Africa, technical and other aid in the CEECs restored socialism²³ or slowed down its demise²⁴, rather than acting as an impetus to capitalism.

The above explains the paradox that the CEECs championing in reforms (Baltics, Czech Republic, Hungary) have received rather symbolic financial aid, while those that were latecomers (Balkans, Ukraine) obtained large financial transfers. Larger transfers discourage reforms. Transfers have temporarily improved the standard of living and macro-economic stability, but they failed to inspire institutional change. Aid raises moral hazard both by reducing readiness for reform and by undermining incentives to invest. Aid reduces readiness for reform because it spreads the message that improvement is possible without reform (due to aid) and foreigners, rather than domestic actors, will improve the situation. By getting a significant amount of foreign aid the recipients, believe that future troubles and poverty will induce future aid.²⁵ In addition, foreign aid makes government stronger, and in many underdeveloped countries, government was already too strong or even dictatorial.

One of the popular trends in aid delivery is to blame the recipient for the failure of aid. Recipients are blamed for being lazy, inactive, disinterested, corrupt, and without appropriate institutions or understanding of the aid objectives. It is not a secret that this description frequently fits into the situation. Taking a different approach, donors are the one who actually have insight into the situation of the target country even before they have decided whether or not to go there. If they have not provided enough information, that is their failure rather than that of the recipient. This picture, where only recipients are blamed for the failure of aid missions, existed merely because the world press shared the prevailing view that donors are good and that only recipients may be at fault. In fact, all important decisions and instruments are in the hand of

²¹ Deepak Lal 2005

²² To be fair, current technical assistance resembles more to central over-regulation than to planning; just a smaller fraction of technical experts still believes in planning.

²³ Examples are in Bosnia and Herzegovina, Serbia, Montenegro and Macedonia

²⁴ Examples are in Poland, Romania and Slovenia.

²⁵ Let us put aside the standard objection that aid finances consumption rather than investment, since the investment conducted by state and non-market funds is notoriously inefficient.

donors. Over time, the verdict of blame for aid failure shifted away from “blame the recipient” to a “blame both sides”. It seems that another lapse of time is needed in order to get courage to locate the main responsibility on donors.

Aid to corrupt regimes is also as problematic as aid to governments conducting anti-market policies. Its size and frequency show that this does not happen by chance. “The world’s 25 most undemocratic government rulers (out of 199 countries the World Bank rated on democracy) got a sum of \$ 9bn in foreign aid in 2002. Similarly, the world’s 25 most corrupt countries got \$ 9,4bn in 2002. The top 15 recipients of foreign aid in 2002, who each got a more than a billion dollars each, have a median ranking in the worst fourth of all governments everywhere (ranked in democracy, corruption, etc.)”.²⁶ It is impossible that donors are not aware of where their means end. One option would be that they eventually deliberately work with corrupt regimes because this enhances corruption opportunities inside the aiding agency. Another option would be that these 25 regimes are among the poorest and that bureaucrats do not care that they are extremely corrupt, too. Experts calculated “that between \$26bn and \$130bn of money lent by the World Bank for development projects since 1946 has been misused”.²⁷ Such a massive misuse of funds cannot coincidentally happen. Even more surprising is that aid agencies have rules stimulating corruption and manipulation. Like the UNDP and WB, rules prevent staff in nearly all aid agencies for testifying in public, including public hearings. This is a blatant contradiction of the aid agencies’ demands on poor countries to operate transparently.

By knowing that monitoring is not precise and tight and that evaluation will be friendly, donor organizations do not need to hesitate to spend resources without a careful analysis of the situation and selection of methods and targets. Once they enter some country, they may like to pursue their own²⁸ instead of a recipient’s interests. But whatever they do, they became a hostage of the situation. Choice is reduced. If they eventually decide to leave a country, this will be booked not just as a donor’s failure but as a failure of all persons involved in aid delivery, damaging their careers. For that reason, an exit option is merely reserved for situations where it is obvious that there are some huge and visible obstacles to the continuation of aid delivery. In fact, situations where aid delivery is questionable, if not ineffective, are much more numerous than these clear situations with obstacles. In such situations donors continue with aid, since this option is perceived as less troublesome. The explanation for this is simple. Social or political embarrassment is delayed, if not averted, and there is a chance to influence and bias the report.

By being similar to central planning according to the structure of incentives foreign aid is also similar to planning in achieving poor results. Central planning, as experience shows, has never ended poverty. It was implemented at home while foreign aid programs are implemented abroad. This distance just deepens the failure. By anticipating that aid design and aid results widely diverge, all intermediaries along the chain have incentive to keep the information on low profile and even to bias it according to the need. No wonder that the aid performance and reactions of beneficiaries sometimes are manipulated to such a degree that they are beyond the recognition.

MONITORING AND EVALUATION OF FOREIGN AID

Because central planning was ineffective, evaluation and reporting were extremely sensitive and important. Their main task was to manipulate results heavily, so disasters were depicted as success stories. Eventual negative reports on planning were highly undesirable or even prohibited. Central planners never conceded that their five year-plans had failed. They used a

²⁶ Easterly 2006, 18.

²⁷ Cf. Carol 2004. The estimate is in 2004 dollars.

²⁸ When the World Bank decides to pay out adjustment loans, despite the fact that in one third of cases countries fail to implement policy targets, it happens because the Bank worries about the country’s ability to service previous Bank or other loans. Debtors hardly may fail to notice aid supplier’s lack of commitment to its own commitment. Cf. Dollar & Svensson 1998.

totalitarian state that provided coercive means to spread lies and capture information. By the same token, foreign aid continues the practice of mass deception through reporting and evaluation. However, it is much more difficult to mimic the manipulative habits of central planning in a constitutionally constrained democracy.²⁹ Despite the fact that aid agencies are exempt from domestic rules and that their inspection and investigation is restricted in different ways, their results are publicly visible, and as such, a legitimate target of research.

An inverse structure of incentives in conjunction with political and geographical separation between taxpayers and beneficiaries make it difficult to monitor and evaluate aid performance feedback process. A broken feedback loop enhances the space for manipulation.

Donors or taxpayers judge the work of an aid agency exclusively by its public image and public pronouncements. Politicians control aid agency by reports that are written either by agency officials or by independent consultants. In many organizations, the task of evaluation is conducted by persons directly involved in projects, like officials of the aid agency itself, so that they can not be considered impartial.³⁰ It is clear that insiders cannot be relaxed from their values, objectives and interests. They may have enough information, while being insiders, but they have an interest to reduce or to intentionally neglect negative information and to overstate positive information. They will tend to produce reports favorable to their past dealings in order to justify their activities and to enhance prospects for their future careers.

But even in those cases where evaluation is conducted by some third party, there are severe problems. Imprecise, 'woolly' and basically useless reports emerge for several reasons. First, when a firm/organization gets an evaluation contract it is short of incentives to search for more detailed information. The search is costly and any further search is financially consuming while the reward/revenue is already fixed by the contract. Secondly, a firm operating at the limited evaluation market should not upset the market with a truth-telling report, thereby losing its foot in that market in the future. Having seen at least ten dozen of evaluation reports during past fifteen years, I was surprised by how they all look similar³¹ to each other, even though they were written by different organizations and authors. Based on experience, one can say that the ideal evaluation report has the following main features:

- 1) The report should repeatedly point out that the aid program has achieved its starting objectives and frequently that this is done beyond the initial expectations.
- 2) The report is based on the evaluation of inputs rather than outputs. This makes it possible to concentrate on good intentions and means used rather than on the efficiency of resource utilization.
- 3) Statements in the evaluation report are broad and general enough, while precise and accurate information is avoided.

²⁹ Researchers that do not share optimistic view on aid face similar obstacles to dissidents under communism. Officials and aid agencies make for them difficult to get the information, declare them not eligible for grants and rents, discourage publication of their works, react with silence to criticism. Nevertheless, authorities cannot stop, imprison or kill unorthodox researchers, as it happened to dissidents

³⁰ The advisory commission, set up by the U.S. Congress and chaired by Alan Meltzer, recommended, among other things, that the aid agencies like the World Bank undergo an independent evaluation. Despite this, independent evaluation in the WB did not take place yet.

³¹ It seems that this type of similarity appears more frequently, as a result of similar structure of incentives: "I was working with a few colleagues and consultants on the two global performance reports of the EC-financed Phare and Tacis... We have worked our way through a pile of monitoring and evaluation reports on individual Phare and Tacis projects... While we were compiling a synthesis report, we were struck by the convergence of views that emerged out of this apparently chaotic pile of information. There were many similarities in project design, implementation and outcomes, in behavior of project managers and policy decisions, despite a wide diversity of project circumstances, across countries, sectors and types of projects. Evaluation reports on EC programmes in other regions of the world revealed similar patterns". Martens et alii 2002, p. 2-3. Emphasize is mine. Not to forget that Martens and others acted as the EU super-evaluators and that they were obliged to be as polite as possible in order to avoid that their report inspires a larger embarrassment.

4) Wording, statements and the general spirit of the report should not disturb any interest group or particular important person. A violation of this rule may result in additional investigation inspired by such a group or person.

5) Heavy criticism of the project execution is to be avoided at any price. The modest, tempered and general criticism may be welcome, especially if it is related to broad or peripheral topics.

6) Humor, irony and cynicism are to be avoided. A sterile bureaucratic language with the proactive formulations, as well as politically correct language is strongly encouraged.

One cannot say that the writers of evaluation reports are born con-artists or illusionists, but they become like that by realizing circumstances and incentives of the evaluation process. Evaluation is highly decentralized and so reports cannot be coordinated to look similar to each other. If they, nevertheless, look similar, it must be the result of similar constraints. False or 'woolly' reports are celebrated as a good product in a sensitive environment of mass deception³² through evaluation concerning foreign aid. Similar to aid reports, planning reports indicated very good results, but they had nothing to do with reality. Reports suggested that plans were implemented satisfactorily, while the economies were in ruins. Some members of interest groups (like party and state officials or managers) got rich, while citizens remained in poverty- nothing different than foreign aid.

There will be no solution to allocate a larger evaluation budget and try to produce relatively more accurate reports on projects since the structure of incentives will remain the same and the new product would be not much different from the current outputs. Even when a grosser misuse of aid is found, as a rule there need not be an appropriate reaction.

Despite all indications that aid fails, a dominant position in aid granting countries and aid agencies is that the aid is helpful to recipient countries. This conviction is based on prejudices, wishful thinking or biased evaluation. Evidences show that foreign aid has no tangible impact on the long-term economic growth and improvement of conditions in target countries. This is in accord with a broader conviction that central planning that never ended poverty. The task of evaluation is to hide failure and damage by reporting some degree of success; therefore, the evaluation process is irreparable. Deliberately spreading delusions is damaging because it distorts perception and prevents proper action. Prospects for getting more accurate reports are murky and this is sometimes confessed even by official super-evaluators of the largest aid donors: "Pessimism prevails to the ability of evaluation to improve transparency and accountability towards taxpayers, or even to enhance aid program performance in general; evaluation itself is subject to political manipulation".³³ Changes external to aid delivery, like more intensive lobby group activities, public awareness campaigns and similar actions may slightly improve the aid performance evaluation, but they can not reshape the structure of incentives.

³² Aid agencies repeat the same promises over decades that better times will come soon and they never come. Easterly (2003, p. 35-36) has collected such anthological quotes from the World Bank reports related to Bank spending in Africa over more than twenty years: "From a 1981 World Bank report, Accelerated Development in Sub-Saharan Africa (p. 3): 'Policy action and foreign assistance ... will surely work together to build a continent that shows real gains in both development and income in the near future'. From a 1984 World Bank report, Toward Sustained Development in Sub-Saharan Africa (p. 2): 'This optimism can be justified by recent experience in Africa ... some countries are introducing policy and institutional reforms'. From a World Bank report, Financing Growth with Adjustment in Sub-Saharan Africa (p. 15): 'Progress is clearly under way. Especially in the past two years, more countries have started to act, and the changes they are making go deeper than before'. From a 1989 World Bank report, Sub-Saharan Africa: From Crisis to Sustainable Growth (p. 35): 'Since the mid-1980s Africa has seen important changes in policies and in economic performance'. From a 1994 World Bank report, Adjustment in Africa (p. 3): 'African countries have made great strides in improving policies and restoring growth'. From a World Bank report, Can Africa Claim the 21 st Century?: 'Since the mid-1990s, there have been signs that better economic management has started to pay off'. From a 2002 World Bank press release on African Development Indicators: 'Africa's leaders ... have recognized the need to improve their policies, spelled out in the New Partnership for African Development (NEPAD)."

³³ Martens, 176.

CAN FOREIGN AID BE SIGNIFICANTLY IMPROVED?

If foreign aid is highly ineffective, can its failure be recovered in order to get better results? Some modest improvement is possible. If reasonable politicians rather than senseless technocrats would be in charge of aid programs; if sensitive and educated aid workers would be recruited rather than ruthless, undereducated and biased individuals; if moral hazard, corruption and adverse selection would be reduced by closer monitoring; if more realistic reports would be produced through further investigations of this process; and if the evaluation agency would be co-responsible for the fate of the program- then foreign aid may be improved to some moderate degree. However, it can neither be effective nor comparable to private investment. The same may be said about central planning. Its failure may be moderated and postponed by implementing suggestions similar to those mentioned above. But that is utopian since it would require the change of human nature. In the present world, the largest hurdle to improve foreign aid or central planning is represented in the structure of incentives.³⁴ It is settled in such a way that aid cannot be reshaped to look similar to the operation of a profit firm, i.e. it prevents the introduction of more effective means for functioning, monitoring and evaluation. Due to its structure of incentives, foreign aid is ineffective because of its nature rather than because of some particular other mechanism. While being similar to central planning, foreign aid is irrecoverable. Central planning was always on the move, but never truly reformed. After its collapse in the Central and East Europe and elsewhere in the late 1980s, the system was abandoned and replaced with some type of market order.

Although this is the case, there are some optimists who would like to revolutionize foreign aid in order to make it efficient. One type of optimists relies on aid privatization, another on conditional aid.

Concerning privatization, let us ignore for now the fact that foreign aid is nationalized. Even if one assumes, for the sake of argument, that foreign aid is private, this will not significantly change the efficacy of aid. There will probably be some slight improvement along the chain of command, as it was suggested before, but the structure of incentives will remain the same. In the case of aid, the market cannot exercise pressure like in some commercial activity. In the best case, some competition may exist among private donors to help recipients in need, but privatization is not needed in order to see competition.³⁵ However, competition among donors does not necessarily improve the quality of aid delivery, since the demand for aid, due to its low cost, is endless rather than limited. It merely provides a good opportunity to diminish the responsibility of each aid agency operating in a country. The more aid agencies operating in a country, the more difficult it becomes to address the responsibility of any particular one among them. Aid failure becomes someone else's fault.

Another idea for aid privatization relies on the ability of private firms to develop aid programs as a part of their commercial programs. For example, in order to get a new market, a soap producer may launch an educational campaign on the risks posed by dirty hands. There were such examples on the Indian subcontinent and elsewhere. Such moves may be more successful compared to classical aid programs. However, potential fields for such programs are relatively rare, and this type of aid is just hardly separable from the usual commercial activity.

Another proposal to improve the efficiency of foreign aid is conditional delivery. Aid will resemble a kind of prize – countries conducting more reforms will get more aid, while countries

³⁴ Easterly (2003, 2006) is inconsistent on the main point. On the one side he believes that aid is similar to central planning and that “the right plan is to have no plan”. On the other side he believes that reform of aid is possible if grand plans are abandoned and replaced with careful social engineering on the small scale. He neglects that small scale planning is still planning. It seems that he is not able to get rid of planning and aid after serving 16 years in the WB aid projects.

³⁵ Competition may exist among different development donors operating in a recipient country.

resistant to reform will get no aid at all.³⁶ This proposal leaves the donor untouched and assumes that the improvement may result from a change in the recipient's motivation. This is the basic tenet of the U.S. project called Millennium Challenge Account (MCA), a new scheme of foreign aid to be introduced step-by-step during the forthcoming years. This proposal initially sounds better, but upon further consideration it shows no improvement. The MCA will not touch the structure of incentives on the donors' side, which is the main problem of aid as it exists now. It will ask for a change in recipients' attitudes, which is a minor problem now, and what will not bring about any significant improvements. Even now, foreign aid is a kind of prize, and the only difference to the proposal consists in the fact that it is now distributed unselectively. If the number of reformers among recipients up to now was low, there will be no profound change in their attitude in the future. The only important consequence of the MCA proposal will be that a significant number of recipients are going to be cut off from aid. Some rulers will intentionally prevent reforms in their countries in order to prevent inflow of aid that creates opportunities for foreign interference into domestic affairs. Despite being in dire need, some populations will not be eligible for foreign aid. Others may be eligible despite being in much better position. This will question the main official rationale of foreign aid. Instead of being distributed proportionally to the suffering and needy, it will become a subsidy to friendly and cooperative regimes.

This exclusion of non-cooperative regimes will happen only if other donors follow the U.S. case. With no change in the attitude among other donors, recipient countries will not be stricken to a degree that they will feel a difference.³⁷ The MCA will affect probably more the U.S. interests in a number of countries rather than inducing a change among potential recipients.

Analogous to the MCA, the UN has launched the program for Africa called the UN Millennium Development Goals (MDG). It is based on sharp increase of donors' contributions for 170% compared to now, i.e. on their rise to 0.7% of donors' GDPs. The MDG recommends eight umbrella goals, 54 indicators of poverty and 449 separate aid operations to be achieved in Africa by 2015. The MDG's main strategist is moderate when he states that the "... goal is to end extreme poverty, not to end all poverty".³⁸ This is another retreat in development philosophy, after it was denominated in 1980s from promoting development to alleviating poverty. It is not clear why the budget now should be larger if the general objective is reduced.

Similar to central planners, Sachs just declares good intentions and never asks how they are going to be achieved. He never poses the question what are the incentives for people to get things done. He just deals with administrative, technical and bureaucratic procedures of providing aid. It is puzzling how the MDG will inspire a change in foreign aid implementation if even its language more closely resembles the press releases of the Soviet committees rather than an inspiring tone inspiring spurring on change in the field. This is visible in the terminology used by its main author, Jeffrey Sachs:³⁹

"... a needs assessment is a key input to ... a policy plan... The second stage of the planning process will be for each country to develop a longterm (10-12 year) framework for action for achieving the MDGs... This MDG framework should include a policy and public sector management framework to scale up public spending and services, as well as a ... financing strategy to underpin the plan. The third stage of the planning process will be for each country to construct its median term (3-5 year) poverty reduction strategy (PRS) based on the long-term MDG plan. The PRS (poverty reduction strategy) is a move detailed, operational document, and should be attached to a Medium Term Expenditure Framework (MTEF)".

³⁶ The measured indicators would be governance, economic liberties, democracy and women's rights, as they are estimated by the World Bank, Heritage Foundation and Freedom House

³⁷ Cutting aid is far too weak to accomplish some results, and the track record of on-again -off-again is miserable.

³⁸ Sachs 2005, 289.

³⁹ Sachs 2005, 285.

Even the communist planners did not frequently use words like planning, framework or strategy as Sachs does. Following that habit, the handbook for the MDG uses the word strategy nine times in the text and six times in the figure, just as on the first page of its introduction. Based on recycled ideas that planners used for several decades, the MDG program may be considered miscarried before its birth, and even more harmful if it is born.

In conclusion, foreign aid is not just ineffective because it has the same structure of incentives like central planning. Instead of inspiring development and alleviating poverty, as it was repeatedly pointed out, foreign aid helps to preserve the poor state of affairs and entrenches power in those responsible for the poor conditions. It is also damaging for preserving poverty, strengthening the state and stimulating corruption. Proposals to change aid either via its privatization or by making it conditional stop short of changing the structure of incentives. Despite being ineffective, aid will probably continue to exist but be followed with less enthusiasm about its effectiveness. Instead of helping those in trouble, it erodes their position while serving some other interests.

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