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A MARKET ECONOMY MANIFESTO FOR BULGARIA

Currency Board Working Paper

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A Market Economy Manifesto for Bulgaria

By Steve H. Hanke

About the series

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Co-Director of the Institute for Applied Economics, Global Health and Study of Business Enterprise (Hanke@jhu.edu).

This working paper is one in a series on currency boards. The currency board working papers will fill gaps in the history, statistics, and scholarship of the subject.

About the author

Steve H. Hanke is a Professor of Applied Economics and Co-Director of the Institute for Applied Economics, Global Health, and the Study of Business Enterprise at The Johns Hopkins University in Baltimore. Prof. Hanke is also a Senior Fellow at the Cato Institute in Washington, D.C.; a Distinguished Professor at the Universitas Pelita Harapan in Jakarta, Indonesia; a Senior Advisor at the Renmin University of China's International Monetary Research Institute in Beijing; a Special Counselor to the Center for Financial Stability in New York; a member of the National Bank of Kuwait's International Advisory Board (chaired by Sir John Major); a member of the Financial Advisory Council of the United Arab Emirates; and a contributing editor at *Globe Asia Magazine*.

In the past, Prof. Hanke taught economics at the Colorado School of Mines and the University of California, Berkeley. He served as a Member of the Governor's Council of Economic Advisers in Maryland in 1976-77; as a Senior Economist on President Reagan's Council of Economic Advisers in 1981-82; and as a Senior Advisor to the Joint Economic Committee of the U.S. Congress in 1984-88. Prof. Hanke also served as a State Counselor to both the Republic of Lithuania in 1994-96 and the Republic of Montenegro in 1999-2003. He was also an Advisor to the Presidents of Bulgaria in 1997-2002, Venezuela in 1995-96, and Indonesia in 1998. He played an important role in establishing new currency regimes in Argentina, Estonia, Bulgaria, Bosnia-Herzegovina, Ecuador, Lithuania, and Montenegro. Prof. Hanke has also advised the governments of many other countries, including Albania, Kazakhstan, and Yugoslavia. In 1998, he was named one of the twenty-five most influential people in the world by *World Trade Magazine*.

Prof. Hanke is a Distinguished Associate of the International Atlantic Economic Society; a recipient of the degree Doctor of Arts, Honoris Causa from the Universidad San Francisco de Quito; a recipient of the degree Doctor of Economics, Honoris Causa from the Free University of Tbilisi; a recipient of the degree Doctor of Economics, Honoris Causa from Istanbul Kültür University; and a Professor Asociado (the highest honor awarded to international experts of acknowledged competence) at the Universidad del Azuay in Cuenca, Ecuador.

Prof. Hanke is a well-known currency and commodity trader. Currently, he serves as Chairman of Richmond Optimus, LLC – a global macro hedge fund located in Richmond, Virginia. He is also Chairman Emeritus of the Friedberg Mercantile Group, Inc. in Toronto. During the 1990s, he served as President of Toronto Trust Argentina in Buenos Aires, the world's best-performing emerging market mutual fund in 1995.

Prof. Hanke's most recent books are *Zimbabwe: Hyperinflation to Growth* (2008) and *A Blueprint for a Safe, Sound Georgian Lari* (2010).

Prof. Hanke and his wife, Liliane, reside in Baltimore and Paris.

About this working paper

Prof. Hanke served as an adviser to Bulgarian President Petar Stoyanov, from 1997-2002
In 1997, Bulgaria adopted a Currency Board System, based on Prof. Hanke's draft Currency Board Law, which he authored at the request of President Stoyanov. The Currency Board brought an end to Bulgaria's hyperinflation, which peaked with a monthly inflation rate of 242%, in February 1997.

This paper, "A Market Economy Manifesto for Bulgaria," was originally presented as the keynote address, delivered at the Investment Forum 2002, Sofia. In that 2002 keynote speech, Prof. Hanke advocated a flat tax for Bulgaria. In 2008, Bulgaria followed that recommendation and adopted a flat tax rate of 10% on personal and corporate income.

Bulgaria is a classic "good news" – "bad news" story. First the good news: Bulgaria adopted a modified currency board system (MCBS) in 1997. And as I documented in a recent essay,[1] Bulgaria's MCBS has confounded its critics. This good news has not surprised me. Indeed, it represents the result I anticipated in 1991, when I first proposed that Bulgaria adopt an orthodox currency board system.[2]

The bad news part of the story is that Bulgaria is still not a market economy. The Economic Freedom of the World Annual Report 2001 published by the Cato Institute in Washington makes that perfectly clear. Of the 116 countries surveyed, Bulgaria ranks 95th,* along with Burundi. Based on work I conducted for the Joint Economic Committee of the U.S. Congress,[3] this is unfortunate. Economic freedom, which accompanies a market economy, is the engine of economic prosperity. If Bulgaria is to prosper, it needs a market economy, now.

A few words about a market economy are in order. As the great Austrian economist and Nobelist Friedrich von Hayek observed: much of the knowledge necessary for social and economic coordination is subjective and widely diffused throughout society. A market economy's price system has proven to be the best form of economic organization for efficiently collecting, transmitting and applying diffused knowledge. In part, this results because the profit and loss system rewards success and penalizes errors and failure. In consequence, a market economy contains built-in incentives and error-correcting mechanisms that allow for the production of usable knowledge through a process of learning by trial and error. In short, market-generated prices facilitate economic calculation and allow resources to be deployed and redeployed rapidly to what consumers consider to be the resources' best use.

It is a mistake to cite examples of so-called "market failures" that are the product of imperfect information because a world of perfect foresight cannot exist under any institutional arrangement. Indeed, the recent examples of Enron, Arthur Anderson and Merrill Lynch in the US have shown that errors occur even in the biggest market economy in the world. This isn't surprising. Nor is it surprising that the error-correcting mechanisms in the US price system have gone into high gear to correct the failures and that the US economy has hardly missed a beat.

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To successfully implement liberal, market-oriented reforms, confidence and credibility are of primary importance. As Keynes argued in the *General Theory*:

> The *state of confidence*, as they term it, is a matter to which practical men always pay the closest and most anxious attention. But economists have not analyzed it carefully and have been content, as a rule, to discuss it in general terms. In particular it has not been made clear that its relevance to economic problems comes in through its importance influence on the schedule of the marginal efficiency of capital. There are now two separate factors affecting the rate of investment, namely, the schedule of the marginal efficiency of capital and the state of

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* As of 2012, Bulgaria ranks 45th

> confidence. The state of confidence is relevant because it is one of the major factors determining the former, which is the same as the investment demand schedule.
>
> There is, however, not much to be said about the state of confidence *a priori*. Our conclusions must mainly depend upon the actual observation of markets and business psychology.

Most economists have completely ignored this passage in the *General Theory*, because confidence is difficult to define and insert in any formal abstract model. Economists find it difficult to quantify and measure. Keynes admitted as much. Perhaps this explains the failure of economists to consider confidence seriously. Yet, it is clearly unsatisfactory to confine analysis only to definable and quantifiable magnitudes and to ignore an important determinant of behavior simply because it cannot be encapsulated in any neat definition or be measured by government statisticians.

Unlike Keynes, I suspect that there is much to be said *a priori* about the state of confidence. For example, it seems likely that confidence is determined by the general credibility of government policy. Therefore, to reach the goal of a market economy in Bulgaria, a confidence shock—like the one delivered by the MCBS—is required.

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As was the case when I introduced the currency board idea to Bulgaria, I am convinced that, if embraced and pressured with vigor, the following four-point manifesto would deliver a major confidence shock and put Bulgaria on the road to a market economy.

1. *Fiscal order and transparency must be established.* Bulgaria lacks the fiscal institutions to guarantee that budget deficits and government spending can be controlled. To put its fiscal house in order, Bulgaria's government should begin to publish a national set of accounts which includes a balance sheet of its assets and liabilities and an accrual-based annual operating statement of income and expenses. These financial statements should meet International Accounting Standards and should be subject to an independent audit.

Just what is an accrual-based operating statement? At present, accounts in Bulgaria are kept on a crude cash basis. Revenues and expenditures are recorded when cash is received or paid out. With accrual accounting, spending and revenues are recorded when they are incurred, regardless of when the money actually changes hands. Accrual accounting gives a much more accurate picture of the realities and avoids many financial tricks that politicians can play with cash accounting. For example, under cash accounting, politicians can promise pensions for future retirees, but since no money is paid until people retire, there are no budgeted costs under cash accounting until the pensions are paid. With accrual accounting, the promises to pay future pensions would appear in the government's accounts when the promises for future obligations are made. Consequently, under accrual accounting, the government cannot distort the magnitude of its spending obligations.

Do any countries use accrual accounting for their public accounts? Yes. For instance, New Zealand started to use it in 1989. As a result, New Zealand presents a far more transparent and honest picture of government operations than do most other governments. This has allowed New Zealand to make more informed decisions and control the state much better.

To reduce corruption in Bulgaria, there is no better medicine than the transparency which would accompany a New-Zealand type set of fiscal accounts.

2. *Supermajority voting must be established for important fiscal decisions*. Many countries require supermajority voting for important decisions. Such a voting rule protects the "minority" from the potential tyranny of a simple "majority." A supermajority voting rule is particularly important for the protection of minorities in countries, like Bulgaria, where the democratic process is not circumscribed by a firm rule of law.

Fiscal decisions are important. The arithmetic of the budget shows us that two new fiscal rules would be sufficient to control the scope and scale of the government and protect minority interests. Total outlays minus total receipts equals the deficit, which in turn equals the increase in the total outstanding debt. Rules that limit any two of these variables would limit the other variables.[4] Which two variables should be limited?

Before I answer that question, I should remark that the goal of reducing Bulgaria's total public debt to something less than 50% of GDP by 2006 is desirable and that it should be vigorously pursued by the Bulgarian government.

The easiest way to answer the question about which two variables should be limited by supermajority voting rules is to sketch an amendment to the Bulgarian constitution:

> <u>Section 1</u>. The total Bulgarian debt may increase only by the approval of two-thirds of the members of the National Assembly.
>
> <u>Section 2</u>. Any bill to levy a new tax or increase the rate or base of an existing tax shall become law only by approval of two-thirds of the members of the National Assembly.
>
> <u>Section 3</u>. The above two sections of this amendment shall be suspended in any fiscal year during which a declaration of war is in effect.

3. *The tax system must be simplified and tax rates must be lowered*. Bulgaria's tax system is too complicated and tax rates are too high. In consequence, economic incentives are distorted and the formal economy is unnecessarily burdened. Not surprisingly, corruption is widespread and the gray economy flourishes. To reform the tax system, Bulgaria should follow the Russian example. Russia's President Putin has it right. Putin has largely ignored the IMF and has developed his own Russian economic strategy. His first step to reforming the Russian tax system was to introduce a 13% flat tax in which that single rate applies to all personal income.

The second step was to reduce the corporate tax rate from 35% to a 24% flat rate. The third step is to grant small businesses the choice between a 20% flat tax on profits or an 8% flat tax on revenues, beginning January 1, 2003. In three short years, Russia will have completely overhauled its tax system. And not surprisingly, these tax changes have resulted in a significant increase in government revenues and a reduction in the gray economy.

4. *Commercial law must be privatized*. At present, Bulgaria's legal and judicial systems are unreliable and do not meet market-economy standards. They explain why corruption is widespread, why private property and contract rights are not properly protected and why foreign direct investments are much lower than they could be. This is unacceptable. After all, the enforcement of the rule of law, which encompasses the sanctity of private property and contracts, is the foundation of all private morality and the foundation of every sane social order. To reform the current legal system, which is a state monopoly, would take years, if not decades.

For commercial activities involving property and contracts, there is a way to provide a reliable, low-cost alternative to the state's monopoly of the legal system. History offers many examples of legal regimes that were designed and administered by private entities. Indeed, commercial law has its origins in purely private regimes: the merchant guilds of medieval Europe. *Lex mercatoria*—the law governing the relationships between commercial traders—was a privately-designed and administered system that was made effective by the power of the sovereign to force compliance. And today, private arbitration serves as an example of such a system.

Bulgaria should amend its constitution to allow commercial law to be privatized. This would protect the sanctity of property and contract rights in the commercial sphere, reduce corruption and greatly enhance the attractiveness of Bulgaria as a destination for foreign direct investments.

Turkey has taken a step in this direction. In an attempt to stimulate direct foreign investment, which has been very low, Turkey's Parliament passed the Turkish International Arbitration Law on June 21, 2001. This law allows disputes involving a foreign element to be resolved by arbitration proceedings. These may occur within Turkey or outside of Turkey, depending on the preference of the parties involved. Because this law allows investors legal recourse and enforces contract rights, Turkey has demonstrated that, at least to a limited degree, it is willing to follow the rules of a market economy.

If embraced and implemented, this four-point economic manifesto would generate a major positive confidence shock in Bulgaria and push the country rapidly toward becoming a market economy. It is only then that Bulgaria will be able to act as a magnet for capital—both human and financial—which is the lifeblood of all vibrant economies.

Notes

[1] Steve H. Hanke. "Currency Boards." Annals of the American Academy of Political and Social Science, no. 579, January 2002: 87-105.

[2] Steve H. Hanke and Kurt Schuler. Teeth for the Bulgarian Lev: A Currency Board Solution. Washington, DC: International Freedom Foundation, 1991.

[3] Steve H. Hanke and Stephen J. K. Walters, "Economic Freedom, Prosperity and Equality: A Survey." The Cato Journal, v. 17, no. 2, Fall; available online at http://www.cato.org/pubs/journal/cj17n2-1.html

[4] William A. Niskanen. "The Case for a New Fiscal Constitution." in W. A. Niskanen, Policy Analysis and Public Choice. Cheltenham, UK: Edward Elgar, 1998: 361-373.