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The Institutional Setting of Multinational Corporations in Bulgaria:
An Empirical Survey

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In the process of transition of Central and East European countries (CEEC) to a market economy the critical importance of multinational corporations is growing in view of the fact that the former socialist economies have to reintegrate into the global economy and that multinational firms are the major transfer agents of goods, services, capital, technology, and human resources. In performing their task MNCs in CEEC are facing staggeringly high transaction costs related to the use of the market mechanism and resulting from the infant local markets as well as from the feeble role of the government and market institutions in providing a safe climate for MNCs.

The current paper has for its main purpose to present the results of a representative empirical survey of MNCs in Bulgaria in their interaction with Bulgarian state institutions. The study covers a population of 51 big international companies and was conducted between January 15 and February 15, 2000. The research results are interpreted in the context of transaction costs as the price of using the Bulgarian market mechanism and reflect the views of social scholars like Janos Kornai about the role of government. The paper tackles the tasks that Bulgarian institutions should perform. Several institutional setting parameters are studied and the last part of the paper provides guidelines for improving MNCs' institutional setting in terms of competition, market information, property rights, infrastructure, and the general climate for MNCs.

Keywords: multinational corporations, Central and Eastern Europe, transaction costs, government

After a decade of profound economic changes the countries of Central and Eastern Europe face the challenge of development and sustainable growth. The development priorities involve achieving income growth, raising investment rates, strengthening technological capacity, improving the competitiveness of local economies as well as distributing the benefits of growth more fairly by creating more and better employment opportunities.

These goals can scarcely be achieved through the national endowments of each country but rather through the world economic environment and the participants in it as for most of the countries in transition exogenous stimuli seem to be a major determinant of success. The reason behind this is the full exhaustion and the ineffective usage of national resources as well as the substantial economic and technological gap between those countries and the rest of the world.

Multinational corporations are viewed as a primary factor for the marketization and the integration of CEEC with the globalizing world economy. The purpose of this paper is to reveal the presence of MNCs in the Bulgarian economy as a small economy in the region as well as the institutional framework in which these companies operate in the country. The results of an empirical survey are presented herein reflecting the MNCs' activities with respect to the transaction costs incurred by them on the Bulgarian market. The analysis focuses on some of the most critical issues concerning the creation of a more favorable investment climate in the country and the implementation of effective governmental policies toward MNCs as the "economic locomotives" of Bulgarian growth at present.

Multinational Corporations's Activities in Central and Eastern European Countries

The importance of multinational corporations has increased in view of the fact that they are seen as a panacea to the stagnant and unstable economic systems in the post-communist world. All countries in the region are now striving to attract more foreign investment in their hope to be able to solve some of their problems with the help of

MNCs as the primary transfer agents of goods, services, capital, technology and human resources in the global economy.

The new global context is characterized by rapid advances in knowledge, shrinking economic space, and changes in the competitive conditions. Influenced greatly by the new international environment MNCs are changing their ownership advantages – rapid innovation and deployment of new technologies in line with logistic and market demands become more important than ever. A striking feature of these processes is how MNCs shift their portfolios of mobile assets across the globe to find the best match with the immobile assets of different locations. The impulse to achieve economic prosperity in the region sets forth the difficult task to tie the competitive advantages of the MNCs with the specific advantages of each of the local economies.

While a large domestic market is still a powerful incentive for foreign investors, MNCs increasingly look for world-class infrastructure, skilled and productive labor, innovative capacities, and a concentration of efficient suppliers, competitors, support institutions, and services. According to K. McMillan, a leading researcher of FDI in CEEC, a drastic increase of this investment cannot be expected as long as there are no substantial improvements of the educational, technological and institutional infrastructure¹. However, the relative isolation of CEEC from the global economic system, the lack of robust economic linkages with the West, of developed telecommunications, transportation and other types of infrastructure impede the processes of globalization in Eastern Europe.

A symptom of this relative isolation is the absence of developed market institutions in the region. Economic instability can be ascribed to conjuncture or to the inappropriate economic policies of local governments but it can also be the sheer result of the economic underdevelopment of these countries. MNCs have been confronted with numerous problems and threats in the region. Banking systems in many CEEC have collapsed through a wave of bank failures that have prevented the bank operations of many MNCs. Another source of uncertainty caused by the financial sector has been the instability of a large number of local currencies, the result of inflationary economies. In

most countries in CEE the capital market is non-existent or just emerging and a credit system is barely functioning. This has been an obstacle for MNCs to repatriate capital back to their home countries as well as to other countries where they have set up subsidiaries.

FDI made by MNCs comprise a package of resources and are not a mere channel for obtaining access to production factors. The attributes of MNCs are numerable and difficult to separate and quantify. FDI contain a bundle of assets, some proprietary to the investor, i.e. technology, brand names, specialized skills, some non-proprietary – finance, capital goods, intermediate inputs and the like that can be obtained from the market.

Governmental policies with respect to FDI in CEE have consistently failed to provide investor benefits with respect to tax, tariff or ecological incentives, the barriers to international trade as well as the restrictions on the activities of foreign investors. This has generated artificial market failures preventing the normal flow of resources within the MNCs. The inconsistent customs laws adopted by CEEC hinder intrafirm trade or the exchanges taking place within the boundaries of large corporations. The rather contradictory and changing legislation in CEEC is a major source of transaction risk for multinationals that are unfamiliar with the local laws and peculiarities of the court systems. A major flaw of East European legislature is its inability to protect industrial and intellectual property, thus, jeopardizing MNCs' property rights on occasions related to licensing, franchising, managerial know-how, etc.

A commonplace risk for MNCs investing in the CEE region is the low purchasing ability of the people, the still high inflation in some countries, and the relatively weak private sector. For instance, the market potential of CEEC has been considered to be extremely high, but the MNCs in some of those countries have found themselves selling their products and services to people with stunningly low income by today's world standards. This, in effect, explains why the high expectations of many foreign-owned companies for skyrocketing sales are not met. Data show that even in the first very promising years of transition when there were projections made for a great consumer interest to foreign products and reforms seemed less painful, a major investor like Coca

¹ McMillan, C. *The East West Business Directory 1990/91*. Ottawa: Carleton University/Duncan

Cola has achieved sales of 6% and 4% for the years 1991 and 1992, respectively, instead the expected 10% and 8%². The operations of MNCs in the region have also been handicapped by the lack of developed distribution systems and the collapse of the existing infrastructure that CEEC are unable to maintain.

With a different pace and direction all CEEC are undergoing privatization of the state-owned enterprises which for the period of 1991-1994 has brought an overall of USD 8,6 billion in the region or 48,5% of the whole flow of FDI. The process of privatization has put a challenge before the MNCs investing in CEE – to integrate into the global network of their operations the acquired production and other facilities unsuitable in most cases for their global strategies. The disparity between the technological base of the appropriating and the appropriated enterprises constitutes a major problem for privatization. At the same time in the conditions of high risk and uncertainty a large group of MNCs prefer to enter the CEE market by acquiring existing plants and facilities rather than through green field investments.

MNCs are faced with the problem of management in their East European ventures. What is needed are high-quality managers with western know-how and a substantial work experience in East European markets but in CEEC there are hardly any such qualified top executives experienced in the tradition of the market economy³.

In the countries of CEE MNCs have to deal with different trade practices and customs, language barriers and cultural differences, lack of tradition in the business relations and lack of knowledge of the business partners. All of these turn business negotiations into an adventurous, lengthy and sophisticated process and market transactions into risky undertakings. Quite often an additional detriment is the unavailability of market information, while the shifting environmental conditions demand that firms maintain abundant data in their information systems.

As to the application of human capital, MNCs investing in CEEC have been challenged with a strong opportunistic worker behavior. In many cases the workers in the newly adopted plants do not have sufficiently good working habits, are not committed to

Publishing, 1991

² *USA Today*. Fountain of Growth Found Abroad, by Martha T. Moore, March, 1993

³ *Advertising Age*. Hiring the right exec tough in Eastern Europe, by Laurel Wentz, March 15, 1993, p. 11ff

quality and do not understand the mission or vision of western corporations. Whenever plans are made for restructuring the factories so that they become fit into the strategic plans of the adopting organization, the need has been for downsizing or for the re-qualification of employees and the result has always been the inevitable clash of employer-employee interests. Such a development in a region with a particularly high rate of unemployment, clearly defined unfavorable demographics and a weakening welfare system augments social tension with respect to MNC activities in the region.

Uncertainty for them stems from the constant political instability in most countries in the region, the change of governments, the lack of sound macroeconomic policies, the corruption in the state apparatus as well as the widely spread common crime.

Bulgaria's place in the overall FDI to CEEC is modest (Table 1). The inflow of investment into the country has been fluctuating for the ten years of transition, while the last two years have seen an essential increase - USD 505 million for 1997 and USD 401 million for 1998.

The Bulgarian economy has never been considered a potentially attractive market for big MNCs. The reason behind this fact is that the country has been for a long time too oriented towards the former Soviet economic zone and has not established any economic relations with big Western firms. However, this holds true for almost all countries in CEE and in the early 1980s when the shortcomings of the Soviet-type economic model outweighed its advantages, the economic and technological gap between Western and East European countries deepened dramatically. In 1986 driven by the need for changes the Bulgarian socialist government decided on a turnaround and issued the so called Decree 56 aimed at institutionalizing the new economic philosophy of the regime to a more balanced and Western oriented foreign economic policy. Decree 56 legitimized and promoted joint ventures with Western firms, thus giving way to interested foreign investors to enter the country. The Decree also encouraged local entrepreneurial initiative and the true outcome has really been a stronger influence on Bulgarians rather than on foreigners. Meanwhile, at least legally Bulgaria had opened itself to Western partners in the mid 1980s several years before political reforms were introduced.

Table 1. Flow of FDI in CEEC for the period 1987-1998 (million dollars)

Country from CEE	1987-1992 (average per year)	1993	1994	1995	1996	1997	1998
Albania	-	68	53	70	90	48	45
Belorus	-	18	11	15	73	200	144
Bulgaria	34	40	105	90	109	505	401
Czech Republic	533	653	868	2561	1429	1301	2540
Estonia	-	162	214	201	151	267	581
Hungary	675	2339	1146	4453	1983	2085	1935
Latvia	-	45	214	180	382	521	274
Lithuania	-	30	31	73	152	355	926
Moldova	-	14	28	67	24	72	85
Poland	183	1715	1875	3659	4498	4908	5129
Romania	61	94	342	420	265	1229	2063
Russian Federation	-	1211	640	2016	2479	6243	2183
Slovakia	91	168	245	195	251	177	466
Ukraine	-	200	159	267	521	624	743
Total for CEE	1576	6757	5932	14266	12406	18532	17513

Source: *World Investment Report*, 1999, p. 480

Table 2. Percentage regional distribution of the world flow of FDI

Region (country)	1995	1996	1997	1998
Developed countries	63.4	58.8	58.9	71.5
European Union	35.1	30.4	27.2	35.7
USA	17.9	21.3	23.5	30.0
Japan	-	0.1	0.7	0.5
Developing countries	32.3	37.7	37.2	25.8
Africa	1.3	1.6	1.6	1.2
Asia	20.7	22.9	20.6	13.2
Central and East Europe	4.3	3.5	4.0	2.7
Total	100	100	100	100

Source: *World Investment Report*, 1999, p. 20

Determinants of the Investment Climate and the Impact of MNCs' Activities on the Bulgarian Economy

Later on the Bulgarian Parliament passed the Law of Foreign Investment (1992) that was quite liberal and offered a package of tax and other fiscal incentives. However, the law did not succeed to attract huge amounts of investments. Bulgaria experienced the competition of its neighboring countries also aimed to attract investors with loose legislature. No matter how liberal, legislature turns out to not be a major determinant for FDI, whenever no quick and appropriate measures are taken to enforce it.

Political environment is a crucial factor on the sum of FDI as foreign companies expect a good political will and assistance from the government. In Bulgaria political stability was virtually absent since the country changed seven governments in ten years following the bipolar political model. This model involving two major opposing political parties, the Socialist party and the Union of the Democratic Forces, did not provide a stable ground for foreign investment to start and evolve. To the foreign investors political inconsistencies and turmoil turned out to be a major source of political risk.

The macroeconomic environment is not beneficial to MNCs either. Bulgarian market is too small in size and market potential can be considered low since income per capita is one of the lowest in Europe. There are no abundant natural resources in the country and substantial infrastructure changes have not been made. The competitive advantages of the country are too few, if none, and there are high transaction costs associated with the activities of MNCs on the Bulgarian market, something our empirical survey showed.

The years of reforms have seen some weak potential for restructuring and sustainable growth. The country was successful in liberalizing prices and in privatizing the state sector, though slightly later than the other CEEC. The process, however, was stopped in 1993 and 1994 when two governments – Berov's and Videnov's purposefully slowed the reforms, thus, giving birth to underground and criminal economy. The inevitable result was a negative growth, hyperinflation, and a soaring unemployment.

The currency board introduced in the middle of 1997 targeted economic and monetary stabilization but failed to generate growth. The newly elected democratic government of current Prime Minister Ivan Kostov attempted to attract some strategic investors by putting on sale the biggest and the most profitable state-owned companies. The loss of credibility from previous governments as well as the extremely unfavorable developments in neighboring Yugoslavia made these attempts futile and placed the country at the bottom of FDI rankings in the entire region.

Bulgaria ranks fourth from the bottom among CEEC with its low and rather cyclical rate of FDI representing just 2,5% of the GDP. In absolute terms the average sum for the period 1987-1992 is USD 34 million which in 1994 increased to USD 105 million, decreased to USD 90 million in 1995 and reached USD 109 million in 1996. The years 1997 and 1998 saw a substantial increase in the level of investment – USD 505 million and USD 401 million respectively. Geographically the investment originates mainly (63%) from the European Union countries, namely Belgium, the Netherlands, and Germany.

The structure of FDI in Bulgaria shows fragmentation and absence of strategic or leading investors that can offer the country a bundle of services necessary to establish a competitive and dynamic market. Most of the investments are small in size and a large part of them come from Russia, Turkey, and Greece. They are concentrated in industries such as trade, services and light manufacturing where there are market niches and opportunities for quick transferable profits gained at a low risk. Similar to all countries in CEE most foreign-owned capital in the country is privatization-led, though there are a large number of green field investments.

The absence of the biggest MNCs in the Bulgarian economy can be considered one of the essential factors for the downfall of market reforms. As it was already emphasized, MNCs inject not only capital into an economy but also invisible assets – technology and know-how, management skills and market culture, all so fundamental to the process of marketization and integration of the country into the global economy. The internalization of operations within large multinationals symbolizes efficiency that serves as an example for domestic firms. On the other hand, in-country competition becomes

more vigorous with the participation of MNCs turning to be a stimulus for local firms to enhance their market strategies and innovate their production base.

MNCs make a difference in the labor market as well. Besides generating new employment they elevate local wage rate, thus, stimulating the qualitative characteristics of labor force. With their presence on a market MNCs affect local consumption as well as the world standardization of local production. The high quality of the foreign goods and the transfer of technology become driving forces for economic development. Local firms can be competitors to MNCs but they can be their partners, too. MNCs corporate culture affects local environment and there have proven to be mutual influences between corporate and domestic culture. This is especially important for a country like Bulgaria where concepts like rational behavior, benefits and costs and market culture are hardly understood and where market institutions are perceived as the mere source of exploitation rather than as a means of achieving economic progress. The importance of MNCs' tangible and intangible investment in Bulgaria is crucial. The absence of serious MNCs ten years after the start of transformations sets the task to investigate the reasons and the obstacles that hinder their development strategies.

Methodology of the Empirical Survey of MNCs in Bulgaria

The aim of the study of MNCs in Bulgaria is to measure the level of transaction costs these companies face in using the Bulgarian market mechanism, the uncertainty and risks associated with the Bulgarian market environment as well as the institutional setting surrounding MNCs. In this sense, some major issues tackled are MNCs' access to market information, transaction and commercial risks, moral hazard and opportunism in business relationships, the role of the Bulgarian court system in defending property rights, the role of state institutions in the fostering of market economy as well as in the development of infrastructure. The survey represents a cost-factor investigation introducing transaction costs as the dominant costs. The scientific hypothesis behind the survey is that transaction

costs in their theoretical meaning articulated by R. Coase⁴ as the costs of using the market mechanism are high in the Bulgarian case which makes the local market a costly mechanism for MNCs to use.

To achieve the above-mentioned goals of the study a data processing project was formulated stipulating the methods and techniques that will be used, the relevant program data will be entered into as well as the types of statistical analysis to be applied. The major tool to processing the collected information was the SPSS 5 Software for the environment of Windows 95.

Data were subjected to appropriate tests to measure statistical significance -- χ^2 -test and Kolmogorov-Smirnov-test for nominal and for ordinal scales, respectively. The type of analysis that has been applied is classificatory and the major strategies used are the descriptive and the experimental ones. The data collection method is a specially designed questionnaire sent to the responding firms through mail and other channels. The method was chosen in that it appears to be very suitable for the descriptive strategy and adequate for the experimental one.

The population of the survey comprises 51 foreign multinational firms that have invested in Bulgaria and have been registered by the National Statistical Institute and the Foreign Investment Agency by September 1, 1999. Each of the firms has made an overall investment exceeding USD 1 million, a size allowing the Agency to classify these firms as major or top investors. The survey was conducted in the period January 15 - February 15, 2000.

To insure multi- or transnationality the researchers have picked two criteria – an investment threshold of USD 1 million and a requirement for at least 2 subsidiaries to exist. Although the two parameters are rather broad, they have been used as a framework for the study in an attempt to cover a larger population as well as to stress that it is not the size of the investment but rather the package of services provided by MNCs that influence the host country's performance. In the "passport" or identification data at the end of the questionnaire two additional questions have been asked related to the size of

⁴ Coase, R. H. The Nature of the Firm. *Economica*, 1937, pp. 386-405, reprinted in *The Firm, the Market, and the Law*. The University of Chicago Press, Chicago 60637, 1988

the investment and the number of affiliates (questions 43 and 47). All respondents satisfy the two criteria.

The sample basis is a list of all major investors with their names, addresses and contact persons, while the sample is a simple random one suitable for the small number of companies surveyed. The size of the sample includes 46 firms selected randomly.

In order to quantify the opinions and the assessments of the company managers on the level of transaction costs and uncertainty of the Bulgarian market mechanism a 5-rank attitude scale has been used in the first part of the questionnaire (questions 1-24) – from 1 (strongly disagree) to 5 (strongly agree). The rationale behind choosing this scale is that it can measure most precisely the subjective opinions of the interviewed corporate managers.

Questions 25-42 concern estimates for which nominal, interval and proportional scales are required. In order to simplify the statistical analysis, the more complex scales have been transformed into simpler ones like nominal and ordinal scales.

Questions 25, 27, 30, 33 and 39 allowed for more than one answer. Since the respondents could check several different options, the total number of answers went over 100. The analysis traces the most repetitive answers.

Questions from the last sections of the questionnaire (43-53) were designed to identify the company and concern the transnationality criterion. More specifically, those are question 43 about the size of the investment, question 45 about the home country or the country of registration of the firm, question 47 about the total number of subsidiaries as well as question 48 about the nationality of the managers or the managerial mix. The factual criteria were used in addition to the two major criteria for transnationality in the last stage of statistical processing when data were adjusted in cases where firms did not provide full or precise answers to the questions dealing with the two characteristics.

Questions 50, 51 and 52 are open questions providing foreign managers with the opportunity to express their opinions in a free form. They concern the costs of using the market mechanism in Bulgaria, the usefulness of governmental agencies as well as the company expectations about the role these institutions should play in guaranteeing the principles of market economy.

Question 53 identifies the industry or sector of the Bulgarian economy in which the foreign investment was made. The formulation used complies with Nomenclature B 40 of the aggregated industry groups of the Statistical Yearbook of the Republic of Bulgaria⁵.

Depending on the selected scale the questions have been tested to check their statistical significance. Questions 1-24 on the ordinal scale have been subjected to the Kolmogorov-Smirnov test, whereas all of the rest with the exception of the multivariate questions (25, 27, 30 and 33) have been tested through the χ^2 -test⁶.

Bulgaria as a Host Country for MNCs

More than half of the studied MNCs in Bulgaria confirm that market information is accessible to them (56,5%), while the other half (43,5%) think there is no access to it. Some 90% of the interviewed companies consider information about Bulgarian market to be their strategic competitive advantage, which means they appreciate the role of market information and are likely to overcome uncertainty with its help. The annual costs for gathering the information are rather high by Bulgarian standards. Some 17,4% of the firms spends more than USD 20,001 on market information. The same percentage spends between 10,001 and 20,000 and more than half (59%) spends less than USD 10,000. Most of the money goes to consulting services (30% of all information costs) and 70% of that goes for the use of lawyers.

Only a very small number of firms (5%) report they do not maintain information bases. Information becomes crucial in overcoming market risks and MNCs in Bulgaria tend to take informed decisions. The range of information collected is wide – firms collect data on the peculiarities of demand (80%), the general environmental conditions (71,1%), and competition (63%). The use of large databases is consistent with the

⁵ *Statistical Yearbook of the Republic of Bulgaria*. National Statistical Institute, Sofia, 1999

⁶ With the help of the Kolmogorov-Smirnov test we have found that questions 1-24 show statistically significant difference in the opinions and can be interpreted at an accepted error of 5%. For the nominal χ^2 -test the alternative hypothesis H_1 has been confirmed for questions 26, 28, 29, 31, 35, 36, 37, 38, 40, 41, 44 and 49. These questions are analyzed in the paper. Questions 32, 34, 42 and 46 did not prove to be statistically significant and only few of them are mentioned in the analysis.

tendency for large global corporations to maintain powerful information systems, even more powerful than those of some governments in the world⁷. Question 27 concerns the sources of this information and a large number of companies (44,4%) have responded they use untraditional sources such as field surveys and marketing research conducted by their marketing or sales people. A unique source of information, we found out, are the many personal contacts MNCs' top managers have established with local officials or businessmen.

Still, the most trivial source of information are the chambers of commerce and various business associations (to some 64,4% of the firms). Second, MNCs (46,7% of them) accumulate data from state institutions, which gives an idea of the secondary role the government plays with respect to information necessary to MNCs. A third source of market data is scientific research but the small percentage of firms (17,8%) referring to it speaks of an inconsistent and rather weak link between MNCs and scientific institutes in the country.

As to the use of market consultants, 49% of the observed corporations turn to Bulgarian market consultants. In 80% of the cases they need juridical advice from these consultants. Around 68% are using multinational consultants on issues concerning their activities in Bulgaria. Only in 2,3% of the cases firms do not refer to consulting agencies. For most MNCs entering Bulgaria consultants with their expertise in the area of marketing, accounting, finance, and law seem to be an inseparable part of the business. Their importance becomes strategic in the attempt of the company to settle down and adapt to local conditions.

The prevailing opinion (80,4%) is that establishing business contacts in Bulgaria is easy and the firms do not seem to encounter high search costs. Time is an essential element of those costs and for half of the firms (56,5%) only 1 to 6 months are needed to locate a business partner, while 34,8% of the firms need less than a month. Only 8,7% of all companies spend nearly a year to find a truly reliable partner but no more than that.

Negotiations are smooth and easy for the majority of respondents (56,5%) but the other 43,5% find a lot of difficulties in the negotiations with their Bulgarian partners. The

⁷ Root, F. R. *International Trade and Investment*. South-Western Publishing Co., Cincinnati, OH, 1990, p.

reflection of that on the *ex ante* transaction costs for the conclusion of the deal and the formulation of the contract is these costs increase substantially.

For a large part of the firms (68,4%) the difficulties stem from the lack of understanding in their Bulgarian partners of the principles of the market economy. It can be inferred that Bulgarian firms are still inexperienced, there is no market tradition in the country and market institutions have a short history. According to some 44,7% of the investigated firms the problems arise from the inability of Bulgarian partners to negotiate, for 34% it is the contradicting business interests that generate those problems. Only to a small number (23,7%) the language barrier is an obstacle to the negotiations. In the meantime the greater part of the investors consider communicating with Bulgarians to be easy, whereas only 28,3% disagree with that.

The length of actual negotiations seems to be great for almost two thirds of the interviewed MNCs. The delayed negotiations can directly be associated with high transaction costs, which means less exchange, less specialization, and less produce⁸. Concluding a commercial contract takes an average of 1 month for 74% of the firms, only 1 week for 17,4% and 1 year to 8,7%. No company has reported to negotiate for more than a year.

The approximate costs of negotiating a single transaction are around USD 500 for half the firms, from USD 501 to USD 1000 for one fourth of them and only some very big companies spend more than 1000 on a particular deal.

The preferred mode of negotiating is face-to-face (91%) and only 8% have a preference for correspondence. Not a single firm opts for negotiating on the phone. The managers seem to prefer the real contact with their partners but the high risks force them to maintain a certain degree of security through the use of correspondence and official business documentation.

Business ethics and trust among partners are essential determinants of transaction costs in Bulgarian economic reality. More than half of the firms (54,3%) deny the existence of business ethics and trust in their partner relations. The result reveals a very

negative characteristic of the economic environment in the country. It also gives an idea of the high commercial risks MNCs are facing in their operation in Bulgaria.

Despite the lack of trust non-compliance with the contract is rather a seldom phenomenon for most of the firms. Only 26% of the firms claim their partners violate contracts on a regular basis. This, in itself speaks of relatively low *ex post* costs. Nevertheless, to the overwhelming part of the responding firms (74%) contracts are breached more often by Bulgarian firms rather than foreign. The ultimate result is the drive for MNCs to substitute Bulgarian firms with non-Bulgarian, whenever possible. It can be concluded that transaction costs resulting from partner opportunism may be substantially higher in Bulgaria than elsewhere.

In the context of transaction costs illegal payments made for doing business, entering a market or concluding a contract, constitute an implicit transaction cost. Corruption seems to be an essential characteristic of the business environment in Bulgaria. Question 39 states “Did you have to pay sums to governmental officials or other authorized persons?” The answer is positive for 11,4% of the respondents most of whom have had to make illegal payments for the resolutions of legal or commercial disputes as well as for the smooth running of their business. None had to pay for the conclusion or the extension of a business contract. Nearly 25% have not answered the question. A conclusion can be drawn that corruption truly exists in the state apparatus in Bulgaria and it increases dramatically the transaction costs for doing business in the country.

To defend their business interests companies refer to contract clauses of force majeure, penalties, and sanctions. Only one fifth of the MNCs claim they take advantage of such clauses whenever business partners do not observe contracts properly. The majority follows contract observance through the hiring of a company lawyer (54,3%) or through a whole juridical department (17%). A significant number of MNCs (28,3%) prefer to use an independent legal consultant and have not employed lawyers the reason being that MNCs are just starting up their activities in the country. No firm has reported to ignore contract observance and all receive some form of legal advice.

The role of law and jurisdiction is essential in a market economy in that the laws and the court system provide the basis for establishing and defending the property rights

of economic agents. It is interesting to consider juridical institutions as part of the institutional setting of MNCs in Bulgaria. Less than half (43,5%) of all interviewed firms respond they refer to the Bulgarian legal institutions with respect to commercial disputes. The other 56,5% of them deny to have used the Bulgarian court system at all. The high costs of following legal suits together with the high costs of those suits determine a higher level of the *ex post* transaction costs. The explanation may be that a great number of Bulgarian partners are relatively diligent but it may also be the case that the Bulgarian courts are inefficient and cannot meet the expectations of big foreign investors. It is possible that firms use other means to settle commercial disputes or do nothing to resolve them. A further effort could be for them to turn to international institutions. An interesting fact, however, is that neither of the observed firms has ever turned to those institutions. This may be due to the lack of serious infringements of contracts but also due to the high costs of solving the dispute in international conditions. In other words, it seems as it may do less harm to the affected party to bear the losses from the contract rather defend its interest through an international legal authority.

The annual losses incurred by MNCs due to contract breaches account for nearly 90% to less than USD 50,000. For a small number they exceed the level of USD 100,000. Twelve of the examined 46 firms have turned to Bulgarian jurisdiction once, 5 firms have done this twice, 4 firms – 3 times, and another four - more than 3 times. The duration of those disputes has been for 60% of the firms from 6 months to 1 year, for 17% the time span is less than 6 months and for the remaining 23% this takes more than a year on average. The empirical data do not show an inefficient and a bureaucratic legal system as we find 6 months to be a reasonable time to reconcile conflicts of this kind.

The overall opinion for a high level of transaction costs of doing business in Bulgaria is supported strongly by 90% of the responding managers. Foreign firms are confronted with a considerable risk in their Bulgarian-based operations and a high degree of market uncertainty, which was the initial hypothesis. To some extent, uncertainty results from the insufficient knowledge of MNCs about local conditions and trade practices, as well as from the tremendous differences in the environment in the home and

the host country. To a prevailing portion of the MNCs (80,4%) business environment in Bulgaria is much too different from the one in their native country.

MNCs are equally divided in their judgment on the effectiveness of the Bulgarian government and state institutions with respect to MNC activities. Some 52,5% maintain that these institutions operating in the sphere of the economy are not useful to them in their activities. The remaining 47,8% opposes this view. The Foreign Investment Agency designed to be a supportive tool for foreign investors discovering the country seems to have a low reputation among those it is supposed to help. Though a large group of investors define the Agency's contribution in the form of general information, consultation and other assistance to be essential, the majority (59,5%) express negative attitudes to it. In comparison to other governments and institutions around the world Bulgarian state institutions rank much lower. Only 8,7% of the firms consider them to be more efficient than foreign governments.

A general conclusion can be made that MNCs in Bulgaria are challenged with strong partner opportunism, inefficiency of the state institutions which is a factor of the feeble role the government and the law play in the economic mechanisms, as well as with higher transaction risks and uncertainty. The corporate managers who have been questioned consider the market mechanism to be a more costly instrument and, relevantly, transaction costs to be higher than in other countries.

Communications and infrastructure having a direct impact on the level of these costs seem to be unsatisfactory to the leading foreign investors. Only one third finds that the level of communications is good enough and 8,7 support the same opinion for the existing infrastructure. Question 24 states: "Your activity is largely related to the transfer of technology." It is answered positively by approximately two thirds of the respondents. Some 45% see technology transfer as the most important part of their activity.

Definitely, MNCs in Bulgaria are confronted with a large spectrum of obstacles – economic, legal, political and cultural, hindering their future development strategies. Half of the surveyed firms are planning to expand their activities within one year, 43,2% within a period of 2-5 years and only 2,7% have no intentions for growth.

Related to expansion plans are the opinions the foreign investors have expressed when answering the open questions. The prevailing recommendation is for privatization procedures and communication with MNCs to be more transparent with a strict adherence to the Law of Competition and local antitrust policies. The dialog, foreign managers state, can be led through the intermediation of organizations such as the Bulgarian Chamber of Commerce and Industry and the Bulgarian Industrial Business Association. A further suggestion is to monitor closely corruption and the way the court system resolve cases. Asked about their expectations for the role of government, most MNCs share they expect it to be more active in setting-up the legal framework and market mechanisms, in enforcing the economic laws as well as in exercising tight control over the informal sector. The MNCs desire more and easily accessible market information, better communications, more developed transportation systems, and less disloyal competition.

The identification questions toward the end of the questionnaire build up the profile of the MNC population. It comprises firms investing USD 1-44,5 million where investments up to USD 2 million account for 30% of all included in the sample, while those over USD 10 million represent 34%. The highest number of firms (19,6%) has 2 subsidiaries on average, 15,2% have more than 8 subsidiaries, and 11% - over 50 affiliates.

The type of the investment made is a direct investment in production for 90% of the MNCs, a form of licensing for 7%, and a commercial office for only 2,3%. The companies send to Bulgaria their native-trained managers who keep a strict control on production activities. The impression is MNCs prefer to maintain wholly owned enterprises, while avoiding the licensing of their technologies, patents and know-how or the franchising of their trade or brand names. It seems extremely difficult for them to use their specific assets efficiently in an environment where property rights are not guaranteed. Rather, the possibility to exert direct control would drive them to expand the scale and the scope of production.

In geographic terms the MNCs originate from many different countries - USA (9 companies), Germany (4), the Netherlands (4), Turkey (4), Belgium (3), Austria (3),

Greece (3), Cyprus (3). A small number of firms come from countries like the United Kingdom, South Korea, France, Sweden, Denmark, Switzerland, etc.

An interesting characteristic of the studied multinationals is the mix of their managers in terms of nationality. The majority of the companies rely on an “international” or a “mixed” management, some of the companies such as McDonalds and DHL involving people of almost all nationalities.

MNCs have allocated resources to all sectors of the national economy, the major part concentrated in the light industry and services. An even number of firms (22,7%) has invested in commerce and in the production of foods, beverages, and tobacco. There is a considerable number (9,1%) investing in the production of pulp and paper products as well as in the printing and publishing industry. Some of the MNCs have been attracted by the copper and lead-and-zinc industry in Bulgaria and are concentrated in the production of ferrous and non-ferrous metals (6,8%). The same number of firms has invested in hotels and restaurants. Slightly smaller is the group of MNCs (6,5%) present in communications, whereas the share of MNC capital in the textile and apparel industry, wood produce and chemical industry is insignificant.

The Role of State Institutions

It is a major task of government in the economy to establish and guarantee the property rights of economic agents. As R. Coase put it, the higher the level of transaction costs, the greater the role of the institutional and legal system⁹. Depending on the laws in a given country is what is traded, by whom, where and under what conditions. This determines the tremendous significance of Bulgarian state institutions in the establishment of a competitive market, in the adoption of rational economic laws and norms, and in the enforcement of those laws with respect to property rights, business practices and contracts.

The state is a silent participant in all market transactions and its part in the establishment and the exchange of property rights is critical for the smooth functioning of

the market¹⁰. The role of government is, therefore, to be an intermediary in the process of exchange but it could be the case that the government is not able to perform this function at its best. Just like the market may fail to achieve efficiency in the process of resource allocation, the government may fail to reach the optimum result of its efforts¹¹. In this sense, a very precise estimation of the role of the post-communist state in the direction of markets is given to us by J. Kornai. He says that the state cannot find its place in the social and economic processes taking place in the newly democratic countries. To J. Kornai the post-communist state is pointlessly active whenever there are no grounds for that and passive in areas where governmental regulation and control, temporary or permanent state intervention are urgent¹². The lack of experience in the newly established democratic state institutions is the reason for them not to perform their tasks successfully.

The more restrictive the laws and the norms, the higher the transaction costs for the participants in the exchange and, consequently, the lower the benefits of a transaction. A more “active” state in the context defined by J. Kornai may bring about restrictions on exchange and, hence, may shrink the market. In the event of exceptionally high transaction costs like those in Eastern Europe there will be no benefits to a transaction so there will be no market. Whenever legislation is liberal, the government has given way to trade and it could be expected that there will be greater benefits to the transacting parties. The task of the government would, therefore, be to establish the rules and procedures of exchange, everything else being free, and then follow conformity with them. It seems like in the conditions of high transaction costs the post-communist state has to provide liberal laws to promote exchange and guarantee it is being done properly.

A favorable condition for the flow of foreign investment is the degree to which laws are enforced in a country. Bulgarian laws are changing all the time in the attempt of the country to adopt the European Union legal framework as part of its integration with the Union. However, it is not the contents of laws but rather their observance that make a

⁹ Coase, R. H. Notes on the Problem of Social Cost. *The Firm, the Market, and the Law*. The University of Chicago Press, Chicago 60637, 1988, p. 178

¹⁰ Hyman, D. N. *Microeconomics*. Irwin, Burr Ridge Illinois, 1994, p. 115

¹¹ Coase, R. H. Op. cit., p. 70

¹² Kornai, J. *Highways and Byways. Studies on Reform and Post-communist Transition*. Chapter 8, *Post-socialist Transition: An Overall Survey*, Cambridge (Mass.) MIT Press, 1995, p. 163

country appealing to the external investors. Therefore, the role of the court system should be revised so that it performs its controlling and regulating function better. The resolution of commercial disputes in Bulgaria is hindered by slow procedures and corruption in the system. What is needed is to speed up the process, while bringing down bureaucracy toward the creation of a smooth and flexible court system.

The surveyed MNCs in Bulgaria declare state institutions are less efficient than those in other countries. Other things being equal, investors would be likely to move to countries where governments work better. As was already mentioned, in the conditions of high transaction costs the government with its attitude can turn into a major driving force for the foreign investment to be made. The Bulgarian government being less concerned with the problem of fair competition and the rules of exchange, is a detriment to the success of economic reforms and growth generated with the help of MNCs.

Governmental assistance for MNCs is mainly in the form of market information that should be abundant and freely accessible. The assessment of the MNCs' managers is that Bulgarian state institutions, namely the Foreign Investment Agency, are not very helpful with information and consultation. The data MNCs receive seem to be disorganized and unsystematic. To ease the use of information the government can address the investor in his own language; to speed up the exchange and transfer of information it can adopt modern systems and communication technologies based on computer networks and the Internet. Through those systems MNCs would learn much faster about the terms of trade, traded volumes, prices and trends, laws and incentives. The introduction of such systems will require substantial financial, technological and human resources but the payback will be invaluable to the economy.

The role of information is crucial in the process of privatization as well. MNCs plead for transparency and clarity. The problem of the openness of privatization deals is interrelated with the problem of corruption in Bulgarian economy. Since corruption brings up transaction costs, it is a major detriment to exchange and the imports of FDI. Corruption is a high-class crime associated with the state apparatus but not the only type of crime. The extremely high current rate of common criminality in Bulgaria is another threat to foreign firms. Taken together, crimes create a very unsafe climate for the

activities of MNCs. It is the responsibility of the court system to discourage the improper use of their specific assets. It is the general impression of MNCs that the infringements of their property rights such as those over new technologies, intellectual or industrial property will always be unpunished in a country like Bulgaria.

Advanced communications can give an impetus to foreign firms. Communications can be improved substantially by replacing the old analogue phone systems with new modern digital ones, with the adoption of cellular and mobile phones. The infrastructure consisting of the railroad and road network, the electricity and the water-supply systems is as important to the activities of MNCs. Without the necessary infrastructure base there could be no factor transfers from one spot to another which hinders the allocation of factors at a great geographic distance. MNC's activities are geographically dispersed and their production in our country cannot be separated from the entire production cycle taking place within their global structures. At the same time the lack of convenient transport infrastructure is an impediment to the transportation of raw materials, components, parts, semi-finished or finished products within or outside the country. The recent developments are promising in that there may be opportunities for improving the road system through the trans-Balkan and trans-European transport corridors. In their endeavor to restore local economies after the destructive war in Yugoslavia the Balkan countries are looking for ways to materialize large-scale transport projects within the framework of the Schifter initiative. The idea is to create stronger linkages among Balkan countries, which will undoubtedly foster their economies in a formerly war-torn region.

The general recommendations for the Bulgarian government toward an improved institutional setting on MNCs in the country concern the fostering of competition, the availability and access to market information, the protection of property rights, the advancement of communications and infrastructure as well as the overall improvement of the social environment for business.

It is essential, in our view, to study the significance of state institutions in the MNCs' performance in a world of high transaction costs. According to T. Eggertsson without the state, its institutions and the framework supporting property rights the invariably high transaction costs will paralyze the complex production systems and,

hence, the specific investments giving birth to long-term exchange relations will not be made¹³. In the absence of transaction costs economic growth and development do not depend on the type of government or the democracy of the political system. However, when the notion of positive transaction costs is introduced the type of the ruling government, the distribution of political power in the state and the structure of its legal and economic institutions are major factors of economic development.

Some Concluding Remarks

The analysis of MNC's activities in Central and East Europe and their impact on the transforming region shows that MNCs can play the role of a decisive factor for the direction of reforms. MNCs are seen as importers of a full package of business services including capital, technological innovation, marketing power, management know-how, cultural influences and exchanges.

To attract large investments local countries should not just try to offer incentives as a carrot to MNCs but rather they should strive to establish a normal market environment and institutional setting in which MNCs would be more willing to operate in the conditions of fairness, openness, and competition. The efforts should be directed toward the improvement and advancement of market institutions in the region lacking tradition in the realm of the market economy.

For one reason or another Bulgaria is one of the CEEC in which MNC's activities are not expanding with the size and speed the government wishes as the transaction costs of doing business are extremely high and the market mechanism is inefficient. The foreign investors are faced with high risks of legal, cultural, and ethical nature. In their institutional setting MNCs are surrounded by inefficient and corrupted governmental institutions and local firms to which the principles of market economy are rather vague. The ultimate conclusion is that the institutional setting for MNCs operating in Bulgaria is crucial to their success. The task of the Bulgarian government is to lead an effective

¹³ Eggertsson, T. *Economic Behavior and Institutions*. Cambridge University Press: Cambridge, 1990, p. 317

dialog with investing MNCs, while trying to create a safe and friendly environment for their investments.

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