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# Bulgaria:

## Background Notes on the Housing Sector in a Reforming Economy

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## **ECONOMIC OVERVIEW<sup>1</sup>**

### **Organizational Reforms**

Bulgarian economic reform has been on hold waiting for the national elections in June and for the organization of a new government in July.<sup>2</sup> The referendum on economic reform in Bulgaria is not as clear as that provided by elections in Czechoslovakia, Hungary and Poland. Reform initiatives had already been planned and were moving slowly. The slow pace of reform and re-election of the communist party may indicate a preference for slow change. Once the new government is in office, future reforms will likely go further but still at a modest pace.<sup>3</sup>

Past Bulgarian reforms have been modest compared to those in Poland and Hungary. It has indicated a commitment to move toward free markets, but specific details remain vague. An illustration is offered by a paper, "New Legislature Opens up Bulgarian Economy," released in early 1990 by Bulgaria's Vice Minister for Foreign Economic Relations, K. Glavanakov (1990). The paper emphasizes four objectives—(1) free markets, (2) competition, (3) decentralization, and (4) financial, monetary and interest rate reform—and glosses over policies and programs. The country is discussing reform measures earlier used or considered by a number of other Eastern European countries. For example, Bulgaria plans to hold limited auctions for currency and to tax firms that increase wages in excess of a cap. It also plans to establish centers to provide assistance to dislocated workers.

Like other Eastern European countries, Bulgaria has in the past discussed numerous economic reforms, attempted some and implemented fewer. Past Bulgarian reforms are modest and include: pay incentives for workers, increased reliance on worker self-management in enterprises, and specialization in banks and

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<sup>1</sup> Unless otherwise indicated economic data are from EIU (1989, 1990).

<sup>2</sup> Bulgarians voted in first-round elections June 10 and in runoff elections June 17 to select the 400 members of the Parliament (National Assembly). The Socialist Party—Bulgaria's former Communist Party—won a majority in the Parliament; but an opposition coalition, the Union of Democratic Forces, made a formidable showing winning 144 seats. The role of the opposition in the new government remains an important issue.

<sup>3</sup> Mr. Kluranov, a leader of the Socialist party, stated that "They would starve if we begin now with shock therapy." (Reported in an interview with the New York Times on June 15, 1990.

financial enterprises.<sup>4,5</sup> Bulgaria has been in the process of encouraging enterprise in agriculture and lifting restrictions in the area.

The pace of economic reform tracks Bulgaria's problem with foreign debt, now totaling US\$11 billion. Its rising foreign debt coincides with a reduction in Soviet trade and assistance. Overall the economy remains firmly in the centrally planned mode and confronts major problems in attempting the transition to a market orientation.

### **Private Sector**

Revolutionary reforms permit the ownership of private real property and treat it with no additional restrictions. Bulgaria had permitted private *personal* property prior to 1990 reforms. Personal property included homes, apartments and small shops. And, as discussed later, the preponderance of Bulgaria's housing is owned by individual occupants; 88.5 percent was privately owned in 1974. Bulgaria has not dealt with the matter of transferring state property—housing and non-housing—to the private sector.

Foreign ownership of critical property (for example, water, land, and minerals) is restricted. Foreign ownership in joint ventures (up to 49 percent) or leasing would provide foreign owners access to the restricted properties.<sup>6</sup> Bulgarian firms were recently permitted to issue equity stock, but the procedure was envisioned to accommodate foreign rather than domestic investors.

### **Economic Performance**

Recently the Bulgarian economy has faltered badly. Growth is stagnate and foreign debt burdens the economy. In the past Bulgaria imported from the West and exported to the Soviet Bloc countries. Table 1 presents data on economic performance.

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<sup>4</sup> Self-management is examined in Petkov and Thirkell (1988). A conceptual treatment is offered by Wallamann and Stojanov (1989).

<sup>5</sup> Information on the amount of pay incentives is provided by Debroy (1984). The share of earnings was stable in the period 1960 to 1980 at approximately 65 percent of total income. Bonuses constituted 11.8 percent of earnings in 1980, a decline from 1975. In the period 1960 to 1980 the minimum wage was roughly 50 to 60 percent of the average wage.

<sup>6</sup> Decree 56, adopted in 1989, opened the door for foreign investment; however, marginal tax rates were prohibitive. The tax rates were lowered in 1990 but indicate the sort of administrative complexity Bulgaria must confront.

**Table 1**  
**Domestic Economic Indicators**  
(percent change from previous year)

	1987	1988	1989a	1990b
Real NMP	5.0	2.4	-0.4	-6.0
Gross Fixed Investment	10.7	13.7	-7.7	-20.0
Real GNP (1987 prices)	0.6	1.7	-0.4	-6.0
Industrial output	4.2	5.2	1.0	-5.0
Consumer prices	0.0	-0.1	3.0	10.0
Nominal earnings	4.0	3.3	5.3	5.0

a estimated; b projected

Real economic growth was negative in 1989; Net Material Product (NMP) declined 0.4 percent compared to the preceding three-year growth rate of 4.3 percent.<sup>7</sup> Investment also dropped sharply. Despite the decline in growth, an increase in nominal wages provides a greater reserve of liquidity to fuel inflation in the future. Some estimates indicate there will be greater inflation and less growth (Perry et al, 1990).

Bulgaria's population has been roughly constant, increasing only 0.8 percent between 1980 and 1985. In 1985 Bulgaria's population was 8.9 million and the largest city, Sofia's, the largest city, was 1.2 million, 13 percent of the country's total population. Bulgaria has become increasingly urban. Urbanization increased from 24.1 percent in 1946 to 64.9 percent in 1985. In the five year period 1980 to 1985 Sofia increased 4.9 percent compared to Bulgaria's 0.8 percent increase.<sup>8</sup> Bulgaria's total employment has declined slightly due to the long-term decline in its birth rate. Child allowances are provided to encourage population growth. Female employment is already 49.2 percent and cannot counter the downward trend. In

<sup>7</sup> NMP is a national income measure similar to GDP, but accounts only the material value of output (i.e., NMP is equal to GDP less: excess value of non-material services (domestic and net imported); consumption of fixed capital; and transfer costs of existing fixed capital (see United Nations, 1989a).

<sup>8</sup> See Ganey (1989) for a discussion of the Bulgarian population's changing spatial distribution.

addition almost one-half million Turks have left the Bulgaria in the past few years.

### **Industrial Composition and Employment**

The Bulgarian economy is modeled after the Soviet economy. Following World War II, Bulgarian economic strategy concentrated on developing industrial capacity. And the bulk of Bulgaria's Net Material Product (NMP) is now in the industrial sector (for example, heavy machinery, etc). Agriculture is organized into approximately 300 large complexes and more than 12 percent of cultivated land is farmed on private plots. Table 2 presents data that describe the industrial composition of the economy.

**Table 2**  
**1987 Sector Net Material Product and Employment**

	Percent NMP	Employment (thousands)	Employment (percent)
Agriculture	12.6	850	20.7
Industry	60.6	438	35.0
Construction	9.6	363	8.8
Transport	7.6	304	7.4
Trade	7.5	368	9.0
Others	2.1	786	19.1
Total Employment		4,108	

### **Prices**

Official claims indicate controls have been lifted from about 40 percent of prices, but controls have been retained on crucial consumer goods (Galavanakov, 1990). Inflation does not yet appear to be a serious problem; but the 1990 forecast is 10 percent. Perry, Koleva and Popov (1990) estimate a higher inflation rate, 15 percent. And as much as another ten percent annual inflation may be "hidden" by declines in quality and by grey markets. When controls are fully lifted, inflation and unemployment will no doubt rise. Goods are in short supply, and liquidity held by Bulgarians exceeds the country's total annual consumption expenditure. However, the demand for transaction balances in a shortage-economy such as

Bulgaria may be large.

### **Fiscal**

Bulgaria's foreign debt has become one of the major driving forces in its economy. The country owes almost US\$11 billion in foreign debt. The debt has been accumulated in a few years, beginning in 1986 at a rate of US\$2 billion per year. The debt was incurred as exports declined during the same period Bulgaria was forced to import more crude oil from the Middle East (as the Soviets had stopped providing cheaper, refined oil). The Soviets are now demanding payment in hard currency for fuel and raw materials.

Bulgaria's annual long-term debt service is about US\$2.2 billion which soaks up roughly 75 percent of the convertible currency current account receipts. Total annual debt service is estimated at US\$3.7 billion of which interest comprises 37 percent. Interest payments are on the order of US\$1 billion dollars a year—one half of Bulgaria's hard currency earnings. The Foreign Trade Bank of Bulgaria has stopped debt service payments amounting to more than US\$3 billion annually. The country is seeking to restructure its debt payments and wants to postpone principal payments for two years.

Bulgaria has applied for World Bank membership and will also request US\$1.5 billion in assistance to service the debt. World Bank and IMF membership and assistance could come as early as September 1990. However, a loan to pay debt service would be tied to restrictions on its economy.

Bulgaria's debt position illustrates the difficulties which foreign debt poses to other Eastern European economies. Interest rates will be allowed to drift up to market. Authorities will insist on convertible currency which will be necessary in the absence of the dominant Soviet role. A first step taken in freeing the exchange system has been to hold limited monthly currency auctions.

### **Finance and Banking System**

Bulgaria established commercial banks three years ago and these could provide a starting point for a capital market which would allocate savings and credit to enterprise investments on the basis of highest expected returns. But that would require many changes.

The Bulgaria banking system has been evolving swiftly toward a Western prototype, but with some important differences. In addition to the central bank, the Bulgarian National Bank, the country has seven large industry-related

commercial banks and a number of local banks recently established by dismantling part of the central bank.

Banks are socially owned but pyramid holding arrangements concentrate control. The control is vested in "owners"—large banks, particularly the central bank, and large enterprises. The commercial banks' directors, creditors and borrowers overlap. The banks have had little latitude in allocating funds; allocations conformed to centralized economic plans. However, banks now are to have more autonomy in client selection. The control structure in the banks—the dual lender and borrower role—is likely to create a decision-making environment which generates conflicts of interest and the attendant inefficiencies. The existing system is more suited as a credit distribution network which allocates based on command and control rather than to provide lending institutions in a capital market. The specialized commercial banks can support staff knowledgeable in industries but is also likely to generate loan portfolios which are not well diversified. In complex financial markets individual investors can efficiently diversify their portfolios. However, investor portfolio diversification and the underlying institutions are unlikely to develop quickly in Bulgaria.

The Bulgarian National Bank (BNB), the central bank, conducted central bank and investment bank functions until 1987. Economic reforms in the 1960s had attempted to separate the two functions but were subsequently reversed. Industry-related commercial banks were established in 1987 to provide investments for clients in particular industries. Two special purpose banks serve foreign trade and innovative economic projects (Mineral Bank). The industry banks have also been set up to serve agriculture, chemicals, construction, engineering, electronics, infrastructure and transport. The National Savings Bank provides most mortgage lending and also some commercial lending; the bank operates at a loss.

The current plan is for the central bank is to regulate credit availability, interest rates and commercial bank operations. Commercial banks are to provide investment funds and monitor investment in enterprises. Recently the central bank was split from its 51 local district branches. Each district branch bank is to operate autonomously. The banks will be allowed to make a variety of business, home and consumer loans. Whatever the loan mix, a total of some 60 odd banks is probably far too many for Bulgaria. Sixty independent banks in a country of 9 million people will mean unnecessary duplication and under-utilization of banking

resources. The arrangement would spread scarce banking skills thin in a financial market which is still severely limited. Worse yet, the independent banks are not yet efficiently connected by financial intermediaries to ensure the efficient flow of financial resources from one to another. Bulgaria simply has too many independent banks and not enough branch bank offices.

Bulgaria's financial structure is rudimentary. The economy is cash. Checks are unusual. Check clearing is not used by branch banks. Bulgaria has virtually no domestic bonds or stock-equity ownership. The central bank, industry banks and 51 district branch banks lack skilled staff. The head of Bulgaria's central bank has called for assistance in providing schooling and instruction in banking. Training is needed for bank staff and for customers in order to use credit-risk analysis. The gap is illustrated by the Annual Report of largest commercial bank in Bulgaria: the 4 page Report has a balance sheet, no income statement and no statement of change in financial position.

Two special organizations are of import for investment in Bulgaria. The first is the Mineral Bank (MB), established in the 1960s, exists to approve and assist in funding "new initiatives". The MB is owned by the BNB and several hundred large Bulgarian enterprises. The 1987 reforms increased the funds allocated in this manner. The MB supplements the industry banks and is in many ways a model for them providing funds for long term investment and working capital.

The second organization is Bulgarian Industrial Association (BIA), a group of enterprise leaders founded in 1962. The organization identifies and supports new ventures. The BIA uses the MB to fund new ventures. For example the BIA has been instrumental in establishing several consulting organizations. Best known are EKO and the IPOMA, both specialize in high-tech issues. When the additional investment banks were added in 1987 the BIA retained its role.

## **THE HOUSING SECTOR**

### **Housing Production and Delivery**

When measured as a share of national output and investment, the housing sector in Bulgaria is smaller than those in Poland and Hungary. In 1985, housing investment in Bulgaria amounted to 4.4 percent of net material product (NMP, a measure similar to GDP), about one fifth lower than in Hungary (5.4 percent) and a quarter lower than in Poland (6.1 percent).

In terms of national investment, the differences are even more marked: housing in Bulgaria accounted for 12.8 percent of all investment in 1985, compared to 21.1 percent in Hungary and 24.6 percent in Poland. Evidence since 1985 indicates the share of housing in national investment has remained static; the share of housing in national fixed assets has remained steady at 17.0 percent (United Nations, 1988).

Housing accounts for about half the output of the construction sector—which made up 9.9 percent of national income in 1985 (EIU, 1989, United Nations, 1989a). The building materials industry shows signs of low productivity, despite being one of the leading sectors for investment and promotion; output from the industry increased only at a rate of 1.3 percent annually during 1985-88.

Housing has been a perennial problem in Bulgaria, particularly in Sofia and other large cities. Production in 1985 amounted to only 80 percent of the number of new households formed, as measured by the total number of marriages and divorces (United Nations, 1988). In fact, these global measures understate the extent of the housing shortage, since they do not take account of the mismatch between housing demand in urban areas (which has grown rapidly since the 1950s) and rural areas (which now show a number of empty units). For example, in 1986, the waiting list for housing in Sofia numbered 80,000 households, or about 30 percent of the city's 1.1 million residents (Miskiewicz, 1986).

The housing stock in 1985 was estimated at 3.16 million units. About half of these were built after 1960 (Grigorov et al, 1987). During 1980-84, 352,400 units of housing were produced, an average of 70,500 per year. In the following period, 1985-88, a total of 247,600 units were produced. This implies a fall in the average annual rate of production of 12 percent, to 61,900 units per year (United Nations, 1988). This fall implies declining productivity and rising unit costs in the sector, as the share of housing in national output and investment has been broadly constant in the 1980s. A shortage of manpower in the construction sector has contributed to the problem.

Because of the pressure of the housing shortage and the declining ability of the state sector to meet demand, actions have been taken to shift the burden of housing provision away from the state. Apartments are usually built by the local authorities, some for rental but most for sale to owner-occupiers. Housing is allocated by a ranking system based on age, number of children, and waiting time.

Owners of buildings replaced by state-built housing are compensated and given first priority to the new units. Since 1983, state enterprises have been instructed to provide housing for their own workers, using their own resources and work force.

Cooperatives, private construction by independent contractors, and "self-help" housing have been allowed to produce housing in Bulgaria without interference as long as the housing is for personal use (McIntyre, 1988). The share of non-state production has increased since 1980. Private construction of housing for other year-round and summer use (*dachas*) is large scale and (particularly in rural areas) dominated by three-storey houses of large size and good quality.

In 1985, about half of all new housing was produced by the state sector (both local authorities and state enterprises building for their employees), with the remainder about equally split between cooperatives and the private sector. Private ownership is the prevailing form of tenure in Bulgaria: as of 1985, over 85 percent of the housing stock was privately owned (McIntyre, 1988). This high overall ownership rate is primarily due to a nearly 100 percent ownership rate among rural households. Recent construction is concentrated in cities where ownership rates are lower; about 60 percent of all units built between 1981 and 1985 were privately owned (Grigorov et al, 1987).

Land for private construction may be purchased for existing private owners or the local authorities. Prices for public land (in 1982) ranged from Lv0.80 to Lv10 (US\$0.85 to US\$10.50 at the 1982 official exchange rate) per square meter depending on the size of the settlement and the type of residential construction. Land purchasers also face taxes of up to Lv29 (US\$30.50) per square meter of floor space constructed (based on residence type) and may face punitive taxes—up to Lv400,000 (US\$421,000) per hectare—if agriculturally useful land is converted to residential use (McIntyre, 1988).

By some quality measures, the housing situation has improved modestly since 1980; per capita floor space increased from 14.8 square meters (161 square feet) to 17.7 square meters (193 square feet) per person. As of 1985, the average dwelling had 2.8 rooms and 48.1 square meters of floor space (which is defined as the area of all rooms plus the kitchen). Newer units are being built larger; the average floor space for units constructed in 1985 was 57.7 square meters (Grigorov et al, 1987). However, there remain numerous complaints about the quality of planning, design, and construction of new housing.

Almost all housing produced by the state sector—currently comprised of about 30 state construction enterprises—follows the Soviet model of large, prefabricated blocks of flats (although the emphasis on construction has lately been shifted from high- to low-rise construction). This industrial method of building has caused problems in several cases where the local planning authorities have failed to provide adequately sized sites to accommodate the large-scale equipment needed to erect these blocks. Efforts have been made to raise quality standards for state-produced housing units by involving new apartment owners in the finishing work for the units.

Coverage of urban services in Bulgaria is high overall, with all settlements being electrified and water supplies available in 98.5 percent of all settlements. Virtually all new dwellings have bathrooms and hot water (Grigorov et al, 1987). However, the quality of service provision and upkeep in state housing has been poor. Maintenance and modernization work has not been carried out and in several cities, the water supplies and heating facilities in state housing are inadequate.

Rents have not changed since 1967 and are insufficient to cover construction and maintenance costs (Parry, Koleva, and Popov, 1990). Local councils may increase the official base rent of Lv0.19 per square meter of useable floor space by as much as 27 percent, or lower it by as much as 50 percent, depending on unit characteristics. Therefore, a household which has the 1985 average annual net family income of Lv3,870, occupying a unit with 58 square meters of useable space, would pay a base rent equal to about 3.4 percent of its net income. The average amount spent on all housing costs (including rent and utilities) is about 11 percent of net household income (Grigorov et al, 1987).

### **Housing Finance**

Finance for housing purchase (at low, subsidized prices) has been available from the state at low interest rates and long terms—typically 70 percent financing, at 2 percent interest, over 30 years for a fixed rate mortgage. The price of housing had been held constant since 1977, being calculated on the basis of a fixed amount per square meter. In 1980, McIntyre (1988) reports state-produced apartments built for cooperatives sold for between Lv10,000 and Lv20,000 (US\$11,600 and US\$23,200); average household incomes at the time were Lv6,000 (US\$7,000).

According to Parry, Koleva, and Popov (1990), The National Savings Bank has been the main source of residential lending, with an annual loan volume of only about US\$140 million. The Bank pays 1 percent on deposits, but offers a special account for accumulating a downpayment that pays 2 percent.<sup>9</sup> Inflation, however, is currently around 15 percent. The Bank operates at a loss and is subsidized by central government revenues.

### **Housing Reforms**

Controls on the price of housing are being lifted, as are other restrictions on the sale of housing. Prior to the reforms, owners were required to transfer their units back to the local housing authority for a low, fixed price. The unit was then held by the authority until purchased by another buyer at the same fixed price. The result of these low prices and heavily subsidized mortgages was a significant queue for access to financing.

The reforms will permit the sale of housing units at market prices and reduce the involvement of local councils in sales. Under the reformed system, the National Savings Bank is likely to remain as the primary source of housing finance. However, interest rates will probably be raised to market rates, with lenders charging the equivalent of the rediscount rate plus a fee for administrative costs and losses.<sup>10</sup>

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<sup>9</sup> The National Savings Bank also offers several special loan packages to assist with the downpayment problems of younger households.

<sup>10</sup> According to Parry, Koleva, and Popov (1990), the Banking Laws were recently changed to permit the creation of nine new commercial banks. While there is some discussion that these banks will become privately owned, they are presently government controlled. Decree 56, passed in January 1989, contains language permitting wider privatization efforts.

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