Contract Enforcement in the Early Transition to a Market Economy

Kenneth Koford     Jeffrey B. Miller
Contract Enforcement in the Early Transition to a Market Economy

Kenneth Koford
and
Jeffrey B. Miller

This paper investigates contract formation and enforcement in the early primitive phase of a transition economy. In the first years of transition, firms lacked experience with commercial contracts, and the court system was unfamiliar with the problems of contract enforcement in a market economy. Managers had to develop new ideas of how to deal with other firms and how much to trust them. Managers learned a great deal through experience. Thus, this was a special period for studying how contractual relations in a market economy might develop.

Our goal was to investigate alternative views of how firms make contracts in this early phase of transition where economic agents lacked recent experience with commercial contracts. Some observers argued that firms would quickly adopt western “best practice” and the economy would soon function much like similarly developed western economies. Others (see Murrell 2001) claimed that firms would learn to work well with their regular counterparts, but they needed larger institutions--good laws, courts, bailiffs--to make the contracts as they would in the West. Still others thought that the customs and traditions of a market economy would take a very long time to develop, so an anarchic or perhaps mafia-ridden economy would prevail (as in Banfield 1958 or Putnam 1993).

We interviewed managers in thirty-six Bulgarian firms about their contractual relations in the summer of 1994. This was not long after Bulgaria began moving to a market economy with
a “big bang” in February 1991. Because of the small size of our sample we felt that, to better interpret our results, it would be best to focus in a reasonably narrow sector of the economy. For this reason the majority of the firms interviewed were engaged in the processing, wholesale distribution or retail sales of food. The food process and food distribution sector was chosen because in this sector in 1994 there were several ownership forms: state-owned, private, cooperative and newly privatized. Each of these ownership forms operated under different internal incentives that could affect their contractual behavior. We used semi-structured interviews; this gave us considerable quantitative information and also allowed the managers to give us their own personal narratives of how they dealt with the problems they faced. The survey focused on detailed descriptions of contractual problems and solutions.

The framework we use in studying these issues was first described by Williamson (1985, 1994) and Klein, Crawford and Alchian (1978) in their theories of informal “reputational” enforcement, self-enforcing contracts, and the use of law and courts. We found that at the beginning of the transition firms were “naive” about contractual enforcement. Firms assumed that having a written contract gave adequate protection. Over time, firms became far more cautious, relying heavily upon reputation based on successful repeated transactions (which might be called “trust”), and to a lesser degree upon contracts structured to be self-enforcing. Although numerous firms carried out lawsuits, reliance upon courts was generally described as a last resort. In contrast to Williamson’s model where “spot” contracts are a fallback position when it is difficult to negotiate more complex contracts, we found that even spot contracts were problematic.

The paper’s next section reviews theories of contractual relations and the related
empirical evidence. Section 2 reviews the empirical literature. Section 3 provides background on the Bulgarian economy at the time of the survey. Section 4 presents the results of the interview survey. Section 5 concludes

1. Theories of Contracts

The theory of contractual relations is based on the seminal contributions of Coase (1960), Demsetz (1964), Williamson (1985), and Klein, Crawford and Alchian (1978). The fundamental principle is to maximize expected gains from trade minus transactions costs. Defining the specific nature of transactions costs has been difficult and subtle; major contributions include Klein, Crawford and Alchian (1978), Klein (1996), Goldberg (1976), and Hart and Moore (1990).

Williamson, following Demsetz (1964), argues that in a market economy institutional innovations will tend to reduce transactions costs. For transactions, Williamson describes three types of governance mechanisms that vary with the degree of interdependence between trading partners: spot markets, long-term contracts and hierarchy. Spot markets are satisfactory when there is little dependence between the transacting parties because neither company has made ‘asset-specific’ investments to facilitate trade with the other company. Competition is important in settling disagreements since the parties can turn to alternative sources if they are dissatisfied.

Alternatively, in situations where asset specific investments have been made on both sides of the transaction, "bilateral dependency" evolves. That is, either party would suffer a loss if further interaction were suspended. Spot markets are inadequate, and sophisticated forms of dispute resolution are needed. With moderate bilateral dependency, long-term contracting can be efficient. As the level of bilateral dependency grows, hierarchical control becomes more
efficient. Thus, Williamson argues that spot markets, long-term contracts and hierarchies can be explained by the degree of bilateral dependency.

Williamson argues that long-term contracting is the most difficult type of governance system to support. Both parties to the contract are "vulnerable" because of bilateral dependence. In the context of developing market economies Williamson argues that:

viable middle range transactions will flee to one of the poles -- by moving to the spot market (attended by the sacrifice of asset specificity and resulting loss of productive value) or by moving to hierarchy (with the added bureaucratic cost load). A high-performance economy will support transactions of all three kinds rather than force polar choices. . . The quality of an economy's contract laws and enforcement efforts . . . can thus be inferred indirectly by the evidence on hybrid contracting . . . (Williamson, 1994, p. 18)

Thus the complexity of observed contracts gives evidence of an economy’s transactional efficiency.1 Transactional inefficiency can lead to large economic losses. Williamson argues that too little investment occurs in projects that may be subject to holdup, where one party fears that the other party will break off the relationship because the other party will suffer less if the relationship is terminated.

Klein, Crawford and Alchian (1978) find several ways of limiting post-contractual opportunistic behavior in the battles over quasirents. They emphasize that it is impractical to write a perfect contract; there are bound to be ambiguities. Thus, parties to a contract are inevitably faced with the possibility of a situation where they can “take advantage” of each other, absent other supports for the contract.2 Vertical integration, including joint ventures, are one

1. La Porta et. al. (1998) give evidence for this proposition regarding the property rights of corporate shareholders.

2. Opportunism is not required; the parties may honestly believe that their own interpretation is the most valid, since any contract is incomplete and subject to multiple interpretations.
potential response. Klein, Crawford and Alchian show that other solutions are also viable. For example, one alternative is repeated sales that include continuing quasirents for both parties. 3

Another solution is available if the parties to the contract are part of a related “group” of firms or individuals. Then evidence of opportunism can be publicized to other members of the group, harming the opportunistic firm.4 Social institutions, such as business clubs, raise the cost of opportunism by creating more personal bonds among group members.

Williamson emphasizes the importance of opportunism in business relationships, as individuals may use clever and unsuspected ways to gain at others' expense. But there are degrees of opportunism. Culture, politics, regulation, professionalization, networks, and corporate culture can dissuade people from exercising the maximum degree of opportunism.5 In the stages of transition many of these elements were in flux or certain behaviors that were tolerated in a planned-economy environment could be very detrimental to the performance of a market economy.

When two firms are willing to deal with each other despite the possibility that one might take advantage of the other, it is often called “trust.” We interpret “trust” as an equilibrium in

3. This point has recently been developed further in the literature on banking and credit (Lamoreaux 1994). Fudenberg, Holmstrom and Milgrom (1990) have a more formal analysis of contracts based on repeated play.

4. Similar arguments have been made by Landa (1994) and Greif, Milgrom and Weingast (1994). Additional models have recently been developed along these lines; see Kali (1999), and also Koford and Miller (2000).

which each firm believes, with good reason, that the other player will fulfill the contract, even though the other firm could act opportunistically and make short-run profits, but it would not be profitable over the long run to do so.  

2. Empirical Tests of Contract Theory


---

6 Williamson (1993) argues that, except where there are close personal relationships, to trust means that the economic agent has done a calculated risk assessment of good and bad outcomes and has concluded the action is worth the risk. So one would not use "trust" for a situation where all parties obviously gained directly from fulfilling a contract.

Casson (1991) develops a model of culture as a factor in building trust in business relationships. Casson’s overall idea is that when a climate of trust can be created, business will benefit from all agents relying upon the expectation that others will act in accordance with their promises.

Banfield (1958) discusses the problems of a culture in which trust is absent.


Additional studies include Paley’s (1984) study of railroad contacting which supports the Williamson rationale for different governance structures, and Lamoreaux’s (1994).study of U.S 19th century banking where members of banking groups obtained loans from the group’s bank and evidence of opportunism was sufficient to destroy a person's business career.
similar to ours.\textsuperscript{8}

In his widely cited study, Macaulay (1963) found that reliance on detailed contracts was considered inappropriate because "[s]uch [excessive] planning indicates a lack of trust and blunts the demands of friendship, turning a cooperative venture into an antagonistic horse trade" (p. 64) among U.S. sales and purchasing managers in manufacturing and machine-building. Norms developed where "[c]ommittments are to be honored in almost all situations, one does not welsh on a deal . . . One ought to produce a good product and stand behind it" (p. 63). A man's word or handshake is seen as binding as a written contract.

Rubin (1993) in his study of markets in Russia during the early years of transition emphasizes the difficulty of relying upon legal enforcement of contracts. He argues that any system of contract law requires a set of working institutions and a common working understandings by businesspeople. He reports cases "of the simplest forms of opportunism. Firms in Russia sometimes take money and provide nothing; at other times, they accept goods and then do not pay. Enforcement even in these cases is apparently difficult (p. 18)." He notes that the concept of conceding to one's partner a significant profit as a matter of policy is unusual in Russia. Multilateral enforcement mechanisms, Rubin believes, are potentially very important. Trade associations and related groups, particularly when using arbitration, can be


Clague (1991), for one, argues that less developed countries do not lack capital, but they are poor because they do not have proper contract enforcement. With better contract enforcement they could utilize a more complex trading structure.
very effective.

A major interview survey of businesses in Russia (Hendley, Ickes, Murrell, and Ryterman (1997) and Hendley, Murrell, and Ryterman (2001)) has results relevant to our findings. These firms were largely former state enterprises and were much larger than the firms we interviewed. Firms prefer to rely on long-term partners, suggesting that personal trust is important. Firms do go to court when problems cannot be resolved, but emphasize mutual negotiation of problems (as in Macaulay), similar to our findings. The largest contrast is that half of firms stated that they would “tell other enterprises about the behavior of an enterprise that did not honor its agreement” and they thought that this was an effective method of enforcing agreements.

McMillan and Woodruff (1999a, and 1999b) investigate contractual relations in Vietnam. They surveyed 259 private sector firms in Vietnam with the goal of determining how firms coped with locating new trading partners in an environment where many supports for contract enforcement were lacking. They used trade credit as a measure of trust and found that more trade credit was extended to firms that had fewer alternative suppliers and to firms which they were connected through business groups. More credit was also given to firms if they had a longer-term relationship with those firms. McMillan and Woodruff (1999a). They also found, however, that firms were also hesitant to break off relations even if they were not paid, since it might hurt their relations with other customers. (McMillan and Woodruff (1999b)) We find similar results in that longer-term relationships are also important in Bulgaria, and there was a similar hesitancy to break off relations as a disciplining device. Our results do differ, however, in that Vietnamese firms used information-sharing more commonly to penalize contract
violation.

In a similar study Johnson, et. al. (2000) look at trade credit in Poland, Slovakia, Romania, Russia, and Ukraine. In these countries the courts are more important and substitute for relational contracts except where investment have a high level of specificity. This is similar to Bulgaria where we found that courts were widely used, especially by state firms.

3. Economic conditions in Bulgaria, 1989-94

General Economic Conditions

The economic conditions existing in Bulgaria at the time of the survey created some special environmental conditions under which contracting took place. In February 1991 price controls were dropped on most goods and private trading activity was allowed, although some prices of agricultural products, where our survey was focused, were still controlled even in 1994. From 1991 onward inflation was high and output declined 30% from 1989 through 1993. Nominal interest rates on bank credit were in the range of 60 to 80% throughout the period. Even for enterprises with access to credit, managers saw borrowing as extremely costly. Trade credit advanced by other firms was considered very valuable, and inventory control was seen as a way to protect profits.

Privatization proceeded very slowly. There was a highly touted agricultural land restitution program, but this was only partially complete at the time of the survey. The new farms were very small, far too small to be efficient. Inexperienced people were working in agriculture, as land was returned to people who lived in cities or new independent farmers took

9 Pyle (2005) extends the work of Johnson, et.al. (2002) and looks more closely at the impact of business groups on relational contracting.
on new tasks. Land restitution was poorly coordinated with the distribution of animals and equipment. Many farmers obtained livestock before receiving grazing land and had to slaughter the animals. By June 1994, herds were much smaller. Due to fewer cows, all the milk producers we interviewed had difficulty in obtaining milk.

In addition to state farms, there were farm cooperatives during the Communist period. Besides farming, they engaged in such activities as food retailing. By 1994, these cooperatives were free of state control and operating basically as independent labor-managed firms.

Entry of new private firms was generally difficult in manufacturing due to the need for large amounts of capital. An exception was bakeries where capital costs of starting a processing plant were low. Without new entry, most state firms were unresponsive to customers' needs. This contrasts sharply with the state-owned bakeries that were producing new varieties of bread to fight the competition coming from the new private bakeries.

As in other sectors, many food producers lost customers from the collapse of traditional trade with the East European trading bloc and were producing well below capacity. Some were looking to markets in Western Europe, but this was difficult since standards were very different and border crossing caused serious delays and made timely delivery difficult.

A general comparison of the progress with reform in Bulgaria in 1994 with other countries in the region is described in Table 1. As can be seen from the table, Bulgaria’s progress in 1994 was closer to Romania than it was to countries in Central Europe. Although we do not have an indicator for legal extensiveness and effectiveness for 1994, the indictors for 1997 (the first year that the EBRD included this indicator) are included. These 1997 indicators show that Bulgaria was lagging behind the Central European countries in developing its legal
Changes in the Contractual Environment

Under central planning the Bulgarian economy was organized as a hierarchy, so relations between economic units were like those between units of a large western firm. There was great continuity over time, as enterprises could expect to deliver to the same customers year after year and receive inputs from the same suppliers. Thus, strong informal relations developed between enterprises.

When enterprises became independent profit centers, they needed new agreements for the new conditions, agreements mediated by markets or by courts. Firms could take on new suppliers and customers, but new partners had to be evaluated (although Bulgaria is small enough that managers often knew each other).

In Bulgaria, as in other transition countries, many firms did not pay their suppliers, and arrears quickly grew. The growth of these arrears eventually stopped (Baer and Gray, 1996, Dobrinsky 1994). Suppliers no longer delivered goods unless they were going to be paid. Exceptions were deliveries to hospitals, schools and military bases.  

The government decision to break up existing enterprises increased competition, but it also created many small new units that had to learn to cooperate with each other. In contrast to a market economy where production units evolve to improve efficiency or gain market power, 

---

10. By way of contrast, Hendley, Murrell and Reiterman (1998) found that, in Russia, suppliers were still delivering goods without any real confidence of payment in the near future.
decisions to break firms up were made centrally. Given the freedom to reorganize, many of these new units might have chosen to combine.

The move to a market economy required major institutional change. Managers had more power to make decisions, but the firms were now subject to market forces. There were also restrictions on merging with other units or privatizing an enterprise. Managers faced pressures to produce high-quality goods (especially if they hoped to export) and increase sales rather than just increase production to meet a centrally determined target. Excess production capacity and the fall in overall demand greatly increased the relative power of buyers compared to suppliers. Overall, firms faced a strong need to learn customers' demands and respond.

**Development of the Legal System**

Under socialism, distinctions were made between contracts among state enterprises and contracts involving private parties. In Bulgaria the Law on Obligations and Contracts of 1950 (amended in 1993) which governed private activity was still the basis of the civil code. Grey (1993, p. 36) says "[t]his law reflects generally-accepted civil law concepts of contract and thus has provided an acceptable legal framework for private sector activity."

In June 1994 it was hard for creditors to begin bankruptcy proceedings (Gray, 1993).

---

11. In dividing firms the government seemed to follow the naive view that the smaller the firm the better. For example, one power engineering firm was divided into a planning and drafting unit, a research unit and a construction unit.

12. The lack of a bankruptcy law does not mean that state enterprises can stay open. As a consultant told us, when enterprises could no longer pay their bills, water and electricity were eventually shut off. Workers who were not paid left. The plant could not function. The director was left sitting at his
However, it was possible to go to court to collect payments and seize assets. Civil courts were clearly able to assure adherence to payment terms, the main concern of firms we interviewed. The Chamber of Commerce established arbitration procedures, including arbitration under international conventions. These could be applied to disputes between Bulgarian and foreign firms and between Bulgarian firms. The decisions reached by arbitration could be binding and enforced by the courts. In 1994, the arbitration courts were not much utilized.

4. Survey procedure

We conducted semi-structured interviews with thirty-six firms throughout Bulgaria. All interviews were done by one of the authors, on most occasions both authors were present. We focused on a specific sector, food processing and food distribution, so that the contracting across firms would be more uniform. The food processing and food distribution sector was particularly interesting because there were several ownership forms (state-owned, private, cooperative and newly privatized), each operating under different internal incentives that could affect their contractual behavior. Indeed, as an example, we found cooperatives that continued

13. We designed the survey using standard techniques for semi-structured surveys. See particularly Devereaux and Hoddinott (1993). Our translators were team members who had graduate training in economics in a program we had organized, and a Bulgarian sociologist experienced with questionnaires. The Bulgarian version was also translated back into English by a third party to check the accuracy of the translation. The English and Bulgarian versions of the form are in Koford and Miller (1995, Appendix A).
to support local agencies, like hospitals, that served their community members even though the cooperative was not being paid for the supplies that it was selling.14

The sample of firms was developed by contacts from previous visits to Bulgaria. While our method of selecting interviewees creates biases, it also created a more open environment for interviewing.15 In most state enterprises the survey was conducted with the enterprise manager or the assistant manager. In private firms, the owner was interviewed. Most interviewees were comfortable answering the questions. This was probably because managers were being asked to describe how they dealt with common business problems, not the firm’s financial condition. On several occasions when a question touched on a sensitive issue, the interviewee simply declined to answer.

Because of the selection technique, there are biases in our results. We interviewed more privatized firms than a random sample would have found. We also suspect that we saw a higher proportion of successful firms than a random sample would have generated. We think that the

14 This created a dilemma. Several interviewees said that they felt an obligation to deliver supplies to these units in spite of their failure to pay because these units provide such essential benefits to society. On the other hand, one firm said that he simply cut off deliveries and was eventually paid.

Also, it appeared that state budgetary units often did not have any money and so could not pay, due to the failure of Parliament or a ministry to act. People noted that sometimes the workers at these units were not paid, and the hospitals had no medicines. Sometimes these units did receive their allotted budget late. When they did, they would make partial payment

15 Bewley’s (1999) description of the merits and disadvantages of his interview procedures are essentially the same as ours.
openness of the interviews more than compensated for this sample bias.

Many responses were far more elaborate than the choices given in the survey. As the survey proceeded, we asked follow up questions to elicit more details. We often found that responses to these more probing questions were the most revealing, consistent with Williamson's thesis that to understand contractual relationships between firms the study must be "microanalytic." The survey form was not always followed strictly, as circumstances sometimes required changes, yet most questions were almost always asked. We thus have complete results on most, but not all, questions.

**Basic Data**

Table 2 describes basic data on the firms. Few state firms were still involved in retail distribution, and there were relatively few private firms in food processing. Thus as food passed

---

16 Koford and Miller (1995), Appendix B provides more detailed descriptions of the individual interviews, while Appendix C includes a detailed set of answers to the questionnaire.

17 In addition to our formal interviews, we consulted with various experts on Bulgarian conditions and laws. We spoke with USDA representative Clay Hamilton about agricultural conditions and privatization. A representative of Land O' Lakes provided information on conditions in the dairy industry. The director of the Chamber of Commerce in a moderate-sized city described the operation of the Bulgarian arbitration system. A Bulgarian and an American lawyer with the American Bar Association's Civil Education Project described the Bulgarian court system in dealing with commercial law, and procedures for assuring payment under Bulgarian law and court orders. A banker described the procedures and principles of offering loans. A representative agent for Dun and Bradstreet described their methods for investigating businesses to assure that they were reputable.
through the production-distribution system, private farmers sold to state-owned food processors who, in turn, sold to private wholesale/retail firms. Cooperatives, on the other hand, were involved in both food processing and distribution.\textsuperscript{18}

While most firms in the survey reported that they were profitable, this response may be biased, implying only operating profits. Also, it may be that interviews were more likely at successful firms. Most firms had also been in business for a substantial period of time, so they were not the “phantom” firms (“fly by night” operations) often encountered during this period in Eastern Europe.

Table 2 here

\textsuperscript{18} A more complete description of the individual firms is in Koford and Miller (1995, Appendix B).

As we promised the firms confidentiality, facts that might identify them are omitted.
5. Interview Results

In our interviews we found that while spot markets, long-term contracts and hierarchical reorganization were used to solve transactional problems, the predominant relation was spot-market interaction. We begin, however, with situations in which hierarchical change and long-term contracts were observed and identify why they were not more widespread.

A. Hierarchy and Long-Term Contracts

Williamson argues that hierarchies will expand when bilateral dependency is high. In Bulgaria we found that mergers and firm break-ups occurred for market reasons in the non-state firm sector, but in the dominant state sector, the Parliament prohibited these options.

Before 1989 many cooperatives not only produced agricultural products, but also had retail outlets through which these products were sold. In several interviews with these, now independent self-managed, cooperatives, we found that the retail and the production elements had split and become independent units.

For new private firms, mergers and splits often related to problems of obtaining sufficient financing. (In many private firms personal relationships were also decisive in determining whether partnerships form or break apart.) Production units needing to finance large capital expenditures with slow paybacks merged with trading units that had more cash flow. Alternatively, forming a private bank supported by several businesses could provide financial support for group members.\(^\text{19}\) That so much reorganization focused on financing demonstrated

\(^{19}\) Under Bulgarian banking law, banks are limited as to the percentage of assets that can be loaned to one customer. By forming groups each member could obtain financing from the bank and still not exceed the maximum loan size.
how hard it was to obtain financing through capital markets.

Other interviews illustrated how limited merger and acquisition activity was, however. For example, a privatized state enterprise that could not convince a firm supplying an important input to improve the quality of its product decided to produce the input itself rather than purchase the other firm (as the other firm could not legally be bought) even though there was local excess production capacity for this input. In another case a firm in the declining rice production industry made a similar decision i.e. expand rather than merger even though there was excess capacity.

These cases illustrate that while bilateral dependency might be high, hierarchy (i.e. merger) was not always an option because of restrictions in the state sector. This led to inefficient investments in the state sector.

In the private sector where merger was an option, the major motivation was obtaining credit. In an environment where the transactions costs (i.e. identifying sound private sector borrowers) for lenders were particularly high, firms found that hierarchy was a way to overcome these barriers to financing.

As Williamson’s theory would suggest enterprises in Bulgaria found long-term relationships with trading partners advantageous, but these were usually a series of spot market trades rather than a formal long-term contract. The most common long-term contractual relationship in our cases was joint venture activity with foreign partners. The principal motivation for Bulgarian firms was once again financing.

We found a few other cases of long-term contracts. For instance, a state-owned food processor maintained close control over its agricultural suppliers. The firm still purchased 90-
95% of local production. It lent money to local growers and provided fertilizer and pesticides, and viewed suppliers as "immoral" if they sold their output to other food processors. When asked what the firm did if a supplier tried to sell to another firm, the interviewee said that the firm tried to convince the grower of the importance of long-term relationships. (His tone suggested that he could be more forceful than his words indicated.)

Another firm described some innovative arrangements for sharing its facilities. It had a profit-sharing arrangement with a seed producer where the seed producer used the firm's land. This firm also had a contract with interesting collateral arrangements. The firm placed some of its sheep on the property of another firm in the mountains. In exchange the other firm had henhouses on the property of this firm. The hens were collateral which could be seized if something happened to the sheep in the mountains. Thus the firm created stronger bilateral dependency than would have normally existed.

This last example illustrates that policing and maintenance of long-term contracts was difficult. This was why we observed so few. This last firm admitted that it had little confidence in the court system. Clearly it also had limited trust in its trading partner. Still, the firm was able to design an awkward but satisfactory contractual relationship.

We found several cases of the absence of valuable long-term contracts. Three involved food processors that purchased fruits or grapes from farmers. The farmers claimed to need advance credits to buy good fertilizer, pay for proper cultivation, and similar expenses. However, the processors had doubts that the farmers would actually sell to them, so they were largely unwilling to provide the credits and, in turn, expected poorer crops to be available.

Consistent with Williamson’s thesis, long-term contracts were difficult to negotiate and
enforce. In some cases firms invented novel methods to enforce these contracts; in others, economic losses occurred because mutually beneficial contracts could not be arranged. The basic problem appears to have been an inability to enforce clear, binding contracts.

B. Spot Markets

Where little investment has been made for very specialized production, Williamson argues that simpler governance arrangements are possible. Still, there can be serious problems when markets just begin to form. As spot market transactions in Bulgaria were so ubiquitous, we present a more expansive description of spot market arrangements. We argue below that while Williamson sees spot markets as a fall back position, serious problems can exist even in spot markets because in the early transition bilateral dependency can exist even here.

We describe four aspects of spot market transactions. The first two apply to pre-exchange costs-- 1) identification of trading partners, 2) bargaining to reach an agreement. The last two relate to problems of enforcement of the agreement-- 3) non-legal controls 4) court action.

1) Identification of Trading Partners

As firms shift from hierarchy to market relations, they must identify worthy trading partners.20 At the beginning of the transition it was not clear that business people understood the value of reliable trading partners. Our perception, from previous experience in Bulgaria, was

20 Under central planning firms had continuing relations with other firms. When market institutions defined the interaction rather than the central plan, contracts had to be negotiated under different circumstances. What surprised us is how many firms sought new partners once the market opened.
that many business people regarded long-term relationships as unimportant. The way to make money was to make a quick deal where the profits were large and then move on to the next deal with someone else. In contrast, firms in the survey, most of whom had been in business for two years or more, emphasized the importance of trust. They tried to find business partners who were reliable and then worked with these partners on a continuing basis. Serious business firms understood the importance of long-run relationships.

Finding good partners was not easy. Almost all firms in the survey sample had been hurt by "phantom firms." These phantom firms went into business to obtain large "trading profits" from a single big deal. Phantom firms take advantage of other businesses by failing to pay for goods, or by receiving payment and failing to deliver. After gaining the profit, the phantom firm would disappear.21

While they may have been naive at first, firms later protected themselves from such firms by doing a careful evaluation of trading partners and insisting on up-front payment terms. For example, the manager of several retail groceries was asked what he would do if approached by a new supplier. He responded immediately with a list of four conditions that he used to evaluate new prospective suppliers: 1) If the supplier offered a low price for a product in high demand, he was suspicious. 2) If the supplier agreed to all the terms dictated to him even when disadvantageous to the supplier, again he was suspicious. 3) A clear time frame was established for delivery to see if the supplier could meet the conditions specified; if the goods did not appear,

21 Koford and Tschoegl (1997) found that many phantom firms approached banks in Hungary at the start of the transition. At first they often obtained loans, but by 1997 banks were able to identify most of them and they were uncommon.
the manager broke off relations with the supplier. 4) The manager never paid before seeing the product.

Another example was a meat producer in a small city. After some commercial customers failed to pay, he required that most firms pay cash. Specifically, customers had to send a truck to his warehouse. Then payment would occur, in cash, counted out on the green felt-covered table in his office. Only then could the customers put the meat in their truck.

With such a high degree of suspicion on both sides, the effort required to evaluate trading partners is costly. Both firms make a major asset-specific investment in finding a reliable partner thus creating bilateral dependency even in an essentially spot market environment. Since it is costly to find new partners, quasirents are lost if the trading relationship is terminated. Under these circumstances, there are few ways to protect these investments and therefore a high probability that in some instances these investments will not take place, and beneficial exchanges will not occur.

In this atmosphere, firms understood the importance of their reputation. As it was very costly to find reliable trading partners, it was important to keep a good relationship with existing partners. Table 3 shows that almost all firms had a core group of partners with whom they traded frequently. Furthermore, their relationship with both suppliers and customers was positive.

Table 3 here

A good relationship with trading partners also makes it possible to obtain trade credit.22

22 McMillan and Woodruff (1999a) and Johnson, et. al. (2000) focus on trade credit (defined as delayed payment) as a measure of trust between businesses. They also found that the level of trade credit increased over time as the
Most firms insisted on up-front payments in any new relationship, but over time these conditions were generally relaxed as people got to know one another better. Greater flexibility lowers transaction costs in an environment where payment is uncertain and needs for cash are often unpredictable. Trade credit was also highly valued when nominal interest rates were high and transactions costs made it difficult for private firms to obtain credit from banks.

New market arrangements assisted the search for new trading partners and enhanced trading efficiency. Active commodity exchanges for wheat were established in Sofia and Dobrich. Forward contracts existed. Each side put down 3% and the bourse held the money. The money was forfeited if the contract was broken.\textsuperscript{23} For more perishable commodities other arrangements were developing. A fruit canning company described a market in which sellers pitched tents and posted prices in a specific location near the orchards as the fruit was harvested. Buyers came with trucks in search of the best prices for good quality fruit.\textsuperscript{24}

Identifying trading partners was made harder by the importance of foreign trade in a small country like Bulgaria. Even relatively small firms engage in foreign trade; see Table 4. Under central planning, most trade had to be carried out through foreign trading companies. At the time of the survey these state trading companies still existed, but there was additional competition from many new private trading companies which performed similar services. Often relationship developed.

\textsuperscript{23} One large active trader stated that he would not break the contract even if the price moved more than 3% because his reputation was on the line.

\textsuperscript{24} Rather than make purchases directly, sometimes the firm employed agents. The agent had an incentive contract where the agent bore some of the cost of low quality purchases.
a Bulgarian firm had a long-term relationship with a foreign company and found that it could bypass the trading firm and deal directly with the foreign company. Several interviewees gave examples of problems with foreign firms where they did not receive payment. One firm was chasing an American "phantom" in California. Still these evolving trade arrangements seemed to reflect rapid development of competition and improved efficiency.

Table 4 here

Despite difficulties, Bulgarian firms expanded their set of customers and suppliers. While they were proceeding cautiously, new institutional arrangements were making this process easier. Dun and Bradstreet had opened an office in Sofia which provided information on potential partners in Bulgaria and abroad. Firms often were members of informal social groups or business associations, which shared information on business partners. Severe economic difficulties gave firms strong incentives to seek out new markets, but the process was slow because most people had limited experience in a market economy.

2) Bargaining

Firms freely engage in exchange when both parties expect to benefit. Bargaining can be interpreted as a negotiation over how the gains will be shared between the two parties. We found that our interviewees understood that if the relationship was going to be long-term, both parties had to benefit.26

25 Pyle (2005) explores these issues in more detail in his study in Russia.

26 Two small private trading firms we interviewed did give the impression that they tried to ‘get the best on deals’, but this may be a basic element in a trading firm. Both complained about ‘slow
Relative market power can also affect the bargaining process. The firms interviewed answered overwhelmingly that bargaining took place in an environment where there was roughly equal bargaining power between the parties. See Table 5.

Table 5 here

It is hard to judge whether these responses really reflected equal bargaining power, or if the firm actually had a stronger position and therefore less to complain about. Comparing the competitiveness of markets for inputs and outputs in Table 5, output markets seem more competitive than input markets and bargaining power appears more equal in output markets.

Some state enterprises we interviewed, especially food processors, clearly had more market power than their suppliers, particularly farmers. Often this was due to their dominant regional position. Under central planning they were often the only producer and their inputs came from many farmers. While we could not judge how much control they had over the price, there was evidence that often firms with superior bargaining power were using this power to impose contractual terms. These firms only made payment after they had time to inspect the quality of the supplies. Payment was based on their evaluation of the quality. However, we

---

27. For example, one firm stated that it bought between 90-95% of the output of the local market. After studying the quality, it made payment 30 days later. (Given high monthly interest rates this is a considerable discount.) When asked if there were ever disputes about the quality determination, the manager described a process where the supplier was brought in and given a ‘scientific demonstration’
encountered one case where similar terms were enforced by a milk processor in spite of the widespread decline in milk production. Thus an alternative explanation is that these large food processors were the more efficient evaluators of quality. Still, this does not explain why the large firms delayed payment to cash-constrained small firms.

In their business relations with West European companies, Bulgarian firms appeared to be at a substantial disadvantage. Several interviewees described situations where they were paid for their goods only after the West European partner had inspected the goods. In contrast, the Bulgarian firm had to pay for foreign supplies in advance or on delivery. A few firms, that had trade relations with a foreign firm for some time, were very proud that they could now obtain trade credit from their partner.

3) Non-Legal Means to Enforce Agreements

From the literature on contract enforcement and the weakness of the commercial court system in Bulgaria, we expected that little reliance would be placed on the courts. In most business communities norms develop which allow business to go forward. At this time Bulgaria had little experience with market relations and community norms were poorly developed. Some norms even hurt commercial relations. We look first at the supply side where contractual nonfulfillment is typically due to poor quality and then at the customer side where the concern is failure to pay.

a) Quality of Goods and Services

how the quality level was determined.
Macaulay (1963) described an important U.S. business norm as "...One ought to produce a good product and stand behind it." In Bulgaria the transition from low quality goods produced under central planning to high quality goods produced in the market was far from complete, but there was a growing sense of obligation to stand behind what you sold. Buyers’ expectations of quality varied widely. Interviewees consistently said that if there was a complaint about quality, the seller would replace the goods. In one interview a buyer described how a supplier had gone far beyond what was required when it was discovered that the inputs were below expected quality standards (replacing the supplies immediately with a larger quantity, for free).

Statements that suppliers would replace substandard goods were made by both buyers and sellers.

A difficulty with maintaining quality was that the quality expectations of buyers was often very low and in many instances quality controls were very poor. In several interviews buyers were frustrated with the low quality of inputs, but they did not see it as a violation of a contract. One food processor had done calculations to show how much money could be saved if the quality of forage from his suppliers were higher. He offered his main supplier a higher price for improved quality but could not get the supplier to put quality standards into the contract. Another frustrated milk processor attributed the low quality of milk to the restructuring of agriculture. Inexperienced farmers, new to milk production, could not keep bacteria levels down.\(^{28}\) In fact, the farmers made no effort to reduce bacteria levels, despite urging, free

\(^{28}\)In the food processing industry, quality has another important dimension. There was great concern among consumers about food sanitation. The government had controls when all food was processed by state companies, but new administrative units had to be established to protect food supplies when
equipment, and instruction by the milk processor.

A private trading company involved in Western Europe related a case where a shipment was rejected by a Western European firm. Even though he questioned the honesty of this firm, he made good on the shipment. Yet, when asked if he inspected goods that were shipped to his warehouses and then shipped out to commercial customers, he admitted that he did not.

In brief, there seemed to be a norm that suppliers had an obligation to stand behind their products when they promised that a standard would be met. On the other hand the expectations of buyers, who were used to the low quality and service standards of central planning, was very low.29

As shown in Table 6, the combination of these factors resulted in relatively few contractual disputes with suppliers compared to complaints about customers.

Table 6 here

b) Payment Practices

After three years of transition, most sellers carefully protected themselves against future non-payment. The easiest way to do this was to require payment either before the transaction private firms evolved. During our interviews we heard complaints that inspectors accepted bribes and that the local government in one area was intimidated by mafia-type figures when the municipality tried to enforce sanitation ordinances.

29. We discussed milk, cheese and yogurt quality with a number of producers. Two described efforts to sell high-priced "fancy" yogurt products, but felt that the deep depression in Bulgarian incomes was limiting demand to the cheapest necessities. Later Danone entered the market with fancier yogurts and dominated the market.
was completed or at the time that the transaction occurred. Where pre-payment or coincidental payment did not occur, payment was often by bank transfer. The major exceptions to this rule occurred when 1) a long-term relationship existed, 2) the Bulgarian firm was anxious to sell to a foreign (usually West European) customer or 3) a state firm or cooperative felt a social obligation to sell to a hospital, school or other social agency. See Table 7.

Table 7 here

If the only viable products in an economy were standardized products that could be sold on spot markets, this would be a very weak economy. In an industrialized economic environment, as in the transition economies, there are huge gains from producing customized or semi-customized goods that can designed for specialized purposes. If contracts can be written only for standardized goods, these gains would be lost. Most of the firms we interviewed produced standardized products, but a few produced a semi-customized product that was modified for individual customers. These latter firms generally received prepayment that approximately covered their costs during the early development of the product. For example, we interviewed a private firm which produced semi-customized packaging/filling equipment (generally, filling lines for food processing firms) for which there was high demand. The firm was paid 40% within five days of signing a contract, 40% at inspection of the equipment two days before delivery, and 20% after the equipment was up and running. They returned ten days after the machine was in operation to help with any problems. This firm stressed that quality and their overall reputation were very important to them. They offered a one-year warranty and repair contract. The scheme protected the firm's interests by compensating for the risks they ran in building a semi-customized product. The buyer, on the other hand, was running a greater risk
of losing their money if the equipment was not delivered. A case occurred in which two machines were ordered, but only one was actually purchased. The buyer lost the 40% down payment.

Another form of contract enforcement was the use of mafia tactics. While we did not ask any direct questions about mafia activities, several interviewees referred to such activities and admitted to using enforcers when necessary. Some firms found it necessary to hire enforcers to protect themselves from others. One firm said it was not safe to sell its product domestically (rather, it exported the product to a neighboring country). Another private firm was worried about answering financial questions for fear that the information would be disseminated. One firm, which admitted using enforcers, made it clear that enforcers were used in the private sector but not in the state sector.

Prepayment in stable market economies is unusual. Payment in cash on the spot for commercial contracts is also unusual. Both of these structures tend to increase costs, and prepayment creates added risks for the buyer as well. We see in Table 7 that over 2/3 of the firms required these two methods of payment. Even for pure one-time spot contracts, this would be unusual in most market economies, suggesting an environment with very difficult conditions for combating fraud.

c) Social reputation

Based on the arguments of Klein, Crawford and Alchian (1978) and the evidence in Table 3, we had expected to find that social reputation was important. We asked firms what they

---

30. In solving contractual problems, two firms referred to ‘self-help’ as the action they took to get the
did if they had problems with their business partners. One alternative was to exert social pressure by informing others of the problem. We found the following evidence:

Table 8 here

While reputation sometimes was used as an enforcement mechanism, it did not appear to be a major factor in assuring contractual enforcement.

4) Enforcement through Legal Channels

From Macaulay (1963) and Ellickson (1991), we expected there to be little litigation. But the opposite was the case. Many firms we interviewed had gone to court or contemplated going to court. (See Table 9). Indeed, the courts were crowded with commercial cases and backlogs were long. Several firms were also suing in foreign courts, although success there seemed very limited.

There was a consensus among our interviewees, including many who were suing trading partners, that court action was unlikely to bring redress. Several managers said that they did not bother with the courts because they did not expect to be compensated. Since this was the general attitude, managers clearly did not depend on lawyers and courts to enforce their contracts. It was also interesting that no one mentioned going to the police to propose criminal fraud cases against "phantom" firms.

In spite of crowded court dockets, several firms were successful in court. One manager who won a court case still complained that it took four months from filing suit before he was other party to abide by the contract.
paid. Another firm expected to receive a chicken farm as compensation in the near future.\footnote{The chicken farm was bankrupt. The firm did not really want a chicken farm. It could not sell the farm, however, since the farm was state property. The firm planned to take out a bank loan using the farm as collateral and then default on the loan. The firm would obtain money this way, although less than it would like. Under the law, the bank was allowed to sell the farm.}

Still another firm had a considerable collection of farm equipment seized by court order from debtors who had not paid. Although our sample is not large enough to verify this, there appeared to be a gap between managers’ low subjective probability of being compensated through court action and the facts.\footnote{In addition to the regular courts, the Bulgarian Chamber of Commerce provided private arbitration procedures. Arbitration had been used mostly in settling disputes involving foreign firms, but it was also available for settling disputes between Bulgarian firms. Judgments still had to be enforced by the courts (should firms refuse to abide by the arbitration decision), but arbitration decisions could be made quickly since the arbitration courts, in contrast to the backlogged legal courts, were little used. (Source: Mark S. Beesley and Stephan Kyutchukov from the American Bar Association's Central and Eastern European Civil Education Project).}

Given the low probability managers attached to success it was surprising that there is so much court action. As seen in Table 9, in 43% of possible cases, the firms were involved in lawsuits that they instituted. These firms were not large, with a median size of 145 workers (most of whom were production workers). This amount of legal action seems very high for such firms. One explanation is that some state firms felt an obligation to sue as a signal to superiors that they had done everything possible to resolve a dispute. Another, based partly on interviews with bankers in 1997 (Koford and Tschoegl 1997), was that the legal and court costs for suing in
Bulgaria’s continental legal system are very low. Table 9 shows that state firms went to court more often than private firms. While 65% of state firms had lawsuits, only 21% of private firms did, and no cooperatives. One cooperative director told us that cooperatives “hate” to be involved in lawsuits.

Table 9 here
Macaulay (1963) and Ellickson (1991) see a very high cost in terms of future relationships in going to court. For Macaulay, court action generally means the end of an important business relationship. In the fluid situation in Bulgaria at the time of the survey, cutting off a customer who refused to pay might have been perceived as having a low cost, especially if the other firm was suspected of being a "phantom" firm. In contrast, one large manufacturing firm we interviewed described a situation where they were agonizing over a decision to sue an important foreign customer. They understood that this would mean the end of an important relationship, but they were starting to conclude that court action was the only way they might receive payment.

While we did not take a census of the firms being sued, most cases seem to have involved normal business dealings in which one party failed to perform. We did hear of a few “phantom” firms that were being sued, however. The large number of lawsuits indicates that firms were failing to evaluate with sufficient care whether their counterparts would default. Firms were largely making “spot” contracts, and they were still facing defaults. This would not be expected in a normal market economy.

5. Conclusion

Our survey addresses the question of how firms in Bulgaria wrote and enforced contracts as they adjusted to the new market economy.

1) We found severe coordination problems among some groups of trading partners. Most

33. It may be that many of the defaulters were not frauds, as well. They were perhaps too optimistic.
occurred when credit was needed and where the breakup of the old fully integrated state monopolies left the firms very small and vertically disintegrated.

2) We found only a few long-term contracts, but many long-term relationships. Virtually all firms viewed long-term relationships as important, yet they did not have long-term contracts with their partners. These cases seem reasonably consistent with Williamson’s argument that long-term contracts are hard to sustain. Where long-term contracts would be desirable but could not be enforced—a very common situation in Bulgaria—they did not occur. The markets often collapsed down to much smaller spot-market contracts. This was particularly true in the ties between specialized agriculture and food-processing, where firms could not offer credit and be sure to receive repayment in agricultural output.

The apparent shortage of long-term contracts could be explained by (1) weak laws, (2) an uncertain environment, or (3) uncertainty about partners. Since all three were present, we cannot determine which.

3) In Williamson’s framework, spot markets are a fall-back position which should operate successfully. We found that what would be well-functioning spot markets in the U.S. still broke down in Bulgaria. Because of the high cost of identifying reliable trading partners, conditions of bilateral dependency developed from the trading situation even in the context of spot markets. The “true” fall-back of the spot market seems like illegal markets in the U.S.—e.g., drugs. Cash paid for goods. Cash was counted at the place and time of providing the good. The good was carefully inspected for quality at this time. Any deviation—e.g., paying by bank transfer, or failure to inspect immediately—could lead to successful fraud or delivery to a firm unable to pay.
4) The large number of lawsuits indicated failure of parties to succeed in mutually beneficial relationships. The rules of the game had not been agreed on.

While it would be inappropriate to associate the large output decline in Bulgaria during the early years of transition to a single cause, difficulties in developing reasonable contractual arrangements was not helpful. During the early transition period economic change occurred quickly and while market relationships did develop, there were major costs associated with the need to develop these new institutions. Blanchard and Kramer (1997) outline these problems in their discussion of ‘disorganization.’ The transactional problems that we found in Bulgaria would lend support to their hypothesis.
Bibliography


Dobrinsky, Rr. 1994 Enterprise Arrears and Bad Loans in Bulgaria, (Working paper XXI Century Foundation - Centre for Strategic Business and Political Studies, Sofia, Bulgaria).


Hackett, S 1994 Is Relational Exchange Possible in the Absence of Reputations and Repeated Contact?" *Journal of Law, Economics and Organization* 10, 360-389


Sako, M, 1992 *Prices, Quality, and Trust: Inter-Firm Relations in Britain and Japan*, (Cambridge University Press, New York)


### Table 1

**Comparative EBRD Indices for 1994**
(Higher scores are better)

<table>
<thead>
<tr>
<th></th>
<th>Bulgaria</th>
<th>Romania</th>
<th>Czech Republic</th>
<th>Slovakia</th>
<th>Hungary</th>
<th>Poland</th>
<th>Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price Liberalization</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Forex and Trade Liberalization</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Small Scale Privatization</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Large Scale Privatization</td>
<td>2</td>
<td>2</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Enterprise Reform</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Competition Policy (1995)*</td>
<td>2</td>
<td>1</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Banking Sector Reform</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Legal extensiveness (company law) (1997)*</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>4</td>
<td>3.3</td>
</tr>
<tr>
<td>Legal effectiveness (company law) (1997)*</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>3</td>
<td>4</td>
<td>4.3</td>
<td>3</td>
</tr>
</tbody>
</table>

* First year that the index was reported.

Source: European Bank for Reconstruction and Development, *Transition Report 1999, Ten Years of Transition*
TABLE 2

Sample Characteristics

<table>
<thead>
<tr>
<th>Main Product or Service</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Food production</td>
<td>19</td>
<td></td>
</tr>
<tr>
<td>Food distribution</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>7*</td>
<td></td>
</tr>
</tbody>
</table>

N = 36

<table>
<thead>
<tr>
<th>Type of ownership</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>state</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>private</td>
<td>11</td>
<td></td>
</tr>
<tr>
<td>cooperative</td>
<td>5**</td>
<td></td>
</tr>
<tr>
<td>municipal</td>
<td>2</td>
<td></td>
</tr>
<tr>
<td>joint venture with foreign participation</td>
<td>1</td>
<td></td>
</tr>
</tbody>
</table>

N = 36

<table>
<thead>
<tr>
<th>Food Industry Ownership Type:</th>
<th>Processing</th>
<th>Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>state</td>
<td>11</td>
<td>1</td>
</tr>
<tr>
<td>private</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>cooperative</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td>municipal</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>joint venture with foreign participation</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

N = 29

<table>
<thead>
<tr>
<th>Firm size</th>
<th>mean</th>
<th>median</th>
<th>range excluding highest and lowest</th>
</tr>
</thead>
<tbody>
<tr>
<td>number of workers</td>
<td>277</td>
<td>145</td>
<td>1-- 2800</td>
</tr>
<tr>
<td>sales (millions of lev)</td>
<td>345</td>
<td>80</td>
<td>0.2 -- 5000</td>
</tr>
</tbody>
</table>
### Years in business

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1-4</td>
<td>9</td>
</tr>
<tr>
<td>5-8</td>
<td>2</td>
</tr>
<tr>
<td>9-16</td>
<td>3</td>
</tr>
<tr>
<td>17-24</td>
<td>5</td>
</tr>
<tr>
<td>25-32</td>
<td>4</td>
</tr>
<tr>
<td>&gt;32</td>
<td>4</td>
</tr>
</tbody>
</table>

N = 27  
median 16

### Averages by type of firm:

<table>
<thead>
<tr>
<th></th>
<th>Number of Workers</th>
<th>Sales in Leva (millions)****</th>
<th>Sales per Worker (millions of leva)</th>
<th>Years in Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>State</td>
<td>464</td>
<td>586</td>
<td>1.26</td>
<td>25</td>
</tr>
<tr>
<td>Private</td>
<td>80</td>
<td>123</td>
<td>1.54</td>
<td>5.6</td>
</tr>
<tr>
<td>Cooperative</td>
<td>125</td>
<td>65</td>
<td>0.52</td>
<td>50</td>
</tr>
<tr>
<td>Other***</td>
<td>275</td>
<td>95</td>
<td>0.35</td>
<td>22</td>
</tr>
<tr>
<td>Total</td>
<td>277</td>
<td>337</td>
<td>1.20</td>
<td>22</td>
</tr>
</tbody>
</table>

* There firms include tourism (2), shoe manufacturing, packaging, market research, transport brokerage, sportswear, and a trading firm.  
** One cooperative reported to the Council of Ministers.  
***municipal, international joint venture  
****The exchange at the time of the interviews was 55 lev/$  
Source: Survey
### TABLE 3

**Long-term Relationships**

<table>
<thead>
<tr>
<th>Suppliers:</th>
<th>Customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core group of suppliers?</td>
<td>Core group of customers?</td>
</tr>
<tr>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>N = 36</td>
<td>N = 33</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Proportion of sales from core group:</th>
<th>Sales to core customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>below 25%</td>
<td>below 25%</td>
</tr>
<tr>
<td>from 25% to 50%</td>
<td>from 25% to 50%</td>
</tr>
<tr>
<td>from 50% to 75%</td>
<td>from 50% to 75%</td>
</tr>
<tr>
<td>above 75%</td>
<td>above 75%</td>
</tr>
<tr>
<td>N = 29</td>
<td>N = 26</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Relationship with suppliers:</th>
<th>Relationship with customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>friendly</td>
<td>friendly</td>
</tr>
<tr>
<td>trustworthy</td>
<td>trustworthy</td>
</tr>
<tr>
<td>hard bargaining</td>
<td>hard bargaining</td>
</tr>
<tr>
<td>not entirely trustworthy</td>
<td>difficult</td>
</tr>
<tr>
<td>other</td>
<td>correct relations</td>
</tr>
<tr>
<td>N = 26*</td>
<td>N = 21*</td>
</tr>
</tbody>
</table>

*There are some multiple responses in the first two categories.*

Source: Survey
<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>Small Amounts</th>
<th>None</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do you purchase supplies directly from outside of Bulgaria?</td>
<td>9</td>
<td>20</td>
<td>5</td>
<td>34</td>
</tr>
<tr>
<td>Do you sell directly to foreign customers?</td>
<td>12</td>
<td>12</td>
<td>8</td>
<td>32</td>
</tr>
</tbody>
</table>

Source: Survey
### TABLE 5

**Bargaining Power and Competitiveness of Markets**

Do your relations reflect equal bargaining power between parties?

<table>
<thead>
<tr>
<th></th>
<th>With Suppliers:</th>
<th>With customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>22</td>
<td>21</td>
</tr>
<tr>
<td>no</td>
<td>9</td>
<td>3</td>
</tr>
<tr>
<td>N = 31</td>
<td></td>
<td>N = 24</td>
</tr>
</tbody>
</table>

Could you easily change your supplier? one of your major customers?

<table>
<thead>
<tr>
<th></th>
<th>With Suppliers:</th>
<th>With customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>16</td>
<td>17</td>
</tr>
<tr>
<td>no, we are bound by a long-term agreement ...</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>no, we are bound by common assets (real estate, equipment, equity, etc.) ....</td>
<td>1</td>
<td>0</td>
</tr>
<tr>
<td>no, this might provoke retaliation harmful to my business</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>no, there are no other good suppliers</td>
<td>6</td>
<td>na</td>
</tr>
<tr>
<td>other</td>
<td>4</td>
<td>6 *</td>
</tr>
<tr>
<td>N = 27**</td>
<td>N = 23**</td>
<td></td>
</tr>
</tbody>
</table>

* One firm has to export its goods.
** There are some multiple responses.

Source: Survey
TABLE 6

Contractual Disputes

Do you ever have formal written contracts?

<table>
<thead>
<tr>
<th></th>
<th>With Suppliers:</th>
<th>With Customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>27</td>
<td>..... 23</td>
</tr>
<tr>
<td>no</td>
<td>10</td>
<td>..... 11</td>
</tr>
</tbody>
</table>

N = 35*  
N = 31*

If you have written contracts, have you ever had a disagreement ... about fulfillment of a contract?

<table>
<thead>
<tr>
<th></th>
<th>With Suppliers:</th>
<th>With Customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>na</td>
<td>..... 16</td>
</tr>
<tr>
<td>no</td>
<td>na</td>
<td>..... 4</td>
</tr>
</tbody>
</table>

N = 20

If you have written contracts, have you ever taken legal action ... in case of contract violation?

<table>
<thead>
<tr>
<th></th>
<th>With Suppliers:</th>
<th>With Customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>8</td>
<td>..... 11</td>
</tr>
<tr>
<td>no</td>
<td>14</td>
<td>..... 9</td>
</tr>
</tbody>
</table>

N = 22  
N = 20

If you do not have written contracts, have you had problems ... ?

<table>
<thead>
<tr>
<th></th>
<th>With Suppliers:</th>
<th>With Customers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>yes</td>
<td>3</td>
<td>..... 7</td>
</tr>
<tr>
<td>no</td>
<td>8</td>
<td>..... 5</td>
</tr>
</tbody>
</table>

N = 11  
N = 12

* There are some multiple responses.
**TABLE 7**

**Payment Guidelines**

When you sell your product to a customer, do you typically require that these enterprises pay you:

- before you ship the goods ........................................ 15
- when they receive the goods .................................. 23
- within a specified time after receiving the goods ...... 15
- within an unspecified time after receiving the goods .. .. 0

\[ \text{N} = 32^{*} \]

Conditions under which delayed payments were permitted:

- Only with most reliable customers ........................ 5
- Only with specific customers .............................. 4
- With state budgetary units ................................. 1
- Foreign customers ......................................... 1
- No special group identified ............................... 3

\[ \text{N} = 14 \]

*There are some multiple responses.*
### TABLE 8

**Reputation and Business Problems**

How did you react [to problems with business partner]?

<table>
<thead>
<tr>
<th></th>
<th>Supplier Contracts</th>
<th>Supplier No Contracts</th>
<th>Customer Contracts</th>
<th>Customer No Contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>“I undermined his reputation”</td>
<td>2</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Other answers</td>
<td>17</td>
<td>15</td>
<td>39</td>
<td>50</td>
</tr>
</tbody>
</table>

N* (firms responding):  6    6   15   15

- There are some multiple responses.

Source: survey
<table>
<thead>
<tr>
<th></th>
<th>State</th>
<th>Private</th>
<th>Cooperatives</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Have lawsuits against suppliers?</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>5</td>
<td>2</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>No</td>
<td>6</td>
<td>5</td>
<td>4</td>
<td>15</td>
</tr>
<tr>
<td>N = 22</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Have lawsuits against customers?</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>10</td>
<td>1</td>
<td>0</td>
<td>11</td>
</tr>
<tr>
<td>No</td>
<td>2</td>
<td>6</td>
<td>1</td>
<td>9</td>
</tr>
<tr>
<td>N = 20</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Yes</td>
<td>15</td>
<td>3</td>
<td>0</td>
<td>18</td>
</tr>
<tr>
<td>No</td>
<td>8</td>
<td>11</td>
<td>5</td>
<td>24</td>
</tr>
</tbody>
</table>

Source: Survey