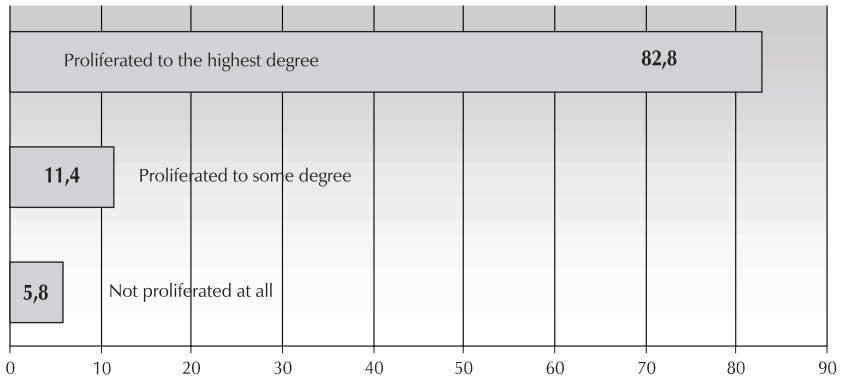
C. THE FIGHT OF CORRUPTION IN THE ECONOMY

The economy is one of the main spheres of interaction between the state and the private sector as this is the realm in which public wealth and resources are generally redistributed. The critical junctures of that redistribution, i.e. the processes which have the greatest potential to generate corrupt practices are privatization, public procurement, business regulation standards including the system of corporate governance, taxation and import and export control. The lack of well working and transparent mechanisms in any of those fields generates corruption which gets transferred to the other of the spheres of the economy and society with adverse consequences for the structure of economic interaction as a whole.

C.1. Privatization and Post-Privatization Control

In comparison with the year 2000 the number of the privatization deals in 2001 was considerably smaller (234 until the end of 2001 versus 589 for the previous year), which can be explained by the fact that the process of privatization is now in its final stages. There are multiple reasons why there is a **general perception of dissatisfaction with the outcomes of privatization**, but most important are the drawbacks of the existing privatization rules and the lack of effective post-privatization control. It is not a surprise that the new government declared its intentions to review quite a few of the privatization deals which were already closed. Such a review, however, should be carefully carried out only if there are clear indications of violation of the rules - otherwise it could turn into a „witch hunt" decreasing the attractiveness of the Bulgarian economy for investment both on behalf of foreign and local investors as well as generating in its own turn a new wave of corrupt practices.

SPREAD OF CORRUPTION IN THE PROCESS OF PRIVATIZATION



Source: CMS of *Coalition 2000*, October 2001

The experience so far shows that **the process of privatization has already constituted two types of interests which are being served by corrupt practices**, producing a social group of high economic capacity, namely:

- Acquiring public assets at a deflated price.

- Using the profits from the privatized assets for acquisition of new assets.

That is why the goal of serving the public interest through privatization (highest possible sale price, large-scale investment, preservation of jobs) has rarely been attained. Moreover, the existing conflicts between public and private interests makes many people believe that the inclusion of additional conditions to the sale price makes privatization deals meaningless and only generates opportunities to evade legal obligations by the parties as a result of corrupt practices.

With regard to the already closed privatization deals it could be said that the existing mechanisms have provided a relatively fast transfer of ownership; these mechanisms, however, do not provide sufficient guarantees for compliance with the agreed upon obligations. The preferential use of the privatization technique of „negotiations with a prospective buyer", the excessive reliance in the recent years on employee/management stock ownership associations as main buyers and the use of indemnifying promissory notes worth only a fraction of their nominal value for payment created wide opportunities, often accompanied by corruption, for the non-monetary obligations to be avoided. The consequences of the deals on Balkan Airlines, Plama - Pleven, etc. which became clear in the year 2001 represent illustration of these practices. A number of these deals brought allegations of corruption in addition to the fact that of considerable losses for the former owner (i.e. the state) and practical liquidation of some of these companies as effectively functioning businesses.

The sale of hotels and individual units of „Slunchev bryag" AD by the Privatization Agency in September 2001 through a tender auction are **a positive example which shows the potential possibilities of auctions as a privatization instrument** (in comparison with the results from the employment of the technique „negotiations with potential buyers")

A large portion of the declared intentions of the new government concerning the privatization process have already been included in the *Draft Law of Privatization and Pos-Privatization Control*. This draft law also contains a number of measures for prevention of corruption some of which have been proposed multiple times by *Coalition 2000:*

- Restoration of the centralized management of the privatization process by the Privatization Agency in order to make control over the individual deals easier.

- Strict compliance with the principle of equal treatment of buyers which has been violated so far by the preferential treatment of employee/ management stock ownership associations.

- Avoiding the use of indemnifying promissory notes for payment in privatization deals.

- Using open auctions and initial public offerings at the stock exchange as main privatization methods while negotiations with potential buyers are practically excluded as a method of divestiture.

- Setting up of a specialized agency for post-privatization control in order

to put an end to the practice when already privatized enterprises get unreasonable waivers of obligations, reconsideration of the clauses for the preservation of jobs and the nature of the business, excluding requirements for compliance with environmental regulations, etc.).

- Creation of a public register of the privatization deals and post-privatization control in order to make the process transparent and information about the deals accessible to the public.

At the same time it should be noted that some of the provisions of **the draft law still create opportunities and increased risks of corruption**. Here are a few of them:

- There is a discretionary authority of the Executive Director of the Privatization Agency over what should be included in the privatization deals. There are no provisions for control over the actions of the Executive Director and his staff at different stages of the preparation and closing of the deals.

- The authority of the Supervisory Board over privatization deals is strongly limited - it is reduced only to formal compliance with the law.

- The new law does not specify even the basic rules for organizing auctions, tenders and selection of privatization intermediaries and consultants; this matter will be regulated by executive acts of the Council of Ministers or by internal rules.

- Rules for reversing privatization deals as well as the financial implications of such actions are entirely missing.

- There is no regulation on coordination the terms of the privatization contracts with the industrial, sectoral and social policy of the government.

- The legal regulation of the Agency on Post-Privatization Control is fragmented. The actual prerogatives of this agency are in fact mentioned only in one short paragraph. Such drawbacks in the legal provisions on the controlling bodies which are supposed to protect the state's interests can, in general, create opportunities for corruption.

In addition it could be noted that the provision of the draft law does not automatically ensure transparency and equal treatment in the course of privatization. If there is no sufficient will for proceeding further in a transparent way, even tenders may turn into a source of corrupt practices and favor certain prospective buyers through putting specific terms as part of the procedure, which only these buyers could possibly satisfy. A special attention should be paid to the procedure of transfer of documentation on already closed deals to be the new Agency of Post-Privatization Control. This transfer of thousands of files from one institution to another creates risks of „unintentional loss" of part of the documentation on certain deals, either with the purpose of cover up of existing violations of the rules or favoring of specific buyers as further control is hard if documentation is missing.

C.2. Conditions for Doing Business and Corruption

Corruption can exist in a transition context as well as within properly functioning market economy. That is why **targeting corruption in the sphere of the economy** is and should be a permanent task of the government and the political class. The existence of a considerable gray sector and a large volume of unaccounted for import of goods means that in addition to the state in the country there exists **a parallel system of management of the economy, which controls about 1/3 of the turnover**. The horizontal and vertical links built by this parallel power will not lose their importance even if there was a functioning market economy in the country. Even in such circumstances considerable money flows will pass through the state budget That is why **the claim that development itself will solve the problems of corruption in the economy is wrong:** first, because the symbiosis between the state and the private sector generates the gray sector (i.e. the parallel power) which will serve as a brake on economic transformations; and second, the consolidated structures of this parallel power will always try to perpetuate the existing channels of corruption. The control of a considerable part of the national economic turnover provides the necessary resources for maintaining the status quo.

In this context one should note that **the practices of the new government concerning the making of rules for the interaction between the state and private business also involve controversial reactions**. The stated intention to set up a Council on Economic Growth with the Council of Ministers including representatives of big business provoked public criticism mainly because a number of these people have been allegedly involved in shady economic activities. This, in turn, raises the problem of formulating clear and transparent criteria for participation in such structures as well as the need to specify what their functions and status should be. The activities of the government so far reflect a conflict between the political platform of the new parliamentary majority and the existing economic realities. On the one hand, the bad shape of the Bulgarian economy requires a mobilization of all available resources; on the other hand, the main message of the new majority for honesty in politics and economic policy is incompatible with the tainted reputation of a portion of big business which the government is trying to work with.

The *White Book of the Bulgarian International Business Association* (BIBA) contains criticism for both governments which have been in office in 2001 for the business environment in the country. Both Bulgarian business leaders and foreign investors note the lack of clear communication channels with the government.

The need for introduction of stable market mechanisms put on the agenda one more issue - the regulation of the market for promissory indemnifying notes - transactions with them have involved massive fraud as opportunities for corruption at both stages of issue and transfer are abundant. Due to a fragmented legal regulation the market for these instruments is under regulated and very volatile; it also lacks necessary transparency - there is no registration of ownership change, there are no adequate mechanisms for fair market pricing and protection of the rights of owners and the other participants in the market, etc. The *Draft Law on Transactions with Indemnifying Notes* submitted by the government to the Parliament provides for a unified regulatory framework of issue, transfer and payment with such instruments aiming at an introduction of a market mechanism for trade through the stock exchange, a reliable and unified

system of registration of transactions and ownership change in the Central Depositary, short and simplified procedures, etc. The adoption and the application of these new regulations is expected to help achieve a transparent and steady flow of trade in these instruments and as a consequence - a radical decrease of the opportunities for corrupt practices.

C.2.1. Corporate Governance and the Supply - Demand Issue within the Corruption Relations

While corruption **demand** on behalf of representatives of the administration is determined in general by the nature of the relationship between government and private business and by the state of public morality, the **supply side** is a function both just of the existing interests but also of the inner structure and rules of corporate decision-making. The principles of corporate governance and its practice in the leading companies over the world reduce considerably the opportunities for corruption. That is why the introduction of sound corporate governance practices can have a strong **anticorruption impact over the supply side of corruption**. Still, there is a lack of adequate regulation in this field in Bulgaria, especially with regard to disclosure of conflict of interests, which creates for serious corruption potential; in other words, tolerance of non-compliance with the rules of sound corporate governance leads also to tolerance of the existence of opportunities for corruption.

This is the place to note that thanks to the efforts of *Coalition 2000,* the Corporate Governance Initiative and civil society in general, anti-corruption efforts in Bulgaria are directly related to the issue of legislating and practicing sound corporate governance which undoubtedly is a novelty for Central and Eastern Europe. Multiple measures for solving the existing problems have been proposed but during 2001 they haven't been paid sufficient attention by legislators and regulators and have hardly been taken into account yet in the preparation of new legislation. Among the necessary changes which need to be introduced one should note:

- Restricting simultaneous participation of the same person in several governing bodies; a necessary measure in this respect could be a compulsory disclosure of board membership and limitation of the maximal number of boards one can participate in.

- An explicit ban on the participation of state employees and representatives of the government in boards of private companies.

- Introduction of the institution of the „external director"; and

- Creation and compliance with clear rules for disclosure and avoidance of conflicts of interests.

Changes of the requirements for selection and functions of the members of governing managing and controlling bodies of publicly traded companies, requirements on disclosure and avoiding conflict of interests as well as introduction of the position of a company director for investor relations were proposed through the *Draft Law on Amending the Law on Public Offering of Securities* in 2001. Their goal is to establish high **professional standards for the members of the governing bodies of joint stock companies in Bulgaria and to improve communication**

between investors and the management of companies. It is logical to expect that if such texts are introduced and corporate governance principles are progressively introduced in Bulgarian business the scope of the supply side of corruption will be restricted too. The preparation of a *Code of Best Practices* which is supposed to happen in the near future is expected to induce Bulgarian companies to voluntarily comply with principles of sound corporate governance, induce discipline and discourage corruption.

So far it is still a norm that ownership rights in Bulgarian joint stock companies are exercised in the interest of majority owners and to the detriment of minority owners; enterprise interests are identified with their managers' interests; there is no real distinction of the spheres of activity of the different managing bodies. Contemporary forms of corporate governance require introduction of rules and procedures for protection of the interests of minority shareholders, clear mechanisms of disclosure of corporate information and avoidance of the conflicts of interests. The existence of such rules makes it more and more difficult to bribe officials or politicians, make unregulated payments and cover up illegal activities.

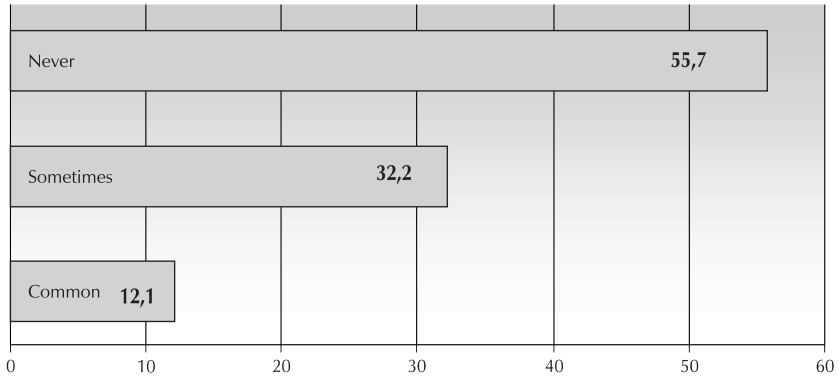
The introduction of such measures, which could significantly contribute to cutting down the opportunities for abuse and fraud, is possible only through a **radical and consistent reform of corporate governance**, based on the principles of maximization of shareholder value and clear separation of the spheres of competence and the responsibilities of the managing bodies of the enterprise.

C.2.2. Corruption and Public Procurement

Public procurement is a sphere of strong corruption pressure. Its legal regime is formulated in the 1999 *Law on Public Procurement*, which was not amended until the end of 2001 inspire of the criticism it provoked. Its major deficiencies include:

- Insufficient **transparency** of the procedures for public procurement which creates suspicions of corrupt practices.

FREQUENCY OF ADDITIONAL PAYMENTS OR BRIBES IN RELATION TO WINNING BIDS CONTRACTS OR INVESTMENT PROJECTS AND OBTAINING LICENCES (%)



Source: Global Competitiveness Survey, Vitosha Research and Center for Economic Development (survey of 119 companies, February 2001)

- Slow and inefficient appeal **procedures** which often block the normal flow of the process.

- Lack of **control** over the preparation of tenders which leads to low quality of in the preparation of prospectuses and related documentation and thus distorts equal treatment of the candidates.

- Narrowly defined **scope of application of the law** with regard to

both the subjects of public procurement and the persons who may open procedures for public procurement, which facilitates law evasion.

Besides the existing problems with the enforcement of this law it must be noted that the first steps towards greater transparency have already been made. A *Register for Public Procurement* has been set up with 7878 deals in its database.

The criticism concerning the existing legislation in the field of public procurement provoked proposals for amendments. At the end of year 2001 three new draft laws were submitted (two by individual members of the Parliament and one by the Council of Ministers). They target further harmonization of the procedures and eradication of the legal opportunities for corruption and discretion. The basic principles for new legislation should be:

- Guarantees for equal treatment of all candidates.
- Obligation of the contracting party to explain the reasons for its choice among the participating competitors.
- Ban on discretionary amendments in the texts of the offers as well as the contracts already agreed upon.
- More flexible approach to setting deadlines in the interests of all parties involved.
- Opportunity for signing a framework contract for public procurement in case of repetitive provision of goods and services.
- Additional guarantees of the transparency of the process.

C.2.3. State Regulation

One of the main sources of corruption stemming from the regulation of economic activities is the existence of **registration and licensing regimes**. The developments in this field in year 2001 concern mainly declaration of intentions on behalf of both Bulgarian governments to revise the existing regulatory framework. A large number of state agencies are involved in licensing (about 1/3 of all) but it is hard to say how many regimes really exist (the estimates vary between 450 and 526). The large number of laws which introduce or cancel such regimes provide no serious obstacles for modification of the existing regimes and even introduction of new ones by various agencies through different procedures.

The attitude toward **such a type of regulation** is still very **contradictory**:

- As a form of state control licensing regimes are one of the ways to reduce corruption by direct (administrative) control over economic activities.
- At the same time, however, exactly because of the way this control is exercised (direct control protecting public interest but opposing private interests which are subject of control) licensing regimes themselves generate considerable economic interests for evasion of control through corrupt practices. The existence of corruption in turn calls for

strengthening of government control and introduction of new regulations, and so on.

The main reason for the emergence of such an ascending spiral of control is that state intervention in this sphere does not introduce **mechanisms for coordination of interests among the participants in economic activities but it creates mechanisms by which administration imposes its authority** over the players in the economy. Thus interests are restructured in such a way that instead of taking into consideration the needs of their business partners these players are motivated by the interests of the administration. At the same time this administration supplements its behavior with a vision that if the state does not intervene in the regulation of certain markets, then the risks that business interests will grow in a direction against the public interest become much greater.

The accession of Bulgaria to the European Union creates additional difficulties in the attempts to solve the problems of licensing regimes: the provisions of the EU directives and regulations include a number of licensing regimes in the member-states. **The problem in Bulgaria is not so much in the existence and the number of regimes but in the clumsy, bureaucratized and badly organized implementation, which creates opportunities for corruption**. The issue of overregulation is, in fact, the issue of administrative discretion instead of providing „one-stop" service for the public. As a rule, obtaining a license in the EU and North America is a rational and efficient process in which the licenser and the licensee may never have to meet but just communicate through the Internet. Public interest is defended through the practice of mandatory follow-up control and the strict imposition of monetary sanctions, even criminal prosecution in cases which qualify as fraud.

The current legislation is full of contradictory provisions like the one described above and creates significant opportunities for corruption:

- It is possible to introduce in a discretionary manner registration and licensing regimes - not only through laws but also through executive regulations (for example ordinances); it is possible to keep an existing regime even after the law which initially led to the introduction of this regime was repealed.

- There is a lack of clearly formulated requirements for introduction of the licensing and registration regimes themselves.

- There are contradictory provisions of different regimes as well as a lack of horizontal coordination with regard to the authority of the different state agencies concerned.

- It is acceptable that one and the same institution defines the content of a regime and at the same time has the responsibility for control over its implementation.

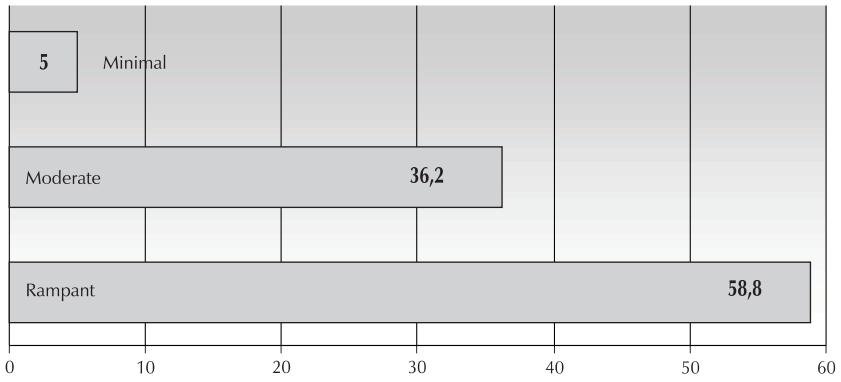
Obviously it is necessary to regulate the introduction of licensing and registration regimes itself in order to optimize the regulatory framework of business activities. **New regimes should be introduced only by law** - only if there is important state or public interests involved and only if there is no other way to achieve the desired outcome. The state should exercise its regulatory authority not just for the sake of controlling individual business players - it should provide equal treatment so that each

of them, taking into consideration his/her own interests, would participate in controlling the others.

C.2.4. Taxation and the Gray Economy

The existence of the shadow economy is a product of the corrupt linkages between private business and the tax administration. One of the stimuli for corruption in this respect is the opportunity to save money if the size of the bribe is lower than the size of the tax liability. A look at the current income levels in the country shows that for the majority of the taxpayers the size of the bribe and the amount of money saved by tax evasion is pretty much the same. People with higher income and especially corporations have a **stronger incentive to evade tax laws through corruption,** as there is big difference between the size of the bribe and the amount of their tax liability. The size of the gray sector (it varies between 27 and 35 percent of the GDP according to different estimates) shows that the tax evasion is a mass phenomenon. We have come to the paradoxical situation in which delinquent taxpayers (i.e. economic agents which are better-off) live at the expense of conscientious tax-payers (i.e. the lower income groups), as tax collection has become a problem.

SPREAD OF TAX EVASION (%)

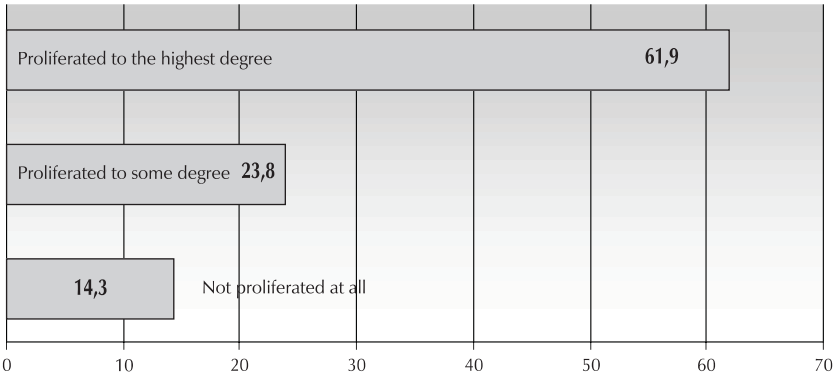


Source: Global Competitiveness Survey, Vitosha Research and Center for Economic Development (survey of 119 companies, February 2001)

Obviously it is not the **tax rates per se**, but **the tax structure and taxation procedures**, which determine what part of the legal economic activities will be taxed in accordance with tax laws. Bulgaria is a country with an average level of tax burden but nonetheless taxes are perceived as heavy because of the low income of the population and the general weakness of private business. The creation of a system of taxation which performs stimulating and social functions, is a pre-election priority of political party running for government but the attempts to implement this in practice clash with objective economic reality and results are often limited. The ambition to restructure taxes by **increasing indirect taxes and decreasing direct taxes** is believe to have a strong anti-corruption potential as it may help achieve higher rate of tax collection and a decrease of the share of the gray sector.

We cannot help noticing the fact that for the last a few years the tax administration has been undergoing a process of modernization. Year 2001 saw **a lot of positive changes in the organization of the work of tax authorities,** as their strategic goal is to both guarantee revenue for the budget and stimulate voluntary compliance with tax laws.

SPREAD OF CORRUPTION IN THE TAX ADMINISTRATION (%)



Source: CMS of *Coalition 2000*, October 2001

C.2.5. Corruption and Import Controls

The open nature of the Bulgarian economy in which between 65 and 75 percent of the GNP is realized through imports and exports creates opportunities for the existence of illegal cross border activities. **Like before, in 2001 the Bulgarian customs authorities were one of the basic mechanisms involved in the redistribution of national wealth**. We can judge about the scale of this redistribution from the surveys of *Coalition 2000* according to which although smuggling were better controlled in the period 1998-2000, 25-35 percent of the imports and the exports passed through illegal channels.

In 2001 the state of gray import and smuggling in the country was marked by two opposite trends. On the one hand, there was a constant **increase of legal import of goods, semi-manufactured articles and raw materials**. A basic factor for this positive development is the increased presence of the big chains hypermarkets like Metro, Billa, Ramstore and the supermarket chains Fantastico, Oasis and others in the country. Similar positive influence comes from the presence of many multinational companies, which continue their penetration in Bulgarian market either directly or by cooperation with a Bulgarian partner.

On the other hand, in 2001 there was **an increase of the pressure over border control authorities to allow illegal and semi-legal import and export of goods** (unlike the initial years of the transition in Bulgaria when smuggling was dominant after 1998 the prevailing violations involved mainly import at lower prices, use of incorrect lists of goods, etc.). The following important **changes on the domestic market** account for this increase:

- The **reduction of the sales** of part of the mass and luxury goods due to worsening economic situation of consumers.

- The **changes in the structure of sales** determined by the penetration of the big hypermarket and supermarket chains which drove out of the market part of the dominating until then elements of the chain „large importer - wholesaler warehouse - retailer".

Squeezed by reduced consumption and the completion of chain stores some importers and wholesalers resorted again to using channels for „cheap goods", which led to a new search for parallel import-export schemes.

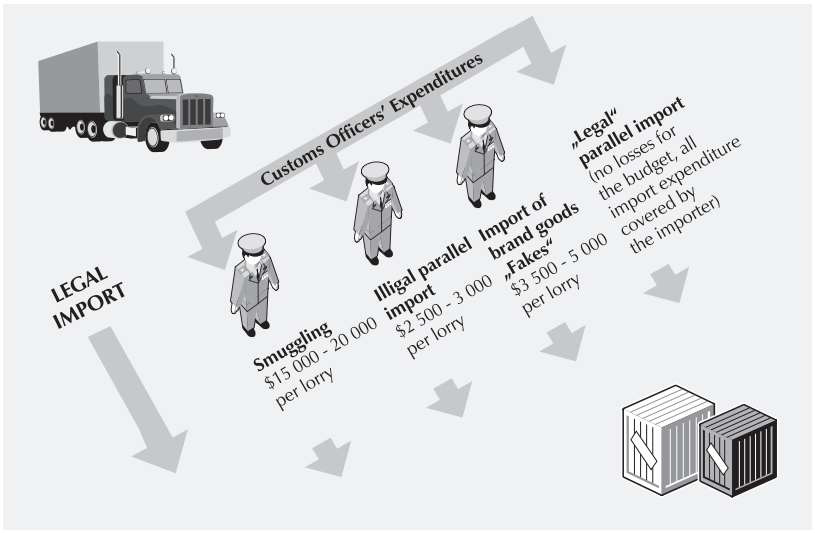
Unlike previous years, in 2001 the **situation in the customs authorities was seriously influenced by the results of the parliamentary elections in June**. The year started with a management change in the five largest

customs offices, later there were conflicts between the new director of the agency - Emil Dimitrov and some of his staff, and finally the British company Crown Agents was hired as a consultant for the overhaul of the customs. The political changes in the country had a controversial effect:

- Constant personnel changes led to a disintegration of old schemes for illegal import and export and seriously hampered smuggling and parallel imports and exports.

- Chaos and fear among managers in the customs administration shortened the horizon of rank-and-file customs officers and the latter started cooperating with gray importers on their own trying to make the „last quick buck" before an eventual dismissal or „a last favor" in order to get a job working for somebody else.

TYPES OF SMUGGLING SCHEMES AND PARALLEL IMPORT



In this sense when both for the customs administration and for the violators it became clear that the elections would bring changes illegal trafficking intensified immensely. According to expert and importer estimates three more channels were open again passing through Varna, Bourgas and Capitan Andreevo. It could be argued that **by the end of August there was massive import of goods levied with very low customs duties**. According to *Coalition 2000* estimates building up reserves of goods in the summer months rose to almost 200 percent in comparison with the same period in previous years. An emblematic example in this respect is the on the import of alcohol. According to big international importers at the end of 2000 the Bulgarian market resembled any other European market with about 10 percent of gray import while in the middle of 2001 again almost 50 percent of the imported alcohol had illegal origin.

An old phenomenon characteristic for the period 1997-1998 was revived: since mid-April 2001 expectations for political changes brought to the **restoration of the practice of buying** offices if no political protection was available both by leaving managers and newly appointed managers. The scandal in Rousse in November 2001 for the first time showed to the public the large scale of selling and buying positions in the customs.

The event, which received the most controversial assessments in 2001, was the **change of the management team of the Customs Agency** after the parliamentary elections. The personnel changes and especially the great number of dismissals of customs officers caused a strong negative reaction. According to critics of the new director of the Customs Agency

mass dismissals brought chaos to the work of the customs authorities and as a result the revenues fell dramatically (between 15 and 30 percent). The charge of „mass dismissals", however, has to be considered carefully. In comparison with the dismissals in 1997 when 377 customs officers and the heads of all 16 regional customs authorities were fired for the period August - December only 258 people were replaced. At the same time the information given by the Management of the Customs Agency shows an increase of the revenues for the period September - November (according to different publications - between 6 and 30 percent). Unfortunately, a **general assessment of the work of the Bulgarian customs since August 2001 is hard to do because of the lack of objective information**. There is still no account of the differences between the revenues declared at the customs and the real revenues entering the state budget. Because of lack of information the assessment method of mirror statistics can be applied for the beginning of 2002 at earliest.

* * *

Given the importance of the problem of corruption for the public the anticorruption initiatives in the field of economy in 2001 could be evaluated as **modest** (less intensive than the initiatives and priorities in politics) and their effect as **moderately positive** (there is some progress and positive experience in different sectors of the economy but the necessary turning point has not been reached yet). The data from the Corruption Monitoring System of *Coalition 2000* shows that the intensity of the different types of corrupt practices in the economy is relatively stable. In 2001 it was clear both for the political elite of the country and for the business community that corruption is among the major issues on the economic agenda for the country. The solution to this problem should be found immediately, which presupposes the introduction of modern practices in the social organization of the economy.