

CENTER FOR THE STUDY OF DEMOCRACY

**ECONOMY OF CRIME AND
ANTICORRUPTION REFORMS**

Discussion Topics

Sofia, 2003

PUBLICATIONS
of the Center for the Study of Democracy

Corruption and Trafficking: Monitoring and Prevention

Center for the Study of Democracy
Reports/Анализи No.9, Sofia, 2000

Smuggling in Southeast Europe

Center for the Study of Democracy
Reports/Анализи No.10, Sofia, 2002

Corruption, Trafficking and Institutional Reform

Center for the Study of Democracy
Reports/Анализи No.11, Sofia, 2003

Informal Economy in the EU Accession Countries

Center for the Study of Democracy, Sofia, 2003

© Center for the Study of Democracy
All rights reserved.

Sofia 1113
5 Alexander Zhendov Str.,
Phone.: (+359 2) 971 3000
Fax: (+359 2) 971 2233
csd@online.bg
www.csd.bg

In the course of transition the Bulgarian economy followed an ever more noticeable route to criminalization. The absence of clear-cut rules and institutions supporting free enterprise and private business helped shape a large gray sector within the economy. According to international estimates **the volume of the gray and black economy altogether ranges between 30 and 36% of GDP, which amounts to nearly 5-6 billion euro.** While “gray” economy presented opportunities for setting up a business at the start of transition, its persistently high share, the emergence of an economy of crime and the sizeable corruption levels enable organized crime to capture the legal economy, thus posing a tangible threat to the country’s long-term development.

Shades of Gray

The **gray economy consists of transactions** that are not prohibited by national law, but whose execution has not been declared before the state in congruence with the relevant rules and/or institutional requirements (declaration, registration, licensing etc).

The **black economy** involves activities that are prohibited and punishable by law and whose execution has not been declared before the authorities in congruence with the relevant rules and/or institutional requirements (declaration, registration, licensing etc).

Example: trade in spirits is a legal activity. If the traded spirits

have no excise band, it is a case of gray trade until excise is actually paid. This means that there is a way of moving into the legal economy. Drug trade, on the other hand, is definitely a “black” type of activity with no channel for changing its “color” within the current institutional framework.

FACTORS FOR THE CRIMINALIZATION OF ECONOMY

The following factors directly affect the criminalization of the economy:

- Systemic corruption during the process of divestiture ensuing from opaque privatization procedures;
- Shortage of investment capital and legitimate business structures able to become key actors in the economy;
- Significant bureaucratic and legal obstacles facing national entrepreneurs and foreign investors;
- Regulatory vacuum in a number of economic areas concerning the relations between the state and business as well as business relations in the private sector;
- Toleration and political protectionism over a sizeable portion of the gray economy and use of liberalization of the import-export mechanisms for large scale contraband operations;

- Sharp rise of poverty levels in the country and the resultant social isolation of large social groups.

THE GRAY ECONOMY AND CRIMINAL BUSINESS

One of the basic reasons for gray sector formation are the high transaction costs in the legal economy which economic literature terms “the cost of compliance”. This “price” includes:

- costs for accessing the legal economy – those for registration of legal persons, payment of licenses and permits, opening of bank accounts etc;
- costs for staying in the legal economy – payment of taxes, regulation of hiring and social security contributions, payment of court fees for settlement of conflicts within the legal judicial system etc.

Saving on any one of these costs means crossing the line into the gray sector, the price of which is engagement in corrupt practices.

From the second half of the nineties on, **organized crime has been consistently integrating Bulgarian business and politics.**

- The **black economy** sector has been expanding, while the gray economic activities run by organized crime have been gradually integrating into the regular, legal business and market.

- The gray economy is turning into a quasi economic system, serving as a link and facilitating the access of organized crime to legal methods and forms of business, which to a great extent secure its immunity from law enforcement.

The gray economy is becoming a tool for gradual legalization of the incomes of criminal business from the black economy and a natural intermediary between persons and structures of business and politics. It reproduces the full cycle of illegal and criminal financial economic transactions – starting with the gray and black import (contraband), through corrupt mechanisms for redistribution of the dirty money, gray commerce and the economic activity, to money laundering and the reintegration of capital in the legal economy.

A typical example for merger between the legal, gray and black economies is car sales and import. According to customs data the import of new and second-hand automobiles in 2002 amounted to nearly 500 million BGN. While new motor vehicles import is arguably almost 100 % legal, second-hand import is responsible for large gray quantities. Expert assessment shows that between 100 and 150 million BGN are clandestinely earned through that activity. It should be stressed that lax control on the second-hand automobile import accounts for a huge gray sector in the spare parts market as well.

The same import regime sustains the traffic of stolen cars that brought such ill fame to Bulgaria. Stolen car networks can market items in the country or abroad untroubled due to the sprawl of car dealerships and service stations. Gray and black automobiles market are further multiplied in the motor insurance market. The total of insurance frauds exceeds 1000 automobiles per month, but there is no data available on the number of cars leaving the country in that way.

- The mechanisms of political protectionism and the incorporation of criminal incomes into traditional and lawful production activities legalize the gray economy..

The threats posed by this gray zone of quasi-economic activity have increased because society and the state in one way or another tolerate it as it is deemed different from “traditional” criminal activity. In fact, the gray sector combines both useful economic activity, often the only way to earn a living, and guises for criminal business used for the gradual legalization of incomes of criminal origin and their seeming legitimacy in society.

Characteristics of the Bulgarian gray and black structures

1. **Organized crime of the Russian, Caucasian or even Turkish type is impossible** in Bulgaria. The main reason lies with the **size of Bulgarian economy**. Bulgarian GDP could be compared to that of a middle-sized EU or US city of 200-300,000 inhabitants; this is why a large criminal organization would be hard to conceal. At the same time, market structures are largely unsophisticated (there's no advanced technological production in the country), so the only way for a criminal organization to survive would be to maintain a variety of activities both within the gray and the “white” zone.
2. The specific cultural environment causes complex **overlaps between purely market relations and existing relations based on friendship, kinship or clientele**. The popular metaphor about “cousins” in fact betrays a dubious boundary between gray and black in the “economy of favors”.
3. To make matters even more complicated, the overlap between criminal and legal surpasses friendship or kinship relations and is transferred to the sphere of politics. In the last 10 years all significant gray networks have become interwoven with an intricate mix of political clientele aimed to keep the balance between “the main political powers” (referring to the largest political parties), i.e. the Bulgarian style of minimizing political risk means to be “on good terms with everybody”. These

Bulgarian rules are most apparent on local level where in some towns 2 or 3 families assume control over the local economy. The situation is worsened with the appropriation of the media by gray strategists. It is no coincidence that at the start of the transition all prominent economic groups were involved in the media business. As they entered a more mature stage, however, they abandoned advertising campaigns as commercially ineffective. Today's golden rule is to be low key and engage in black PR against rivals.

In addition, some new trends in criminal groups' activity have been visible:

- Rise of criminal activity in the financial system.
- Improvement of money laundering schemes to involve capital export and its return to the country for privatization deals;
- Spread of forged documents to be used for financial fraud;
- Ongoing regrouping of organized crime and their engagement in sectors of easy and fast turnover of capital. The resulting clashes between organized criminal groups for market and territory redistribution are often resolved through "traditional" crime.
- Illegal (forced) crediting proliferates. Organized crime uses the weak points of the banking system to use large amounts of cash for money lending usually ending in racketeering, extortion and

seizure of the property of borrowers. On the other hand, due to increased crediting by banks the resources of forced crediting dropped by between 300 and 500 million BGN during the last year.

THE CONSEQUENCES OF AN EXPANDING GRAY AND BLACK ECONOMY

The gray economy is turning into a chief means for economic groups to pressurize civil servants and state institutions. The inadequate counteraction to the economy of crime produces a number of **negative consequences**:

- Deepening of the socio-economic problems of the transition by the draining of public resources;
- Marginalization of a large portion of the working age population into long-term unemployment;
- Undermining free and fair competition and free private enterprise;
- Raising investment risks and warding off foreign investors from Bulgarian markets;
- Participation in international corruption and criminal networks through which the country is “integrated” in the regional criminal

infrastructure, which emerged under the impact of the developments in the Western Balkans;

- Creation of a negative image of the country among foreign business and political partners, and thus intensifying Bulgaria's isolation from Western democracies and creating obstacles for the country's EU and NATO integration;
- State capture and the resulting threat to the stability of democratic institutions;
- Criminal funds are "reinvested" for a boost to criminal activities; this further secures a fresh inflow of dirty money to support corruption lobbies on all levels of government.
- The impact of dirty money in politics is made especially negative through the financing of political parties and their election campaigns. In this way, covert schemes of financial dependence are set up creating prerequisites for amplifying the influence of organized crime.

THE PUBLIC REACTION

The boom of economic crime conducted by mafia-type groups and structures in close cooperation with corrupt politicians and civil servants has been closely monitored by civil society and the state institutions for more than a decade. Yet, **this phenomenon and the measures for curbing it still need to be reconsidered.**

There are several **stereotypic notions** representative of the public attitude towards organized crime:

- Crime is a problem isolated from other transition issues;
- There are no clear-cut criteria for prioritizing the economy of crime in the national security agenda as it has been recently redefined;
- There are also no criteria for measuring the economic cost of crime (including the often ineffective measures of law-enforcement and judicial bodies against it);
- The focus is on the manner of committing a given crime, not its significance and place in the context of illegal and criminal transactions typical of the quasi-economic relations in the shadow business;
- Corruption is considered separately from organized and economic crime, thus underestimating its detrimental effect;
- The threats posed by the economy of crime are not being prioritized;
- The legal regulation of measures against the new types of crime typically lags behind its appearance in various forms and structures which hurdles law-enforcement and judicial bodies in their fight against it.

COUNTERING THE GRAY AND BLACK ECONOMY

The success of the fight against the economy of crime requires the **following measures:**

- Improving the **legal environment for business**, and notably the implementation of the laws, which guarantee equality to all actors, further separation of the public and private sectors, ensuring the autonomy of business and free competition as a leading principle of the market economy and increasing the risks for non-market instruments in business, corruption in particular. A very important priority in this direction is the **improvement of the legislation, specifically commercial law, including insolvency, as well as the tax, customs, bank and financial legislation.**
- Adoption and implementation of a law on the **forfeiture of criminal assets.**
- Undertaking political, legal and regulatory reforms aimed at guaranteeing the **independence of government from improper influence** and transparency in the financing of political parties.
- Extending the powers and increasing the efficiency of the work of the **Financial Intelligence Agency, the Customs Agency, the tax authorities, the National Audit Office** and other control agencies in their fight against corruption and crime. Particular attention should be paid to the creation of a system for comparing import data and the collection of customs duties, which would restrict the size of the contraband and the various customs violations.

- No substantial results can be expected from traditional methods of combating economic crime unless they are coupled with corresponding reforms for curtailing the gray and black sectors.
- A comprehensive reform in the security sector overcoming inadequate inter-agency cooperation and coordination by improving information sharing is needed. This reform is necessary with respect to the new global threats such as the terrorism, trafficking in humans, drugs and arms;
- Broadening the partnership between the government and the civil society in countering corruption, in particular with the law-enforcement institutions, and implementation of **civil monitoring of the fight against organized crime and of the measures against the new economic crime in particular**. Independent control to restrict the abuse of EU funds is also very important.
- A more efficient and focused **international cooperation** in countering new economic crime. More efforts are needed to accelerate **regional cooperation against trans-border crime**. In order to achieve this, additional personnel as well as financial and technical resources should be made available.

The fight of the state and civil society against organized crime should become a top priority in their future activities. This statement has to be backed up by concrete effective **measures for checking organized crime participation in economic life and its decisive ousting into the black economy where it could be prosecuted.**