



LEVELLING THE PLAYING FIELD IN BULGARIA
***How Public and Private Institutions Can Partner for Effective Policies
Targeting Grey Economy and Corruption***

Summary

- This paper outlines the result of the consultations, which the Center for the Study of Democracy held with representatives of business and government on the feasibility of public-private partnerships in promoting a level playing field in Bulgaria. Its findings seek to inform further discussions with Bulgarian and international stakeholders on the modalities of possible future initiatives in this area on the example of public policy on the grey economy;
- If the efforts of the Bulgarian government and the business community to reduce the adverse impact of grey economy on the nation's welfare are to succeed they need to bring on board the experience from successful coalition building for good governance from the non-government sector, based on best international practices. International experience has revealed that there are no easy fixes to pervasive grey economy and corruption. This brief proposes an overview of measures undertaken thus far to tackle the grey economy in Bulgaria and outlines a possible platform for engagement of the business, NGO and government sectors for long-term partnership for leveling the playing field in the country;
- This platform should combine the power of the government, the efficiency of the business and the know-how and experience of the civil society in the presence of a strong outside anchor and committed partner – the European Union. Its structure should allow for a combination of broad policy guidelines with focus on specific tangible actions. It should focus on strengthening enforcement, improving public resource management and enhancing business integrity. The platform needs to start with a narrow high impact issue e.g. the use of PPPs and EU funds in infrastructure, tourism or energy;
- The grey economy is one of the main constraints to investment and growth in Bulgaria. Different estimates put the size of the grey economy in the country between 20 and 35% of GDP, with some sectors, reporting less than 50% of the actual value of transactions. These hidden revenues create a self-perpetuating pool of corruption payments used to secure anything from tax “breaks” to state capture;
- Lower tax and social security rates and increased control intensity introduced by the Bulgarian government since 2003 and continued credit-and FDI-based economic growth have reduced the share of the grey economy by some 30% between 2002 and 2008. As these measures are likely to have one-off, limited impact on the grey economy and related corruption, priority must be given to strengthening enforcement, in particular for severing grey business monopolies' corrupt access to high-level administration and political officials.

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Background

In the past 30 years public private partnerships (PPPs) have become a **preferred approach** for combining private efficiency and public gains in the leading economies of the world in the face of: (i) increasing demand for higher quality and efficiency of public services, (ii) the rising share of public spending on social and health care, and (iii) the globalization of financial services which created many diverse financial instruments and opportunities for the private sector. As a result, various forms of public-private partnerships have sprung up in many countries and on all levels of governance - national, regional and local. They provide a platform for transparent and long-term commitment of local and international businesses, non-governmental organizations and public bodies to combine their efforts in formulating policies and carrying out public projects.

Public-private partnerships could produce a **number of benefits**. The most important among them are: the use of private sector skills and knowledge to find innovative solutions to public challenges, enhancing the effectiveness of public services, and mobilizing financial and human resources supplementing those of the state administration.

Partnerships between business, government and NGOs become increasingly relevant in Bulgaria where the issues of the rule of law, good governance, fair competition and level playing field for companies and citizens cannot be yet said to have achieved the EU standards. In the European Union these PPPs are usually seen through the prism of private investment in the provision of traditionally public services but are also increasingly taking on wider functions. Although there is no universally accepted definition or a uniform practice at Community level, the first

attempts at change were made after 2004 with the European Commission issuing its *Green Paper on Public Private Partnerships*. It recognizes that the capacity of national public administrations to attract private investors and to engage with the business sector in a transparent and competitive manner will make a key difference in how these nations' infrastructure develops in the future and whether their international competitiveness grows.

In Bulgaria, partnerships between government and private institutions - commercial and non-profit - are also increasingly seen in the context of the country's integration into the EU. The Ministry of Finance, for example, has set up a specialized Public Private Partnership Unit within its Management of EU Funds Directorate. The Bulgarian NGOs sector has also developed and built substantial capacity for the promotion of PPP projects. The Center for the Study of Democracy established and led the Bulgarian anticorruption initiative *Coalition 2000*, which is one of the success stories in public-private partnership in Bulgaria. The initiative was launched and sustained with support from several governments (the US, Bulgaria, the UK, Norway, the Netherlands, and Ireland) and international institutions (the World Bank, IMF, and the UN) and engaged a number of Bulgarian NGOs. *Coalition 2000* provided the much needed PPP platform for the public and private stakeholders to combine their efforts and accomplish successful anticorruption reforms.

CSD's consultations revealed that there could potentially be a critical amount of support among the corporate sector and public stakeholders in Bulgaria for a long term cooperation platform provided it is implemented under the format and substantive focus, described below.

Outline of a Potential Format

A PPP Initiative would provide an independent and transparent forum for collaborative effort of the **main stakeholders**:

- Domestic and international businesses active in Bulgaria: representatives of the major investors and employers with a history in or capacity for PPP participation, such as banks, investment agencies, pension funds, law firms and consultancies, construction companies and architects, etc.
- Central government, regional and local authorities, and the judiciary: the Ministry of Finance with its already substantial capacity should play a major role.
- Non-governmental, educational and business organizations working for the promotion of PPPs, e.g. EBRD, UNECE, UNCITRAL, etc.

The Initiative will have the following main **goals and tasks**:

- Provide a platform where the government, businesses and civil society negotiate their ideas on the advancement of good governance policies in Bulgaria with a specific focus on measures contributing to a level playing field.
- Strengthen the capacity of the public administration and the private sector for designing and monitoring good governance policies training seminars and conferences, manuals, distance learning from organizations based abroad, etc.
- Awareness raising and promoting accurate and competent coverage of these issues in the Bulgarian media.
- Promoting good governance practices, strategies for specific sectors, models and guidelines.
- Building a network of international contacts of public and private stakeholders to

support and foster the progress of the Initiative.

Outline of a Potential Focus: The Grey Economy

CSD's consultations revealed that the grey economy is the focus area that could potentially be of interest by the widest range of corporate stakeholders. It appears as the least common denominator of the interests of NGOs, government and business and could thus serve as the initial substantive focus of a potential cooperation platform.

The grey economy, and related unfair competition and corruption, has emerged as a top concern to businesses operating in Bulgaria prompting an increasing number of proposed corrective policy actions on the side of the government, the business community, trade unions and think-tanks. Recent tax and social security contribution cuts and increased government control intensity have resulted in a de-shadowing of some parts of the grey economy. However, most policy proposals are based on the conventional wisdom that the grey economy is solely the byproduct of government regulation and high taxes. CSD research over the last ten years has shown that reality in Bulgaria, with its history of government sponsored smuggling routes, party loops of companies and organized crime strengthened by regional wars, is much more complex. Failure to recognize this complexity might render current policy initiatives and their social and economic gains short-lived. Successful leveling of the playing field in the country requires **sustained policy action over several political cycles** from committed reformers in the government, the business community and civil society. An important first step in this direction is developing a strong **public-private platform** for government accountability and business integrity,

modeled on successful coalition models such as the Bulgarian anti-corruption initiative *Coalition 2000*¹.

Grey Economy in Bulgaria: the Other Side of the Corruption Coin

Weaknesses in the fight against corruption and organized crime in Bulgaria have been major areas of concern by the European Commission and the country's international partners before and after its accession to the European Union in 2007². In effect Bulgaria's access to EU funds has been tied to the government's progress in prosecuting and bringing to justice political corruption and organized crime in the country³. In this regard, in June 2008 Bulgaria expects the second progress report by the European Commission, which is likely to underscore the need for the country to do more to curb political corruption and organized crime, following a series of political storms and a temporary suspension of some EU pre-accession financing tools in the second half of 2007 and the first half of 2008.

The focus on the narrow areas of judicial reform and the fight against corruption and organized crime risks losing sight of a very important underlying issue – **the size and dynamics of grey economy in Bulgaria**. There is an increasing body of studies showing that grey economy and corruption are closely linked. Recent research has shown

that in lower income countries, such as Bulgaria, grey economy and corruption seem to be complementary⁴. **Reducing incentives and opportunities to hide in the shades lowers the available resources for corruption, which in turn puts additional pressure on non-compliant players** to come out of the dark. Research on the links between grey economy and corruption performed by the Center for the Study of Democracy in its annual corruption assessment reports since 1998 has demonstrated that corruption has been the main tool for staying off the record books and even for generating government protected monopoly grey income and rents⁵.

Size and Scope of the Grey Economy in Bulgaria

Although grey economy is notoriously difficult to measure and understand it is easily identifiable by businesses when they face partners and competitors who operate outside the law by not paying taxes, social security and health contributions, hiding actual employment, circumventing product quality, safety or environment regulations, infringing copyrights, etc. According to the latest Enterprise Survey of Bulgarian firms performed by the World Bank in 2007 **informal practices** have topped the list of constraints to firm investment in Bulgaria. In fact **unfair competition**, which is how firms see and understand grey economy and corruption, has topped firm's concerns in Bulgaria in the last 10 years (since CSD started its corruption monitoring in 1998).

¹ For a summary of the structure, history and impact, and main activities of *Coalition 2000* visit <http://www.csd.bg/en/c2000/>.

² For a comprehensive assessment of Bulgaria's progress on good governance and anti-corruption see *Anti-Corruption Reforms in Bulgaria: Key Results and Risks*, Center for the Study of Democracy, 2007.

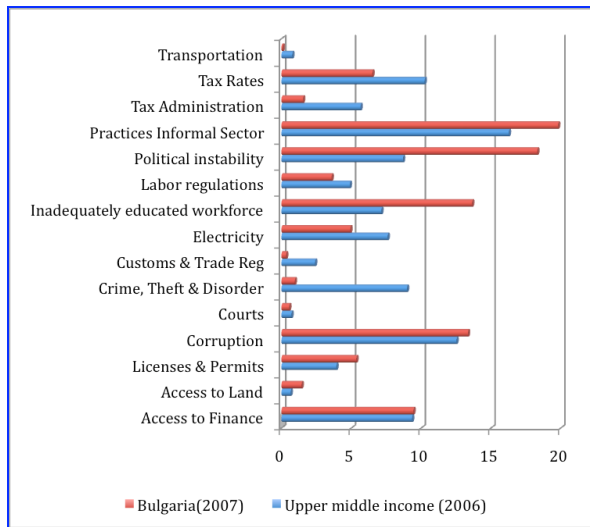
³ For an overview of the EU post-accession monitoring mechanism on Bulgaria see the latest European Commission *Report on Bulgaria's progress on accompanying measures following Accession*, Brussels, 27.06.2007.

⁴ Dreher, A., F. Schneider, *Corruption and the Shadow Economy: an Empirical Analysis*, Center for Research in Economics, Management and the Arts, Basel, 2006.

⁵ Each *Corruption Assessment Report* from 1999 until 2007 contains a separate section on grey economy, which together with the texts of the whole reports are available at: <http://www.csd.bg/en/c2000/artShowCAR.php?id=1339>.

Companies understand and feel much more at ease to identify and talk about grey economy and its negative impact on their competitive positions than about corruption, which they view as an instrument for preserving unfair competitive advantages⁶.

Top 10 Constraints to Firm Investment



Source: www.enterprisesurveys.org.

Notwithstanding differences in concepts and methodology, estimates of the size of the grey economy in Bulgaria since 1990 have ranged from 16% to 38% of GDP⁷, which has consistently ranked the country among the “top” new EU member-states. According to different estimates the size of the grey economy in Bulgaria in 2007/2008 ranges between 20% and 35% of GDP, with some

⁶ Interviews with international and local investors conducted by the Center for the Study of Democracy under a MATRA supported project of the Royal Dutch Embassy in Sofia in 2008.

⁷ Belev, B., *The Informal Economy in the EU Accession Countries*, The World Bank and Center for the Study of Democracy, 2002; Iliev, P., ed., *The Hidden Economy in Bulgaria*, Center for the Study of Democracy, 2004 (in Bulgarian); Feige, E., I. Urban, *Measuring Underground (Unobserved, Non-Observed, Unrecorded) Economies in Transition Countries: Can we Trust GDP?*, MPRA, University of Munich, 2007; Schneider, F., *Shadow Economies and Corruption All Over the World: What Do We Really Know*, Institute for the Study of Labor (IZA), Bonn, 2006.

sectors, such as construction and real estate, reporting less than 50% of the actual value of transactions⁸. While the National Statistical Institute imputes and adds part of the grey economy into national accounts and these numbers need to be interpreted with great caution when making conclusions about policy actions, they send a clear signal to policy makers that grey economy is a sizable challenge to Bulgaria’s economic development. The most hardly hit sectors are the labor intensive construction, tourism, agriculture and services (e.g. repairs, private education and healthcare, etc.) but research has also shown that there are also considerable grey pockets in manufacturing, in particular in excise industries (alcohol and cigarette production and fuels), textiles and transport.

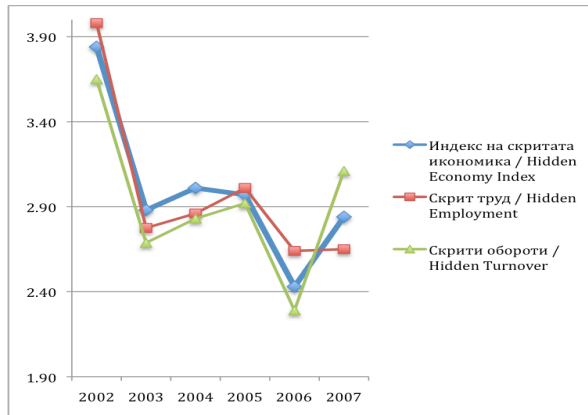
Grey Economy Dynamics: Time for More Action/The Hidden Economy Index

In response to business concerns and initiated policy action to reduce the level and scope of the grey economy in Bulgaria in 2002 the Center for the Study of Democracy and Vitosha Research constructed a ***Hidden Economy Index***. The *index* aims to track the dynamics of the hidden economy in Bulgaria and its main components – hidden labor and hidden turnover/taxes through annual surveys of Bulgarian businesses and the population. The *index* was developed by an expert group comprising of professionals from the National Statistical Institute, the Bulgarian National Bank, the National Social Security Institute, the tax administration and the University for National and World

⁸ *Anti-Corruption Reforms in Bulgaria: Key Results and Risks*, Center for the Study of Democracy, 2007, face to face and media interviews with managers of international and local companies.

Economy⁹. It is important to note that the *index* does not measure the size of the grey economy but its dynamics, giving important feedback to the policy makers and the business community on the effectiveness of measures to curb grey economy and related corruption.

The Dynamics of Grey Economy in Bulgaria: the Hidden Economy Index



Source: Vitosha Research, Center for the Study of Democracy

According to the *index* there has been a rebound in the grey economy in Bulgaria in the first year of EU accession. In 2007 there has been a change in the “leading” component of the *index* from hidden labor to hidden turnover signaling a need for rebalancing policy measures and responses. These results comply with the findings of the World Competitiveness Yearbook 2008, which showed that although the country has experienced an overall improvement in the country’s relative competitiveness in 2008, it has experienced a slide down in its position under the indicators on parallel (black-market, unrecorded) economy, bribing and corruption, and bureaucracy during the last

⁹ Goev, V., V. Boshnakov, *Measuring the Hidden Economy in Bulgaria* in Iliev, P., Ed., *The Informal Economy in the EU Candidate Countries*, Center for the Study of Democracy, 2003 (in Bulgarian). For an overview in English of the Hidden Economy Index methodology and the pilot results see, please visit the web-site of Vitosha Research: <http://www.vitosha-research.com/artShow.php?id=5493>.

year¹⁰. This might reflect both, reform fatigue on the side of the Bulgarian government following intensive efforts in 2006 to join the EU, but also the rising concern of the business community in the country over unfair competition from the grey economy as international competitive pressure squeeze down their margins. In any case these developments call for renewed attention from decision makers in the public and the private sector in Bulgaria on the mechanisms of the grey economy in the country and its adverse effects on productivity and welfare.

Shades of Grey: the Hidden Mechanisms of the Grey Economy in Bulgaria

CSD research for the past ten years has shown that there are three major areas of grey economy in Bulgaria¹¹, which have different motives and functioning mechanisms:

- the first is the **subsistence motivated grey economy**, usually found in agriculture and rural areas, as well as among poverty stricken unskilled labor. It rarely engages in bribing as detection is usually evaded through kin/friendship relations. With the monetizing of the economy this home production/service model moves into the next category or into the official economy;
- the second forms the bulk of the grey economy. It is caused by **institutional deficiencies** (lack of legislation, new and emerging sectors, etc.) and **high government regulatory and tax burden**, which drive firms and households to seek refuge by hiding (usually) part of their

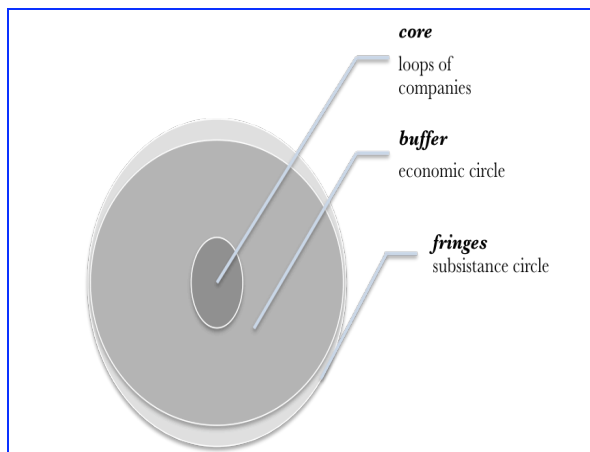
¹⁰ For a detailed presentation of the Bulgarian position in the IMD World Competitiveness Yearbook 2008 by the Center for the Study of Democracy, please visit <http://www.csd.bg/infocusShow.php?id=9350>.

¹¹ Belev, B., ed., *The Informal Economy in the EU Accession Countries*, The World Bank and Center for the Study of Democracy, 2003; *Organized Crime in Bulgaria: Markets and Trends*, Center for the Study of Democracy, 2007.

income and bribing public officials if detected/inspected;

- the hard core of the grey economy is composed of the **loops of politically connected companies**, which seek to gain preferential treatment and unfair advantage over their competitors through close ties to local and central authority. These companies **use their politically protected grey monopoly profits for state capture** to preserve their preferential treatment and to build up legal front companies, which can be used as a hiding place in cases of (temporary) trouble. Such mechanisms have been employed in excise industries, such as alcohol and cigarette production, duty-free trade, fuel trade as well as in state monopolies and public procurement heavy sectors – energy, healthcare, etc.

The Grey Economy Areas in Bulgaria

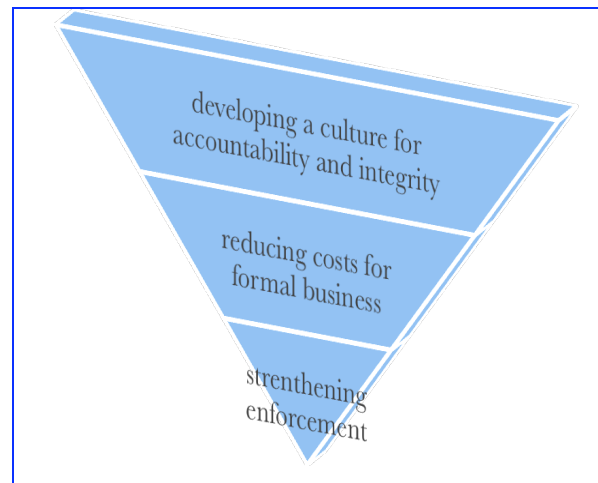


Reducing the grey economy in Bulgaria would have immediate positive effects on investment and economic growth. However, its diverse structure and complexity requires an **integrated policy response**¹² targeting the root causes of grey economy in its three areas:

¹² Farrell, D., *The Hidden Dangers of the Informal Economy*, McKinsey Quarterly, No 3, 2004.

- Priority should be given to strengthening control and enforcement institutions to sever entrenched state capture schemes;
- The second level of impact should be sought along the lines of reducing costs and increasing benefits of operating formally;
- Developing a culture, stable institutions for government accountability and business integrity.

The Grey Economy Policy Pyramid



While there is no universal blueprint for tackling grey economy the policy pyramid presented here provides a guide for designing comprehensive and actionable strategies. It requires the joint efforts and commitment of integrity leaders in the public and the private sector.

Gathering Momentum: Current Policy Initiatives for Reducing the Grey Economy

Since 2003 the Bulgarian government has undertaken a number of economic incentive measures and increased control intensity to reduce the level of grey economy in the country, such as the sizable reduction in corporate and personal income taxes, as well as social security contributions, the

integration and modernization of tax collection under the National Revenue Agency, the introduction of compulsory labor contract registration, etc. These measures to improve the business environment compounded by sustained high economic growth have resulted in a gradual reduction of the share of grey economy in the country. According to CSD estimates based on the ***Informal Economy Index*** the hidden turnover of companies in Bulgaria decreased from 29% in 2002 to 17% in 2007. The unemployment rate halved between 2004 and 2007 to 6.5%, while employment increased steadily by to 66.3% in 2007¹³. Though difficult to decouple fully from growth effects, there is compelling evidence that the resurficing of parts of the grey economy in Bulgaria in recent years has brought in more revenues in the government's coffers allowing for an improvement in public investment programs and the easing of social inequality. Increasing tax revenues and the promise of EU funds' inflows create room for further improving public services thus setting in a virtuous circle for further reduction of the grey economy.

However, lowering taxes and increasing control intensity alone, will not be enough to set this virtuous cycle in motion. It requires increased attention on strengthening enforcement and the development of a sustainable public-private platform for support of reform policies. The government will need to follow up with more bold steps such as the recent decisions to close down duty-free trade along the country's land borders – one of the longest standing core grey economy schemes in the country.

The government's efforts to reduce the share of the hidden economic activity in the

country have received strong support from the Bulgarian business community and the Bulgarian trade unions in 2006 when the three parties signed the *Pact for Socio-Economic Development of Bulgaria until 2009*. The pact outlines as one of its top priorities the fight against the grey economy, corruption and organized crime in the country. It put forward a number of specific measures aimed, primarily towards increasing control intensity, e.g. "carrying out strict tax, customs, financial, etc. control on the activities on economic agents' compliance with regulations; harsh treatment for economic agents in breach of tax and social regulations; improving control measures against offenders of social security regulations; broadening the coverage of social security to include agriculture and tobacco producers."

In 2007 the Bulgarian Industrial Association has followed up on its earlier efforts launching a campaign "Na svetlo"¹⁴ to curb grey economy in the country. While its immediate effects on the grey economy are difficult to discern it has raised the profile of the problem in the public domain attracting for partners the major national electronic media. The initiative has established a dedicated web-site to reducing the grey economy in Bulgaria, which contains a growing list of proposals for tackling the challenges.

Proposed Measures for Curbing the Grey Economy by the Bulgarian Industrial Association and the Bulgarian Industrial Capital Association

- Amnesty for violations of tax and social insurance legislation, related to the concealment of real incomes (applying only to already successfully hidden incomes);

¹³ Source: *Bulgaria: Macro Fiscal Assessment, An Analysis of the December 2007 Update of the Convergence Programme*, European Commission, Brussels, 27.02.2008; Eurostat.

¹⁴ In Bulgarian "coming out of the dark"

- Introducing fines for workers who receive and do not declare higher remuneration than the actually stated in their employment contracts. Exempting from fines and ensuring protection and anonymity against layoffs for whistleblowers that inform the National Revenue Agency, the National Social Security Institute and/or Economic Police that their employers pay “envelope” wages;
- Outsourcing administrative control functions from the government to the private sector, e.g. licensing National Revenue Agency authority to private certified public accountants to carry out audits in reported companies;
- Tying real estate tax appraisal to market prices with possibility for dynamic updates;
- Reducing taxes and notary charges on real estate sales;
- Introducing compulsory VAT registration for all economic agents;
- Reducing VAT tax rate to 18% or 16%;
- Installing wireless GPRS connection between all cash registries in the economy and the tax administration;
- Carrying out intensified control campaigns on mortgage loans by the Bulgarian National Bank.

Source: <http://nasvetlo.net/>

Setting a Platform for Integrated Policy Action

Despite the overall positive trend towards reduction of the grey economy in Bulgaria in the past years, it remains a major drag on the country's competitiveness and economic growth. In 2007 some 1,750,300 people in the age group 15 – 64 remained outside Bulgaria's labor force – a tremendous **waste of human capital** for a country that ranks lowest in productivity in the European Union. In a perfect world these people **could have added 6.7 billion euro or 23% to**

the country's GDP in 2007 assuming they were employed and produced output equal to the annual GDP per capita. With 14% of employees reporting they had received “envelope” wages, Bulgaria ranks third highest and thrice above the average level in the EU¹⁵. The Bulgarian society should make best use of the positive trend in its economic development in the past ten years, the proactive and cooperative stance of the businesses, the trade unions and the government, as well as the stock of knowledge and expertise available in its non-governmental sector to come up with an **innovative and actionable pack of measures** and a **suitable implementation platform** to counteract the negative impact of the grey economy on its welfare.

Remaining Challenges: New Policy Approaches

The **main challenge** for reducing the size and the scope of the grey economy in Bulgaria is **strengthening the rule of law** – the enforcement of regulations. Probably the most important test in this respect is the severing of illegitimate links between high-ranking government officials and grey businesses, i.e. **defeating loops of companies**, in particular in the excise- and public-contract-heavy industries, such as alcohol and cigarette production, construction and infrastructure, energy, etc.

Meeting this challenge requires a long-term approach, which should focus on **strengthening the institutional capacity of enforcement and control bodies**. After the country's accession to the European Union and the transposition of Community into national legislation, it is already time to shift efforts from institution towards capacity

¹⁵ *Undeclared Work in the European Union, Special Eurobarometer*, European Commission, October 2007.

building, with less legislative changes outside new EU regulations. The current policy focus on intensifying controls in a campaign-like manner¹⁶ produces temporary compliance at best, and higher regulatory burden on official businesses at worse. For example, one of the most effective control agencies in the country - the General Labor Inspectorate carried out 33,031 inspections, which resulted in 4,920 thousand Bulgarian levs in collected fines (i.e. roughly 149 levs per inspection) in 2007. The National Construction Control Directorate received 75,052 signals from citizens and legal entities and carried out 9,919 construction inspections in 2007 but collected only 1,258,999 levs from enforced fines (i.e. 127 levs on average per construction inspection). The annual inspection reports of some agencies, such as the National Veterinary and Medical Service are not even available on their web-sites. The profile of Bulgaria's control agencies¹⁷ shows an **unbalanced risk approach** – too much focus on micro enterprises and/or smaller value contracts and regressive penalties (much lower in value than the financial interest at stake), which only increases the regulatory burden on the economy and **encourages large-scale non-compliance**. These observations alone are

enough to show the urgent need to beef up national control agencies¹⁸ through:

- enhancing transparency – every control agency should have its annual report available online. The reports should allow to track at least simple efficiency measures first (e.g. revenues from inspections), with a view to expanding them further into an elaborate **performance assessment systems**;
- improving financial incentives and human resource management, including selection, pay bonuses and performance appraisal, career development and training. While base salaries should depend on education and experience, **pay bonuses and promotion** should be tied to personal performance and integrity;
- streamlining **written operational processes**, including through the introduction of effective information systems to manage document flows and pinpoint weaknesses in the operational setup. In particular audit and examination targeting, performance and reporting methods should be introduced based on state of the art risk assessment and monitoring. E.g. according to the Annual Report 2007 of the Financial Intelligence Agency notaries in Bulgaria filed only 2 reports on suspicious transactions under the Law on the Measures against Money Laundering, which against the backdrop of a substantial grey economy in construction and real estate should be enough to prompt closer scrutiny from the authorities;
- the **structure of penalties** should be revised to narrow discretion on the part of the administration and to account for the financial interests involved. Currently, most penalties are dwarfed by the financial gains offenders receive from operating outside the law;

¹⁶ *Anti-Corruption Reforms in Bulgaria*, Center for the Study of Democracy, 2004 revealed that in the Bulgarian government's campaign to reduce the share of the grey economy in the country in 2003 the collected fines from targeted financial inspections of tobacco and alcohol producers amounted to 2.52 levs per inspection.

¹⁷ Agencies listed in the text are only examples that apply to the wider circle of public control bodies: Public Internal Financial Control Agency, Financial Intelligence Agency, Regional Inspections for Protection and Control of Public Health, State Commission on Gambling, Bulgarian Privatization Agency, the Inspectorate General at the Council of Ministers, etc.

¹⁸ For a detailed analysis of measures to increase the institutional capacity of control agencies on the example of the tax administration, please see Pashev, K., *Corruption and Tax Compliance: Challenges to Tax Policy and Administration*, Center for the Study of Democracy, 2005.

- improve anti-corruption enforcement by developing **corruption risk-assessment systems** based on control officers' personal wealth registers and their control and audit effectiveness. Particular attention should be paid to high corruption risk units of the public administration such as – public procurement and concessions units, VAT fraud units, EU funds' audit units, excise control units, etc.;

- identify and attract for consultations businesses with proven integrity, based on recommendations from good governance NGOs, European business associations and publicly available integrity rankings of reputable international media.

The proposed measures for strengthening the institutional capacity of control agencies are in no way exhaustive and cannot be realized overnight. They require a concerted approach – agencies need to work together on identified risk areas/issues/sectors. As resources are inherently limited **focusing the public control system on a well-defined set of grey economy risks** is the only way to guarantee better enforcement. For example, over the next 18 months the agencies might want to focus their attention on **public procurement** (concessions, public-private partnerships, EU funds) in construction, as this is one of the fastest growing sectors in the economy carrying substantial grey economy risks and involving many contracts with the public sector. Increasing horizontal accountability, i.e. joint work between control agencies is a cornerstone for improving enforcement.

The second outstanding challenge is using **the mechanisms of public resource management** to promote business integrity and fair competition. Currently, **public-private partnerships, concessions, public procurement, outsourcing of public services, privatisation, land and forest swaps** are areas with very high corruption risks and are recognized as

frequently used channels for creating and sustaining the “loops of companies”. Ensuring fair access and wide competition in public contracts is key for reducing the possibilities for inducing large financial flows in the grey economy from diverted public funds¹⁹:

- The government's responsibility on ensuring competitive bidding should not end with the publishing of the tender announcement. Responsible agencies should be involved in active sourcing of tenderers/participants, especially in cases of bigger projects. There were many exemplary cases when tenders were won by single contestants.

- The government should strive to ensure legal clarity and stability in the area of public contracting, making certain that there is enough administrative capacity to manage and control complex public-private relations under existing regulations before introducing new instruments and legislation in the area. The recently proposed amendments to the *Law on Concessions* and the *Law on the Management of the Black Sea Coast* are a clear example of a legislation induced higher risk of grey economy. The amendments increase administrative discretion to end and/or to prolong concession agreements, expand the the object scope of the laws, allow granting concessions to public-private companies (not yet legally regulated) without competitive tendering, and propose to scrape concession analysis in some cases. The proposed amendments are not necessitated by EU regulations, challenge further already poor administrative capacity in this area and clearly increase the risk of diverting public funds into the grey economy.

¹⁹ For a detailed discussion on the deficiencies and possible reform actions in the area of public contracts, see Pashev, K., A. Dyulgerov, G. Kastchiev, *Corruption in Public Procurement: Risks and Reform Policies*, Center for the Study of Democracy, 2007.

The **third major challenge** that requires policy attention is the promotion of **business integrity** and **good corporate culture**. This is the area that requires the most active involvement of the representatives. Some of the worst rankings and declines in Bulgarian competitiveness in 2008 are in the quality of business management and ethical practices implemented in the firms²⁰. While this might be considered a normal consequence of the lack of market and business experience and history of most companies in Bulgaria, it sends a clear signal that business associations and business integrity leaders need to come up with more and better practices of spreading good corporate governance among their members, partners and competitors and **putting more pressure on non-compliant firms**. One such tool might be the adoption and implementation of **business integrity codes**, which should be used to publicly rank companies and if needed to put pressure on laggards. In this relation business associations can make better use of the acquired know-how and experience of the Bulgarian non-governmental sector.

In addition to the urgent areas of attention outlined above, the government should sustain its efforts to improve the business environment and public service delivery in order to reduce further economic incentives for operating in the grey economy. Tax cuts are a major tool for reducing the grey economy in poor institutional environments but their effects will only be temporary if not supplemented by measures to improve business entry, regulation and exit. Lower tax rates on direct taxes have resulted in a decrease of grey economic activity in Bulgaria but their positive one off effect on tax revenues might back-fire in the future as overreliance on indirect taxes and already

wide deficits in the social security system might turn budget surpluses into deficits during economic downturn²¹. Hence, the government should continue its focus on improving administrative capacity to support business start-ups, SMEs and level the business playing field²². Particular attention should be paid towards the implementation and promotion of e-government solutions including the streamlining and proper operation of the National Commercial Registry and the National Electronic Registry Center²³.

Setting a Public-Private Platform for Policy Action

Implementing the measures proposed in this policy brief and winning the Bulgarian economy over from the grey sector is a challenging long term effort, which cannot be carried out by any one national actor alone, be it the government, the business or the civil society. Only their concerted efforts through an integrated institutional approach can deliver impact. Delivering on policy options and developing new innovative measures require a strong **public-private platform for government accountability and business integrity**, modeled on successful coalition brands such as the Bulgarian anti-corruption initiative *Coalition 2000*²⁴. The platform should combine the power of the government, the efficiency of the business and the know-how and experience of the civil

²⁰ *IMD World Competitiveness Yearbook 2008*.

²¹ *Bulgaria: 2007 Article IV Consultation*, IMF Country Report No. 07/389, International Monetary Fund, 2007.

²² The European Commission *Assessment of the Bulgarian National Reform Program on Growth and Jobs 2008* (http://ec.europa.eu/growthandjobs/pdf/european-dimension-200712-annual-progress-report/200712-annual-progress-report-BG_en.pdf).

²³ *Commentary of the Law on the Commercial Register*, Center for the Study of Democracy, 2007.

²⁴ For a summary of the structure, history and impact, and main activities of *Coalition 2000* visit <http://www.csd.bg/en/c2000/>.

society in the presence of a strong outside anchor and committed partner – the European Union. Its structure should allow for a combination of broad policy guidelines with focus on specific tangible actions.

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The successful reduction of the grey economy in the past six years might come to an end with the slackening of reform efforts following EU accession. This calls for a renewed attention on reducing the grey economy through setting up a public-private platform for government accountability and business integrity that combines the efforts of the government, the business community and the civil society. It should focus on strengthening enforcement, improving public resource management and enhancing business integrity. The platform needs to start with a narrow high impact issue e.g. the use of PPPs and EU funds in infrastructure, tourism or energy.