Will Democratic Government Fight Corruption?
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Trying to assess the prospects of Bulgarian Reforms, emerging market analysts fail to observe bureaucratic factors. But these were the factors that blocked reforms under the previous administration, and had played a major role during the “Technocratic” (1993-1994) and Socialist cabinets of 1995-1997. Focusing only on macroeconomic indicators one could grasp results of the reintroduced reforms but loose the opportunity to foresee developments which may stem from the current government role of a privileged market maker. In the past, such development were: high formal and informal taxation, high capital and transaction costs, and non-transparent rules and decision-making procedures. The results are known: capital flight, disinvestment, virtually no foreign investment and no incentives to growth.

Prerequisites for such developments were not simply inherited from the Communist regime but were consciously created in 1993 - 1996. Bulgarian Socialists were believed to have been running the country led by a mixture of ex-Communist and populist ideologies. Their cabinet, however, was rather pragmatic, and even hypocritical and opportunistic. Most of the decision-makers had some Western education or technocratic background. This was particularly true for the advisors of their cabinet who were prompt concentrating powers in the hands of then prime minister Zhan Videnov, remaining behind the scene as a decision-making center parallel to the central government but more important.

Socialists have paid a tribute to the populist moods of their supporters, and thus we can explain the anti-NATO foreign policies of the last two years and their dubious economic rhetoric.

But core disadvantages of the Socialist rule - delayed and even stopped privatization, quasi-fiscal subsidies to idle industries, political consensus to drain banks but not force public enterprise to pay their debts, artificial electricity prices and mismanaged monopolies - had a deeper, although simple and ordinary, background.

Socialists believed they would benefit from redistributing resources. Sticking to the tradition, they replaced virtually all managers and boards of the public sector enterprises with their fellow-partisans and stopped privatization to give them a chance to gain from being insiders. Electricity prices, cheep labour and fuel as well as quasi-fiscal subsidies were believed to maintain competitive prices of Bulgarian exports. Exporters were licensed or controlled by the government, and domestic producers were protected by different tariff barriers. Whoever wanted to cut gains from the price difference between domestic and foreign markets had first to please the government. The system has been working somehow for twelve months, from February 1995 to February 1996 but was doomed to fall apart. There were clear incentives to keep gains outside the country. To keep local costs low (including that of labour) Socialist had to reintroduce price controls or start printing money, and they did both. Then, the only way to stop producing losses was to close enterprises and fire workers. Socialists needed an excuse to do so, and here came the IMF with its program of July 1996. In the eyes of the public at large Mr. Zhan Videnov, Socialist PM, made an attempt to transfer the responsibility to the IMF and the World bank but the administration resisted to fulfill orders, and he resigned. Usual rhetoric about dangerous unregulated market forces, prices as a means of welfare policies, etc., which usually was the instrument used to disguise Socialists' policies, this time did not work and they have lost political face.

The Heritage

Bulgaria has a working, though time to time malfunctioning, democratic constitution. All instances and channels to block reforms have received a legal foundation. If not profoundly reshaped these foundations would again work against growth and prosperity.

To stop privatization Socialist had to delay implementation of the capital market regulations and adopt amendments to privatization rules which have prevented equity trading but created conflicts of interest and allowed administration to collect rents from licensing. Among other things, Socialists initiated a voucher privatization scheme mixed with conventional privatization methods, postponed registering investment intermediaries and stock exchanges, and forced the Securities and Exchange Commission to license voucher privatization funds. The funds, however, were prevented from investing and trading, from introducing any form of corporate governance or venture capitalism.

The law contains a number of "procedural" hurdles which do not allow for moving sales of public assets forward:

- a ban on privatization funds to sell equities of privatized enterprises and/or their own shares six months after the last auction (without any firm idea how many auctions would take place and when);
- a ban on insiders (both workers and managers) and outsiders (other corporate shareholders and creditors) to sell their shares five years after privatization deal is completed;
- a ban for voucher privatization funds to acquire more than 34% of the shares of a given enterprise;
- a ban on creditors to accept any assets but real estate as collateral;
- a five-year ban on insider buyers to sell their share or use it as a collateral;
- a ban on foreigners to benefit from management (or employee) buy-out schemes,

and this list may be continued.

There are conflicting procedures which have supported the so called "selection of a strategic buyer" as a major method of privatization.

The government has obtained similar discretionary powers in virtually all segments of the market and the administration in Bulgaria has an extraordinary opportunity to control all instances of access to capital and factors of production.

Small savings and credit institutions (like the German sparkassen, roscas in Mexico or town banks in other countries) are prohibited by law. After three years of unregulated operation of stock exchanges, the Socialist government introduced such barriers to entry that that it took more than two years for the existing players to comply with the requirements. Commodity exchanges and wholesale markets exist already six-seven years. Last year, the Socialists adopted a law which creates the Government Commodity Exchanges and

Wholesale Markets Commission which includes nominees of the Council of Ministers but no merchants. The December resignation of the cabinet has delayed implementation of the act. Commodity traders still have to apply for a licence.

Good and Evil

This is where the things stand at the moment.

Democrats, led by Ivan Kostov, have several administrative advantages viz-a viz their predecessors. As a PM, Mr. Kostov has enforced more or less strict division of responsibilities within the Council of Ministers. It is very unlikely that there will be a parallel decision-making center. Democrats have no need to make concessions to populist moods of the voters as they were elected on the ticket of a reform consensus and have a clear mandate to proceed as fast as possible. They have the backing of both domestic and international public opinion.

Apart from a few instances related to central banking and finance--areas closely monitored by the IMF and World bank--democrats have a disadvantage of lacking bureaucratic experience: key administrative posts were a preserve for true believers and party-fellows who are not corrupted yet but might be spoiled by the system if the system is not abolished before the fall of this year. However, the prevailing mood of the new administration is, for the time being: “we are the best, we have high moral standards, we can use the system.”

A major merit of the current situation is the functioning of the currency board regime. The administration is adjusting itself to hard budget constraints but seems slow in giving up rent-seeking privileges.

Systemic Sources of Corruption: Where We Stay at the Moment?

Macroeconomic dimensions of 1997 so far provide grounds for an optimistic outlook. Recent Bulgaria reports of Merrill Lynch and Deutsche Morgan Grenfell have already disseminated such moods among investors. They would prove to be correct if and only if the new administration ceases to exercise “manual control” over the economy.

Key tool for “manual” (or, in other words, through direct involvement of the central government officials and/or appointees) control is <u>the procurement of “state property rights.”</u> Rules here were established by the Council of Ministers’ Decree №7 of January 1994 which replaced an older regulation (Decree №265 of January 1992).

Articles 10 and 11 of the Decree №7 stipulate that in the state-owned enterprises (SOEs) sole proprietor’s rights are being exercised by the line ministries and committees (those of industry, trade and tourism, agriculture, energy, posts and telecommunications, etc.), and by the Council of Ministers (in the case of military industries). In fact, the prime mister and the council are established as sole proprietors of last resort due to their control functions over the acts of the line ministers. Line ministers appoint SOEs managers and board members at their discretion. Members of the central administration are not allowed to sit on the boards of more than two enterprises, although there

is no limit for members of parliament. There is no competition requirement or any provision to contract out managerial teams or use venture capital schemes. There is no prohibition to do so but in reality it has never happened. Being required to exercise the public interest in SOEs, line ministers are afraid of being accused for not fulfilling this requirement. All government line-ups Bulgaria has changed in the last seven years have preferred to bring fellow-partisans, thus paying back for political services and loyalty.
Decree №7 requires also managers and ministers to close down enterprises when liabilities exceed 50 per cent of the assets. This provision has never been implemented by the Socialist administration. As a recent IME survey of decision making at SOEs has indicated, no measures to improve SOEs performance through remuneration of managers and/or board members have been workable. For the time being Democratic administration under Mr. Kostov has no intention to abolish or amend Decree №7.
Corporate governance at state monopolies such as the National Electric Company (NEC) and the Neftochim oil refinery suffers old diseases. NEC determines on its own what are its conditionally fixed costs, the costs which allow NEC enterprises to function as if there is no consumer. The oil refinery has no outsider to measure the so called technological losses. The new cabinet, following the provisions of Decree №7, has replaced all former board members but it is not clear yet whether the new managers will close channels of asset stripping. Recently, Mr. Kostov asked the new Neftochim board to determine the concrete amount of the losses. Any concrete judgment on corporate governance issues is difficult due to regulations which declare any information on the major monopolistic enterprises state and national security secret.[1]
Another important source of corruption in Bulgarian circumstances has been price controls and quasi-fiscal subsidies. The latter has practically no place already given the fact that agreement with the IMF and the currency board regime have forced the government to reduce subsidies to 0.1 per cent of GDP. Price controls were abandoned thanks to high inflation in 1996 and early 1997. At the same time, the new administration re-established price controls in the form of controls over trading contracts. It issued Decree №269 of June 1997 which requires producers and wholesale merchants to determine the final “contractual” (in fact, retail) price of a product. The intention was to eliminate wholesale intermediaries. City police in the major towns of the country, under the joint leadership of the trade and interior ministers, have flooded commodity markets asking merchants to “prove” that their contracts are “correct.” This regulation deals with “contractual prices” of only fifteen consumer products, mostly foodstuffs, and it is hardly possible to implement it. But the actual damage is that it both induces populist expectations by the public at large and creates a wide-spread source of *petit* corruption. It also prevents farmers from bargaining the prices of their produce, and thus hampers the adjustment of the entire agricultural sector to changing market conditions. Similarly, Democrats have started the implementation of the above mentioned Commodity Exchanges Law; they have established the Government Commodity Exchanges and Wholesale Markets Commission and expect the latter to help “control” the market. The

[1] See the special article on the NEC in this issue of the Newsletter.

Commission was established after the annual budget was adopted and is expected to finance its operation through fees and fines.
The case with the Commodity Exchanges Commission reveals a more general statist philosophy of the new administration. It has no members representing self-regulatory bodies of the commodity market itself. A similar philosophy is reflected by the draft bill on deposit guarantees where the Deposit Guarantee Fund is managed by the government and the central bank, though being capitalized by fees collected from banks according to their founding capital and the volume of attracted deposits.
Control over the domestic commodity markets motivates merchants to try to export goods if they can find a better price for it in neighbouring countries. "Fighting smugglers" has been an excuse for the government to stick to complicated customs procedures and to delay the abolishment of tariff barriers.
Bulgarian customs are now probably the most ridiculous in Europe. There are regulations requiring physical control on hundred per cent of the goods crossing Bulgarian borders no matter they are carried by a cargo or a transit carrier or by an individual trading across the borders.
Issues related to the so called *grand corruption* seem not to be treated with the needed radicalism as well. Here we must again mention privatization procedures (as they are of particular importance) as well as special investment and concession contracts in utilities, communications and infrastructure.
Complication of the privatization procedures and of existing capital markets entry barriers are being removed slowly. Of the barriers established by the Socialist cabinet, the new one has scheduled the abolishment only of the ban on voucher funds to sell equity of enterprises from the mass privatization list as well as their own shares. But for the time being, capital market entry fees are so high that funds would obviously prefer over-the-counter trading. In the area of market privatization complications are still in place and are being caused by the so called "selection of a strategic buyer." With the help of the President's Economic Policy Council, the cabinet has launched the idea to speed up privatization of "blue chips" of the Bulgarian economy: it invited top investment banks and consultant companies to prepare the auction for those enterprises but the selection of consultants is not complete yet and is largely lacking transparency.[2] There were publications in the press that the government has changed the terms of Deutsche Morgan Grenfell's contract to consult Bulgarian telecom's privatization, but officials did not dismiss this information.
In the field of infrastructure, there are number of significant policy changes attempted by the new government. It has amended the concessions' regulations (initially adopted in November 1995 but not enforced by the Socialists). A positive development is that the new regulations overcome all prohibitions related to twelve monopolistic rights of the government which were established by the Constitution of 1991. According to the amendments it would be possible: to acquire a concession on all construction and road

[2] The short list of investment banks advising the government on credit rating and the foreign debt issue is similar: the list (for the time being) includes CSFB, J.P. Morgan, Goldman Sachs, CBS Warburg, Merrill Lynch and some other banks but nothing is known on the selection procedures and criteria.

facilities built before by the government; on electric distribution networks; on mineral, natural and water resources; to build new facilities, and to obtain a concession to investigate and explore natural resources. Absence of such provisions has been considered as one of the key impediments to some major privatization deals, e.g. Sodi Devnya deal was postponed for more than two months because of banned concession on soda-dash mine which is a key supplier to the plant. The new regulations endow the buyer to exercise concession right in an interim period until concession contracts are being arranged; these rights are determined by the privatization contract, and the interim period can not be longer than three months. In addition, the act stipulates procedures omitted in the previous arrangement: 85 percent of concession revenues are being channeled to the central budget, the rest remain in a separate off-budget account to cover the costs of concessions; the funds are being spent under the supervision of the Council of Ministers; the term of the concession (not more than 30 years but subject to prolongations authomatically) enters in force as determined in the contract; and there is no possibility newly (after the act was adopted) established state companies to obtain a concession. What matters, however, in terms of corruption, is the right if the government to provide concession without an auction or any sort of competition. Three months after the act was adopted, i.e. by 1 November 1997, line ministries are required to propose to the Council of Ministries solutions to all inherited privatization cases where a special concession arrangement is needed. Concession Act itself leaves a lot of important details (the size and the term of investment, construction rights etc.) to be specified in the concession contract while containing no or few guidelines on what grounds to select concessioners. Bulgaria has been very slow in negotiating oil and gas pipe-lines and communication cables which may cross its territory and allow use of the country's absolute advantage of geographic location. Besides some progress in communication networks, pipe-lines were the most disadvantageous case of Bulgaria's reform attempts in the recent years. They have resulted in nothing but internal political tensions and raising Russian (official and private, transparent and hidden) influence on Bulgarian affairs. A key deficiency in this respect was the inability of the Bulgarian government to negotiate with Russia and Greece. The very approach to negotiations has been based on the wrong assumption that these are governments that establish and fulfill agreements; Bulgarian government was in fact contacting other government institutions which, in their turn, were representing huge companies and/or vested interests. Thus, Bulgarian position has always been the weaker one, especially given the one-side resource dependence of the Bulgarian economy on Russia. Currently, Democrats are fighting interest groups on the domestic scene. All of them, like Multigrup subsidiary Topenergy, have Russian counterparts or at least backing from huge companies like Gazprom, Atomenergo or the government of the Russian Federation. For the time being, Bulgarian government is playing alone. As in the case with other huge companies and monopolies, e.g. NEC, government had for the time being just replaced the Board members, reducing conflict of interest. For instance, Neftochim executive director is no longer executive manager of the major supplier Rosbulneft (a joint venture with Rosneft). But again, as in other cases, newcomers are rather unknown and presumably as a rule, with a limited professional experience. They failed to organize auctions for crude oil supply to the refinery and lost more than two months on orientation, delaying to restructure the management and accounting procedures. At the same time suppliers succeeded to fix prices and boycott auction proposals. The government seems to have succeeded in replacing Multigrup from Topenergy, a joint venture between Bulgarian government and Gazprom. Multigrup is expected to strike back which would mean at least political tensions with other parties in the Parliament. While this is relatively no problem for the government, regrouping of the interests is to be expected with a still unclear outcome for either of the parties. If the cabinet at all is seeking support for its pipe-line and infrastructure efforts, it is from International Financial Institutions and other government or multilateral organizations. The only way to avoid traps of future links behind the front stage is to invite transnational corporations to initiate, finance and implement projects on Bulgarian territory. Simultaneously, Bulgarian government still has to learn how to avoid or reduce geopolitical risks relying on private corporate, but transparent interests. Such learning seems difficult due to intrinsic suspicion against foreign corporations and private institutions.

Conclusions and scenarios

It is likely that the currency board regime would help to skip instances of *petite* corruption, like that of price and trade controls, custom procedures etc. likewise it virtually has closed fiscal and quasi-subsidies. Trade controls, a particularly important case, are at the cross-roads. Efforts of the government here have two intentions. The first one is to improve tax collection and introduce accounting, labeling and packaging requirements which may lead to better reporting, quality and competitiveness standards. However, the background problem here is the level of taxation which forces entrepreneurs to reduce costs. The second one is the ridiculous idea to eliminate wholesale trade. It would never work unless merchant community itself seeks more transparent transaction rules on the commodity market. For the time being, the government seems not to understand this. All regulatory bodies are being established and recruited by the cabinet and its supporters while paying little attention to the interests already present on the market place. Public seems to support government rhetoric and efforts to “fight speculators”. Feeling strong, the cabinet is establishing one government agency after another; just recently it founded the so-called Tobacco Commission and Energy Efficiency Commission; and seems ready with a commission to control every industrial (or trade) sector. These activities seem not so far to increase government expenditure, most of the different commission members come from the administration itself and are not remunerated for the job they are going in the commissions. But there is a danger that, when critical mass of such bodies and/or duty requires, administrators would start seeking opportunities to maximize their utility thus contributing to an additional and probably an informal tax on entrepreneurs. Sources of *petite* corruption are being established by different multilateral aid programs. To the extent IME has information, representative of the donor community in Sofia are aware of the problem and are constantly trying to set as prudent procedures as possible. Newly established government bodies are currently oriented to obtain support from such programs but the latter cannot last forever. Sooner or later, it would lead to additional costs imposed on the private sector.

Grand corruption, quite naturally, seems to be the major problem. It would prevent implementation of transparent and fair rules of the game, increase costs and frighten foreign investment. For the economy as a whole, this would mean less or no opportunities to make use of infrastructure projects, regardless current favorable conditions provided by the currency board and regional constellation. Currently, the government of the Democrats reassemble first six months of that of the Socialists: it has good prospects to tackle economic challenges but it may be caught in the chains of mutually blocking interest groups. Altough 1997 scheduled privatization revenues of $350 million is likely to be exceeded, new boards of public sector enterprises may attempt delays in privatization. Combined with the increased role of bureaucrats in controlling capital and commodity markets it could lead to a slow adjustment of the Bulgarian economy to the international markets and, thus, to diminished prospects to growth and prosperity. For the time being, however, we witness a period of an administrative adjustment to hard budget constraints which would mean, at the first stage - at least till the end 1997 and 1998, more organized and probably more "efficient" corruption: its impact on economic growth would come later when it would incur additional costs of dealing with the government. A factor which may act in both directions - to prevent such scenario or facilitate it - is the government awareness of its long-term political interests; it has all the prospects to remain in power for a second or even third mandate if and only if it succeeds not to give up to the temptation to get all the benefits of being in power from the very beginning.