

*Chapter VII*

**Corruption and Economic Development in Bulgaria**

*G. Ganev*

**1. CONNECTION BETWEEN CORRUPTION AND ECONOMIC DEVELOPMENT**

The connection between corruption and economic development in a country like Bulgaria, which is in the midst of an economic transition, is an issue, which exceeds the pure academic meaning.

**1.1. Initial economic analysis of the phenomenon**

Corruption always occurs when an “outside” resource is placed under somebody’s control. Of course, this can happen in the private sector, too, but this is typical of the public sector and thus the corruption in this sector will be the topic of the present analysis.

*1.1.1. Measuring corruption*

Favourable conditions for corruption exist when a public resource is placed under the control of one or a group of public officials; this resource is valuable because it can satisfy a need or be profitable. Under such circumstances the public official may offer to “transfer” the control over the resource to persons from the private sector in exchange for personal profit. The number of the acts of corruption, which the public official will suggest, depends on the size of potential profit. On the other hand, this size influences the number of acts of corruption sought by the private sector. So, it is easy to note that the price of a corruption deal equal the profit for the public official. It is more difficult to determine the issue of what exactly is being exchanged for this price. The number of acts of corruption is a possible measure of how widespread the practice is, but it does not consider their value and attaches the same importance to a police officer who lets a guilty driver go for a packet of cigarettes and a senior leader who awards a large project to a less worthy candidate. Another possible measure is the total value of bribes but if a few corrupt deals involve large amounts of money, this may give a false impression.

The measuring of corruption is an issue, which raises intractable problems, and the best, which can be done, is to use approximation. The index of corruption perceptions, used by Transparency International, is currently the most popular such method in the world. The advantages of this methodology is that it is relatively consistent, and follows international practice and makes possible the drawing of parallels between different countries. The disadvantages are that the index depends on personal assessments and they may be influenced by factors different from reality. This problem may take on serious proportions in the economies in transition where the lack of rules of the game and the weak control over the quality of information may lead to an exaggeration of the situation due to the sensationalism of the media or the penchant for those negatively affected by a decision of a state body to unfairly make accusations of corruption.

Regardless of the weaknesses of the different measures of corruption and which variable will be used to represent the quantity of corruption, the supply and demand of corruption can be presented in a graphic that is traditional in economics:

Figure 1.

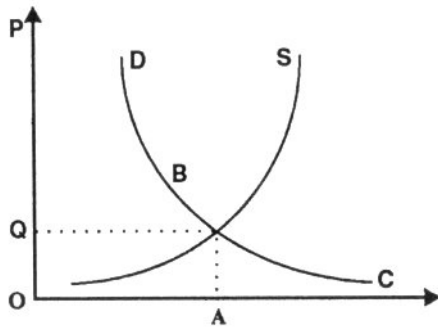


Figure 1 attempt to visualise the statement that when the price (the profits for the public officials) is low, the demand (curve D) of the corruption behaviour is high but its supply (curve S) is low and vice versa. The demand and supply curves cross at a point of balance (curve B), which supposes some quantity of profits (presented by the distance OQ) and some quantity of corruption (the distance OA).

### *1.2.2. Corruption factors*

There are many factors which influence the positioning of the corruption supply and demand curves and from there the level of corruption in an economy. Generally, the possibilities for corruption, and respectively the consumption itself, in an economy depend on three main determinants:

- The value of the resources (or the possible rent) which are placed under the control of the public official;
- The level of personal discretion of the public official in the managing of these resources;
- The level of responsibility of the public official for his or her own decisions and actions.

These three determinants can, in practice, occur in many different ways and can affect both the demand as well as the supply of corruption. In analysing corruption in Bulgaria, one of the main initial points is the fact that due to the specific features of the totalitarian system and the transition period in this country, the value of the resources under control of the state is still significant, the level of personal discretion of the bureaucrats is high, and the control is ineffective. Logically the conclusion follows that there is nothing peculiar in the fact that the level of corruption in Bulgaria, regardless of the method of measure, is high.

### *1.2.3. Factors, which influence the demand for corruption*

A more thorough analysis of the conditions, which influence corruption, makes it necessary to differentiate the factors affecting demand and those affecting the supply. The demand for corruption depends on four main factors:

- The number and nature of the registration, permission and licence regimes and their regulation. The simple existence of such regimes is a favourable ground for corruption because the contractors will offer bribes in order to form a business. This does not mean that because of the corruption all such regimes should be abolished. But when an expert or a political decision is made on whether to introduce, amend or abolish such a regime, it is necessary to consider the consequences of such a decision for the level of corruption. When this is done, it is possible that some decisions may be radically altered;
- The tax system, which includes the tax rate and structure, taxes and import duties and the procedure and organisation of their collection. In order to avoid the tax burden and thus their

production expenses, business owners are willing to offer bribes when paying taxes, tariffs and import duties. Even the most perfect tax system cannot reduce corruption to zero but every tax system can be created in a way to provide more efficient control;

- The level of state expenditure on goods and services. Investment programmes, state projects and purchases of goods and services, and out-of-budget accounts are examples where authorities decide where or, to be more precise, to whom the significant financial means are directed to. These deals are lucrative and many players are willing to offer bribes to get them;
- The total value of the state-supplied goods and services that are at prices lower than the market. Every country has social programmes that involve such a pricing scheme, which is an excellent opportunity for “enterprising” businessmen who in return for a bribe can receive the opportunity to buy low and sell high.

The four main factors are all connected with the control of the state over any valuable resource and this control is being conducted by public officials with a certain degree of freedom. So, one can easily notice that if corrupt public officials are willing to increase demand for their “product”, the illegal transfer of a public resource to private parties, and thus raise its “price”, they will attempt to place more resources under the state, i.e. their own, control. If they are powerful enough, they may succeed.

#### *1.2.4. Factors, which influence the supply of corruption*

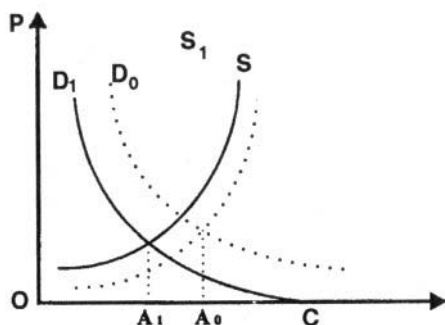
On the other hand, the supply of corruption depends on the responsibility. From an economic theory point of view, it can be considered as the expected price, which the public official has to pay for being corrupted or, simply put, as an expected expense for the production of corruption. This is defined by a few factors:

- The circumstances, which define the material losses, which a public official charged with corruption, may suffer. Mostly, they are defined by the possibility of being discovered and the following loss of public status and punishment. The possibility of discovering the corruption is influenced by the transparency of the control over the public resources and by the level and quality of the institutional supervision over the public officials. When the rules, the legal regulations and the procedures are issued, clearly and publicly, corruption is easy to spot and prove. The ease of discover also increases when the supervision over the activities of the public officials is institutionalised and is effectively applied. In this sense, for a country like Bulgaria where wide-scale corruption goes on with impunity, an effective fight against corruption is impossible without at least a few cases of public disclosure and punishment because it is only the practice which can change the subjective assessment of the potential participants in future corruptive activities. It is the transparency and supervision over the activities of the public officials in the sectors where the structures of civil society may effectively intervene and help solve the corruption problem;
- The size of the losses suffered: Public officials will be less likely to engage in graft if the punishment is severe or the material losses relating to the change of their public status are significant. In this sense, the supply of corruption is inversely proportional to the level of payment of public officials and to the severity of the punishments provided for by the law;
- The non-material factors, such as the moral principles of the officials, the qualities of the officials and the procedures for their selection, appointment and development. Moreover, the attitude of the public officials at lower levels is influenced by that of their managers and senior politicians;

*1.2.5. Correlation of the factors in the fight against corruption*

The changes in any of the factors defining the supply and demand of corruption lead to changes in the two curves from Figure 1. The aim of any programme against corruption is usually to decrease its scale. Figure 1 shows that it is possible by influencing the various factors which will shift the demand curve, the supply curve or both, to the left, i.e. towards lesser demand and supply of corruption at any possible price. This aim is illustrated at Figure 2:

*Figure 2.*



If the anti-corruption programme is successful, then the curves of demand ( $D_0$ ) and supply ( $S_0$ ) are shifting respectively to  $D_1$  and  $S_1$  and, regardless of the influence of this shift over the corruption value, the new balanced quantity of corruption,  $OA_1$ , is significantly lesser than the quantity of corruption before the implementation of the programme,  $OA_0$ .

Two important observations are hidden behind Figure 2, which should be taken into account when preparing assaults on official misdeeds. The first one is that every anti-corruption programme consists of a package of actions, each one of which affects some factor and the realisation of each one of them is expensive. That is why one of the necessary conditions for the success of the anti-corruption programme is that the package of actions should be efficient. This means that the programme should be prepared in a way that the profit of every lev spent is maximised. The second observation hidden behind Figure 2 is that due to the high cost of the crusade, the optimum quantity of corruption in a society does not equal zero. A point of view exists that from some level downwards the public gain from a further decrease of the corruption will be less than the public expenditures made for its realisation. Unfortunately, all indices show that Bulgaria is still far away from such an “admissible” level of corruption.

**2. CORRUPTION IN BULGARIA: MAJOR FRONTS OF ACTION**

The analyses of the economic features of corruption in Bulgaria cannot be defined as thorough or numerous. For example, despite the anti-corruption rhetoric of a few members of the political elite, Bulgaria was included in the index of Transparency Intonation and received its first assessment only in 1998.

The serious research, which may be useful in making, the best political decisions have only just started. It is at such an initial stage that it is too early to answer the question whether the corruption is a *reason* for ruining the foundations of the economy or is a *consequence* of their weaknesses. Both are probably true. The cause and effect relation between the level of corruption and the special features of the Bulgarian economic system is bilateral, dynamic and poorly studied. That is why the analysis, which follows here, is notional rather than strictly theoretical or empirical. The aim is to follow some major tendencies through which corruption influences the economy and the society and through which it influences the development of Bulgaria.

## **2.1. Macroeconomic indices of corruption and Bulgaria**

First, corruption affects the relative prices in the economy. It is an expenditure for doing business and producing and actually is a theft of a public resource. As it happens outside the market, at its juncture with the state, it *distorts the idea of the value* of various goods and services. The free market is the most efficient mechanism for defining the optimum relevant prices in most sectors and for many of the goods and services, which are being exchanged in an economy. In some cases, in both theory and practice, the state interference is justified by reasons more important than economic efficiency. But every interference on behalf of the state is a distortion of the market prices and corruption multiplies this distortion.

### *2.1.1. Inefficient distribution of resources*

The distortion of prices is a reason for the inefficient distribution of resources. The society loses from this because each resource can be used for the production of something of added value. It is necessary to note that the claim that corruption leads to inefficient distribution of resources at a macro level has not been accepted in the literature without reservations. There are two arguments against it. The first is that even when corruption exists, the most efficient producer or supplier who can win control over the resource will win even if there is no corruption, too, because he can afford to pay the highest bribe. This means that the resources will be efficiently distributed and there will be re-distribution of the income provided by them. The second argument is that sometimes the corruption of public officials creates a market where previously there was no market due to state interference or a ban and thus the corruption may even improve the distribution of resources.

As the discussion here below will show, these two arguments have missed the *macro-consequences of the macro-processes*. For example, the redistribution of income from the private sector to public officials changes the situation of the private producers and affects their future decisions. Also, the increased income of the public officials creates a motive for them to place more and more resources under their control, i.e. to deprive the market of territory so, in reality a market shortage will occur due to the corruption.

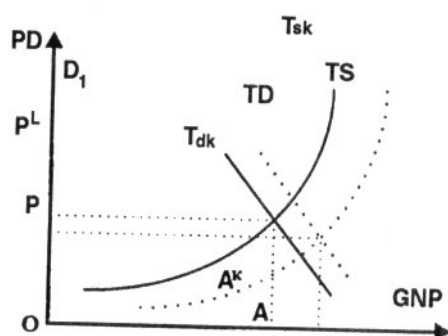
The inefficient distribution of resources and the re-distribution of income are the reason for the low investment in the private sector because the expected profit from all activities connected with interaction with the state is lower if corruption exists rather than when it is missing. On the other hand, corruption could be come about through increased state investments due to the striving of the corrupt officials to “distribute” the resources in order to receive bribes. In case of the proven inability of the state to estimate correctly the efficiency and the profitability of investment projects, the collective effect of the corruption on investments in the economy is to decrease their total benefit to the public. This is an obstacle to the investment process and leads the economy to lower growth.

Moreover, the combination of the inefficient distribution of resources and the fiscal pressure of corruption on the budget, which will be discussed below, creates conditions for higher inflation. Meanwhile, the effect of corruption on investments and the competitiveness of Bulgarian producers, which will also be discussed, give rise to high unemployment. All these problems have a great effect on the common financial stability in the economy and its ability to grow.

### *2.1.2. The connection between corruption and demand and supply in total*

In order to visualise the arguments up to this moment, they can be incorporated in the standard analysis of supply and demand in total, as illustrated in Figure 3.

Figure 3.



At Figure 3 the thick-lined curves Tdk and Tsk express the total demand and the total supply if corruption exists, while the curves TD and TS represent them when corruption is absent<sup>1</sup>.

The effect of corruption on total demand is not a simple quantity. On one hand, corruption suppresses the total because of the lower investment in the private sector and the lower consumption connected with the lower profits. Besides, as will be discussed in the following sections, the existence of corruption worsens the entire investment climate, which leads to lower investment and, respectively, to lower total demand. On the other hand, corruption results in higher consumption and<sup>1</sup> investment from crooked public officials because of the bribes received by them. A precise assessment of the effects cannot be made but it seems realistic to suppose that the negative consequences on the total demand due to the existence of corruption are stronger than the positive, i.e. the index of corruption in Bulgaria, measured by Transparency International, hints that it seriously obstructs the investment process. That is why in Figure 3 the curve Tdk of the total demand, if corruption exists, is placed slightly more to the left than the one of the total demand TD if corruption is absent.

The effect of corruption on the total supply is unambiguously negative. First, corruption increases production and purchasing expenditures, which leads to lower production. Second, the inefficient distribution of resources decreases their productivity. That is why in Figure 3 the curve of the total supply TS where corruption is non-existent is placed further to the right than the one of the total supply Tsk where corruption exists.

As a result, it becomes clear that the serious existence of corruption in Bulgaria means that the macroeconomic balance is determined by a *very low level of GNP* ( $\hat{A}^K$ ) and by a *relatively higher price level* ( $OP^L$ ) than the country could have if it was free of corruption (OA and OP respectively).

Of course, the direct macroeconomic effects, especially when considered in isolation, as in Figure 3, expresses only part of the problems which corruption creates. Corruption affects the entire society, the state and its ability to carry out activities, business and the entire economic environment and thus additionally influences the macroeconomic indices and the long-term potential for economic growth.

## 2.2. Corruption and the social environment

Corruption, even though it basically relates to economic processes, affects the *society as a whole as well as the quality of life*. For example, very often corruption leads to abuse of the environment, i.e. pollution. This is due to the fact that the quality of the environment is a public

<sup>1</sup> Of course, the “existence” or “absence” are relative terms here. “Existence” relates to the level of corruption, which is high enough to reflect on the economic system as a whole. The Bulgarian corruption index hints that the level of corruption in Bulgaria is of such scale. “Absence” relates to a level of corruption which optimum law and further fight against corruption is inefficient from a public point of view.

resource, which is difficult to measure and control. Its preservation is usually an expense for polluters who attempt to avoid the outlay through means of corruption. The other way in which corruption affects the common quality of life is crime. The corruption itself is a criminal act and the existence of corrupt public officials welcomes the criminal to act with impunity and expand their “business”.

As far as corruption is a process of distribution of resources and redistribution of income, and as far as the main object of corruption is the social activities and programmes of the state, it leads to an increase of the imbalance. Corruption helps the rich to get richer, diverting public resources that could be of help to the poor.

Moreover, as far as the level of corruption depends on public tolerance, too, and on the ability of the society to react against it, the level of corruption is varies greatly from region to region. This leads to a heterogeneous development of these regions, to varying levels of investment and to a different growth potential, which creates tension and imbalance in the national economic system.

As a result of these and many other consequences, the common quality of life in Bulgarian society is lower than if corruption was absent. The feelings of insecurity, of an unjust distribution of resources and incomes, the unevenness of regional development, inevitably lead to high social tension. The low quality of living also affects demographic processes in the country, with a greater impact on the future.

### **2.3. Corruption and the role of the state**

Corruption, as is obvious from its definition and the economic analysis of the phenomenon, significantly reduces the ability of the state to manage the public resources efficiently. On the other hand, it stirs up appetites for redirecting more and more resources and placing them under the control of the state.

This means that for Bulgaria, where the level of corruption is high, the optimum quantity of resources, which have to be placed under the control of the state, is lower than it needs to be if corruption were absent. This idea contradicts the structure of the state inherited from the communist regime, which was based on the idea that all resources in the economy should be under control. Due to this heritage, the Bulgarian State still interferes in the control of resources, justifying it by saying that if it withdraws, there will be a vacuum, which could lead to social crises. The conflict between the necessity of reducing state participation in the economy due to the high incidence of corruption and the inherited desire of the state to control the resources is one of the most difficult problems confronting the programme for battling corruption in Bulgaria. This is a *fundamental issue* about the role of the state in Bulgaria which is yet to be resolved.

Corruption affects the ability of the Bulgarian State to act in many indirect ways.

- Corruption reduces income to the budget and increases expenditures because both state collection and spending of the resources are activities, which create favourable conditions for stealing resources. The deficit of the state rises due to the simple reason that its resources are being wasted or misappropriated. The strain means that the state either has to limit its activities or to increase income, or both. In any case, though, it is an inefficient use of resources. Furthermore, it is well known that the budget deficit reflects negatively on the stability of the financial system and the inflation which additionally reduces the ability of the state to act;
- The budget deficit issue is usually solved by increasing the tax burden, which hampers the private sector, decreases investment and consumption but also increases the stimulus to avoid taxes through corruption. Thus a vicious circle is entered which is well known in Bulgaria. Exiting it is another serious problem which has to be solved by an anti-corruption programme;

- Corruption also reflects negatively on the attempts at implementing economic reforms strengthening market relations and establishing market institutions and mechanisms. Where a true market exists, the possibilities for bribing are small. The wide expansion of corruption to all levels of state organs means that the market reforms have influential enemies everywhere. There are many subjects both in the state and in the private sectors that profit from the fact that the state has shifted the market to one or another side. These two parties effectively organise their struggle to maintain their interests. This phenomenon in Bulgaria is expressed in many privatisation deals, the deregulation of certain markets, the establishment of control over previously uncontrolled monopoly structures, the attempts at introducing transparent procedures and clear rules and responsibilities;
- Corruption obstructs the administrative and economic integration of Bulgaria into European structures, which highlight graft as a very important issue. Thus, corruption is an obstacle in the way of the Bulgarian State to achieving one of the few aims on which a public consensus exists.

#### **2.4. Corruption and business activities in Bulgaria**

Corruption *increases expenses*. It increases the expenses on the physical production of goods and services due to the necessity of giving bribes, which is true for the concluding of deals not only between the state and private economic subjects. The entire uncertainty of the environment is due to the increased fragility of the financial system and the inflationary tendency, the narrowing of the markets due to state control – these are all consequences, which have been already analysed. The increase of business expenses causes a further narrowing of the markets, reduces training and leads to lower levels of production.

Corruption enables inefficient but corrupt producers to compete effectively with the other players, to shift them from the market and thus reduce the level of competition in the economy. It is not only the power of the market that chooses winners. State officials can do this too. In Bulgaria this is combined with the inherited monopoly structure of the economy and the net effect on the economy is a crucial decrease in internal competition. This is reflected in the inflation and unemployment, as well as on the competitive power of Bulgarian production in foreign markets and obstructs the use of exports as one of the possible channels for stable growth.

Actually, one of the most significant consequences of the existence of corruption in Bulgaria is that it stimulates the already existing *superiority of the unproductive over the productive*. As far as unproductive entrepreneurship does not create new value, it is obvious that as far as economic growth, this kind of entrepreneurship is definitely objectionable, while the other kind is obviously necessary. The corruption, which by nature is a misappropriation of a resource, is heaven for the unproductive entrepreneur.

It creates the notion that efforts, skill and any other means of production are used only for redistribution of the already created products and not for the producing of new goods. Actually, this is one of the expressions of the link between corruption and the inefficient distribution of resources.

All this worsens the conditions for doing business in Bulgaria and it bears heavily on small and medium size business. High expenses and the level of corruption first strike the smaller enterprises and deprive them of their most valuable qualities, namely flexibility, the ability to adapt and create new occupations and constantly detect new niches of production. This blow upon the small and the medium size firms is actually a blow upon public support for economic reform because it is these enterprises which represent the part of the society that is most interested in the success of the reforms.



## **2.5. Corruption and the quality of the economic environment**

All effects of the corruption on the economy, as mentioned above, reflect on the quality of the economic environment and the ability of the society to improve it.

First, corruption changes property rights by creating the possibility for misappropriation of public resources. The main reason for that is the corruption in the legislative power, which sets the rules in the judicial system, which is in charge of applying them. This hampers any creative economic activity.

But the effect of such misdeeds does not end here. Their presence shapes the relations between economic subjects, and affects the informal rules of behaviour. Thus, the entire institutional framework, which consists of the formal and informal limitations on human behaviour and the specific features of their implementation, is distorted. One of the expressions of this effect is the low level of trust, which exists in Bulgaria. It is the trust at all levels, trust in the businesses, in the state administration, in the magistrate's office, in the ability of the economic system to create favourable conditions for work. Thus, corruption helps to establish the perception in Bulgaria that "all are knaves", the building of long-term relations based on trust is useless and the only way to succeed is to think only of the short term and grab everything in sight.

This way corruption is one of the main factors, which *turn cooperation and trust into a losing strategy* in Bulgaria. The lack of cooperation and trust obstructs a great number of deals and completely stops many of them and thus limits the market range and the scale of training. Moreover, the economic culture based on mistrust, willingness to breach norms and certainty in the efficiency of misappropriation, gain the upper hand. Growth is impossible when such an economic culture dominates.

## **2.6. Conclusions**

The analysis gives reason to make the following two general conclusions:

- The answer to the question whether corruption is the reason for ruining the bases of the economy or is a consequence of its weaknesses, is probably, both. On one hand, the lack of a solid basis for creating public capital, economic growth and market-oriented attitudes, enables corruption to become deeply rooted in the tissue of the public and economic life in Bulgaria and ruin what already exists;
- Obviously, in these conditions, it is very difficult to say the Bulgarian economy has serious potential for growth. In this sense, the preparation and the implementation of an effective anti-corruption programme is compulsory. Long-term growth cannot be achieved any other way.