

5. HIDDEN ECONOMY AND PROCUREMENT

Corruption payments are closely related to the overall level of institutional quality and the informal money flows within the economy, which CSD has measured since 2002 through its flagship *Hidden Economy Index*. The diagnostics of the hidden economy is important in many respects but it is paramount in differentiating between institutional imperfections and **regulatory burdens**, which cause more benign forms of informal payments and corruption, and **entrenched political – economic networks**, which are often linked to or are themselves white-collar organized crime to breed corruption loopholes and **capture the state**. These networks are effectively immune to prosecution as they either include representatives of the judiciary or create legal frameworks that legalize their corrupt transactions, e.g. through creating monopolies or when regulators turn a blind eye to glaring regulatory breaches.

The means of exchange between the public and the private parts of such networks is public procurement, including its various forms ranging from privatization to public-private partnerships. With time, and in particular during years of crises or low growth, such as the 2009 – 2016 period, these networks seal off opportunities for non-connected contenders, **reducing upward social mobility, stifling economic growth and prosperity, and pushing the most capable to move outside the country**, thus further reducing society's resilience to corruption and state capture. With the opening up of data, the strengthening of investigative journalism, civil society actions, and the peer pressure coming from other EU member-states (e.g. through the continuing rebuttal of Bulgaria's membership in the Schengen area of free movement), **such networks have become too visible in Bulgaria**, explicating to the Bulgarian public the many and diverse forms of rent extraction and their beneficiaries, as well as their links to the ruling elites. The case of the rise and fall of the Corporate Commercial Bank, and in particular the wrangling over its remaining assets, has exposed many such "loops of companies",²⁵ which are unlikely to face any form of prosecution in the foreseeable future.

Hidden economy trends

Often participation in the hidden economy is explained only through fiscal factors, such as the size of the taxes. In many cases, however, it is not the size of the tax that precludes entrepreneurs and citizens from contributing but the procedure for its administration and the quality of the public good taxpayers gets in return. Thus the effective and efficient functioning of the regulatory agencies directly influences hidden economy

²⁵ "Loops of companies" is a phrase coined by the leader of a political party – the Movement for Rights and Freedoms – in the beginning of 2000s, when he wanted to portray how much stronger politicians are than businessmen in Bulgaria, noting there has not been any single significant business created in the country without at least his benevolent smile at them.

dynamics, as well as related corruption payments, mainly through several specifics of their administrative functions, such as:

- Cost of entering the formal market (e.g. registration of new or formalization of existing business);
- Cost of compliance with existing regulations, including transaction costs for monitoring and inspection by the regulators;
- Mechanism through which regulatory and control agencies select businesses and/or individuals for inspection.

Two public bodies in particular have direct link and responsibility to influence the hidden economy dynamics in Bulgaria. The National Revenue Agency (NRA) is the institution entrusted with the task and the highest public expectations to curb hidden economic activities. In recent years, the NRA work has been primarily directed towards the collection of social security payments (11.5 % increase in the number of checks year on year),²⁶ which is an additional factor contributing to the improvement of compliance in this particular area. This trend is also visible in CSD's 2015 *Hidden Economy Index* data. According to the latest available data, the violations that the NRA uncovered through its activities had a fiscal impact amounting to BGN 1.7 billion, roughly similar to that in previous years. It is unclear how many of those were confirmed by a court decision. Ensuring that NRA's Annual Reports contain data on the court confirmed fiscal impact of its inspection activities would be a substantial improvement of performance evaluation. In this respect NRA has continuously been improving its work by gradually introducing better risk management and targeting of inspections. In 2016, it also introduced a *Strategic Plan for the Work of the Internal Audit of the National Revenue Agency 2016 – 2018* targeting precisely the areas with highest corruption risk: interaction with customers (citizens and businesses), tax audits, inspections, and fiscal control. This strategy and continued focus on transparency and performance evaluation should enable the agency to deliver better public services in the future. In light of the Panama Papers affair and the very slow progress in bringing to justice the key players involved in the CCB case, NRA should also aim to strengthen considerably its capacity for international cooperation, as well as ensure better coordination with the public prosecution and the financial intelligence.

The General Labor Inspectorate Executive Agency (GLIEA) is the other important public body with significant role in tackling the hidden economy. In 2015, GLIEA decreased the number of inspections (50,229 against 52,543 in 2014), while increasing slightly the number of secondary or follow up inspections to strengthen enforcement.²⁷ The level of inspections still remains high compared to similar organizations in other EU member-states, meaning increased regulatory burden and corruption risk. GLIEA, similarly to the NRA, has been trying to limit these risks, for example by focusing less on microenterprises, which are more likely

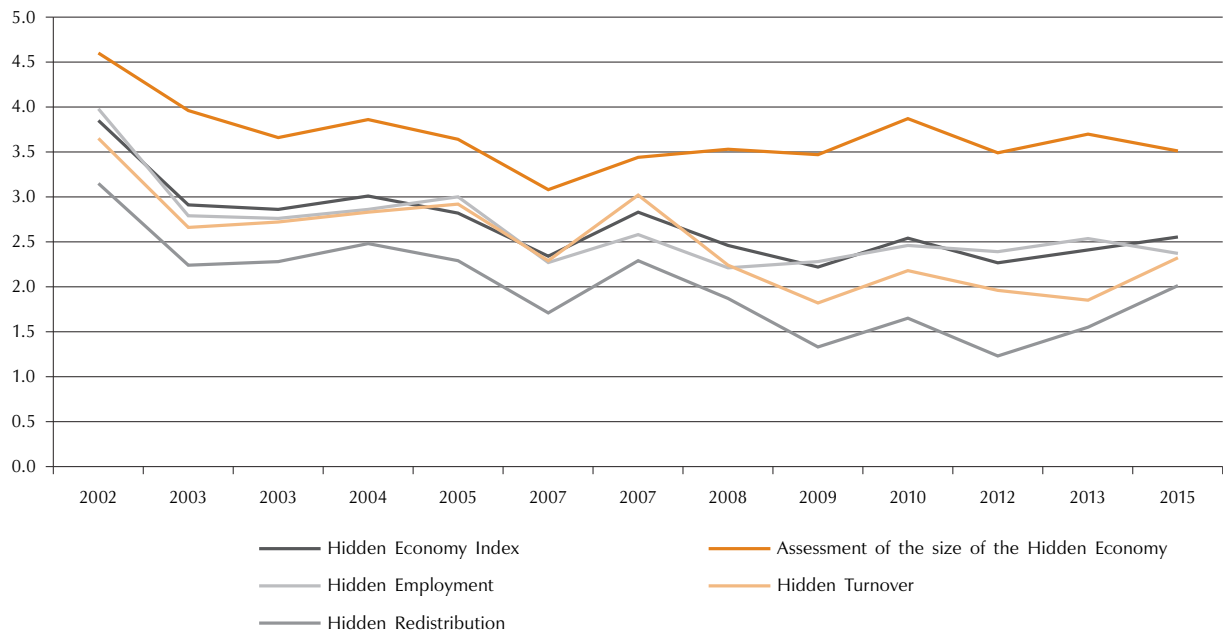
²⁶ The latest available Annual Report of the Agency is for 2014.

²⁷ According to the 2015 Annual Report of the GLIEA the number of follow on inspections increased in 2015 by 6 % and reached 12,856.

to have minor or low-impact violations. More effort is required in this respect, as well as higher education and cooperation GLIEA with citizens and businesses, as the number of uncovered violations remains stubbornly high, signifying gaps in the deterrence effect. Unlike in previous years, the majority of the uncovered violations (50.4 % of a total of 222,245) concerned health and safety, while 49.4 % were labor law violations. Non-compliance of working time regulations, working hours, and holiday entitlements represented the biggest share of labor law violations. The GLIEA also notes a decrease of the uncovered individuals with missing employment contracts, which might be the result of the more flexible rules introduced for seasonal employment in agriculture, among others.²⁸

Prevalence of corruption is one of the substantial factors in understanding the existing hidden economy trends and dynamics. Data from the 2015 *Hidden Economy Index*, developed and implemented by the Center for the Study of Democracy, shows that **hidden employment recedes according to both business representatives and the public at large**. Reduction is observed in the cases of undeclared work. Avoidance of social and health insurance payments decreases too. This dynamic contributes to the lowest level of the “hidden employment” indicator for the 2002 – 2015 period. Nonetheless, a quarter of the persons employed still withhold some or all of the social security payments.

FIGURE 10. HIDDEN ECONOMY INDEX 2002 – 2015



Source: Survey among business representatives, 2002 – 2015, Center for the Study of Democracy.

²⁸ General Labor Inspectorate Executive Agency, Annual Reports 2014 and 2015, available from <http://www.gli.government.bg/page.php?c=40>

On the business side, business executives assess the current hidden economy levels as lower, compared to those in 2009 and 2012, but remain concerned about illegal import and exports, VAT and excise payment avoidance and fraud. Unlike the evidence of higher collection reported by the Bulgarian government, according to polled businesses, the level of VAT and excise fraud has increased to levels last seen prior to 2009. On the labor market the major challenges in reducing hidden employment prove to be the wider coverage of young employees (18-29 years of age), particularly males, and the increase of social security income for specific groups of employees. On the taxation side, in 2016 an issue which demonstrated the difficulty of introducing a more sophisticated tax system in Bulgaria without generating hidden economy and corruption has been the matter of introducing VAT for the personal use of premium goods/services listed as company expenses. Although the measure has existed in EU and in Bulgarian legislation for some time, it has never been properly administered and enforced. The measure was announced as a new initiative in the 2016 state budget discussion in parliament late in 2015, and was never properly communicated to the business and citizens to ensure compliance and proper enforcement. This is an example of how a fair tax practice might be turned into a hidden economy and corruption risk by poor implementation.

Box 5. The shrinking illicit cigarettes market

One of the areas where state capture is most visible is the collection of taxes and other revenues by the state. Here political and administrative corruption, on the one hand, and counter-efforts of law enforcement institutions, on the other, have the strongest impact.

In this respect 2015 brought certain progress. **Revenues from VAT and excise taxes were 960 mln BGN more than in 2014, a growth of 8.5 %** (while GDP grew by 3 %, per estimates of the National Statistics Institute). Based on this data, the claims that the additional revenue is due to improved performance of the revenue agency and curbing of administrative corruption seem plausible.

This positive trend is most visible with tobacco products. Analysis of CSD had indicated that in the 2009 – 2014 period illicit cigarettes became one of the largest organized crime markets. ‘Empty pack’ surveys²⁹ suggest that illicit cigarettes accounted for about 19-20 % of total cigarette consumption (Figure 10), or about 3 billion cigarettes per year. The annual lost budget revenue from illicit tobacco products is estimated at 600 mln – 650 mln BGN.

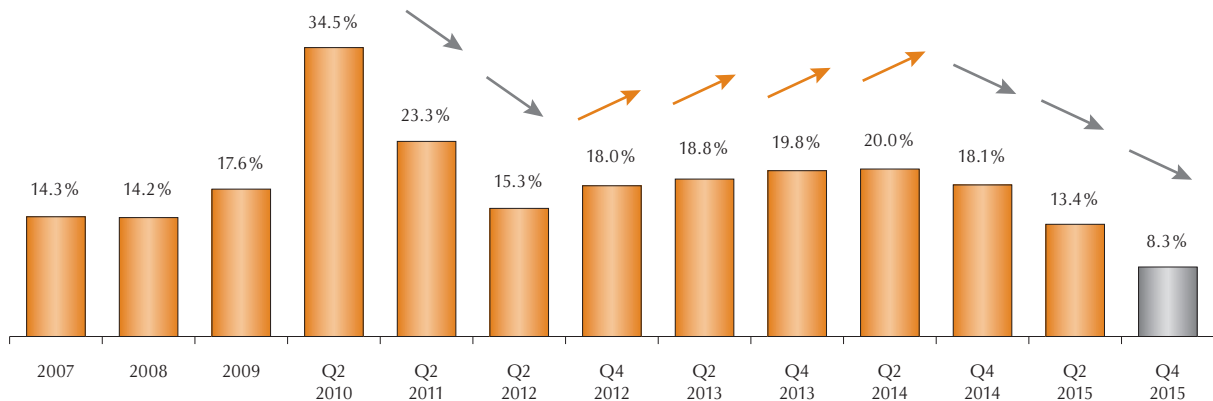
²⁹ The ‘empty pack’ method is used in the largest study of the illicit cigarette market within the EU which is conducted with the support of major cigarette producing companies. The method is based on collection and analysis of used empty cigarette packs in randomly selected areas in big cities. ‘Empty pack’ surveys in Bulgaria collect usually between 5,000 and 8,000 packs, to find out what share of them is from legal sources and what is illicit domestic production or illicit imports.

Studies of CSD have pointed out that this enormous criminal market is responsible for a large share of the corruption practices both at the political level and at the level of revenue administration and law-enforcement institutions.

The high share of the illicit cigarette market after 2009 is due to both **smuggling** and **domestic production by legal cigarette manufacturers**. The direct and constant control introduced by the government at the end of 2014 and beginning of 2015 resulted in sharp decline in the supply of illicit cigarettes in the country. Parallel with these efforts, Mol and the Customs Agency prevented any new external sources of illicit cigarettes from entering the Bulgarian market. The combined effect was steep decline in illicit cigarettes consumption, as evidenced by recent 'empty pack' surveys. In the first half of 2015, this share declined to 13.4 %, and in the second half, to 8.3 %.

These levels of illicit cigarettes consumption place Bulgaria below the average for the EU. The impact is confirmed by the **excise tax revenues from tobacco products**. In 2015, total excise tax amounted to 2,008 mln BGN, up from 1,787 mln BGN in 2014.

FIGURE 11. SHARE OF ILICIT CIGARETTES CONSUMPTION IN BULGARIA (2007 – 2015)



Source: 2015 'Empty pack' surveys (part of an anti-illicit cigarette initiative of PMI, BAT, JTI, Imperial Tobacco, Bulgartabac).

Corruption risks in public procurement

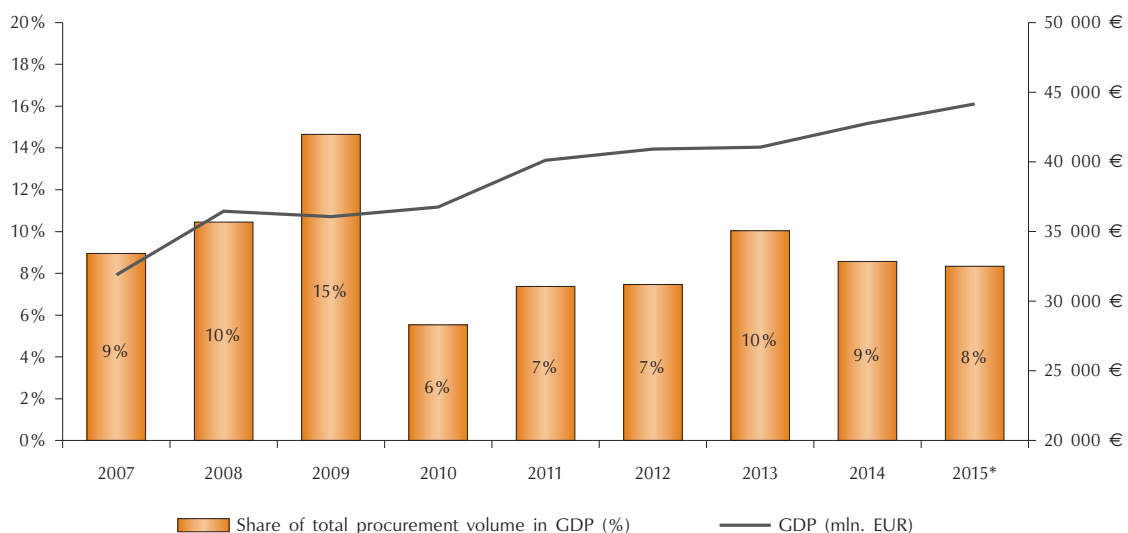
Similar to the deficiencies of the majority of regulatory and control agencies in Bulgaria, **the country continues to struggle with establishing an efficient and effective public procurement (PP) system**. The allocation of public resources remains particularistic and uncompetitive.³⁰ The Bulgarian

³⁰ CSD, *Anti-Corruption Policies against State Capture*. Sofia: Center for the Study of Democracy, 2014.

EU membership has had an important contribution towards improving public spending, mainly with respect to enhancing transparency and accountability but also to streamlining relevant legislation and providing for stricter control and oversight of public procurement procedures involving EU financing. However, the latter has also significantly impacted the public procurement domain by further increasing corruption risks, as EU funds gradually replaced national financing in many sectors, and as the effects of the introduction of new rules wore out. In 2016, **public procurement has again been associated with oligarchic networks and state capture**, after the Prime Minister abruptly cancelled key contracting procedures in infrastructure, printing of identity documents, etc., citing only public concern with the procedures, for some of which the government had gone an extra mile to push through just a few months ago, e.g. by updating the annual budget for 2015.

On average, from 2007 to 2015 public procurement made up 9 % of Bulgaria's gross domestic product (GDP) (Figure 12). While small by EU standards, public procurement grew steadily from EUR 1 billion in the early 2000s to a peak of just above EUR 5 billion in 2009 before dropping to EUR 3 billion in 2010 in the wake of the Eurozone crisis. Both peak years of public procurement contracting since Bulgaria's EU accession – 2009 and 2013 coincided with parliamentary elections. In both years, the non-cyclical spike in public procurement came in the months just before the elections, clearly indicating the intent of incumbent governments to win voter support through the allocation of public funds.³¹

FIGURE 12. SHARE OF THE TOTAL PUBLIC PROCUREMENT VOLUME TO GDP IN BULGARIA (2007 – 2015)



* Preliminary data

Source: PPA, NSI, 2015.

³¹ CSD, *On the Eve of EU Accession: Anti-corruption Reforms in Bulgaria*. Sofia: Center for the Study of Democracy, 2006.

EU funds have been playing an increasingly important role in the public procurement market, providing for roughly a quarter of all procurement announcements. This has added pressure on the Bulgarian authorities to spend funds at any cost before their eligibility period runs out, leading to spikes in EU funds' financed public procurement in the years 2009 and 2014.³² At the same time, the European Commission (EC) has pointed out on many occasions the continuing inability of the country to properly manage EU funds. For example, irregularities in the management of the Phare and Sapard pre-accession funds exposed by the EC, coupled with the lack of adequate ex-ante and ex-post controls, and the tenuous response of the Bulgarian government to those findings, led to the forfeiture of EUR 220 million from the national Phare program, as well as to the freezing of EU funds earmarked for road infrastructure development.³³ At the end of 2013, suspension of payments was also imposed upon Operational Program Environment, particularly due to public procurement irregularities.

Box 6. Public procurement trends in the Bulgarian construction sector

Both the number and value of public procurement contracts for construction works marked a significant increase between 2010 and 2015. Their numbers rose from 1,269 in 2010 to 2,842 in 2015. The respective increase in the total value was from EUR 728 million to EUR 1,326 million. The spike was even sharper in the period 2010 – 2013 (from EUR 728 million to EUR 2,047 million), the last year in which EU funds from the 2007 – 2013 period could be contracted. There was also a clear trend of concentration of public procurement contracts in construction works vis-à-vis the supply of goods and services, and in larger value contracts within construction works. While in terms of numbers the share of the construction works contracts remained relatively stable, their share in the total value of public procurement contracts has increased steadily to over 50 % in 2013. This rising concentration of public procurement in construction works has been attributable entirely to the rise of large-scale public procurement contracts and the increasing weight of EU financing. Large-scale contracts for construction works with value above EUR 1.1 million have risen to 43 % of the total public procurement value in Bulgaria.

Concentration of public procurement is also visible at below sector levels. The top 40 procurement winners from the Tenders Electronic Daily (TED) database account for 62 % of the total procurement volume in construction (in the same database). Four

³² EU funds are disbursed at 7-year budget cycles (2007 – 2013) under the so-called “n+2” rule, meaning that money has to be contracted at the latest by year *n* (e.g. 2013) and invoiced by year *n*+2 (e.g. 2015) or has to be returned to the EU budget.

³³ CSD, *Crime without Punishment: Countering Corruption and Organized Crime in Bulgaria* Sofia: Center for the Study of Democracy, 2009.

companies account for 23 % of all TED records. In 2013, the top 40 construction companies controlled 23 % of the total value of the public procurement market in Bulgaria, which was more than double their share in the last pre-crisis year 2008. After the economic crisis began in 2008 – 2009, EU funding replaced national funding in large-scale public procurement of construction works (reaching 78 % in 2013). It could be expected that – other things being equal – with the rise of the EU funding share in their turnover, and as they become more accustomed to EU funding and oversight rules, incumbent companies will try to find ways of capturing EU funds in similar ways as they have done with national public procurement.

Source: Stefanov, R., Yalamov, T. and Karaboev, S. (2015). The Bulgarian public procurement market: Corruption risks and dynamics in the construction sector, In Mungiu-Pippidi, A. (Ed.), Government Favouritism in Europe. Barbara Budrich Publishers: Opladen, Berlin, Toronto.³⁴

The findings of the main control bodies of public procurement in Bulgaria – the Public Procurement Agency (PPA), the National Audit Office (NAO) and the Public Financial Inspection Agency (PFIA) confirm the existence of high levels of corruption risk in the PP process. Violations of the public procurement law and procedures uncovered by the PFIA remain very high. In 2014, out of 2,440 checked contracts 924 were discovered to contain violations. Similarly, the ex-ante control performed by the PPA on EU financed public procurement showed high number of violations. As of 2014, some 30 % of the checked procedures were not fully compliant with the law.

Risks of corruption are exacerbated by frequent legislative changes to the *Public Procurement Act* citing EU legal approximation as the underlying reason. While the EU has enacted only two major changes in public procurement in the past decade, Bulgarian lawmakers have introduced a total of 27 sets of amendments to the public procurement law since 2005. This indicates that while EU accession apparently led to the creation of new and more legal constraints to corruption, its implementation remains problematic.

Public procurement in Bulgaria remains trapped in the wider governance problems of the country, which still display the main features of a particularistic regime. Declining private sector opportunities in the wake of the Eurozone crisis in 2009 and the rising pressure on the Bulgarian authorities to deliver full EU funds absorption by the end of the EU funding cycle in 2013 have led to concentration of procurement resources and market leverage in the public administration. This, as well as the lack of trust in national law enforcement, has kept Bulgaria high on the radar of the EU anti-fraud office OLAF. In 2015, Bulgaria

³⁴ The firm-level analysis is based on a database with 4,928 procurement contracts between 2009 and 2014 from the TED structured dataset, and a manually constructed database using a sample of the top 40 construction companies, ranked according to their total turnover for the period of 2008 – 2013.

remained, together with Romania, the country with the most cases of incoming information and initiated investigations by OLAF. The overwhelming majority of cases reported to OLAF from Bulgaria come from private sources, and not the legally mandated for the matter public institutions, which is another testament to **the very low trust of citizens in Bulgarian public institutions.**³⁵

³⁵ According to the OLAF Report 2015, the organisation received altogether 34 information signals from Bulgaria, of which 32 were from private sources. OLAF initiated 19 investigations for Bulgaria in 2015.

