

## Bureaus, investment and honest policies<sup>1</sup>

Honesty is the best policy, because it's better than any other policy. In the economy, such policies eliminate or reduce government control over prices, profits and contracts. The aggregated effect is believed to be lower transaction and contract enforcement costs and increased economic freedom. Honesty is to be sought in relations between the state, its representatives - i.e., bureaus<sup>2</sup> - and entrepreneurs.

Entrepreneurs, within the existing freedom of choice, aim to reduce above mentioned costs (and thus increase their profit). The bureaus also aim at maximizing their specific utility. Unlike entrepreneurs they are non-profit organizations, and they finance themselves, at least partially, through the distribution of funds collected from others (mostly taxes) and/or grants.

On the bureaus' side there is a supply of goods and services, which under normal accounting systems are reported as a share of total government expenditures. On the entrepreneurs' side lies an objective to supply of the same or similar goods and services, but not as a participation in distribution but merely as gaining a certain share on the market. An important principle in analyzing corruption is the believe that on the market both buyer and seller gives less than gets. In other words, anti- and non-market mechanisms tend to increase transaction costs, in principle.

### Honest policy and freedom

Based on these reflections, at the first meeting of independent experts and the government of Bulgaria in Borovets (July, 1997)<sup>3</sup> I presented a list of sources of corruption stemming from intervention in setting prices, government controls over trade contracts and profit-margins, and from regulations on government appointment of state-owned enterprise management. The idea was that cabinet decrees are easy to amend or discontinue. Had it been done, current costs of doing business in Bulgarian could have been lower. As of mid-1998 everybody started discussing corruption, and the third meeting in Borovets I chaired a special debate to the issue.

It seems that the expert community believes that the basics of honest policy and freedom coincide: countries tend to rank at a similar level for indices of both economic freedom and corruption perception.

### Weighted Summary Index, 1997

Index	Country (Rank)	Index	Country (Rank)
9.6	Hong Kong 1	6.2	Cyprus 63

<sup>1</sup> This paper is reviewed version of a report presented at the Conference Foreign Investment, Transparency and Economic Growth (Sofia, Sheraton Hotel, 22 October 1998), organized by IME, The Center For Liberal Strategies, and The Institute for Regional and International Studies and sponsored by National Endowment for Democracy and American Standard Companies Inc.

<sup>2</sup> This term is broadly used by William Niskanen, Jr., CATO Institute Chairman; I use this term to underline impersonal nature of the attitudes at relations in question.

<sup>3</sup> In 1997 and 1998 it became a tradition all members of the cabinet and majority faction of the parliament to meet non-government experts and discuss current economic policy issues; there were two such meetings in 1997 and one in 1998; it seems that this tradition will be skipped by the government.

9.4	Singapore 2	6.2	Uganda 63
9.2	New Zealand 3	6.2	Bahamas 63
9.1	Unites States 4	6.1	Sri Lanka 66
9.0	Unit. Kingdom 5	6.1	Venezuela 66
8.8	Canada 6	6.1	Barbados 66
8.7	Argentina 7	6.0	Israel 69
8.6	Netherlands 8	6.0	Malta 69
8.6	Panama 8	6.0	Ghana 69
8.6	Australia 8	5.9	Tunisia 72
8.6	Luxembourg 8	5.9	Egypt 72
8.6	Ireland 8	5.8	Jordan 74
8.5	Switzerland 13	5.7	Colombia 75
8.4	Japan 14	5.7	Zimbabwe 75
8.3	Denmark 15	5.6	China 77
8.3	Norway 15	5.6	Belize 77
8.2	Belgium 17	5.5	Brazil 79
8.2	Finland 17	5.5	P.N. Guinea 79
8.2	Germany 17	5.5	Zambia 79
8.2	El Salvador 17	5.5	Slovenia 79
8.1	France 21	5.5	Fiji 79
8.0	Sweden 22	5.5	Morocco 79
8.0	Bahrain 22	5.3	Gabon 85
7.9	Italy 24	5.3	Poland 85
7.9	Chile 24	5.3	India 85
7.9	Mauritius 24	5.2	Tanzania 88
7.9	Austria 24	5.2	Namibia 88
7.9	Thailand 24	5.2	Cote d' Ivoire 88
7.9	Costa Rica 24	5.1	Bulgaria 91
7.9	Oman 24	5.1	Iran 91
7.8	Bolivia 31	5.1	Russia 91
7.8	Philippines 31	5.0	Senegal 94
7.8	Spain 31	5.0	Mali 94
7.7	Iceland 34	5.0	Niger 94
7.7	Portugal 34	5.0	Cameroon 94
7.7	Trinidad/Tob. 34	5.0	Pakistan 94
7.7	Uruguay 34	4.8	Chad 99
7.7	Guatemala 34	4.8	Burundi 99
7.6	Kuwait 39	4.8	Nepal 99
7.6	Paraguay 39	4.7	Syria 102
7.6	Peru 39	4.7	Benin 102
7.6	Taiwan 39	4.6	Nigeria 104
7.6	Malaysia 39	4.6	Congo, Rep. 104
7.5	South Korea 44	4.4	Bangladesh 106
7.5	Greece 44	4.4	Togo 106
7.4	Mexico 46	4.3	Romania 108
7.4	Lithuania 46	4.2	Madagascar 109
7.3	Estonia 48	4.2	Algeria 109
7.2	Jamaica 49	4.2	C. Afr. Rep.109
7.2	Czech Rep. 49	4.2	Ukraine 109
7.2	Indonesia 49	4.1	Malawi 113
7.1	Latvia 52	4.1	Sierra Leone 113
7.1	Ecuador 52	4.1	Albania 113
7.0	Kenya 54	3.5	Rwanda 116
6.9	Honduras 55	3.1	Congo, Dem.117

6.9	Hungary 55	3.1	Guinea-Bissau 117
6.8	Slovakia 57	2.5	Myanmar 119
6.8	Domin. Rep. 57	N/R	Croatia
6.6	Botswana 59	N/R	Guyana
6.5	Nicaragua 60	N/R	Haiti
6.5	South Africa 60	N/R	Somalia
6.3	Turkey 62	N/R	Unit. Arab Em.

### Corruption Perception Index 1998

Rank	Country	Index	Rank	Country	Index
1	Denmark	10	43	Zimbabwe	4,2
2	Finland	9,6	45	Malawi	4,1
3	Sweden	9,5	46	Brazil	4,0
4	New Zealand	9,4	47	Belarus	3,9
5	Iceland	9,3	47	Slovakia	3,9
6	Canada	9,2	49	Jamaica	3,8
7	Singapore	9,1	50	Morocco	3,7
8	Netherlands	9,0	51	Salvador	3,6
8	Norway	9,0	52	China	3,5
10	Switzerland	8,9	52	Zambia	3,5
11	Australia	8,7	54	Turkey	3,4
11	Luxembourg	8,7	55	Ghana	3,3
11	United Kingdom	8,7	56	Mexico	3,3
14	Ireland	8,2	56	Philippines	3,3
15	Germany	7,9	56	Senegal	3,3
16	Hong Kong	7,8	59	Ivory Coast	3,1
17	Austria	7,5	59	Guatemala	3,1
17	United States	7,5	61	Argentina	3,0
19	Israel	7,1	61	Nicaragua	3,0
20	Chile	6,8	61	Romania	3,0
21	France	6,7	61	Thailand	3,0
22	Portugal	6,5	61	Yugoslavia	3,0
23	Botswana	6,1	66	Bulgaria	2,9
23	Spain	6,1	66	Egypt	2,9
25	Japan	5,8	66	India	2,9
26	Estonia	5,7	69	Bolivia	2,8
27	Costa Rica	5,6	69	Ukraine	2,8
28	Belgium	5,4	71	Latvia	2,7
29	Malaysia	5,3	71	Pakistan	2,7
29	Namibia	5,3	73	Uganda	2,6
29	Taiwan	5,3	74	Kenya	2,5
32	South Africa	5,2	74	Vietnam	2,5
33	Hungary	5,0	76	Russia	2,4
33	Mauritius	5,0	77	Ecuador	2,3
33	Tunisia	5,0	77	Venezuela	2,3
36	Greece	4,9	79	Columbia	2,2
37	Czech Republic	4,8	80	Indonesia	2,0
38	Jordan	4,7	81	Nigeria	1,9
39	Italy	4,6	81	Tanzania	1,9
39	Poland	4,6	83	Honduras	1,7
41	Peru	4,5	84	Paraguay	1,5
42	Uruguay	4,3	85	Cameroon	1,4
43	South Korea	4,2			

Although economic freedom is measured objectively, while a corruption index measures perceptions, coincidences on the two scales show that corruption is perceived as a lack of freedom. Contrary to this conviction, at the last Borovets meeting Prime Minister Kostov declared that in Bulgaria economic freedom is being restricted in order to fight corruption. Here I would like to discuss this point in some detail.

The economic freedom index (EFI) is compiled from the following groups of indicators:

- ? size of government: consumption, transfers, and subsidies
- ? structure of the economy and use of markets
- ? monetary policy and price stability
- ? freedom to use alternative currencies
- ? legal structure and property rights
- ? international exchange: freedom to trade with foreigners
- ? freedom of exchange in capital and financial markets

The index for Bulgaria increased in 1997.<sup>4</sup> In 1995 the country was on the lower part of the table, with a freedom rating of less than 5 points. With 4.1 points, Bulgaria ranked 87<sup>th</sup> out of 115. Now Bulgaria's rating is 5.1, but it ranks 91<sup>st</sup> (together with Iran and Russia) out of 119 countries. Slovenia, which in 1995 was the only CEE country behind Bulgaria, is now ahead our country, ranking 73 with 5.9 points.

Bulgaria's progress on the economic freedom path last year is equal, in terms of speed but not in starting point, to that of Poland. Bulgaria's low rating results from several indicators, quite important for the last year: restricted liberalization of prices and international trade, high share of state property and the actual stage of development of the capital market.

What is most important is that the leading 20 countries in terms of economic freedom index are at the same time on the lower end of the scale for perceived corruption.<sup>5</sup> Out of the emerging CEE markets only Hungary and the Czech Republic happen to be in this group; at the same time, their economic freedom index is the highest in CEE. It is also interesting that in Romania the corruption perception index is lower than in Bulgaria, although it (together with only Ukraine and Albania) has a lower EFI rating. If a conclusion from the above unveiled reflections could ever be derived, it would by no means be that the restriction of economic freedom might result in a reduction of corruption. It does not matter that the corruption index measures perceptions: the very feeling that corruption is a norm makes it such.

### **State intervention and investment process**

The current level of government intervention in the economy is to great extent indirect and non-financial. The overall instability of legal framework in 1996 and 1997, economic instability and the memory of it disoriented perceptions. Among representatives of the state, the *bureaus*, we witness an appetite for retaining control. Entrepreneurs are left with the "shadow" economy as the realm of possible economic

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<sup>4</sup> IME is a member of the Economic Freedom Network, and co-publisher of the Economic Freedom of the World; the data below is from 1998/1999 Interim Report (editors: James Gwartney and Robert Lawson) and reflect the constellation of 1997 economic liberty factors.

<sup>5</sup> See Transparency International Corruption Perception Index 1998: [www.transparency.de](http://www.transparency.de).

freedom. Dishonest policy is conducted on both sides. In a narrow definition introduced recently by the World Bank, corruption is the “abuse of public office for private gain” and appears on the side of the government official and his “bureau.”

As an economic phenomenon corruption is the erosion of relations, rules and efficiency. In a single transaction the rent (price) for getting past the bureau might result in either positive or negative outcome; i.e., the transaction intermediated by the bureau either is realized or fails. For a sequence of transactions, however, the quality of the environment deteriorates due to a blocked mechanism of supply and demand of the most favorable conditions and the lowest available cost. The cumulative effect on net investment impedes growth and decreases wealth.

It might sound interesting that until 1991 in Bulgaria, as in most CEE countries, gross fixed capital formation was comparable to that in countries with developed market economies. Later the dynamics were quite different. From a level of about 30% of GDP at the beginning of the decade, gross investment in Romania, Bulgaria and Poland (from a lower starting point) fell to below 20% in 1992. In Hungary the big decline took place in 1991, and since 1994 the level has been restored to the previous 22%. In Poland the recovery took place in 1995-1996, while in Romania gross investment reached 22-23% of GDP in 1995. Major reasons for these drops were economic instability, adjustment to new markets, weak domestic demand, and for all of the countries except Hungary, delayed privatization.

Only in 1997-1998 Bulgaria do the above-mentioned factors continue to act almost all together at once. Gross fixed capital formation fell to less than 10% of GDP in 1994, then increased to 15% in 1995, only to fall again to below 10% in 1996 and remain at this low level (11.3% in 1997 and 7.1% in the first quarter of 1998).

A comparison between investment in capital accounts during corresponding periods of 1997 and 1998 is disturbing. For the first half of 1997 these investments reached \$504.4 million, while for the same period in 1998 they remained at \$299.1 million. The decrease is as high as 40.7%. The difference results from the lack of foreign direct investment and the outflow of portfolio investments at the end of 1997 and entire 1998. Bank credit for the same period has been almost entirely short-term, with an interest rate on deposits of 3% and an interest rate on commercial loans of 14%. The reasons again lie in delayed privatization, underdeveloped capital market, and - probably - the fact that investment in long-term assets is taxed.

The country will (hopefully) soon conform its regulations to Art. 4 and Art. 8 of the IMF Statutes. This means that discriminatory actions against convertibility, exchange rates and capital flows would be legally impossible. Another point would be added to the country's EFI score.

Despite the latest positive macroeconomic developments, local entrepreneurs are pessimistic and foreign ones restrain themselves from coming in.

I suppose the explanation might be in the effort of the government to simultaneously enact incompatible policies: liberalization of the economy through stated intention to adjust to the practices of developed markets, and at the same time preservation of the “license-requiring state,” exercising control over entrepreneurship and investment within the country via non-financial constraints.

The license-requiring state can be defined as one in which the *bureaus* function as agents for collecting rents. Rather than having all economic activities not explicitly prohibited by law automatically be allowed, the government sets artificial entry barriers.

In the field of privatization Bulgaria has the most complicated legislation in CEE, as well as controversial implementation and a lack of consistency. In regard to taxation, Bulgaria has maintained a confiscation regime, with no respect for the fact that people produce more when they keep for themselves more of what they earn.<sup>6</sup>

Currently as many as 82 laws deal specifically with some kind of licensing, endorsement or registration. Of them, 20 provide rules related to “martial-law-situations,” and about 10 refer to pure administrative procedures or permits within the non-profit sector. Roughly, about 50 regulations provide “special” rules for certain economic activities. Moreover, about 150 regulations and law provisions require some sort of licensing, permit or registration.

#### Corruption, state-owned enterprises (SOEs) and the “rules of the game”

Contrary to the generally-spread impression, empirical studies do not prove a direct correlation between public procurement in SOEs and corruption.

In a representative study conducted by IME and the Agency for Socioeconomic Analyses (A.S.A.) in 1997 on the role of bureaucracy in SOE management, we at IME asked several questions geared toward evaluating the inclination of executive directors toward abuse of power.

It is interesting that the rules of the game look quite clear with regard to SOEs, while at the same time vague and obscure for the country as a whole.

In both private and state-owned enterprises, the internal rules of organization are perceived in a similar way.

One Answer	Valid per cent	SOEs	Private
<i>How do you estimate administrative rules for enterprise operation that the State defines?</i>	Completely unclear	8.0	18.8
	Unclear	15.9	25.0
	Clear to some extent	46.6	31.3
	Clear	21.6	25.0
	Completely clear	8.0	0

Both in private and state-owned enterprises internal rules of organization are perceived in a similar way.

	Valid per cent	SOEs	Private
<i>Are the “rules of the game” clear in Bulgaria</i>	There are no such rules	21.3	20
	Completely unclear	6.4	5
	Unclear	21.3	30
	Clear to some extent	39.4	35
	Clear	8.5	10
	Completely clear	3.2	0

#### The same uniformity of opinion might be observed in inclination towards general rules of the game.

One of the aphoristic definitions in the Public Choice theory, of **substitution of** rules of the game and abuse of power, is as follows: abuse of power is like winning a tender without having the money to participate in it - there are two ways of doing this:

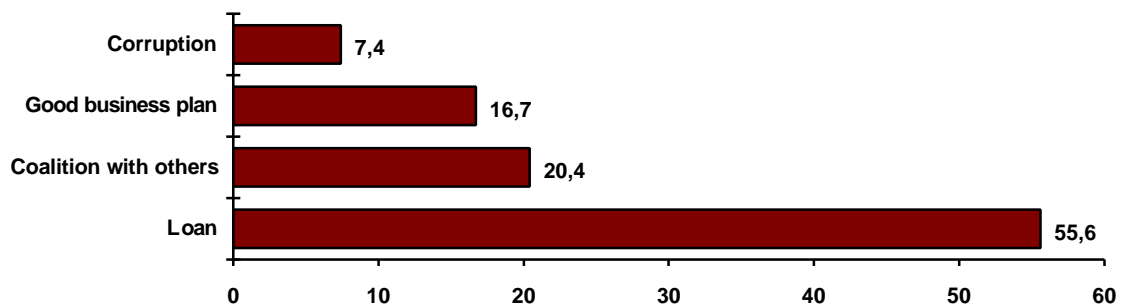
<sup>6</sup> See L. Bogdanov’s article in this issue.

physical elimination of rivals or substitution of the rules of the game. Assuming that a SOE's manager has above-average political influence, IME asked the following question: If you wanted to win a tender at any cost but you lacked the money, what would you do?

I will participate anyway



I will win through:



It seems that the real problem in SOE management is not corruption as such, but rather in the cost of decision-making and efficiency.

#### Operational time and efficiency

State representatives and their bureaus do in fact have one resource at hand, which is time. A standard model for defining time efficiency might be used. We defined time cost as “high” and “low” simply by evaluating the amount of time spent. It turned out that 75% of CEOs spend a substantial amount of time on daily consultations with the owner (the State) about operational problems. This lack of autonomy obviously leads to wastage of time in coordinating with the owner (the State). No other institutions (labor unions, tax officers, politicians, etc.) require substantial time use.

#### Time spent on coordination with the owner (Percent of respondents)

Time spent on coordination with the owner	
Little operational time	12,5
Medium operational time	12,5
High operational time	75

The question is what if not autonomy motivates managers to keep doing their job.

Guaranteed income	39,8
Security	32,6
Contacts that allow for additional benefits	12,8
Prestige	9,1
Clear obligations	24,4
It is well-defined who takes the decisions	26,7
Comparatively low personal responsibility about issues not directly connected to the own position	31,8
Clear career prospects	13,8
Fixed working time	29,2

The question is what, if not autonomy, motivates managers to keep doing their job.

The most motivating factors for professionals in SOEs appear to be guaranteed income and security. Next comes the low level of personal responsibility in making decisions not directly dependent on the manager. Opportunities for additional benefits or dividend income from equity are not, however, seen as such incentives.

Obviously, the incentives cited by SOE managers are outside the enterprise as a market agent. The discontent stems not from the rules of the very operation of the enterprise, but rather from the unstable and obscure rules of the game in general. If this holds true, the sources of corruption and dishonest economic policy can be found in the system (network of relations), rather than in the SOEs themselves.

#### Systemic errors and deadlock

Despite their secondary role in the GDP, SOEs are still a nominal owner of the physical assets in the Bulgarian economy. *De jure* and *de facto* the owners are the Council of Ministers and the line ministries.

Relations between the owner (the State) and the SOEs are regulated by CM Decree 7/25 of January 1994, on procurement of "state property rights in SOEs."

It is barely known that these regulations have been amended 17 times in the four and a half years of their existence, mostly in sections dealing with the remuneration of managers and board members. If our empirical studies hold true, this is the least effective amendment, given that income is not a primary incentive at all. If incentives to decapitalize the enterprise exist, they obviously cannot be revealed. A lot of efforts were concentrated on restructuring SOEs' operation under the general provisions of the Commercial Code. None of the amendments succeeded in solving the major problem: the appointing of executive management with at least an element of competition or venture capitalism, for a designated period of three years.

As a result, the managers protect their places in the administration of the respective line-ministry, or on its "list" of people entitled to certain positions. It is not difficult to suggest, or even prove, that they thus maximize their personal utility. This incentive, however, coincides neither with increased profit nor with the acquisition of managerial knowledge under market conditions.

The problem is that the coalition formed by the above-mentioned alliance of interests multiplies the detrimental effects on the economy in general. As a result, loss-making enterprises are not being closed down. It also leads to political pressure for soft bank

loans. It blocks privatization. It drained the commercial banks. It made Videnov's government crash. Nevertheless, five governments (two of them interim ones) maintained the same system.

There are several (theoretically) possible solutions to the problem. For instance, through formulating strict management rules for a single enterprise (or a group of enterprises) and then organizing a public tender for the managerial contract that provides autonomy and guarantees in case of default (loss). Or through privatization. Or liquidation. There are, however, no funds available for the first and the third solutions, nor human resources for the first one. The second option remains the only feasible one; this is the reason why *coalitions* come up with controversial privatization schemes and delay the process in order to retain control.

In general, what is good for the economy and prosperity is good for curbing corruption. The question is where this honest policy could come from. The government has a program for the formation of a "competitive economy driven by a viable private sector." This program is approved by the IMF. One would not discover anything exceptional in it; all of the measures in it have been proposed on different occasions by both local and foreign experts. No honest policy is ever possible beyond these measures; however, they were imposed by the International Financial Institutions. The question again is: to what extent have they grasped the hearts and the minds of those who sit behind the "bureaus?"