# VI. CORRUPTION IN THE ECONOMY

In modern times the Balkans have been always the least economically developed region of Europe. Even the accelerated industrialization of some of the countries from the region, after the end of World War II, did not help overcome the gap between those countries and the more developed Western European states. The investment decisions were not based exclusively on their economic advantages, but were also politically motivated in the context of the rivalry between the two blocks. When eventually the economies of those countries had to face the competition of the world markets, most of their fixed assets turned out to be non-viable. Given the new market conditions, their value was significantly decreased. For those countries, the last decade of the 20th century was a period of economic degradation.

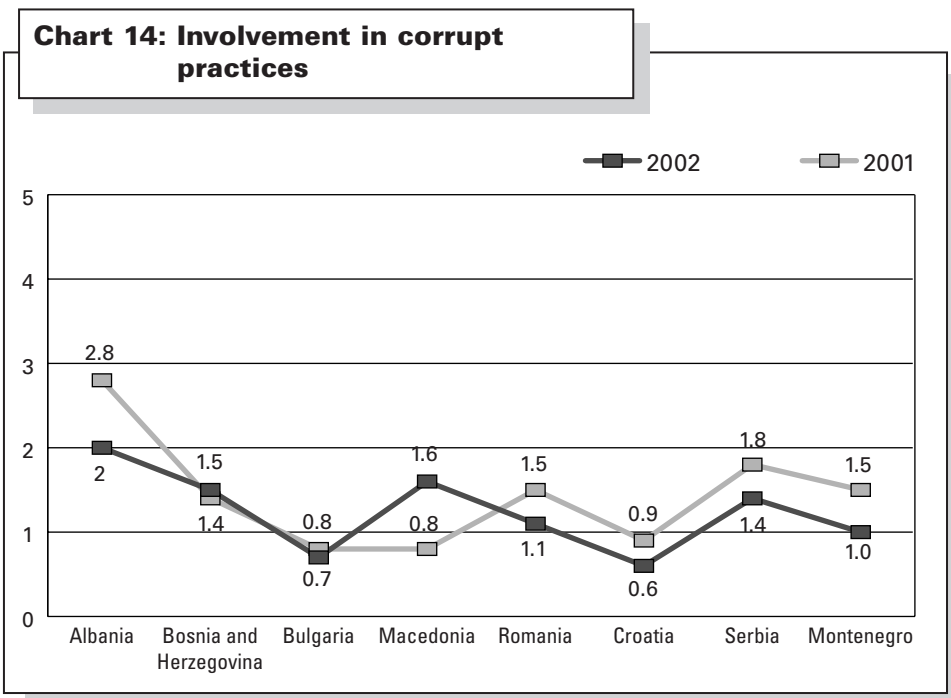
The process of disintegration of former Yugoslavia, ridden with conflicts and violence, maintains the instability and unpredictability of the region. The establishment and consolidation of new states, the issues of national security and minority problems are distracting the attention of governments and social structures from the economic aspects of the reforms. Many of the countries from the region are too engaged in building new political systems, solving constitutional, ethnic, legal and many other problems. Thus, there are little political, legal and institutional conditions for launching a market-oriented economic activity, particularly as the predominant stereotypes of economic development in South-Eastern Europe are ones of a state-dominated economy.

All these conditions appear to be a very fertile ground for corruption and it became one of the striking features of the transformation in the Southeast Europe. The widespread corruption was enhanced by the state collapse, the rotation of elites and the widespread failure to introduce and enforce appropriate legal and cultural norms.[53]

## 6.1 Privatization And Post-Privatization Control

Over the past decade, the pace of privatization in the South-east European transition economies had clearly lagged behind that in the "early reformers" from central Europe, suffering from basic difficulties and repeated delays due to a lack of commitment, inconsistent policy measures, complicated legislation and administrative deficiencies. While the late 1990s and early 2000s witnessed a general acceleration in the process across the region, as well as considerable improvements in the procedures and their implementation, many problems still remained especially with respect to the transparency of the transactions, the application of selection criteria and the post-privatization control. The institutions in charge of privatization have been typically granted large discretionary power that is generally seen as a hotbed of corruption. Moreover, the administrative capacities of the privatizing agencies appeared overall weak and these institutions have practically remained under rather strong political influence despite their nominal independence. The

**Chart 14: Involvement in corrupt practices**




*Source: SELDI Corruption Monitoring System*

[53] *Economic Survey of Europe*, 2000 No.2/3, Economic Commission for Europe, UN, Geneva, 2000, p. 134.

prevention of potential conflicts of interest, insider favoring and corrupt behavior proved also a particularly challenging task in the context of the existing legal loopholes and the preferential use of some privatization techniques. Therefore, it was not strange to see that the transfer of state-owned assets into private hands has been accompanied by growing public discontent over the outcomes of privatization and allegedly widespread corruption.

### *6.1.1. The process of privatization in South-east Europe: legal frameworks and current progress*

During much of the 1990s, the privatization process in South-east European transition countries had been rather slow and hesitant, with the region's economies trailing well behind the more advanced reformers from central Europe in the pursuit of their ambitious strategies. While most of the former countries had made a relatively quick progress in transferring the ownership of small- and medium-sized enterprises, large-scale privatization had been considerably delayed due mainly to political constraints and controversies, as well as low incentives on the part of insiders. The overall slow pace of economic reforms and the gradualist approach towards the sell-off of state assets created fertile ground for rent-seeking behavior. In the second half of the 1990s, however, there was a marked pick up in large-scale sales that contributed to the notable acceleration of the whole process. This strengthening momentum reflected important policy changes and a general diversification of the employed privatization schemes and methods. In line with the shifts in the policy of divestiture the basic laws governing the privatization process have been amended rather frequently, although the effect of the legal changes fell apparently short of expectations with respect to reducing the risks of corruption.

Yet, the significant strides in privatization during the latter half of the 1990s played a key role in the restructuring of the South-east European transition economies, with the private sector gaining a dominant position in overall output. The wide-ranging reforms undertaken in **Albania** since the fall of the communist regime have totally reshaped the national economy. The process of privatization has been going on in the country for 10 years on end and at present approximately 80% of Albania's GDP is generated by the private sector. The *Privatization Law* of 1991 paved the way for the rapid privatization of small-sized entities employing up to 10 people. That was the first step forward in terms of changing the ownership structure of the then public property followed by the adoption in mid-1990s of a voucher scheme. A Mass Privatization Program was launched in September 1995 with a view to privatizing all small and medium-sized state-owned enterprises. By now, almost all of them are already privately owned and even some strategic state-owned companies are about to be privatized soon.

Since 2000 there has been considerable progress in the field of liberalization and privatization in both entities of **Bosnia and Herzegovina (BiH**). Despite the intensified efforts, however, the process of large-scale privatization is only at the beginning. Consequently, many of the larger companies are still state-owned (almost all of the top 100 companies in terms of net capital book value and the number of employees are owned by the state), although the number of small- and medium-sized private enterprises appears substantial. The process of mass privatization is also well under way, with the registration of people for vouchers and their distribution and investment being already completed. In addition, a number of bidding procedures for the privatization of enterprises with the capital value below and above 300,000 KM (approximately 150,000 EUR) have been carried out in the Republika Srpska (RS), as well in the Moslem-Croat Federation (FBiH). Yet, the privatization process could hardly be described as being fast. The primary reason for this seems to be the size and unattractiveness of the BiH market for investment, and not so much the unwillingness to privatize. Besides, there were a number of forced delays and frauds in the privatization process that caused some pullouts and revisions of the privatization status, resulting in an even lesser interest in the purchase of existing enterprises. Finally, the model that was to offer as much participation, transparency and equality to all citizens proved to be rather complex, slow, expensive and painstaking. However, any additional review of the model itself (having undergone some two to three crucial structural adjustments in the last decade) would prove to be even more costly.

For the whole period since the start of 1993 up to end-January 2002, a total of 4,789 privatization deals have been concluded in **Bulgaria**. A reported 52.64% of all state assets have been already privatized, representing more than 80% of the assets slated for privatization. Meanwhile, the share of the private sector rose to 71.7% of total value added in 2001, up some two points from the previous year. The basic *Law on Transformation of State and Municipal Enterprises* was passed in April 1992 and has been amended many times afterwards. The initial legal framework provided

for a wide range of cash privatization methods, although a 1995 major amendment in the original law allowed for a mass privatization program to be launched in 1996 based on a voucher-type scheme close to the Czech model. Further important amendments were made in 1997 and 1998 in order to accelerate privatization by offering greater flexibility with regard to the employed multiple methods. In early 2002, a new *Law of Privatization and Post-privatization Control* has been adopted that includes, among others, several provisions aimed at the prevention of corruption and increasing the transparency of the process. The major goal was, however, to streamline the procedures with a view to rapidly completing the remaining large-scale deals and paving the way for the second-round privatization in network industries.

In 2000, around 60% of **Croatia's** GDP was produced in the private sector. At least three institutional and legislative framework factors proved to be decisive in the process of privatization in the Croatia. The first is the concept of privatization chosen, which resulted in the *Law on Ownership Transformation of Socially Owned Property* (1991). It was mainly based on methods of selling, on a case-by-case principle with preferential treatment for former and current employees. The frequent changes and amendments of the original text put, however, the new owners in an unequal position, produced feelings of legal insecurity and created favourable conditions for many forms of "grey economy" activities. The original Law of 1991 had six amendments, with the majority of them being aimed at the protection of small shareholders in the privatization process. Their participation was extremely important for the government, seeking to ensure broad public support for privatization as the process had lost a great deal of its vitality and strength during the first two years of implementation. The pace of privatization remained, however, rather slow and tainted by insider favoring, lack of transparency surrounding some transactions with privileged individuals (tycoons) well-connected to the political elite, as well as increasing reports of alleged corruption that raised the concerns of potential investors. The concentration of decision-making in the privatization agency and the existence of many legal lacunae with respect to important practical issues contributed also to the rise of irregularities during the privatization process of the 1990s. Thus, the latter was widely perceived as conductive to the expansion of the informal economy and corrupt practices.

The privatization process in **Macedonia** started by the end of the 1980s and the beginning of the 1990s. During this period, a number of companies went through transformation of ownership, according to so-called "Markovic Law". The privatization was mainly based on the method of selling to the managing board and employees in the respective companies. There were several positive examples of companies privatized under this law that succeeded in increasing investment, broadening the field of business activities, keeping all employees and improving the company's efficiency in general. In 1993, Macedonia adopted a new *Law on Privatization and Restructuring of the Enterprises with Social Capital* which has been amended and supplemented several times. A special Law for the privatization of agriculture companies (kombinats) was also passed. According to most analysts, however, the privatization process in Macedonia has been rather slow and hesitant. Moreover, during the last three years the government has privatized many companies practically for its own interest, creating the so-called "false privatization". Yet, according to the Privatization Agency, the sell-off process is near completion. In the past decade, a total of 1,678 companies have been privatized and there remain approximately 89 companies scheduled for privatization via public tender. The number of minority shares packages that remain to be sold is, however, very large. There are currently about 390 such packages with a total nominal value of EUR 400 million and it will likely take between three to five years for this process to be completed if its recent pace is further maintained.

The government of **Romania** has recently also made an important step towards addressing some of the existing problems in the employed privatization techniques by passing a *Law for the Speeding Up of Privatization* in March 2002. This so-called "law for 1-Euro selling" admits that privatization of state-owned companies on complicated contracts, with many investment promises and social strings attached, proved to be detrimental, since such contracts are hard to monitor and enforce. Instead, the open tenders will be preferred with the contract awarded to the highest bidder. Several hotels and other small companies have already been sold for cash, but analysts still wait to see an important privatization deal taking place under the new law.

In contrast to the rest of the South-east European transition economies, the process of privatization in **Serbia** had been delayed during the whole of the past decade. Three attempts had been made under the former regime to transform social- and state-owned property into private ownership along the lines of the following laws: the *Law on Social Capital* (1989), the *Law on Conditions and*

*Process of Transforming Social Property into the Other Forms of Property (1991), and the Law on Property Transformation* (1997). The dominant method of privatization was the so-called "wild privatization", referring to the transfer of social property into private hands in a murky way. Such transfers were not necessarily illegal, but were inevitably accompanied by corruption. Although the pace of privatization accelerated during the period of hyperinflation, the subsequent amendments in the Law of 1991, as well as the Code on Revalorization put the whole process to the very beginning by annulling all the privatization transactions that were closed at the time of the inflation hikes. Following these acts of annulling the hitherto privatization deals, the share of the privatized capital was reduced to only 3% in 1994.

Until the change of regime in October 2000, only 400 enterprises, or 5% of all social-owned companies, had stepped in the process of privatization under the Law of 1997. Since the political changes of October 2000 the process of privatization has accelerated for a number of reasons, ranging from new incentives for managers of socially-owned enterprises up to the possibility to gain a greater share of free of charge capital after the official exchange rate came on par with the market one. However, until the suspension of privatization under the Law on Property Transformation, a modest total of 800 enterprises, or slightly more than 10% of all enterprises subject to privatization, have been privatized. Thus, it may be concluded that legal privatization had virtually stalled until the new *Law on privatization* was adopted by the People's Assembly of Serbia in June 2001. Adding to the legal framework of the privatization process are also the *Law on the privatization agency* and the *Law on the share fund*, as well as three government decrees that refer to the methodology for valuation of capital and property and their sale through public auction and tender. The new model of privatization has two main features: first, the dominant method is sale, and second, the government granted itself significant discretionary power in order to play the main role in the privatization process.

After the ten years of practical stagnation, the process of privatization in Serbia could be accelerated under the new law. There are currently 7,500 socially-owned enterprises. Larger enterprises (about 150-200 of total) will be sold through public tender, while the remainder will be privatized through public auction. The first tenders were organized in December 2001 when three cement factories were sold to foreign investors. Privatization through auctions has began only recently, with the first auction being held on March 22 when three out of nine enterprises offered were successfully sold. The recent experience showed that the privatization process under the new law has been fairly smooth and transparent until now. Public concern has been raised only once on the occasion of the privatization of the cement factory BFC Beocin as the government tried to sell the enterprise by a mutual agreement with the purchaser, instead of organizing a public tender. As a result of huge public pressure, however, a tender was finally organized, with the pre-selected buyer actually winning the tender.

*6.1.2. The institutions in charge of privatization*

In **Albania**, the National Agency of Privatization (NAP) is the main government institution responsible for the implementation of the *Privatization Law* and the organization of the prescribed procedures. It is also supposed to be a sort of register containing detailed information on privatization deals. The Agency has its own branches all over the country. While the Ministry of Public Economy and Privatization prepares the whole package of privatization, the Agency is the executive institution of the bidding procedure. The Agency reports every month at the Council of Ministers and at the Anti-Corruption Commission about its work. Throughout the transition period the Agency has been allegedly involved in politically biased and corrupt privatization deals in several cases. However, while the media has been especially aggressive when it comes to denouncing suspicious deals during the privatization process, there has been not a single accusation of corruption from either the High State Control or the General Prosecutor for the period 1999-2000.

The Agency for Privatization is in charge of the process in the Moslem-Croat Federation of **BiH** with offices in each of the ten Cantons that con-

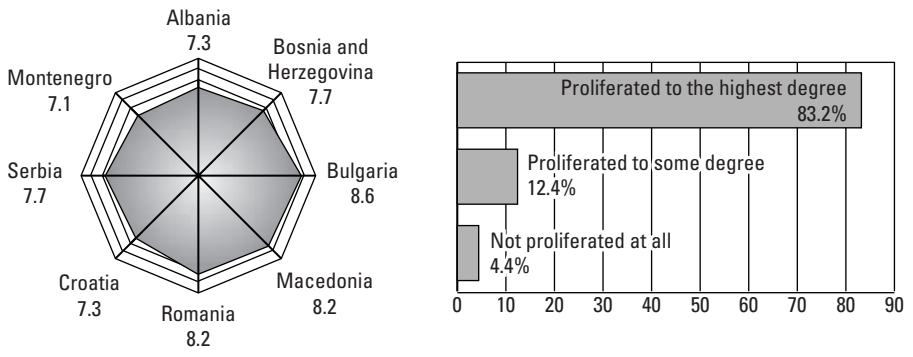
***Corrupt privatization***
According to results of Transparency International BiH survey, 79.4 percent of respondents think that corruption exists in privatization process. 37.4 percent of respondents mark the privatization process as mostly unsuccessful, and 38.5 percent of respondents as very unsuccessful. The most corrupt are managing directors in the state owned enterprises (31.2 respondents think in that way), then officials in Agency for Privatization/ Directorate for Privatization (26.7 percent of respondents) and finally those officials in Entity governments and ministries (20.9 percent of respondents). (TI-BiH, ibid.)

duct the day-to-day operations, while in Republika Srpska this function is assigned to a centralized Directorate for Privatization. The agencies work very closely with the respective governments, with their staff and especially chief executives being typically appointed by the same political parties that are in charge of the cabinet formation. Therefore, there are substantial political and partisan interests at play. The distribution of the higher-ranking posts in the respective agencies mirrors the distribution of cabinet seats. The same applies to the appointment procedure with respect to the top executive positions in state-owned enterprises, which are all subject to the so-called "party co-ordination meetings". Convergence of the party interest at these various posts all relating to privatization, either ensure depletion of the enterprise budgets, spontaneous privatization or extra profits from the "legal" one. Often, it allows even for a combination of all that mentioned above. Press reports appear to confirm such assumptions on a daily basis, entailing the reaction of the IC in some instances.

Under the Law of 1992, various state agencies were entitled to initiate privatization deals in **Bulgaria**. Municipally owned enterprises were privatized by municipal agencies, the privatization of small enterprises was handled by the line ministries, whereas that of larger companies was the responsibility of a special body - the Privatization Agency - that also served as a general coordinator of the whole process. With the start of the mass privatization program a separate institution was also set up to carry out the specific tasks in this area. Until the notable pick-up in privatization during the second half of the 1990s, however, the line ministries and the municipalities appeared rather reluctant to pursue a rapid transfer of the ownership under their supervision. On its part, the Privatization Agency remained vulnerable to political pressures usually exercised through its Supervisory Board whose members were appointed by the government and the parliament. While the process of transferring state assets into private ownership accelerated markedly since 1996, the vast array of programs and employed privatization techniques strained the administrative capacities of the implementing agencies. Despite some problems in administrating and coordinating the whole process, the latter part of the 1990s saw a strong momentum in privatization, although its outcomes caused growing dissatisfaction among the population. Given the advanced stage of privatization and the public outcry against alleged corruption, the new Law of 2002 stipulates a centralized management of the process by the special Agency, as well as a strengthened control both on the conclusion of deals and their subsequent implementation.

One of the main factors that is deemed conductive to the increase of irregularities in **Croatia's** privatization experience was the concentration of decision-making in the hands of a single state agency, with the latter being also in charge of the subsequent implementation. The central role of the state in managing the entire process of privatization had a series of undesirable side effects. Although all firms and companies had been guaranteed the right to suggest their preferred privatization modes under the Law of 1991, the final decision on the privatization of a particular company was made by the Agency for Restructuring and Development (later to become the Croatian Privatization Fund, CPF). This meant in practice that it was the Agency that had the final say on whom to sell and at what price, even though the companies themselves had the right to propose privatization methods and the potential buyers that suited them best. Thus, corruption and other irregularities were some of the undesirable side effects of the disproportionate role of the state Agency in charge of privatization. Yet, this was not something specific to Croatia alone as it is to be found in other countries in transition and everywhere in the world (especially in developing countries),

**Chart 15: Spread of corruption in the privatization agencies, April 2002**




*Source: SELDI Corruption Monitoring System*

mainly in situations when a large part of decision-making is left in the competence of a government body or administration.

The Law of 1991, however, did not precisely establish the order of priorities or criteria for the assessment of application for ownership transformation and privatization. The opacity of the criteria and the procedure itself opened up possibilities for an unusually large area of discretionary maneuvering space for the Agency (CPF) administrative council to assess each case separately and according to ad hoc established goals. This unrestricted arbitrary decision-making and the right to use own discretionary right in assessment of individual purchase offers can by all means be held responsible for the consequent development of numerous irregularities in the process as it fostered expansion of corruption and intermeshing of politics with the new private elite. The lack of transparency surrounding the conditions for sale and their adjustment to each individual case produced negative consequences on the decisions of individual investors and immensely damaged the general perception of the privatization process in the eyes of the public. In this respect, the biggest problem was the lack of legal restrictions of the role of and arbitrary decision-making by the state administration in the privatization process. Had the Agency not been given the role of central arbiter by the Law, the problem would nowadays be far less critical.

According to the Law, the key institution that is responsible for administration and support of the privatization process in **Macedonia** is the Privatization Agency whose mission falls in line with the final goal of ownership transformation in the country. Although the Privatization Agency is defined as an independent institution, it is under strong political influence. By appointing its Director and other senior officials the government can directly influence all the decisions of the Agency. The Director has always been a member of the political party in power, implying his/her acting in the interest of the given political formation and the government. For example, during the last three years several directors of the Agency were appointed and dismissed accordingly to the ruling coalition parties' wishes and their particular interests in the selection of a potential buyer for profitable companies (usually accompanied with indications for corruption).

The institutions that have been created under the new privatization laws in **Serbia** are the Agency for privatization, the Shares fund and the Central share register. The Agency for privatization is the main body in charge of the process and has large discretionary power. The institution promotes, initiates, executes, and controls the process of privatization, although the latter can also be initiated by an enterprise slated for privatization and a potential buyer. The Agency is also empowered to approve the results of the tenders and auctions. Thus, it appears to be granted strong discretionary power, being at the same time burdened with functions that should be distributed among the enterprises slated for privatization, state and independent bodies. The Agency is operating under the control of the Ministry for Economy and Privatization, the Government of the Republic of Serbia, as well as the Serbian Parliament and representatives of the World Bank. Through this four-fold monitoring of the Agency's work, corruption possibilities seem vastly reduced. Moreover, there is no evidence that political parties exert influence on the privatization process. The present minister of privatization, Aleksandar Vlahovic, is not a member of any political party, as well as the other high officials of the Ministry.

### *6.1.3. Litigation, implementation and renegotiations of closed deals*

The experience of **Albania** showed that during the privatization process, there have been several cases where the parties involved claimed for renegotiations. That was the case of the Italian brewery "Peroni" which was the wining bidder for a domestic brewing company and 6 months after the privatization deal was struck "Peroni" demanded renegotiations of the details of closed contract. The request was not accepted by the government and the deal was awarded to the second-best bidder during the privatization process.

In **BiH** as well, there have been many cases of undertaken campaigns for renegotiations of already closed privatization deals. They are being typically launched by the directors of the then state-owned companies, most of whom are political appointees, the moment the award of a privatization bid has been made public. All these efforts have an aim to postpone the privatization of the cash-cows that fill the party budgets, primarily during the frequent election campaigns. Flagrant is the example of the Banjaluka Brewery that was the first cash-cow to undergo an international tender. The winning bidder - the Belgium Interbrew - withdrew after two years of struggles and an eventual Constitutional Court ruling, much to the disgrace of the executive and the overall privatization process in RS and BiH. The second-place bidder - the Slovene Lasko Brewery - currently faces similar difficulties and the final result is yet unknown.

In **Croatia**, the ownership transformation of 2,650 companies resulted in 908 legal proceedings initiated against the CPF in the courts of jurisdiction. Thus, more than one third of all companies that have undergone ownership transformation feel that they were not accorded their due rights. Moreover, nine company ownership transformations were completely annulled, while other 94 were partially cancelled. According to the law, the annulment of ownership registration is possible only within three years following share registration in the share register. Therefore, it seems likely that ownership of privatized companies' shares will consolidate regardless of the manner of their acquisition. A large number of companies were bought on an installment plan that did not, however, affect their new owners' rights to immediate management. A little more than a year ago, an intensive trend was observed in connection with some of these companies. Unable to fulfill their obligations towards the CPF they began being returned to state ownership. Their adverse financial positions could be explained by the fact that a significant part of their resources had gone "private". These failures very much affected the state, the taxpayer-creditors and the banks that extended loans to these companies. The structure of those who demanded a review of the transformation is also indicative of the public perception, with most of such demands being made by the owners of nationalized and confiscated property, small shareholders and unions. The reactions of the legal system were, however, overall slow and the first indictments were made only after the HDZ government was ousted out of power, although some cases had been investigated earlier.

While the existing mechanisms in **Bulgaria** ensure a relatively fast transfer of ownership once the privatization deals are struck, they do not provide sufficient guarantees for compliance with the agreed upon obligations. The preferential use of such a technique as "negotiations with a prospective buyer", the excessive reliance in recent years on MEBOs and the use of indemnifying promissory notes for payment created wide opportunities, often accompanied by corruption, for the non-monetary obligations to be avoided. The consequences of the deals with Balkan Airlines, the Plama refinery and several other companies became clear in 2001, serving as a fine illustration of these practices. A number of these privatizations brought about allegations of corruption in addition to the fact that they provoked considerable losses for the former owner (i.e. the state) and a practical liquidation of some of the enterprises concerned.

The discretionary power of the Privatization Agency in **Macedonia** with respect to the assessment of individual purchase offers and the final decision to whom to sell have resulted in numerous irregularities. Such large rights in the selection of buyers are typically a fertile soil for the abuse of public office for private gains. Due to allegedly corrupt practices and irregularities in the completed procedures, more and more privatization deals have been disputed at the court that usually finds out an infringement of the Law.

*6.1.4. Post-privatization control*

The problem with post-privatization control in **Croatia** appears profound. Rather paradoxically, the governing laws stipulated that the control over privatization had to be performed by the CPF, or the very same organization that was in charge of the process. So, the unbiased public control over privatization was practically absent through the 1990s. In this aspect the role of media turned to be quite important in filling the gap. The need to strengthen the legal and institutional framework remains, however, an urgent task in view of providing efficient safeguards to ensure a strictly rule-based interface between public and private interest.

The lawmakers in **Bulgaria** have recently made some important steps in this direction by stipulating, among a number of anti-corruption measures, the creation of a separate Agency for post-privatization control. The role of such a specialised body is seen as key in reducing the opportunities for the assumed legal obligations under the privatization contracts to be evaded by the parties involved. Indeed, the country's experience showed a rather widespread practice of privatized enterprises getting seemingly unreasonable waivers of obligations, following the renegotiations of the initial clauses of the contracts. The Agency for post-privatization control was set up in April 2002 and it remains to be seen whether this controlling institution can prove effective in protecting public interests, although already at this stage some analysts warn about its fragmented legal regulation.

Given the non-negligible amount of lawsuits and the existing potential for litigation and renegotiations with respect to already closed privatization deals, it seems most surprising that the issues related to the control over ongoing procedures and post-privatization implementation of the contracts have either been largely neglected or got rather undue attention on the part of the legislative and the executive. Moreover, the controlling functions are typically assigned to the privatiza-

tion agency that is responsible for organizing the procedures, specifying the terms of the sell-offs and selecting the actual buyers. According to the Law, for example, the control over the privatization process in **Macedonia** should be performed by the Privatization Agency and its bodies, which may terminate the agreement for selling a particular company if an infringement of the procedure is found out. A compliant against the Agency's decisions may be submitted to the government whose conclusion could, in turn, be disputed in court.

*6.1.5. Preferred methods of privatization*

Since the beginning of transition in **Albania,** a very liberal privatization law provided that privatization could be carried out through a variety of forms such as auction, free selling of shares, direct selling of objects to employees and managers, or any other appropriate form. A decision of the Council of Ministers (No. 248 of April 1993) accepted auction as the only way of transforming state property to privately owned property, considerably narrowing the latitude of the privatization law. That led to social tensions among different groups of employees. This situation drove the Government to review the privatization strategy and the Mass Privatization Process through voucher scheme came into effect. The process was launched on September 11, 1995.

The privatization process in **BiH** is proceeding along separate lines in the two entities, although there are many basic similarities. The divestiture in Republika Srpska includes the privatization of enterprises and banks on the basis of equal treatment of domestic and foreign individuals and legal entities. The basic law governing the process is the Law on Enterprise Privatization in Republika Srpska that was passed in June 1998. Subject to privatization is the capital in state owned enterprises and enterprises that had already been partially privatized according to the ex-Yugoslav "Markovic's" program of the late 1980s. Enterprises are being sold partly against cash and partly against vouchers issued as compensation for frozen foreign exchange deposits, validated restitution claims, claims related to unpaid salaries during the war, but mostly general claims that have been distributed to all the citizens. Vouchers cannot be, however, used in banking sector privatization as the strategy adopted is based primarily on fresh capital injection and know-how to the banks themselves rather than on cash for the state budget. The transfer of ownership in the Federation BiH encompasses the privatization of enterprises, banks and socially owned apartments. As in RS, the privatization program also establishes various claim categories for FBiH citizens (frozen foreign currency savings, earned but unpaid military salaries, pension arrears and restitution) that they can use in the privatization schemes through certificates (vouchers). Many of the strategic big companies are not, however, subject to voucher privatization in either entity. This refers mostly to the disguised cash-cows that generate large natural monopoly profits. The other part represents those businesses that are out of the market and for which the government does not wish to take the risk of losing electoral support as a result of painful measures, primarily in the form of closures and declaration of bankruptcies. On its parts, the loosely defined voucher privatization has led to the existence of some privatization funds and quasi-funds operated by the enterprise directors with the inputs from the labor that have shown signs of insider privatization. However, given the current level of economic activity of most such enterprises, this has not been a major cause for concern except as a procedural and legal matter.

The original *Privatization Law* in **Bulgaria** provided for a wide range of methods, including auctions, tenders, direct negotiations, debt-for-equity swaps, public offering of shares and MEBOs. The subsequent amendments allowed for a mass privatization scheme to be launched, as well as a more preferential treatment for managers and employees. The latter contrasted with the virtual absence of favouritism in the initial law, although the most recent changes in the legal framework restored the principle of equal treatment of all prospective buyers. Besides, the new Law of 2002 prescribes open auctions and public offerings as main privatization techniques, while direct negotiations are practically excluded as a method of divestiture.

The most common method of privatization in **Croatia** was the management-employee buyout, while as a second measure voucher privatization was applied. Unfortunately, the inherited economic system with its deep structural flaws and the initial "transitional depression", later enhanced by the war, were not particularly beneficial to the adopted basic concept of selling with a preferential treatment of formerly and currently employed persons. As time passed, it proved more and more unrealistic with regard both to the receipts realized through it and the extent of privatization. In the time limit laid down in the law, no significant interest was shown in the purchase of parts of socially owned capital, except by employees and managers. Because of the war the interest of foreign investors was almost non-existent. Consequently, the greater part of socially

owned capital finished up as a state-owned property. A number of serious economic analyses had very clearly and correctly foreseen this, considering as highly questionable a concept based only on selling. According to the Law, all the unsold property of the socially owned enterprises was transferred without any compensation into the ownership of three public funds: to the Croatian Development Fund (two thirds) and two pension funds (one third). The same happened to the assets of companies that failed to apply for ownership transformation in the authorized time limit. Non-privatized socially owned property thus formally became state-owned property and the citizens who had participated in creating that property in the first place were now represented by state institutions. The chosen model of privatization with its forms of preferential sale had at least three negative consequences. These were the centralization at the level of the state administration of all decisions concerning ownership transformation and privatization; the state take-over of a significant part of socially-owned capital; and the selection of large buyers according to political loyalty.

Although the companies in **Macedonia** have the guaranteed right to suggest the method of privatization and buy out the enterprises, the final decision to whom to sell and at what price is in the hands of the Privatization Agency. Thus, a large number of companies have been privatized in a non-transparent way with respect to criteria and procedure, by announcing the specific conditions to known buyers before the public announcement for the bidding procedure was started. The Constitutional Court abolished some provisions of the *Privatization Law* that had not been in accord with the rules of a market-type economy (for example, the privatization through direct sale, which does not provide equal opportunities for all prospective buyers). However, several privatization transactions with government shares were accompanied by non-transparency, lack of public tender and under-estimation that decreased the value of the companies up to 80%. The sale of the largest profitable state companies (such as the country's oil refinery) through non-transparent tender procedures indicated an involvement of the highest government officials, although no one was investigated. Very often, the defined criteria, procedures and methodology for value estimation were not strictly applied, provoking a considerable number of lawsuits. In 2001 alone, there were several cases when the value of the companies slated for privatization was decreased by up to 90% and they were sold to members of the political parties in power or their relatives. Numerous privatization procedures turned being disputed by the employees at the court and on several occasions the latter cancelled their implementation that was not in conformity with the proscribed rules and criteria. Besides, the Privatization Agency itself changed its decision for selling several companies under the pressure of employees' protests and disagreement.

In **Romania**, the main factors that stimulate corruption in the area of privatization are related to enterprise restructuring before privatization, the inclusion of municipal property on the privatization list, the application of qualification criteria and other requirements for potential investors. For example, the legislation gives the state property fund (currently APAPS, a ministry-like institution) the option to restructure companies if such a restructuring increases the sale price or make the firms more attractive. This restructuring is paid for either with proceeds from other privatizations, or with money squeezed out of banks by political pressure. The restructuring can also be used as a pretext for postponing privatization or taking loans and extending guarantees on behalf of the state.

The experience of other states as well shows that state-managed restructuring is often protracted. First, there is the theoretical argument that, if the state had been able to restructure and make a company more efficient, there would be little need for privatization in the first place. In the second place comes a more practical point: while being under special supervision of the state fund, the companies' performance typically declines, whereas assets are dissipated. The restructuring capital is often siphoned off by interest groups active in the company. Moreover, restructuring is sometimes an easy excuse to delay action, especially when no clear timetable is set up. Though there were many attempts to reduce government's discretion in this area, little progress has been made so far. Many times the restructuring is launched with no clear vision of what the final state of the company should be. Adding to this is the absence of a firm blueprint of splitting the firm into independent entities in order to sell them one by one which seems to be the only rationale for engaging in restructuring in the first place.

With respect to municipal assets the local governments have the right to decide which of them should be slated for privatization, as well as when and how these assets are to be privatized. As the privatization laws do not define automatic rules or criteria for putting municipal property up for sale, many municipalities and local public com-

panies tend to retain commercial assets under their control and postpone the privatization. Delays in these areas are often related with corrupt interests and attempts to derive personal gains from the management of commercial items. The situation is all the more serious since the legislation covering the conflict of interests in the local government is quite loose, and there are many local councilors who engage in private business transactions with the public institutions they supervise. Such a high-profile case was the General Council of Bucharest, where about two dozens of councilors from all parties (roughly 1/3 of the total) were doing business with the local government institutions or public companies in a way or another. Moreover, the provisions against conflicts of interest introduced by a law passed in 2001 were considered inapplicable to the current council who had been elected before the legal changes. In this context, the central government took the extreme measure to dissolve the General Council and call for new local elections in Bucharest in the first half of 2002.

Most of the cases of corruption disclosed by the media in Romania were connected with public tenders, both at the national and local level. Preselection of the would-be owners has been one of the most cited flaws. This selection is done by customizing the terms of the contract so that they fit the prospective winner only, or even by changing the conditions of the tender when things run out of control. Even though sometimes such changes can be motivated by genuine attempts to defend the public interest, the non-standard behavior is overall highly susceptible and opens broad opportunities for corruption to materialize. The means available so far to expose possible manipulation in such schemes are very limited.

The search for "strategic investors" also raises problems. A strategic investor is understood as a credible company with a high level of efficiency and expertise in a specific line of business. The idea is that such investors are more capable than "ordinary" ones to restructure and manage efficiently important companies currently owned by the state and which the government would not like to close down. The problem is, however, that privatization executives have the right to establish different criteria for assessing how "strategic" an investor is. This is another entry point for corruption, since the arbitrariness and executive discretion stimulate would-be buyers to offer "success premiums" and other kickbacks to the decision-makers. Moreover, evidence shows that even if clear qualification criteria are put forward, they are usually skewed later on to the benefit of well-connected investors.

The privatising agency in Romania has also in many cases the right to negotiate with the top two bidders over the improvement of their price and investments proposals. Although in principle this may seem beneficial with a view to enhance the terms of privatization, evidence shows that such procedures invite corruption and abuse of official power. First, when negotiations are carried out with two potential investors, leaks of confidential information may help eliminate the rival. Second, serious incentives for abuse of official power stem from the powers of privatization executives to offer potential investors special concessions of exemptions provided that they revise their bids in return. Very often, what looks like an improvement of the initial bid ends up as a contract with more favourable terms for the buyer. The same pitfalls are involved in the powers of privatization authorities to establish requirements relating to the preservation of jobs and the volume of investment as well as the right of investors to request additional concessions and exemptions.

The **Serbian** *Law on privatization* prescribes the sale by tenders and auctions as a basic method. The tender procedure is stipulated for larger enterprises, whereas auctions are being envisaged for the smaller companies. Seventy percent of the social capital is to be sold, while the remaining 30% should be distributed free to employees and citizens. If the purchaser does not accept the offer of 70%, a lesser percentage of the capital will be sold. In the case of prior restructuring, all of the capital or property is offered for sale. The procedure can be initiated by the entity to be privatized, by the Agency for Privatization or by the Ministry of Economy and Privatization. The privatization process is to be completed within a four-year term; otherwise the Agency for Privatization is obliged to do it.

*6.1.6. Transparency of the privatization process*

The privatization process in **Albania** is believed to be fairly transparent and is reported to the public generally through the mass media, with the information about the deals being filed with the NAP. However, even though the country has adopted a *Freedom of Information Law*, there are practical difficulties in finding data and information on privatization issues sometimes.

Transparency is one of the basic principles of the adopted privatization model in **BiH**. The rules of

privatization are known to all those who wish to participate, thus providing possibility for public scrutiny of the process. Besides, the privatization agencies in both entities are running pubic education and information programs. On the implementation side, however, the story differs from the technical issues relating to the model itself and the mass privatization, which does not apply to the profitable strategic enterprises. With respect to the latter it is extremely difficult peeking behind the thick curtain and finding out what is truly happening with those companies that are not subject to the more transparent mass privatization method. Already mentioned was the case of the brewery that was on the never-finalized list of some 60 so-called strategic enterprises in RS. The media and the public are still trying to investigate the actual course of events and the complexity of various interests. The same has happened in FBiH with the privatization of several hotels in Sarajevo (Holiday Inn, Bristol), BH Steel and, more recently, with large utilities such as the energy distributors, telecoms etc.

The general lack of fully transparent mechanisms for the transfer of public assets into private ownership is seen as one of the main sources of corrupt behavior in the economic sphere. While the privatization process in **Bulgaria** showed sustained improvement in this respect during the late 1990s and early 2000s, the recent changes in the legal framework have included further measures to ensure greater transparency of the procedures and outcomes of the sell-offs. The notable shift in the preferences away from such a privatization technique as direct negotiations with prospective buyers is an important step in the government's drive for increased transparency and prevention of corruption. The new Law of 2002 provides also for the creation of a public register of the closed privatization deals and post-privatization control that aims at making the process more transparent and information easily accessible to the general public. Despite this further strengthening of the legal framework, however, the recently adopted provisions could hardly be automatic safeguards as even open tenders may turn into a source of corrupt practices and favor certain prospective buyers through the customization of the specific terms of the procedures.

Privatization in **Croatia** is widely perceived as a hotbed of crime and illegality, corruption and grey economy, as well as a symbol of all the negative social consequences of the process of transition. These perceptions have been partly attributable to the existing problems with transparency of privatization deals that seem to be very profound. The CPF management Board often made decisions that were not fully in compliance with legislation (such was, for example, the change of illiquid for liquid shares between PIFS and CPF). Some of those decisions were, however, ruled out by the Court of Arbitration at Croatian Chamber of Commerce. The lack of rule of law is also perceived as the underlying cause for corrupt privatization practices. In its 2000 program, the new government expressed the intention to improve the situation, but it has so far focused the efforts on the legal basis for the review of the privatization process, instead on building up appropriate institutions. Obviously, the revision of an already done ownership transformation is not the best of all available solutions. On the one hand, such a revision seems inadequate and inefficient, while on the other hand, it sends a bad message to investors and puts new uncertainties into the area of property rights. Instead of a revision of an ownership transformation, broader institutional measures are required, especially those aimed at the prevention of any future irregularities and corrupt practices. Having this in mind, it should be pointed out that there is still no public register containing detailed information on privatization deals in Croatia. Even such organizations as the CPF and the Central Depository Agency do not have a chronological record on ownership change and privatization deals, which is indicative of current transparency problems.

In **Macedonia** , the privatization deals have been publicly reported through the media, especially when it comes to large-scale sell-offs or disputable cases. The Privatization Agency has an investment section on its website in which potential investors can find information about the country, company-specific data, as well as information about the current offer of residual shares, public tenders etc.

Following the adoption of the new privatization laws in **Serbia**, the analysts share the opinion that the process could be very transparent by being performed through tenders and auctions whose procedures are clearly defined. Nevertheless, there is a potential for corrupt behavior during the tender procedures since the Law does not establish a sole criterion for the selection of the winner. Furthermore, the minister and the other officials of the Ministry for Privatization and Economy have declared several times that price offered would not be the most important factor determining the winner of a tender. In the absence of a sole criterion, a tender might appear largely senseless because of the vast possibilities for an arbitrary decision to be taken.

## 6.2. Corruption and Public Procurement

Public procurement appears to be a major hotbed of corruption as this area typically gives officials large discretionary power. Yet, the South-east European countries have made recent progress in strengthening the legal framework of the process and its harmonization with the EU Directives, even though law enforcement has continued to be characterized by many problems. The procurement procedures generally remain insufficiently transparent, which creates suspicions of corrupt behavior in the context of a seemingly widespread customization of the terms. With the preselection of the prospective suppliers being apparently one of the typical flaws in the implementation of the stipulated procedures, the legal guarantees for equal treatment of all candidates should be further strengthened together with the mechanisms for control over the preparation of tenders. Adding to the reduction of the existing legal opportunities for corruption and discretion in this sphere could also be an explicit obligation for the procurers to publicly explain the reasons for their choice of winning bidders, as well as a ban on discretionary amendments in the already signed contracts. The enhanced introduction of an electronic system of public procurement seems also an important step in ensuring greater transparency of the process.

### *6.2.1. Regulation of public procurement procedures*

Public procurement is broadly perceived in **Albania** as one of the areas most heavily affected by corruption. On the organizational side, the Law established a National Public Procurement Agency (NPPA) which is reporting to the Council of Ministers as the central government body for co-ordination and development of the public procurement system in the country. Over the past several years, Albania has made significant progress in the development of its public procurement system. The *Law on Public Procurement* was modeled on best international practices and became effective from January 1, 1996. This law offers the simplicity of a single unified law, which decentralizes the authority for conducting procurement to procuring entities at both the central and local government levels of the administration. The law provides for a comprehensive range of procurement methods, which should enable procuring entities to cope with different procurement requirements. One of the strengths of the law is that it established open tendering (OT) as the preferred method of public procurement. In practice, however, the efficacy of this provision has to date been undermined by weak enforcement of legislation. Other advantages of the law are the provisions for a two-stage bidding method for complex procurements, a specific method for consultants' services and a simple request for quotations (RFQ) method for low-value purchases.

In **Croatia**, important efforts have been made in order to enhance public procurement practices and the established system was largely based on the UNCITRAL Model Law. The *Public Procurement Law* regulates the conditions and procedures of public procurement that precede the conclusion of contracts for acquisition of goods and services with the aim of efficient use of budget and available public resources, as well as strengthening market competition. The basic principles that have to be followed relate to the efficiency of procurement, the equal position and non-discrimination of offers, as well as the publicity and transparency of procurement procedures. The Law also defines the range of government bodies and other legal entities that should be engaged in public procurements. The provisions of Law are applied on every public procurement during the budget (fiscal) or business year if its value equals or exceeds HRK 200.000,00 (ca. EUR 26.666,67).

The *Law on Public Procurement* was enacted by the Parliament of **Macedonia** in 1998. According to its provisions, the procurement procedure shall be carried out by a special commission, which is established by the procurer. In cases when the procurer is a user and an individual beneficiary of budget funds, an authorized representative from the Ministry of Finance without a voting right shall participate in the commission in order to supervise the procurement procedure. According to the Law, the procurement may be carried out through open announcement, restrictive announcement, collecting offers and direct agreement. There is an obligation to publish the open and restrictive announcement in the Official Gazette of the Republic of Macedonia and in the local media at the same time, while the announcement for an international procurement tender have to be published in foreign media. The procedure of open announcement is to be launched when the denar value of the procurement exceeds EUR 50.000. When the value of the procurement is higher than EUR 250.000 it shall be carried out through limited announcement by collecting documentation from a limited number of bidders. Procurement by collecting offers shall be carried out when the value of the procurement is between EUR 2,500 and 50.000.

According to Transparency International, **Serbia** is at present the only country in Europe without a separate law on public procurement. The legal provisions regulating public procurement are currently dispersed among a number of different laws. The government of the Republic of Serbia has, however, approved a draft Law of Public Procurement, which was sent to the National Assembly for adoption. The draft regulates the process of public procurement in a very detailed manner with a view to stimulating competition among bidders, increasing the transparency of the procedure and obtaining goods and services under the most favourable conditions for the state. It encompasses all direct and indirect beneficiaries of budget resources, compulsory welfare organizations and public companies. Public procurement is to be conducted by means of open tenders, except in very precisely defined exceptions. There are no restrictions concerning the accessibility to tenders. Since this draft law is developed under the standards of the European Union, it incorporates provisions relating to eligibility and conflict of interest. A distinct feature of the draft is that it provides for the creation of a Public Procurement Agency, which will work within the Treasury department of the Ministry of Finance and Economy. In its Article 14 the draft law also contains particular anti-corruption provisions, stipulating the rejection of a bid that involves attempts to influence the course of the public procurement procedure.

From the beginning of 2002 the government of **Romania** has put in place an electronic system of public procurement and all public institutions are required to start using it in one-year time span. This is the first substantial piece of e-government implemented in Romania so far. The pillar of the system is a web page-cum-database administered by the Ministry of Public Information where the public entities must register all their tender calls. The system has been in use for just about two months, which was not long enough to build a critical mass of clients and suppliers. Moreover, some contracts may by their nature be inappropriate for electronic bidding. Nevertheless, this is a serious effort by the government to institutionalize greater transparency in the public procurement process.

*6.2.2. Enforcement of procurement rules*

While the organizational arrangement of public procurement in **Albania** is in conformity with the internationally accepted practices, the effectiveness of the NPPA has so far been severely undermined by the weakness of this institution characterized by under-searching, continuing staff changes and susceptibility to political influence. The Agency is included in the government Anti-Corruption matrix but still there are lots of problems to be solved in the future in order to have a competitive procurement system that limits the authority of government officials and influences in curbing corruption. It appears that poor application and enforcement of the rules in Albania are undermining a good procurement law. Put simply, it is too easy for procuring entities to avoid strictly implementing the law because of the weakness of the NPPA. Procuring entities too often employ non-competitive procurement methods, which lead to poor value in terms of money and also facilitate corruption. Therefore, one of the government's top priorities should be to take appropriate measures to combat corruption and strengthen the enforcement of existing legislation.

The continuous lack of a modern and EU Directives-harmonised *Law on public procurement* has played a detrimental role in the loss of public revenues in **BiH**. It is estimated that some 5 percent of the country's GDP relate to direct government procurement of goods and services, while this area remains largely unregulated and subject to serious fraud. For example, the parliament buildings were built without applying any known method of public procurement and in the most non-transparent manners. Simultaneously, that lack of legislation opened the room for growing corruption in the administration and ever more irrational expenditures at all levels. At state level, there is neither a decree, nor a law regulating public procurement, whereas the entities do have a legal framework - a law of 2001 in the case of RS and a decree of 1999 in FbiH, - although it does not correspond to the EU positive practice and is currently subject to review. In 2002, the Ministry of Treasury of the Joint BiH Institutions has proposed a draft Law on public procurement at that level to the BiH Parliament, with its adoption pending. At entity level, the legal changes and amendments are being prepared by the respective ministries of finance with a view to accomplish the process by the year's end.

The legal regime of public procurement in **Bulgaria** is laid down in the 1999 *Law on Public Procurement*, which has not been amended as of yet despite the criticism it provoked. The deficiencies of the law are typically associated with its rather narrowly defined scope of application, the lack of control over the preparation of the tenders, the overall insufficient transparency of the procurement procedures, as well as the slow and inefficient appeal procedures. However, a new law on public procurement is being currently dis-

cussed in the parliament (three separate drafts has been submitted by the end of 2001) with the aim of further harmonizing the procedures and eradicating the legal opportunities for discretion and corruption in this particular area.

The transparency of the procurement procedures in Bulgaria has been also seen as rather insufficient, which together with the existing problems with the enforcement of the 1999 Law created suspicions of corrupt practices. The avoidance of the current regulations has been facilitated by the narrowly defined scope of their application with regard to both the subjects of public procurement and the persons entitled to open the procedures. The proclaimed equal treatment of all bidders has been often infringed due to lack of control over the preparation of tender documentation.

The recent experience in **Croatia** showed some cases of public procurement procedures not being performed according to the Law. They were, however, cancelled by the Ministry of Finance, which is the administrative government body that controls the procurement decisions. Yet, it seems too early to estimate the effect and application of the new Law, although according to an expert's opinion it is an important improvement to the former *Law of acquisition of goods, services, and relinquishment.* The former Law had not provided for enough transparency of public procurement, so that the process had been pretty murky and complex. The rules had also been very often not respected. According to reports of the State Audit Office, the public procurement process had been characterized by substantial disorder. Some bidders had turned to be in advantageous positions, not according to any real criteria and measures, but according to criteria with completely private characteristics. The new Law stipulates much better enforcement procedures. The value of acquisition during the fiscal year should not be divided in such a way that the value of public procurement would be lower than the amount stated in the Law, so that the implementation of the latter could be avoided. Besides, the new Law stipulates the estimated value of acquisition when the exact value is not known. The Law also defines the process of public procurement for the insurance industry, banking and other financial services and project offices.

The adoption of the 1998 Law in **Macedonia** was aimed at meeting the international standards with respect to the procurement and biding procedures, their openness, fair competition, and transparency. However, the public procurement process became subject to criticism from the public, especially on the part of bidders, for abuse of the principles of equal participation and opportunities for all participants by giving privileges to pre-selected bidders. There have been serious indications for non-transparency and infringement of the Law, most notably in the case of larger procurement. Many of the public procurement procedures, especially for large-scale deals, were disputed in the Court. The general public opinion is that, in spite of the proscribed procedure and criteria in the Law, the high-value tenders are agreed before the biding procedure has even been started. Certain unclear provisions in the Law create opportunities for abuse. For these reasons, the Law is being currently examined by domestic and EU experts in order to provide more transparency, efficiency and rationality of the biding procedures in line with the European standards and to limit the opportunities for corruption.

In **Romania** as well, most cases of alleged corruption disclosed by the media were connected with public tenders. The pre-selection of the prospective suppliers appears to be one of the typical flaws in the implementation of the stipulated procedure. As already mentioned, such a pre-selection is done through the customization of the terms of the tender to the advantage of a particular bidder. This practice is generally believed to involve kickbacks for government officials, but the means to expose possible corrupt behavior in the process of specifying the terms of a public tender remain extremely limited.

### *6.2.3. Control over procurement decisions and public registers of procurement deals*

A register for public procurement has been set up in **Bulgaria**, with its database containing currently some 8,000 deals. This is considered by analysts as an important step towards ensuring greater transparency of the process. In **Croatia**, the public register of procurement is at present in the process of implementation. The establishment of such registers is reportedly being envisaged as an important step in strengthening the legal framework in **BiH** and its harmonization with the two Public Procurement Directives of the EU.

The supervision over the use of procurement for beneficiaries of budgetary funds in **Macedonia** shall be performed in compliance with the Law on State Audit. The supervising functions are executed by the inspectors for Budget control and public procurement from the Ministry of Finance. If an inspector finds out an infringement of the procedure, a criminal act or misdemeanor, he/she must without delay inform the competent authorities. Besides, any participant in a procurement

procedure who is not satisfied with the selection of the winning bidder may file an appeal to the Committee of appeals within 8 days from the date of the announcement of the results. The appeal postpones the execution of the decision for the selection of winning bidder. The decision of the Committee of appeals is final. The bidder may, however, dispute the decision of the Committee at the Court.

*6.2.4. Foreign participation*

The new **Croatia's** Law on public procurement does not contain any provision about privileges for local suppliers and enables a complete opening of the domestic market. Foreign companies participating in local public procurement usually did not complain on decisions, but on some particularities in the required documentation. Opening of the public procurement to international competition and/or favouring Cupertino with foreign contractors, e.g., for rolling stock maintenance/rehabilitation, road maintenance, and the provision of transport services, have the potential to reduce public procurement costs significantly.

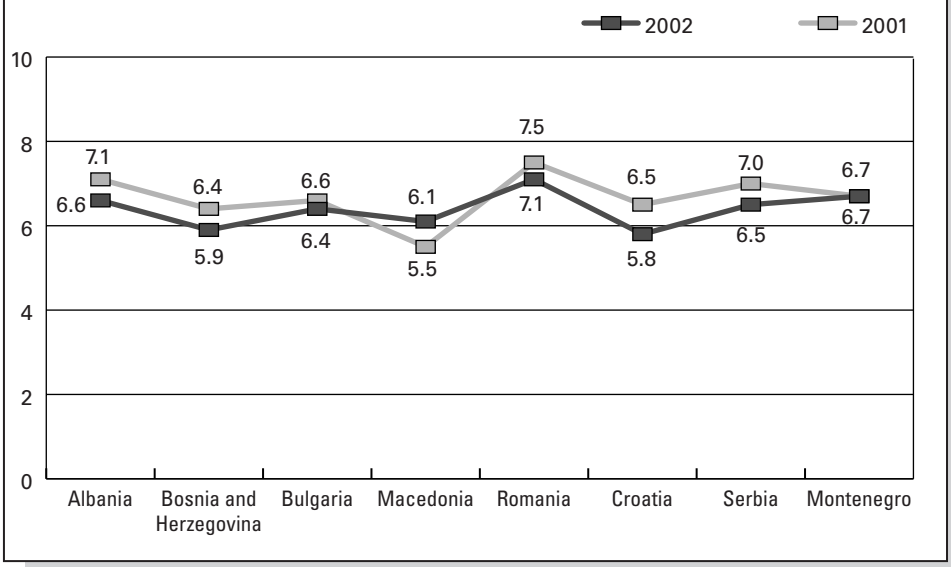
There is a reasonably good framework for public procurement in **Albania**, although some of the provisions of the respective law could be strengthened further with the objective of increasing competitiveness, transparency and enforceability, thereby minimizing corruption. For instance, the Law on public procurement imposes excessive limitations on the participation of foreign bidders by establishing an arbitrarily differentiation between domestic OT and international OT. As the procuring entities are left with the discretion to decide whether to apply OT as a domestic or international procedure, they most frequently limit it to domestic bidders. The choice of domestic bidders in cases where international competition could be more cost-effective leads to waste of budget resources. In this respect, the discretionary power of the procurement entities also leaves room for corruption and the current situation should be corrected by amending the legislation.

The experience in **BiH** with respect to foreign participation in public procurement has been so far rather limited. It relates mostly to the larger projects of the World Bank and to a lesser extent to the European Commission donor projects that are being implemented by the local units (PIUs). While legally the PIUs are agencies of the Entity governments, their public procurement rules are those of the WB and EC respectively. The experience of foreign businesses with those procedures is rather positive and there has been a lasting attempt to transform the PIUs into strategic units for procurement that will be designing, implementing and monitoring the procurement process in the future. With the PIUs running procurement projects worth tens of millions of EURO annually, there have only been a few isolated instances of objections by either the bidders or the donors.

## 6.3. Taxation and Tax Evasion

The existence of shadow economy in many transition countries is largely associated with corrupt linkages between private businesses and the tax administration. One of the stimuli for corruption in this respect is the opportunity to save money if the size of the bribe is lower than the size of the tax liability. Over the past decade, the South-east European countries introduced new tax systems that have been undergoing rather frequent changes aimed at maximizing the overall collection rate and minimizing tax evasion. The latter has, however, remained a

**Chart 16: Practical efficiency of corruption**




*Source: SELDI Corruption Monitoring System*

mass phenomenon, with its forms and mechanisms exhibiting both basic similarities and some country-specific variations. Moreover, tax frauds have apparently important cross-border implications in the context of the existing differences in tax and trade regimes across the region, as well as generally cumbersome custom regulations whose implementation typically lacks transparency, leaving room for corrupt behavior.

*6.3.1. Forms and mechanisms of tax evasion*

Tax evasion in **Albania** seems to be of high levels. According to a 1999 survey, 75% of businesses stated that fiscal evasion of companies ranged from "often to very often". Tax evasion in the country takes many forms and corrupt practices are allegedly widespread in the tax administration. One of the most notable mechanisms used by many businesses to evade taxes is by operating with double balance sheets. In many cases when tax inspectors find evidence of tax evasion, they accept bribes in return for reducing the amount of taxable revenues. The opportunities for tax evasion and corruption appear to be particularly vast in the sector of small businesses that are taxed at 4% of their annual turnover. Measuring turnover is highly ambiguous due to a lack of documentation and that leads to arbitrary calculations in returns for bribes. VAT reimbursement is, however, the most problematic issue concerning the tax administration. Even though the procedures of the relevant law are clear and thorough, in reality the tax inspectors quite often abuse their powers. Lots of cases related to charges of corruption have been brought to the courts. The penalties have ranged from simple fines to criminal prosecution. It is important to note that since 1998, more than 200 companies have been taken to court on different charges having to do with financial cheating and hiding evidence. Still, for such reasons as unclear accusations, lack of clear facts and procedural irregularities, the tax department has lost about 85%-90% of the cases. A more general problem relates to the fact that the tax administration has a very important but constantly misunderstood attitude towards the methods of achieving its revenue goals. The revenue goals are set, compared and analyzed based on the GDP weight of the tax burden to the economy and its yearly growth. The Albanian tax administration and the Ministry of Finance set their revenue targets based on macroeconomic indicators, and the tax burden to the economy is consequence of the economic growth and, more specifically, of the taxed portion of the economic growth. Setting performance criteria outside of this framework damages the traditional mission of the tax administration. The tax department ends up arbitrarily calculating tax obligations without using the formulas, which are part of the legislation.

After gaining independence in 1992, **Croatia** had adopted a new income and profit tax system effective from 1 January 1994. Following the general elections of 2000, the new government decided to change the existing system and since 1 January 2001 the country has a new system of corporate and personal income taxation, embodied in the new Income Tax Act and Profit Tax Act. It could be argued, however, that the tax laws are not clear and simple. Besides, they are subject to very frequent changes that could make the tax system less transparent, more vulnerable to the misuse of discretionary power and the arbitrary interpretation of the laws. In spite of the experts' advice, some relief and exemptions were introduced in the Personal Income Tax in order to protect certain categories of taxpayers. Given the many changes in the tax system in the last two years, the experts believe that it is necessary to carry out a new reform to ensure a neutral tax system that is not to be used to carry out governmental social, economic and development policies. They also argue in favor of a much broader basis for taxation, with as few exemptions and privileges as possible. The principal causes underlying the tendency towards tax evasion are associated with the rise in the overall tax burden, the inappropriate legislative framework, the existing administrative obstacles, the low credibility of the legal system and the rather poor quality of public services.

The current average income levels in **Bulgaria** imply that for the majority of the taxpayers the notional value of a standard bribe and the amount of money that could be saved by tax evasion should apparently be pretty much the same. People with higher incomes and especially corporations have, however, a stronger incentive to evade taxes through corruption given the bigger difference between the size of the bribe and the amount of their tax liability. The size of the grey sector (it varies between 27 and 35 percent of the GDP according to different estimates) shows that tax evasion is a mass phenomenon. With tax collection remaining a problem, a paradoxical situation is created in which delinquent taxpayers (i.e. economic agents which are better off) live at the expense of conscientious taxpayers (i.e. the lower income groups).

Obviously it is not the tax rates but the tax structure and taxation procedures, which determine what part of the legal economic activities will be taxed in accordance with tax laws. Bulgaria is a

country with an average level of tax burden by international standards, but nonetheless taxes are perceived as being quite high because of the low incomes of the population and the general weakness of private businesses. The creation of a system of taxation which performs both business stimulating and social functions, seems a pre-election priority of any political party running for government, but the attempts to implement this in practice clash with economic reality so that the results are typically rather partial. The ambition to restructure taxes by increasing indirect taxes and decreasing direct ones is believed to have a strong anti-corruption potential as it may help achieve higher rate of tax collection and a decrease of the share of the grey sector. For the last few years the tax administration has been undergoing a process of modernization. The year 2001 saw a lot of positive changes in the organization of the work of tax authorities, as their strategic goal is to both guarantee revenue for the budget and stimulate voluntary compliance with tax laws.

The new tax system in the Republic of **Macedonia** was introduced on January 1, 1994. Since then several changes and amendments have been made in the tax legislation. Tax evasion is a big problem in Macedonia as well as in other transition countries. There are several mechanisms stipulated by the law, which aim at the prevention and sanction of tax evasion. According to the law, the tax inspector has a right to confiscate temporally accounting books, other documents, evidence and materials, being essential for making assessment of tax obligation. The tax inspector has also the right to confiscate goods for which excises and other duties haven't been paid, as well as vehicles used to transport such goods. The law provides for an enforcement procedure with respect to non-paid taxes and monetary penalties for misdemeanor. According to Article 279 of the Criminal Code, large-scale tax evasion is defined as a criminal act. The punishment for tax evasion is from 6 months to five years of imprisonment and monetary penalties. However, in spite of the apparently widespread tax evasion there has been so far no major case brought up to the court. Tax evasion seems to be on the increase during the last years and the Public Revenue Office has been often criticized for tolerating such a situation and ensuring no equal treatment of taxpayers. Besides, tax evasion appears to be closely related to the increased crime in the country, especially in its western part. It is considered that tax evasion is most acute with respect to excises on goods, such as cigarettes and petrol, with the phenomenon being largely the result of corrupt relations between representatives of the tax administration and the taxpayers.

Officially, the **Romanian** laws are quite strict in the collection of taxes and there are few ways to avoid paying. In practice however, tax compliance has always been a problem, as the overall collection rate is slightly below 60% (higher for VAT and lower for other national taxes). Tax frauds to sales taxes and excises are quite common, and they occur either in the small retail sector (VAT non-payment) or in some special areas of business subject to excise taxes (alcohol, fuels, and tobacco). The latter type of fraud has also cross-border implications. Quite often, tax evasion goes hand in hand with the smuggling of excise goods, which implies some sort of regional criminal organization. A more recent pattern of tax frauds has also developed with the use of fake import-export documents for products that actually do not cross the borders but are sold on the domestic market. This second possibility has created a small regional trade in forged documents (fuels production certificates, alcohol and cigarette stamps) that represents a very lucrative smuggling niche in itself.

The existence of trade restrictions and special taxes on certain goods that are not the same in two neighboring countries thus creates strong incentives for traffic and the associated corruption of public officials. Custom officers are the most exposed. The implementation of VAT special regimes and excises, as well as the inspection of origin and quality of imported goods provide opportunity for corrupt practices. Also, the cumbersome custom regulations, sometimes implemented in bad faith by the officials, represent a stimulant for kickbacks aimed at bypassing some regulations or simply accelerating the procedure. There is ample room for administrative improvement in this area. Yet, realistically speaking corruption cannot be completely rooted out as long as tax regimes in the SEE region differ considerably from one country to the other and unnecessary restrictions to trade are still in place.

To start with, the duties and responsibilities of custom officers have to be defined more clearly, and the vague language in the Custom Code should be eliminated (phrases such as "may apply" or "by the decision of the custom officer"). Secondly, the abundant import tax exemptions must be reduced in number and grouped in one single document. Following intense lobbying of interested parties, many such exemptions have been adopted and they are subject to a myriad of special regimes, delays and clauses of applicability. Interpreting and advising on these regulations

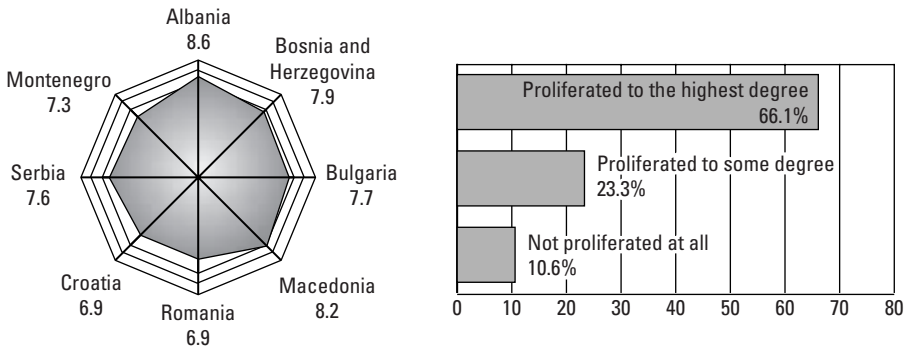
have become a business in itself, which usually employs on a part-time basis the same custom officials that are supposed to administer the system.

Tax exemptions are clearly an area that is far from being transparent and based on well-defined regulations. There is a small circle of top officials in the Romanian Ministry of Finance and the Ministry of Welfare who have the power to grant tax exemptions or rebates upon request, on a case-by-case basis. According to the government, business confidentiality protects the list of companies who have obtained tax relief over time. However, this kind of sensitive information invariably finds its way into the newspapers. Very often, the list included companies for which forced payment or bankruptcy would not have created severe economic or social problems, as the government claimed (private tobacco and alcohol firms, TV stations, some of them with obvious political connection). Leniency in collection execution towards such economic agents can only exacerbate the moral hazard associated with tax relief in general. Yet, in a recent move to improve the business environment, the Ministry of Finance has set up a new system of tax exemptions granting, based on objective criteria. It is being even envisaged that the initial claim and the first step in assessing eligibility will be performed on a new web page to be created by the government in the near future. Among the criteria taken into consideration will be the social relevance (proportion of employees in the population of a community), total turnover, stability of the firm's location, compliance with the current tax obligations. Any default from the rules associated with tax relief will automatically lead to the abolition of the granted status and imposition of high fines.

Yugoslavia does not have a common fiscal system and policy on the federal level. The foundations of the new fiscal system of the Republic of **Serbia** were established in March and April 2001 when the People's Assembly adopted several key laws. The fiscal reform from early 2001 was one of the major steps in the process of economic reforms in Serbia. At the first stage, eight new laws were passed (among them on excises, sales tax, income tax, tax on enterprise profit, property tax, etc.), with most of these acts coming into force on June 1, 2001. With respect to corruption, the major feature of the undertaken reform was the simplification of the whole tax system. Indeed, the former system of 235 different fiscal forms was cut down to 6 main taxes and few fiscal forms. In order to provide better conditions for tax collecting, the Republican Directorate of Public Revenues took an important part in preparing the laws and issued subsequently several decrees on the rules and procedures concerning the collection of taxes and other duties. Thus, according to data of the Revenue Service, revealed tax evasion increased in 2001 compared with the previous year. About 26% of the total revenue was the result of revealed tax evasion, while the ratio for 2000 was 20%.

In **BiH**, the tax rates are not harmonized between the two entities and neither of them has a VAT system in place. Moreover, the existing tax systems appear rather complex and burdened with provisions for different exemptions and rebates. The personal income tax in the Federation is for example characterized by a number rates, brackets and rules for granting exemption and rebates. In RS this complexity has been recently reduced as a lot of more transparent, broader-based and exemption-free system was put in place since 2002. In order to promote inward investment, the Federation grants an annual profit tax exemption for newly established companies with local and/or foreign shares at the level of 100 % for the first year of operations, 70 % for the second and 30 % for the third year. If foreign investment exceeds 20 % of compa-

**Chart 17: Spread of corruption in the tax administration, April 2002**




*Source: SELDI Corruption Monitoring System*

ny equity, that company is exempted of profit taxes for the first five years, proportionally to the foreign stakes in the total capital. In RS, the exemption from profit tax is for the first five years.

As in other complex fiscal systems, tax evasion is a widespread phenomenon in BiH, rather than an exception. The tax holidays given to foreign investors have caused a lot of forged FDI to register, i.e. companies that would operate for as long as the period lasts and then close down and register anew. The authorities experienced much of a headache with the infamous Volkswagen deal that sought large exemptions in order to re-enter the country after the war. The same status was then expected by other sizeable investors, which led to a disarray in the overall tax system. The hopes are that this will be overcome with the gradual introduction of VAT in the next three years. Yet, many entrepreneurs find the fiscal system extremely burdensome and see tax evasion as the only way to stay in the market. While the system of social funds indeed represents a large payment problem and the concern may be justified, the smuggling of excise goods is a major issue linked much more to organized crime than to a weak tax system. To deal with tax evasion the authorities have been intensifying the inspections, although the results seem to be far from tangible. The tax inspectors themselves are prone to corruption and would frequently revisit those firms where they would receive larger bribes, irrespective of the genuine outcome of the inspection. This has only increased administrative corruption and helped little to eradicate tax evasion. However, considerable efforts are being made to increase the efficiency of the tax administrations and reduce corruption. The World Bank have sponsored several projects that focus on a less restrictive practice of the compliance mechanisms, i.e. inspectors making their schedules and visits less of a burden on enterprises, reducing corruption and making them control only suspected evasions in a co-ordinated manner with other compliance authorities.

## 6.4. Informal Economy

The existence of typically large informal sectors characterizes the economic development of all transition countries, with the region of South-east Europe being widely seen as a rather notorious example for thriving activities of various shades of grey. The estimated size of the shadow economy in the South-east European countries varies considerably, although it generally falls within the range of 25 to 40% of GDP. The studies reveal a considerable similarity in the factors that contributed over the past decade to the expansion of the informal economy across the region. In the context of the overall slow progress in macroeconomic stabilization and market-oriented reforms, informal economic activities appeared to have become deeply rooted largely as a reflection of rising unemployment, the growing hardship of everyday life that forced many to engage in the smuggling of goods to make the two ends meet, the low levels of tax awareness and people's perceptions of the existing tax burden as quite high, the perceived injustice of the legal system and general distrust in government institutions, the lack of fair competition and transparency, as well as the inherently weak institutional settings. Another rather common feature of the informal economy across South-east Europe seems to be its close relationship with the networks of organized crime that has become the focus of government policy efforts in many countries. The fight against money laundering has also gain importance recently on both national and international scale since a considerable portion of the funds involved is believed to serve terrorist organizations and activities.

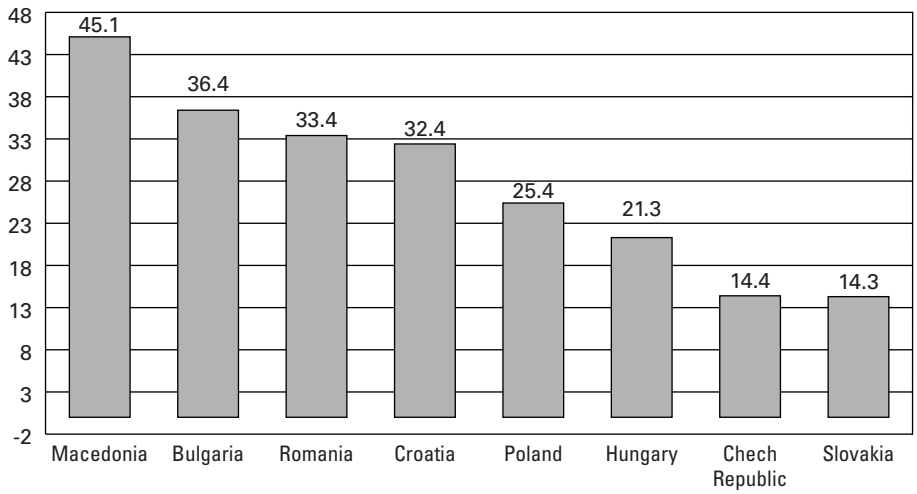
### *6.4.1. Estimated scope and networks of informal economy*

The informal economy in **Albania** is estimated at more than 35% of the country's GDP. This figure is derived as an approximation based on the model of the power supply consumption and it is widely believed to represent the minimum level of such an economy. It is supposed that this sector is more active in retail trade, transport and construction. The shadow economy appears consolidated to that extent that it has now become one of the main obstacles to the functioning of the formal sector because of the unfair competition. On the other hand, there exists an organized crime, involved in trade and smuggling of drugs, human beings, etc. However, no one knows the real extension of the underworld in the economic activity of the country, even though it is supposedly large.

The results of a recent survey carried out by the Economics Institute on the territory of **Serbia** have indicated a very significant scope of the informal economy. According to estimates, at least one million people have been engaged in the shadow economy. Their share of the total labor force amounted to 30%. Somewhat more than one half of the participants in this black market performs informal activities every month. If the number of self-employed who performed their activities in the informal sector is added, the total reaches 1.2 million people. In the structure of

revenues, the grey economy participates with 18% of total revenues. The results of the survey showed that the hidden economy has become a major survival strategy for a considerable portion of population. Namely, around 90% of the respondents feel materially endangered due to the decline in living standard and the quality of life, as well as the risk of being left out of work. Therefore, it seems understandable that for 80.7% of the respondents with additional activities, the main motive for engaging in the hidden economy is associated with satisfying living necessities, which is a pure survival strategy. If this percentage is added to those participants in the hidden economy who wish to maintain the higher standard of living from the previous period, it becomes apparent that over 90% of the respondents engage in additional activities in order to earn income for sustaining more normal living conditions.

**Chart 18: Gray economy comparisons - % of GDP**




*Source: International Conference, "The Informal Economy in the EU Accession Countries: Size, Scope, Trends and Challenges to the Process of EU Enlargement Sofia", April 18-19, 2002* [54]

At least two patterns of informal activities are to be found in Serbia. First, there are large and well-organized criminal gangs performing illegal activities of large scale, including trafficking, contraband, and drug dealing. Second, there is a wide range of petty violators, including petty smugglers, informal labor and hidden economy in trade, crafts and agriculture. While the government has a tacit policy toward the grey economy, much more attention is paid to large-scale criminal and organized crime. Criminal gangs formed in murky times continue to exert their influence after the period of wars and sanctions. Their main activities are trafficking of oil, cigarettes, and narcotics. The Serbian Prime Minister recently stated that he was irritated by the fact that in 50 towns in Serbia everybody knew who was the criminal boss and still nothing happened. Regarding this, it is important to emphasize that the present Minister of Internal Affairs Dusan Mihajlovic was the president of the political party that had been in coalition with Milosevic's Socialist Party during the period 1993-1997, giving him necessary support to stay in power. It is particularly interesting that Mihajlovic's firm "Lutra" succumbed to the Law on extra profit and has already paid the fine.

There are no surveys or official data and analyses regarding the scope of the grey economy in **Macedonia** after 1998. Some analyses carried out by particular experts indicate a very high level of the grey economy, even up to 30% of GDP. Its impact is deemed considerable for the loss of revenue to the budget. The fall in budget revenues, especially from customs duties and other import duties in the last years, appears to confirm this supposition. Namely, the custom revenues fell to Euro 96.7 million in 2001, down from Euro 99 million a year ago, while for 2002 the total amount of revenues from customs and other import duties is projected to decline further to Euro 71 million. Although the official statements of the Customs Administration cited the recent free trade agreements with several countries as the basic reason for the fall in revenue, another important factor for that could be found in the weak and inefficient custom control, as well as corrupt customs officials. Indeed, several low-key customs officers have been already arrested for involvement in smuggling and bribe. Besides, public opinion survey data constantly place tax inspectors and customs officers on the top of the table of corrupted

[54] http://www.csd.bg/news/bert/schneider-paper.PDF

public officials. The inefficiencies in the tax administration, the overall weak tax control and allegedly widespread corruption create ample room for the expansion of the grey economy. Among the social factors for the latter phenomenon the experts point to the high rate of unemployment (up to 35% of the workforce) and the deterioration in living conditions that forced thousands of citizens to engage in the smuggling of goods. The legal aspects are associated with the widespread awareness of injustice in the legal system and distrust in the government institutions, while the moral one reflect the general disapproval of the behavior of public officials who become rich in a short period of time. The most serious reason relates, however, to the improper functioning of the market economy, resulting in the lack of fair competition and transparency, dominant monopolistic structures, different standards for the companies with regard to taxation and benefits, as well as opportunities for corruption with the involvement of high-ranking officials.

The open nature of the **Bulgarian** economy in which between 65 and 75 percent of the GDP is realized through import and export creates opportunities for the existence of illegal cross-border activities. The customs authorities have continued to be one of the basic mechanisms involved in the redistribution of national wealth. The scale of the latter can be assessed on the basis survey data showing that some 25-35% of imports and exports still passed through illegal channels, even though smuggling appeared to have followed a decelerating trend during 1998-2000. In 2001, two opposite trends marked the development of grey imports and smuggling into the country. On the one hand, there was a steady increase in legal imports of goods, semi-manufactured articles and raw materials, with the process being positively influenced by the growing number of multinational companies on the Bulgarian market. On the other hand, last year saw increased pressures over border control authorities to allow illegal and semi-legal imports and exports of goods. In contrast to the initial years of transition, however, the post-1998 prevailing pattern of custom violations involved mainly imports at lower-than-the-actual prices, use of incorrect lists of goods, etc. Squeezed by subdued consumption and the intensified competition from rapidly expanding chain stores, some importers and wholesalers restored the usage of channels for "cheap goods", which lead to a new search for parallel import-export schemes. The 2001 situation seemed to have been also affected by the constant changes in the customs management. The personnel changes caused disintegration of the old schemes for illegal import and export and seriously hampered smuggling and parallel imports and exports. This positive effect turned, however, to be counterbalanced by the growing chaos and fear among the managers in the customs administration that shortened, in turn, the horizon of the rank-and-file customs officers. The latter started co-operating with grey importers on their own, trying to make the "last quick buck" before an eventual dismissal or "a last favor" in order to get a subsequent job in the private sector.

In 1996, the Institute for Public Finance in Zagreb (IPF) did research into the informal economy in the Republic of **Croatia** for the period 1990-1995. The authors of the study evaluated that the most probable ratio of the informal economy to the country's GDP was at least 25% by 1995. Sector data were consistent with this estimate as it covered a range from 8% of output in industry to 68% of output in commerce in 1994. In the 1990-1993 period, the proportion of the informal economy to GDP rose. In the 1994-1995 period it was impossible to make any final judgment, because some important indicators actually pointed to an increase in the scope of the informal economy, although most of the other signs suggested a fall. While considering the 25% ratio of the informal economy to GDP as rather high, the authors concluded that it could be expected to stay equally high in the foreseeable future due to the inherited tradition, the ongoing transition with its vigorous sectoral and institutional restructuring, and the continuing great role of the state in the economy, particularly in the field of privatization. They were also of the opinion that the high tax burden, the resumption of growth and the enhanced creation of new enterprises might well support further the expansion of the informal economy.

During 2001, the IPF went on with the previous research and started a new chapter in the investigation of the informal economy in Croatia. The measurement of the informal sector at the level of the economy as a whole was done through the national accounting discrepancy method, monetary methods, an adapted Eurostat method, estimates of tax evasion and an assessment of the informal activities in certain industries, such as agriculture, industry and commerce, tourism and foreign trade. With the use of the national accounting method for the 1996-2000 period, the informal economy has been estimated at an average of 10.4% of output. Such results seem fairly logical, because in the earlier period Croatia had the war, hyperinflation, the beginnings of the transitions and reform, and in the second period stabilisation and the strengthening of the ethical

and legal system. Other methods gave different results, but there is no huge discrepancy. Although it has been reasonably expected that the level of the informal economy in Croatia would to a certain extent decrease given the acceleration in the rates of economic growth, a more important feature seems to be the change in its structure and phenomenology. If the survey results from 1995 and 1999 are compared, one will notice that the level of opportunism has decreased in both diffusion and intensity. The number of those who think that tax evasion and corruption can never be justified has doubled. But the fact still is that 46% of respondents were prepared in certain circumstances to tolerate these phenomena; the age structure of opportunism has remained unchanged – the youngest age group is still most apt to justify tax evasion and taking bribes. This gives ground for concern because it suggests the phenomenon might be of a long-term nature. Moreover, the distrust in institutions has increased, and is once again most pronounced among the young, which is a worrying feature. In contrast, economic traditionalism has ceased to be a relevant factor, which is rather encouraging as people are after all getting used to differences in wages. Rising social security contributions have, however, added to the generally high tax burden that typically pushes economic activity underground.

According to some economic analyses conducted before 1998, the size of the informal sector in **BiH** had been estimated at around 60% of GDP. This figure would appear overstated nowadays due to a number of systemic measures that tried to incorporate some of the informal activities into the formal economy. Therefore, a more accurate estimate would possibly leave the grey economy as high as 40% of GDP. Its most obscure segments seem to be the smuggling of immigrants (particularly from the Islamic countries), prostitution, illicit drugs sales, weapons, racketeering and money laundering. However, measuring their impact would be next to impossible and there have been no such known attempts, although the overall size of the informal sector seems to be larger than in the rest of the region. The informal economy networks appear to be very strong and closely related to organized crime of whose existence the general public is well aware as demonstrated by a recent survey of Transparency International - BiH. Illegal trafficking, mainly of oil, alcohol and cigarettes, was perceived as the most widespread form of organized crime, with respondents' answers resulting in an average grade of 4.57 on the scale from 1 to 5. Following the September events, some of the criminal activities related to the shadow economy were branded as terrorism and the efforts to combat the underground groups have been strengthened with the help of foreign agencies. Apart from being strong nationally, Mafia linked to the excise goods smuggling appears to have well established networks regionally with links in Belgrade, Zagreb, Podgorica, Pristina and Tirana according to press reports. They are mostly focused on oil and cigarettes, as well as other excise goods. It may be assumed that these groups partially, or in total also cover prostitution and human trafficking, although there are no certain validations of this assumption, other than the UNMBIH vague findings.

*6.4.2. Government policy*

The government policy toward the informal economy in **Croatia** appears to be rather inconsistent. According to the circumstances and situation, it vacillates between varying attempts to make it completely illegal and a policy that would tacitly tolerate the informal economy. The efforts undertaken by the government are not commensurate with the gravity of the problem and there is a lack of determination to confront and limit the informal economy, and to root out corruption. On their part, many researchers have suggested detailed measures of economic policy necessary for the suppression of the informal economy, and particularly stressed that in the attempts to reduce the phenomenon it was more important to do away with the causes than to penalize the consequences. They also stressed the importance of the development of the institutional framework and the relation between the state and the economy. Besides, survey data shows a higher level of opportunism (inclination to break any rules that do not involve high risk of punishment) in Croatia than in such countries as Slovakia, Hungary and Romania. More than two thirds of the respondents seem convinced that the majority of public officials are involved in corruption. There is also a widespread public perception of injustice in the legal system and dissatisfaction with the way government functionaries and state civil servants perform their duties.

The practices of the new **Bulgarian** government concerning the making of rules for the interaction between the state and the private business involve controversial reactions. The intention to set up a Council on Economic Growth with the Council of Ministers including representatives of big business provoked public criticism mainly because a number of these people have been allegedly involved in shady economic activities. This, in turn, raises the question of formulating clear and transparent criteria for participation in

such structures as well as the need to specify what their functions and status should be. The activities of the government have so far reflected a conflict between the political platform of the new parliamentary majority and the existing economic realities. Apart from the declared zero-tolerance to corruption, the authorities will need to make rapid progress in improving the overall business environment and strengthening the institutional framework, increasing thereby the opportunities for incorporating informal activities into the main road of the organized economy. The existence of a considerable grey sector and a large volume of unaccounted for imports of goods means that in addition to the state in the country there exists a parallel system of management of the economy, which controls approximately 1/3 of the turnover. The horizontal and vertical links built by this parallel power will not lose their importance even if there was a fully-fledged market economy. Therefore, the argument that development itself will solve the problems of corruption in the economy is overly erroneous. First, because the symbiosis between the state and the private sector generates the shadow economy that, in turn, hinders the transformation process; and second, the consolidated structures of this parallel power will always try to perpetuate the existing channels of corruption. In this context, priority should be given to the sustained improvement in the conditions for doing business, which seems of key importance for the gradual legalization of the shadow economy.

The **Macedonian** government is tacitly tolerating informal economic activities, and it seems that it does not have a real political will to combat the grey economy, despite some official statements of commitment to the cause.

Until now, the **Albanian** government has not been clearly declared in the fight against informal economy as well. The main tool used by the authorities has been the extension of the tax base of businesses. The legal framework is continuously updated in order to keep up with the new challenges, but weak implementation remains a problem.

While some informal activities appear to be tolerated, the government of Serbia has announced a fight against large criminal groups. Besides, one of the most widespread forms of informal activity in the recent past - the foreign currency dealing - was brought to an end by introduction of convertible Yugoslav Dinar. In order to crack down on oil smuggling, the government issued in March 2001 the Decree on special conditions and procedure of import, process, distribution and trade with oil and oil derivatives. Yet, it is not certain whether such a decree is going to reduce large-scale corruption, although one evident result so far has been the lower number of smugglers caught. In turn, smuggling of cigarettes has been fought through increased border control. According to a Report on the activities on preventing illegal flows of tobacco, 50% of the consumed cigarettes in 2000 was subject of illegal trade, whereas in the first half of 2001 this share has diminished to 17%. A further step in fighting cigarette contraband will be the Tobacco Law whose draft has been recently approved by the government with the aim of regulating the production, processing and trade activities in the sector. While such a strengthening of the legal framework will likely help to reduce the scope of contraband, the new law shall provide government officials with large discretionary power in issuing the necessary licenses, which is a major source of corrupt behavior.

In the context of the political and economic developments in Serbia during the last decade, it could appear that the informal sector was in a sense beneficial for the country. High taxation, government encroaching, huge administration, rent-seeking and rampant corruption had created a discouraging business environment. Given the growing extent of poverty among vast strata of the population, the tolerance towards informal economic activities could be regarded as a social policy. Since legal business environment has not been radically changed after the overthrow of the old regime, it seems that the grey economy still performs some social policy tasks and boosts the whole economy up even now. Therefore, the government appears to continue tacitly tolerating the informal sector of the economy to some extent. Meanwhile, recent survey data have shed light on the prerequisites that would motivate those engaged in the grey economy to turn to the formal sector. Half of the respondents assigned prime importance to a decrease in tax rates, tariffs and other duties, 25% of the interviewed pointed to the necessity to reduce barriers and regulations for doing business, whereas 9% thought that the key factor was state administering. Besides, 25% of the respondents considered sentences as rather soft, whereas 40% found that control was poor, thus creating incentives for the expansion of the grey economy.

Statistical data on economy-related crime in **FBiH** show that the prosecution pressed 13,183 charges in 2001, with another 4,419 being inherited from previous years. The respective figures for **RS** were 11,997 and 2,211. On top of that, there have been continuous efforts to close the smuggling

channels and to clean up the street markets, where goods go untaxed. These activities hurt, however, mostly the "little people", since much of the economy is unregulated and so is their employment status and the sale of their goods. With constant improvements in the tax regime and social benefits, it is expected that this long-term process will be gradually moving towards more formal channels.

*6.4.3. International connections*

The opportunities for performing illegal and criminal activities in **Macedonia** were markedly boosted in the wake of the 2001 sharp deterioration in the political and security situation in the country. In the context of the subsequent slow process of the government regaining control on a significant portion of the territory, the continuing precarious situation in neighboring Kosovo and the rather weak border control, organized crime appears to have remained widespread in certain parts of the country. Moreover, there are serious indications for well-developed international connections of the criminal activities pursued through smuggling of different goods, drugs, arms and etc.

The economic sanctions imposed on **Serbia** by the United Nations in the period 1992-1995 paved the way to the rapid expansion of the informal sector. At the time of the embargo on all exports and imports it was much more important to provide necessary consumer goods and allow for means of exchange than to enforce rules and laws. Thus, the dominant pattern of informal economic activities during the sanctions was foreign trade supported obviously by established international links. Under the embargo, the authorities were fairly tolerant towards this type of shadow activity, although the same practice continued even after the sanctions were lifted. Large trafficking groups formed during period of sanctions and war stepped into close relations with state officials. The main activities were trafficking of oil, cigarettes and narcotics, with many signs pointing to vast international channels.

With respect to the international connections of informal economic activities a most comprehensive study was conducted by several investigative journalists from the Zagreb's weekly *Nacional*. They uncovered links between organized crime in all countries from the Western Balkans, with many signs also pointing to regular links to the policy-makers in power. That has prompted parliamentary committees to be formed for the investigation of the claims and a growing number of institutions are being drawn into this attempt ever since the first traces sprang up in early 2001.

*6.4.4. Anti-money laundering*

With the recent adoption of an anti-money laundering law **Albania** made an important step in strengthening its legal framework in the field of financial transactions. The purpose of the *Law on the Prevention of Money Laundering*, enacted in May 2000, is "to prevent the laundering of money obtained through criminal activities and to combat financial crimes", to quote the Article 1. The law also provides for the establishment of a Co-ordination Agency for the Fight against Money Laundering at the Ministry of Finance. The Agency is the government body in charge of collection and verification of all reports on effectuated transactions, and is also entitled to exert control over the observance of the reporting procedures. However, the effectiveness of such administrative arrangements have not yet been tested, since the law has rather recently come into effect and the Co-ordination Agency itself is still in the process of organization and therefore unable to push for better implementation standards. Even though with a limited experience so far, the very existence of a proper regulatory framework is an important element of the fight against money laundering in the country. Meanwhile, the Bank of Albania seems to be the state institution, which have taken the issue most seriously. Its supervisory council has issued instructions to all commercial banks to unify their standards of behavior in the face of suspected money-laundering activities.

In **Macedonia**, the *Law on Prevention of Money Laundering* was adopted in August 2001 but has become effective only from March 1, 2002. According to the Law, there is an obligation for identification of clients for transactions exceeding the equivalent of EUR 10.000. If there is an indication for money laundering, the obligation for identification of the clients is effective regardless of the amount of transaction. All suspicious transactions are to be reported to the Office for Prevention of Money Laundering that has been established within the Ministry of Finance. Its task is to collect, proceed, analyse and keep the received records, and inform the competent authorities in case of an indication for criminal act. The Customs Office is also obliged to register all transferred cash money in and out of the country. However, the law did not incorporate all forty recommendations of FATF, which is obligatory for every country that adopts such legislation. This refers to the provisions for the disclosure of the banking secret, postponing of the suspicious transactions, clear identification of the clients who have an obligation to make a report regarding the indication for money laundering, etc. Moreover, the necessary regulations related to

the law have not been drafted and adopted by the government so far. The banks and other financial institutions have not adopted internal rules of procedures or started with internal training of the staff for recognition of suspicious transactions and implementation of the law. In compliance with the Law the Government established the Office on prevention of money laundering. However, the Office has not started with performing its activities yet. The lack of experience of the staff, including its Director, cannot guarantee successful and efficient implementation of anti-money laundering legislation. The Office has not started with preparations for implementation of the Law, training of the subjects, publicity of the anti-money laundering legislation, and the like. Due to the lack of any control measures so far, Macedonia is especially vulnerable to money laundering. It seems that there is also no political will to deal with these phenomena. Such situation creates potential for laundering of the funds derived by criminal activities through legal banking system and other institutions. Also, the lack of anti money laundering control mechanisms, was used for acquiring companies, business premises, banks, land and other property for enormous amount of cash, without any proof for its origin.

Money laundering in **Serbia** had not been fought at all for a long time, and no relevant estimation on the scope of these activities is available. The *Money Laundering Act* has been adopted at the federal level only in September 2001, and implemented starting from July 1, 2002. This act prescribes the actions and measures to be undertaken for the purpose of discovering and preventing money laundering, although it does not stipulate any provisions regarding the international Cupertino. (Yugoslavia is not a party to the Council of Europe's Convention on Laundering, Search, Seizure and Confiscation of Proceeds from Crime.). The Federal Government in Serbia has formed the Federal Commission for prevention of money laundering (Official Gazette of the FRY, No 15/2002), as an independent federal institution. Commission will be responsible for collection, processing, analysis, providing information to competent public institutions (Judiciary, Inspection, Ministry of Interior), keeping record, taking other measures according to the Law and finally keeping data and information received from obligors from Article 5, the *Money Laundering Act* which are:

- Banks and other financial organizations (Post Office Savings Bank, savings banks, savings and credit organizations, and savings and credit cooperatives);
- Post Office units, other enterprises;
- Government agencies, organizations, funds, bureau and institutions as well as other legal persons which are in whole or in part financed from public revenues;
- The National Bank of Yugoslavia – Clearing and Payments Department as the executor of the country's payment operations;
- Insurance companies;
- Stock exchanges, stock brokers and other persons engaged in transactions involving cash, securities, precious metals and jewels as well as purchase and sale of claims and debts; and
- Exchange offices, pawnshops, gambling rooms, betting places, slot machine clubs as well as organizers of commodity and money lotteries and other games of chance.

Commission has a president and four members that are nominated by the Federal Government on proposal of Federal Minister of Finance, given that the president manages its work and is responsible for the performance of the organization.

The general impression is that the ability of Serbia to efficiently co-operate internationally in financial investigations and money laundering cases is very limited. The Federal Ministry of Internal Affairs has direct control over the Federal police but not over the police of the Republic of Serbia. Yet, the head of the Crime Investigation Directorate of the Federal Ministry is also heading the INTERPOL National Central Bureau. The Crime Investigation Directorate's staff serves as a link between the police administrations of the two Republics related to international requests for assistance to and from international police forces. In accordance with the Criminal Procedure Code (Article 535), full data is to be provided to the Federal Ministry of Internal Affairs by the authority before which proceedings are conducted with regard to criminal offences related to counterfeiting of money, money laundering and trafficking.

The **Bulgarian** legislation has made significant progress with respect to measures against money laundering. After the first law of 1996 had proved to be ineffective, a new one was adopted in 1998, based on the principle of self-organization of the financial system to prevent and uncover attempts for money laundering. At the end of 1998, a Financial Intelligence Bureau was established and subsequently transformed into an

agency within the Ministry of Finance. In early 2001 some important amendments to the *Law on Measures against Money Laundering* came in force, with most of them being aimed at harmonizing the Bulgarian legislation with the *EU Directive on prevention of the use of the financial system for money laundering.* The Financial Intelligence Bureau was transformed into an agency - a legal entity within the Ministry of Finance, funded by the state budget and located in Sofia (*Organizational Rules of the Agency Financial Intelligence Bureau*, adopted with Council of Ministers *Regulation No. 33* of February 12, 2001).

The commercial banks reported the highest number of signals of suspicious operations, followed by the tax authorities. This confirms the conclusion that most of the money laundering operations and transactions are carried out through the banking system or through illegal accounting operations. According to the available data for the period October 1998 - April 2001, 43% of the cases involved operations for introducing financial resources of criminal origin into the financial system; 11% represented operations for layering the financial resources aimed at removing their criminal origin; 6% related to privatization deals in which financial resources of criminal origin were invested in the legal economy and the remaining 40% of the cases concerned criminal activities generating the so-called "dirty money". The fact that most of the cases of money laundering are related to corrupt practices with both national and international dimensions and that the funds involved can serve terrorist organizations and activities increases the need for cooperation between the Financial Intelligence Bureau and other state institutions - the Prosecutor's Office, the Ministry of the Interior and the administrative authorities performing similar functions, as well as for international cooperation in this field. The new challenges require to further improve the legal framework and modernize information technologies on a regular basis so that specialized control against money laundering can continue to contribute to the prevention and uncovering of acts of corruption. Further amendments to the Law on Measures against Money Laundering are currently being prepared, aimed at blocking terrorist group's accounts (financial resources) and introducing stricter controls and sanctions.

The anti-money laundering legislation exists in **FBiH** since 1998 and in **RS** since 2001. The OHR has taken a leading role in co-ordinating this activity through its Anti-Fraud Department. The latter has recently organized a conference titled: "Mechanisms for prevention of money laundering in BiH: How applicable and efficient they are". A preliminary action plan was agreed upon during the forum and the principles of work in this area were established. The existing money laundering prevention mechanisms foresee supervision of the bank accounts where suspicions exist and the formation of a department for anti-money laundering within the Ministry of Justice (ex-Financial Police in FBiH) and a new one in RS with the Ministry of Finance. According to the law, a single register of public and private entities should also be set up and a number of related laws are being currently amended to incorporate provisions that would sanction this particular activity.

In FBiH, the role of Financial Police that was an integral part of the Ministry of Finance was restructured and the administrative authority over it has been shifted to the Ministry of Justice with its mandate narrowed only to cover money laundering. OHR was particularly instrumental through its AFD in restructuring the Financial Police and drafting its new curriculum.

In RS this role is now with the tax administration, the Revenue Service, which is a part of the Ministry of Finance and as of 2002 it combines what used to be the Revenue Administration and the Financial Police. Their mandate extends to money laundering and in April 2002 charges were pressed against several companies on merit of money laundering.

### 6.5. Barriers to Business

The existing registration, licensing and permit regimes are constantly generating two types of problems that appear to be particularly acute in the transition economies of South-east Europe despite generally intensifying policy efforts to deal with the underlying causes. On the one hand, the overregulation of economic activities results in considerable administrative barriers to market entrants and higher costs of doing business, pushing, in turn, many entrepreneurs into the informal sector. On the other hand, the very existence of registration and licensing regimes is one of the main sources of corruption as it typically gives officials large discretionary power, creating opportunities for the abuse of public office for private gains. With respect to the latter, the overall unfavorable institutional environment across the region remains clearly a notable root cause of corruption. Yet, the current enhanced development of market-type institutions is rightly placed into the general context of reforming the government's role in the economy. This broader perspective reveals, among others, the impor-

tance of minimizing the institutionalized opportunity for corrupt practices as a result of overregulation. Furthermore, the alleviation of administrative barriers through streamlining of registration and licensing regimes, simplifying the procedures and making them more transparent will contribute both to a marked improvement in business conditions and a gradual reduction in corruption levels.

*6.5.1. Registration procedures*

There are two laws regulating the issues related to the foundation, registration, operation, etc. of companies in **Albania**, namely the *Law on Commercial Companies* of 1992 and the *Law on the Business Register* of 1993. The Trade Register is located at the Court of the first instance of the Tirana District for all businesses that operate in the Republic of Albania. The laws prescribe the procedure that should be followed in order to register a company and the necessary set of documents to be submitted to the court, which should take the decision on the request in one-month time. The registration procedure for business entities in **Macedonia** is defined in the *Trade Company Law*. Following the decision of the Court for enrolment of a new company the latter is registered in the Trade Company Register and receives a classification from the State Statistical Office.

The overall operating environment in **Croatia** does not pose significant administrative challenges and the country compares well with leading transition economies from central and Southeast Europe. On the other hand, the process and requirements for acquiring entry visas and work permits – many investors' first encounter with the country – are unnecessarily complicated and burdensome. Also, the process of acquiring land, registering it and building new premises is fraught with difficulty for investors. Although these issues clearly entail a long-term agenda, Croatia needs to take immediate actions where possible to improve its performance. According to the recent expert analyses, the greatest barriers to business, which appear a major source of corruption as well, are created by the lack of detailed zoning plans and the ensuing complicated procedure for obtaining building permits. The quality of zoning plans varies considerably across the country. As things stand, the absence of clear zoning plans in some areas creates opportunities for corruption and confusion amongst investors.

The *Investment Promotion Act* of 2000 regulates the promotion of investments by domestic and foreign legal entities or natural persons with the aim of stimulating the economic development of Croatia, its integration into international trade through the increase of exports and the competitiveness of the Croatian economy. Investment promotion comprises incentive measures, tax and customs benefits. The latter could, however, be granted only to newly established companies registered exclusively for the activities subject to promotion measures. The envisaged incentive measures are divided into three groups. The first one includes leasing, granting of construction rights and sale or usage of real estate or other infrastructure facilities owned by the Republic of Croatia, local government or self-government units under commercial or favourable conditions. The second group of incentive measures refers to assistance granted for the creation of new jobs. The third group comprises incentive measures related to assistance granted for vocational training or re-training. The various authorised state administration bodies, utility companies and other institutions are obliged to provide decisions on consents, permits, certificates or other documents within 30 days of the submission of the outline planning permission application; otherwise, the City Office is empowered to take the decisions.

Today, the costs of doing business in **BiH** are much too high, overloading the operation of private firms. The country is still dominated by a bureaucracy geared to the old socialist system and controlled by officials with formalistic mindsets. Missing are the market-type economic incentives, while some informal remnants of ad hoc wartime arrangements still remain. Costly administrative barriers create opportunities for rent seeking and are particularly onerous for SMEs. Many of the laws critical to business development have not yet been promulgated or are not supportive of private sector development. Ownership rights remain unclear, contract law is difficult to enforce, and the courts are slow, nontransparent and unpredictable. The tax rates on business are high, the whole tax system is complex and corruption is allegedly widespread. These factors combined with perceptions of high levels of political risk impede both foreign and domestic investment. Companies and entrepreneurs with yearly income of more than KM 200,000 are entered in the register of the respective court according to the procedure set by the *Law on Enterprises*. According to the *Law on the Policy of Foreign Investment registration* of 1998, foreign investment must be registered with the authorized entity's body, and also has the permission of the Ministry of Foreign Trade and Economic Relations of BiH. This step may be abolished within the next six months since it is obso-

lete with a view to differentiating between foreign and domestic enterprises. In total it is a 15-step procedure from the commencement of the process, until the firm is able to operate and it includes a number of official institutions and registration requirements.

The procedure of registering enterprises in **Serbia** is clearly defined in the *Company Law*. In practice, however, the procedure of registering firms in the respective courts is so complicated that it seems almost impossible to register a firm without professional help. A number of special acts complicate the process. For example, estimation of the initial capital is required even for brand new things with invoice delivered. The *Law on procedure of registration in the court register* (1994) and the *Decree on registration in the court register* (1997) regulate this procedure. It is required from the firm to report all activities it is planning to perform. The fact that only 37 companies were founded in 2001 may be good indicator of the difficulties of the registration process. Among the greatest problems is the procurement of construction land and obtaining building licenses. Construction land cannot be the private property, but the right to use the land can be granted in the form of concession. The *Law on construction land* stipulates that land can be granted through public tender or collecting bids in response to a public announcement.

Although there are no significant obstacles to the registration of a business in Serbia, the prescribed procedures appear to be rather time-consuming and costly. The G 17 Institute has done a large study based on empirical analyses of the existing regulation and interviews with entrepreneurs, showing that the costs of registering and the time needed were extremely high in some cases. According to the findings of the study, the procedure typically lasted longer than the amount of work needed for its completion. Moreover, 21% of the interviewed entrepreneurs had to bribe an official during the process of registration. The study also found that the overall cost of the licenses required for construction was DEM 7,787.

In **Romania**, new entry in the banking sector has always been fairly easy, though tougher criteria were imposed lately. Romania is still ranked by international agencies as one of the European countries with the lowest barriers to entry and the loosest banking supervision. As a result, many small boutique-banks have been set up just to tunnel funds from public institutions and collapse one or two years later. These were among the most serious examples of state-capture corruption we have seen so far. The completion of the bank sector privatization in 2002 or 2003 will probably reduce the scale of the phenomenon, but loose supervision and standards will make possible for private entrepreneurs with political connections to continue to steal public resources through various schemes.

*6.5.2. Licensing regimes and their dynamics*

One of the main sources of corruption stemming from the regulation of economic activities is the existence of registration and licensing regimes. Their practical implementation has also proved rather burdensome for the overall business environment in Southeast Europe that remains generally difficult and needs to be improved markedly in order to create the necessary conditions for sustainable growth. In this context, the past several years saw many attempts across the region to revise the existing regulatory framework with a view to both strengthening the institutional settings and streamlining the regimes. However, the attitude toward the licensing type of regulation still seems very contradictory. As a form of state control licensing regimes are one of the ways to reduce corruption by direct (administrative) control over economic activities. Yet, exactly because of the way this control is exercised (direct control protecting public interest but opposing private interests who are subject to control) licensing regimes themselves generate considerable economic interests for side-stepping them through corrupt practices.

In **Bulgaria**, a large number of state agencies (about 1/3 of total) are involved in licensing, registration and issuing permits but it is hard to say how many regimes really exist (the current estimates point to a figure of slightly above 500). Given the numerous laws, which introduce or cancel such regimes, there are no serious obstacles for modification of the existing regimes and even introduction of new ones by various agencies through different procedures. Still, the optimisation of the regulatory framework has long remained a priority of government policy, even though the declared intentions and the actual developments point to considerable discrepancies. Out of an estimated total of 526 licensing, registration and permit regimes 148 had been cancelled in the period 1999-2001, while another 102 had been slated for alleviation. According to most recent estimates, the overall number of regimes that are being currently reviewed is 512, which is indicative of the ongoing developments. The government has, however, reiterated its commitment to alleviate the existing regulations. Out of a total of 360 licensing regimes, the Council on

Economic Growth has proposed the abolition of 74, as well as amendments of 194, with the package of legal changes being reportedly planned for mid-2002. Among the line ministries in Bulgaria, the Ministry of Agriculture is clearly the leader in terms of the number of licensing regimes. It currently administers 62 such regimes of which 9 are to be cancelled, while another 22 are to be alleviated. In terms of the overall number of licensing, registration and permit regimes, however, the Ministry of Agriculture comes second with 75, whereas the Ministry of Regional Development and Welfare administers a total of 88 regimes.

The Bulgarian experience has also shown that the accession process is creating additional difficulties in the attempts to solve the problems in the field of licensing regimes as the provisions of the EU directives and regulations include a significant number of such regimes in the member-states as well. Yet, the problem in Bulgaria is not so much in the existence and the number of regimes but in the clumsy, bureaucratised and badly organized implementation, which creates opportunities for corruption. The issue of overregulation is, in fact, the issue of administrative discretion instead of providing one-stop service for the public. Adding to this, the current legislation is full of contradictory provisions and creates a room for corrupt behavior. Besides, it is possible to introduce in a discretionary manner registration and licensing regimes - not only through laws but also through administrative decrees, ordinances, etc. It proves also possible to keep an existing regime even after the law that initially led to the introduction of this regime was repealed. The lack of clearly formulated requirements for the introduction of licensing and registration regimes obviously raises the necessity for regulating the very process of installing control mechanisms to protect public interest.

The licensing process in **Romania** is used to regulate the access to business areas such as telecommunications, electronic broadcasting, finance and insurance, foreign trade with a selected list of goods (arms, products with quota requirements) and mining. Even though the procedure of licensing should be transparent and more or less automatic, there were many cases in the past when the procedures resulted in suspicion. Moreover, the Romanian national and local administrations in general do not act as accurate providers of public services, but as an annoying structure to be tolerated and dealt with in case of strict necessity. The frame of mind in the public regulatory agencies is to be as uncooperative as possible, by spotting flaws in the business or individual documents and use them as reasons for blocking procedures. By doing so the bureaucrats are rational agents who maximise their status and income.

Advice and assistance from civil servants are in short supply, and often provided in exchange for cash. For example, the Ministry of Finance has not yet organized a service that can provide statements with legal status on request. As a result, different opinions on the same matter can be heard from different offices of the ministry, while an honest business that is seeking advice on a complicated procedure can never be sure it is in compliance with the law. This again expands the decision-making discretion of public officials and opens new possibilities for corrupt practices. Local governments are not immune, either. For private individuals it is so difficult to get a permit to renovate or build a house on private land, that the current practice is to start building first and then apply for permission. In exchange for a fine, which is less than the total administrative costs of getting a legal permit, the construction can be legalized afterwards. Such behavior perversely saves time and money for the private agent, but in time reduces the total welfare in society and destroys the credibility of the public sector.

In **Macedonia**, there is a large number of licenses, approvals, reports or statements as preconditions for opening a business, changing its nature or starting construction activities. The rather long and complicated bureaucratic procedures create opportunities for the abuse of discretionary power and corruption. The system of issuing and obtaining permits, licenses and various approvals for doing business in Macedonia has not changed much during the last years. Its deficiencies have provoked many complaints and initiatives by businessmen aiming at a decrease in the number of existing licenses. The country's preparations for membership in the WTO would also require a streamlining of such regimes within the broader scope of the targeted reduction in barriers to business and functioning of the market economy. Introducing a "one stop shop" is an important step in order to shorten and improve the efficiency of the necessary procedures, narrowing at the same time the possibility for corruption of public officials.

It is estimated that the average enterprise in **BiH** needs to obtain about eight licenses annually in order to function legally. Typically, firms with foreign direct participation need more licenses, while large public companies have, on average, five licenses. In co-operation with the entity governments, the Council of Ministers of BiH has developed a Global Framework of Economic

Development Strategy (GFEDC). The ultimate goal of this effort is to achieve sustainable economy in the context of declining international assistance that would require a marked improvement in the existing business environment in order to stimulate domestic and foreign investment. In this sense, one of the most important tasks is to enhance the development of the private sector and to reduce the sources of corruption. The Strategy makes an immediate reference to the elimination of administrative barriers to doing business, among which particular importance is attached to the simplification of the registration process, streamlining the controls for compliance and decreasing the scope of the licensing regimes. While BiH had seen a deterioration in most of these factors during the initial transition period, it could be reasonably expected that the situation will start to gradually change as much of the foreign aid is being now conditional on the improvement in the overall business climate.

*6.5.3. Foreign trade operations*

The conduct of international trade business in **Macedonia** is regulated by the provisions of the *Foreign Trade Law*. According to it, the Ministry of Economy issues the necessary licenses, permits and approval for performing foreign trade operations. The law determines all the needed documentation and data that have to be submitted to the Ministry of Economy in order for the latter to make its decision upon it. Thus, the issuing of licenses and approvals is in the discretionary right of the Ministry, which decides whether the criteria have been met. The resulting practice has appeared fraught with irregularities and cases of providing licenses and permits to companies closely related to the ruling parties in a non-transparent way and without fulfilment of criteria. Most notorious was the scandal with a company owned by a close friend of the Minister of Economy that got the license to import sugar irrespective of the criteria and conditions, and brought the deliveries in the country without paying any customs duties. Other examples refer to the import licenses for meat from Croatia, as well as recent imports of sugar free of customs duties.

Business entities wishing to conduct foreign trade in **Serbia** have to register with the Commercial Court and with the Federal Customs Service. The former obligatory report of every import-export transaction to the National Bank of Yugoslavia was abolished in 2001. Out of 8,552 products specified in the Customs tariff nomenclature, 94 require an export license, 142 require an import license, while the exports of 34 products are regulated by quotas. International trade operations with certain goods require also additional approvals from relevant ministries such as the Ministry of Health and Social Policy, the Federal Institute for Measures and Precious Metals or from the Federal Institute for Standardisation. Licenses are necessary for the export and import of goods regulated by international agreements and conventions (arm, drugs, etc.). Many agricultural products are subject to quotas. The Federal Government sets the conditions, criteria and procedures concerning quotas and the Federal Ministry for Economic Relations issues authorisations. Since May 2001, quotas on imports have been abolished. Thus, the country has recently made notable progress in liberalising foreign trade operations, reversing the situation under the previous regime when foreign trade had been almost exclusively organized on the license system. Most of the licenses were abolished by the end of 2000, while additional measures were undertaken in May 2001 to significantly simplify the import and export procedures. As mentioned earlier, however, the Serbian government sometimes tries to solve corruption problems by granting monopolies to the state. There is a state monopoly on imports of oil and oil derivatives since April 2001 and the draft Tobacco Law provides for a monopoly on the import of tobacco and cigarettes.

In **Romania**, a small circle of top government officials, who follow some rules that are not always transparent, administers import-export quotas, licenses and standards. The sheer complexity of this activity makes the abuse hard to prove as bureaucrats make use of very subtle means to favour their business associates. For example, the introduction of new quotas and licenses may be done on official short notice, while those who are well-placed are informally notified in advance so that they have time to prepare all the cumbersome documentation. Or, new quality standards may be imposed overnight (ex. in the food trade) as a competing firm has a large quantity ready for import of export. The use of non-tariff instruments may not only be bad for the domestic business environment, creating uncertainty and uneven playing ground, but also detrimental for the whole society, since many such measures are often just national protection against competition for rent-seeking business groups (another example of state capture).

Considering that many companies in **BiH** need to obtain several export licenses annually, the licensing procedures could be a source of corruption, if they are not clear and transparent, and hence create obstacles for doing business. Yet, almost all respondents in a survey carried out

under a World Bank project (90% of firms that applied for export licenses and 93% of those who had experience with obtaining import licences) found the procedures clear and transparent. 60% of the surveyed firms got all the export licenses they applied for, and another 29% received almost all of them. Out of those firms that applied for import licenses, 69% received all import licenses they applied for, another 22% received most of them. Overall, the analysis shows the process of obtaining licenses being seen by the respondents as clear, transparent and efficient. The time spent by firms on obtaining licenses depends, among other things, on how many signatures are required for each license. According to respondents' experience, the number of required signatures is low – three on the average for either export or import licenses. However, a considerable number of enterprises reported paying bribes that equal, on the average, 2.6% of the export license value and 2.8 % of the import license value. 85% of the respondents who answered this question put the size of the bribes at 2% of the license value, suggesting that the amount of the needed bribes is fairly well known.

### 6.6. Corporate Governance

Against the background of the existing supply-demand interface within the corrupt relations, the need to strengthen corporate governance in the transition countries from South-east Europe appears to be another key area of reform efforts that should contribute to lower levels of corruption. The demand for kickbacks on behalf of representatives of the administration is determined in general by the nature of the relationship between government and private business, as well as by the state of public morality. Viewed from the supply side, the phenomenon is a function both of the existing interests and of the inner structure and rules of corporate decision-making. The experience clearly demonstrates that the principles of sound corporate governance and its practice in the leading companies over the world reduce considerably the opportunities for corruption. Therefore, the enhanced introduction of sound corporate governance practices across the region can have a strong anticorruption impact on the supply side and help the South-east European countries in casting off a corrupt reputation.

Corporate governance culture in **Albania** is at its initial stages of development. Although the private sector has been growing up dramatically during the last decade, its corporate mentality is far from being developed. Corporate governance is a very powerful tool for curbing corrupt behavior. The bribes offered to public officials by companies' managers would drastically fall, should better corporate governance practices be in place. Thus, improving corporate governance means reducing the opportunities for corruption practices. The current managers (who in the majority of cases happen to be the controlling shareholders) of the private sector have a large authority on the way the business is conducted. Establishing a healthy corporate culture and strengthening the legal framework with respect to publicly disclosed information should reduce the opportunity for the top management of a company to act in an abusive way and engage in bribery practices.

Given the negative past experience in **Croatia**, the necessity to promote efficient corporate governance has been clearly recognized. An important step was made in the autumn of 2000 with the establishment of the Corporate Governance Council within the Croatian Employers' Association. This consultative body seeks to engage in intensive dialogue to find answers for some burning issues of corporate governance in Croatia, and it is hoped that it will make itself heard in the preparation of the new legislation in that domain. On the other hand, on the level of the state, the policy-makers have at their disposal a series of measures that might improve the general corporate culture, as well as the governance and restructuring of companies. Such measures would include the removal of all obstacles to a greater participation of foreign investors in the domestic economy, as well as the adoption of the necessary legal amendments in order to make possible the sale of land and real estate to foreigners. Another key area of policy efforts relates to the effective judicial protection of ownership and contract rights, the strengthening of the legal mechanisms for owners' control over the management of the company and streamlining the procedures for exit from the market (winding up and bankruptcy). Particular attention should be given to the enhanced development of financial and capital markets that is very important for raising the standards of corporate governance and increasing financial transparency. At the same time the authorities have to abandon the practice of salvaging non-viable companies at the taxpayers' expense as the rescue operations are weakening the incentives for corporate restructuring and efficient governance.

Looking at the supply side of corruption, **Bulgaria** still lacks adequate regulation in the field, especially with regard to disclosure of conflict of interests, which creates strong potential for corrupt practices. In other words, the apparently tolerated non-compliance with the rules of

sound corporate governance leads also to tolerance of opportunities for corruption. Yet, thanks to the Corporate Governance Initiative and civil society in general, anticorruption efforts are directly related to the issue of legislating and practising sound corporate governance that undoubtedly is a novelty for central and east Europe. Multiple measures for solving the existing problems have been proposed, although they failed to attract sufficient attention on the part of legislators and regulators during 2001. The legal changes deemed necessary include restrictions on the simultaneous personal participation in several governing bodies, an explicit ban on the participation of state employees and representatives of the government in the boards of private companies, as well as clear rules for disclosure and avoidance of conflicts of interests. With the goal to establish high professional standards for the members of the governing bodies of joint stock companies in Bulgaria and to improve communication between investors and the management of the companies, a draft law on amending the *Law on Public Offering of Security* was prepared in 2001. It envisages important changes in the requirements for selection and in the functions of the members of managing and controlling bodies of publicly traded companies, specific requirements for disclosing conflicts of interests, as well as the introduction of the position of company director for investor relations. The preparation of a *Code of Best Practices*, which is supposed to be completed in the near future, is also expected to induce Bulgarian companies to voluntary comply with principles of sound corporate governance, induce discipline and discourage corruption.