

## **Informality in Bulgaria: what policies?**

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Everyone who has spent some years studying informality in countries such as Bulgaria ultimately comes to the conclusion that he is dealing with a series of sub-plots, and there is a bigger plot; and that, consequently, any policies addressed at formalizing economic activity should not remain at a sub-plot level, but also address the main plot.

*Informal work* is a sub-plot to informal economy.

*Informal economy* is a sub-plot to “grey” economy and corruption.

“Grey” economy and corruption are – as eg. the IMF has now realized – a sub-plot to “good governance”.

And, since everything you can imagine feeds into the problematic of *good governance*, that itself is a sub-plot to larger, truly systemic developmental issues.

Thanks to the Inregia-Regioplan report “Undeclared work in an enlarged Union”, we can now address this tangle in more promising ways.

Building on this Report, we are also able to get away from the over-detailed debates on measurement<sup>1</sup> and concentrate on the anatomy of the problem.

### ***The informal work sub-plot***

As far as we can see, there are two kinds of informal work as regards perceived legitimacy, therefore – the chances of change and therefore – the shape of possible policy.

1. There is the informal household-destined work, in which up to 40 per cent of all households engage nationally. This is pre-capitalist, pre-market subsistence production out of own plots of land and is seen as traditional legitimate and inoffensive. Not much can be done about this, given its perceived legitimacy. This pool of informality can slowly dry up as capitalist-market relations begin to digest pre-market forms of economic activities.

2. There is the undeclared provision of goods and services, and the unregistered or semi-registered hire of workforce that is part of

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<sup>1</sup> We at the CSP have, after three years’ work on informality, come down decisively in favour of the kind of direct measurements, including the in-depth interviews of typical professions in typical situations referred to on p.92 of the Report. Once we know the structure of informal situations, we can hope to produce policy responses, and that is to us more significant than arguments over the precise measurement of a phenomenon that by its very nature is at best semi-visible.

the division of labour and the market, but evades registration in order to decrease costs in terms of time, money and discomfort. People engaged in this kind of informality are fully aware that they are acting illegitimately, and that time and progress is against them.

Building on this lack of perceived legitimacy, institutionalized responses and policies are possible. Of course, the belief that time is against the rule-breakers needs to be encouraged, for it would be quite another matter were the informals to suddenly become convinced that the agents of order are incapable of imposing it.

### ***The grey economy sub-plot***

As far back as 2002<sup>2</sup> we at the CSP came to the conclusion that:

A/ The grey economy, while considerable in comparison with an average EU member, is a shrinking *remnant* of a once universal mentality and practice: of the conviction, which settled during the quasi-market activities of the 1980s, that unregistered and Hobbesian-type behaviour, including the pilfering of resources and patronage, is what capitalism is all about. By the end of the 1990s people had come to realize that this was not the case, and that the future would bring rules, registration and formalisation.

B/ We are dealing with a *three-headed* reality:

B.1. Household-informal economic activity for own consumption, mostly by-passing the market and money relations, or having marginal dealings with them.

B.2. Grey economy proper: the production and distribution of legal goods and services (including labour) in illegal, semi-legal or unrecorded ways.

B.3. Black (criminal) economy: the illegal production and distribution of illegal goods and services.

These are not air-tight compartments with no interchange between them. In particular, actors of the grey economy were found, by use of direct methods, to find no great difficulty in making occasional forays into the criminal economy. There is no fundamental difference between smuggling cigarettes and smuggling drug precursors.

In terms of policy, it was obvious that not much can or should be done about the informal household economy (B.1.); that a stick-and-carrot policy has chances of success in terms of pulling actors out of the “grey” and into the light of the formal and registered economy (B.2.); and that the criminal economy is a matter of law enforcement rather than economic or administrative policy (B.3.).

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<sup>2</sup> “The Gray Economy in Bulgaria: reasons, consequences, policies”. Sofia, CSP 2002

Such policies did appear. The “stick” came down in 1999, with the rigidly enforced implementation of fiscal receipts across the economy; and again in 2003 with the enforced registration of all work contracts, existing and new, with the authorities.

The “carrot” was promised in 1999 with the government pledge that the cost of doing business would be dramatically decreased with the simplification of legislation, the drastic limitation of registration and licensing regimes and the simplification of taxes and their significant reduction. This did not start happening until 2003-4, when the government declared: a course of tax reductions; the gradual end to investor privileges (eg. the application of encouragement rules to domestic as well as foreign investors); a dramatic decrease in licenses and a move to simple registration of businesses.

Only some taxation reductions have since been implemented.

Over 2003 Parliament voted a special piece of legislation aimed at creating a business-friendly environment and thereby encouraging the move from informality to formality: the Act for limiting administrative interference in economic activity. The Act addresses only municipal-level administrations and is, furthermore, not currently being implemented because of lack of administrative capacity.

In Bulgaria increasingly the opinion, shared by the CSP, is that the “grey economy” is to a very great extent a consequence of a “grey state” – i.e. of the refusal of the state to see itself as the neutral guarantor of rules equal for all, and the propensity of the state to see itself as a corporate interest with its own aims and goals. On balance, it is the grey state which puts pressure on businesses to stay “grey”, rather than businesses putting pressure on the state for it to become involved in under-the-table practices.

Therefore, most *policy thinking* has concentrated on institutional and administration-related responses to informality – i.e. on A/ legislation that sets up rules for formality and B/ on change of administrative practices and mechanisms that limits bureaucratic influence, discretion and face-to-face contacts with business actors.

Notwithstanding the pernicious influence of corruption (see below), companies are increasingly tempted to leave informality and become legitimate. Compared to 2003, today: more companies (14 per cent as opposed to 10 per cent) are convinced that there are no significant barriers to doing business; and 27 per cent (compared to 20 last year) believe that administrative barriers are not the main problem of doing legitimate business<sup>3</sup>.

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<sup>3</sup> “Regional Policy and Legislative Reform a Report “, Centre for Economic Development-Sofia, 2004.

This improved climate regarding informality is largely due to several factors, not all of them to do with government policy: A/ easier access to bank credit, following years of deficits in this area; B/ increasing operations on the international market, where informality is a burden; C/ stable macroeconomic environment, encouraging longer-term planning and legality; D/ the trend of gradual tax decreases; E/ enforcement of new standards of registration and accountancy and the appearance of a National Accounts Office since 2003; F/ continued government promises to decrease administrative barriers to doing business which, although only partially fulfilled, create a climate of expectations that legality is profitable.

### ***The corruption sub-plot***

Corruption is the bridge that links the grey and the black economy. Corruption is a sufficient explanation – sufficient cause – of the current government's notorious inability to limit the influence of organized economic-criminal interests.

Just as there is no cardinal difference, to the smuggler, between smuggling cigarettes and smuggling drug precursors, so to the corrupt official there is little difference whether he represents an industrial lobby or a criminal syndicate that mimics a lobby.

The widespread conviction that corruption is the rule rather than the exception discourages investment and expansion plans and slows down the trend of emergence from the informal to the formal arena of economic activity.

A cluster of studies<sup>4</sup> indicate that there may now be an important divergence between the problematic of corruption and the problematic of formality. Corruption seems to be concentrating in petty here-and-now bribery (traffic police, medical and teaching personnel) and in major deals and / or dealings with entities associated with organized crime. There seems to be a lessened impact of corruption, thus organized, on the motivation of economic actors to leave the arena of informality and become more formalized.

Rules are bearing fruit, albeit slowly; and businesses have increasing opportunities to avoid or minimize corrupt practices and stay legal and legitimate.

### ***The good governance sub-plot***

Over recent years the IMF has declared a strategy under which corruption and informal economy are a sub-plot to the larger agenda of

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<sup>4</sup> "Coalition 2000" – annual reports on corruption; "Centre for Economic Development" – quarterly and annual surveys of the business climate.

good governance, defined as “all aspects of the way a country is governed, including its economic policies and regulatory framework”.

Of course, once we say “all aspects” we enter the arena of the big master plot. This is where the Inregia-Regioplan report makes a considerable contribution by organizing the relevant factors into three groups: 1. socio-economic/market; 2. institutional and 3. societal, including cultures of everyday life and relations individual-society-state.

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For a policy to have sustainable results, *all of these sub-plots* have to be addressed (or – if not addressed, this should be a conscious and argued decision), as well as the *three major arenas* set out by Inregia-Regioplan.

We assume that, on the one hand, household-informal work is not to be addressed by policy, and that, on the other, the criminal economy is a matter of law enforcement rather than development policies – assumptions also made (but not clearly formulated) by the government.

In Bulgaria (and in suchlike countries) this means forming policy at the following levels:

### **1. Socio-economic.**

Here there is common consensus that informal work is encouraged by:

A/ High levels of taxation. A recent *I-Watch* report finds little overall impact of tax cuts since 2002 on the outcome. A person earning 500 EURO per month (a comfortable income) ultimately still pays out 55.5% for various taxes, excluding excise and various forms of compulsory insurance; and for a hired worker to take home 120 EURO the employer pays out 202 EURO.

This means that governments have to make more determined efforts to decrease the general impact of taxation – something that has been pledged for a number of years.

B/ Rigid labour market, underpinned by stringent legislation (Labour Code) and by continued government increase of the obligatory minimal wage – something which encourages informal payments for work.

C/ Continued existence of too many registrational and licensing regimes and the haphazard introduction of new such regimes as fast as existing ones are being removed by legislation.

D/ Over-regulation of the economy. The instinct of parliament and government is still to regulate the market because of the prevailing semi-conscious conviction that the market is a dangerous place if left to its own dynamics. The ground-breaking Act on administrative non-

interference is targeted only at the municipal level (whereas most obstacles to business are at central government level) and remains, furthermore, non-operational

Declared policy is to minimize the impact of these factors and thereby cut the cost of being legal. The process is slow and halting because of the impact of the factors set out below.

## ***2. Institutional***

This is where short-term policies can and do make an impact on undeclared work.

This has been the case with the obligatory registration, at the beginning of each year, of work contracts since January 2003 – something which has brought to light, according to critical independent analysts, 180,000 work contracts over the past 15 months (on the base of 3.2 million total workforce, of which 2.8 million actually employed).

Other effective institutional policies have been:

- the obligatory use of fiscal receipts for all transactions since 1998
- the stage-by-stage lowering of the threshold of VAT registration
- loosening up of stringent central bank controls over bank credit (a trend that is about to be overturned for 2005 by a re-tightening of controls), leading to stimuli for legality
- the introduction of international accounting standards since 2003
- the appearance of a National Accounts Office since 2003
- the computerization of the tax system and training of tax officials.

When the cumulative impact of such measures outweighs the profits to be made out of staying informal and bribing officials, economic actors are motivated to become formalized.

Such results, positive as they are in themselves, are not however sustainable unless policies tackle the next and most difficult arena:

## ***3. Societal, including cultures of everyday life and relations individual-society-state***

This is where we clearly come to understand that the issue of informal work (and other informality) is not to be resolved by economic policies alone, because the problem is not of the economy alone.

A political-policy package is necessary.

Policy-making in this sense must inevitably address the following major areas in order to make sustainable any measures to limit informality under the above headings.

3.1. There are policies suitable for strong states and other policies suitable for weak states.

*Strong states* (i.e. those seen as efficient, legitimate, impartial, useful and just) are able to impose policies of “the stick” because the public would be motivated to obey, seeing the state as impartial and fair.

*Weak states* (seen as not very useful, self-serving and not impartial) should not attempt such measures but rather concentrate on policies of “the carrot”: encourage formalization by removing obstacles and creating incentives.

The usual mistake (made in Bulgaria for example) by weak states is to over-compensate for their lack of legitimacy and support by trying to be overbearing and heavy-handed – and inevitably concentrating on the “stick” rather than the “carrot”. And just as inevitably not arriving at the desired results.

Which means that, while other policies can and should be implemented, a reform of administrative cultures and practices is of fundamental significance. And it is here that weak states perform badly: they not only find it difficult to understand the sense of such reform, but actively oppose it, feeling (quite correctly) that it takes away their discretionary powers. An evaluation of the degree of success of administrative reform in any CEE country would immediately tell you what kind of state are you dealing with – and what policies it can or cannot take.

In fact, it should not be very difficult for the EC to produce a matrix of states in terms of their strength / weakness and thereafter base policy on this distinction. Eg. what will work for Slovenia (strong and legitimate state) will not work for Macedonia (weak state).

### 3.2. There are policies suitable for modernized societies and other policies suitable for weakly-modernised societies.

*Pre-modern societies* are those, where the individual relies on the unwritten codes of conduct and the informal solidarity of the group; and the individual is seen as less important than the group or other large entities (the state).

*Modern societies* are those, in which the individual relies on written rules upheld by formal institutions; and the individual is seen as more important than institutions.

Pre-modern societies are *informal*. Modern societies are *formal*.

Therefore, for policies limiting informality to be sustainable, they need to be underpinned by larger policies of modernization in countries, such as Bulgaria, where modernization was partial and incomplete before the arrival of the communist regime.

This requires a sustained effort based on: a/ education of the *public* at large to change the dominant assumptions that see informality as the rule; b/ *re-training* of key players in the modern values of formality and institutional behaviour; c/ completing a wide-ranging *reform of the*

*education* system aimed at encouraging modern attitudes and behaviour patterns.

While in Bulgaria a/ is happening on an on-off basis, b/ and c/ are not taking place. This is the reason why the World Bank has discontinued the funding of both the administrative reform and of education reform.

A concerted national and international effort, therefore, is needed in countries such as Bulgaria to ensure that administrative and education reforms take place. The fact that there are no acquis in the field of education is an unfortunate problem, but not an insuperable one.

Without such effort countries such as Bulgaria will continue to lean in favour of informality, including – informal work.

3.3. There are policies suitable for zero-sum mentalities and other policies suitable for win-win mentalities.

Weakly modernized societies are zero-sum societies: if someone has a lot of something, then he has unjustly taken it from other people.

Usually this has been interpreted as “egalitarian mentalities”, which is true: such societies see “the rich” as the bad guys and therefore affluence is not a strong life-motive.

There is another outcome also: such societies assume that the government is self-serving and not impartial. Therefore: a/ people expect officials to be corrupt (and corrupt official behaviour underpins this belief) and b/ people believe that business success depends on patronage from government, rather than on competitiveness in the marketplace.

Such societies do not believe words but daily behaviour patterns – and therefore action on behaviour, rather than education and propaganda, is the level at which policy should be pitched.

For policies against informality to work, therefore, you need additional stamina in the fight against corruption, and also – to (again) re-structure and re-train administration at all levels. In this way you can demonstrate through daily institutional behaviour that the zero-sum mentality is not the road to success.

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Systemic change can be attained by such integrated policy approaches. Without them, short-term and at best incremental progress is possible.