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# Is Unofficial Economy a Source of Corruption?

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## IS UNOFFICIAL ECONOMY A SOURCE OF CORRUPTION?

### Abstract

This paper discusses the link between unofficial economy and overall economic efficiency. Special emphasis is put on tax evasion and corruption and their interaction with unofficial economy.

The role of the state in the genesis of unofficial economy and corruption is addressed in the first part. The second part gives insight into the multitude and ambiguity of definitions used to describe the unofficial economy and the impact of the particular definition chosen on the final conclusions. Although we opt for the ‘classical’ definition of unofficial economy as unrecorded economic activity, we maintain that, according to this definition, unofficial economy in transition countries does not have an adverse effect on economic efficiency and growth.

It is also important to make a clear distinction between unofficial economy and tax evasion, as well as between unofficial economy and corruption. Arguments are provided in support of the view that such activities are linked more closely with official than unofficial economy, as the former uses them as a mechanism for protection against competition. Unlike unofficial economy, these irregular activities pose a more serious threat to general welfare, economic efficiency and growth. We conclude that both unofficial economy and irregular activities are caused by a high degree of politicisation, the reduction of which would have a positive impact on the reduction of both.

In the final part, the measures which could help preventing irregular activities are addressed. The stated anti-corruption strategy would not completely eliminate unofficial economy, but would disable activities impairing economic efficiency and growth.

**JEL** O17, H26, K42

**Key Words:** Official economy; Unofficial economy; Corruption; Tax Evasion;

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# IS UNOFFICIAL ECONOMY A SOURCE OF CORRUPTION?<sup>1</sup>

## 1. Introduction<sup>2</sup>

During the course of the historically unprecedented transition, opinions differed concerning the appropriate pace of the transition process. However, in the course of the process it appeared that the role of the state was not being reduced to the extent necessary and that private entrepreneurship seemed to be developing much slower than expected. Empirical research indicated that in the early years of transition, a significant growth of the private sector took place that remained unrecorded in administrative statistics. This can partially be explained by the inertia of statistical services, which for ideological as well as practical reasons did not use statistically adequate procedures to follow activities of private entrepreneurs in centrally-planned economies. More importantly, entrepreneurs decided to enter a sector outside the scope of their states' legal protection. This paper concentrates on the reasons that have led entrepreneurs to move into the unofficial economy and on the economic implications of the expansion of the unofficial economy.

Increased profit, resulting from tax evasion and rules and regulations violation but also from a disregard for the influence of politicians' arbitrary decisions on profitability, was certainly a motivation for entrepreneurial decisions to participate in the unofficial rather than official sector. The expected costs of acting in the unofficial economy include the direct costs of fines that result from being caught as well as the opportunity costs arising from impossibility of conducting certain activities from the "shadows." Obviously, the state has political measures to affect the level of business costs in unofficial economy.

Since unofficial activities represent a form of non-compliance with state regulations, (Feige, 1999) they may actually improve efficiency when the regulations violated represent "bad rules" or rules that reduce overall welfare.

This paper presents the view that the best way to reduce unofficial activities in transition countries would be to optimise taxation and regulation levels and reduce the level of politicisation in the economy thereby preventing politicians from affecting entrepreneurs' profitability by way of arbitrary decisions. Costs of doing business in

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1 This paper was presented at "Tax Administration: Institution Building in Transition – Tax Evasion, Compliance Costs and Taxpayer's Rights", Conference organized by the Zagreb Institute of Public Finance, June 3-5, 1999. The Croatian version was published in journal *Financijska praksa* 23 (4-5) 1999, the English translation in *Institute of Public Finance Occasional Paper Series*, No. 9, 1999.

2 We would like to thank Edgar L. Feige for his very helpful comments and suggestions. The authors are responsible for any remaining errors and omissions.

the official economy may often include amounts that must be paid for bribery - without the adequate provision of public goods, especially law and order.

## 2. Unofficial Economy – Different Views of Different Concepts?

The interest of scientists and a great number of papers produced both in Croatia and abroad on the role of unofficial economy and its effect on the overall economy have not brought about a consensus on the definition of unofficial economy. Different definitions of unofficial economy attempt to highlight its different aspects.

In literature on Western countries the most exploited concept of unofficial economy is *unreported* economy which accounts for activities evading tax regulations. On the other hand, *unrecorded* economic activities, or those activities that escape inclusion in the national accounts, served mostly as an ‘academic’ subject and sometimes were used as a proxy for calculating unreported income. There are also other activities that deserve to be included in the general category of unofficial economy, but fall short of these two concepts. For example, a deal between the state and a favoured entrepreneur which also includes a hefty reward in return for the favoured treatment will be included in the national statistics and therefore will not be considered as part of unrecorded activities. In contrast, activities such as selling own home-grown vegetables on the market are not outside the law. Nevertheless, according to this definition these activities may represent a significant part of unrecorded activities.

Authors aiming at a different focus of analysis will try to overcome this shortcoming with another definition of unofficial economy. A possible approach is also that which labels unofficial economy as all activities not included in the “system of ownership rights guaranteed by the state and system of regulations and obligations which give the economic process and economic activities a legally acceptable and politically legitimate form.” (Franičević, 1997a). This concept, also known as the informal economy, is the most frequently used in literature concentrating on the developing economies, but shows a great potential for research on transition economies too (Feige, 1990). This definition encompasses all types of activities that are outside the law, but omits rent-seeking redistributive coalitions between politicians, bureaucracy, and interest groups<sup>3</sup>. To broaden the definition to include these activities implemented in institutional structures creates two problems: 1) it enters the area of ethical norms which is characterised by large differences in opinions and is too abstract for applied analysis; and 2) only a small section of economy would remain outside the unofficial economy. Thus, we prefer to limit our analysis to a consideration of unrecorded activi-

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3 For economists who exclude from their micro-analyses the theory of public choice, the fact that one country can introduce import taxes remains a mystery. However, from the point of view of collective action the introduction of import taxes is much clearer if we consider that they benefit only a relatively small group of producers, while their costs are distributed over a large number of consumers. Even if consumers were informed of the costs imposed by import taxes, low import tax cost for an individual consumer would hinder organising opposition (Olson, 1982).

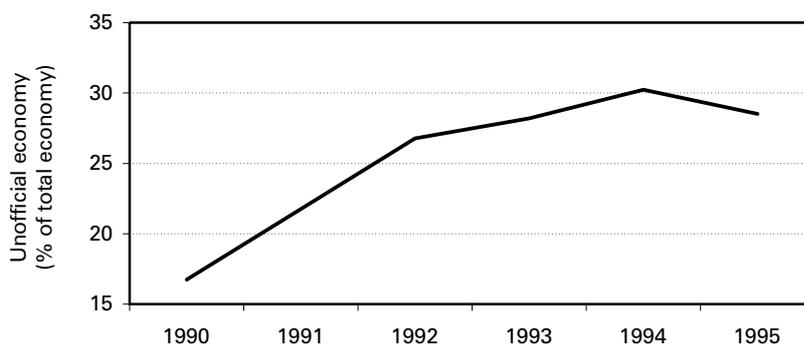
ties. When the focus is on fiscal issues, consideration of unreported activities becomes germane.

One of the indirect methods used for measuring tax evasion is to use the assessed size of the unreported activity and multiply it by an average tax rate to arrive at the “tax gap”. (Tanzi, 1993) This method may be misleading since tax evasion need not necessarily be connected to the activities of the unrecorded economy. Unreported income arises from not reporting or misreporting income, profits, sales or overreporting deduction items on tax returns. Such tax evasion does not necessarily imply that economic activities will be excluded from the national income accounts if the accounting methods are independent of tax based information source. It is even possible to imagine a case of a country with no unrecorded economy, yet with a very high level of tax evasion, and hence, a large unreported economy.

The major motivation for engaging in economic activities that entrepreneurs attempt to conceal from the state reporting apparatus are regulations and taxes, the former often being the predominant cause. On the one hand, regulations create expenses to companies while on the other hand, they do not create revenues which a state could use for financing certain public goods (e.g. ownership rights protection) of benefit to companies participating in the official economy (Johnson, Kaufmann and Schleifer, 1997).

Studies on the unofficial economy conducted in the countries with developed economies have presented this sector in an unfavourable light, especially because of this sector’s negative influence on economic efficiency and growth (Kesner-Škreb, 1997). Apart from its positive shock-absorbing role in cases of social disturbances, the view generally held is that the unofficial economy reduces budget revenue and the quality of public goods, distorts macroeconomic indicators and distorts the allocation of productive resources. The implicit assumption behind this line of reasoning is that the demand for public goods is best met by the state from taxes collected and that marginal cost of public regulation equals the regulation’s marginal public benefit. However, the situation in transition countries is far from this idealised image of a benevolent state. Moreover, this view does not take into account the role of unofficial economy in transition countries before the introduction of economic and political reforms. “In an economy which is characterised by dominant state ownership, vast private sector restrictions, high taxation of legitimate personal incomes, almost universal price control and physical allocation and rationing of goods, numerous forbidden consumer goods, inefficient and slow formal production and distribution, chronic surplus of currency in circulation, all-level government corruption and important role of personal connections, horizontal and vertical social networks, unofficial economy becomes more than what is marginally official.” (Franičević, 1997b)

All arguments speak in favour of the fact that the unofficial economy played a role in promoting economic efficacy in countries where state-imposed distortion mechanisms were at work before transition process started. Obviously there is a difference between the role the unofficial economy played in the centrally planned economies and the role it plays in the countries with developed market economies. This change in the importance of unofficial economy should be achieved by enabling entrepreneurs

**Figure 1:** Share of unofficial economy in transition economies

**Sources:** Authors' calculations based on Johnson, Kaufmann and Schleifer (1997), and for Croatia Ott (1997)

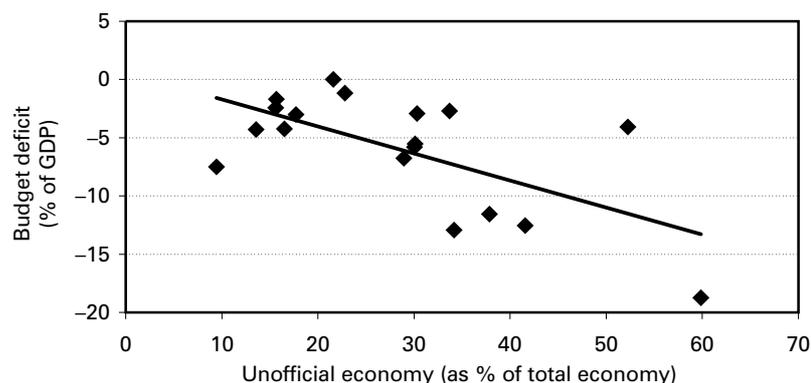
to move into the official economy sector by means of new regulation and system of taxation.

However, the mechanism at work in the transition countries proved to be completely different from what this theoretical model of the unofficial economy in transition would suggest. Figure 1 shows the evolution of unofficial economy in transition countries in the first half of the '90's. It presents an unweighted arithmetic mean of share indicators of the unofficial economy in 17 transition countries<sup>4</sup> as assessed by the methodology of electric energy consumption by Johnson, Kaufmann and Schleifer. This estimation method is not fully reliable and has its drawbacks. Besides, other methods have to be employed for the unofficial economy evaluation in the starting year. However, in the absence of better quality data obtained by means of a single methodology covering a longer period of time and a greater number of countries we have to rely on this source. As shown in figure 1, a strong growth of unofficial economy is evident after the beginning of the transition process.

This trend should not be interpreted entirely as the result of more intense regulation by the state and higher taxation levels, but rather as a result of reduced political pressure. By political pressure we mean mobilisation of resources by the political elite in order to repress the unofficial economy because of its supposed obtrusive effects for society and presumed effects for the regime, like undermining the social fabric and eroding political legitimacy (Feige, 1999). It is a known fact that political pressure is one of the "more efficient" ways of fighting unofficial economy. The question remains if it is wise to eliminate unofficial economy in this way since the full implications of such methods are not entirely known. In countries with rigid regulations and poor allocation of resources in the public sector (or inefficient provision of public goods) a reduction in unofficial economy would have negative effects on welfare and efficiency.

The rise in transition countries' unofficial economies should not, however, be attributed exclusively to reduced political pressure. The indications are that these states' governments have not done much to keep entrepreneurs away from unofficial

<sup>4</sup> Countries referred to include Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Latvia, Lithuania, Moldova, Russia, Ukraine and Uzbekistan.

**Figure 2:** Share of unofficial economy and budget deficit

Sources: Johnson, Kaufmann and Schleifer (1997) and WIIW (1998), for Croatia Ott (1997) and WIIW (1998)

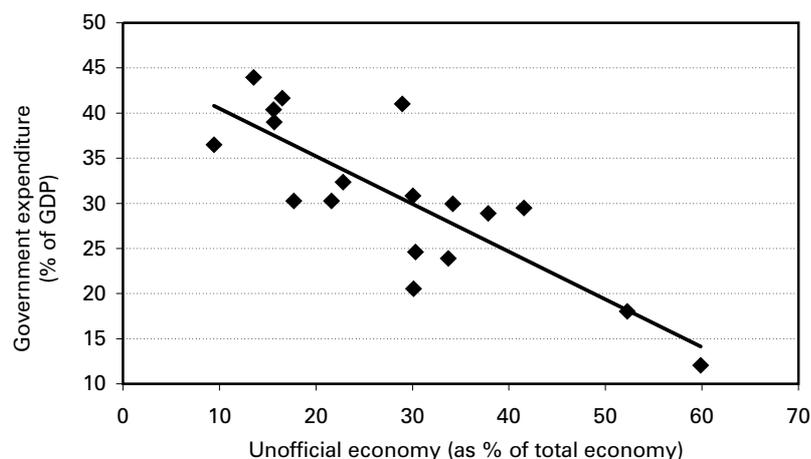
economy. Transition countries are still faced with largely politicised economies with high payoffs from rent seeking activities. This results from the absence of the basic institutional rules such as clear property and ownership rights, which represent the basic public good in any given country.

The unofficial economy can benefit consumers in several ways. It can create competitive pressures in markets that are characterised by lack of competition. This is especially important in view of the fact that politicians in transition countries have significant control over entrepreneurs' decisions for entering any specific sector. If unofficial economy participants are concentrated in a smaller number of sectors, their competition will result in lower product prices to consumers' benefit (Kesselman, 1995). The unofficial economy may also offer its products at prices lower than those offered by the official economy in the case of non-homogeneity between its products and informed consumers who are willing to pay a lower price for lower quality or lack of product's warranty.

Another way in which unofficial economy can reduce the level of politicised economy is its interaction with tax evasion. Even though tax evasion is not the primary cause of unofficial economy, participants in the unofficial economy generally do not pay taxes in order to conceal their business activities. The greater the share of unofficial economy in total economy, the greater the potential tax revenue loss will be. Loss of tax revenue can trigger several reactions – increased taxes, higher borrowing or expenditures' cuts. Borrowing can be perceived as higher tax rates in the future or lower future expenditures or as a combination of the two. Figure 2 shows the relationship

**Table 1:** Results of regression of budget deficit and budget expenditure to the size of unofficial economy

| Independent variable             | Constant             | Unofficial economy | R <sup>2</sup> | F      |
|----------------------------------|----------------------|--------------------|----------------|--------|
| Equation 1<br>Budget deficit     | 0.608904<br>(0.276)  | -0.232<br>(-3.303) | 0.405          | 10.907 |
| Equation 2<br>Budget Expenditure | 45.78453<br>(15.807) | -0.528<br>(-5.718) | 0.671          | 30.761 |

**Figure 3:** Share of unofficial economy and government spending

**Sources:** Johnson, Kaufmann and Schleifer (1997) and WIIW (1998), for Croatia Ott (1997) and WIIW (1998)

between the share of unofficial economy in the total economy and budget deficit, calculated as averages for the period from 1992-1995 (equation 1). It is evident that, though not strong, there exists a negative relation between the two.

Figure 3 shows the relationship between the average share of the unofficial economy in the total economy and the average share of budget expenditures in total GDP in the same period (equation 2), adjusted for the size of the unofficial economy to capture its effect on expenditures. Coefficients of determination<sup>5</sup> point to the fact that this relationship is more significant than the previous one and the equation parameters prove it to be stronger too. It is obvious that in the transition countries an increase in the unofficial economy results in reduced government spending rather than in greater borrowing. One of the factors contributing to the regression weakening lies in the difference between tax evasion and unofficial economy because ways to evade taxes may differ from country to country. The effect of lower government expenditure share in GDP on overall efficiency is difficult to discuss without a detailed analysis of government apparatus efficacy and optimal expenditure level. However, as indicated in a previous paper, the level of government spending in the transition countries was found to be too high with regard to these countries' level of development (Faulend and Šošić, 1999). This analysis also suggests that the inclusion of unofficial economy into official economy and a reduction of tax gap<sup>6</sup> would cause an increase in government expenditures rather than a decrease in the taxation levels. An alternative view argues that the institutional factors that give rise to an unofficial economy also affect tax eva-

5 The available data on 18 transition countries do not provide sufficient information to enable unreserved acceptance of these conclusions.

6 Regardless of the discussed differences between unofficial economy and tax evasion, we believe that reduced unofficial economy would lead to reduced tax evasion. The decision to engage in activities within unofficial economy, whether prompted by tax evasion or some other reason, always implies some kind of tax evasion which enables entrepreneurs to conceal their businesses from the state, while the decision to operate in the official economy may (although it does not have to) lead to paying taxes.

sion, which is independent of the unofficial economy. Institutional changes would at the same time decrease both tax evasion and the unofficial economy. Regardless of which explanation may be true, it is clear that transition countries tend to spend as much as possible, rather than to adjust their spending to some outside parameter which would consider the level of optimal spending.

The most frequent arguments in favour of relative efficiency of official economy compared to unofficial economy are its access to public goods that include the already mentioned protection of ownership rights and access to judicial system. Entrepreneurs operating in unofficial economy cannot use these facilities. If these basic preconditions for efficient functioning of the official economy are not met, or if there reigns legal insecurity and judiciary inefficiency, the comparative advantages of official over unofficial activities are lost together with the overall high efficiency of the whole sector of official economy. If they cannot exercise their rights by institutional means, the participants in the official economy may, in an effort to overcome such a shortcoming, turn to the political elite for connections. This may result in numerous side-effects which are discussed in the following chapter.

Privatisation is an issue with a serious possible impact on the relative efficiency of the official economy. Recent findings on comparisons between performances of companies with different backgrounds show “*de novo*” companies to be the greatest employment and growth generators while companies, which emerged before the transition, were mostly found to be laying off workers and reducing production. (Bojniec and Konings, 1998). While the major part of official economy in transition countries has undergone or still has to undergo privatisation, companies in the unofficial economy sector are not state owned. This fact actually stresses the significance of unofficial economy as an “entrepreneurs’ nursery garden” which is especially important for the transition countries which did not use to promote entrepreneurship.

When discussing the dynamic aspect of unofficial and official economy efficiency, it is useful to observe them with regard to the issue of restructuring. The change in ownership structure in itself is just a nominal change of no benefit to the economy. Privatisation should actually serve as an introduction to the restructuring process. The increased allocation efficiency that should accompany stabilisation, privatisation and restructuring processes cannot be separated from legal security and the system’s transparency in contrast with politicised economy. Therefore, economic growth, as the final test and final evaluation of all the efforts exerted by transition countries in building their markets, will depend on the success they achieve in limiting the extent of politicisation of their economies.

### **3. Corruption and Institutional Factors**

When official and unofficial sectors are discussed in general, the official sector has a positive connotation and the unofficial negative one, since this is the sector where bribery and corruption are predominant. The authors of this paper do not intend to contest the established belief, but to encourage further discussion on the interaction between official and unofficial sectors, the state and corruption. One intriguing assertion

suggests that corruption predominantly takes place in the official sector and that corruption in the official economy accounts for the rise and development of the unofficial sector.

Corruption is a phenomenon not related only to the transition and other less developed countries. It is a phenomenon dependent on human behaviour and as such appears in all the countries irrespective of the level of their economic and political development. Nevertheless, the incentives for corruption occur more frequently in the less developed countries<sup>7</sup>. The reason for a more frequent corruption present in less developed countries can be in the abundance of elements that stimulate corruption, and that are more pronounced in less developed countries. Both direct and indirect elements stimulate corruption (Tanzi, 1998). Direct elements include regulations and authorisations, taxation, making decisions on government expenditure, various discretionary decisions, and financing of political parties. Indirect factors are related to direct ones, encompassing: bureaucracy quality, level of public sector wages, penalty system, institutional controls, transparency of rules and laws, and examples by the leadership. Less developed countries are generally more regulated, since governments are unable to stimulate individual industries by financial means because of the lack of funds. In such conditions, regulations sometimes present the only way by which a state can stimulate individual sectors and industries. Small companies in these countries transfer to the unofficial economy because of the disloyal competition (regulations and authorisations) and relatively high tax burden in the official sector. A shrinking official sector additionally reduces the tax base, which adds pressure for further increases in taxes. Decision making on government expenditure is mainly discretionary. In that way, particular economic units from the official sector are favoured, which additionally strengthens their monopolistic position. Accordingly, these economic units often support the ruling party. Bureaucracy quality, in terms of public servants quality, greatly depends on the amount of salary within the public sector and allocation of human resources. Employees often hold inappropriate positions, which has an adverse effect on the efficacy of public service. Additionally, more educated and qualified staff leaves the public sector due to better financial conditions offered by the private sector. Inadequate penalty systems, as well as inadequate institutional controls, enable malpractice of public servants mainly in terms of discretionary decisions. The absence of transparent rules and laws additionally induces public servants to make discretionary decisions and misuse their authority. Finally, the example of state governing indicated by Tanzi, together with the example of all leaders of individual public institutions, significantly contributes to adequate conduct of the staff in lower positions.

Naturally, the question arises why all these elements are more pronounced in transition countries. Although economic reasons can certainly account for many things, transition does not only involve economic transformation, but also implies political transformation<sup>8</sup>. Conduct of politicians in transition countries has not signifi-

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7 This is supported by the corruption perception index list for several countries published by Transparency International every year.

8 Most of the transition countries have made a greater progress in the area of economy (EBRD Report 1998).

cantly changed when compared to the previous behaviour of politicians in centrally-planned economies. Politicians frequently use their positions to pursue their own interests. Accordingly, they castigate entrepreneurs from the opposing parties, and support those from the “friendly” parties (Johnson, Kaufman, Shleifer, 1997). They also abuse their power and become rich by offering exemption from various levies in exchange for a bribe.

The above-mentioned forms of behaviour that, apart from bribery, include extortion, blackmail and nepotism are classical examples of corruption. Corruption must have sociological roots as well (Faulend, 1998). However, corruption is generally considered to be an inevitable characteristic of particular social, economic, and political transformations in situations of weak institutional frameworks, limited competition, and vague distinctions between public and private activities. Weakness of institutional framework present in the transition countries could be the main reason for more pronounced direct and indirect elements stimulating corruption. Politicisation of economic processes, presenting at the same time the cause and consequence of institutional framework and the source of corruption-related activities, must not be disregarded.

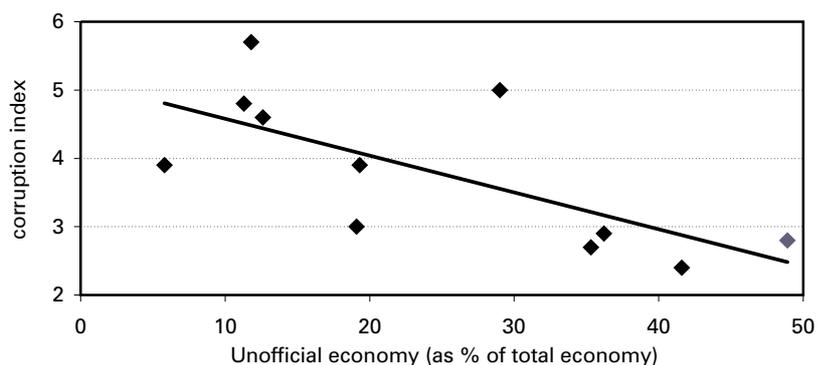
It is not surprising that corruption is most frequently related to the public sector, which accounts for a demand for corruption. The supply side of the market for corruption is made up of individual economic units from the official sector, who offer bribes to public servants in order to be allowed to transact certain business, authorisations, etc. They directly weaken their competition by undertaking such activities. These interest groups generally arise in pre-election periods when individual economic entities finance political campaigns of certain politicians, with an aim to be returned a business favour when these politicians come to power. The connection established between politicians and businessmen is an obvious example of politicisation that has an adverse effect on market competition. Politicisation of economic processes will increase under conditions of insufficiently developed institutional framework, which will create preconditions for corruption to enter all aspects of economic and political life. The final result could be a systemic, or endemic corruption that forms an integral part of the system. In a country where corruption has developed a systemic character, the interaction between politics and segments of official sector is so strong that it puts an enormous pressure on the remaining segment of the official sector. Under such conditions, it is natural for some entrepreneurs from the official sector that are not favoured to move to the unofficial sector. The above-mentioned facts support the initial assertion that corruption in the official economy accounts for the development of unofficial economy. In these circumstances, the unofficial sector is not a cause, but a consequence of corruption and politicisation of economic processes in general.

Empirical research, conducted with an aim of establishing the connection between corruption and unofficial sector, is rather limited due to insufficient data. The research was thus carried out only for some transition countries<sup>9</sup>. Corruption level indica-

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9 It should be stressed that these are not selected transition countries, but the countries for which both information (corruption index and unofficial sector size) were available. Countries included in the research were the following: Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Belarus, Estonia, Latvia and Russia.

**Figure 4:** Relationship between unofficial sector and corruption index



**Sources:** Johnson, Kaufmann and Schleifer (1997) and Transparency International (1998)

tors were adopted from the international organisation, Transparency International, and data from the previous chapter were used as indicators of unofficial sector size. The data from the above stated sources should be treated with considerable reserve, since these are the data on phenomena that cannot be quantified. Tanzi stated on one occasion: “If corruption could be calculated, it could be eliminated as well”. The same analogy can be applied to the unofficial sector. In that respect, it should be kept in mind that data, as well as the analysis results, are indicative. Figure 4 shows the relationship between the corruption level and size of unofficial sector for some transition countries. It should be noted that corruption level can range from 0 to 10, where 0 presents maximally corrupted environment and 10 indicates a complete lack of corruption. Therefore, it could be observed that there is a positive relationship between corruption level and unofficial sector, since greater corruption (lower numerical values) corresponds to a greater share of unofficial sector. The empirical data support the assertion that a higher level of corruption, which is a consequence of increased politicisation of economic processes, expands the unofficial sector.

Politicisation of economic processes arising from the relationship between political and economic circles definitively presents the main source of corruption in transition countries. Prevention the further development of corruption and elimination of the existing corruption are unavoidable tasks assigned to the institutional framework of transition countries. The main aim of the systematic anti-corruptive strategy implementation is a distinction between the area of private and public activities, which presents the basis for severing connections between individual economic and political circles. It is a historic fact that institution-strengthening process is parallel with democratisation of society. A political consensus in parliament is thus a precondition for implementing any anti-corruption strategy. If there were an adequate institutional framework in transition countries that would prevent, by eliminating corruption, the interaction between a segment of the official sector and state, the official sector regulation could be reduced. Reduced regulation would limit the discretionary power of public servants and enable greater competition. A decreased level of politicisation would have a positive impact on the quality of public goods supplied and permit a decrease in the tax burden. This would in turn influence economic units, previously forced to

work in the unofficial sector, to transfer to the official sector. In short, the result would be increased competition, better resource allocation, improved efficiency and welfare.

#### 4. Politicisation of the Croatian Economy

The problem related to the study of sources of unofficial economy come to light when we review specific instances of political involvement in economic activities. Faced with a dilemma whether to give an arbitrary evaluation of the situation or provide rare, anecdotal, evidence, we have opted for a compromise with which we hope to maintain the needed level of abstraction and at the same time makes use of the available data. To illustrate some of the aforementioned issues, we shall focus here only on the recent activities of the state in Croatia in four areas: in privatisation, in generating arrears, in its relation with commercial banks and the central bank. Each of these issues is studied separately in this paper. However, as we show, their mutual interaction is also relevant because it has proved to be a fertile ground for political intervention in the Croatian economy.

Privatisation processes in transition economies gave opportunity for the consolidation of transition countries' governments. Privatisation has enabled politicians to reward political loyalty with special access to state property. In Croatia, privatisation was done through sales on a case-by-case basis and privatisation decisions were centralised by the state administration. Croatian legislation had important shortcomings that allowed privatisation outcomes to be affected by political clientism, granting of credits by state banks without corresponding collateral, "privatisation" of companies' profits by incumbent managers at the expense of other shareholders, and use of company cash-flow to pay for shares and other criminal activities (Čučković, 1997).

In Croatia, the ownership transformation of 2650 companies<sup>10</sup> (Privatizacija, 1998). has resulted in 908 legal proceedings in competent courts initiated against the CPF<sup>11</sup>. This reveals more about the general feeling of people involved in privatisation who think that their due rights were not accorded than what it reveals about the real level of irregularities (Banka, 1999). Also the fact that 9 company ownership transformations were annulled, and 94 were partially annulled does not indicate a low level of irregularities. Annulment of ownership registration is possible only within three years following share registration in the share register. Therefore, it seems likely that ownership of privatised companies' shares will consolidate regardless of the manner of their acquisition. A large number of companies were bought on an instalment plan, which did not, however, affect their new owners' right to immediate management. A little more than a year ago an intensive trend was observed in connection with some of these companies. Unable to fulfil their obligations towards the CPF they began being returned to state ownership. Their adverse financial positions could be explained by

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10 Ownership transformation differs from privatisation. There are companies which have undergone transformation and are under majority or minority ownership of Croatian Privatisation Fund or Pension Fund.

11 Croatian Privatisation Fund.

the fact that a significant part of their resources went “private”. These failures adversely effected the state, tax payers, creditors and the banks which extended loans to these companies.

The role of the state in the genesis of the arrears issue in Croatia is not completely clear. The fact that someone is a net creditor is a poor excuse not accepted by the state for non-payment of debts and should not be used by it either. The state’s failure to meet its payment obligations can be seen in the 2008 cases registered at the Zagreb Municipal Court between 1990 and 30<sup>th</sup> October 1998 with the state as debtor (Poslovni svijet, November 25, 1998). This accounts for less than 5 percent of foreclosure cases in that court. The figure would be increased if dismissed suits filed by companies against the state were also taken into account. There are also cases when companies do not even invoice state ministries for services rendered or goods supplied unless they get a tip these will be paid. In this way, they knowingly break the law by not paying the VAT on the uninvoiced amount, regardless of the fact that the state is a debtor who is late with payment. This is also confirmed by the Agency for domestic payments findings on the discrepancy between the entrepreneurs’ total income and expenses and movements in prices and the real sector of economy. This discrepancy could be logically explained by the aforementioned change in the entrepreneurs’ accounting policy (ZAP, 1999). An additional feature that discourages companies from seeking settlement of their claims in court is the fact that the Agency for domestic payments tends to refuse to execute courts’ foreclosure orders (Poslovni svijet, December 25, 1998). Once such practices are established, ministries gain more power to make discretionary decisions as to who gets paid first. This could induce some officials to offer their “help” if adequately compensated for their service (Banka, November 1998).

Given the fact that the state is also a large creditor, a similar atmosphere of preferences can be created with regard to its claims. If certain companies are excused from settling their obligations towards the state, it is hard to expect strict adherence to rules from other companies. The state’s contribution to the problem of arrears in Croatia may not be so large with regard to its amount, but it has certainly had a very important “demonstration effect”. If the state is late with its payments and does not pay default interest on them, why should anybody else do so? In view of all this, it is not surprising that the State Treasury project<sup>12</sup>, initiated in 1993 is still (mid 1999) inoperative<sup>13</sup> (Poslovni svijet, April 21, 1999). Viewed together, the issues of default of payment and the slow implementation of the State Treasury project clearly indicate there are interests opposed to any centralised management of state expenditures.

Independent and effective judiciary would certainly diminish the negative role of politicisation (in the sense of influencing economic efficiency) that was established in the privatisation process and genesis of arrears. When only one of these conditions is impaired, a fertile ground arises for the development of politicisation with all the accompanying phenomena. As Franičević (1997a) states: “In the situation of the lack of public democratic control, when the judiciary independence is questionable and inef-

12 The project of building a State Treasury includes the creation of an information system that integrates all state entities (ministries, agencies, extra-budgetary funds...). This would allow overall control of expenditures. Also, possible misuses or irregularities would be minimized.

13 State Treasury was planned to go into operation at the end of 1996.

fectiveness monumental, this market (*unofficial asset market in the privatisation process – author’s remark*) can be expected to flourish.” Judiciary ineffectiveness can be illustrated by a large number of unresolved court cases, which is the reason why companies unwillingly take legal actions in order to resolve their legal disputes. Furthermore, huge court fees limit the access to the legal system for small companies and individuals, which suggests that the “small” entrepreneurs are not adequately protected. Due to unreasonable fees and extensive duration of court proceedings the price of justice is in many cases much higher than the benefit that the companies seeking justice can expect. The independence of judiciary is also questionable in view of the fact that some cases “jump the queue”, whereas other cases are stuck for a long time at the various court levels. It is not easy to win the case against the state, and to execute the court order seems almost impossible, even when the state evidently defaults on its obligations. The discrepancy between the market rights of entrepreneurs and the state is contained within the institutional framework, which does not leave much space to the legal system to intervene. Whereas the state collects its claims by automatism, entrepreneurs have difficulties in collecting their claims, which was already referred to. Granting of independence to the judiciary would provide the legal system with all the functions that it normally has in the market economy. In the event of default of entrepreneurs on their obligations, the state should use the same methods for exercising its rights that are at the disposal of entrepreneurs.

The scope of interaction between the state and commercial banks and the central bank and the degree of politicisation of the banking system cannot be determined with precision. But it is evident that this interaction exists and that it can partly be blamed for the banking system crisis that erupted in Croatia in 1998. In its 1998 Annual Report, the Croatian National Bank pointed out three major causes of banking crisis. “First, poor lending policies of some banks which were not based on market criteria and proper risk assessment resulted in these banks’ poor asset quality. Secondly, too high interest rates, and thirdly, inadequate experience in matters relating to bank acquisitions, bankruptcy or liquidation of banks.” The first cause, which is described as credit policy not based on market criteria actually means, connected lending. Some bankers will offer preferential treatment to good friends, relatives, and recommended acquaintances in the form of loans under lower interest rates, uncollateralised loans or some other benefits. Naturally, not every loan extended under non-market conditions implies involvement of politics. However, in the case that a “favourable” loan is granted to a person belonging to the ruling party or that it is granted on the basis of a recommendation coming from a person from the party in power, then we can talk about elements of the politicisation of the banking system. This type of involvement can be found in both state and private banks. Because of a greater extent of reliance, political interest may be more pronounced in state banks. However, this does not have to be the rule. A recent example of political interest in a state bank is the meeting which took place between Zlatko Mateša, the Prime Minister and Božo Prka, Managing Director of Privredna banka Zagreb, a large state bank on the occasion of the protest by employees of Nama, the largest national chain store. The protest was provoked after the negotiations between Nama’s management board and Privredna banka concerning loan payment extension failed. The failure to reach an agree-

ement meant that the store's outlets would put up for sale and its workers laid off. The protest, involving a hunger strike of nine Nama's employees, in the current socially tense situation, prompted the Prime Minister to arrange a meeting with the Privredna banka Zagreb Managing Director. As a result of the conversation, sales of Nama's stores were immediately halted (Poslovni svijet, May 5, 1999).

That political intervention in private banks is not unknown is shown by the fact that the six banks<sup>14</sup> faced with difficulties in 1998, out of the total of sixty banks, were all private banks. There were speculations in the media at the time as to the involvement of certain ruling party individuals into scandals relating to bank failures. The ongoing court investigations of the failed banks' leading managers will show how relevant these speculations were. They will also reveal the extent of political involvement and how much it contributed to the banks' failures.

The banking crisis also challenged the independence of the central bank. Prompted by the problems in Dubrovačka banka at the beginning of 1998, the Croatian National Bank put forward a proposal for the foundation of a State Co-ordination Committee for Banking. However, as the media correctly reported "The CNB's report to the Parliament on the Conditions of the Banking Sector which exposed the risky business operations of some banks met with no response as did its proposal to set up new financial bodies. Obviously the central bank has difficulty in winning political support for its views of the situation". The same article also quotes: "Although the draft Banking Law really affords greater and better defined authority to the Croatian National Bank, it does not seem likely that the present legislation prevents the central bank from acting to such an extent that several banks in Croatia have already been effectively excluded from the financial system, but are now in limbo and no one dares to deal with them without word from above. Evidently, the Croatian National Bank knew what was going on, it kept the Parliament informed and was willing to take proper action. But it seems as though political directives tied its hands. We have to face the truth, especially at the moment when initiatives are taken by the country's top executive power for the founding of a co-ordination body" (Poslovni svijet, November 11, 1998). The central bank came under pressure from the banking circles as well. The most notable example of this is the pressing demand made by Marko Marčinko<sup>15</sup>, Managing Director of Glumina banka<sup>16</sup> on the CNB to give a positive evaluation for the feasibility of rehabilitation of Glumina banka. Despite the pressure, a bankruptcy proceeding was started in the bank and its Managing Director, Marčinko came under pre-trial investigations. This shows that the central bank has won itself some degree of independence, or at least political support. The fact that the central bank did not have sufficient freedom to perform its duties reveals that the central bank and the state are also interrelated. Admittedly positive was the support offered by the state to the

14 Four of these banks belonged to the group of small banks, two to medium-sized banks. Three banks had undergone procedure for evaluating economic feasibility of rehabilitation. It was decided that rehabilitation was feasible only in the case of Dubrovačka banka, the largest of the six banks. Bankruptcy proceedings were initiated in the remaining five banks.

15 Poslovni svijet, August 19, 1998.

16 One of the six failed banks.

central bank to resolve the banking crisis, thus enabling further development of the central bank as an independent institution.

The involvement of politics in described areas of economic life is characterised by complex interrelation. Certainly, privatisation based on non-market criteria had a negative impact on privatised companies' efficacy and liquidity. Arrears also brought about the exhaustion of companies' funds before they were put up as candidates for rehabilitation. The involvement of politics in banking also did its share in supporting this type of privatisation thereby putting pressure on the banking supervision.

Highly indebted companies as well as some professionals have repeatedly criticised the CNB's policy of maintaining stability of the exchange rate and price level. Conditions characterised by high inflation and arrears are profitable for those who would need to change their business habits in stable conditions. It follows that legal protection of ownership, which we stress to be one of the basic elements of public good and basic motivation for operating within official economy framework, still does not work properly.

Freeing the economy from political ties and creating the rule of law are basic preconditions for growth. The change cannot be made overnight. A political consensus has to be reached on the issue. Draft of general anti-corruptive strategy, envisaged to follow the political consensus with the basic aim of preventing abuse of power and of discretionary authority of civil servants is given in the final section below.

## 5. Conclusions

The authors of this paper do not support the view that stimulation of unofficial economy in transition countries could be beneficial. On the contrary, every transition country should set as one of its goals the reduction of unofficial economy share in the overall economy. However, the unofficial economy in the transition process has had positive impacts that should not be rejected *a priori* or considered exclusively as a social shock-absorber. Positive impacts of the unofficial economy, mainly include stimulation of efficiency and growth, which is important in cases when the system is regulated to such extent that implementation of regulations on the part of a company decreases the overall welfare of society. The lack of expert staff capable of evaluating influences of overall regulations on economy is not necessarily the only reason for such conduct of the state. Other reasons could be a question of political economy, reflecting the extent to which the political elite strives to maintain control over economy for the purpose of realisation of its interests.

Under such conditions, it would be inappropriate to react with repressive measures to the occurrence of unofficial economy, since these measures would impair the initiation of entrepreneurship and would have an adverse effect on the present welfare and growth in the dynamic perspective. Development and implementation of strategy with an aim to reduce the level of politicisation of economic processes would have a more favourable impact on the economic environment. The existing welfare and economic growth would thus not be threatened and preconditions for the mid-term and

long-term unofficial economy reduction would be created. Such strategy would imply a systematic anti-corruptive strategy based on three pillars.

The first pillar would be based on administrative and legal reforms. The main idea is to simplify and rationalise the existing rules in order to limit the discretionary power of public servants and thereby reduce the scope of rent seeking activities. This implies establishment or improvement of the existing internal controls that enable enhanced supervision of public servants, with the aim of increasing the probability of detecting irregular activities.

The second pillar would be based on morality. The aim is to publicly disclose and punish the corrupt public servants and other people from the official sector who participate in the corruption process. The main goal of the morality approach is to form a negative public opinion of corruption and detect the weak points of the systems where corruption occurs.

The last pillar would be based on systematic reforms, which imply macroeconomic and structural reforms in general. The aim is to reduce the role of state<sup>17</sup>, that is, to eliminate the conditions that enable the development of politicisation and corruption. Systematic reforms encompass three types of complementary policies. First, policies aiming to rationalise the role of state in economy by deregulation, liberalisation, and privatisation. Second, reform policies for the remaining state functions that enhance governing institutions and provide the minimal level of transparency. Finally, there are policies with an aim to create a competitive environment where rules of the game are clearly defined, enabling effective market operations.

A continuous and systematic implementation of this anti-corruption strategy, particularly its third part, will enable corruption prevention even in those countries where corruption has developed a systemic character. A reduced level of corruption and politicisation of economic processes, will have a positive impact on overall welfare and economic growth<sup>18</sup>, and will, at the same time, create preconditions for the reduction of the unofficial sector.

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17 It is important to note that one of the main roots of corruption is too extensive state apparatus that is mainly reflected in huge public sector, too many complicated rules, and high tax and tariff rates.

18 Paolo Mauro performed an analysis on the sample of several countries within a longer time period and established that if a country improved its corruption index by two units, the economic growth rate at the annual level would increase by a half of the percentage point (Mauro, 1996).

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Tables, figures and charts that are a constituent part of the paper must be well laid out, containing: number, title, units of measurement, legend, data source, and footnotes. The footnotes referring to tables, figures and charts should be indicated by lower-case letters (a,b,c...) placed right below. When the tables, figures and charts are subsequently submitted, it is necessary to mark the places in the text where they should be inserted. They should be numbered in the same sequence as in the text and should be referred to in accordance with that numeration. If the tables and charts were previously inserted in the text from other programs (Excel, Lotus...), these databases in the Excel format should also be submitted (charts must contain the corresponding data series).

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