

Corruption risks in EU funds spending in Hungary

Report for the meeting “Understanding Corruption in the EU: the Policy Dimension” based on preliminary findings for 2009-2012¹

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MAIN FINDINGS

- *There are a few new anti-corruption initiatives* of the new government which entered office in 2010. While these initiatives may represent a positive step towards higher public sector integrity, results are yet to be seen.
- *Large-scale institutionalized corruption in Hungary may be widespread primarily driven by political cycles.* Such corruption, often labelled as legal corruption, typically doesn't involve bribery or collusion between lower level bureaucrats and private individuals; rather, it operates through contractual relationships benefiting the highest echelons of the political and business elite.
- *EU funds are likely to fuel the abuse of public spending in spite of tight regulatory framework.* Even though public procurement using EU funds faces considerably more stringent regulation, it represents much higher corruption risks than spending of Hungarian funds. Corruption risks are particularly pronounced for large projects.

KEY RECOMMENDATIONS

In order for the EU and Hungary to combat corruption in EU funds spending and avoid waste of public resources they should:

- *Ensure effective transparency and active access to information on public procurement*
Timely information provision in a format readily comprehensible and at a location easily accessible is the only way to fight corruption through transparency. Information which is outdated, barely comprehensible for non-experts, and accessible only after a large investment of time and effort helps fighting corruption little more than no transparency at all.
- *Close loopholes of public procurement regulation.*
Exceptions, emergency regulations, and minimum thresholds are abused way too often. By closing these routes and ensuring a minimum level of transparency for currently loosely regulated purchases make hiding corruption much more difficult.
- *Review quality of outcomes and price of inputs rather than procedures of spending.*
The current administrative framework largely focuses on procedural and financial compliance making the administration of EU funded projects costly while achieving little in preventing corruption. Refocusing audits and reviews on the quality of outcomes and price of inputs is capable of revealing and curbing corruption.

1. Introduction

This report delivers preliminary evidence on large-scale institutionalized corruption² in EU funds spending in Hungarian public procurement based on data from 2009-2012. We only look at EU funding which is spent by Hungarian public and semi-public organisations (i.e. mixed public-private owned) through public procurement. Hence, our study covers almost the complete Cohesion Fund and much of Structural Funds spending, but no spending within the Common Agricultural Policy.

Our findings come from the analysis of interviews with key individuals who have seen corrupt transactions ‘from close’ and a large database recording every public procurement procedure in Hungary which was conducted under national or EU public procurement law between 1st of January 2009 and 31st of December 2012. This database contains over 56 000 contract awards allowing for an unprecedented detailed view at public spending and high-level corruption.

There are a few new anti-corruption initiatives of the new government which entered office in 2010. Most of these are integrated into the Corruption Prevention Program of the Public Administration launched in early 2012 (for full list of recent initiatives see Annex A). While these initiatives may represent a positive step towards higher public sector integrity, results are yet to be seen.

Hungary is one of the top beneficiaries of EU cohesion policies with allocated per capita spending close to 3000 EUR for 2007-2013. However, EU funds absorption has been an issue with contracted ratio of 64% by the end of 2011 slightly below the Central and Eastern Europe (CEE) average of 67%³.

2. Change of government and public procurement contractors

Change of government and the corresponding turnover of political leadership seems to drastically alter the winning chances of companies on the public procurement market both EU and non-EU funded. In interviews, top managers of large construction, IT, and health care suppliers to public organisations concurrently supported the view that the swings in market shares of companies reflect the changing preference of political leadership for particular well-connected companies. According to this interpretation, success on the public procurement market depends much more on political connections rather than the competitiveness of companies, leading to waste of public resources. Such corruption, often labelled as “legal corruption”, typically doesn’t involve bribery or collusion between lower level bureaucrats and private individuals; rather, it operates through contractual relationships benefiting the highest echelons of the political and business elite.⁴

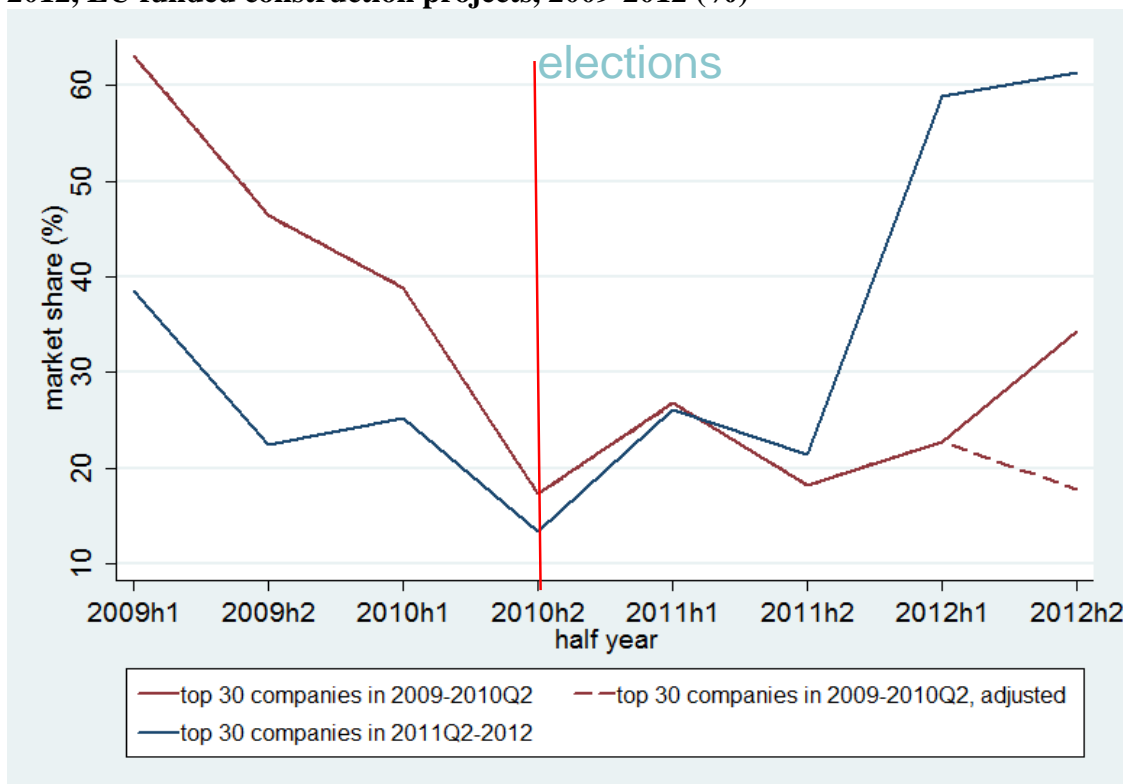
² For a detailed discussion of large-scale or legal corruption see: Kaufmann, Daniel, and Pedro D Vicente. 2011. “Legal Corruption.” *Economics & Politics* 23(2): 195–219.

³ KPMG. 2012. *EU Funds in Central and Eastern Europe*. 2011. Warsaw, Poland: KPMG.

⁴ See Kaufmann & Vicente. 2011.

Such claims are demonstrated by tracking the change in market shares of the largest companies before and after the new government entered office (Figure 1), but they are also underpinned by regression analysis looking at the total public procurement market financed from EU funds (Annex B1). Figure 1 amply demonstrates that the companies with highest market share throughout the one and a half years leading up to the elections in the first half of 2010 lost about 25-30% of their combined market share. This change was accompanied by a comparable increase in the total market share of companies dominating the post-election market between 2011 second half year and 2012 (the one year period between 2010H2 and 2011H1 was excluded as it was a transitory period between the two governments).

Figure 1. Changes in market shares of the top 30 firms of 2009-2010H1 and of 2010H2-2012, EU funded construction projects, 2009-2012 (%)⁵



Source: MaKAB

Note: market share of company i in time $t = \text{total value of contracts won by company } i \text{ in EU funded construction in time } t / \text{total value of contracts won in EU funded construction in time } t$

One of our previous report⁶ found similar patterns on the entire public procurement market, albeit the magnitude of seemingly politically driven spending is comparatively larger in EU-funded contracts. Regression analysis in Annex B1 supports the same conclusions while looking at the entire EU-funded public procurement market and taking into account the effects of companies' main markets' size, companies' size, amount of capital investment, location, and profit margin.

⁵ It is possible to adjust the combined market share of the top 30 companies of 2009-2010H1 in 2012H2 because the figure is highly upwards distorted by a single highway construction contract. In addition, interview evidence points at the strong political involvement into the management of that contract award procedure.

⁶ Fazekas, Mihály and Tóth, István János, 2013. „Political Influence in the Public Procurement Market? Analysis of market share 2009-2011 – preliminary results” Corruption Research Centre, Budapest. See: http://www.crc.uni-corvinus.hu/download/kb_adatok_2010_4riport_130220.pdf

Thus, based on the available evidence, it is likely that at least 25-30% of EU funded construction spending is driven directly by politics in Hungary, but it is conceivable that this proportion is as high as 80-90% (several interviewees suggested that contracts going to the opposite political camp's companies function as "payment" for future contracts for companies whose political connections currently hold the power, but may lose it in the future). Evidence to date indicates that large-scale institutionalized corruption is widespread in Hungary.

3. EU funds spending compared to national public procurement

When comparing public procurement contracts financed from EU funds to those without any EU sources on some elementary corruption risk indicators⁷, EU funds perform considerably worse than national funds. This underpins the claim that EU funds fuel the abuse of public spending in spite of a tight regulatory framework.

33.8% of contracts awarded in projects financed by EU funds throughout 2009-2012 received only one bid as opposed to 29% of contracts purely financed from national funds (Table 1). This implies that in spite of strong support for effective competition, one third of EU funds spending through public procurement by Hungarian authorities is conducted with no competition whatsoever. Modifying contracts after contract award is also much more frequent in EU funded projects than only nationally funded ones (17.7% and 6.5% respectively). This is a surprising difference as contract modifications are allowed only in a few unforeseen situations such as extremely bad weather or unusually high exchange rate fluctuations. As contract modifications allow for pushing the prices up and quality down after the competitive contract award process ends, we can suspect that EU funds are much more prone to corrupt rent extraction. Interview evidence supports this interpretation pointing out the lack of incentives for contracting parties (i.e. issuers of tenders and contract winners) to reveal corruption as it would imply that funding is returned to the national EU funding disbursement agency, i.e. the loss of external funding for both parties.

Regression results presented in Annex B2 underline that these differences between contracts awarded in project with and without EU funding cannot be attributed to some obvious alternative explanation such as contract size, market of spending, or type of issuer.

⁷ For a full discussion of these and further indicators see: Fazekas, Mihály, István János Tóth, and Lawrence P King, 2012. "When government serves the interests of the few: Corruption and state capacity in Hungarian public organisations." Hungarian Economic Association: Annual Conference 2012, Budapest: Hungarian Economic Association.

Table 1. Selected corruption risk indicators of public procurement contract awards with and without EU funds (2009-2012)

Period	2009		2010		2011		2012		Total 2009-2012	
Proportion of occurrence among contracts with/without EU funds	Public procurement contracts using EU funds?		Public procurement contracts using EU funds?		Public procurement contracts using EU funds?		Public procurement contracts using EU funds?		Public procurement contracts using EU funds?	
	NO	YES	NO	YES	NO	YES	NO	YES	NO	YES
single bidder	30.9%	40.2%	30.6%	43.4%	25.7%	28.0%	28.1%	24.9%	29.0%	33.8%
non-open procedure	43.5%	39.7%	32.9%	32.2%	36.9%	36.6%	45.4%	56.9%	39.2%	40.9%
no call for tenders in Official Journal	48.7%	38.9%	25.4%	23.8%	56.2%	66.5%	55.2%	73.5%	44.7%	50.9%
accelerated submission deadline (<21 days)	17.7%	20.8%	26.5%	28.4%	24.0%	40.7%	19.9%	26.4%	23.2%	29.2%
extremely short submission deadline (<12 days)	2.7%	3.1%	2.3%	1.9%	2.3%	3.5%	2.6%	3.4%	2.4%	2.6%
contract modification	4.6%	16.2%	9.8%	25.4%	8.0%	22.0%	2.5%	4.6%	6.5%	17.7%
assessment criteria contains non-price elements	47.2%	52.0%	48.4%	64.3%	35.8%	40.4%	34.0%	34.1%	41.8%	48.0%
Total N	7,711	3,144	11,019	6,467	8,148	5,904	8,514	5,340	35,392	20,855

Source: MaKAB

Note: differences deemed substantive are highlighted in grey.

The most striking characteristic of these corruption risk indicators, called irregularities by the European Court of Auditors⁸, is that they are not irregular or random at all. They are particularly high for those companies whose market share appears to be driven by the political cycle as identified in the previous section and in Annex B1. This can be interpreted that those companies which win public procurement contracts funded by the EU with the help of their political connections tend to win under conditions prone to corruption. This point is demonstrated by the differences among companies which perform according to what a standard economic logic would predict and those which considerably under- or over-perform compared to the pure economic logic⁹ (Table 2).

For example, companies under or over-performing are 2 to 3 times more likely to experience contract modification after their contract has been approved than those which perform according to a standard economic logic. But differences are similarly striking in the frequency of accelerated and extremely short submission deadlines.

⁸ European Court of Auditors, 2012. Annual Report on the Implementation of the Budget concerning financial year 2011. Brussels.

⁹ Under-performance is defined as large negative error in the regression of Annex B1 taking into account standard economic variables determining market performance, while over-performance is large positive error in the same regressions. Those companies are deemed performing according to what is expected which have regression error close to zero.

Table 2. Selected corruption risk indicators according to company groups, EU funded public procurement, 2011

	single bidder	non-open procedure	no call for tenders in Official Journal	accelerated submission deadline (<21 days)	extremely short submission deadline (<12 days)	contract modification	assessment criteria contains non-price elements
under-performers in line with econ. predictions	24.6%	37.1%	58.5%	42.0%	6.4%	33.5%	49.3%
over-performers	22.9%	28.2%	45.0%	36.2%	0.4%	11.4%	39.2%
	27.3%	34.3%	52.2%	41.1%	2.7%	23.7%	48.0%

Source: MaKAB

Note: N=266

All this evidence underpins the hypothesis that EU funds represent much higher corruption risks than spending of Hungarian funds in spite of considerably more stringent regulation. As corruption risks are particularly pronounced for large projects and for companies dependent on their political connections for winning contracts, EU funds-related corruption is most likely driven by national politics. Our findings are confirmed by data from the previous and the current governments, that is the whole period of 2009-2012, pointing at the potentially systemic nature of corruption in post-communist Hungary.

Annex A: Anti-Corruption Initiatives of Hungarian Government

Briefing (in Hungarian):

<http://www.kormany.hu/hu/gyik/osszefoglalo-a-kormany-korrupcioellenes-intezkedeseirol>

September 2010.

Hungary joined the International Anti Corruption Academy (IACA).

The government has strengthened the Department of Public Prosecution. The government has founded the anti-corruption working group into Department of Public Prosecution and added more than 3 billion HUF (10 million EUR) to his budget in 2011.

December 9. 2010.

Anti-Corruption Measures of Hungarian Government in 2010

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/government-measures-to-combat-corruption-summary-for-world-anti-corruption-day-9-december>

November 18 2011.

Deputy Prime Minister Tibor Navracsics signs anti-corruption cooperation agreement with President of the State Audit Office of Hungary, the President of the Supreme Court of Hungary and the Chief Prosecutor

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/deputy-prime-minister-tibor-navracsics-signs-anti-corruption-cooperation-agreement-with-president-of-the-state-audit-office-of-hungary-the-president-of-the-supreme-court-of-hungary-and-the-chief-prosecutor>

January 2012.

The government has published by internet the first draft of his anti-corruption plan (in Hungarian):

http://www.kormany.hu/download/e/da/70000/korrupcio_megelozes_program_v1_01.pdf

March 28 2012.

The government has adopted his „ Two-year programme on preventing corruption in central government institutions”

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/govt-launches-2-year-anti-graft-programme>

April 6. 2012.

Government decision on anti-corruption measures and program on preventing corruption in central government institutions (Official Journal of Hungary, in Hungarian), Government Decision 1104/2012 (IV. 6.)

<http://kozlony.magyarorszag.hu/pdf/12506>

April 16 2012.

Hungary is joining the international Open Government Declaration

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/open-government-declaration-a-major-step-in-the-fight-against-corruption>

June 28 2012.

Parliament has passed the New Penal Code (law no. C/2012 [VI. 25]). More stringent rules to sanction crimes of corruption

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/parliament-has-passed-the-new-penal-code>

July 5 2012.

Hungary declares its intention to join the Open Government Partnership

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/another-anti-corruption-measure-hungary-declares-its-intention-to-join-the-open-government-partnership>

October 8 2012.

On-the-job training programs for public service workers in the Public Administration Development Programme. The future trainings contain knowledge on ethical norms specific to the profession and a methodology for recognising corruption phenomena.

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/on-the-job-training-of-public-service-workers-also-forms-part-of-public-administration-reform>

December 17 2012.

Civil society organisations are also participating in the anti-corruption working group

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/civil-society-organisations-are-also-participating-in-the-anti-corruption-working-group>

January 22 2013.

The Ministry of Public Administration and Justice prepared a Green Book laying down ethical guidelines for state agencies. The document serves as an occupational code of ethics under the auspices of the Government's fight against corruption.

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/social-consultation-to-begin-on-ethical-guidelines-in-the-public-sector>

January 24 2013.

Ministry of Public Administration and Justice prepared an Action Plan that contains the undertakings in conjunction with accession to the Open Government Partnership (OGP).

Press release:

<http://www.kormany.hu/en/ministry-of-public-administration-and-justice/news/action-plan-in-the-making-regarding-undertakings-of-accession-to-open-government-partnership>

February 25 2013.

Government Decree (50/2013. [II.25]) on the Integrity Structure in Public Administration and the Regulation of Meetings with Lobbyists

See:

<http://www.magyarokzlony.hu/pdf/16226>

Annex B: Regression results

B1. Results of regressions on change in total contract value

Multilevel modelling results for individual companies' change in total contract value before and after the change of government are reported. Our analytical approach is similar to Goldman, Eitan, Jörg Rocholl, and Jongil So. 2013.¹⁰ looking at US data. We estimated the coefficients using the following system of equations:

$$Y_{ij} = \beta_{0j} + \beta_{1j}X_{ij} + r_{ij} \quad (1)$$

$$\beta_{0j} = \gamma_{00} + \gamma_{01}Z_{0j} + u_{0j}, \quad (2)$$

where Y_{ij} is the logarithm of the difference of total contract value won in 2009 and 2011 by the i th company which operates on j th public procurement market¹¹, β_{0j} is the constant characterising the j th market, X_{ij} is the characteristics matrix of the i th company operating on the j th market encompassing characteristics such as county of company headquarters, log employment (2009), log turnover (2009), log capital expenditure (2009), and profit margin (2009), r_{ij} stands for the regression error of the company level regressions (first level regressions), γ_{00} is the constant of the market level regressions (second level regressions), Z_{0j} represents the vector characterising the j th market that is market concentration (Hirschman-Herfindahl Index (2009)), and u_{0j} is the error term of the market level regressions.

¹⁰ See Goldman, Eitan, Jörg Rocholl, and Jongil So. 2013. "Politically Connected Boards of Directors and The Allocation of Procurement Contracts." Review of Finance, January.

¹¹ We carried out the logarithmic transformation of the change in contract value according to Goldman et al.: when the difference was positive, we took its logarithm; if it was negative (in 2009 the contracted amount was higher than in 2011) we calculated its absolute value, then took its logarithm, and the resulting value was multiplied by minus one. There were no differences in contract values falling between -1 and +1.

Table 3. Multilevel regression results

Mixed-effects ML regression		Number of obs	=	1847	
Group variable: fő piac		Number of groups	=	23	
		Obs per group: min	=	6	
		avg	=	80.3	
		max	=	823	
R ² =	0.0886	Wald chi2(22)	=	221.95	
Log likelihood =	-7149.62	Prob > chi2	=	0.000	
Dependent var.: log(D. total contr. value)	Coef.	Std. Err.	z	P> z 	95% Conf. Interval
county of company headquarters					
Borsod-Abaúj-Zemplén megye	0.37	1.85	0.20	0.84	-3.25 4.00
Budapest	-0.16	1.59	-0.10	0.92	-3.28 2.96
Bács-Kiskun megye	-0.64	1.94	-0.33	0.74	-4.44 3.16
Békés megye	-2.33	2.12	-1.10	0.27	-6.49 1.83
Csongrád megye	-1.58	1.95	-0.81	0.42	-5.40 2.24
Fejér megye	-2.69	2.27	-1.18	0.24	-7.14 1.76
Győr-Sopron-Moson megye	0.25	2.03	0.12	0.90	-3.74 4.23
Hajdú-Bihar megye	1.99	1.87	1.06	0.29	-1.68 5.66
Heves megye	-4.93	2.49	-1.98	0.05	-9.81 -0.05
Jász-Nagykun-Szolnok megye	1.27	2.28	0.56	0.58	-3.20 5.75
Komárom-Esztergom megye	0.75	2.39	0.32	0.75	-3.92 5.43
Nógrád megye	-1.14	3.34	-0.34	0.73	-7.70 5.41
Pest megye	1.16	1.77	0.66	0.51	-2.30 4.63
Somogy megye	1.63	2.48	0.66	0.51	-3.24 6.49
Szabolcs-Szatmár-Bereg megye	-1.31	1.90	-0.69	0.49	-5.04 2.42
Tolna megye	1.30	2.69	0.48	0.63	-3.97 6.56
Vas megye	3.53	2.27	1.55	0.12	-0.92 7.98
Veszprém megye	-0.89	2.14	-0.42	0.68	-5.09 3.31
Zala megye	-1.11	2.12	-0.52	0.60	-5.26 3.04
log employment (2009)	-0.23	0.35	-0.67	0.50	-0.91 0.45
log turnover (2009)	-2.20	0.30	-7.27	0.00	-2.80 -1.61
log capital expenditure (2009)	0.21	0.16	1.25	0.21	-0.12 0.53
profitmargin (2009)	0.01	0.02	0.30	0.76	-0.04 0.06
main market HHI	8.81	4.62	1.91	0.06	-0.25 17.87
constant	37.82	3.30	11.46	0.00	31.35 44.28
Random-effect parameters	Estimate	Std. Err.			95% Conf. Interval
var(main market constant)	5.93	2.74		2.40	14.66
var(Residual)	133.16	4.40		124.81	142.08
LR test vs. linear regression: chibar2(01) =	40.08				Prob >= chibar2 = 0.00

Source: MaKAB

B2. Results of regressions on the differences between EU funded and nationally financed public procurement contracts

Binary logistic regression results explaining whether a contract is financed by EU funds or not are reported below. We estimated the following equations:

$$\Pr(\text{EU funded contract}_i=1) = \frac{1}{1+e^{-Z_i}} \quad (3)$$

$$Z_i = \beta_0 + \beta_{1j}X_{ij} + \beta_{2k}Y_{ik} + \varepsilon_i \quad (4)$$

where EU funded contract_{*i*} equals 1 if the *i*th contract awarded was partially or fully financed by EU funds and 0 if not; Z_i represents the logit of a contract being financed from EU funds; β_0 is the constant of the regression; X_{ij} is the matrix of *j* corruption risk indicators for the *i*th contract such as single bidder, non-open procedure, assessment criteria containing non-price elements, contract modification, and submission period category; Y_{ik} stands for the matrix of *k* control variables for the *i*th contract such as year, type of issuer, market of the contract, and size of the contract; ε_i is the error term; and β_{1j} and β_{2k} represent the vectors of coefficients for explanatory and control variables.

Table 4. Binary logistic regression results

N=27,165 % correct=74.6	dep.var:EU funded/non-EU funded contract				
	B	Exp(B)	S.E.	Wald	Sig.
single bidder	0.378	1.46	0.033	130.979	0.000
non-open procedure	0.126	1.134	0.037	11.452	0.001
assessment criteria contains non-price elements	0.204	1.226	0.031	41.825	0.000
contract modified	0.763	2.146	0.04	361.178	0.000
<i>standard submission period (>21 days)</i>				7.703	0.021
accelerated submission deadline (<21 days)	0.081	1.084	0.035	5.227	0.022
extremely short submission deadline (<12 days)	-0.127	0.881	0.096	1.722	0.189
<i>year=2009</i>				21.977	0.000
=2010	0.152	1.165	0.042	13.341	0.000
=2011	0.181	1.199	0.05	13.271	0.000
=2012	0.225	1.253	0.053	17.925	0.000
<i>type of issuer=national</i>				988.649	0.000
=utility	-2.445	0.087	0.138	314.383	0.000
=regional/local	0.222	1.248	0.04	30.563	0.000
=supported agency	1.704	5.495	0.123	190.543	0.000
=body est. by public law	-0.806	0.447	0.058	190.463	0.000
other	-0.306	0.737	0.061	25.109	0.000
missing	-0.78	0.458	0.096	66.341	0.000
<i>market of contract=agriculture&mining</i>				2136.46	0.000
=oil	-4.444	0.012	0.342	169.154	0.000
=food	-2.099	0.123	0.073	832.418	0.000
=clothing	-2.274	0.103	0.314	52.322	0.000
=office&electrical machinery&telecoms	-0.279	0.757	0.066	17.881	0.000
=medical&laboratory	-1.169	0.311	0.065	322.967	0.000
=transport	-1.686	0.185	0.132	162.747	0.000
=defence&security	0.018	1.018	0.223	0.007	0.935
=construction	-0.567	0.567	0.054	108.409	0.000
=IT	-0.428	0.652	0.109	15.454	0.000
=maintenance	-4.191	0.015	0.362	134.002	0.000
=other services	0.975	2.651	0.094	107.865	0.000
=real estate, finance	-2.198	0.111	0.152	208.44	0.000
=recreation, sports	-0.406	0.666	0.117	11.983	0.001
=utilities&cleaning	-3.687	0.025	0.234	247.474	0.000
=other	-1.158	0.314	0.118	95.481	0.000
log(contract value)	0.246	1.279	0.009	804.627	0.000
constant	-4.327	0.013	0.149	839.494	0.000

Source: MaKAB