



Government Favouritism in Europe

The Anticorruption Report

Volume 3

Alina Mungiu-Pippidi (editor)

Government Favouritism in Europe

The Anticorruption Report 3

written by

Muhittin Acar

Elizabeth Dávid-Barrett

Valentina Dimulescu

Mădălina Doroftei

Uğur Emek

Mihály Fazekas

Stefan Karaboev

Péter András Lukács

Roberto Martínez B. Kukutschka

Alina Mungiu-Pippidi

Munir Podumljak

Salvatore Sberna

Ruslan Stefanov

István János Tóth

Alberto Vannucci

Andrew Wilson

Todor Yalamov

Barbara Budrich Publishers

Opladen • Berlin • Toronto 2015

All rights reserved. No part of this publication may be reproduced, stored in or introduced into a retrieval system, or transmitted, in any form, or by any means (electronic, mechanical, photocopying, recording or otherwise) without the prior written permission of Barbara Budrich Publishers. Any person who does any unauthorized act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

You must not circulate this book in any other binding or cover and you must impose this same condition on any acquirer.

A CIP catalogue record for this book is available from
Die Deutsche Bibliothek (The German Library)

The information and views set out in this publication are those of the author(s) only and do not reflect any collective opinion of the ANTICORRP consortium, nor do they reflect the official opinion of the European Commission. Neither the European Commission nor any person acting on behalf of the European Commission is responsible for the use which might be made of the following information.

© 2015 by Barbara Budrich Publishers, Opladen, Berlin & Toronto
www.barbara-budrich.net

ISBN 978-3-8474-0795-9 (Paperback)
eISBN 978-3-8474-0921-2 (e-book)

Das Werk einschließlich aller seiner Teile ist urheberrechtlich geschützt. Jede Verwertung außerhalb der engen Grenzen des Urheberrechtsgesetzes ist ohne Zustimmung des Verlages unzulässig und strafbar. Das gilt insbesondere für Vervielfältigungen, Übersetzungen, Mikroverfilmungen und die Einspeicherung und Verarbeitung in elektronischen Systemen.

Die Deutsche Bibliothek – CIP-Einheitsaufnahme
Ein Titeldatensatz für die Publikation ist bei Der Deutschen Bibliothek erhältlich.

Verlag Barbara Budrich  Barbara Budrich Publishers
Stauffenbergstr. 7. D-51379 Leverkusen Opladen, Germany

86 Delma Drive. Toronto, ON M8W 4P6 Canada
www.barbara-budrich.net

Jacket illustration by Bettina Lehfeldt, Kleinmachnow, Germany –
www.lehfeldtgraphic.de

Printed in Germany on acid-free paper by
Strauss GmbH, Mörlenbach, Germany

Contents

<i>Abbreviations</i>	7
1. Government Favouritism in Europe.	9
2. Corruption Risks in the Romanian Infrastructure Sector	19
3. The Bulgarian Public Procurement Market: Corruption Risks and Dynamics in the Construction Sector.	35
4. The Political Economy of Grand Corruption in Public Procurement in the Construction Sector of Hungary	53
5. Political Favouritism in Croatian Public Procurement	69
6. Public Procurement in Infrastructure: The Case of Turkey	84
7. Ukraine's Uncertain Reform Process.	97
8. The Criminal Organisation of Political Corruption in Europe	105
<i>Acknowledgements.</i>	127

Authors

Muhittin Acar, PhD, is Professor of Public Administration in the Department of Political Science and Public Administration, Faculty of Economics and Administrative Sciences, Hacettepe University, Ankara, Turkey (acar42@yahoo.com)

Elizabeth Dávid-Barrett, PhD, is a lecturer in Politics at the University of Sussex, UK (E.David-Barrett@sussex.ac.uk)

Valentina Dimulescu is a researcher at the Romanian Academic Society and Managing Editor of the Romanian Journal of Political Science, Bucharest, Romania (valentina.dimulescu@sar.org.ro)

Mădălina Doroftei, PhD, is a post-doctoral researcher at the Romanian Academic Society and Assistant Lecturer at the Bucharest University of Economic Studies, Bucharest, Romania (madalina@sar.org.ro)

Uğur Emek, PhD, is an Associate Professor of Economics and a Senior Expert in the Ministry of Development, Ankara, Turkey. He is currently a visiting research fellow at Hacettepe University and teaches at Baskent University, Ankara, Turkey (uemek@baskent.edu.tr)

Mihály Fazekas, PhD, is a Post-Doctoral Researcher at the University of Cambridge, UK (mf436@cam.ac.uk)

Stefan Karaboev is an Analyst at the Economic Program of the Center for the Study of Democracy, Sofia, Bulgaria (stefan.karaboev@online.bg)

Péter András Lukács is an Analyst at the Corruption Research Center Budapest, Hungary (lukacs.peter.andras@gmail.com)

Roberto Martínez B. Kukutschka is a PhD Candidate and a Research Associate the Hertie School of Governance, Berlin, Germany (kukutschka@hertie-school.org).

Alina Mungiu-Pippidi, PhD, is Director of the European Research Centre for Anti-Corruption and State-Building at the Hertie School of Governance Berlin, Germany and author of the 2015 Cambridge University Press monograph '*A Quest for Good Governance. How Societies Develop Control of Corruption*'. (pippidi@hertie-school.org).

Munir Podumljak is the Executive Director of the Partnership for Social Development, Zagreb, Croatia (munirpodumljak@psd.hr)

Salvatore Sberna, PhD, is a Research Fellow at the European University Institute and coordinator of the APC Master's Program on Analysis, Prevention and Control of Organized Crime and Corruption, organized by the Department of Political and Social Science, University of Pisa, Italy (Salvatore.Sberna@eui.eu)

Ruslan Stefanov is Director of the Economic Program at the Center for the Study of Democracy, Sofia, Bulgaria (ruslan.stefanov@online.bg).

István János Tóth, PhD, is Co-director at the Corruption Research Center, Budapest, Hungary (tthstvnjns@gmail.com).

Alberto Vannucci, PhD, is Associate Professor of Political Science at the Department of Political Sciences at the University of Pisa and director of the Master Programme in "Analysis, prevention and fight against organized crime and corruption", organized by University of Pisa-Libera-Avviso Pubblico, Pisa, Italy (alberto.vannucci@unipi.it)

Andrew Wilson, PhD, is Professor in Ukrainian Studies at University College London, a Senior Policy Fellow at the European Council on Foreign Relations, London, UK and the author of '*The Ukrainians: Unexpected Nation*', New Haven and London: Yale University Press, (fourth edition 2015) (tjmsalw@ucl.ac.uk).

Todor Yalamov, PhD, is a Senior Analyst at the Economic Program of the Center for the Study of Democracy (Sofia, Bulgaria) and also Assistant Professor at the Department of Economics and Business Administration, Sofia University "St. Kliment Ohridsky", Bulgaria (todor.yalamov@online.bg)

All these contributions were given as part of the European Union Seventh Framework Research Project AN-TICORRP (Anti-corruption Policies Revisited: Global Trends and European Responses to the Challenge of Corruption). The views expressed in this report are solely those of the authors and the European Union is not liable for any use that may be made of the information contained therein.

Abbreviations

ACR	Anticorruption Report
AKP	Adalet ve Kalkınma Partisi
ALB	Abnormally Low Bids
ANRMAP	National Authority for Regulating and Monitoring Public Procurement
ANTAC	Anti-corruption Action Centre
ANTICORRP	Anticorruption Policies Revisited: Global Trends and European Responses to the Challenge of Corruption
BCE	Corvinus University of Budapest
BDP	Bariş ve Demokrasi Partisi (Peace and Democracy Party)
BGN	Bulgarian Lev
BOT	Build, Operate, and Transfer
CAE	Identification Data for Contracting Authority
CCI	Commission for Conflict of Interest
CHP	Cumhuriyet Halk Partisi (People's Republican Party)
CPO	Central Procurement Officer
CPV	Common Procurement Vocabulary
CSD	Center for the Study of Democracy
CVM	Cooperation and Verification Mechanism
DNA	Romanian National Anticorruption Agency
DPPS	Directorate for the Public Procurement System
EC	European Commission
EFSI	European Fund for Strategic Investments
EPPP	Electronic Public Procurement Platform
EU	European Union
EUI	European University Institute
FOI	Freedom of Information
GDP	Gross Domestic Product
GVA	Gross Value Added
HDZ	Croatian Democratic Union
HRK	The Croatian Kuna
IKS	Kosovar Stability Initiative
IMF	International Monetary Fund
LPP	Law on Public Procurement
MHP	Milliyetçi Hareket Partisi (National Movement Party)
MP	Member of Parliament
MSZP	The Hungarian Socialist Party
NABU	National Anticorruption Bureau
NAO	National Audit Office
NGO	Non-Governmental Organisation
NSI	National Statistical Institute
NSRF	National Strategic Reference Framework
NUTS	The Nomenclature of Territorial Units for Statistics
OC	Organised Crime
OCC	Organised Crime and Corruption
OP	Operational Programs
PFIA	Public Financial Inspection Agency

PPA	Public Procurement Agency
PPB	Public Procurement Board
PPP	Public-Private Partnership
PPL	Public Procurement Law
PPR	Public Procurement Registry
PSD	Partnership for Social Development
QOG	Quality of Government Institute
RPR	Reanimation Package of Reforms
SAO	State Audit Office
SAR	Romanian Academic Society
SCSPPP	State Commission for Supervision of Public Procurement Procedure
SEAP	Electronic Public Procurement System
SEEs	State Economic Enterprises
SICAP	Romanian Electronic System for Public Procurement
SME	Small and Medium-sized Enterprises
TCA	Turkish Court of Accounts
TED	Tenders Electronic Daily
TPC	Turkish Penal Code
TGNA	Turkish Grand National Assembly
TMAC	Minister of Transport, Maritime Affairs, and Communications
UNCAC	The United Nations Convention against Corruption
UNODC	United Nations Office on Drugs and Crime
USKOK	Croatia's Office for the Prevention of Corruption and Organised Crime
VAT	Value Added Tax

4. The Political Economy of Grand Corruption in Public Procurement in the Construction Sector of Hungary

MIHÁLY FAZEKAS, PÉTER ANDRÁS LUKÁCS
AND ISTVÁN JÁNOS TÓTH

Bidding companies linked to political officeholders are more likely to win in procurement tenders overall in Hungary. The share of companies that are openly connected politically winning public procurement tenders in 2005-2012 was between 5% and 31% depending on how narrowly connections are defined. This significant association is stronger in the construction sector compared to the rest of public procurement and deteriorated after 2011. The material stakes are very high as constructions make up to 60-80% of the total advertised public procurement spending, mostly funded by EU.

Introduction

Government contracts represent a major form of siphoning off public resources by well-connected business and political elites (Transparency International, 2012) and they allow for a direct assessment of how corporate political connections are used for corrupt and non-corrupt purposes. Hence, public procurement favouritism and the use of bidding company political connections is the key focus of this chapter. In particular, this chapter sets out to (1) describe the structure and magnitude of high-level corruption risks in Hungarian public procurement, in particular in the construction sector; and (2) provide direct evidence on how political connections are used in public procurement in Hungary, with particular focus on tendering procedures with different levels of integrity and markets with varying degrees of corruption risks.

Hungary is a suitable case for investigating these research questions. A middle income country with substantial risk of systemic corruption, it enjoys a public sector encompassing enough variation when public integrity is concerned (Fazekas & Tóth, 2014a). Focusing on a single country with sufficient internal diversity allows the study to concentrate on the key explanatory story while controlling for a range of common cultural, legal, and economic factors. The chapter is organized as follows: first, it reviews prior literature on political connections in public procurement in order to place the subsequent Hungarian analysis in a global perspective. Second, the data and variables used are outlined. Third, it explores the first research question on the structure and magnitude of corruption risks in Hungarian public procurement. Fourth, it discusses the diverse effects of corporate political connections in public procurement. Finally, it begins to explore the potential policy consequences.

1. Corruption, Political Connections, and Public Procurement

Personal connections between political office holders and private companies bidding for government contracts, political connections in short, are of diverse nature¹: companies having as

¹ Note that no particular direction of influence is assumed: company to politics or the other way around.

shareholder or employee a current or past political office holder or his/her kin or other trusted agent, public organisations hiring former employees of corporations (revolving door) and a brokers or intermediaries establishing personal links (Rajwani & Liedong, 2015). The use of these different strategies of personal connections and control very much depend on the threat of exposing corrupt dealings and the specificities of the country's legal framework (e.g. conflict of interest regulations) (Trapnell, 2011).

As some of these types of personal connections are more difficult to measure than others, there is an inherent risk that the most important types are left out from the analysis. In addition, connections between political office holders and private companies can be established in a variety of other ways such as through political party funding (OECD, 2014) or lobby (David-Barrett, 2011). Again the use of these different channels of influence and the ways in which they are combined partially depend on the probability of exposure to the public or law enforcement agencies adding to measurement challenges.

Nevertheless, all of these different forms of political connections, personal or impersonal, direct or indirect, are theoretically expected to work in a similar way in terms of corruptly rewarding companies with government contracts. The roles of political connections in relation with such exchange of political favour for private gain can play multiple roles: first, political ties are means of controlling and managing the transaction in an informal contract non-enforceable by courts. Second, they also serve as a vehicle for rent extraction when the political office holder earns income from the company receiving government contracts. Third, political connections can also serve a broader trust building, facilitating, and information sharing role, especially when the corrupt network is large and benefits and costs of corruption are spread across the network.

Prior empirical literature looked at either personal political connections or political influence established through political party donations. Academic papers considered short as well as long term direct benefits to the connected companies (1-4 years) (Goldman, Rocholl, & So, 2013; Luechinger & Moser, 2014) while others considered ties either to specific individuals or parties as a whole (Akey, 2013; Straub, 2014). Most studies looked at individual countries with only partially comparable research questions, data, and analytical tools. For example, in Brazil, companies' campaign contributions translate into additional contract won worth 14 times more than the contributions (Boas, Hidalgo, & Richardson, 2014), the same figure in the US is only 2.5 times (Bromberg, 2014). Moreover, in the US the largest predictor of company procurement volume from before to after the 1994 change in the controlling majority of the House and the Senate is the party connection of the publicly listed company (Goldman et al., 2013). Surprisingly, even in Denmark which is one of the least corrupt countries of the world, direct family ties between companies and politicians increase company profitability, especially in sectors dependent on public demand, i.e. public procurement (Amore & Bennedson, 2013). All these studies provide only indirect evidence on the corrupt use of political ties.

Establishing whether political connections are used for bending universalistic rules of the game in general is a necessary first step towards better fighting corrupt politico-business networks. In addition, peeping into individual countries and the strength of different organisations and market norms to withstand political pressure represents a key step forward. The only study which explains intra-country variation in institutional quality focusing on the association between procurement income and political connections analyses Russia by means of a unique database of all bank transfers leaked from the national bank (Mironov & Zhuravskaya, 2011). They find that in more corrupt regions, illicit political financing leads to a larger increase in company procurement income. This chapter is inspired by this work, but goes

beyond it in that it decomposes the influence of corrupt environments on privileged contract allocation by tender-specific and market-specific corruption risks. Digging deeper into the contextual effects determining how political connections can or cannot be used for receiving favoured treatment in public procurement can pave the way for in time designing effective solutions to high-level political corruption.

2. Data and Variables

2.1. Public procurement data

The main database derives from Hungarian public procurement announcements from 2005-2012 (this database is referred to as PP henceforth). The data represent a complete database of all public procurement procedures conducted under Hungarian Public Procurement Law. PP contains variables appearing in 1) calls for tenders, 2) contract award notices, 3) contract modification notices, 4) contract completion announcements, and 5) administrative corrections notices. As not all of these kinds of announcements appear for each procedure, we only have the variables deriving from contract award notices consistently across every procedure.

These documents are published in the Public Procurement Bulletin which appears on a weekly basis and is accessible online². As there is no readily available database, we used a crawler algorithm to capture every publicly available announcement. Then, applying a complex automatic and manual text mining strategy, we created a structured database which contains variables with clear meaning and well-defined categories. As the original texts available online contain a range of errors, inconsistencies, and omissions, we applied several correction measures to arrive at a database sufficient quality for scientific research. For a full description of database development, see Fazekas & Tóth (2012a) and Csizmás, Fazekas, & Tóth (2014) in Hungarian and in somewhat less detail Fazekas & Tóth (2012b) in English.

A major limitation of our database is that it only contains information on public procurement procedures under the Hungarian Public Procurement Law as there is no central depository of other contracts. The law defines the minimum estimated contract value for its application depending on the type of announcing body and the kind of products or services to be procured (for example, from 1 January 2012, classical issuers have to follow the national regulations if they procure services for more than 8 million HUF or 27 thousand EUR). By implication, PP is a biased sample of total Hungarian public procurement of the period, containing only the larger and more heavily regulated cases. This bias makes PP well suited for studying more costly and more high-stakes collusion where coverage is close to complete.

2.2. Data on companies

Our data on firms comes from the so-called Amadeus database supplied by a commercial company data provider Bureau van Dijk³. The database consists of 463,049 unique, non-repeated firms identified by their tax ID. Apart from data on the firms' structure (legal status, size of company, etc.), activity (primary line of business) or location, the dataset contains information on financials from annual balance sheets such as profit margin, number of employees, operating turnover, etc. between 2003 and 2011. In total, there are nine time-varying variables and each is supposed to have nine years of data, that is each firm is supposed to have

² See: <http://www.kozbeszerzes.hu/adatbazis/keres/hirdetmeny/> (in Hungarian).

³ <https://amadeus.bvdinfo.com/version-20141118/home.serv?product=amadeusneo>

81 time-varying entries. However, unfortunately on average 57.8 entries are missing out of the 81 resulting in a 71.35% missing rate. Luckily, the missing rate of the operating turnover variable that we will need the most is slightly lower. Here the number of missing entries (out of the 9) on average is 5.2, meaning a 58.19% missing rate.

2.2. Data on political connections

In the analysis below, we use information on companies' political connections as political officeholders owning or managing firms which bid in public procurement can serve as a proxy for government favouritism. In this context political connection simply refers to a binary variable (0-1) that indicates whether a firm has or had either an owner or manager who is or was a political office holder in the observation period.

In order to obtain the database on political connections we made the following steps: first, we obtained the full list of registered owners and managers of the companies winning in public procurement (we could identify at least one owner or winner for about 85% of winning companies). And we also obtained the full list of elected officials at the national and local levels as well as key appointed officeholders (Table 1). Connections to the former are denoted as government connections as most recorded elected officials serve in national or local government or support the government in elected bodies.

Table 1. List of institutions and positions of the political office holder database, 2002-2014

Institution	Position	Position type
Hungarian Parliament	Members	Government
Municipal administrations	Mayor	Government
Registered political parties	Top officials such as treasurers	Government
Public bodies registered by the Treasury	1-12 designated CEOs	Public administration

Note: full list of registered public bodies can be accessed at www.mak.hu

Second, we matched the names (and other data) of politicians and firm owners and managers. The matching was done between more than 35,000 owners/managers of bidding firms and more than 10,000 political officeholders based on full name.

Third, to establish the identity of individuals and validate the matching, we collected further information and carried out further matching procedures. We checked the matched persons' birth date, mother's maiden name, and place of birth. For those names where we lacked data, we checked their photos available from reliable sources such as company websites and political parties' web pages. As there were names left whose matching could not be certainly established with these methods, we executed a statistical matching procedure based on the rarity of the names (calculated from the number of name occurrences from all the available names in the two initial databases) and the geographical distance between the firm and the political institution associated with the names. Then, we normalised the two indices (between 0 and 1) and combined them with simple multiplication, meaning that the final index measuring the goodness of match also ranged between 0 and 1 (0 meaning a most probable match, while 1 indicating the less probable one). A positive consequence of the multiplication in our case is

that if one of the indices is 0 (i.e. the two institutions are located in the same settlement or the names occur only once in each database) and the other one is missing, we can still calculate the combined index. Once this combined similarity index was created, we determined a cut point above which name matching is determined only a coincidence rather than indicating truly identical persons. To determine the cut point, we chose a threshold for both normalized indices (name occurrence and settlement distance) separately. For the distance variable we selected 50 kilometres, since that is the longest distance that still classifies as commuting according to the Hungarian Central Statistical Office. (The normalized value of 50,000 meters is 0.0794.) We determined the cut-point value for the normalized name occurrence at 0.1 under which we can find those names which are highly idiosyncratic. Thus, if the combined index does not exceed we declare that a political connection is present in the corresponding company. The company database used for name matching consists of 14,367 unique firms with judging finally only 664 firms as having highly likely political connection based on the above exact as well as statistical matching procedures.

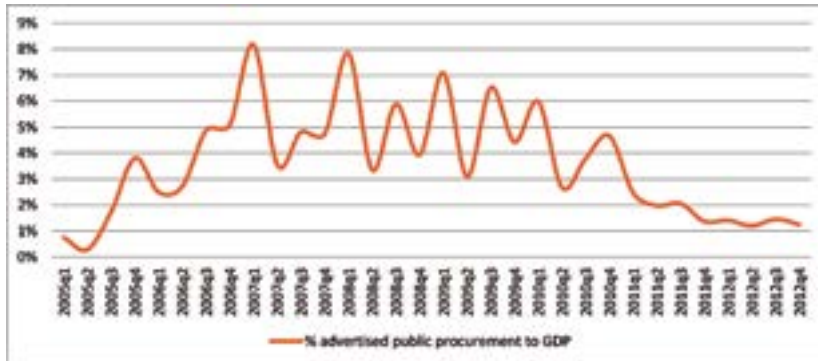
3. Structure and Scope of Public Procurement Corruption Risks

Hungary is characterized by a high degree of material resources for corruption and weak controls of corruption which together point at elevated corruption risks and partial state capture (Lukács & Fazekas, 2015). Some of these key determinants of corruption risks are reviewed briefly to provide a broader background to the specific analysis.

3.1. Material stake

In terms of material stake in public procurement, total announced public procurement spending relative to the GDP between 2005 and 2012 followed a marked political trajectory (Figure 1). Announced public procurement spending was negligible at the beginning of 2005, but started to increase rapidly during the second half of the first MSZP government up until 2010 when the government changed. Then the Fidesz government – starting from the second quarter of 2010 – cut back publicly announced public procurement expenditure substantially. These varying spending shares result from a wealth of factors among which a few are more dominant: the introduction of a new public procurement law in line with EU requirements at the beginning of the observation period, GDP falling substantially in 2009 with total government spending contracting likewise, and an increasing portion of spending avoiding transparency regulations and publication in the official public procurement journal (see below on this). An alternative estimate of total public procurement spending can be derived from the system of national accounts which suggests that the share of public procurement spending in annual GDP has varied between 13% and 14% between 2009-2012 (European Commission, 2014).

Figure 1. Total announced public procurement spending relative to GDP, quarterly, 2005-2012



Source: Hungarian Public Procurement Database (PP)

At the same time, advertised spending on public procurement of construction⁴ oscillated between 20-50% of total advertised public procurement spending. The greatest increase came at the end of 2011 when it jumped to around 60-80% (Figure 2). This marked increase from 2011 closely coincides with the incoming Fidesz government gaining full control of the Hungarian public procurement apparatus and the spectacular success of the construction holding centred on Közgép plc., owned by the prime minister’s school roommate and long term associate of Fidesz⁵.

Figure 2. Share of construction procurement in total public procurement, % of contract value, 2005-2012



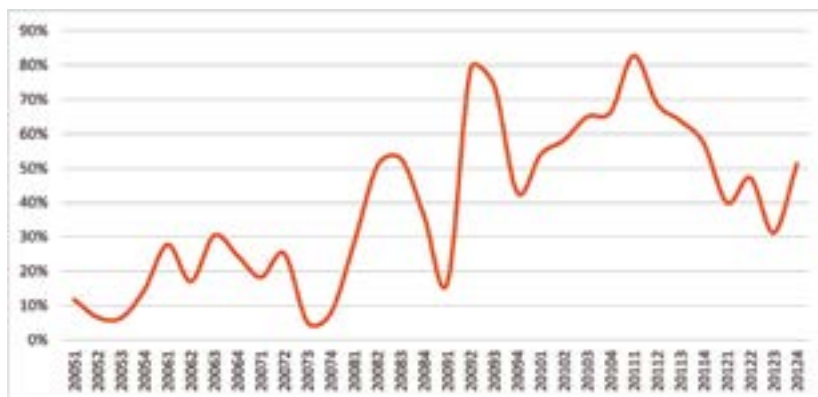
Source: Hungarian Public Procurement Database (PP)

⁴ Public procurement of construction defined using the Common Procurement Vocabulary (CPV) with divisions 44 – construction structures and materials; auxiliary products to construction (except electric apparatus), 45 – construction work, and 71 – architectural, construction, engineering and inspection services. This means that the construction sector in public procurement includes a range of services, goods, as well as public works activities.

⁵ For more on the spectacular rise of Közgép plc. See: <http://www.crcb.eu/?p=808>

This high and considerable increase in construction spending in Hungarian public procurement has been principally financed from EU funds⁶ at least since 2008 (Figure 3). While the EU funds' share in construction was between 10-30% until about 2008, this ratio skyrocketed to 40-80% making it the most important funding source for infrastructure development in Hungary. The sheer fact that there is an increasing share of EU funds in the construction sector already raises the possibility that EU funds are subject to high corruption risks in Hungary (Fazekas, Chvalkovská, Skuhrovec, Tóth, & King, 2014).

Figure 3. Share of EU funded public procurement of construction, % of contract value, 2005-2012



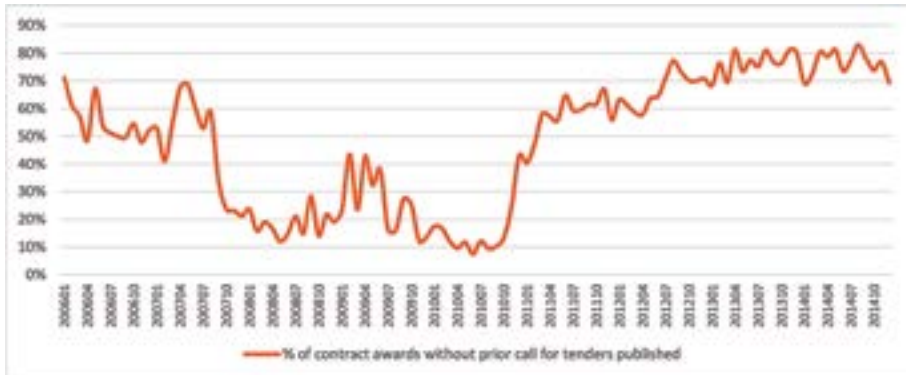
Source: Hungarian Public Procurement Database (PP)

3.2. Institutional controls

In spite of some positive reforms, the new Fidesz government reduced transparency and open competition in public procurement both of which considerably contributed to corruption risks. Crucially, changes to the Public Procurement Law made less transparent procedure types more easily available to contracting entities (*2010. évi LXXXVIII törvény a közbeszerzésekről szóló 2003. évi CXXIX. törvény módosításáról*, 2010) which drastically decreased the proportion of procedures with call for tenders published in the Hungarian Public Procurement Bulletin (Figure 4). In addition, the requirement, rare in Europe, to publish contract completion announcements which disclose the final contract value and completion date has been removed effectively since 1st January 2012.

⁶ The spending of EU Funds in public procurement can be directly identified in each contract award announcement which records the use or non-use of EU Funds along with the reference to the corresponding EU program. However, no information is published as to the proportion of EU funding within the total contract value. Hence, we had to employ a simplistic yes-no categorization of each contract awarded. In most cases, regulation allows for the EU contribution to cover 80-95% of total investment. Data from large investment projects indicate that EU Funds amount to the majority of project costs if EU funding is involved. This paper's accounting approach has to neglect the national co-financing of 5-20% of contract value.

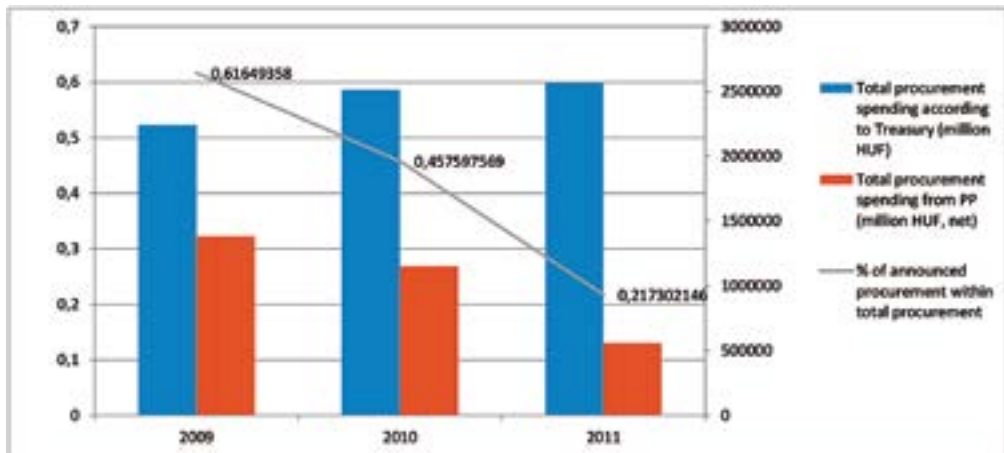
Figure 4. Proportion of contracts awarded without a prior publication of a call for tenders in the Hungarian Public Procurement Bulletin, 2006-2014



Source: Hungarian Public Procurement Database (PP)

Moreover, the proportion of public procurement spending announced in the Hungarian Public Procurement Bulletin within total procurement spending has also decreased since 2010 (Figure 5). Decreasing transparency in public procurement constitutes a considerable risk to integrity across OECD countries (OECD, 2009).

Figure 5. Public procurement spending announced in the Public Procurement Bulletin and total public procurement spending, 2009-2011



Notes: for details of calculating total procurement spending from Treasury annual budget accounts see: (Audet, 2002; European Commission, 2011). The ratio reported is only an estimation as spending as announced in PP refers to the total lifetime of the contract while Treasury accounts contain only the spending accrued in a given year. Further reason for imprecision of the ratio is that the set of institutions submitting accounts to the Treasury and those subject to the Public Procurement Law are somewhat different.

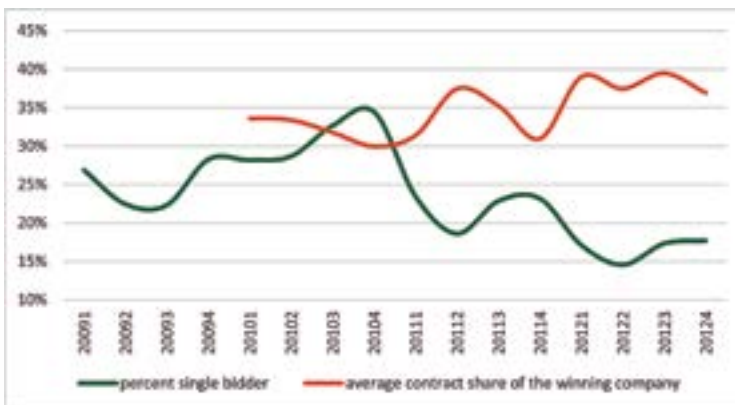
Source: (Fazekas, Tóth, & King, 2013)

3.3. Corruption risks

Given the high and increasing material stake in public procurement of construction and weakening controls, especially transparency in public procurement, high prevalence of corruption risks all across Hungary is hardly a surprise (Fazekas et al., 2013).

We use two simple indicators of competitiveness and corruption risks for comparing construction and non-construction sectors (Kenny & Musatova, 2010): single bidding and winner company contract share (i.e. share of the winner company within the total procurement activity of the contracting body in the 12 months prior to contract award) (Fazekas et al., 2013) They reveal a mixed picture: on the one hand, the apparent lack of any competition, i.e. single bidding, is widespread both in construction and non-construction sectors with the former performing somewhat better (25% and 34% single bidder contracts respectively). On the other hand, the construction sector tends to be of considerably higher concentration than non-construction sectors at the level of contracting bodies (31% versus 24% of average winner company contract share respectively). In addition, some major construction subsectors such as highway construction have seen a set of proven cartel cases involving practically every major player linked to either side of the political spectrum as well as foreign firms (Tóth, Fazekas, Czibik, & Tóth, 2014).

Figure 6. Key indicators of corruption risks in public procurement of construction in Hungary, % of contracts awarded, 2009-2012

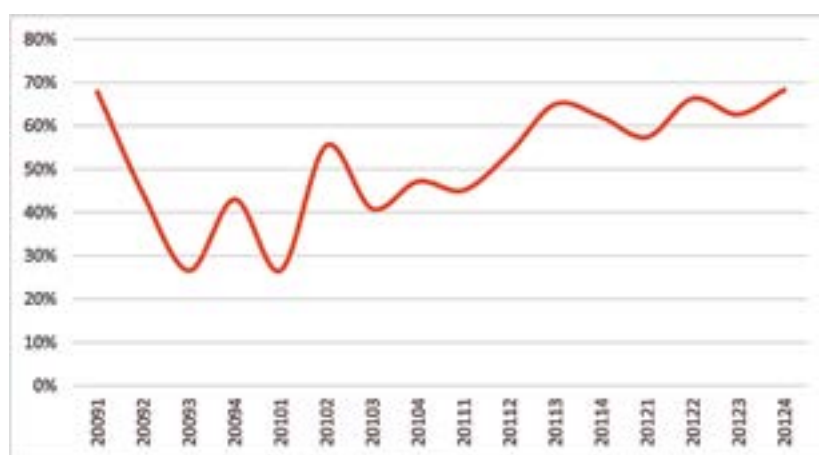


Source: Hungarian Public Procurement Database (PP)

Tracking corruption risks in the construction sector over time with the same headline indicators reveals a striking picture (Figure 6). While the overall share of contracts awarded when only one bid was submitted is 25%, it reached as high as 35% in late 2010. Both figures are considered particularly alarming given the prevalence of high value competitive markets in construction where single bidding should be rare. With the introduction of the new public procurement rules in 2011 single bidding became much less prevalent (15-20%) predominantly due to the extensive use of invitation procedures where three bidders had to be invited. This positive development in bidder numbers, however, hasn't been accompanied by the expected opening of competition and decreasing winner contracts shares. Instead, the market became even more concentrated with the average winner company winning more than 35% of the contracting body's total awarded contract value.

In order to gain a fuller picture of the total scale of corruption risks and the amount of public money affected, we tracked the contract value won in the construction market by companies which are either single bidders or control a very high share of contracting authority public procurement spending (above 50% of spending in 12 months). This combined indicator, reinforces the previous picture painted by more disaggregated indices, namely corruption risks and the involved share of public funds have been on the rise at least since 2010 in Hungarian public procurement construction sector (Figure 7). Given that single bidding and dominant company position provide only a lower bound estimate of corruption risks, it is safe to say that particular resource allocation is most likely the rule rather than the exception in Hungarian public procurement of construction.

Figure 7. Combined market share of government suppliers either single bidders or captor firms (contract share above 50%), % contract value, 2009-2012, Hungary, construction



Source: Hungarian Public Procurement Database (PP)

4. Political Connections in Public Procurement

We estimate the winning probability of companies as a function of political connections of all bidding companies while controlling for major explanatory factors of company success such as company location, market or size. The analysis is repeated

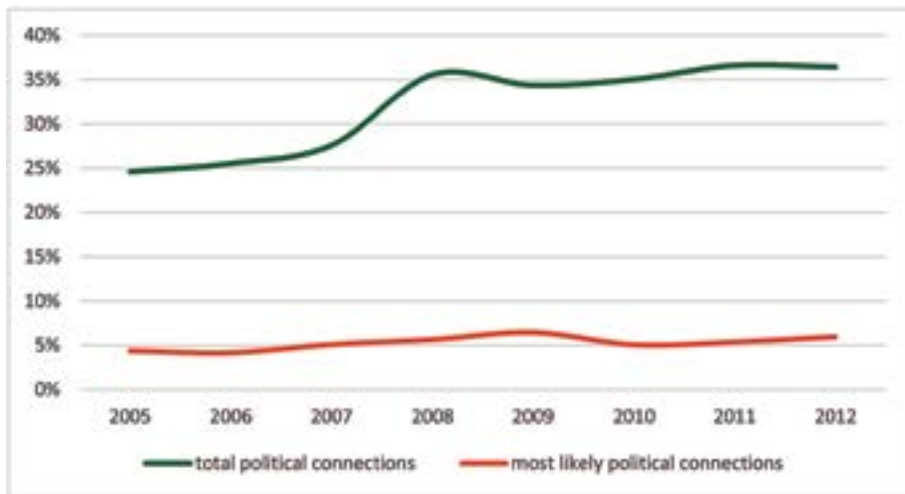
- for the total sample,
- for tenders of different corruption risk level using a unique measure of corruption risks in the tendering process Corruption Risk Index (Fazekas et al., 2013), and
- for markets of different corruption risks, namely construction sector and the rest of the public procurement market.

Before directly addressing our theoretical expectations, the extent of political connections among companies bidding and winning in public procurement tenders is explored in order to better understand the magnitude of challenge. Anecdotal evidence of political connections leading to public procurement success and rapid wealth accumulation is plenty in the Hungarian media. One particular example is the mayor in the home village of Viktor Orbán, the prime minister since 2010. His construction company in operation since 2001, Mészáros

és Mészáros ltd., earned very little income until the change of government in 2010 with no public procurement contract whatsoever. However, since 2011 turnover and profitability have skyrocketed, coinciding with the first public procurement successes of the company and the change of government (Lukács & Fazekas, 2015). While such successes of politically connected persons prove nothing on their own, they prompt the analysis below and the patterns to be identified with statistical analysis.

Looking at the total prevalence of government suppliers which have political connections, i.e. a tie to any kind of political office holder, reveals a striking picture (Figure 8). The share of politically connected companies winning public procurement tenders in 2005-2012 was between 5% and 31% depending on how narrowly connections are defined⁷. The total political connections line below is our upper bound estimate, taking any name match between a government supplier owner or manager and any political office holder in the period; while the most likely political connections line below represents our lower bound estimate where only very infrequent names and individuals whose organisations are located in the very same settlement are considered. While the gap between the lower and upper bound estimate is wide, both trajectories point at the increased prevalence of political connections among government suppliers with a particularly marked increase after 2008.

Figure 8. Proportion of bidding firms with political or government connections, 2005-2012



First, we have to assess to what degree political ties influence public procurement decisions in Hungary across the board. To do so, we used the most likely company political connections, i.e. whether a company has an owner or manager who has been member of the political establishment at any time in 2002-2014 applying the strictest criteria for matching individuals. We only focus on all three governments of the observation period in order to provide the most complete assessment of the likely impact of political connections in Hungary. Regression analysis reveals that having at least one political connection increases a company's winning chances by roughly 2% across the whole public procurement market in Hungary in 2005-2012 (Table

⁷ These percentages are quite similar when using total contract value won rather than the number of companies as a basis.

2, model 1). While 2% may appear to be a marginal contribution to company success, this is because a range of other characteristics of the bidding process are controlled for which could and in fact often mediate political favouritism. For example, the number of bidders is typically smaller when a politically connected firm bids. The 2% higher winning chance for politically connected firms hence represents our best estimate of the independent effect of political connections on company winning success.

However, this general association between government connections and company public procurement success masks a considerable variation across markets in line with our prior discussions. First, in construction markets, a government connection proved to be a particularly strong force explaining bidding company winning chances (4%), while in the rest of the total public procurement market political connections appear to be largely ineffectual (Table 2, model 2 and 3). This hardly comes as a surprise given the high perceived levels of corruption in construction projects (Rose-Ackerman, 1999) and the central importance of visible development projects for political actors in Hungary (Muraközy & Telegdy, 2015).

Table 2. Binary probit regression results, average marginal effects, sectoral comparisons, 2005-2012

	(1)	(2)	(3)
	Total	Other	Construction
<i>Dependent variable: Winning the public procurement tender</i>			
Political connection	0.0180***	-0.00400	0.0352***
	(10.26)	(-1.61)	(14.63)
Public body-bidder location			
Reference category: different location			
Same location	0.0232***	0.0114***	0.0378***
	(30.72)	(10.59)	(36.44)
Location: missing	0.335***	0.387***	0.255***
	(325.19)	(311.91)	(156.64)
Nr. of applicants	-0.00676***	-0.00568***	-0.0119***
	(-120.32)	(-80.73)	(-120.66)
Tender market share	0.000102***	-0.00206***	0.000159***
	(42.86)	(-116.73)	(71.30)
Firm size			
Reference category: Small			
Medium	0.0408***	0.0542***	0.0235***
	(36.58)	(36.64)	(13.76)
Medium-large	0.0309***	0.0749***	0.00583***
	(27.23)	(48.25)	(3.42)
Large	-0.0356***	0.0742***	-0.0503***
	(-31.48)	(43.28)	(-30.07)

Missing company financial data	-0.440***	-0.247***	-0.424***
	(-629.61)	(-92.35)	(-479.40)
<i>N</i>	90255	44620	45635
pseudo-RP ²	0.1298	0.1480	0.1510

Note: *t* statistics in parentheses, year dummies suppressed, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$; observations weighted by log contract value

Second, in tenders conducted in the presence of different corruption-related red flags, bidder's political connections appear to have diverse effects. Here, the quality of the tendering process is measured by the Corruption Risk Index of the tender. As determining the 'red flags' indicating corruption risks in tendering are largely in the hands of the public body managing the tender, it is also more broadly indicative of the quality of the public body and bureaucracy (Fazekas et al., 2013; Fazekas & Tóth, 2014b). Dividing tenders into three equal groups according to their Corruption Risk Index leads to a partition of low, medium, and high corruption risk sections of the whole public sector's contracting activities. Regression analysis was conducted on 2009-2010 data only as earlier comparative Corruption Risk Index values are not yet available and later values are not directly comparable due to an overall increase in corruption risks. In line with our prior expectations, government connections are only weakly effectual in low to medium corruption risk tenders (2-4%), while strongly associated with higher winning chances in high corruption risk tenders (9%) (Table 3). In a similar vein, the observed variability in company success is best explained in the high corruption risk sub-sample further strengthening the understanding that political connections play a more pronounced role only where weak bureaucratic controls allow for deficient tendering practices. Quite importantly, this effect is not driven by the difference in the prevalence of political connections in the three sections of the public procurement market as the shares of politically connected bidders and winners hardly differ among the three groups.

While these results are robust to different ways of establishing direct ties between bidding firms and various types of political office holders, they remain susceptible to more sophisticated strategies for hiding connections. Some companies could not be identified in procurement announcements, not every company had identifiable owners and managers in the official company records; moreover, there are certainly many companies linked to political officeholders through brokers and interlocutors. These jointly warrant that results are only indicative of the scale of corruption risks and their effect overall effect. Our results could be considered as a lower bound estimate only.

Table 3. Binary probit regression results, average marginal effects, comparison of companies bidding on different corruption risk tenders, 2009-2010

	(1)	(2)	(3)
	Low CRI	Medium CRI	High CRI
<i>Dependent variable: Winning the public procurement tender</i>			
Political connection	0.0230**	0.0435***	0.0917***
	(2.87)	(4.64)	(11.85)
Public body-bidder location			

Reference category: different location			
Same location	0.0355***	0.0551***	-0.0358***
	(9.10)	(13.49)	(-11.05)
Location: missing	-0.0300**	-0.0634***	0.0197*
	(-2.65)	(-5.07)	(2.40)
Nr. of applicants	-0.00530***	-0.00999***	-0.00338***
	(-14.78)	(-24.48)	(-9.92)
Tender market share	-0.00235***	0.000477	0.000721***
	(-8.31)	(1.82)	(3.93)
Firm size			
Reference category: Small			
Medium	0.0225***	0.00247	-0.0184***
	(3.83)	(0.37)	(-3.48)
Medium-large	0.109***	0.0244***	-0.000180
	(19.07)	(3.72)	(-0.03)
Large	0.0397***	-0.0343***	-0.0301***
	(6.83)	(-5.41)	(-5.77)
missing company financial data	-0.347***	-0.488***	-0.578***
	(-22.33)	(-34.53)	(-58.06)
<i>N</i>	3394	2938	3663
pseudo-RP ²	0.1631	0.1606	0.2935

Note: *t* statistics in parentheses, year dummies suppressed, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$; observations weighted by log contract value

Policy Implications

The review of prior literature in this field and the novel Hungarian empirical results jointly underline the importance of tracking corporate political connections and their relation to government favouritism in public procurement across Europe. We found that bidding companies linked to political officeholders are more likely to win in procurement tenders overall in Hungary. This association is the strongest in the construction sector where high value, complex projects are more visible; and in tenders set with high corruption risks by the responsible contracting entity.

Prior literature and our empirical findings jointly suggest some tentative policy lessons worth considering as part of broader anti-corruption policies:

Limiting overall material stake or corruption resources: Decreasing public funds available for privileged allocation (rents) could contribute to decreasing the strength of corrupt networks and their grip on political power (Mungiu-Pippidi, 2011). This can be done by privatization, out-sourcing, transparent and competitively selected private-public partnerships.

Improving the bureaucracy: While directly attacking corporate political connections and the revolving door phenomenon may be fruitful strategies, they may simply lead to

1.

2.

more sophisticated hiding strategies. Instead, disrupting the corrupt exchange by better controlling the discretion of political officeholders to allocate government contracts might deliver better results. Increasing transparency of public procurement, insulating bureaucrats' career pathways from political influence, and furthering meritocracy in the civil service could be fruitful avenues of reform (Charron, Dahlström, Fazekas, & Lapuente, 2015).

3. **Tailoring spending for cost benchmarking and monitoring:** Construction projects are often large, complex, and long making them difficult to monitor. Directing spending to projects which are more readily monitored, for example through the immediate availability of unit prices or their smaller scale can contribute to corruption control (Benitez, Estache, & Soreide, 2010).

References

2010. évi LXXXVIII törvény a közbeszerzésekről szóló 2003. évi CXXIX. törvény módosításáról (2010). Budapest.
- Akey, P. (2013). Valuing Changes in Political Networks: Evidence from Campaign Contributions to Close Congressional Elections. *Available at SSRN 2336131*.
- Amore, M. D., & Bennedsen, M. (2013). The value of local political connections in a low-corruption environment. *Journal of Financial Economics*, 110(2), 387–402. doi:10.1016/j.jfineco.2013.06.002
- Audet, D. (2002). Government Procurement: A Synthesis Report. *OECD Journal on Budgeting*, 2(3), 149–194.
- Benitez, D., Estache, A., & Soreide, T. (2010). *Dealing with politics for money and power in infrastructure* (No. 5455). *Policy Research Working Papers*. Washington, DC: The World Bank. doi:doi:10.1596/1813-9450-5455
- Boas, T. C., Hidalgo, F. D., & Richardson, N. P. (2014). The Spoils of Victory: Campaign Donations and Government Contracts in Brazil. *Journal of Politics*, 76(2), 415–429.
- Bromberg, D. (2014). Can Vendors Buy Influence? The Relationship Between Campaign Contributions and Government Contracts. *International Journal of Public Administration*, 37(9), 556–567. doi:10.1080/01900692.2013.879724
- Charron, N., Dahlström, C., Fazekas, M., & Lapuente, V. (2015). *Carriers, connections, and corruption risks in Europe* (No. 2015:6). Gothenburg.
- Csizmás, K., Fazekas, M., & Tóth, I. J. (2014). *Tű a szénakazalban – Az un. “Educatio hiba” és az eset kapcsán felvetődő problémák valamint ezek megoldása*. Budapest.
- David-Barrett, E. (2011). *Cabs for Hire? Fixing the Revolving Door Between Government and Business*. London.
- European Commission. (2011). *Public Procurement Indicators 2010*. Brussels.
- European Commission. (2014). *Public Procurement Indicators 2012*. Brussels.
- Fazekas, M., Chvalkovská, J., Skuhrovec, J., Tóth, I. J., & King, L. P. (2014). Are EU funds a corruption risk? The impact of EU funds on grand corruption in Central and Eastern Europe. In A. Mungiu-Pippidi (Ed.), *The Anticorruption Frontline. The ANTICORRP Project, vol. 2*. (pp. 68–89). Berlin: Barbara Budrich Publishers.
- Fazekas, M., & Tóth, I. J. (2012a). *Hibák, javítások és előzetes eredmények - magyarországi közbeszerzések 2010-2011*. Corruption Research Centre, Budapest.
- Fazekas, M., & Tóth, I. J. (2012b). *Public Procurement, Corruption and State Capacity in Hungary – objective measures and new insights*. Corruption Research Centre, Budapest.
- Fazekas, M., & Tóth, I. J. (2014a). *From corruption to state capture: A new analytical framework with empirical applications from Hungary* (No. CRCB-WP/2014:01). Budapest.
- Fazekas, M., & Tóth, I. J. (2014b). *New ways to measure institutionalised grand corruption in public procurement* (No. 2014:9). U4 Anti-Corruption Resource Centre, Bergen, Norway.
- Fazekas, M., Tóth, I. J., & King, L. P. (2013). *Anatomy of grand corruption: A composite corruption risk index based on objective data* (No. CRCB-WP/2013:02). Budapest: Corruption Research Center Budapest.
- Goldman, E., Rocholl, J., & So, J. (2013). Politically Connected Boards of Directors and The Allocation of Procurement Contracts. *Review of Finance*, 17(5), 1617–1648. doi:10.1093/rof/rfs039
- Kenny, C., & Musatova, M. (2010). *“Red Flags of Corruption” in World Bank Projects: An Analysis of Infrastructure Contracts* (No. Policy Research Working Paper 5243) (p. Policy Research Working Paper 5243, World Bank, Washington DC). Washington, DC.
- Luechinger, S., & Moser, C. (2014). The value of the revolving door: Political appointees and the stock market. *Journal of Public Economics*, 119, 93–107.

- Lukács, P. A., & Fazekas, M. (2015). *The political economy of grand corruption in public procurement in the construction sector of Hungary*. ANTICORRP: Work Package 8 - Corruption, assistance and development, Berlin.
- Mironov, M., & Zhuravskaya, E. (2011). Corruption in Procurement and Shadow Campaign Financing: Evidence from Russia. In *ISNIE Annual Conference*.
- Mungiu-Pippidi, A. (Ed.). (2011). *Contextual Choices in Fighting Corruption: Lessons Learned*. Oslo: Norwegian Agency for Development Cooperation.
- Muraközy, B., & Telegdy, Á. (2015). *Political Incentives and State Subsidy Allocation: Evidence from Hungarian Municipalities* (No. 2015/31). Budapest.
- OECD. (2009). *OECD Principles for Integrity in Public Procurement*. Paris: OECD.
- OECD. (2014). *Financing Democracy. Supporting Better Public Policies and Preventing Policy Capture*. Paris: OECD.
- Rajwani, T., & Liedong, T. A. (2015). Political activity and firm performance within nonmarket research: A review and international comparative assessment. *Journal of World Business*, 50, 273–283.
- Rose-Ackerman, S. (1999). *Corruption and Government: Causes, Consequences, and Reform*. Cambridge, UK: Cambridge University Press.
- Straub, S. (2014). *Political Firms, Public Procurement, and the Democratization Process* (No. TSE-461). Toulouse.
- Tóth, B., Fazekas, M., Czibik, Á., & Tóth, I. J. (2014). *Toolkit for detecting collusive bidding in public procurement. With examples from Hungary* (No. CRCB-WP/2014:02). Budapest: Corruption Research Center Budapest.
- Transparency International. (2012). *Money, politics, power: corruption risks in europe*. Berlin: Transparency International.
- Trapnell, S. (2011). Actionable Governance Indicators: Turning Measurement into Reform. *Hague Journal on the Rule of Law*, 22(3), 317–348.

Acknowledgments



This project is co-funded by the Seventh Framework Programme for Research and Technological Development of the European Union

This policy report, *The Anticorruption Report 3: Government Favouritism in Europe*, is the third volume of the policy series “The Anticorruption Report” produced in the framework of the EU FP7 ANTICORRP Project. The report was edited by Prof. Dr. Alina Mungiu-Pippidi from the Hertie School of Governance, head of the policy pillar of the project.

ANTICORRP is a large-scale research project funded by the European Commission’s Seventh Framework Programme. The full name of the project is “Anti-corruption Policies Revisited: Global Trends and European Responses to the Challenge of Corruption”. The project started in March 2012 and will last for five years. The research is conducted by 21 research groups in sixteen countries.

The fundamental purpose of ANTICORRP is to investigate and explain the factors that promote or hinder the development of effective anti-corruption policies and impartial government institutions. A central issue is how policy responses can be tailored to deal effectively with various forms of corruption. Through this approach ANTICORRP seeks to advance the knowledge on how corruption can be curbed in Europe and elsewhere. Special emphasis is laid on the agency of different state and non-state actors to contribute to building good governance.

Project acronym: ANTICORRP

Project full title: Anti-corruption Policies Revisited: Global Trends and European Responses to the Challenge of Corruption

Project duration: March 2012 – February 2017

EU funding: Approx. 8 million Euros

Theme: FP7-SSH.2011.5.1-1

Grant agreement number: 290529

Project website: <http://anticorrrp.eu/>

Full country reports were published at <http://anticorrrp.eu/publications/integrated-report/> and at <http://anticorrrp.eu/publications/country-policy-reports-on-institutions-in-public-procurement-for-the-infrastructure-sector/>

All these contributions were given as part of the European Union Seventh Framework Research Project ANTICORRP (Anti-corruption Policies Revisited: Global Trends and European Responses to the Challenge of Corruption). The views expressed in this report are solely those of the authors and the European Union is not liable for any use that may be made of the information contained therein.