The Anticorruption Frontline

The Anticorruption Report

Volume 2

Alina Mungiu-Pippidi (editor)

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5. Are EU funds a Corruption Risk? The Impact of EU Funds on Grand Corruption in Central and Eastern Europe

MIHÁLY FAZEKAS, JANA GUTIERRÉZ CHVALKOVSKÁ, JIŘÍ SKUHROVEC, ISTVÁN JÁNOS TÓTH AND LAWRENCE PETER KING

It is hard to miss the 'buzz' around how extensively corruption affects the spending of European Union (EU) funds across many new and old member states: Italian mafia hijacking highway projects, or the European Commission freezing Structural Funds payments in countries such as Romania, Bulgaria, or Hungary. Some of these cases point at the involvement of high-level politics and organised criminal groups, raising the possibility that the EU in fact extensively finances large-scale corruption in a number of countries. EU funds constitute a considerable part of GDP in many member states, especially in Central and Eastern Europe (CEE) where it amounts to 1.9-4.4% of annual member state GDPs (KPMG 2012) and well above 50% of public investment. Even if only a fraction of these amounts is impacted by corruption, the negative effects are likely to be considerable in terms of misinvestment and distorted economic incentives, jeopardizing regional convergence. If corruption in EU funds spending is connected to high-level politics and organised crime, ramifications are more severe, impacting political competition, democracy, and eventually social welfare.

Given high level of perception of corruption risks in EU funds spending, especially in CEE, the large sums involved, and the potential negative consequences, this chapter sets out to explore **the impact of EU funds spending on institutionalised grand corruption in CEE.**

It focuses on three new EU member states: **Czech Republic, Hungary, and Slovakia** throughout 2009-12. These three EU member states represent different levels of wealth and development trajectories. Their political institutions differ considerably with Hungary lately displaying increasingly authoritarian characteristics and generally failing to tackle corruption; Slovakia making some progress towards clean government albeit with question marks, and Czech Republic being one of the good performers of CEE while displaying some signs of a deteriorating situation. In spite of differences, these countries share a broadly similar post-communist heritage and a relatively homogenous regulatory framework defined by the EU.

2009-12 constitutes a turbulent period with the global economic crisis unfolding and turning into a sovereign debt crisis in Europe, with the three countries being affected in different ways. There was at least one general election in 2009-12 in each

of these countries. This turbulent environment provides the perfect setting for testing the robustness of our theory in different political and economic contexts.

EU funds are spent in various forms, which makes it impossible to arrive at a blanket assessment. Therefore, this analysis only looks at **public procurement spending by public or semi-public organisations (e.g. state owned enterprises) financed from EU funds**, which predominantly means the use of Cohesion and Structural Funds. The advantage of this approach is that we can compare projects which are similar in most respects apart from the source of financing. Moreover, there is exceptionally good data available on public procurement spending in all three countries on the level of individual contracts for the period. Our approach is a major departure from prior studies in this area, as it utilizes a large-scale micro-level quantitative database, which allows for unearthing a rich detailed picture on the level of individual actors while also being broad enough to evaluate whole systems of governance.

1. Previous work

In spite of the considerable public and policy interest in corruption risks in EU funds spending, there is **remarkably little scientific work on the question to date.** Looking into the broader discussion, there are two potential sources of theoretical underpinning: the broad economic, sociological, and political science literature on aid dependence and the Europeanization literature in political science. These offer no unambiguous theoretical expectation on whether and how EU funds contribute to the quality of institutions and impact corruption. Rather, what we find is a set of conflicting predictions and mechanisms which need empirical evaluation.

The literature looking at the effect of development aid on quality of institutions and corruption is vast; however, it can be applied to the context of CEE countries and EU funds only with caution due to the differing contexts and funding volumes (i.e. EU funding amounts to 3-4% of recipient countries' GDP whereas many developing countries receive aid more than 10% of GDP). Nevertheless, according to this literature, **foreign aid can have a positive effect on governance** by providing clear policy goals of improving the civil service and helping countries to overcome the lack of resources for state building (Knack 2001). However, **development aid can also destroy institutions** and impede state building in a similar way as natural resources can (Djankov, Montalvo and Reynal-Querol 2008). Development aid can weaken accountability and the development of civil society by breaking the link between domestic revenues (i.e. taxation) and government services. It can also directly destruct domestic administrative capacity by reallocating talented bureaucrats from domestic institutions to aid organisations and by providing additional organisational goals potentially increasing institutional fragmentation. Probably most importantly, development aid increases the pool of public resources available for rent seeking which can mean more corruption in countries with low control of it (Bräutigam 2000). While these causal pathways may work differently in the CEE context, the above arguments may still account for a large part of the mechanisms linking EU funds to corruption

in the region. Combining these insights with scholarship specific to CEE and EU governance leads to more robust theoretical underpinnings.

In the literature on the process of Europeanization, few would debate that the **EU contributed to institution building and improvement of governance in CEE countries throughout the accession process** (Epstein and Sedelmeier 2009). The EU provided the highly popular goal of accession for CEE governments and guidance on which institutional improvements should be implemented to reach this goal albeit with varying clarity (Meyer-Sahling 2011). These resulted in a wealth of reforms of public administration, democratic checks and balances, or financial management. However, many authors expressed **concerns that CEE countries reversed a range of reforms after accession** and left many EU-supported and/or requested new rules as 'empty shells' (Epstein and Sedelmeier 2009; Mungiu-Pippidi 2007). These concerns stem from the EU's diminishing leverage to keep new member states in line with principles of good government and the perception that many pre-accession reforms have not become embedded in domestic law or administrative activity. Many of these reforms were either 'implemented' only on paper or created islands of excellence isolated from the rest of public administration (Goetz 2001).

Similarly to the literature on aid dependency, the Europeanization literature delivers good reasons for believing that **EU funds advance good government**. First, one of the most important remaining post-accession tools in Brussels for disciplining new member states is the promise of allocating or the threat of withdrawing EU fund (Epstein and Sedelmeier 2009) which should motivate recipient countries to manage funds well. Second, the disbursement of EU funds is more heavily regulated, making corruption more costly. Heavy administrative and regulatory requirements can also contribute to higher administrative capacity in the recipient organisations as they often have to invest in their capacities to be able to receive and manage EU funds. Third, extensive monitoring and controls of EU funds in addition to the usual national audit frameworks make detection and punishment of corruption more likely (European Commission 2003; European Court of Auditors 2012, 2013). Moreover, the European Court of Justice represents an additional venue for judicial review, making the capture of domestic courts a less effective way of avoiding punishment for corruption.

Similar to the development aid literature, Europeanization literature also delivers arguments stating that external funding such as **EU funds in CEE deteriorate the quality of government and increase corruption** for at least three reasons. First, EU Cohesion and Structural Funds are spent on investment projects where public discretion is high. From the wider literature, it is clear that discretionary spending is more likely to involve corruption than non-discretionary spending such as pensions (Mauro 1998; Tanzi and Davoodi 2001). Second, EU funding provides a large additional pool of public resources for rent extraction. Hence, all else being equal, EU funds add to the pool of particularistically allocated public resources (Mungiu-Pippidi 2013). Third, EU funds, like external funding in developing countries, weaken the link between domestic civil society, taxation, and policy performance.

In addition to the broader arguments above, preliminary evidence from Hungary (Fazekas, Tóth and King 2013c) and Romania (Dimulescu, Pop and Doroftei 2013) suggests that corruption in EU funds reaches up to high-level politicians. Therefore, it is conceivable that EU funds, in fact, fuel high-level corruption networks which can simultaneously control business and political positions. This implies that EU funding keeps corrupt elites in power rather than promoting integrity.

From the above discussion, the following hypotheses result:
on the one hand,

H0: EU funds decrease institutionalised grand corruption in CEE,

on the other hand:

HA: EU funds increase institutionalised grand corruption in CEE.

In the context of public procurement, institutionalised grand corruption refers to the allocation and performance of public procurement contracts by bending prior explicit rules and principles of good public procurement in order to benefit a closed network while denying access to all others (Mungiu-Pippidi 2006; North, Wallis and Weingast 2009; Rothstein and Teorell 2008).

While causal mechanisms cannot be tested one by one in detail, two major effects can be identified and hence will be tested separately: 1) the effect of additional resources represented by EU funding; and 2) the effect of different monitoring and incentive structures attached to EU funding.

2. Data and variables

2.1. Data sources

The database derives from public procurement announcements from 2009-12 in Czech Republic, Hungary, and Slovakia (this database is called the Public Procurement Comparative database, referred to as the **PPC** henceforth). The data represent a complete database of all public procurement procedures conducted under national public procurement laws. The PPC contains variables appearing in 1) calls for tenders, 2) contract award notices, 3) contract modification notices, and 4) administrative corrections notices. Not all announcements are available for every procedure, meaning that we have information on contract award notices for all procedures. All the countries' public procurement legislation is within the framework of the EU Public Procurement Directive and hence is, by and large, comparable. Utilization of certain regulatory tools is different, nevertheless, which provides useful variability for later analysis.

The data derives from official government online sources in each country (Table 1). As there is no readily available database, we used a crawler algorithm to capture every announcement available online. Then, applying a complex automatic

and manual text mining strategy, we created a structured database, which contains variables with 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 of sufficient quality for scientific research[1]. For a full description of database development, see Soudek and Skuhrovec (2013) on the Czech Republic, Fazekas and Tóth (2012a, 2012b) on Hungary, and Transparency International Slovakia (2009) on Slovakia.

Table 1. Primary sources of public procurement data and minimum thresholds.

Country	Source of PPC data	URL	Minimum thresholds (EUR)[1]
Czech Republic	Ministerstvo pro místnírozvoj ČR	http://www.isvzus.cz/usisvz/	39,000
Hungary	KözbeszerzésiÉrtesítő	http://www.kozbeszerzes.hu/	27,300
Slovakia	Úrad pre verejnéobstarávanie	http://www.uvo.gov.sk/sk/evestnik	30,000

The resulting database describes at the micro-level a considerable proportion of GDPs and public spending in these three countries (**Table 2**). In spite of the relative similarity of thresholds for applying national public procurement laws, the three countries have very different proportions of transparent public procurement spending to total GDP. On the one hand, this is due to the use of exceptions, most notably in Hungary, and announcing contract awards in the official journal even if they would fall outside the remit of the law, most typically in the Czech Republic. On the other hand, this is due to the different total amounts spent on public procurement in the three countries whereby Hungary spends the least.

Table 2. Main statistics of the analysed data by country, total public procurement spending, 2009-2012.

	Czech Republic	Slovakia	Hungary	Total
Total number of contracts awarded (with valid contract value)	46945	20841	51231	119017
Total number of unique winners	11015	4912	10739	26666
Total number of unique issuers	5838	2069	5171	13078
Combined value of awarded contracts (million EUR)*	41591	22947	12514	77052
Combined value of awarded contracts (% GDP)**	6.90%	8.50%	3.20%	6.10%

*Notes: * Exchanged into EUR using average monthly exchange rate of the contract award, not corrected for inflation; ** GDP figures are from Eurostat (GDP at market prices).*
Source: PPC.

[1] For example, contract award announcements and calls for tenders are directly linked through a unique procedure ID in the Czech Republic only. Whereas in Hungary and Slovakia, the announcements refer to each other in varying formats making our linking procedure imperfect.

2.2. Variables used in the analysis

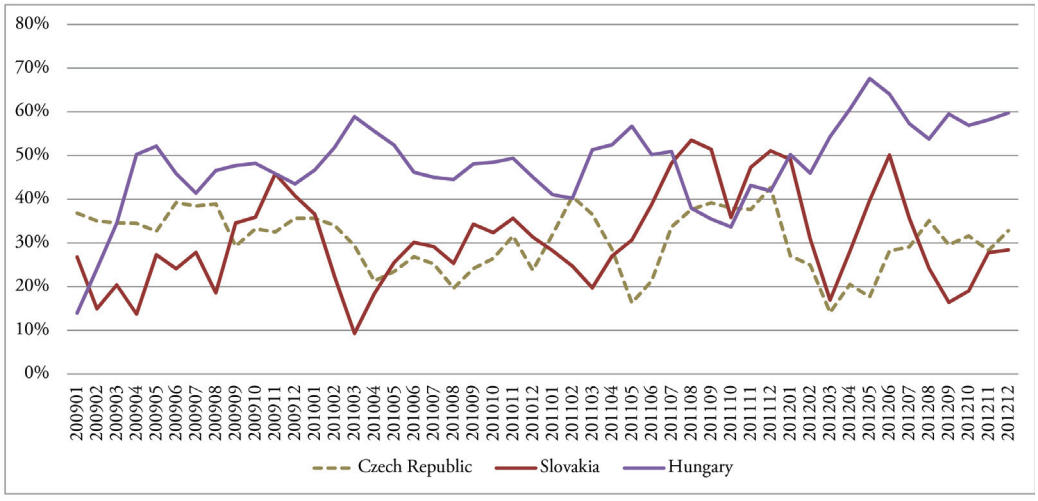
i. *EU funds use*

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 (this latter information will only be used at a later research stage as it requires text mining procedures for precise program identification). 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 categorisation 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. Our approach nevertheless implies that throughout this paper, EU funding figures also include some national co-financing of between 5-20%.

Contrary to popular perceptions, public procurement from EU funds does not fall under a different procedural regime. The same procurement rules and thresholds apply regardless of funding source. **Common national and European public procurement legal frameworks warrant a meaningful comparison between EU funded and non-EU funded public procurement procedures**. The crucial difference between procurement procedures funded from EU funds and by national governments lies in additional monitoring and controls and different motivation structures associated with spending EU funds.

The three countries have made use of EU funding in their procurement spending to varying degrees with Hungary spending most extensively (**Figure 1**).

Figure 1. Proportion of contract value making use of EU funding to total contract value, 2009-12, by country (% of total contracted value*, 3-month rolling averages).



*Notes: * contract values are converted to EUR using the average exchange rate of the month of contract award, and they are corrected for inflation differentials across the 3 countries. Values are in 2009 Slovak EUR.*
Source: PPC

ii. Indicators of institutionalised grand corruption

Developing comparative indicators of institutionalised grand corruption in public procurement for all three countries represents the primary methodological innovation of this article. The approach follows closely the composite indicator building methodology developed by the authors (Fazekas, Tóth and King 2013a) making use of a wide range of public procurement 'red flags'.

The measurement approach exploits the fact that **for institutionalised grand corruption to work, procurement contracts have to be awarded recurrently to companies belonging to the corrupt network**. This can only be achieved, if legally prescribed rules of competition and openness are circumvented. By implication, it is possible to identify the input side of the corruption process, that is techniques used for limiting competition (e.g. leaving too little time for bidders to submit their bids), and also the output side of corruption, that is signs of limited competition: single bid received and recurrent contract award to the same company. By measuring the degree of unfair restriction of competition in public procurement, a proxy indicator of corruption can be obtained. This indicator, called **Corruption Risk Index (CRI) represents the probability of particularistic contract award and delivery in public procurement falling between 0 and 1**. The variables describing the input side of the corruption process in public procurement, that is **elementary corruption techniques**, are reported in **Table 3**.

Table 3. Summary of elementary corruption risk indicators.

Proc. phase	Indicator name	Indicator values	availability		
			CZ	HU	SK
submission	Single bidder contract (valid/received)	1=1 bid received	x	x	x
		0=more than 1 bid received			
	Call for tenders not published in official journal	1=NO call for tender published in official journal	x	x	x
		0=call for tender published in official journal			
	Procedure type	0 =open procedure	x	x	x
		1=invitation/restricted procedure			
		2=negotiation procedure			
		3=other/framework procedures			
		4=outside PP law			
		5=missing/erroneous procedure type			
	Call for tender modification	1=modified call for tenders	x	x	
		0=NOT modified call for tenders			
	Length submission period	Number of days between the publication of call for tenders and the submission deadline (for short submission periods weekends are deducted)	x	x	x

assessment	Number of evaluation criteria	number of distinct evaluation criteria (separate rows)	x	x	
	Length of decision period	number of days between submission deadline and announcing contract award	x	x	x
overall	winner contract share	12-month total contract value of winner / 12-month total awarded contract value (by issuer)	x	x	x
Number of components			*8*	*8*	*6*

Source: PPC.

Component weights are assigned to elementary corruption risk indicators (CRI) using a set of regressions directly modelling corrupt rent extraction in public procurement (**Table 4** and **Table 5**). In these regressions, two likely corrupt outcomes of the corruption process: 1) single bidder contracts and 2) winner's share of issuer's contracts are regressed on elementary corruption risk indicators (**Table 3**) and variables controlling for alternative explanations:

- low administrative capacity: number of employees of the issuer,
- institutional endowments: type of issuer,
- market specificities: CPV division of products procured (2 digit level),
- number of competitors on the market: number of unique winners throughout 2009-12 on CPV level-3 product group (4 digit level) and NUTS-1 geographic region,
- contract size and length, and
- regulatory changes: year of contract award;

and using a restricted sample in order for the regressions to adequately fit a corrupt rent extraction logic as opposed to market specificities or inexperience with public procurement:

- markets with at least 3 unique winners throughout 2009-2012 for markets defined by cpv (level 3) and nuts (level 1) categories for each country; and
- issuers awarding at least 3 contracts in the 12 months period prior to the contract award in question.

For continuous variables such as the length of submission period, **thresholds** had to be identified in order to reflect the non-linear character of corruption. This was done using statistical techniques, in particular analysing the residual distributions.

Regression results indicate that there is considerable market access restriction, hence likely institutionalised grand corruption, going on in all three countries during the 2009-12 period, by and large following the same techniques and 'tricks' (**Table 4** and **Table 5**). These results on their own demonstrate that corruption is systemic in public procurement in these countries. Arriving at robust regression models with considerable explanatory power by using the same regression set-up and variables point at the feasibility of cross-country measurement.

While there is not enough space to discuss each variable in detail, some examples show the logic of analysis and our approach to interpretation. In the **Czech Republic**, the modification of the call for tenders is associated with a 0.6% higher probability of receiving a single bid and with a 1.5% higher winner's contract share. Both results point at a likely interpretation that modifying call for tenders during the bidding phase is systematically used for restricting access and recurrently benefiting the same company. This result warrants that the modification of call for tenders will be part of the Czech CRI. In **Slovakia**, not publishing the call for tenders in the official journal is associated with 9.0% higher probability of a single bidder contract award and a 1.3% higher winner's contract share. Both results suggest that avoiding the transparent and easily accessible publication of a new tender can typically be used for limiting competition to recurrently benefit a particular company. This implies that call for tenders not published in the official journal becomes part of the Slovak CRI. In **Hungary**, leaving only 5 or fewer days, inclusive the weekend, for bidders to submit their bids is associated with 20% higher probability of a single bidder contract and with a 7.9% higher winner's contract share compared to periods longer than 20 calendar days. These indicate that extremely short submission periods are often used for limiting competition and awarding contracts recurrently to the same company. Once again, this provides sufficient grounds for including this category in the Hungarian CRI.

Following this logic, only those variables and variable categories are included in CRI which are in line with rent extraction logic and proven to be significant and powerful predictors in at least one of the two regressions for each country.

Table 4. Binary logistic regression results on contract level, 2009-12, by country, average marginal effects, for markets where nr. of winners >=3.

Dependent var: single bidder contract (1), multi-bidder contract (0)					
Independent vars-CZ	CZ	Independent vars-SK	SK	Independent vars-HU	HU
NO call for tenders in off. journal	0.116***	**NO call for tenders in off. journal**	0.091***	**NO call for tenders in off. journal**	0.098***
Prob.	0.000	Prob.	0.000	Prob.	0.000
procedure type		**procedure type**		**procedure type**	
ref. cat.=open procedure		ref. cat.=open procedure		ref. cat.=open procedure	
1=invitation procedure	-0.042***	1=invitation procedure	0.01	1=invitation procedure	0.082***
Prob.	0.000	Prob.	0.575	Prob.	0.000
2=negotiation procedure	0.4***	2=negotiation procedure	0.498***	2=negotiation procedure	0.074***
Prob.	0.000	Prob.	0.000	Prob.	0.000
3=outside PP law	-0.087***	3=other procedure types	0.344***	3=other procedure types	0.276***
Prob.	0.435	Prob.	0.000	Prob.	0.000
4=other/missing/erroneous procedure type	-0.049	4=outside PP law	-0.029	4=missing/error	0.025***
Prob.	1.000	Prob.	0.190	Prob.	0.000
modification of call for tenders	0.006***	**modification of call for tenders**	n.a.	**modification of call for tenders**	n.a.
Prob.	0.000				
short submission period		**short submission period**		**short submission period**	
ref.cat.=s.period>55*		ref.cat.= s.period>25		ref.cat.=s.period>20	
1= 47<s.period<=55	0.044***	1= 14<s.period<=25	0.078***	1= 17<s.period<=20	0.001
Prob.	0.000	Prob.	0.000	Prob.	0.875
2= 43<s.period<=47	0.067***	2= s.period<=14	0.02	2= 5<s.period<=14	0.103***
Prob.	0.000	Prob.	0.680	Prob.	0.000
3= 38<s.period<=43	0.05***	3= missing	0.064	3= 0<s.period<=5 (incl.weekend)	0.2***
Prob.	0.000	Prob.	0.600	Prob.	0.000
4= 27<s.period<=38	0.007			4=missing	0.05***
Prob.	0.440			Prob.	0.000
5= 0<s.period<=27	0.009				
Prob.	0.230				
6=missing submission period	-0.053				
Prob.	0.455				
number of assessment criteria		**number of assessment criteria**	n.a.	**number of assessment criteria**	
ref.cat.= nr.of criteria=0				ref.cat.=2<nr.of criterioa<=4	
1= 0<nr.of criteria<=2	0.053			1=nr.of criterioa=0	0.053***
Prob.	1.000			Prob.	0.000
2= 2<nr.of assessment criteria<=8	-0.006***			2= 0<nr.of criterioa<=2	0.087***
Prob.	0.000			Prob.	0.000
3= 8<nr.of criteria	0.009			4= 4<nr.of criterioa	0.068***
Prob.	0.520			Prob.	0.000
length of decision period		**length of decision period**		**length of decision period**	
ref.cat.= 113<dec.period<=201		ref.cat.=62<dec.period<=120		ref.cat.= 44<dec.period<=182	
1= 0<dec.period<=54	0.212	1= 0<dec.period<=62	0.127***	1= 0<dec.period<=32	0.14***
Prob.	0.470	Prob.	0.000	Prob.	0.000
2= 54<dec.period<=67	0.111***	3= 120<dec.period<=227	0.134***	2= 32<dec.period<=44	0.056***
Prob.	0.000	Prob.	0.000	Prob.	0.000
3= 67<dec.period<=100	0.083***	4= 227<dec.period<=322	0.16***	4= 182<dec.period	0.16***
Prob.	0.000	Prob.	0.000	Prob.	0.000
4= 100<dec.period<=113	0.053***	5= 322<dec.period	0.173***	missing	-0.045***
Prob.	0.000	Prob.	0.000	Prob.	0.000
6= 201<dec.period	0.075***	6= missing	0.047		
Prob.	0.000	Prob.	0.550		
7= missing decision period	0.128				
Prob.	1.000				
constant included in each regression					
N	39423		16957		32006
Pseudo-R2	0.295		0.231		0.108

Note: * p<0.05; ** p<0.01; *** p<0.001

*Note: * p<0.05; ** p<0.01; *** p<0.001; clustered standard errors clustered by issuer for P(Fisher), Monte Carlo random permutation simulations for P(permute) (200 permutations) using Stata 12.0.*
Source: PPC.

Table 5. Ordinary least squares regression results on contract level, 2009-12, by country, average marginal effects, for markets where nr. of winners >=3**.**

Dependent var: winner's contract share in the last 12 months					
Independent vars-CZ	CZ	Independent vars-SK	SK	Independent vars-HU	HU
single bidder contract	0.032***	**single bidder contract**	0.021***	**single bidder contract**	0.02***
Prob.	0.000	Prob.	0.000	Prob.	0.000
NO call for tenders in off. journal	-0.002***	**NO call for tenders in off. journal**	0.013	**NO call for tenders in off. journal**	0.021***
Prob.	0.000	Prob.	0.055	Prob.	0.000
procedure type		**procedure type**		**procedure type**	
ref. cat.=open procedure		ref. cat.=open procedure		ref. cat.=open procedure	
1=invitation procedure	0.015***	1=invitation procedure	0.099***	1=invitation procedure	-0.037***
Prob.	0.000	Prob.	0.000	Prob.	0.005
2=negotiation procedure	0.01***	2=negotiation procedure	-0.014	2=negotiation procedure	0.011***
Prob.	0.000	Prob.	0.115	Prob.	0.025
3=outside PP law	-0.009***	3=other procedure types	0.054***	3=other procedure types	0.03***
Prob.	0.000	Prob.	0.000	Prob.	0.000
4=other/missing/erroneous procedure type	0.004***	4=outside PP law	-0.003	4=missing/error	-0.005
Prob.	0.000	Prob.	0.820	Prob.	0.275
modification of call for tenders	0.015***	**modification of call for tenders**	n.a.	**modification of call for tenders**	n.a.
Prob.	0.000				
short submission period		**short submission period**		**short submission period**	
ref.cat.=s.period>55*		ref.cat.= s.period>25		ref.cat.=s.period>20	
1= 47<s.period<=55	-0.009***	1= 14<s.period<=25	0.016	1= 17<s.period<=20	0.014***
Prob.	0.000	Prob.	0.170	Prob.	0.000
2= 43<s.period<=47	0.016***	2= s.period<=14	0.036	2= 5<s.period<=14	0.05***
Prob.	0.000	Prob.	0.210	Prob.	0.000
3= 38<s.period<=43	-0.016***	3= missing	-0.019	3= 0<s.period<=5 (incl.weekend)	0.079***
Prob.	0.000	Prob.	0.845	Prob.	0.000
4= 27<s.period<=38	-0.005			4=missing	-0.01***
Prob.	0.735			Prob.	0.485
5= 0<s.period<=27	-0.005***				
Prob.	0.000				
6=missing submission period	0.155**				
Prob.	0.010				
number of assessment criteria		**number of assessment criteria**	n.a.	**number of assessment criteria**	
ref.cat.= nr.of criteria=0				ref.cat.=2<nr.of criterioa<=4	
1= 0<nr.of criteria<=2	-0.01			1=nr.of criterioa=0	-0.01***
Prob.	1.000			Prob.	0.010
2= 2<nr.of assessment criteria<=8	0.014			2= 0<nr.of criterioa<=2	-0.005***
Prob.	0.610			Prob.	0.430
3= 8<nr.of criteria	0.092*			4= 4<nr.of criterioa	0.022*
Prob.	0.040			Prob.	0.000
length of decision period		**length of decision period**		**length of decision period**	
ref.cat.= 113<dec.period<=201		ref.cat.=62<dec.period<=120		ref.cat.= 44<dec.period<=182	
1= 0<dec.period<=54	0.006	1= 0<dec.period<=62	0.033***	1= 0<dec.period<=32	0.013
Prob.	0.365	Prob.	0.000	Prob.	1.000
2= 54<dec.period<=67	0.008**	3= 120<dec.period<=227	-0.001	2= 32<dec.period<=44	0.017***
Prob.	0.010	Prob.	0.830	Prob.	0.000
3= 67<dec.period<=100	0.011***	4= 227<dec.period<=322	0.016	4= 182<dec.period	0.047***
Prob.	0.000	Prob.	0.205	Prob.	0.000
4= 100<dec.period<=113	0.03***	5= 322<dec.period	0.014	missing	0.026***
Prob.	0.000	Prob.	0.115	Prob.	0.000
6= 201<dec.period	0.001	6= missing	-0.039		
Prob.	0.270	Prob.	0.370		
7= missing decision period	-0.11				
Prob.	1.000				
constant included in each regression					
N	26830		12847		20658
Pseudo-R2	0.294		0.185		0.234

*Note: * p<0.05; ** p<0.01; *** p<0.001; clustered standard errors clustered by issuer for P(Fisher), Monte Carlo random permutation simulations for P(permute) (200 permutations) using Stata 12.0.*
Source: PPC.

Once the list of elementary corruption risk indicators is determined with the help of the above regressions, each of the variables and their categories receive a component weight (**Table 6**). As we lack the detailed knowledge of which elementary corruption technique is a necessary or sufficient condition for corruption to occur, we assign equal

weight to each variable and the sizes of regression coefficients are only used to determine the weights within variables. For example, if there are four significant categories of a variable, then they would get weights 1, 0.75, 0.5, and 0.25 reflecting category ranking according to coefficient sizes. The component weights are normed so that the observed CRI falls between 0 and 1.

The strength of this composite indicator approach is that the individual components of CRI are vulnerable to changes in regulation, competitive environment, or elite power balance on their own, but taken together they are a more **robust proxy of legal corruption over time**.

In an international comparative perspective, a further strength of CRI is that it **balances national specificities with international comparability**. On the one hand, it provides a comparative indicator in as much as the logic of indicator building and the underlying indicators are the same in each country (of course, as much as data availability permits, further work is in progress). On the other hand, component weights and variable category thresholds (e.g. the definition of accelerated procedure in terms of submission period length differs by country and year) reflect the different national contexts. The same overall scale of country level CRI (i.e. 0-1) lends some meaning to the 'which country is more corrupt' question; nevertheless, the primary purpose of the measurement exercise is to go beyond simplistic understandings of corruption and explore the structure of corruption within each context.

Table 6. Component weights of CRI reflecting variable and category impact on corruption outcomes, normed to have an overall sum of 1.

Czech Republic		Slovakia		Hungary	
variable	weight	variable	weight	variable	weight
single bid	0.16	**single bid**	0.17	**single bid**	0.15
NO call for tenders published in o. journal*	0.16	**NO call for tenders published in o. journal***	0.17	**NO call for tenders published in o. journal***	0.15
Procedure type		**Procedure type**		**Procedure type**	
open	0	open	0	open	0
invitation	0	invitation	0.06	invitation	0.11
negotiation	0.16	negotiation	0.17	negotiation	0.07
outside pp law	0	other/framework	0.11	other	0.15
other/missing/error	0	outside pp law	0	missing/error	0.04
		missing/error	0		
Modification of call for tenders	0.16	**Modification of call for tenders**	n.a.	**Modification of call for tenders**	0
Length of submission period		**Length of submission period**		**Length of submission period*** **	
s.period>55**	0	s.period>25	0	s.period>20	0

47<s.period<=55	0.08	14<s.period<=25	0.17	17<s.period<=20	0.04
43<s.period<=47	0.16	s.period<=14	0.08	5<s.period<=14	0.11
38<s.period<=43	0.12	missing	0	0<s.period<=5 (incl. weekend)	0.15
27<s.period<=38	0.04			missing	0.07
0<s.period<=27	0.04				
missing	0				
Number of assessment criteria		**Number of assessment criteria**	n.a.	**Number of assessment criteria**	
nr.of criteria=0	0			nr.of criteria=0	0.05
0<nr.of criteria<=2	0			0<nr.of criteria<=2	0.1
2<nr.of criteria<=8	0			2<nr.of criteria<=4	0
8<nr.of criteria	0.16			4<nr.of criteria	0.15
missing	0			missing	0
Length of decision period		**Length of decision period**		**Length of decision period**	
0<dec.period<=54	0.16	0<dec.period<=62	0.17	0<dec.period<=32	0.1
54<dec.period<=67	0.12	62<dec.period<=120	0	32<dec.period<=44	0.05
67<dec.period<=100	0.08	120<dec.period<=227	0.04	44<dec.period<=182	0
100<dec.period<=113	0.04	227<dec.period<=322	0.08	182<dec.period	0.15
113<dec.period<=201	0	322<dec.period	0.13	missing	0
201<dec.period	0.08	missing	0		
missing	0.12				
Winner contract share	0.16	**Winner contract share**	0.17	**Winner contract share**	0.15

*Note: * for procedures with missing call for tenders, component weights are proportionately increased to account for missing information on variables: 1) modification of call for tenders; 2) length of submission period; and 3) length of decision period.*

*** for invitation procedures: submission period>31*

**** exact thresholds deviate from the given numbers depending on the year and procedure type, for full description see (Fazekas, Tóth and King 2013b)*

3. Corruption risks and particularistic allocation of EU funding

EU funds can exert influence on institutionalised grand corruption in CEE countries in two principal ways: **first, by providing additional funding for public investment hence increasing the pool of potential rents to extract; second, by changing the motivation structure and constraints of corrupt networks**. Motivations and constraints of corruption are different for EU Structural and Cohesion Funds because monitoring may be more intense and thorough, and because national accountability mechanisms may work in a different way when funding comes from outside. The first approach focuses attention on increased amount of spending, whereas the second on the different motivations for and controls of corruption.

The prevalence of corruption and changes in it are approximated by calculating the expected value of public funds allocated in a particularistic way, where the expected value is calculated by relying on standard expected value theory:

Expected total value of particularistic resource allocation (EUR) =
probability of corruption (%) * total value spent (EUR)

where the probability of corruption to occur is measured by CRI. This value captures the amount of resources allocated in a particularistic way which, by no means, equates with the value of corruption rents extracted or cost of corruption. Rather, it implies the overall value of public funds most likely available for rent extraction, while this rent very much depends on the profitability and cost structure of benefiting companies (e.g. even in a very corrupt road construction project, something must be built which costs at least some amount to the contractor). The total social cost of corruption is composed of many components of which corruption rent is only one, and perhaps not even the biggest. Imagine, for example the misallocation of public investment to high corruption rent, but low social return projects such as barely used stadiums, which are expensive to maintain.

3.1. Corruption risks of spending more

Institutionalised grand corruption thrives on public resources, especially on public resources whose allocation can be influenced to benefit a small circle of businessmen and politicians without restraint (Soreide 2002). Hence, by increasing the overall value of public procurement spending, corruption risks and corrupt rent extraction increase, unless they are offset by more stringent controls of corruption. This section estimates the increase in corruption risks due to increased spending only, while holding motivations and controls, that is average corruption risks, constant.

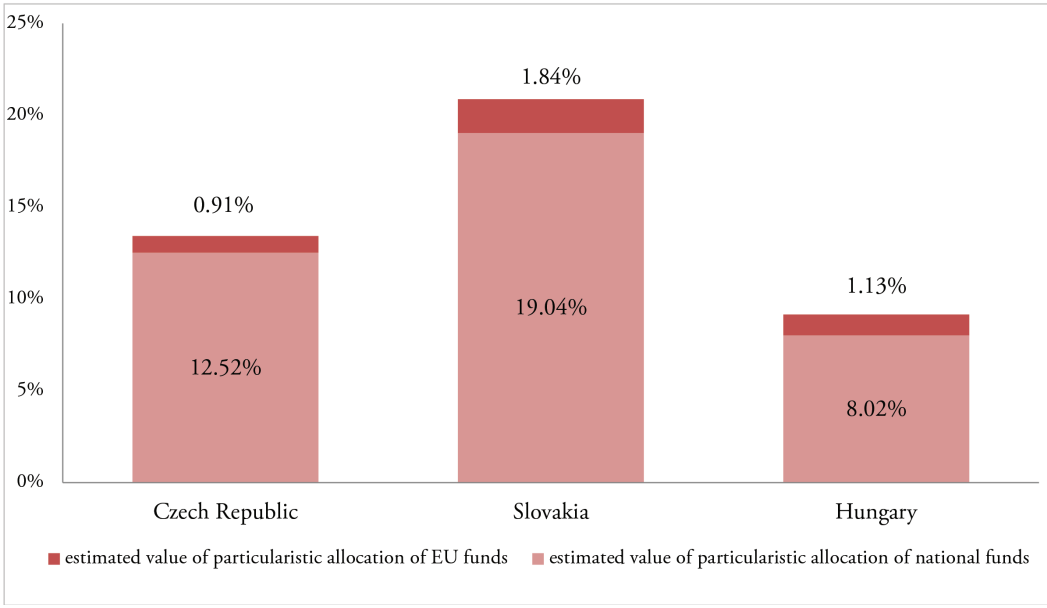
As EU regulation prescribes that EU Structural and Cohesion Funds should represent additional spending rather than substituting national spending (European Council 2006), we assumed 100% additionality, including national co-financing. This means that every Euro of EU funding spent in public procurement is considered to come on top of nationally funded public procurement.

For calculating the expected value of particularistic resource allocation due to additional public spending generated by EU funds (for simplicity: additional particularistic resource allocation), CRI of EU funding has to be held constant at the average CRI of nationally funded public procurement. This is for separating the effect of additional spending from the effect of different motivations for and controls of corruption. Hence, the following formula was used:

Expected value of *additional* particularistic resource allocation $_{EU}$ **=**
probability of corruption $_{national\ average}$ * **total value spent** $_{EU}$

Using this formula, **the value of particularistic resource allocation due to additional public spending generated by EU funds was between 0.9% and 1.8% of national GDPs in 2009-12 in the three countries** (**Figure 2**). Differences between the three countries, by implication, are driven by the different (estimated) amounts of EU funds spent through public procurement.

Figure 2. Estimated value of national and EU funded public procurement disbursed in a particularistic way, by country, % of 2009-12 total GDP.



Source: PPC.

3.2. Corruption risks of spending differently

While additional public resources available for discretionary allocation have considerably increased the prevalence of corruption in the Czech Republic, Hungary, and Slovakia, it is possible that such additional corruption is counterbalanced by more stringent regulation, monitoring, and transparency. If such controls are effective, overall corruption risks would not increase at all or would increase only slightly. In order to check

the effectiveness of EU and national institutional frameworks to control corruption of the additional resources, we compare corruption risks (CRI) in public procurement from EU and non-EU funding. Furthermore, the defining aspects of corruption risk differentials are also explored in detail in order to develop policy recommendations.

i. Corruption risks in EU and non-EU funded procurement procedures

In order to identify the causal impact of EU funding on corruption risks, EU and non-EU funded procurement procedures are compared which are as similar in every major respect as possible except for the funding source. As EU funding is not randomly assigned to procurement procedures, we have to rely on state-of-the-art statistical methods to select similar procedures, that is constructing the treatment (EU funding) and control groups (no EU funding). Therefore, first, we show a baseline comparison of CRI between EU and non-EU funded procedures in the three countries; second, we employ propensity score matching.

EU and non-EU funded procurement procedures' CRIs are compared within each country. In Hungary, two alternative comparisons are made: one using a comparative CRI (henceforth hu(comparative)), and another one using a CRI composed of a wider set of indicators (henceforth hu(extended) (for a full description see: Fazekas et al. 2013a). The reason for also including the extended CRI for Hungary is that it paints a richer picture of the driving forces behind the corruption risks of EU funding.

A simple comparison of average CRI scores within each country suggests that EU funded procurement carries higher corruption risks than nationally funded procurement in the Czech Republic and Hungary, while it carries lower corruption risks in Slovakia (**Table 7**). However, these comparisons may very well be biased as EU and non-EU funded projects could be fundamentally different. For example, if EU funded projects are larger and more complex, then comparisons are inadequate.

Table 7. Naïve comparison of EU and non-EU funded procedures' CRI, 2009-12, by country.

	cz	sk	hu (comparative)	hu (extended)
non-EU funded	0.36	0.522	0.291	0.251
EU funded	0.369	0.421	0.31	0.289
Difference (non-EU - EU funded)	**-0.009**	**0.101**	**-0.019**	**-0.038**
95% c.interval-lower bound	-0.014	0.092	-0.023	-0.041
95% c.interval-upper bound	-0.005	0.11	-0.015	-0.035
N non-EU funded	26975	14159	25437	25460
N EU-funded	12470	2827	13698	13711

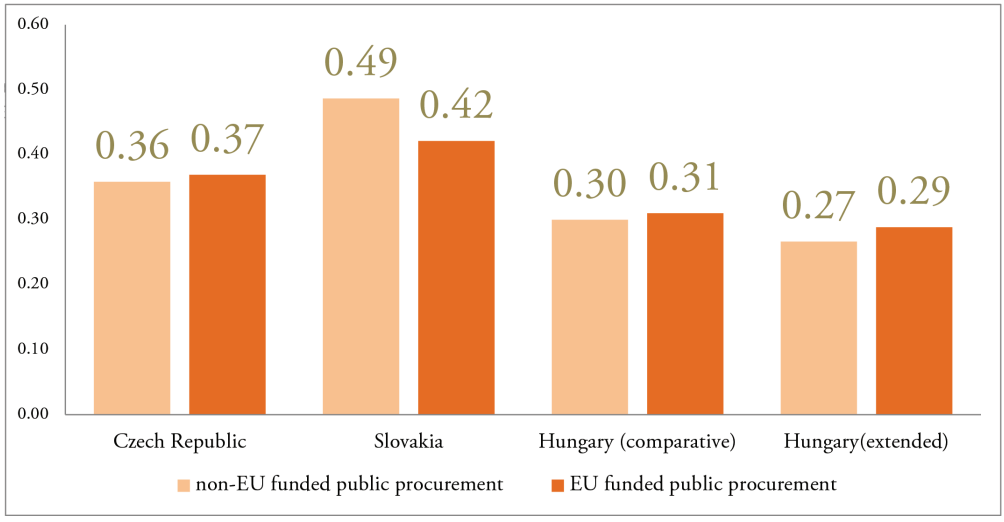
Source: PPC.

The propensity score matching technique employed attempts to select procedures as similar as possible in terms of 1) the main market of procured goods and services; 2) log value of contract; and 3) contract length, as corruption risks can be very different for procurement procedures on different markets and of different sizes or complexities.

Propensity score matching, taking into account confounding factors, reveals a similar picture as above, albeit one different in effect magnitudes (**Figure 3**). The negative effect of EU funding on worsening corruption, has stayed the same in the Czech Republic, while it slightly decreased in Hungary. The positive effect in Slovakia greatly diminished compared to the baseline. All the effects are statistically significant at the 0.001 level. **In the Czech Republic, EU funded projects have 0.011 or 3% higher CRI compared to similar non-EU funded projects. In Slovakia, EU funded projects have 0.065 or 13% lower CRI than similar non-EU funded projects. In Hungary, EU funded projects have 0.01 or 3% higher CRI compared to similar non-EU funded projects using the comparable CRI definition.**

The effect on **Hungarian extended CRI is a great deal larger than for the comparative CRI: 0.022 or 8% higher CRI for EU funded projects than for comparable non-EU funded projects.** This suggests that with corruption risks may come factors associated with the implementation phase such as contract modification (note that Hungary is unique among the three countries in the mandatory publication of every contract modification and contract fulfilment notice). As the differences in driving factors may reveal additional findings, they are explored in the next section.

Figure 3. Average CRI scores of EU and non-EU funded public procurement procedures, by country, 2009-12, N_{cz}=39320, N_{sk}=15760 N_{hu}=38862.



Note: Every within country difference is significant at p<0.001 level, standard errors obtained using Monte Carlo random permutations (200 repetitions).

Source: PPC.

In order to get a sense of how big these differences are, we calculated the expected value of particularistic resource allocation due to different motivations and controls of corruption associated with EU Funds (in short expected value of particularistic resources of different source). We used the following formula:

Expected value of particularistic resources of *different source* $_{EU}$ **=**
(probability of corruption $_{EU}$ **- probability of corruption** $_{national\ average}$ **)**
*** total value spent** $_{EU}$

Using this formula yields that **in the Czech Republic, the increase in the expected value of particularistic resource allocation due to higher corruption risks of EU funds amounts to 158 million EUR or 0.03% of the total 2009-12 GDP. In Hungary, the same figure is only 52 million EUR or 0.02% of total 2009-12 GDP.** The difference in overall values between the Czech Republic and Hungary are due to lower public procurement spending in Hungary and slightly smaller average effect**. In Slovakia, the expected value of lower average corruption risks associated with EU funds translates into a 381 million EUR or 0.23% of total 2009-12 GDP.** While this positive effect appears very large in comparison to the other two analysed countries, it must be borne in mind that Slovakia seems to have a much higher overall prevalence of institutionalised grand corruption. This improvement of 0.23% of GDP is only a small correction in comparison to the 1.84% of GDP additional particularistic resource allocation (see **Figure 2**). Taken together, the overall effect of EU funds spending in Slovakia is still considerably higher than in the two other countries: 1.61% (1.84% minus 0.23%) as opposed to 0.94% (0.91% plus 0.03%) and 1.15% (1.13% plus 0.02%) for Czech Republic and Hungary, respectively.

Overall, effect sizes are dwarfed by the effect of additional amount of spending, discussed in the previous section. **This implies that the increasing corruption risks due to higher amount of public resources allocated could not be offset by more stringent controls of corruption**. In spite of being designed for controlling fraud and misuse, the EU's monitoring system have failed to moderate increasing corruption risks in Hungary and Czech Republic, while it only partially offset increasing risks in Slovakia. What is most striking is that EU funds are of slightly higher corruption risks in Czech Republic and Hungary than comparable nationally funded procurement procedures calling into question the overall monitoring framework in place in these countries.

ii. Components driving corruption risk differentials

In order to identify the driving factors behind corruption risk differences between EU and non-EU funded public procurement procedures, we performed binary logistic regression with EU funds use on the left-hand side of the equation and corruption risk components on the right-hand side of the equation, while also including the control variables used for propensity score matching.

The comparison of elementary corruption risk indicators driving CRI differences between EU and non-EU funded procurement procedures reveals a remarkably consistent picture across the three countries (**Table 8**). First, EU funded procedures

perform better in highly visible formally required aspects of procurement such as publishing the call for tenders, using open procedure type, or allowing sufficient time for bidders to bid. Second, less strictly regulated aspects such as period of time for making an award decision, call for tender modification, or complexity of assessment criteria represent consistently higher corruption risks for EU funded projects. Third, the key dimension according to which **EU funded projects are underperforming is corruption risks associated with lack of competition**: single bidder contract award and winners' contract share. The extensive efforts to make EU funded projects high value for money through competition seem to be insufficient.

Taking into account the broader set of elementary corruption risk indicators in Hungary alters the picture considerably. First, the detrimental corruption risk effect of weak competition remains very strong. Second, the effects of procedure type, submission period length, and decision period length have become insignificant or only weakly negative. Third and most importantly, some less visible procurement corruption risk characteristics take on a crucial role in increasing EU funds corruption risks: weight of non-price evaluation criteria, length of eligibility criteria, and contract modification during delivery.

Table 8. Summary of driving factors of CRI differences between EU and non-EU funded projects, 2009-12.

variable/country	cz	sk	hu(comp)	hu(ext)
Winner contract share	++	++	++	++
Single bid	+	+	+	+
NO call for tenders published in o. journal	- -	-	-	-
Procedure type	- -	-/+	-	0
Length of submission period	- -	- -	- -	-/0
Length of decision period	-/+	-/+	-/0	-/0
Modification of call for tenders	+			0
Number of assessment criteria	-/0		-/+	
Weight of non-price evaluation criteria				++
Length of eligibility criteria				++
Relative price of documentation				-
Annulled procedure re-launched subsequently				-
Contract modification				++
Contract lengthening				- -

Note: - - means strong negative effect on EU funds corruption risks; - means weak negative effect on EU funds corruption risks; + means weak positive effect on EU funds corruption risks; ++ means strong positive effect on EU funds corruption risks; 0 means insignificant or negligible effect on EU funds corruption risks; representing two signs in the same cell indicates a diverse effect of corruption risk categories within the same variable.
Source: own calculation

Conclusions and policy consequences

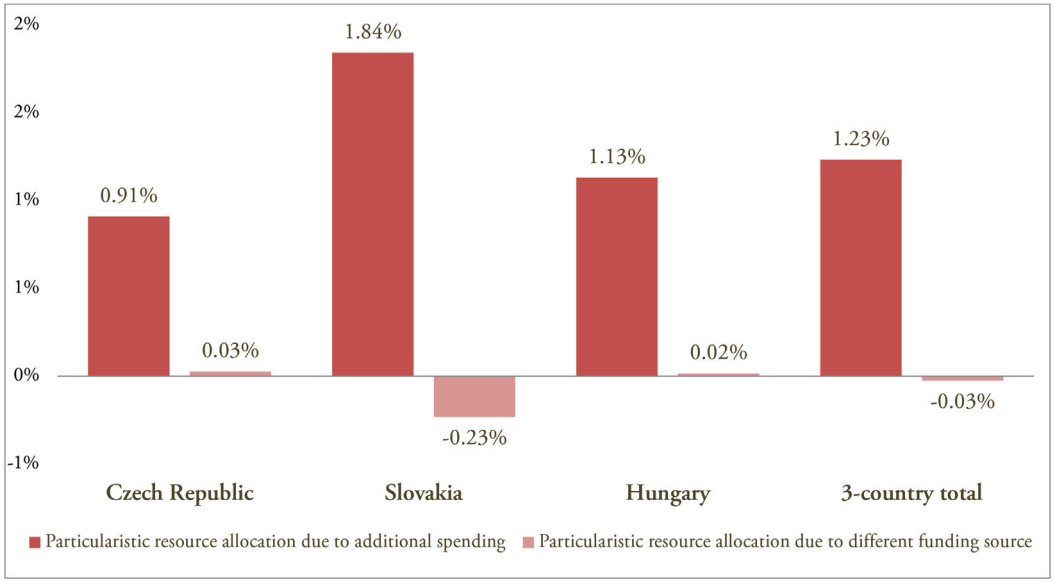
While much additional work is needed, this paper has already demonstrated that it is feasible and fruitful to use detailed, contract-level data for tracking corruption risks over time across EU countries. Such monitoring can be done in real-time if the necessary investment into database development is made. Fazekas et al. (2013b) discusses data availability in Europe and beyond in detail.

Our preliminary findings indicate that EU funding considerably increase corruption risks in Central and Eastern Europe in at least two principal ways (**Figure 4**). First, by making a large amount of additional public resources available for rent extraction in public procurement; second, by failing to implement sufficient controls of corruption counter-balancing additional resources for corruption. In spite of extensive monitoring efforts of EU authorities, EU funded procurement spending represents even higher corruption risks than the comparable national spending in Czech Republic and Hungary. EU funded public procurement in Slovakia carries only slightly lower corruption risks than comparable national procurement spending, albeit national spending is generally of much higher corruption risk than in the two other countries. In either case, this positive effect falls long way short of offsetting the negative effect of increased discretionary spending available. Nevertheless, the comparatively better performance of Slovakian public procurement projects funded by the EU suggests that EU funding can have a somewhat positive effect in a very high corruption risk environment. Based on this finding further research could look at the conditional effect of EU funding on corruption.

For the three countries combined, our results imply an estimated additional particularistic resource allocation worth up to 1.20% of combined GDP of the three countries throughout 2009-12. This is the result of an estimated maximum 1.23% of GDP in terms of additional funding disbursed in a particularistic way, and an estimated maximum 0.03% of GDP in terms of lower corruption risk of EU funded procurement than national procurement. These figures are exceptionally high, for example compared to total EU funds allocation to these countries, which is about 3.3% of their GDP.

While EU funded public procurement may be effective in lifting growth rates in Central and Eastern Europe, its desired benefits stand in contrast with corruption risks and potential corruption costs. While further work is needed to get more precise estimates of particularistic resource allocation and the associated corruption costs, our preliminary findings already indicate that such costs may not be negligible.

Figure 4. Estimated value of additional particularistic resource allocation due to EU funding in national public procurement, decomposition into effect of additional spending and different funding source, by country, % of 2009-12 total GDP.



Source: PPC

Looking at the driving forces behind corruption risks in EU funding reveals that salient, easily controlled corruption risks are considerably lower, while risks of more subtle procedure characteristics and overall strength of competition considerably increase corruption risks in EU funded public procurement procedures. These findings highlight the importance of monitoring the whole project cycle from initiation to completion as well as the need for a wide indicator set for adequately measure corruption.

If further research confirms the higher corruption risks associated with EU funds, the EU will have to consider implementing more effective policies for protecting its financial interests and promoting good government; in particular:

- **Introducing an EU-wide, real-time monitoring mechanism of EU funds spending designed to detect systematic fraud and corruption in public procurement using data mining techniques, elements of which can be derived from ANTICORRP research;**
- **Refocusing the monitoring and control mechanisms from procedural adequacy to supporting effective competition and controlling bid rigging; and**
- **Considering the reallocation of EU funding going into discretionary investment projects, which typically constitute high corruption risks, towards non-discretionary spending such as unemployment benefit.**

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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.

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