



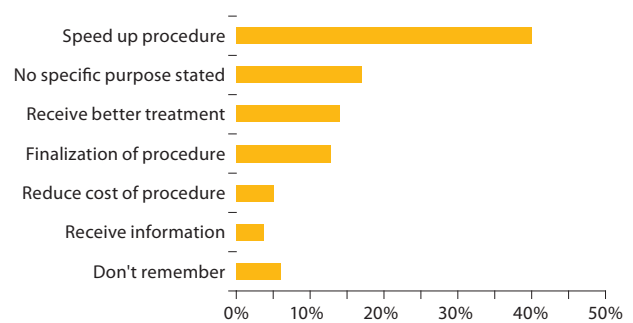
The stifling of economic growth, entrepreneurship and fair competition are among the diverse and well documented effects of corruption on society and its governance. More recent research has shown that corruption exacerbates bad fiscal policy, and deficits are skewed towards discretionary spending, and away from socially universal goods such as healthcare and education.<sup>121</sup> The correlation between corruption and economic development is so strong that the dominance of the former gets a country into a vicious circle of more corruption and less development, while when the latter dominates it generates a virtuous circle of more growth and less need for bribery. In Southeast Europe, the considerable involvement of governments in the economy generates a number of points of potential conflict between public institutions and business; in turn, this creates corruption risk.

## 5.1. BUSINESS ENVIRONMENT AND INFORMAL ECONOMY

In the SELDI area, business overregulation – mostly concerning registration, licensing and permit regimes implementation – constantly generates various barriers to market entrants and higher costs of doing business. This drives entrepreneurs in the informal sector and/or compels them to resort to bribery. In a downward spiral this then justifies further regulation and administrative barriers. Experience and studies on SEE countries demonstrate that businesses in the region pay most often to speed up procedures and to avoid penalties. The latter is related to overreliance of the authorities on mass, punitive measures.

The variety of circumstances that occasion corruption in the interactions of business and public officials illustrate the difficulty anticorruption policies face. When initiated by business, corrupt practices can be divided into two main categories – avoiding extra costs and gaining unfair advantage. In the first group are the kickbacks necessitated by poor or excessive

Figure 58. How business in Southeast Europe<sup>122</sup> justifies the payment of bribes to officials



Source: (UNODC, 2013w, p. 28).

regulation, individual or institutional incompetence, etc.; the second are related to various types of fraud – tax evasion, VAT fraud, smuggling, non-compliance with health and safety standards, etc.

A key corruption risk factor in the SELDI area is the informal or hidden economy. The Center for the Study of Democracy in its annual *Corruption Assessment Reports* has demonstrated that corruption has been the main tool for unscrupulous businesses to stay off the record books and to generate government-protected monopolies and undue rents. “The size and scope of the hidden economy provide cover for large grey and black financial flows from the business sector into politics, which in turn influence the operation of the official economy.”<sup>123</sup>

The impact of corruption on the business environment in **Albania** is evident in the raking of corruption as the second most significant obstacle to doing business after high taxes, with an average prevalence of business bribery of 15.7 percent.<sup>124</sup> Given that small enterprises are around 90 percent of companies, the fact that prevalence of bribery is higher among small businesses than among businesses of other sizes is particularly worrying. It has a detrimental effect for several reasons:

- they are more vulnerable to increases in costs;
- they are an important source of income and employ-

<sup>121</sup> (Pippidi, 2013).

<sup>122</sup> Covers Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro, and Serbia.

<sup>123</sup> (Center for the Study of Democracy, 2009, p. 57).

<sup>124</sup> (UNODC, 2013a, p. 5).

ment for a large number of people;

- SMEs have a greater potential for growth and the long run impact of corruption on these businesses might be even bigger.

Corruption in the customs has been continuously ranked among the highest in the country.<sup>125</sup> The government expects to generate additional income equal to 1 percent of the national GDP by bringing in foreign monitoring of customs operations,<sup>126</sup> which is indicative of how much revenue it estimates is lost through corruption. Estimates of the informal economy in Albania are very high, generating a large part of the country’s GDP and thus hindering fair business competition as well as substantially reducing income generated by tax. There are no official figures but various estimates suggest that its share has been revolving around 30 percent of GDP in the past 5 years.<sup>127</sup> Index Mundi 2013 suggests that its share might be as high as 50 percent of GDP.<sup>128</sup> The shadow economy is regarded by most businesses as one of their main concerns and constraints due to the unfair competition. With a share as large as 30 to 50 percent of the GDP, the number of unreported transactions and resources that go for bribes is potentially large as well, with higher incentives for informal businesses to bribe public compliance bodies. As of January 2014, the government of Albania has adopted a progressive tax system, which might raise concerns of an increase in informal economy especially of the medium-sized (but also large) enterprises which would prefer to declare less and benefit from the lower tax rate. The results from the tax changes will depend to a very high degree on the government’s success in winning back trust, including by delivering on anticorruption promises.

The World Bank ranked **Bosnia and Herzegovina** 131 out of 189 countries in the 2014 Doing Business survey – last among the SELDI countries. It takes 11 procedures and 37 days to start a business in Bosnia and Herzegovina, which puts it on the 174<sup>th</sup> place in the ranking on this specific indicator. In the 2009 – 2013 period, the country introduced no reforms to reduce corruption risks in the economy; in 2012, the government replaced a required utilisation permit with a simple notification of commencement of activities and simplified process for obtaining a tax identification number.

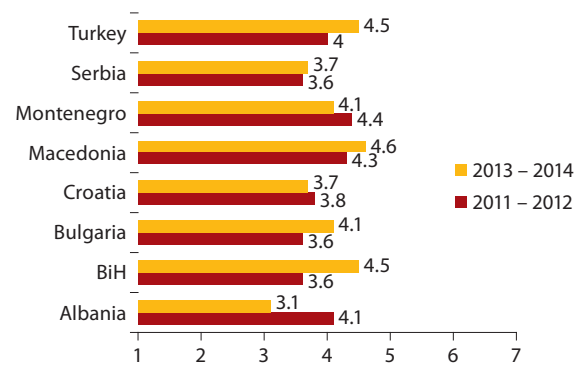
<sup>125</sup> Please refer to Table 2, page 83.

<sup>126</sup> (Doganat, “Crown Agents” 450 kontrolle në muaj, 2014).

<sup>127</sup> (Boka & Torluccio, 2013).

<sup>128</sup> Index Mundi (2013), Albania Economy Profile.

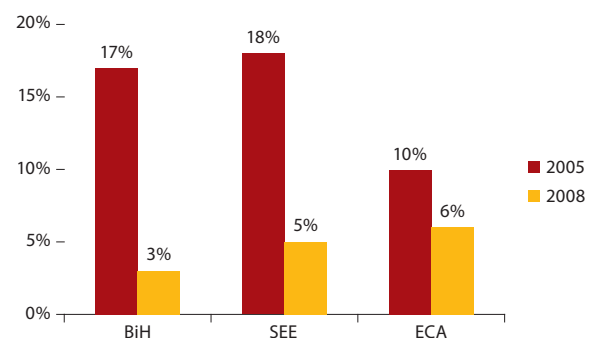
**Figure 59. Performance of SELDI countries in the indicator “Irregular payments and bribes” of the Global Competitiveness Report<sup>129</sup>**



Source: World Economic Forum.

Business in Bosnia and Herzegovina “is having hard times to survive in the difficult political environment and still needs registration in the two state entities – Republika Srpska and the Federation of Bosnia and Herzegovina (FBiH). In the former, the registration of firms was significantly reduced from 23 to 3 days and the price also dropped to €200. But in the FBiH, the establishment of a company is much more complicated and expensive. The share of non-performing loans is also high and growing. In the second quarter of 2013 they reached 14.3%. Bosnia and Herzegovina's public sector is huge and inefficient, as many of the competences overlap or are duplicated,<sup>130</sup> which creates high risks of corruption.

**Figure 60. Share of businesses stating bribery is frequent in dealing with courts, BiH compared to Southeast Europe and Europe and Central Asia**



Source: BEEPS At-A-Glance 2008, Bosnia and Herzegovina.

The hidden economy and informal employment represent one of the greatest challenges in the

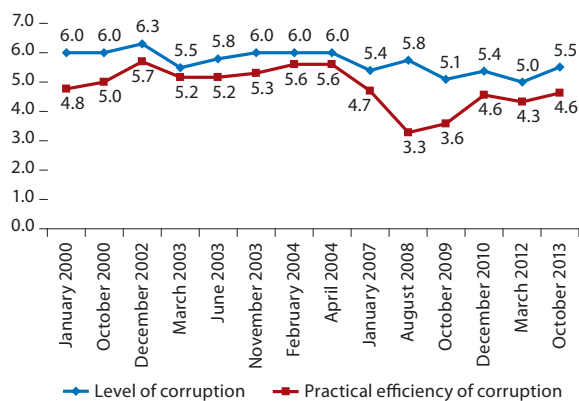
<sup>129</sup> The indicator is based on the weighted average score across responses to a survey question inquiring how common is it for firms to make undocumented extra payments or bribes. The answers range from 1 (very common) to 7 (never occurs).

<sup>130</sup> (Marini, 2014).

economy of Bosnia and Herzegovina. The labour market is characterised by low dynamics, high level of unemployment and informal employment. In the summer of 2012, the Labour and Employment Agency of Bosnia and Herzegovina announced that informal employment, by their estimations, reached about 200,000 persons.<sup>131</sup> According to other estimates, around 34 percent of working people do not pay pension and health insurance, and the government has no strategy or plan to deal with this issue.<sup>132</sup>

In **Bulgaria** 51% of the companies consider corruption as a problem to their operation. There is almost universal agreement among business – 94% – that the close links between business and politics leads to corruption. Somewhat smaller share of companies (66%) state that the only way to succeed in business is to have political connections. 85% of the Bulgarian and 69% of the European firms consider that bribery and the use of connections is often the easiest way to obtain certain public services in their country. In Bulgaria, 71% of the respondents consider unlikely that corrupt people or businesses would be caught or reported to the police or prosecutors, higher than the EU-27 average of 60%.<sup>133</sup>

**Figure 61. Level and practical efficiency of corruption in the Bulgarian business sector\***



\* **Note:** **Level of corruption:** The index ranges from 0 (nobody from the public administration is involved in corruption) to 10 (almost everybody from the public administration is involved in corruption). **Practical efficiency of corruption:** The index assesses whether corruption pays off. It ranges from 0 (not likely at all) to 10 (very likely).

**Source:** CMS, Center for the Study of Democracy, 2013.

In the business sector, the indexes for corruption pressure and involvement in corruption have not changed significantly in recent years. **Concentration**

<sup>131</sup> (Labour and Employment Agency of Bosnia and Herzegovina, 2012).

<sup>132</sup> (Federalni Zavod Za Zapošljavanje, 2013).

<sup>133</sup> All data from (TNS Political & Social, March 2014).

**and the emergence of monopolies** have pushed corruption to the higher strata of administrative and political power, alleviating it at lower administrative levels. The fact that political corruption affecting the business sector is not changing is confirmed by the perception of businesses about corruption levels and practical efficiency of corruption.<sup>134</sup>

**Figure 62. Problems encountered in doing business: Bulgaria compared to EU-27**



**Source:** (TNS Political & Social, March 2014).

Over the last 10 years the informal economy in Bulgaria shrunk due to various factors, including the economic convergence with the EU, the deepening of the credit markets, introduction of mandatory employment contract registration in 2003 and the real-time linking of fiscal devices with the National Revenue Agency servers as well as performed inspections. Still, according to CSD's 2013 *Hidden Economy Index*,<sup>135</sup> the share of the hidden economy in Bulgaria increased in 2013 among both businesses and the population. The main reasons behind this development can be sought in low income, harsh labour market conditions, the decline in the economic outlook, as well as the overall political instability in 2013. The high unemployment rates are of particular concern as a risk factor providing incentives to more people to engage in hidden economy activities. Among the results of the 2013 *Hidden Economy Index* two main trends stand out:

- Increase in the incidence of **hidden employment**, mainly due to seasonal work and semi-formal employment schemes. According to CSD's conservative

<sup>134</sup> (Center for the Study of Democracy, 2013(43), p. 6).

<sup>135</sup> (Center for the Study of Democracy, 2013(42)).

estimates a total of BGN 245.6 mln (€126 mln) in social security payments were lost from underreporting and non-reporting of income in 2013.

- Increase in public perceptions on **tax evasion** and mild deterioration in terms of the government's tax collection rates. The latter can be explained by the deflation in certain months in 2013, as well as a variety of other related economic conditions. Still, tax revenue growth since 2009 has been subdued – its year-on-year growth was below 1% in September 2013. At the same time, almost BGN 1.45bn (€743.5 mln) annually is lost to VAT evasion and social security contribution gaps, according to rough approximations, while the real figure could be even higher.<sup>136</sup>

Almost half of the business representatives in **Croatia** consider corruption to be a serious obstacle in doing business, which affects the overall business climate and investment decisions and results in the Croatian economy being one of the most affected by cancelled investment projects in the Western Balkans (5.6%).<sup>137</sup> Starting a business was made easier in Croatia by the introduction of a new form of limited liability company with a lower minimum capital requirement and simplified incorporation procedures. Tax payments were reorganised by introducing an electronic system for social security contributions. Streamlining litigation proceedings and transferring certain enforcement procedures from the courts to state agencies and introducing an expedited out-of-court restructuring procedure contributed to overall improvement in doing business in Croatia.<sup>138</sup> The *Index of Economic Freedom* concurs with the World Bank's assessment, stating that the business start-up process has become less burdensome, taking less than 10 procedures. However, it is emphasised that obtaining necessary permits takes over 200 days and costs over four times the level of average annual income. Despite ongoing reform efforts, the labour market remains relatively rigid.<sup>139</sup> In 2012, the shadow economy in Croatia was 28 per cent of GDP, close to the levels of Bulgaria (31%) and Turkey (27%).<sup>140</sup>

As in the other SELDI countries, **business in Kosovo** claims to employ bribery mostly to overcome bureaucratic inefficiency: the lead reason it gives by for

bribing government officials is to “speed up business-related procedures” (28.4%), although only 3.2 percent admit to have done so.<sup>141</sup> As for how corruption discourages business activity, “some 3.3 per cent of business representatives decided not to make a major investment [...] due to the fear of having to pay bribes to obtain requisite services or permits.”<sup>142</sup> This is especially the case for smaller businesses.

Kosovo has improved its position in the World Bank Doing Business rankings moving up from the 96<sup>th</sup> spot in 2013 to the 86<sup>th</sup> in 2014. The greatest progress has been achieved in the “Starting a business” category. In this category Kosovo has moved from the 126<sup>th</sup> place to the 100<sup>th</sup> due to the decrease in the number of procedures, time, and cost of registering a business. Progress related to many corruption cases and the environment for doing business has been made in the “Dealing with construction permits” category. Construction permits red-tape has led to so much corruption that anyone even associated with these activities is perceived as highly corrupt and responsible for the spatial planning degradation, especially in the capital city. It is debatable whether the removal of red-tape will have a positive effect; however, shortening the time and the making the process of obtaining construction permits more efficient will surely help the business environment. Improvement has also been registered in the ease of registering property. Property disputes in Kosovo have had a devastating effect in the economy, especially in pushing up interest rates as the banks take more risks due to the uncertainty regarding who owns what.

In 2013, businesses in Kosovo reported on average only 65.6 percent of their sales for tax purposes – a 34.4 percent evasion rate.<sup>143</sup> Research finds the main causes of informality in the economy to be factors such as fiscal morale, trust in institutions, and the cost of compliance. Trust in institutions was found to be statistically significant at the 95% confidence level. The discrepancy between what businesses pay in taxes and what they receive in form of public goods and services – a discrepancy which most likely is explained by corruption – is another factor for such a high rate of informality.

Given the share of the public sector in the economy in Kosovo the system is still highly vulnerable. When

<sup>136</sup> (Center for the Study of Democracy, 2013(42)).

<sup>137</sup> (UNODC, 2013c)

<sup>138</sup> (The World Bank, 2013, p. 162).

<sup>139</sup> <http://www.heritage.org/index/country/croatia>

<sup>140</sup> (Schneider, *The Shadow Economy in Europe*, 2013, p. 4).

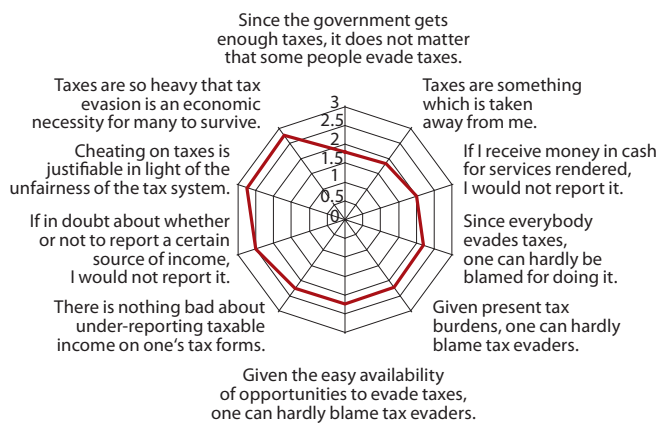
<sup>141</sup> (UNODC, 2013a, p. 4).

<sup>142</sup> *Ibid.* p. 6.

<sup>143</sup> (Riinvest Institute, 2013, p. 8).

private domestic consumption and exports increase, and businesses rely less on public contracts, corruption will not be such an important barrier to business.

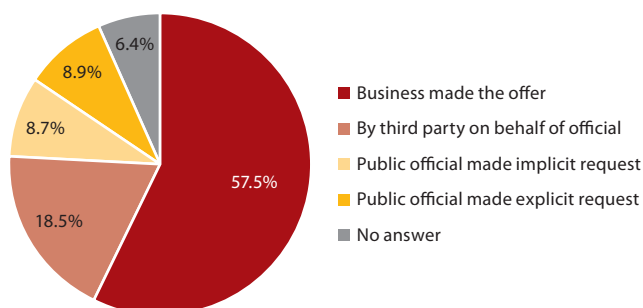
**Figure 63. How tax evasion is justified by Kosovo business**



Source: (Riinvest Institute, 2013, p. 19).

**Macedonia** has the highest rank among the SELDI countries in World Bank's 2014 Doing Business index. Nevertheless, the Macedonian business environment is affected by corruption: „Investors and businesspeople have reported being solicited for bribes, particularly when participating in public procurements and government projects.”<sup>144</sup> The share of businesses reporting to have paid a bribe in the preceding year is double that in Kosovo – 6.5 percent.<sup>145</sup> As in the other SELDI countries, the prevalence of bribery is slightly higher among small businesses than among businesses of other sizes.

**Figure 64. Origins of bribe offers in the business-government transactions in Macedonia**



Source: (UNODC, 2013m, p. 24).

As measured by the electricity consumption method, the informal economy in Macedonia has decreased

over the period 2000 – 2010 from 34% of GDP in 2000 to 24% of GDP in 2010, measuring almost €1.7 billion in 2010.<sup>146</sup> The main causes of the grey economy are considered taxes, unemployment, regulation intensity, bureaucracy, etc. According to the latest data from the State Statistical Office (Labour Force Survey, 2012), informal employment accounts for 22.5% of total employment in the country.

**Businesses in Montenegro** rank corruption as the “fifth most significant obstacle to doing business, after high taxes, complicated tax laws, limited access to financing and labor regulations.”<sup>147</sup> Furthermore, the “establishment of a sound business environment continues to be hampered by the weak rule of law and corruption.”<sup>148</sup> Such conditions and perceptions are not encouraging for foreign or domestic investors. On average, 1 out of 12 (8.5%) entrepreneurs in Montenegro state that they had not made some investments in the previous period because of fear of corruption and organised crime.<sup>149</sup>

In **Serbia**, most studies find that the government intervention is ubiquitous, that barriers to business, i.e. costs of doing business, are substantial, and that there are two main consequences of such an arrangement: low level of economic freedom and breeding ground for corruption. The most important barriers to economic activities and the most important contributing factors to the low overall ranking of Serbia are: (1) dealing with construction permits; (2) paying taxes; (3) enforcing contracts and resolving insolvency.<sup>150</sup> Not only are all of these obstacles government-created, but all of them are also prone to corruption. Construction permits are a corruption risk of the investment process and it discourages greenfield investments in Serbia, thus affecting the economic growth rate. The costs of paying taxes affects corruption in taxation as there is an incentive to speed up the procedure – not necessarily breaching tax regulation, but paying a bribe for tax authority officials to do their job properly. Problems related to enforcing contracts, mainly due to the inefficient and overloaded judiciary, provide incentives for corruption in the judiciary. The aim of bribery is not necessarily to get a favourable outcome, but to get the outcome as soon as possible, without considerable delays. The same appears to be the case of resolving

<sup>146</sup> (Centre for Economic Analyses, 2012).

<sup>147</sup> (UNODC, 2013n, p. 9).

<sup>148</sup> (European Commission, SWD(2013) 411 final, p. 3).

<sup>149</sup> (UNODC, 2013n, p. 7).

<sup>150</sup> (The World Bank, 2013).

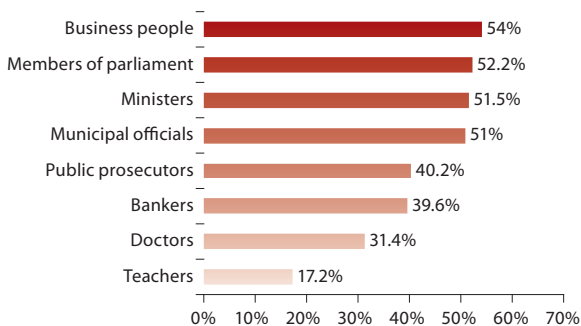
<sup>144</sup> (U.S. Department of State, 2013m).

<sup>145</sup> (UNODC, 2013m, p. 5).

insolvency, the process that is time-consuming beyond any reasonable standard. Furthermore, the main developments in the past five years in the fields of these major costs of doing business are not favourable, i.e. the cost of doing business has increased.

In **Turkey**, 52% of international companies operating in the country believe that bribery/corrupt practices happen widely in business.<sup>151</sup> In addition, 56% believe that corrupt practices have increased due to the economic downturn. In contrast, only 2.4% of business executives surveyed in the 2013 – 2014 Global Competitiveness Report consider corruption among the truly problematic factors for doing business (compared to tax rates with 14.8%). The same businesses executives, however, do not seem to be trusted by the general public (Figure 65), which creates a unique picture of corruption perceptions in Turkey, with the main culprit seen on the business side, and not on the side of the government.

**Figure 65. Businessmen considered most corrupt in Turkey<sup>152</sup>**



Source: SELDI/CSD Corruption Monitoring System, 2014.

In 2009, the informal economy in Turkey was estimated at 33% of the 2004 – 2005 GDP.<sup>153</sup> More recently, however, Turkey’s Minister of Finance noted in an article<sup>154</sup> that informal employment in Turkey has declined by 14.5 percentage points since 2002, to 37.6% in April 2013. He also added that the informal economy as a share of GDP declined by six percentage points during this period, to 26.5% in 2013. This is almost in line with another study, which estimates the size of the shadow economy in Turkey as 27.7% of GDP as of 2012, compared to the OECD average of 19.2%.<sup>155</sup>

<sup>151</sup> (Ernst & Young, 2013, p. 4).

<sup>152</sup> Share of respondents answering “Almost everybody is involved” and “Most are involved” in corruption.

<sup>153</sup> (Reis, Angel-Urdinola, & Torres, 2009).

<sup>154</sup> (Şimşek, 2014).

<sup>155</sup> (Schneider, Shadow Economy in Turkey and in other OECD-Countries: What do we (not) know?, 2012).

## 5.2. GOVERNMENT BUDGET AND REDISTRIBUTION

The composition of public spending and the redistribution of the budget have major implications not only for the efficient and fair allocation of public funds, but also the risks and vulnerabilities for corrupt practices. “Public expenditure – and especially public investment – is known to offer some of the best opportunities for corruption.”<sup>156</sup>

In the SELDI area, fiduciary risk is enhanced because of a number of reasons which include corruption:

- Large share of public spending in GDP;
- Large share of the informal economy which, among other things, compromises revenue planning;
- Corruption in public procurement, which compromises the value for money aspect of public expenditure;
- Low transparency of the budget process and fiscal management;
- Confusion – deliberate or not – among aspects such as budgetary and extra-budgetary figures, and between functional and administrative allocations.
- Poor institutional monitoring, oversight and auditing.

Thus in these countries corruption could be associated with all stages of the budget process – preparation, adoption, use of funds and ex post control.

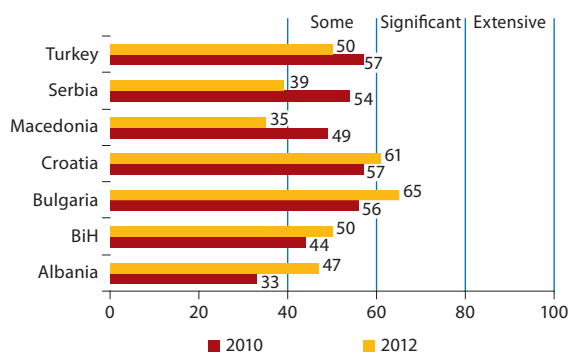
An important factor in the corruption risk associated with public finances is poor transparency. While some SELDI countries have improved the level of publicity of their budget process, in a number of others there has been tangible backsliding (Figure 66).

Evidently, most SELDI countries fall into the “Some information” range associated with some corruption risk. While EU member-countries, like Bulgaria, provide much more information on the planning, execution and evaluation of the budgetary process to their citizens, actual accountability in terms of programme budgeting and efficiency indicators remain underdeveloped. All the other SELDI countries are even further back on the road to budget transparency and accountability.

Another measure of the integrity of public finances is contained in the views of private business of the

<sup>156</sup> (Isaksen, 2005, p. 4).

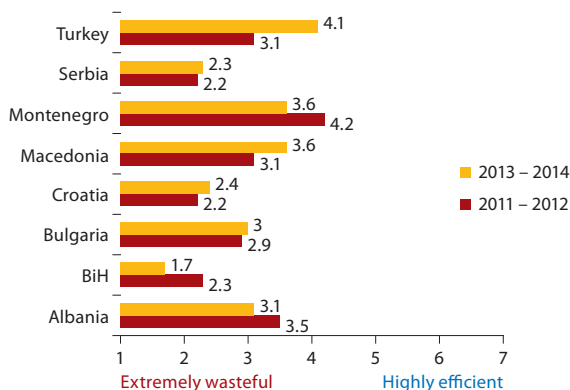
**Figure 66. Performance of some SELDI countries in the index of the Open Budget Survey<sup>157</sup>**



Source: International Budget Partnership.

composition of public spending. In this, again the performances are mixed – while Montenegro, Bosnia and Herzegovina and Albania have deteriorated, the governments of Turkey, Macedonia, Croatia and Bulgaria are believed to have become more wasteful (Figure 67). With the exception of Turkey in 2013 – 2014 none of the other countries reached even half of the maximum score on efficiency.

**Figure 67. Performance of SELDI countries in the indicator “Wastefulness of government spending” of the Global Competitiveness Report<sup>158</sup>**



Source: World Economic Forum.

Some of the outstanding issues in the management of public finances in **Albania** include the quality of the budget analysis, the parliamentary debate on

the national budget, proper monitoring of public expenditures, and production of consistent evaluation reports. Despite the process of budget hearings in parliament being generally well regulated and organised, doubts about the quality of the debate have been raised, including that individual debate sessions in the Committee on Economy and Finance of the Ministry of Finance are too short to allow for in-depth discussion. Although parliamentary groups have the right to call for sessions with the government including the Prime Minister, ministers are unlikely to participate in the hearings unless there is a political issue. Since the committee in charge of budget approval and budget oversight is chaired by an MP of the majority party, the opposition does not have much influence on budget oversight. To improve the quality of budget discussions the Albanian parliament should reconsider establishing a non-partisan budget office in order to address the lack of independent analytical capacity for MPs, as OECD experts have advised.<sup>159</sup>

Controls of non-payroll expenditure are primarily ex-ante voucher checking. There is very little internal audit functionality at the ex-post stage as required by international best practices. Budget institutions receive invoices from suppliers and prepare expenditure documents and perform ex-ante controls. Since “many budget institutions do not have access to the treasury system they send expenditure documents to the relevant Treasury district office that records and performs an additional ex ante control before payment. Through this practice the Ministry of Finance keeps a strong central control on budget execution.”<sup>160</sup>

In **Bulgaria**, the 2014 draft budget represents a mix of social pledges including employment, education, healthcare and regional development and a statement for reduced administrative burden on the business. One of its major assumptions providing for higher revenues is the improved collection of VAT. This is expected to come from a reverse-charge mechanism for VAT and stricter control over goods with higher fiscal risk. While these measures can improve budget revenues, they are unlikely to change the overall business environment, and hence the level of hidden economy in the country. The success of the measures hinges critically on the ability of the government to end political patronage of selected companies involved in VAT fraud, in particular at the local level.

<sup>157</sup> Scores out of 100. The index has four ranges according to the amount of budget information provided to the public: 81-100 Extensive; 61-80 Significant; 41-60 Some. Kosovo and Montenegro are not surveyed.

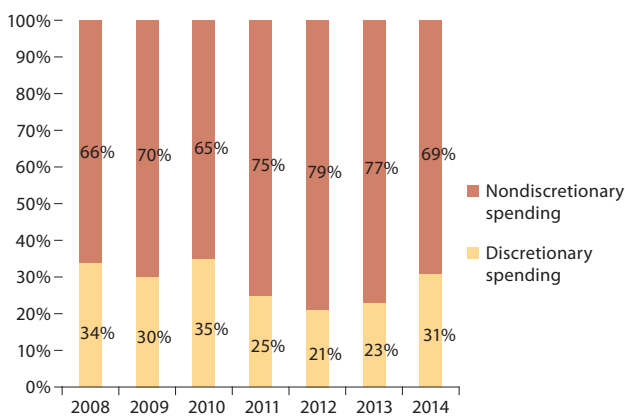
<sup>158</sup> The indicator is based on the answer of a sample of global business executives to the question “How would you rate the composition of public spending in your country?” with answer ranges from 1 (extremely wasteful) to 7 (highly efficient in providing necessary goods and services).

<sup>159</sup> (Klepšvik, Emery, Finn, & Bernhard, 2013).

<sup>160</sup> (Klepšvik, Emery, Finn, & Bernhard, 2013, p. 38).

The Bulgarian 2014 budget plan indicates growth in discretionary government spending compared to 2013 and preceding years, including slight rise in capital expenditure, annual budget deficit expansion and a two-fold increase of the size of the contingency fund. Large part of the contingency fund will be used for financing investment projects at the municipal level. The fund is part of the government’s decentralisation program but raises transparency and accountability issues as the contingency reserve allows for disbursing the funds without any official rationale. The government has set vague procedures and criteria guidelines for the public investment program for financing municipality projects. According to government reports, the projects will be evaluated by the ministers of six departments – finance, economy, regional development, investment, transport and environment, together with a representative from the National Association of Municipalities. The overall result has been inefficient spending of public resources, with some estimates showing that the government approved some of the projects within a day, which clearly is insufficient for any proper evaluation of the feasibility, let alone the quality of the project. Overall, it is expected that although Bulgaria has quite high level of budget transparency, in 2014 the country will have a steep rise in its budget deficit, due in part to lack of accountability and indiscriminate discretionary spending.

**Figure 68. Shares of discretionary and non-discretionary government spending in Bulgaria**

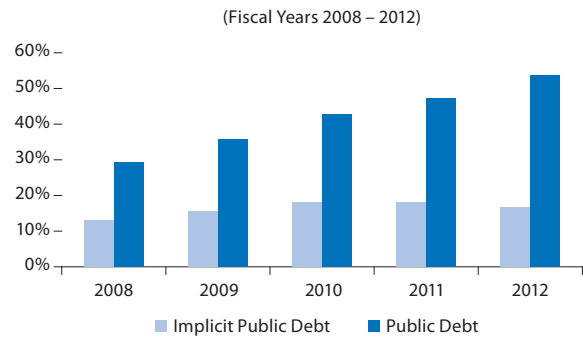


Source: Bulgarian Ministry of Finance.

The case of **Croatia** illustrates the threat to the viability of the budget represented by the level of the public and implicit public debt (including issued state guarantees and total debt of the Croatian Bank for Reconstruction and Development). Failing to account for public debt impact on current spending is often indicative of high

level political corruption, often associated with large-scale infrastructure projects.

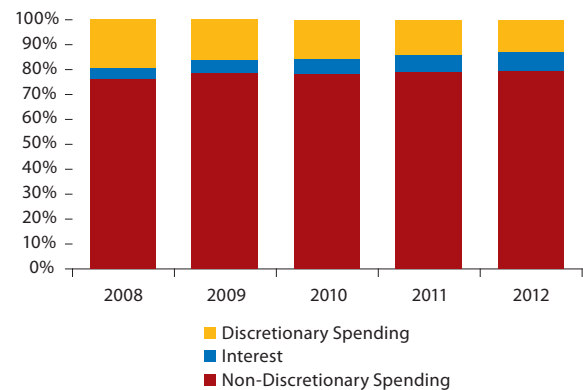
**Figure 69. Share of public and implicit public debt in the Croatian GDP**



Source: Ministry of Finance, Yearbooks (2008 – 2012).<sup>161</sup>

Discretionary spending over the years has been in the 13.3% – 19.4% range. Criteria for awarding and monitoring of certain programs, grants and support have not been established.

**Figure 70. Discretionary vs. non-discretionary spending in the Croatian national budget**



Source: Croatian Ministry of Finance.<sup>162</sup>

The Croatian *Fiscal Responsibility Act* defines rules that limit government spending, strengthen accountability for the legal, functional and purposeful use of budgetary resources and strengthen the system of controls and supervision to ensure fiscal responsibility. The Fiscal Policy Committee has pointed to the need for the government to prepare projections of the fiscal rules application according to the appropriate methodology as an integral part of all official budget

<sup>161</sup> Calculation of PSD researchers based on Ministry of Finance data.

<sup>162</sup> Calculation of PSD researchers based on data from the Ministry of Finance, Annual Reports of the Execution of the State Budget.



documents within the framework of the state budget adoption procedure.<sup>163</sup>

Since Croatia has very large public spending, budget planning over the years has become unsustainable. The government refused to accept significant reduction of current income considering that current revenue had not been realised repeatedly, and had to sharply increase indebtedness instead. Part of the debt has been amassed through subsidies or state aid awarded as rescue policy to state-owned enterprises. Worryingly, the share of subsidies to financial institutions and companies outside the public sector varies from 9% – 20% of the total subsidies. This creates a clear risk of corruption and favouritism with strong negative consequences for fair competition and economic viability.

In **Montenegro**, the government has an absolute monopoly over the process of budget proposal development: parliament, CSOs and other stakeholders do not have an institutional mechanism enabling their participation in the decision making process. MPs are left with the option of proposing amendments, advocating reallocation of the specific amounts for certain spending units, but not applying a systemic approach in reference to the analysis of the principles governing the budget. This side-lining of the parliament from the early stages of budget preparation compromises the effectiveness of its participation in the later stages of the budget cycle. The parliament is therefore placed in a situation of *fait accompli*: unable to consider the principles governing the planning of the budget for the next year and unable to exercise the influence to the main capital budget directions or to be consulted in reference to the strategic economic policy priorities.

Further, lately the process of the parliament's review of the budget proposal was to a great extent hampered due to poor implementation of the programme – or performance – budgeting. The introduction of performance budgeting in Montenegro has been slow and hesitant. Although currently all spending units have their programmes on paper, they still do not contain performance indicators to monitor achievement of programme goals. The action plan for introducing programme budgeting announced in 2007 has not been adopted. Numerous deadlines for establishing full programme budgeting with performance indicators and their top-down implementation in budget preparation and planning have been missed. Although certain

delays and problems in the implementation could be expected – since this is a long-term reform – the problem is that the current situation suggests that the reform has stopped and that no efforts are made to move to the next steps of implementation.

The *Annual Report of the State Audit Institution* for the year 2012 – 2013 reveals the worrying degree to which its recommendations on the year-end budget report (which parliament adopts as its own conclusions) are not being implemented. Out of 47 recommendations, only 7 recommendations were fulfilled, 12 recommendations were completely neglected, while the others are in the early stages of implementation. This means that the auditees fulfilled only 15% of the recommendations, while the State Audit has found that many of the government's figures on the implementation of the State Audit's recommendations are not accurate. A similar situation happened the previous year, when the State Audit Institution found that more than 70% of its recommendations remained unfulfilled. This suggests that there is a systemic problem in the government's attitude towards the work of the public audit, namely towards solving the problems that cause breaching of the *Law on Budget* during the fiscal year and other related laws (such as the *Public Procurement Law*).

State aid in Montenegro, although it has been decreasing over the years, is still high, especially when compared to the average in the EU countries, or the SEE countries. In 2012, it amounted to 1.14% of GDP, which is more than double the average of the EU countries, which is 0.51%.<sup>164</sup> Additionally, its structure is problematic, since it is given almost entirely for the purposes of recovery, restructuring and sectoral assistance, while the analysis of the effects to that aid shows that the money was not spent in accordance with the plans of restructuring.<sup>165</sup>

In April 2014, the parliament of Montenegro adopted a new *Law on Budget and Fiscal Accountability*. The Law brings several changes that are quite important for the aspects of transparency and accountability in the budgetary cycle:

- the introduction of liability provisions – the previous law could be breached without consequences;
- the introduction of the budgetary inspection, as a new body that will carry out controls on how the budgetary bodies comply with the law.

<sup>163</sup> (Croatian Ministry of Finance, 2013).

<sup>164</sup> (Komisija Za Kontrolu Državne Pomoći, 2013).

<sup>165</sup> (Turković, 2012).

Consolidated government spending in **Serbia**, which includes central government, local and provincial governments and social security funds (health, pension and unemployment funds) is considered high, at more than 46% of GDP in 2013. From the viewpoint of economic classification of expenditures, spending is dominated by mandatory spending (pensions, wages, interest, social assistance, health), while nominally discretionary spending (capital expenditures, goods and services and subsidies) is about 25% of total spending. However, large part of these items is in effect also mandatory. For example, about one third of the subsidies is related to agriculture, where most of the subsidies are actually entitlement (for example, per hectare subsidies), and also a large portion is given to the railways company for the payment of wages. Regarding goods and services, the most significant part are medicines purchased through the Health Insurance Fund, and another large part are actually wages (for government research institutes) and also large parts are communal services, electricity and gasoline. In summary, the discretionary spending share is probably below 10% of the total spending, and the largest component is capital expenditures.

However, the fact that there is not much room for discretionary spending in the budget does not mean that corruption risk is low. Much of discretionary spending is in state-owned funds (such as the Development Fund and the Export Credit and Insurance Agency) with not effective oversight mechanisms, state owned banks (three have collapsed in the past several years) and state owned companies (several large public enterprises and hundreds of still not privatised companies). The level of transparency, accountability and public oversight of these institutions is much lower than in the case of the state budget. For example, the Development Fund currently has a portfolio with more than €1 billion in loans issued to private companies and absolutely no data is available publicly on the quality of the portfolio and, for example, who the major beneficiaries of these “cheap loans” are.

Within the central government budget in **Turkey**, the share of mandatory primary expenditures (non-discretionary spending) grew from 47% of total spending in 2008 to almost 60% in 2013.<sup>166</sup> This leaves the share of discretionary spending extraordinarily high by regional standards.

Turkey had planned to implement a fiscal rule in 2010, which aimed at introducing anti-cyclicality to

budget performance by making growth and previous year's budget performance part of the current year's budget performance. After having been discussed in a parliamentary commission, the proposed law was withdrawn the night before voting as the government changed its mind on the necessity of a fiscal rule. This episode is telling in terms of the low stability and predictability of fiscal rules.

After 2008, budget expenditures exceeded the planned amounts every year by margins that were not negligible. The parliament's approval was not sought during the year and it was circumvented in the following way:<sup>167</sup> the allowances for wage expenditures were released for other purposes and the Ministry of Finance exceeded the target budget expenditures by the end of the year as it had to make wage expenditures. The exceeding expenditures were approved by the parliament at the end of the year when conclusive figures for the ending year were submitted. Government's breach of expenditures during the year without the parliament's approval is also pointed out in the annual report of Turkish Court of Accounts.<sup>168</sup> While this is not necessarily linked to corruption risks, it leads to increased opportunities for corrupt exchanges at the highest governmental level, usually related to the large businesses and/or public investment projects.

### 5.3. PUBLIC PROCUREMENT

Procurement by government bodies and state-owned companies is one of the significant corruption risk areas in the SELDI countries. In the post-communist among them, it is privatisation that is often referred to as the “original sin” from which current integrity problems sprang. Divesting significant publicly owned assets over short periods of time in weak institutional environments gave rise to a momentum of corruption that has not been stemmed yet. “The institutions in charge of privatisation had been typically granted large discretionary power that is generally seen as a hotbed of corruption. Moreover, the administrative capacities of the privatizing agencies appeared overall weak and these institutions have practically remained under rather strong political influence despite their nominal independence.”<sup>169</sup> Later on, the nominally

<sup>166</sup> (International Monetary Fund, 2013, p. 16).

<sup>167</sup> (TEPAV, 2012, p. 18).

<sup>168</sup> (T.C. Sayıştay Başkanlığı, 2013a, p. 14).

<sup>169</sup> (SELDI, 2002, p. 115).

private enterprises, in particular the largest ones, either capable of inflicting significant social pressure through layoffs or controlling critical parts of a value added chain (e.g. repairs in coal fired plants), could continue draining public resources through receiving state aid, public procurement, etc.

When later public procurement took over as the main channel for transferring money from the public into the private sector, it became the major source of corruption in the SELDI countries as this area typically gives officials large discretionary power. Currently, corruption risk in government procurement in the SELDI area is associated with a number of deficiencies: insufficiently transparent procedures, large share of non-competitive procedures, weak oversight and ineffective judicial review (given judicial corruption), etc. Although more than a decade ago a SELDI study found that the countries in the area had “made recent progress in strengthening the legal framework of the process and its harmonisation with the EU Directives,”<sup>170</sup> public procurement continues to be among the weakest aspects of public governance.

In the current SEE environment, finding solutions to a problem in a complex system such as public procurement, requires identification of vulnerabilities at each stage of the cycle – pre-tendering, tendering and post-award. “In order to implement good practices and mechanisms for enhanced performance at each stage of the public procurement cycle, there is a need for in-depth exploration of the associated risks. [...] It is imperative, therefore, to identify the techniques used to misappropriate public funds, and look at the various types of fraud.”<sup>171</sup> Recent European research into corruption and fraud in public procurement in the EU has shown that very often public procurement falls within the domain of “legal” corruption, i.e. high-level understanding between politicians and large companies, which is then pushed through the channels of formal approval. The main risk characteristics or red-flags associated with such public procurement corruption have been identified as the following:<sup>172</sup>

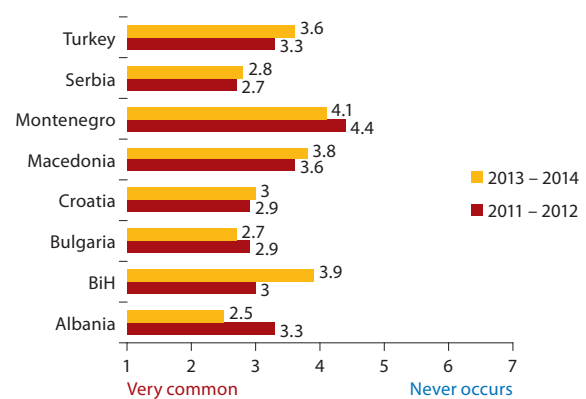
- no published call for tenders in the official journal and/or not all data for the call available in the journal;
- non-open procedure;
- single bidder.

<sup>170</sup> (SELDI, 2002, p. 126).

<sup>171</sup> (Center for the Study of Democracy, 2013c, pp. 13-14).

<sup>172</sup> (Pippidi, 2013, p. 78).

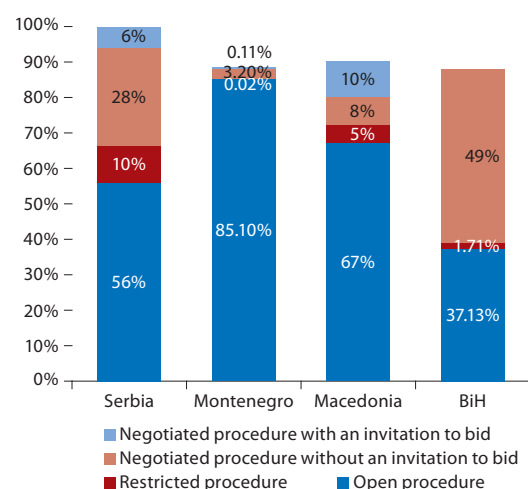
**Figure 71. Performance of SELDI countries in the indicator „Diversion of public funds“ of the Global Competitiveness Report<sup>173</sup>**



Source: World Economic Forum.

There are a number of similarities in the institutional arrangement of public procurement in the SELDI area. For example, a number of countries – Bosnia and Herzegovina, Macedonia, Montenegro, Serbia – apply the so called dual-centralisation model in which public procurement functions are performed by two government institutions, usually termed a directorate or an office and an administration or a commission. There are also significant differences, notably in the share of the various types of procurement procedures. Montenegro has the highest share of open procedures in public procurement, while Bosnia and Herzegovina has the lowest (Figure 72). However, these numbers should be

**Figure 72. Share of various types of public procurement procedures in four SELDI countries, 2012**



Source: (Balkan Tender Watch, 2013, p. 14).

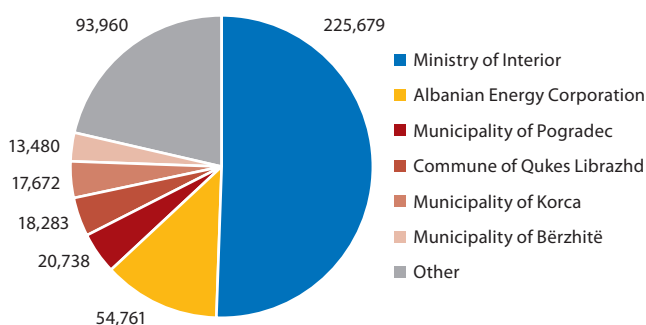
<sup>173</sup> The indicator is based on the weighted average score of the following Executive Opinion Survey question: “In your country, how common is diversion of public funds to companies, individuals, or groups due to corruption? (1 = very common; 7 = never occurs).”

treated with caution as data availability is not universal, and often it is exactly the most corruption ridden cases that are missing from data-bases.

**Albania** has implemented an e-procurement system which has made the process more transparent by making public bids accessible for free on the Public Procurement Agency website. Despite this, concerns still remain about the effectiveness and the real extent of the reduction in corruption. The 2011 report from the Procurement Advocate suggests that there are problems in implementing the selection criteria and, according to the State Audit report for data from 2011, public procurement is the sector in which the biggest abuses were registered. According to the latest data from 2012 in the Supreme State Audit report, the economic cost in public procurement in 2012 amounted to ALL 444.5 million (€3.1 mln), marking the highest level in four years.

The institution with the highest losses through procurements for 2012 is the Ministry of Interior, with ALL 225.6 million or 50% of the total cost to the sector. This was due to the actions of the Public Procurement Commission in violation to the tender rules, disqualifying economic operators which offered lower bids. In total, municipalities are estimated to have caused approximately ALL 401 million worth of damage to public finances. Much of the identified cost comes from the procurement sector as result of violations of tender rules and slow implementation, followed by the urban sector. These sectors, together, explain about 66% of the fiscal damage caused by local government.

**Figure 73. Economic losses due to irregularities in public procurement in Albania, 2012, (in 000 ALL)**



Source: Supreme State Audit of Albania, 2013.

**In Bosnia and Herzegovina**, “the enactment of the anti-corruption legislation has equipped authorities with the right tools and the legal framework for fighting

corruption in public procurement.”<sup>174</sup> Nevertheless, public procurement law has not been sufficiently harmonised and upgraded, evident in the many flaws and practical problems detected in its nine-year implementation.<sup>175</sup> There has been a clear regress in this area in the last few years, particularly as regards transparency. While in 2008 there were 9,074 open procedures, which was around 90 percent of all procedures, in 2012, there were 6,376 advertised and open procedures, which was around 30 percent of all tenders. The cost of poor governance is evident in the fact that the prices in direct agreements and negotiated procedures are 20 to 60 percent higher than the prices in the open procedures.<sup>176</sup> Three out of five procurers think that corruption has a major influence on public procurements in Bosnia and Herzegovina, while all believe that corruption in public procurements has not decreased in the last five years.<sup>177</sup> It all results in an estimated annual flow of more than BAM 700 million (around €350 million) into private pockets.<sup>178</sup> Further, in 2012 there were a total of 2,391 annulments of public procurements with open procedures, and one of the main reasons was because there were not enough bidders. The second reason for annulment was manipulation of information in the call for bidders, where authorities sometimes deliberately ask for goods that are not available on the market, so that they could – after two failed open procedures – conduct negotiations without tendering.

In **Bulgaria** legislative developments have brought about a level of complexity that is impeding effective enforcement of the law. The e-procurement system still has limited functionalities. Inspections by the Public Procurement Agency do not cover decisions for derogations from the application of EU procurement legislation, nor the technical specifications of the tenders. More importantly, however, there are doubts about the effective enforcement of rules and the application of sanctions.

Among EU businesses, it was Bulgarian companies that mostly agreed that “in the last three years corruption has prevented a company from winning public tender or public procurement contract” – 58% in Bulgaria vs. 32% EU average.

<sup>174</sup> (Center for the Study of Democracy; Center for Investigative Reporting, 2012, p. 14).

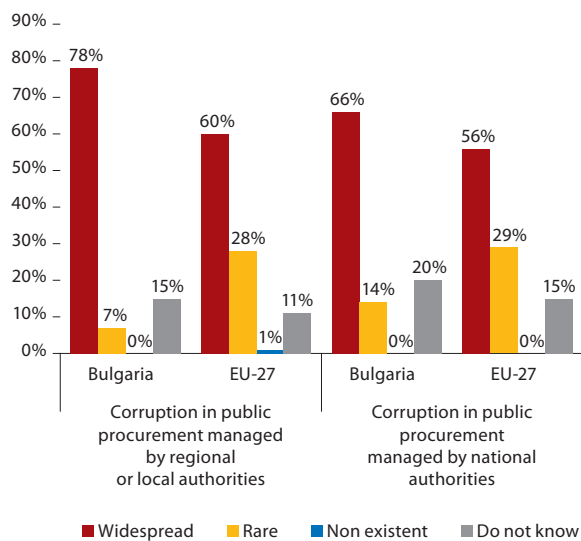
<sup>175</sup> (Balkan Tender Watch, 2013).

<sup>176</sup> (Civic Association “Tender”, 2013, p. 3).

<sup>177</sup> (Center for Media Development, 2013).

<sup>178</sup> (Civic Association “Tender”, 2013, p. 3).

**Figure 74. Corruption in public procurement: Bulgaria compared to EU average**



Source: (TNS Political & Social, March 2014).

A kind of centralisation of corruption is discouraging all but big companies from bidding in public tenders.<sup>179</sup> Because large enterprises have started to dominate the various public procurement markets, the number of enterprises bidding has shrunk while enabling the substitution of illegal influences on authorities by means of bribes with the more legal, but still often secret, means of lobbying or silent political pull.

Although the Public Financial Inspection Agency only monitors the legality of the costs incurred, its financial inspections of sectoral contracting authorities suggest certain conclusions about the contractors' decision-making. The capacity of the Agency to tackle problematic public procurement increases, but its deterrence and prevention effects are very limited and violations continue to be widespread. One reason is the constant political interference in its work in particular on bigger public procurement contracts.<sup>180</sup> According to its latest report, in 2013 the Agency inspected 2,484 procurement tenders and found irregularities in 1,376. Most of the violations were related to the work of hospitals and the procurement of medicines, food for the patients and other hospital materials. Notable cases also relate to road infrastructure, the energy sector, and the EU funds.

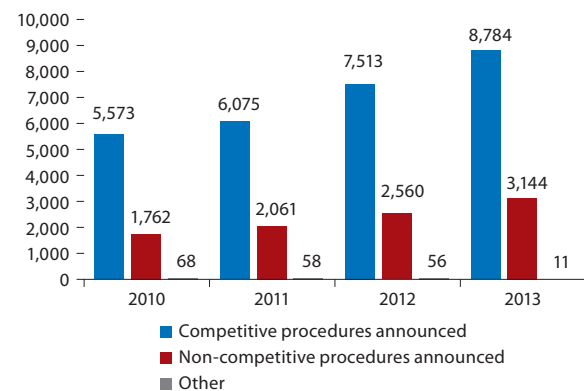
An issue of concern remains the **share of non-competitive procedures** among announced public procurements

<sup>179</sup> (Center for the Study of Democracy, 2011a).

<sup>180</sup> (Stoyanov, Stefanov, & Velcheva, 2014).

(25% in 2012 and 26.3% in 2013), including negotiated procedure with and without publication of a contract notice, which are generally considered an instrument particularly vulnerable to fraud and corruption.

**Figure 75. Number of announced public procurements in Bulgaria by type of procedure**



Source: Bulgarian Public Procurement Agency.

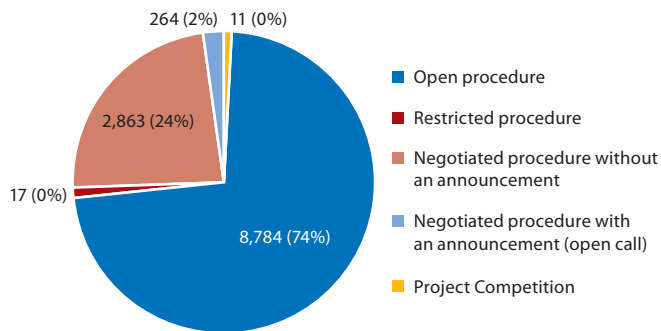
According to data from the Public Financial Inspection Agency the volume of the public procurement contracts with discovered violations range from BGN 601 million in 2007 to BGN 1,488 million in 2012 (€308mln – €763mln).<sup>181</sup> Another method to estimate the losses could be based on the data of the latest PricewaterhouseCoopers and Ecorys report on the topic.<sup>182</sup> If the same shares of losses, as suggested in that report, are applied for Bulgaria and corrected with the weighted Transparency International 2013 scores, the direct cost of corruption in public procurement as share of the overall value of the published public procurement contracts in Bulgaria for 2013 could be assessed to be **between BGN 334.1 and 506.9 million**

<sup>181</sup> Between 3 and 8% of the government budget.

<sup>182</sup> (PricewaterhouseCoopers, 2013). PwC estimate that for eight countries, out of the 86 corrupt/grey cases, there are 53% encountered cost overruns. The cost overruns (winning high price of a bid meeting the technical specifications) from public procurement contracts amounted to 22% of the total average budget involved. In addition, the cost increases during implementation, delays in the implementation and overall loss in effectiveness are also considered and assessed. As aggregated value, the total direct public losses are estimated to be 31% of the average case budget or 18% of the total budgets of all 86 corrupt/grey cases combined (this is a different value as both large and small corrupt/grey cases are assessed, and as they have a different weight). The report also notes that out of the 18% calculated budget volume loss from corrupt / grey public procurements in the 8 analysed Member States, 13% of budgets' loss involved can be attributed to corruption and clean cases generate a public loss of 5% of their projected costs. In addition, the overall direct costs of corruption in public procurement in 2010 for the five sectors studied in the 8 Member States constituted between 2.9% to 4.4% of the overall value of procurements in the sector published in the EU Official Journal.

(€171mln and €260mln). The above is an approximation and the value is calculated just for general reference.

**Figure 76. Number and share of all announced public procurements in Bulgaria by type in 2013**



Source: Annual Report of the Bulgarian Public Procurement Agency 2013.

**Public procurement using the EU funds** in Bulgaria presents a distinct subset of problems. One of the major shortcomings of the process is the focus placed on documentation checks, and not on the value for

money (a deficiency, incidentally, that applies to all government spending in the SELDI area). The process presents a kind of vicious circle – the pressure by the European Commission aims at introducing additional controlling mechanisms to prevent abuses, while this strengthens the bargaining position of the administration and increases its bureaucratic leverage on the citizens and business, along with the corruption risks.

Corruption risks appear in several areas:

- **Large projects** create corruption risks, similar to large public procurement contracts. The online information system for the management and oversight of the EU Structural Instruments in Bulgaria presents data on the largest beneficiaries (mostly public entities), some of them awarded 40-80 projects each.
- **Burdensome administrative procedures** both during the application and reporting stages are also a factor for petty corruption.

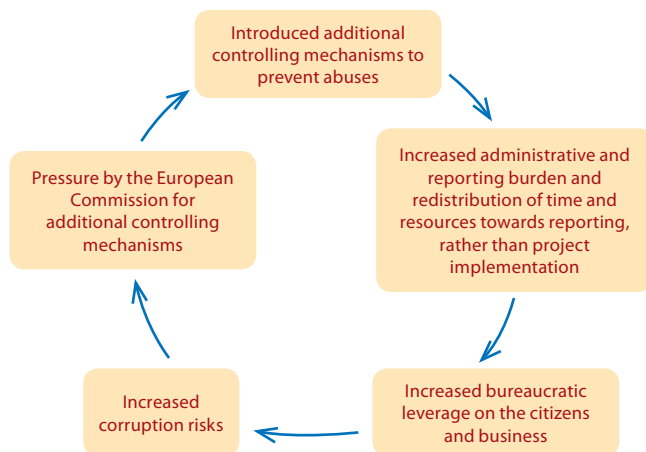
#### Box 4. Procurement in the Bulgarian energy sector<sup>183</sup>

In Bulgaria, one in four public procurement contracts relates to the energy sector, which renders it one of the biggest spenders of taxpayer money. However, 38% of all procedures for the awarding of public procurement contracts in the energy sector for 2012 were non-competitive, encompassing the various negotiated procedures with or without the publication of a contract notice under the *Law on Public Procurement*, and negotiated procedures following an invitation under the *Regulation on Small-Scale Public Procurement*. The share of non-competitive public procurement contracts in the energy sector is systematically higher than the share of non-competitive contracts for the rest of the economy for the period 2010 – 2012 (the non-competitive public procurement contracts in the economy ranged between 23.9% in 2010 to 25.2% in 2012). Still, it should be noted that in 2012 the percentage of contracts awarded on competitive basis in the energy sector increased to 62%, compared to 48.1% in 2011 and 46.4% in 2010. This improvement could be interpreted as the result of increased public scrutiny and criticism by various stakeholders.

The sector is of particular social importance, since most of the Bulgarians are energy poor – 14.4% of the average yearly income per household is spent on energy (electricity, water, heating), according to 2013 Eurostat data. There is non-transparent formation of electricity prices, and high concentration at the Bulgarian gas market in terms of monopoly of supply and distribution. When audited, most of these procedures are found to contain irregularities and other abuses. The analysis of 13 inspections of energy enterprises carried out by the Public Financial Inspection Agency over a period of four years shows that 39 violations were found in 41 cases. Most big energy projects (e.g. the Belene nuclear power plant, Tsankov Kamak hydro power plant and the rehabilitation of facilities) can serve as examples of the misuse of public procurement mechanisms. The failure of the checks and balances system raises legitimate concerns of corrupt practices at all levels in the energy sector and questions government's ability to manage large infrastructure projects worth over €500 million.

<sup>183</sup> Compiled from: (Center for the Study of Democracy, 2014); (Center for the Study of Democracy, 2013(43)); (Center for the Study of Democracy, 2013a); (Center for the Study of Democracy, 2011a); (Center for the Study of Democracy, 2011).

**Figure 77. The escalating corruption-bureaucracy-corruption cycle of EU funds management in Bulgaria**



Source: CSD/SELDI.

- **Inspections and audits**, as well as imposing financial sanctions, also present corruption opportunities.
- **Public procurement contracts** commissioned by EU funds beneficiaries bear similar corruption risks to public procurement contracts in general. During the recent economic crisis the value of public tenders fell sharply, which redirected corruption pressure towards EU-funded tenders. Another specific feature in the case of EU funds is the high risk of appeals and complaints that can stop the procurement procedure

and result in missed deadlines by the beneficiaries.

- **Lack of understanding of the technical aspects** of the implemented projects can easily lead to misinterpretation of the results. Although the managing authorities use external experts in different areas for evaluation of project applications, expert knowledge and consultations are not readily available on all stages of the project monitoring process.
- The pressure to **achieve fast absorption in the 2007 – 2013 period**, and at the same time to prepare for the next 2014 – 2020 programming period, are other factors that need to be taken into account. The end of programming period 2007 – 2013 was marked by increase in the number and value of contracts, as well as increased payments, to compensate for the initial low absorption rates. This trend, especially when focusing on larger projects, also presents risk factor in terms of decreased control and corruption. In addition, in order to accelerate absorption some managing authorities shifted away from competitive distribution of funds to direct contracting.<sup>184</sup>

In 2008 – 2009, **several cases of embezzlement of EU funds** led the EC to block pre-accession funding for all seven operational programmes. EC also asked Bulgaria to improve its procedures for absorbing the EU funds before access can be restored. Similar freezes occurred in 2014.

#### Box 5. Irregularities in the distribution of EU funds in Bulgaria

- European Agricultural Guarantee Fund and European Fund for Rural Development: 149 cases of financial irregularities for € 5,356,732.
- Structural Funds (European Regional Development Fund and European Social Fund): 49 cases of financial irregularities for € 5,423,511.
- Cohesion Fund: 2 cases of financial irregularities for € 571,350.

Examples of violations and irregularities included:

- Timely investigations of the credibility of complaints in relation to the Structural and Cohesion Funds are not initiated; rather, only planned inspections at various stages of project implementation are carried out.
- Lack of timely updates to the information entered in the records of received signals for irregularities.
- The follow-up activities and other changes in previously reported cases of irregularities are not reported to AFCOS.
- Delays in taking measures for forced recovery of undue or overpayments, as well as unduly or improperly utilized resources.

Source: (Дирекция АФКОС, МВР, 2011).

<sup>184</sup> (Обединение „Европейски анализи и оценки“, 2012).

The most common irregularities in public procurement in **Croatia** are related to procurement planning, delivering public procurement reports to responsible bodies, publishing the register of public procurement contracts and framework agreements on the website, as well as monitoring the execution of the contracts.<sup>185</sup> As in the other former communist SELDI countries, in Croatia the public procurement system inherited the flaws of the earlier process of privatisation. Although Croatia has changed its Constitution in order to avoid the statute of limitation in cases of privatisation,<sup>186</sup> such changes do not represent a safeguard from the corruption and crimes in privatisation. The 2013 *Act on the Management and Disposal of Assets owned by the Republic of Croatia* closed down the Asset Management Agency and transferred its powers to the following bodies: the State Office for State Assets Management as the central body of management and disposal of state assets, which acquires the power of management and disposal of real estates and shares in strategic companies; the newly established Sale Centre as a new body that acquired the power of management of the minority shares of the state in companies which are not declared of strategic interest for Croatia. The Act also defined the overall legal framework for the establishment of the Central Registry of State Assets

that includes the widest possible number of types of assets owned by the state. The main goal of this law is to ensure more efficient and transparent use of state assets, in order to create a new value and achieve greater economic benefits; whether this new system of management and disposition of state assets would bring the expected results remains to be seen. Overall, the public procurement process in Croatia continues to be opened up, including through initiatives of civil society, such as the Integrity Observers' database, which contains some 50,000 public tenders and 13,000 contracts which citizens and other interested stakeholders can search freely.<sup>187</sup>

In **Kosovo**, the legal framework on public procurement is generally "sufficient and allows for centralised purchasing, although some technicalities regarding the signature of the contract need to be adjusted."<sup>188</sup> According to the Public Procurement Regulatory Commission the annual value of public contracts in Kosovo fluctuates around €800 million.<sup>189</sup> Businesses in Kosovo have come to take it for granted that winning public contracts comes about as a result of some informal favour to the officials with vested power in granting contracts in the contracting authorities.

#### Box 6. Oiling the wheels: collusion between ministers and businessmen in Croatia

On March 13, 2014 the State Attorney's municipal office in Karlovac indicted Jozo Kalem, a businessman from Rijeka and close friend of Minister of Finance Slavko Linić, and his company "RI Petrol" on suspicion that they illegally gained 103 million kuna (€13.5 mln). Following the information that the Karlovac office of State Attorney raised the indictment against Kalem, Minister Linić confirmed in an interview that he was a close friend of the suspect and that Kalem was being used to smear him. Media had written about their friendship many times before. Though Kalem's work flourished during the war years, he achieved a real business boom a little more than 10 years ago after his friend Slavko Linić became Deputy Prime Minister and Head of the Supervisory Board of oil company INA in which the Croatian state is a majority shareholder. An investigation was launched regarding the preferential position which was allegedly given to Kalem's company "Europetrol" in petroleum product selling and favouritism by INA. In 2010, Kalem's company Europetrol was mentioned in relation to favouritism by the state-owned companies Rijeka – Zagreb Motorway and Carrier Autotrolej from Rijeka. There were allegations that lower offers from other oil companies participating in competition were rejected because of trivial reasons, and a contract was signed with Kalem whose offer was more expensive. However, the relevant institutions never proved these allegations. Moreover, the State Commission for Supervision of Public Procurement rejected every objection to the legality of the procedure, even though they themselves admitted that there were some incongruities.

*Sources:* (Index.hr, 2013) and (Dalje.com, 2014).

<sup>185</sup> (State Audit Office of Croatia, 2014).

<sup>186</sup> (Hrvatska Radiotelevizija, 2010).

<sup>187</sup> [www.integrityobservers.eu](http://www.integrityobservers.eu)

<sup>188</sup> (SIGMA, 2013k, p. 59).

<sup>189</sup> (Riinvest Institute, 2012, p. 26).



The Procurement Review Body is the oversight institution in public procurement. An issue of concern is that as of May 2014 it still had no full board. Parliament has not yet designated anyone on the vacant positions and appeals are being left unaddressed. In its latest annual work report it has found that:

“Legal violations and repeated irregularities by the Contracting Authorities are found in particular in some important aspects of development of public procurement procedures. Review panel in most of the cases has encountered irregularities during the bid evaluation process and on wrong decision making for announcing the successful bidder. Violations were also found of the *Law on Public Procurement* which resulted into annulment of announcements for award of the contract by the respective Contracting Authority or the matter has been returned to Review Panels for re-evaluation.”<sup>190</sup>

In 2012, 82% of the cancelled procurement procedures were due to the absence of competition (fewer than two valid bids or requests to participate).<sup>191</sup> On the positive side, there are fewer “unjust or ill-grounded appeals to the Procurement Review Body, which is particularly encouraging when taking into account the relatively negligible effort made to provide the training for economic operators in public procurement.”<sup>192</sup>

In **Macedonia**, a number of bodies exercise the regulatory and oversight functions with respect to public procurement: the State Appeals Commission on Public Procurement, the Public Procurement Bureau, the State Commission for Prevention of Corruption, and the State Audit Office. The State Appeals Commission “received and resolved 658 complaints [...] in 2012, a slight decrease from 690 in 2011.”<sup>193</sup> The Commission attributed the decrease to better knowledge of procurement law by the public and private sectors, the publication of its decisions online and the requirement for 100% e-auctions, most of them based on lowest price criteria only. Compared with 2011, 4% fewer cases went to the administrative court. In 2013, the Commission was presented with a total of 569 motions for appeals related to public procurements.<sup>194</sup>

Due to the electronic procurement system, media campaigns and greater awareness of the general public, more corruption cases are being uncovered. In 2012, for example, the number of reported corruption related procurement cases more than doubled in comparison to the previous year: 28 cases (up from 12 in 2011); 12 persons were convicted for procurement related crimes and misdemeanours in 2012 (no convictions in 2011 and 2010).<sup>195</sup>

Still, competition in public procurement in Macedonia remains low. The average number of bids submitted in

### Box 7. Dealing with high level corruption in Kosovo

A notable case of high level corruption is that of the former Minister of Transport, Post and Telecommunications Fatmir Limaj, and some of its staff. EULEX has been investigating Limaj since April 2010 when police raided the Transport Ministry and Limaj’s properties in Pristina as part of a corruption probe linked to road tenders issued between 2007 and 2009. The public raid in 2010 was a historical point as it was the first time a high profile figure was brought to such a position, as before they were thought of as untouchable. Having delegated some judicial powers to the European Union Rule of Law Mission, Kosovo was thus able to engage in more active fight against corruption at the highest levels. It took years after the raid to prepare the case against him, and there was insufficient proof to bring a conviction.

Another notable case has been that of the mayor of Prizren, the second largest city in Kosovo. The mayor and others were accused of misappropriating public property which was managed by Kosovo’s Agency for Privatisation. The mayor was convicted and the case got wide attention as it was the first time a conviction had been issued against a high ranking politician.

*Sources:* (Balkan Insight, 2012); (BIRN, 2013); (Balkan News Agency, 2014).

<sup>190</sup> (Procurement Review Body of Kosovo, 2012, p. 89).

<sup>191</sup> (SIGMA, 2013k, p. 58).

<sup>192</sup> Ibid.

<sup>193</sup> (SIGMA, 2013f, p. 49).

<sup>194</sup> (Center for Civil Communications, 2014, p. 6).

<sup>195</sup> (SIGMA, 2013f, p. 50).

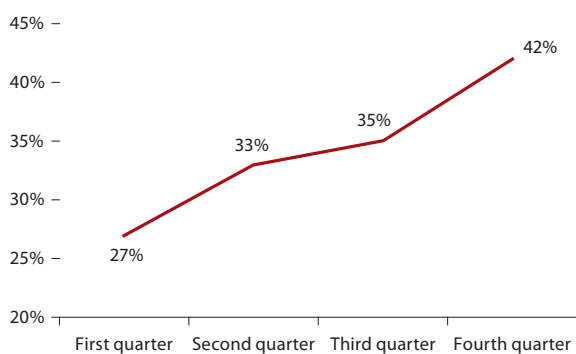
### Box 8. Sample criminal referrals on public procurement related charges by the Macedonian State Commission for Prevention of Corruption

- The directors of the Agency of Civil Aviation-Skopje for abusing their official duties, causing significant damage and creating an opportunity for obtaining for themselves and others significant property gain while conducting public procurement procedures.
- The director of the Public Enterprise "Geoengineering" – Tetovo, when representing and presenting the enterprise and when conducting the procedures for public procurement has not provided proper and legal use and protection of the means, the property of the municipality, by which a damage has been caused on a significant scale and the possibility for obtaining unlawful property gains.
- The directors of the Health Centre Bitola, by its managing, presenting and representing the institution and with the disposal of the funds of the Centre and conducting of the procedures for public procurement, have not provided legal and appropriate usage and protection of the funds of the institution, by which significant damage have been caused and have created the possibility for obtaining significant unlawful property gains.

Source: State Commission for Prevention of Corruption, Annual report for 2012.

the 2013 tender procedures monitored (total of 160) was 2.6 and more than one third of the tender procedures received only one bid (Figure 78).

Figure 78. Share of tender procedures in Macedonia with only one bid submitted, 2013<sup>196</sup>



Source: (Center for Civil Communications, 2014).

In the fourth quarter of 2013, a total of 388 contracts of total value of around €33 million were signed by means of negotiation procedures without previously announced calls for bids.<sup>197</sup>

Public procurement legislation in **Montenegro** is largely harmonised with the EU *acquis*. However, there are numerous examples of violations of basic provisions: poor control of contract implementation, separation of unique procurements into multiple smaller ones

<sup>196</sup> Among a sample of 40 public procurement procedures implemented by central level contracting authorities, whose public opening of bids took place in the period October – December 2013.

<sup>197</sup> (Center for Civil Communications, 2014, p. 14).

in order to avoid the use of transparent procedures, submission of incorrect information by the contracting authorities. In 2012, for example, government agencies signed 147 procurement contracts without using public tenders; the same year, the Commission for Monitoring Public Procurement Procedures examined 649 complaints, 49 of which involved tenders of more than €500,000. The Commission fully or partially cancelled 213 such tenders.<sup>198</sup>

Despite the fact that half of Montenegrin citizens believe public procurement procedures are not carried out in a fair manner,<sup>199</sup> the Public Procurement Administration receives on average one complaint annually for corruption.

Public procurement has been designated by the Ministry of Finance as one of the five high-risk areas for corruption. The remit of institutions, primarily the Administration for Inspection Affairs, which currently has only two employees – inspectors for public procurement, is limited to contract implementation control. The *Public Procurement Administration's Report* contains many statistics but not indicators for identifying corruption risks and for measuring real progress on combating this phenomenon.

The State Audit Institution stated in 2011 that certain government institutions – including the Ministry of

<sup>198</sup> (U.S. Department of State, 2013, p. 29).

<sup>199</sup> (Institut Alternativa, 2012, p. 13).

### Box 9. Procurement irregularities in Montenegro

In 2013, the State Commission for Control of Public Procurement Procedures issued a decision ordering the Health Insurance Fund to repeat the evaluation of bids for 4 out of 27 parties who had participated in the tender procedure, to the amount of €4,309,436. The Fund had to re-evaluate within 15 days the parties covered by the tender which was issued in December 2012. Due to problems with the tender, for nearly four months patients were not able to undergo medical procedures for thyroid problems, pregnancy and tumours in the Clinical Centre of Montenegro.<sup>200</sup>

Inspectors for combating economic crime by order of the Municipal Prosecutor in Podgorica have inspected procurement procedures of the Montefarm pharmacy for suspicious tenders.<sup>201</sup> Montefarm awarded procurement contracts to drug companies that have not been registered for this activity. According to published data, it planned €26.5 million for drugs procurement for 2013; in these procedures, by July 2013 about 100 cases had been controversial, worth €2.5 million.

Finance, Ministry of Economy, Ministry of Foreign Affairs and European Integration and Ministry of Health, as well as Protector of Property and Legal Interests and Agency for Protection of Personal Data – provided false information to the Public Procurement Administration. However, it is not clear whether responsible persons in these bodies have been penalised for the delivery of false reports. Although there have been many irregularities in the implementation of public procurement procedures, in the past ten years the police and the State Prosecutors Office brought a negligible number of criminal charges.

In **Serbia**, the number of public procurement contracts has dropped significantly over the years, while the total value has increased. The result is that the average value of the public contract has increased almost ten-fold in nominal terms over the past ten years (Figure 79).

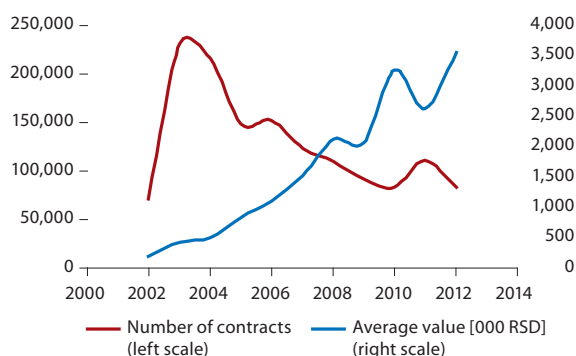
About 87% of all contracts are so called “large-value contracts” which have to be awarded in accordance with strictly specified procedures, while so called “low-value contracts”, where the procedure is simplified, accounted for 13% of the contracts in 2012.

From the anticorruption point of view, perhaps the most relevant data is related to the type of procedure which was used in the public procurement process. Data shows that the share of open procedures (as the most transparent procedure) has been rising in recent years, but it is still below 60%. Together with restricted procedures (which also require public announcement and invitation) the share is below 70% by value. It is worrying that negotiation procedures account for 34%, but even more worrying is that there has practically been no improvement over the past 5 years.<sup>202</sup>

The implementation of the non-transparent negotiation procedure has to be explicitly justified (Figure 80).

In almost half of the cases the grounds for direct negotiations were supposed “technical and artistic reasons”. In such cases, the law envisages that the procurer has to publish its decision to directly hire a certain company, but other companies have 8 days to appeal this decision by claiming that they can also supply the necessary goods or services. It seems that other bidders were not aware of this possibility. The next justification is “urgency” and in these cases procurers have to submit their decision to the Public Procurement Office together with the justification for

**Figure 79. In Serbia, fewer procurement contracts at an increasing value**



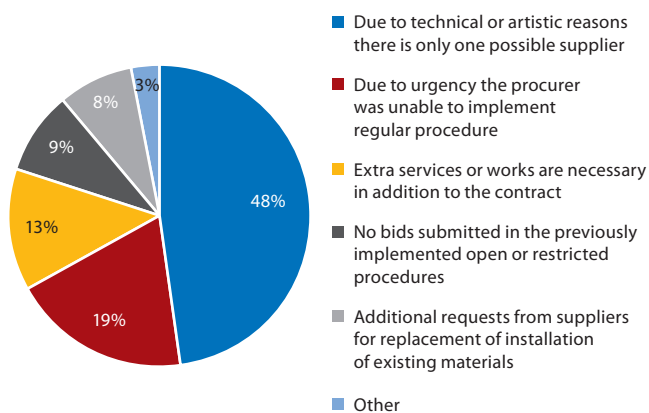
Source: Public Procurement Office annual reports.

<sup>200</sup> (Daily newspaper “Dan”, 2013).

<sup>201</sup> (Daily newspaper “Vijesti”, 2013).

<sup>202</sup> A comparison of Serbia with some other SELDI countries is provided in Figure 72.

**Figure 80. Justifications for the use of negotiations for public procurement in Serbia, 2012**



Source: Public Procurement Office annual report.

this procedure. The Public Procurement Office has found several typical problems with such justification:

- There was no legal ground as the problem of urgency was created by the procurers themselves (in 47% of the cases);
- No effective competition was ensured, but only one bidder was called (in 39% of the cases);
- Stalling of the procedure – in many “urgent” cases, the formal decision was made more than two weeks after the bids were opened.

In Turkey, “public procurement reforms were designed to make procurement more transparent and less susceptible to political interference, including through the establishment of an independent public procurement board with the power to void contracts.”<sup>203</sup> Still, tenders in energy, water, transportation and communication are not regulated by the public procurement law. Further, the Public Procurement Authority has the right to provide exemptions to public procurement tenders under TL 6.6 million in 2012 (€2.3 mln) upon requests from public institutions. In 2012, the Turkish State Railways and in 2013 the postal services were taken out of the provisions of the public procurement law.

During 2012, the volume of public procurement increased by 21% compared to the previous year, 6.2% above the consumer price inflation. In 2012, 83% of all public procurement in state economic enterprises was in transportation and communication and energy sectors, most of which were exempt from public procurement law,<sup>204</sup> thus creating a corruption risk.

<sup>203</sup> (U.S. Department of State, 2013t).

<sup>204</sup> (T.C. Sayıştay Başkanlığı, 2014, p. 88).

One of the most important general criticisms by the Turkish Court of Accounts is that internal financial control units are not established at all in some public institutions and not properly established in the rest,<sup>205</sup> thus violating the *Public Financial Management and Control Law* which aims at aligning public finance governance in Turkey with that of EU. Pre-financial control units do not exist. Lack of internal financial control units within public institutions make them more susceptible to misconduct in public procurement. Of the more specific findings of the Court of Accounts which came to the attention of the media and public were incidents involving procurement by the electricity company TEDAŞ,<sup>206</sup> writing-down of social security debt of a private company in return for assets,<sup>207</sup> procurement by Turkish Railway Enterprise,<sup>208</sup> and procurement by the Housing Development Administration of Turkey.<sup>209</sup> In addition, in a 2012 report on TEDAŞ<sup>210</sup> the Court of Accounts reports that during the privatisation of electricity distribution channels, a total of TL 171 million (€59.4 mln) which was in cash accounts was not taken into account during the valuations and eventually left to the new buyers.

In April 2014, the Turkish Treasury announced that it would guarantee projects costing more than TL 1 billion (€345.8 mln). Accordingly, the Turkish state would reimburse 85 percent of loans to companies involved in project tenders if the deal is cancelled due to company-related faults. The Treasury would reimburse the total amount of loans if the tender is annulled for any other reason. The Treasury emphasised that state-owned enterprises and local administrations would not be eligible for the program and the guarantee would be limited to €2.2 billion annually. This new legislation is likely to raise further questions about public finances and the anticorruption efforts of the government, if transparency issues regarding the implementation of the regulation are not resolved.

According to the 2012 report by the Turkish Court of Accounts, the Ministry of EU Affairs did not provide the necessary financial reports and tables for an inspection;<sup>211</sup> thus, there has been no 2012 control

<sup>205</sup> (T.C. Sayıştay Başkanlığı, 2013b, p. 10).

<sup>206</sup> (SAYDER, 2013a).

<sup>207</sup> (SAYDER, 2013b).

<sup>208</sup> (SAYDER, 2013c).

<sup>209</sup> (SAYDER, 2014).

<sup>210</sup> (T.C., 2013c, pp. 22-24).

<sup>211</sup> (T.C. Sayıştay Başkanlığı, 2013).

on the spending of the Ministry. Also, the European Commission has launched an investigation into allegations that a Turkish government agency misused EU funds.<sup>212</sup> The probe followed reports in Turkish media in January 2014 of tender-rigging and illegal recruitment at the Centre for EU Education and Youth Programmes in Ankara.

## 5.4. RECOMMENDATIONS

### *Business environment:*

- Streamline the environment for entrepreneurship, including through continued deregulation, decreasing and abolishing barriers to business.
- Reduce to a minimum and review annually state aid policies as they create considerable corruption risks. Introduce in advance strict enforcement of EU state aid rules, and develop the capacity of national independent state aid regulators to enforce the rules.
- Improve the enforcement of anti-monopoly legislation in order to promote free enterprise and competition. Apply special care and review regularly concentration in sectors which are heavily regulated and face licensing and other restrictions, thus creating a risk of collusion between larger competitors and politicians.

### *Budget process:*

- Countries that have not done so should establish institutional links between the management of assets and liabilities of all public finances, including state-owned companies, in order to mitigate financial risks and enhance the government's credibility in public finance management. State-owned enterprises should meet stringent corporate governance and reporting requirements (e.g. OECD rules), on par with publicly traded companies. These enterprises should publish online quarterly reports.
- Publish a mid-year report on the implementation of the budget. Detailed data on the budget should be published in online searchable format which allows big data analysis, including at ministry and executive agency level.

- Enhance the transparency in the selection of capital expenditure projects by introducing clear guidelines for planning and evaluating of public investment in this area.

### *Public procurement:*

- Adopt policies to reduce the share of public procurement tenders with only one bidder and enhance competition.
- Introduce liability and sanctions for contracting authorities who fail to submit reports on public procurement in continuity, reports on violations of anticorruption regulations or submit incorrect or incomplete data.
- Improve oversight of procurement by large public procurers (state-owned enterprises and utility companies in particular) to maximise the efficiency and reduce irregularities.
- Make available to the public all public procurement contracts and annexes, including direct agreements. Publish in online searchable format the complete documentation on public procurement pre-notices, notices, bids, contracts, and any addendum thereof.
- Define a legal and institutional framework for the management and control of contracts concluded by public-private partnerships.
- Require all compliance bodies to publish annual reports on their operations and the results of their inspections.
- EU candidate countries that do not have one should establish decentralised implementation systems for EU funds to provide the appropriate legal and administrative framework for the transfer of responsibilities for the implementation of the EU funded programmes. Oversight should remain centralised and independent of implementation bodies.
- Broaden the scope of e-government, specifically e-procurement and (in Croatia and Bulgaria) introduce electronic submission and reporting for all EU operational programmes.
- Provide training to judges on the technical knowledge of new types of fraud in the business sector, including with respect to public procurement where the technical specifications in open calls restrict free competition.
- Introduce the concept of value-for-money in the evaluation of public procurement contracts.

<sup>212</sup> (Hürriyet Daily News, 2014).

