



# **Corruption risks in the business sector**

## **National Integrity System Country Study**

### **Part two**

**Hungary  
2008**

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## Disclaimer

Comments of reviewers have only been partially incorporated into this study thus the opinions expressed here reflect the views and positions of Transparency International.

The closing date of the study was April 2008. We have verified the accuracy of data and statements published in the study according to the best of our knowledge. Nevertheless, Transparency International takes no responsibility for the using of information contained in the study for specific purposes and/or in a changed context.

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## Introduction

The study is Part Two of *Corruption risks in Hungary, The National Integrity System Country Study*. Published in December 2007, Part One of the exercise focused on the public institutions of the Hungarian integrity system while this research is especially dedicated to corruption mechanisms in the business arena. The current analysis does not contain general data about the corruption profile of, and anti-corruption activities in, Hungary, since these topics are covered in detail in Part One.<sup>1</sup>

Part One was based on the National Integrity System methodology elaborated by Transparency International, while the methodology of Part Two was completed by the methodology worked out by the Institute for Sociology and Social Policy of the Budapest Corvinus University. The Introduction covers both of the methodologies applied.

## What is the National Integrity System?

The National Integrity System (NIS) consists of key institutions and specific sectors (the 'pillars') that contribute to integrity, transparency and accountability in a given society. When it functions properly, the NIS combats corruption as part of the larger struggle against the abuse of power, malfeasance and misappropriation in all its forms. Strengthening the NIS involves promoting good governance in all aspects of a particular society.

The NIS concept has been developed and promoted by Transparency International (TI) as part of its holistic approach to countering corruption. While there is no blueprint for an effective system to prevent corruption, there is however a growing international consensus about the salient features of anti-corruption/pro-integrity systems that work best. Country studies are based on qualitative assessments of the institutions involved in the anti-corruption system.

## Why produce NIS country studies?

The aim of each study is to assess the National Integrity System in theory (laws and regulatory provisions) and in practice (the extent to which these work). Via these studies, Transparency International aims to provide an overview of the National Integrity Systems in countries in all regions of the world. These studies provide both benchmarks for measuring further developments in these countries and also a basis for cross-country comparison. In terms of establishing benchmarks, the studies offer a starting point for identifying the areas in need of priority action. They also constitute the basis on which the relevant parties can assess the initiatives involved in the fight against corruption. The NIS country studies highlight, for example, the pillars that have proved most successful and why, whether the pillars are mutually supportive and the factors supporting or hindering their effectiveness. The country studies also assess the areas that must be addressed in order to improve the system and the factors required to support the overall development of the NIS.

Regarding cross-country comparisons, the country studies create a strong, empirical basis that contributes to our understanding of how countries with strong and weak performance records are governed. Within regions or among several countries sharing a similar political, economic and social structure, the results of the study can create a type of peer pressure for implementing reforms or create opportunities for learning from countries at comparable stages of development.

The country studies are an important measuring tool for Transparency International. They complement TI's indices and surveys such as the Corruption Perceptions Index (CPI), the Indice de corruption des pays exportateurs (ICPE) [index of corruption in exporting countries] and the Global Corruption Barometer, or the national surveys that explore the specific practices and constraints within each country, to produce empirical, qualitative results on the rules and practices governing the integrity systems. As of

August 2007, more than 70 of these studies have been carried out.

TI believes it is necessary to understand the regulatory provisions for, and the capacity of, the NIS pillars, as well as their interaction and practices, in order to be in a position to diagnose the risks of corruption and to draw up strategies to counter these risks. The NIS country studies are a unique TI product inasmuch as they reflect the systemic approach adopted by TI to counter corruption and the independence of analysis that the world's leading anti-corruption NGO can offer.

## **Methodology of NIS studies**

The NIS country studies provide a qualitative assessment of a country's integrity system. These studies are based on both objective and subjective information sources, which differ in quantity depending on the country being assessed. The studies therefore require both desk and field research.

There is at least one focus group convened for each country study. Focus groups' participants include governance and anti-corruption experts from the public and private sectors, representatives from the liberal professions (for example lawyers, accountants and engineers), from among moneylenders if need be, the media and civil society. The aim of the focus group is to bring together a wide range of actors to assess the NIS and discuss the first draft of the country study, which is then revised on the basis of the conclusions of the focus group meeting.

Each country study is revised by an independent external expert.

NIS country studies are usually composed by one single author, however we could not follow this methodology. In Hungary research activities on corruption concentrate on certain segments and lack cross-sector approach, therefore each chapter was written by experts of that specific area.

The research provides an analysis of the functioning and interaction of the 'pillars' of the NIS and therefore does not necessarily cover in detail all areas which are perceived as corrupt in a given country. In the case of Hungary the health care system – which is perceived as one of the most corrupt fields – could not be covered by the scope of this analysis due to methodological constraints.

## **Research into the business sector**

Corruption in the business sector is a less researched field and anti-corruption activities still concentrate exclusively on the public sector, therefore the business environment needs special analysis. Transparency International Hungary in cooperation with the Institute for Sociology and Social Policy of the Budapest Corvinus University dedicated a special research initiative to reveal the corruption mechanisms of the private sector and has published the results in a separate volume.

The private sector as a pillar of the NIS plays a key role in countering corruption. A close relationship can be detected between transparency and economic growth<sup>2</sup> thus the type and extent of corruption which business players have to face in everyday business life – as well as the clarity and reliability of the legal, economic and cultural environment for business – substantially determine the competitiveness and the investment environment of the given country. Most public spending ends up in orders from the private sector, the public and private sectors existing in continuous co-operation. If regulations on the intersection between the public and private sector are clear and transparent in practice then the system allows little room for abuse.

Our research goal was to map the weak points resulting from inappropriate regulation, or from the enforcement practice of rules, and to identify those rules and regulations that bear corruption risks and/or hamper fair and ethical competition within business life or at the meshing points of the public and private sectors.



Mapping the corruption mechanism in the business sector required a revision of the methodology used in the NIS country studies. Traditional research methodologies of sociology such as surveys, interviews, focus groups, document analyses, media analysis, etc. applied exclusively do not lead to adequate results. Therefore we are convinced that a combination of research techniques is necessary for the empirical analysis of corruption: the application of qualitative methods together with quantitative ones increases the possibilities of revealing corruption mechanisms and estimating the scale of corruption.<sup>3</sup> According to the NIS methodology the study is based on both objective and subjective information sources, therefore both desk and field research was applied.

In order to improve the robustness of our findings the desk research has been completed by undertaking 30 in-depth interviews<sup>4</sup> with entrepreneurs, heads of state institutions and experts of economy as well as through the analysis of online media articles on corruption for the years 2006 and 2007.<sup>5</sup> Due to the increased number of complaints involving cases of corruption ambassadors of countries representing 85 per cent of foreign investors established the *Transparency Working Group* in the spring of 2007. The Transparency Working Group and the chambers of commerce of its member countries supported the preparation of the NIS study in order to obtain an objective, independent analysis concerning the corruption situation in Hungary. The methodology of the research focuses on revealing corruption risk situations raised by our donors, therefore 50% of the interviewees are heads of international companies.

The present study is based on the research of Transparency International Hungary, three background studies<sup>6</sup> and a summary study<sup>7</sup> ordered by Transparency International Hungary from the Institute for Sociology and Social Policy of the Corvinus University of Budapest.

A group of businesspeople and researchers have discussed the draft study at a round-table meeting and several external experts have also commented.

Corruption can be defined from several points of view.<sup>8</sup> Background studies of the research are based on the principal-agent-client model of modern political economy and economic sociology.<sup>9</sup> The model is derived from the theory of rational decisions: actors of the model consider the expected profit and expenses of their possible actions and choose the alternative which promises the highest profit.<sup>10</sup> In addition to corruption mechanisms the report also touches upon some phenomena of the black economy. We apply the definition used by the tax and the economic policy approach of the black economy<sup>11</sup> since both of them concentrate on the damages (loss of state income and disadvantage in competition) caused by the phenomenon.

Transparency International does not address individual corruption cases. Based on specific corruption cases coming to our knowledge we establish general corruption symptoms and patterns to reveal the weak points in the system and develop recommendations in order to remedy the problems. Nonetheless we decided to present certain individual corruption cases in the study, because they serve to excellently illustrate the operating mechanisms of the system. In order to clearly separate such cases and individual opinions from the general findings of the research we have presented them in text boxes.

Transparency International Hungary initiated the analysis of corruption mechanisms in the business sector in January 2008. The goal of our research was to reveal for decision makers the factors obstructing fair business in a clearly understandable way, supported by scientific data as well as to provide policy recommendations. This study presents the corruption situations judged as most problematic by businesspeople and state decision-makers. A full scale detailed analysis of corruption mechanisms in Hungary requires further special research activities.

We truly hope that the results of the research will contribute to the elaboration of adequate anti-corruption activities in Hungary.

## **Executive summary**

Business and competition rules in Hungary provide a proper and stable base for the freedom of business

and the enforcement of fair competition in principle. Sanctions on business crimes and corruption offences are sufficiently strict but law enforcement is however gravely deficient. Regulations on the broader environment of business operations such as tax and lobby laws and the public procurement and party acts do not provide for reliable, easily predictable, transparent and unbiased business procedures.

Several government initiatives have shown improvements, however the state in its regulatory and economic role has not been able to establish an adequate business climate which would enhance performance and competition. Excessive administrative requirements and bureaucratic regulation make business management more difficult and arbitrary simplification in administration bears corruption risks.

Companies working on the Hungarian market face low economic growth and an unpredictable economic and tax policy. The administrative and tax burden on companies is high compared to other European countries. The contribution of the black economy is high, partially due to the fact that consistent law enforcement and sanctions show serious defects.

Causes of corruption are the deficiencies in legislation and in the implementation of regulations, the scarcity of economic possibilities and also cultural traditions. Hungarian business culture does not focus on fair competition and the public is unaware of the long-term profit making and risk reducing effect of ethical business behaviour. The public judgment on companies caught in abuse practices is not really negative.

According to businesspeople active in Hungary, it is impossible or almost impossible to advance business in Hungary without corruption. For businesspeople, business corruption is a larger problem in transactions between the public and the private sectors than within the business sector.

The small size of the economy and a flooded market leads to a lack of competition in Hungary. A large part of the private sector survives on state and local government orders and subsidies. The expenditure of political parties and the revenues of the political elite are not transparent and so we cannot therefore refute the assumption that the business sector assists in the financing of politics partly through corruption mechanisms. Political, personal and business interests are intertwined both at state and local government level thus sometimes it is hard to separate corruption cases solely within the business sector from cases between business and (local) governments.

Corruption mechanisms within the business sector are primarily determined by its structure. Small and medium sized companies – with low capital – face subsistence corruption, with typical symptoms such as illegal employment, tax evasion, issuing invoices with no valid activity performed, paying back part of the value of an order to decision makers and cartel agreements. Concerning larger companies, their corruption is aimed at increasing profit– through unfair market behavior, cartel agreements – or employees seeking private gain.

Corruption is widespread in Hungary. Its different forms can be detected independently of political groups or economic sectors. According to most of our interviewees, corruption has increased in Hungary over the past five to ten years. Both types of corruption – mutual favors with no money involved and classical money transfer based ones exist. Concerning the latter, transactions with many participants organized in a chain are spreading warning us that corruption is becoming institutionalized – as a trend.

Corruption free company management in Hungary results in a competitive disadvantage that – together with the present unfavorable economic developments – pressures many businesspeople to help counter corruption and promote the establishment of transparent business affairs, not only within business but also between the private and public sectors.

Reform measures aimed at improving the situation can only be successful if they are accompanied by massive cuts in state expenses and focus on sustainable structural changes as well as on the change of approach of political and business actors.

# Business environment

## Legal environment

In Hungary, the freedom and independence of enterprise is stipulated by the Constitution. According to the Constitution private and public ownership enjoy equal status and equal protection. The Republic of Hungary recognises and supports the right of enterprise and the freedom of business competition<sup>12</sup>. The freedom of business is actual practice.

Laws regulating the foundation and operation of business companies are stable and meet the requirements of the European Union. Act IV of 2006 on business companies regulates the foundation, organisational structure and operation of companies having seats in Hungary, the rights and duties as well as responsibilities of founders/members/shareholders, the change of legal forms of business companies and their merger, division and closure. Business companies can conduct any business activities that are not banned or restricted by the law.

Company registry courts are responsible for the legal supervision of business companies and keep the records of companies as well as manage the publication of the final accounts of companies as ruled by Act V of 2006 (Company Procedures Act) on company court procedures and company final accounts. If a business company becomes insolvent company registry courts manage its liquidation according to Act XLIX of 1991 (Bankruptcy Act) on bankruptcies and liquidations.

The structure, system and content of the Company Procedure Act and the Company Act have basically proven to work well. The Hungarian company and company procedure law meets the EU guidelines currently in force. With the modifications made in 2006 to these laws the operation of companies became less complicated and the legal supervision over companies became more intense. Conditions on legal remedies have improved but the efficiency of these forums of complaint is still not the best.

The "Doing Business" study of the World Bank ranks countries according to the quality of the regulations on business and of their implementation. Based on this international survey, Hungary ranked 5<sup>th</sup> among East European EU countries in 2007 following Estonia, Latvia, Lithuania and Slovakia.<sup>13</sup> On the global list Hungary was 45<sup>th</sup>, moving forward 21 places compared to its rank in 2006. The "Business Tuning" program of the Economy and Transport Ministry launched in April 2007 – aimed at easing the administrative burden on companies – probably also contributed to the improvement in the ranking.<sup>14</sup> In spite of the improvement the administrative burden on companies is still high in Hungary and reaches 4.5-6.7% of GDP as compared to the 3.5% average in the EU-25.<sup>15</sup>

Most business activities do not require permission. Authorities issue permissions based on meeting objective requirements. Most requirements can be met easily but in certain areas, like banking and insurance, they are – understandably – very strict. Regulations on specific activities may demand the satisfaction of additional requirements, i.e. some activities require specific company forms – for instance shareholder companies or affiliates in investment business.

Act LVII of 1996 (Competition Act) on the prohibition of unfair market behaviour and limiting competition contains the anti trust and fair competition regulations in Hungary.<sup>16</sup> Stipulations of the Competition Act provide an adequate set of tools (controls without previous notice, high fines and, since 2003, the lenient policy) to act against cartels. These tools are to be strengthened by the current amendment of the law.<sup>17</sup>

Act CXII of 1996 (Banking Act) on banking, Act CXX of 2001 (Capital Market Act) on capital markets and Act XV of 2003 (Money Laundering Act) on preventing and inhibiting money laundering are the main legal sources on banking and anti money laundering regulations. The Money Laundering Act has been comprehensively revised after the Financial Action Task Force (FATF) of the OECD placed Hungary on its

“black list” of non co-operating countries and territories (NCCT) in July 2001. The modification remedied the shortcomings objected to by FATF and harmonised Hungarian regulations against money laundering with EU guidelines.<sup>18</sup> As a result the modified Money Laundering Act also put some additional professions listed in the EU guidelines, – such as solicitors and public notaries –under its scope.

Business crimes and crimes against fair public administration are dealt with in the Penal Code. It distinguishes between corruption in administration and in business. In the case of bribery and abuse of official power both active and passive behaviour are penalised.<sup>19</sup> As a relatively new development corruption in international affairs is also included among the crimes defined.

Regulations in Hungary on founding businesses and operating them as well as fighting business crimes (with the exception of the Bankruptcy Act) provide an adequate legal background for the proper operation of businesses. Nevertheless the administrative burden on business is still substantial. Sanctions on business crimes and crimes against fair public administration have become stricter since the system change but the enforcement of the law is problematic because the efficiency of detecting business corruption cases is still not efficient enough and the corresponding court rulings do not always reflect the strictness of the law.

Regulations on the broader environment of business operations like tax and lobby laws and the public procurement and party acts do not provide for reliable, easily predictable, transparent and unbiased business administration. In Hungary, some 30 acts regulate taxation and social security contributions.<sup>20</sup> Tax and customs regulations are rather complex and sometimes contradictory. Contrary to strategic promises,<sup>21</sup> tax regulations are changed often and unpredictably creating uncertainty in the legal as well as in the investment environment. The present Public Procurement Act – currently under modification – is overcomplicated and contains loopholes. The Lobby Act that came into force in September 2006 did not have the results expected, because it narrowly defines the range of lobbyists and the control mechanisms of enforcement are also weak.

The actual party and campaign financing regulations merit a separate mention. The law created to meet the needs of system change set up a HUF 1 million campaign spending limit per candidate driving parties to fund a significant part of their campaign spending – as much as 90% according to independent estimates – through “non transparent” ways.<sup>22</sup> It is a general assumption that some of the sums paid by companies to parties make their way back to the business circles through state orders.

## **Economic environment**

“Hungary successfully implemented major transition reforms in the early 1990s. Its dynamic enterprise and bank privatisation and favourable investment climate attracted significant foreign direct investment, including in green-field projects and major utilities. A few strong local companies emerged in the late 1990s, now increasingly aspiring to a regional role, whereas the growing SME sector is still undercapitalised and is in dire need of innovation and improved management skills.”<sup>23</sup>

The GDP growth rate has fallen from 5.1 per cent in 2000 to 1.3 per cent in 2007, meanwhile the budget deficit has been continuously growing and employment figures deteriorating – the unemployment rate increasing from 5.7 per cent to 7.4 per cent.<sup>24</sup> According to the survey of the National Bank of Hungary, businesses and households expect lower and lower economic growth rates. After the unfavourable cost shocks experienced since the summer of 2006 – first the tax, social contribution and regulated price hikes related to the budget adjustments, then in the summer of 2007 the substantial increase in food prices – the company sector has had to accommodate further cost increasing effects.<sup>25</sup>

Budget expenses in Hungary amount to nearly 50 per cent of the GDP while the average in the Visegrad countries is about 40 per cent. The difference can mostly be explained by high social and welfare expenditures in Hungary.<sup>26</sup> The EBRD’s Strategy for Hungary expects the fiscal consolidation plan of the government “to reduce fiscal expenditures and decrease the deficit in government finances. ... The

reforms started in summer 2006 .... Direct tax increases followed in autumn 2006 with hikes in employee social contributions, value-added tax and business taxation. In the medium term, social security and business taxes are expected to be the largest contributors to the increase in the public revenue base, accounting for more than half of the expected reduction in the fiscal deficit in 2007. While considered to be the first step in reducing the deficit, there has been a widespread concern that this plan may have a negative effect on international competitiveness. Even before the new tax rises, Hungary had the third highest labour tax level in the OECD.”<sup>27</sup> High social contribution duties attached to labour result in low employment figures that have an unfavourable effect on economic growth through reduced investments.<sup>28</sup>

The small size of the economy and the flooded market leads to a lack of competition in Hungary.<sup>29</sup> A large part of the Hungarian economy makes its living directly or indirectly through government orders. State subsidy programs stimulating the development of enterprises are also substantial. Thus state resources play an important role in the Hungarian economy restricting the intensity of competition.

The state acts as regulator, as business partner and as the organizer of social tasks in the business arena.<sup>30</sup> In each of its roles the state has a significant influence on the operation of business life and therefore its corruption risks as well. There have been a number of government initiatives which have resulted in improvements.<sup>31</sup> The state, however, exercising its regulatory and economic functions has been unable to provide a business climate sufficiently conducive for a better generation of performance and competition.<sup>32</sup> Overburdening administrative requirements and bureaucratic regulation have made the running of business more arduous, and ad hoc changes intended to simplify administration carry with them the risk of, and opportunities for, corruption.

Corruption and the black economy are strongly interrelated and overlapping phenomena: the spread of corruption is one of the causes of the black economy and in this sense the proportion of the black economy indirectly indicates the scale of corruption. The tax and the economic policy approach to the black economy<sup>33</sup> concentrate on the damage of which the disadvantage in competition is related to our topic.<sup>34</sup> The size of the black economy – according to various estimates – reaches 15-18 per cent of the GDP. In addition the tax and social contribution base is narrow. Most typical cases of the hidden economy are illegal employment (30%), services without invoices (20%) and irregularities related to wages (17%).<sup>35</sup>

The government launched several measures aimed at reducing the black economy between 2006 and 2007.<sup>36</sup> Tax income increased by 10 per cent both in 2006 and 2007.<sup>37</sup> Government measures aimed at whitening the economy resulted in an additional HUF 96 billion in budget revenues – as calculated by Ecostat.<sup>38</sup>

Compared to other EU countries the joint burden of taxes on profit – company tax, special solidarity tax and the turnover tax collected by local government – and on labour is high in Hungary. On the other hand the group of taxpayers is small, overhead-type taxes are common and many smaller taxes exist. High tax and social contribution requirements are matched by low payment morale and there is a general attitude of searching for loopholes in regulations. Due to tax evasion a sum equal to a quarter or a third of the GDP is “missing” from the tax base.<sup>39</sup> The volume of tax fraud is the highest in micro businesses and large companies, documentation in the former is often absent, employing illegal labour is the general rule, while the latter face high costs in the event of committing errors. Most of the tax fraud cases are related to VAT, accounting for 80 per cent of cases detected by the Tax Authority (APEH). Tax fraud is most prevalent in the construction industry, followed by IT parts trading, car trading and catering. According to the Tax Authority, tax discipline is slowly improving in spite of the low tax morale. Tax reform is continuously on the agenda but so far no significant changes have taken place.

The State Audit Office announced its proposals for public finance regulations in April 2007<sup>40</sup> These were directed at establishing rules, institutions and technical solutions to make public finance more transparent, more predictable, and more efficient at the levels of government, local government and public institutions. Better operation of the public finance sector – through securing monetary balance and thus increasing trust in the system – would, in all probability improve the internal and external conditions for competition

and sustainable growth. The much discussed proposals aim to change three laws, including the constitution, but their success is uncertain. The danger is that they will not survive political bickering.<sup>41</sup> The proposals can also be applied as self-restraining directives for the state and local governments – if the necessary political will is in place, which is doubted.

International credit rating agencies have improved their ratings for Hungary in 2007 as a sign of improving global assessment<sup>42</sup> but our interviewees expressed the belief that according to their perception this assessment has been worsening consistently since 2001. According to an OECD report published in April 2008, Hungary faces a relatively difficult economic situation, but this does not alter the main tasks of settling public finances, accelerating job creation, reforming the social security system and consolidating the budget.<sup>43</sup> Economic policy and the reform of the welfare system are 10-15 years behind the times and have negative effects on the competitiveness of Hungary. According to some, Hungary has no considered economic strategy and ad-hoc measures create an uncertain environment for market players.<sup>44</sup>

Companies working on the Hungarian market face low economic growth, an unpredictable economic policy and a high tax burden. For the moment the economic environment does not guarantee the transparent and predictable operation of the market and this lack of stability favours the development of situations inviting corruption. Reform measures aimed at improving the situation can only attain success if they are accompanied by massive cuts in state expenses and are directed towards sustainable structural changes as well as to a change in the approach of political and business actors.

## Structure

Following the system change, in the first phase of privatisation which lasted until 1994, the government sold the easily marketable state companies. Large strategic companies were sold between 1995 and 1997. In 1997 the state also began selling its not so easily marketable minority stakes. Since 2002, the government obviously aims to complete the privatisation process by selling its stakes in MOL, Dunaferr, Richter Gedeon, Antenna Hungária, Budapest Airport etc. The privatisation of local government owned companies is still going on.

The ownership structure of companies has profoundly changed following the system change. Now the public sector contributes only 23 per cent of the GDP, while the contribution of the domestic private sector increased to 51 per cent and that of foreign companies to 26 per cent.

In recent years a surge occurred in the Hungarian private sector, especially manifest in the growth of the number and importance of micro businesses. Today 707,756 companies operate in Hungary, the number of registered businesses reached 1,233,704 in 2005.<sup>45</sup> Foreign ownership is on the rise in businesses of all sizes and this has noticeably improved the operational efficiency of the enterprises.

In Hungary, foreign owned companies are a dominant factor in the production of the GDP, the supplier position of Hungarian companies has improved only slightly. The number of companies registered in Hungary with at least 10 per cent foreign ownership has little changed between 1997 and 2005, their number being 26,019 in 2005. The state offers different incentives for foreign investments but the structure of these incentives is not transparent due to non-public data; the access of the public to some contracts – and therefore the control of NGOs over the implementation of these contracts – can be ensured only through a lawsuit.<sup>46</sup>

Among companies operating in Hungary 99 per cent are SMEs, 67 per cent having no more than a single employee. 924 companies employ more than 250 people. Our interviewees all agree that Hungarian SMEs suffer a disadvantage in competition with, and are powerless against, companies partially owned by foreigners. The SME sector is characterised by “subsistence corruption”. These businesses are not able to make enough profit to pay the high tax and social contribution and so bringing their activities back into the legal sphere carries the risk of total SME insolvency. In addition, in many cases SMEs are dependent on only one large order (from a company or from a local government) thus they accept conditions

dictated by the purchaser.

In the autumn of 2007, the government approved its *SME Development Strategy* giving priority to the regulatory environment, access to financing and the development of entrepreneurial skills and infrastructure.<sup>47</sup>

The state now owns 172 companies, of which 93 have elected to remain in long-term state ownership. The state fully owns 25 companies, and wants to retain a golden share in eight of those. Among the companies selected for long-term state ownership the state has majority stakes in 86 and minority stakes in 7 companies. 79 state owned companies are still open to privatisation.

State ownership is present in Hungary in the following key industries:

- full ownership in 23 companies: 19 forestries, the postal company (Magyar Posta Rt.), a hydropower plant on the Tisza river (Tiszavíz Vízerőmű Kft.), the national lottery company (Szerencsejáték Rt.) and the national railway company (MÁV Zrt.)
- 99 per cent ownership in two companies: the electricity works (MVM Rt.) and a wine trading company (Tokaj Kereskedőház Rt.)
- 25 per cent plus one vote in 5 companies: a porcelain manufacturer (Herendi Porcelánmanufaktúra Rt.), Budapest Airport Rt., a textbook publisher (Nemzeti Tankönyvkiadó Rt.), an export-import credit bank (Eximbank Rt.), and export loan insurer MEHIB Rt.
- a "golden" share with special voting rights: oil company MOL Rt., OTP Bank Rt., drug trader Hungaropharma Rt., a food (paprika) processing company KAGE Rt., salami and meat processing companies Pick Szeged Rt. and Herz Rt. and a real estate company CD Hungary Rt.

The cost of Budapest Stock Exchange (BSE) transactions is relatively low and requires little administration but the number of newly listed companies is small. In 2008, there are 35 brokerages and 62 issuers on the BSE and shares of 41 companies are traded. The Hungarian population holds only 1.2% of their savings in equities which is low by international standards. BUX, the index of the BSE increased by only 6 per cent in 2007 – less than in previous years. On the other hand the monthly turnover of trading in shares increased from HUF 200 billion to HUF 250 billion.<sup>48</sup> The small number of new BSE listings can only be partly explained by the weak macroeconomic performance: companies in Hungary are interested in minimising their profits to reduce the tax burden while actors on the stock exchange have to be transparent and profit-oriented.

## Accountability

Companies have to submit their financial accounts annually as required by the Act on accounting and to submit their approved financial statements to the Company Registry Court. Specific acts regulate their reporting to the tax authority and to the social security institutions such as the health and pension funds. In practice failing to report to the Company Registry Court is not heavily penalised. Sometimes even large companies fail to provide data and even over a number of years this does not meet with sanctions.

The Company Registry Court has the authority to enforce through the so-called legal supervision procedure the lawful operation of a company in order to guarantee the veracity of the public register.

According to the regulations of the Money Laundering Act, selected actors from the business world have reporting duties. The most important categories concerned are financial, investment, postal and insurance service workers, brokers, real estate agents, auditors, accountants, tax advisers, casino operators, precious metal traders as well as attorneys and public notaries.

Reports are filed with the National Police (ORFK) and the Customs and Excise Tax Office (VPOP) by persons appointed by the organisations concerned.

Registering a company no longer requires membership of a relevant chamber but operating licences in

special professions can only be obtained for members of the given chamber.

In addition to the state organs mentioned above, the Competition Office (GVH) and the State Financial Supervisory Authority (PSZÁF) play a role in supervising business actors. The Competition Office was set up in 1991 to enforce the Competition Act. Its tasks include promoting competition in general, creating competition on markets where it did not previously exist and preparing proposals for state regulation. Thanks to its firm stance the Competition Office is earning a more and more positive reputation among businesspeople. Some businesspeople criticise the fact that a fine should be paid immediately, as in the event that a fine is not justifiable, it can take years to get it refunded. It should be noted that most of the decisions of the GVH are approved by the first and second instance courts,<sup>49</sup> and therefore the system of strict sanctions is well supported.

The goal and duty of the State Financial Supervisory Authority is to guarantee the reliable, continuous and transparent operation of financial markets, to strengthen the trust in financial markets, to promote the development of financial markets based on fair competition, to protect the legitimate interests of market players, to provide appropriate information to reduce the risk to consumers and to play an active role in the struggle against financial criminality.

Interviewees state that the implementation of laws has serious defects in Hungary. Most typical problems are long procedures and a lack of professional knowledge of the law enforcement agencies and courts. Imperfect law enforcement in corruption and economic crimes results in a lack of retentiveness of court decisions.

The information necessary to commit a crime of money laundering took just three seconds to be obtained by the perpetrator but it took half a year to get through the police procedure during investigation.

In the first quarter of 2007 195,091 procedures related to economic crimes were completed: 60 per cent of the cases ended with the annulment of the investigation and 35 per cent with an accusation.<sup>50</sup> It has to be noted that strict regulations concerning the protection of personal data may hold back the proof for economic crimes.

The detection of business crimes can be hindered by the lack of expertise of the investigation staff responsible, the lack of investigative capacities, and in the case of a high profile crime also by political pressure from the intertwined political and business groups. Court rulings based on inadequately prepared investigation documents impose sanctions that do not have a deterrent effect. According to the perception of the general public, violating the law has no serious consequences because of the inextricable and never ending nature of court cases.

Accountability could be substantially improved by the development of internal control systems of enterprises. The survey conducted by PricewaterhouseCoopers shows that 30% of the abuses in companies are uncovered by chance. 32 per cent of the cases are revealed by the internal control systems and 17 per cent of cases through whistleblowing.<sup>51</sup>

## **Integrity mechanisms**

The Business Ethic working group of the Hungarian Business Leaders Forum developed a questionnaire to survey "the actual status of business ethic policies in companies active in Hungary".<sup>52</sup> Upon completion of the small-sample survey, they have concluded that the public is unaware of the long-term profit-making and risk-trimming effect of ethical business behaviour and SME companies have little interest in developing codes of conduct. Existing norms are mostly applied only within the companies and the main goal of these companies is to protect their own operations. These norms extend less to the support of healthy market mechanisms and competition and seldom cover subcontracts. Even where written norms exist at the company level, consistent enforcement is absent and those breaking the rules are held accountable in very limited ways.



The introduction and promotion of compliance mechanisms as well as the strengthening of individual responsibility is recommended to enhance integrity mechanisms.

Employment contracts seldom contain specific anti corruption clauses. This is mostly seen with employers partly or fully controlled by foreigners and who apply employment contract templates developed by their "headquarters". Employers in general offer commission or similar additional wage incentives to their employees in order to discourage corruption and try to control the workflow by other means such as requiring that employees use the fixed line phones of the company and the recording of all their communication with clients etc.

The Company Act provides for conflicts of interest regulations to be followed by leading managers and members of the supervisory board of companies. Conflicts of interest regulations on business actors and public service employees have developed considerably but still do not cover all conflict of interest situations. The regulation of conflicting business and political interests is especially problematic in local government matters. This situation cannot be easily changed without a properly elaborated and implemented lobby act as well as a code of conduct applied in the public sector.

## Transparency

In Hungary, the Company Registry Courts keep records on companies seated in Hungary as well as affiliates of foreign companies operating in Hungary. Upon the request of anyone, and for a fee, the Company Registry Court provides a company abstract, a copy of company documents, and a company certificate. These data are also made available online for subscribers to this service and partially at [www.e-cegjegyzek.hu](http://www.e-cegjegyzek.hu) free of charge. The Company Registry Court allows the study of these data free of charge in its offices where copies can also be obtained for a fee.

The Company Registry Court is responsible for keeping accurate records and supervising the registration of changes. The Company Registry Court publishes announcements concerning companies in the Official Company Gazette (Céglőnlöny). The company registry makes the business relations of companies transparent only in theory, in practice it may be the case that information kept in the registry of the Company Registry Court and of the Company Gazette differ.<sup>53</sup>

The most important register concerning investments is the real estate register, in which authorities entitled by special laws have the right to search information by names of owners, while personal inquiries can be made by addresses. The system of real estate registers is highly problematic in Hungary. The registration of changes suffers long delays but there is a way to have matters settled on a fast track – usually by offering cash to the corrupt employee.

If we consider stock exchange listing as a reflection of transparency then we can conclude that in Hungary there are very few companies ready to meet the transparency and integrity criteria attached to appearing on the stock exchange.

Fields of the business sector in which the state or the political establishment takes a direct or indirect interest attract the attention of the media. Corruption cases in these fields receive broad press coverage. Corruption cases involving fully private businesses – except those of large companies – do not receive press coverage. However it should be noted that the media in Hungary is highly influenced by, and dependent on, politics and it is assumed that many corruption scandals are made to order thus it is difficult to detect the political motivation behind cases.

## Complaints

In Hungary, a Standing Arbitration Court works alongside the Hungarian Chamber of Commerce and Industry. Act LXXI of 1994 regulates the operation of arbitration courts. Companies that sign contracts

stipulating the acceptance of the competence of the Standing Arbitration Court in the event that legal disputes may evolve, also accept the rules of procedure set by the arbitration court.

Foreign investors regularly turn to their embassies and chambers with their complaints if they face untoward practice. As a consequence of the growing number of complaints ambassadors of countries – Austria, Canada, France, Germany, Italy, Japan, the Netherlands, the USA and the UK – representing investors contributing 85 per cent of foreign direct investment in Hungary have set up a working group to apply pressure on the Hungarian government to make business life transparent.

In the event that a foreign company files a complaint the relevant embassy decides whether to support the company. Embassies in general handle the cases reported by companies with moderation but the complaints of foreign investors on corruption patterns in Hungary are often controversial. Our interviewees have pointed out that companies led by foreign investors are not always free from corruption themselves and it might happen that they turn to their embassies if they simply do not agree with the penalties and fines levied by Hungarian authorities or were not successful in a competitive bidding situation conducted fairly.

The Chamber of Commerce and Industry in Hungary is regulated by Act CXXI of 1999 on Business Chambers. Public duties of chambers concerning commercial, industrial and handcraft activities are performed by the relevant chambers of commerce or industry. Business chambers are operating in counties, county-status (larger) cities and in Budapest being registered by the relevant County (or Budapest) Courts. Membership is not compulsory.

## Corruption risks

According to the opinion of businesspeople working in Hungary it is extremely difficult or impossible to prevail in business without corruption. Different opinion and business surveys, media studies and the in-depth interviews of this present study verify unambiguously that corruption cases represent a bigger problem for business players at the intersection of the public and business sectors than within a business sector itself.

In almost half of the corruption cases covered by the media an employee of a ministry or of a national agency was one of the parties involved in the corruption. Furthermore the police and judicial institutions appeared as bodies affected by corruption. One-third of exposed corruption cases is related to those institutions which hold responsibility for persecuting the phenomenon.

Businesspeople are concerned about corruption; this expression is an integral part of their business vocabulary. None of our interviewees found it difficult to give a rather correct and detailed definition of the term of corruption. Most of the definitions are ethically based and as a consequence most people define corruption in a wider sense: they describe even those incidents to be corrupt which do not infringe the law but should be condemned on a social or ethical basis. Our respondents mostly classified arranging and providing business opportunities for financial compensation, giving off the record personal remuneration to the buyer by the seller and disclosing political or organizational information as corruption activities.

Among typical corruption infected areas, our respondents mentioned the local government sector, tendering (state and local government procurement), the distribution of EU subsidies, issuing permissions and licences and commercial bribery (paying back part of the amount of an order to the person who made the decision on the order) as primary activities.

Political, personal and economic interests are intertwined at both governmental and local municipal levels therefore it is sometimes rather difficult to separate pure business corruption from the corruption between the private and public sectors.

It cannot be concluded that business players in general are corrupt. According to our interviewees persons who “tend to be” corrupt can be “recognised”, because Hungary is a small country and

businesspeople often discuss this topic. A survey conducted among heads of small and medium size enterprises by Sonda Ipsos in 2007 shows that corruption has deeply rooted historical and cultural causes in Hungary.<sup>54</sup>

The initiator of corruption may be a politician, a businessman or a government or municipal official. Our research results show that public and private sector players have a similar level of inclination to corruption. Our media research shows that most of the corrupt actors are of high social status, some 74 per cent of the active and 57 per cent of the passive agents work in leading positions. There is a very close correlation between the social status of the corrupter and the corrupted.

The original residence of agents in corruption in the majority of cases (passive) or nearly half (active) was Budapest (54 per cent of passive and 46 per cent of active agents). It is an interesting finding that the presence of foreigners among the active agents is not at all rare (11 cases representing 15 per cent of the total). There is a strong correlation between the place of residence of the active and the passive agent – indicating also the close link between their personal relationship networks.

Corruption is widespread in Hungary and business people have learned to adjust to conditions where competition is not determined by the law of the market only. According to our interviewees, corruption-free business management results in a competitive disadvantage in Hungary. In an unfavourable economic situation competitive disadvantage can be fatal for businesses and so many businesspeople have a vital interest in countering corruption, and establishing transparency in business as well as between the public and private sectors.

## **Business and (local) government sectors**

The Unified Police and Prosecutors' Criminal Statistics System (ERÜBS) records the known criminal cases. The number of known crimes in public administration shows a high variance between 2003 and 2007 (782 in 2003, 536 in 2004, 955 in 2005, and 480 in 2006).<sup>55</sup> From the figures shown above no far-reaching or unambiguous conclusions can be drawn concerning the business corruption situation in Hungary, because in the interpretation of the statistics the following factors should also be considered: a, the system does not record malpractices defined in the Civic Code, such as the abuse of trust<sup>56</sup> or the violation of administrative duties<sup>57</sup>, because they do not fall under the Criminal Code. b, due to the hidden nature of corruption<sup>58</sup> data on bribery and insider trading (e.g. 480 cases in 2006) reflect only a fraction of actual cases.<sup>59</sup> c, the "high variation" in figures (e.g. 955 in 2005 but 480 in 2006) is a feature of small statistical sets<sup>60</sup> but does not reflect the general trend of corruption offences. d, annual figures include cases only after the date of the criminal activity could be defined by court rulings.<sup>61</sup> The limited scope of the available data suggests that known corruption crimes reflect only a small fraction of existing corruption practices, most of which remain hidden.<sup>62</sup>

A 2001 survey of Gallup Hungary supports the fact that businesspeople consider business to government corruption more problematic than business to business corruption. At least a third of responding managers believed that the level of corruption is high in state development projects (53 per cent), public procurement (53 per cent), certification of the technical condition of a car (46 per cent), obtaining local government permits (38 per cent), customs handling of goods (37 per cent) and obtaining products and services from the government (36 per cent). Concerning the practice of foreign multinational companies, some 38 per cent of the respondents thought that multinationals are involved "almost always" or "regularly" – together with politicians – in corruption cases. The respective percentages are 39 in state administration and 32 concerning Hungarian companies.

In Hungary, there are 3,194 local governments with independent budgets and a total of 13,872 budget institutions delegated to them. As a result of the decentralised system the local government of many communities is only a distributor of money, but there are also 280-300 towns with considerable assets. Our research results show that the use of public funds by the local governments of towns or Budapest

districts is far less transparent than in the case of government use.

According to one of our interviewees, wealthier local governments operate like autonomous business units whose board of directors is the local council – with the difference that its members bear no personal financial responsibility for their decisions.

Our interviewee distinguishes two major groups of corruption present at the intersection of the private and public sectors: when representatives of the political community intervene in large transactions (which, the interviewee thinks, happens often) on the one hand, and when corruption aims to speed up the routine work of administration to have matters settled in the expected way on the other.

The main reasons for corruption emerging at the intersection between the private and public spheres are the inadequate legal environment (public procurement, party and campaign financing, lobby act, collective responsibility instead of personal responsibility), the close personal links, the liquidity problems of local governments and the low wages of politicians and local government officials.

The motivation behind business to (local) government corruption can serve private, community or party interests or a combination of these. Both at government and local levels the public procurement system is a serious problem, is considered by our interviewees as very corrupt and is linked by them unequivocally to party financing although it is not exempt from seeking individual gains either. Private gain is the main motivation behind the corruption related to the issuing of licences and permits that mostly occurs in local governments – but it is also possible that this corruption indirectly serves party interests as well. Corruption in customs and tax inspections or bribery in speeding up the real estate registry process obviously serves the private interests of the agent of corruption.

### **Party financing**

Current rules of party financing do not guarantee the transparent tracking of the incomes and expenses of parties. In addition campaign financing rules definitely encourage political players to keep their finances off the record. The legal environment already generates corruption mechanisms within parties but it is generally assumed that amounts destined to support parties will return in the form of government orders to the companies involved in party financing. Similarly to the formal party financing system, the political elite is also underpaid, its actual incomes not being transparent.

Politicians maintain close links with the business sphere at both central and local levels establishing an opaque network of mutual favours. The business sphere provides the resources needed to finance politics using its networks. As already mentioned, a large part of the business sector in Hungary makes its living on state and local government orders, thus investment in politics returns in the form of these orders.

It is impossible to live as a decent politician. The system excludes honesty. Climbing up on the party ladder through honest means is an impossible exercise. It is very difficult to keep one's integrity in a leading position.

Concerning corruption mechanisms related to financing political parties and the political elite, our respondents mentioned public procurement the most frequently but also experienced it in licensing and permission granting, in state and local government asset management as well as the use of state and EU subsidies.<sup>63</sup> Corruption mechanisms in this segment usually involve several participants. Financial resources are transferred indirectly – through several agents – to political parties or companies in which politicians have interests, thus only a fraction of the original sum ends up in party budgets.

Businesspeople know this very well, and are certain that later they will get back the amount invested in campaign periods in one way or another. Also the timetable of campaign financing has changed: now businesspeople know that it is worth piling up money for the next campaign in the year immediately following the previous campaign, because that is the time for "donations", not the period before the next campaign.

Political parties are supported by private persons (businesspeople), who get back their investment in favours and also in cash.

There is a company which takes politicians to Croatia for yachting. The list of the sailing guests has to be provided in the port for records but when they return from the cruise they arrange it with the port staff to change the names on the list.

It is not the political cycle that influences whether a party expresses interest but the amount of the procurement. One of the state institutions operates with a HUF 50 million stimulus threshold.

The "broker" is not always rewarded in cash from the amounts transferred to the political parties, but can get a seat on a supervisory board later or some other type of assignment when the party starts to use the money.

The adverse situation in financing politics is an open secret and forces political parties, politicians and businesspeople to opt for tricks and illegal solutions undermining the trust in democratic political institutions. The need for change is continuously on the agenda of every side but no agreement has been reached after long series of negotiations.

The problem of party financing cannot be linked to parties solely on the political left or right – all important political players are part of the deal. According to independent analysts, ruling and opposition parties made a deal to split state money illegally paid to parties 70/30 – using channels of state orders but with the sums ending up sooner or later in party budgets.<sup>64</sup>

The present status quo serves the short-term interests of part of the political and business elite and change is still waiting to happen because short-term thinking led by vested interests and attached to the political cycles is characteristic of Hungarian politics.

There is no stability in the public sphere and the political class recruited from SME businesspeople, a very stable, small and narrow circle has been at the top of the whole system for nearly 20 years. This group uses all its force against change, protecting their interest vested in the present status quo.

## **Public procurements**

The wide range of corruption techniques used by government or local government institutions in public procurements serves the purpose of giving the order to a pre-selected company, because the official or a related party gains from the order.

16 per cent of corruption cases revealed corruption related to public procurements in the media in the years 2006-2007.

Different corruption techniques can be observed in the different phases of the public procurement. One of the most serious problems is when loopholes in the Public Procurement Act (PPA) are utilised to sign state or local government contracts without a public procurement procedure.<sup>65</sup> It is not exceptional in these cases to find persons related to one of the larger parties among the owners of the company getting the order.<sup>66</sup>

There are plenty of exceptions to the main rules set out in the PPA (i.e. cases where general public procurement procedures do not apply). Some of these are based on internationally accepted principles, such as the exception for proceedings that concern a state secret or a service secret, the fundamental security or national security interests of the country, or need to be accompanied by special security measures. What is more questionable and shows the impact of purely political interests is that the power to initiate an exception of this kind is vested in the competent parliamentary committee, which does so by adopting a preliminary resolution. This leaves the exemption subject to the danger of significant manipulation, since it is very easy to find connections – however distant or artificial – between public funds and special security measures. Other exceptions (e.g. with regard to the procurement of broadcasting material) are only partially justified, since most of the contracts signed in this area go well

beyond issues of special artistic ability.<sup>67</sup>

### Call for tenders

When the order is made by a public procurement procedure, it is a frequent complaint that only one company can meet the technical or formal specifications set in the call for tenders. Since most of the procurements – especially at local level – are repeated, these cases cannot be convincingly justified by the lack of professional knowledge of the official preparing the tender. This cannot be excluded of course, especially in the case of ordering special services. In such cases the future bidder is often asked to prepare the specifications of the tender, or it offers its services in order to make the call for tenders “good enough” from the professional point of view.

The institution calling for tenders can invite external experts to help in the specification of the call and these experts have to sign a ‘no conflict of interest’ declaration. If the external expert is also a consultant to one of the bidders the conflict of interest cannot be verified but the specification of the call may favour the bidder concerned.

The Public Procurement Council is not tasked to check the technical content of the call for tenders but bidders can challenge it before the Public Procurement Arbitration Court. It is a serious shortcoming that the approval of the tender documentation is generally made by a body thus no one individual bears personal responsibility for it. If the public procurement tender actually shows irregularities and the Court decides on a fine, the institution calling for the tender pays the fine from public funds.

### Bidding

The start of the public procurement process also entails a permanent informal flow of information. In legal disputes bidders often refer to information that, in principle, they should not be aware of.

A special pattern is when a bidding coalition is formed stimulated by the institution calling for tenders – the future winner is asked to provide at least two other bids that state a higher price than his, and simultaneously to include “extra services” (serving private, party or community interests) in the bid.

A state company announced a call for tenders by invitation, and the responsible person at the company called the manager of a small business asking him to obtain two additional bids from other companies, and to include three laptops into his own bid for the intention of the person responsible. It happened as follows: the actual cost of fulfilling the order constituted 55 per cent of the HUF 7 million winning bid, 15 per cent was the cost of bribery (laptops and some cash), 8 per cent the cost of obtaining fake invoices to hide illegal employment. Calculating some 10 per cent as the cost of administration of the whole process leaves a 12 per cent profit margin for the winning bidder.

In the above case there is a close relationship of trust between those calling for tenders and the companies participating. This is not the case when bidders are approached by ‘dummies’ in the bidding phase, who undertake the task of guaranteeing success for the given company in the tender against a certain percentage of the value of the order.

There is a mayor who was nicknamed “Mr. Ten Percent”.

A tender was announced to purchase seats for a hall in a college but at the same time a businessman was approached and it was promised that he could get the order without bothering about any tenders if he was willing to pay HUF 60 million in cash.

In the case of a procurement of a town, the party treasurers came first to talk over the price and conditions, only after this did technical and other experts come for discussions.

In the construction industry a company put in a bid in a tender to build a tunnel and received a call from the government asking them how much they would offer to get the work. The interviewee has also heard about calls that “hinted” for instance that the HUF 40 million tender could also be won with a bid of 31 million.

It is not rare that the institution calling for tenders agrees with the future winner on the signing of subcontracts with certain companies. The subcontractors have personal connections to the person calling for tenders and reward the order by providing favours to the representative of the institution or his/her party.

The bidding phase, especially concerning larger state orders, is characterised by cartel agreements. The Competition Office, authorised to conduct investigations, can produce evidence in every tenth reasonably suspicious cartel case, leading to uncovering three to five cartel cases per year.<sup>68</sup> The deterrent effect of fines levied by the Competition Office falls very far short of the claim for damages made by the original institution calling for tenders. In Hungary, so far none of the court cases claiming damages from members of a cartel has been concluded and therefore we have no experience concerning judicial practice in this field.

According to the Public Procurement Act the authority has the right to exclude bidders that had taken part in cartel agreements over previous years and where a court decision is in force. To date no company has been excluded from public procurement. Moreover, excluding a given company from public procurement might not even solve the problem, because the very same business groups have stakes in several different companies.

Cartel agreements are either concluded to divide the market among companies that have a high level of familiarity or are initiated by political considerations. Companies forming cartels especially on political grounds feel in most cases that they are protected by a political umbrella – typically formed by several parties. Recently this situation has changed; the ring of political protection can be broken.

#### Tender evaluation

The most common corruption techniques in the tender evaluation process are to exclude bidders on the grounds of failing to meet the formal requirements or to declare the whole public procurement process inconclusive. Under the Public Procurement Act, if the institution calling for tenders is unable to conclude or fulfill the contract it has to declare the procedure inconclusive. If the superior authority withdraws financial support, the institution calling for tenders is by definition unable to conclude or fulfill the contract and therefore has to declare the procedure inconclusive. A new procedure may be initiated if the superior authority once again provides the necessary financial support. This is one of the typical methods by which a contracting authority creates an opportunity for the favoured bidder to take part - in a new procedure.

It is a common complaint that bidders are excluded because they have made an error in providing the name of the tender on one of the pages of the 200-300 page documentation, someone's mobile phone number is missing or the page numbering is confused. On the other hand, larger companies often file bids routinely without reading the tender announcement properly and if they do not win they automatically appeal against the procedure.

A case of tender by invitation: a call comes in from the superior authority stating that something should be ordered from a certain company. Then the institution calling for tenders contacts the companies in the given business sector asking whether they can deliver the product – if the answer is no, they are invited to bid. The first tender may be declared inconclusive but in the second procedure having only one bidder is sufficient for the process.

There are officials who tell bidders that they can arrange for them to win the tender for 10 per cent of the value of the order. Then they get the 10 per cent from the winner and tell the others that they did their best but were unsuccessful.

According to our interviewees, it sometimes happens that large companies do not want conflict with any of the institutions calling for tenders so they refrain from appealing against the procedure.

While the general rules on tendering give preference to open procedure, there are different types of procedure in each category of tender by value: open bidding, bidding by invitation, negotiated bidding, simplified procedure, and competitive dialogue.<sup>69</sup> It would seem reasonable to assume that the "bidding by invitation" procedure is where corruption is likely to be the most widespread, but experts believe that

participants ready to engage in corruption will always find ways of manipulating the procurement process no matter which type of tender applies.

### Implementation

After the contract is signed, it often happens that the actual delivery is less than the contract requires but is still approved as a complete fulfillment of the contract.<sup>70</sup> The profit stemming from the difference goes into party budgets or private pockets – depending on the situation.

In a town the HUF 30,000 per m<sup>3</sup> price for asphalt used to build a road around the settlement was calculated at HUF 59,000 the difference being quite significant on a scale of 50,000 m<sup>3</sup>.

It is stipulated in the Public Procurement Act that the authority should provide information about the implementation of tenders. In reality the fulfillment of contracts is difficult to follow for an outsider and lower performance rarely meets with sanctions.

Tricks and second-best solutions in the implementation phase are often the result of problems emerging in the earlier phases of the public procurement process. According to our interviewees it is also a regular phenomenon that the institution calling for tenders signs a contract with a bidder offering an unrealistically low price, the contractor undertakes the job with not enough reimbursement to cover its costs, and makes up for the money missing by not paying its subcontractors. Even if such tender contracts can be legally valid, the trend itself acts against transparency in the long term, because it keeps the dependent SME sector in the grey zone of the economy.

The quality of delivery can be poor even if the contract was agreed and signed at market prices. First of all, the contracting price can include the cost of corruption and so less remains to cover the cost of fulfillment. Secondly, in practice the actual work is sometimes done by subcontractors of the subcontractors and those who are at the end of the chain receive only a fraction of the price of the deal.

Too detailed a specification in a call for tenders bears the risk that the supplier adjusts its product or service to the requirements in a very short time frame but in the end will not be able to meet those requirements at the time of delivery. It has an obligation to fulfill the requirements specified in the contract – but its actual performance will not be in line with the proper quality standard.

It is hard to judge in the case of excessive and unnecessary costs in orders whether they are the result of corruption or just sheer stupidity. According to some authorities the rigidity of the public procurement system increases the price of the procurement and the length of time for the procedure.

According to estimates by Transparency International, systematic corruption adds as much as 20-25 per cent to the costs of government procurement, and often results in the purchase of inferior quality, or superfluous, goods and services.<sup>71</sup> By countering cartels and carefully selecting tender specifications, costs of public procurement could be substantially cut,- by as much as 20-30 per cent according to the Economy and Transport Ministry.<sup>72</sup>

The Hungarian public procurement system has high corruption risks. The ongoing modification of the Public Procurement Act is a step in the right direction but is not likely to prevent corruption based on the network of mutual favours formed on the basis of personal connections.

### **State and local government assets**

Assets sales and real estate development characteristically carry with them corruption risks at local government level.

When real estates owned by local governments are up for sale, information obtained via personal connections provides a "competitive edge". According to our interviewee, the purchase of the construction site itself may already involve corruption.

The architects' office knows whom to corrupt to get (or get quickly) the construction permission for the given site. Business players who do not have this information are "in big



trouble". The general pattern is to exploit the situation whereby if someone has already invested in a construction site then he or she cannot "drop" the construction project, because of the fear of "massive losses" thus creating a perceived necessity to corrupt someone.

In the relationship between foreign investors and local government decision-makers the situation often emerging is of the type "is this building for sale? – it depends". Our interviewee thinks this is what happens in 98 per cent of the cases.

One of our interviewees wanted – as a private individual – to purchase a construction site from a local government and called the local government office asking for the price but was told that "the site is sold by the mayor."

In local government's real estate purchases the typical corruption mechanism is to charge an above the market price from which the seller pays a certain percentage "kickback" to the buyers. Similar mechanisms can be observed when renovating buildings owned by local governments and also in smaller purchases that do not require the launching of a public procurement process.

A company launched a new business and started to build business connections. They approached service companies owned by local governments and were surprised that they had no interest in buying cheaper.

In a town, the local government decided to purchase real estate and members of the town council made clear that they wanted 20 per cent "back" from the purchase price. They checked that the vendor company had cash to pay their "commission" and then approved the purchase at higher than market prices although the town did not really need the building.

A recent case shows the drawbacks of the privatisation of state assets: a small consultancy firm received a particularly high "success fee" from the purchaser of a subsidiary of state owned Hungarian railway Magyar Államvasutak, the "consultants" meanwhile could be indirectly linked to political forces.<sup>73</sup>

### **Public Private Partnership**

The cooperation of the public and private sector through Public Private Partnership (PPP) contracts means that the state entrusts the private sector with the performing of public tasks in a comprehensive manner typically by transferring the responsibility for providing a public service.

The State Audit Office evaluated the implementation of PPP projects in Hungary and came to the conclusion that the first projects "caused significant loss for the public sector while the other party reached ("topped") its goal by realizing a substantial profit and by establishing a secure (state) background for a long period."<sup>74</sup>

None of our respondents mentioned PPP projects among the areas exposed to corruption which most probably means that interviewees more frequently encounter other procedures with corruption risks. The study of the SAO emphasizes that "the operation bears the risks of wastage and corruption which is rooted mainly in the short-term interest of government decisions, the non-preparedness of the public sector, the profit interest of the private sector i.e. in the mutual and relatively easily enforceable interests of the parties".

Due to the high corruption risks of PPP projects it may be constructive to sum up by saying that according to the research results of the SAO it would be advisable to unify the legal regulations concerning PPP projects especially at local government level and to improve and develop the change of approach with regard to the mutual prejudice of the private and public sector.

### **State and EU subsidies**

Transparency International examined the EU structural fund allocation rules in Hungary over the budget period of 2004-2006 and concluded that the allocation system of resources is in line with EU norms and offers protection against most situations of corruption.<sup>75</sup> The inquiry did not address the efficiency of the use of funds, or the quality of the public procurement procedures applied in the process, or the quality of

implementation.

Our present research found a strong suspicion of corruption in the allocation and use of EU resources aimed at economic development. Our interviewees told us that the Regional Development Councils follow political deals and break down the number of winning applications by county. In 2007, the Economic and Enterprise Research Institute (GVI) of the Hungarian Chamber of Commerce and Industry investigated the reasons for companies not filing applications for subsidies from the economic development programs. SMEs were held back by the required relatively high amount of self-funding, to be committed, larger companies were deterred by the complex regulations for application and by corruption.<sup>76</sup> If allocation decisions can really be influenced in this way then it might be that consultants or professional application writers use part of their success fee for paybacks to persons involved in making decisions concerning the allocation.

A new law on improving the transparency of the subsidy systems came into force on April 1, 2008,<sup>77</sup> regulating the conflicts of interest more strictly in the competitive application process. Chairmen of the Regional Development Councils have been excluded from making decisions concerning subsidy allocation thus they or their close relatives cannot file applications and cannot receive subsidies.

It is the inadequate financing mechanism and the liquidity problems of local governments that, in the first instance, cause the phenomenon – contrary to the principle of fair and transparent competition – that local governments file development project subsidy applications with the help of a given company. It is a common practice of utility development companies to approach local governments offering to provide the stipulated “own” financing of the project if the company then gets the opportunity to carry out the work. The offer of the constructing company obviously contradicts the principle of fair competition, hinders the development of enterprises and in all likelihood has the effect of pushing prices up. On the other hand, local governments often really do not have resources to provide the ‘own contribution’ element of the financing, and often lack the capacity to write proper subsidy applications, thus such deals serve the short-term interests of the community. Neither is it clear whether the service or product for which the company offers to provide the ‘own contribution’ element of the financing satisfies the needs of the community in the best fashion. The driving force behind the mechanism is the business motive of the company in question in seeking an opportunity to sell its product and the way of achieving its goal is through the exploitable subsidy tenders. Thus it is not guaranteed that the local government uses its resources for what it needs the most, but decisions on public issues are made according to the considerations of private business.

“Everyone gains, it is just the country that goes bankrupt.” That is why “part of the EU subsidies are not used where they should be but will be converted for instance into a decorative pavement somewhere.” They say that there are two types of mayors: the one who steals for himself and the one who steals for the community. If he receives an offer that a company can build three public toilets for the town and in addition it pays back 10 per cent of the amount that can be won on a subsidy tender, then there is no risk and it does not cost any money. The problem of providing the ‘own contribution’ element is usually solved by announcing a pre-public procurement procedure and one of the banks will then finance it.

The process described above can push up prices considerably if not only the given company is manipulating the situation but also political interests are at play when the amount of the public procurement is set.

In 1988, a local government applied for PHARE “micro-region” subsidies to build a sewage network. The local government had no money and the project would have cost HUF 580 million. An application for HUF 800 million was filed to the county where another HUF 400 million was added, but by the time the application finally arrived before the economic committee of Budapest the claim had grown to HUF 1.5 billion.

### **Licences and permits**

According to the 1999 Business Environment and Enterprise Performance Survey (BEEPS) of the European

Bank for Reconstruction and Development, respondents most often experienced corruption in public administration when involved in the procedure of obtaining certain licences and permits (some 25 per cent believed that – seldom, sometimes, frequently, mostly or always – bribing is necessary).<sup>78</sup> 16% of corruption cases covered by the media in 2006 and 2007 are related to licences and permits.

Local governments often set conditions on issuing licences or permits. These conditions can serve the interests of the local community, or the obligation of including given subcontractors, or the individual interests of the official who issues the permit necessary to execute the work.

It is a typical local government corruption mechanism that – taking into account the interests of the local community – a construction permit is issued only if the investor is prepared to provide extra services such as, for example, laying a decorative pavement.

Sometimes contractors of local government orders are forced to enter into subcontracts with certain companies entertaining close political and business links with the leaders of the local government if they want to obtain the necessary permits. It is generally assumed that such transactions also involve the transferring of part of the money paid to subcontractors to party budgets.

Earlier, a company contacted a local government, because it had taken over project X from a different company and it needed a permit to repaint a building within project X. The work went well but just before completion the local government informed them that a study was necessary to evaluate how the building blended with the townscape. They were told how much the study cost and from which company to order it. Finally they agreed and ordered the study, because the project was worth HUF 20 million. As a result Santa brought them the permit on December 6.

In the case of corruption in obtaining licences or permits, the bribe serving the individual interests of the issuing person can be cash, dinner invitation or other, non material advantages such as giving jobs to relatives.

There is a local government officer with whom a dinner invitation helps to settle the issue of construction permits. In this case, the officer himself calls a certain restaurant, reserves a table for his family and eats on the account of the company involved in the corruption.

In the case of permission and licence procedure, time provides the largest room for manoeuvre for the passive agent of corruption.<sup>79</sup> If the expiry of a given deadline automatically resulted in the granting of the permission the corruption risk in issuing licences and permits would be substantially reduced.

## **Lobbying**

In Hungary, “state capture” in general – when strong private interest groups capture the legislative power – is not a problem but certain industries (energy, tobacco, IT and pharmaceuticals) have considerable lobbying power. It is corruption not involving direct cash transfer but rather based on networks, not violating the law that is characteristic of influencing the legislature. In such transactions, as a general characteristic, the favour or gain requested in exchange for satisfying lobby interests is separated in time from the assertion of the lobby interest.

According to the 1999 Business Environment and Enterprise Performance Survey (BEEPS) of the European Bank for Reconstruction and Development, 8 per cent of the companies reviewed thought that payment is also required in order to influence the content of new legislative rules, decrees or regulations.<sup>80</sup>

The Lobby Act that came into force in September 2006 does not guarantee transparency related to the influencing of the legislature. The Act defines the range of lobbyists narrowly and its enforcement is not consistent: its control mechanisms are absent and violations are not, in practice, met with sanctions .

Since the Lobby Act came into force there have been 531 lobby reports submitted averaging. 88 lobby reports per quarter. During this period there were 37 cases of factual lobby activity while the public sector reported 57 lobby cases.<sup>81</sup> The figures clearly show that there is a significant discrepancy among the number of lobby events registered by the two parties and only a part of lobby activities is registered.

Recently the press unveiled, in the energy sector, favours – indirectly also concerning the political elite – that were the result of uncontrolled lobby influence.<sup>82</sup>

### **Inspections**

According to the 1999 Business Environment and Enterprise Performance Survey (BEEPS) of the European Bank for Reconstruction and Development, in 2002, at least 10 per cent of the organisations responding suspected regular corruption in obtaining government orders or in dealing with customs and imports (11 per cent). By 2005, two other fields had been added: health/fire inspections (up from 5 per cent in 2002 to 12 per cent in 2005).<sup>83</sup> Most of the corruption cases (42%) revealed by the media in 2006 and 2007 are related to inspections.

In order to fight the black and grey economy, both the Tax Authority (APEH) and the Customs and Excise Tax Office (VPOP) allocate growing resources for inspections.

With regard to the inspection practices of APEH, we have met with many complaints in our research. Our interviewees stated as their main problem that tax inspectors dealt with managers “almost as criminals”, not regarding them as partners.

Tax inspectors called a foreign company in Hungary telling them that they were coming, because it had been a long time since they last found irregularities there.

A small IT company realised significant earnings after which it paid “too much” company tax. The next year they were subject to continuous tax inspections, so they learnt to be more creative in accounting and permanent inspections ceased.

The Hungarian tax law regards taxpayers as potential criminals who should be punished. They are not taxpayer citizens on whose taxforints the state lives and sponges. Neither are they regarded as normal human beings who are fallible and might commit errors. Instead of encouraging us to understand the rules and be able to see how much taxforints are spent and on what purposes, they punish and sanction and without saying it outright consider us deceivers. What else could have been the motivation behind e.g. imposing tax on company phones?

Contradictory information exists concerning the corruptibility of tax inspectors. Some accountants say that it is useless to prepare for an inspection without having some slush fund prepared, while others say that they are hardly ever forced to bribe inspectors. Our interviewees say that tax inspectors often “have to produce” a given amount of budget revenues from fines and collected tax to meet targets. In order to guarantee success, company managers sometimes strike a deal with the inspector agreeing on the amount of bribe and the fine to be levied thus the company is not exposed to the several day or week long inspection procedures that otherwise would occur.

The manager of the inspected company can appeal against the fine. It can happen that the Supreme Court changes the ruling of the first and second instance courts which favoured the company manager. This shows – according to our interviewee – that there is political pressure to maximise tax revenues.

Concerning customs duties, SMEs are mostly characterised by “subsistence” corruption, that is they try to evade the payment of duties or excise tax and trade goods with fake brand logos. Large companies` corruption aims to ease customs administration: they pay for a “fast lane” or to avoid having a special inspection.

Based on data from the Customs and Excise Tax Office (VPOP) some 80-85 per cent of known corruption cases during inspections are initiated by clients.

Inspections of other public authorities (environmental, health, etc.) might bear further corruption risks, but were not mentioned by respondents.

### **Bankruptcy procedures**

The Bankruptcy Act does not support bankruptcy protection, since almost all bankruptcy procedures end up in liquidation. Nevertheless, the owner of the liquidated company can set up a new company without any restrictions and the independence of the liquidators can often be questioned.<sup>84</sup>

One of our interviewees considers the spreading of a new corruption mechanism in acquisitions as a sign of worsening corruption in Hungary. In this mechanism, companies that employ registered liquidation commissioners approach other companies facing liquidity problems and offer their "services" in guaranteeing the result of a bankruptcy or liquidation process. The court "surprisingly" appoints them as liquidation commissioners. By this time, they have already made an offer through off-shore companies for the purchase of the remaining assets of the company in trouble.

## Corruption within the business sector

Based on our in-depth interviews, the size of corruption in pure business to business transactions, outside the political interests and the work of public sector employees does not reach the extent of corruption at the intersection between the public and private sectors.

According to the Unified Police and Prosecutors' Criminal Statistics System (ERÜBS) the number of known business crimes – after a continuous increase – significantly dropped by 2007 (15,088 in 2003, 16,661 in 2004, 17,106 in 2005, 17,862 in 2006 and 14,201 in 2007).<sup>85</sup>

The fact that business culture in Hungary does not focus on fair competition can only be partly explained by the business environment stemming from the financing problems of the political elite. It is an additional difficulty that the justice system works slowly and court practices are erratic. The public does not judge companies fined negatively and many believe that making cartel agreements is not at all unethical.

A businessman in the construction industry does not understand why it is a problem if companies split the market among themselves since all of them will be better off.

According to the Prime Minister, "business players are inclined to limit competition, to seek agreements for setting prices above the market and to realise extra profit under non market conditions."<sup>86</sup>

### Large companies

Concerning the pure business transactions of large companies, private activities of employees working in procurement and cartel agreements carry the highest risk of corruption.

The biannual Global Economic Crime Survey of PricewaterhouseCoopers – focusing on business corruption and economic crime in particular – indicates higher figures than official criminal statistics. According to the 2007 figures of the survey, nearly two thirds (62 per cent) of the companies in Hungary became victims of serious business crimes in the two year period examined.<sup>87</sup> The most frequent crimes were theft and the mismanagement of funds (48 per cent), crimes concerning intellectual property (26 per cent) as well as bribery and corruption (17 per cent). Respondents estimated the loss caused by criminal practices to reach HUF 3.9 billion – HUF 62 million per company over the given two years.

The gain-seeking efforts of employees working in procurement reflect the classic mechanism of kickbacks. The purchasing employee prefers the supplier that promises extra 'perks' for him or her (travel, car, cash, free medical treatment etc.). "Despite the respondents' growing confidence in their risk management systems, nearly 30 per cent of the most serious reported cases in Hungary were detected by chance (i.e. by accident or from tip-offs). Internal control is by far the most successful fraud detection mechanism in Hungary, helping to discover 32 per cent of the most serious economic crimes reported in Hungary."<sup>88</sup>

In some industries the institution of "kickbacks" exists. These industries have a typically high business risk: the payment is based on weight, the goods are always on the way or the quality is important (e.g. in the food industry), the decision depends on one person in certain situations, and problems may arise in business practice. For example in the meat industry, say the meat content should be 70 per cent in a certain product but the supplier can produce only 60 per cent. The purchaser will "forget to check" the meat content in exchange for a special compensation.

One of our interviewees was an inexperienced manager when he had the task of selling the unused real estate of a Hungarian bank, and the Austrian purchaser said it wanted to pay more than the price agreed. First, he could not even understand the situation. The difference – 2.5 per cent of the price – was to be given back in Vienna. Our interviewee underlined the fact that in Austria the people do not want 10-15-20 per cent and are able to restrain themselves.

Cartel agreements not influenced politically are created by companies that know each other well and come to an understanding on how to split the order between them. The most cartel infected industries are IT and construction. As already mentioned in relation to public procurement procedures, the fines levied by the Competition Office (GVH) do not deter large companies. On the other hand, it is a positive development that middle-sized companies in Budapest having 60-80 employees form cartels less frequently due to the fines of the Competition Office (GVH).

Even without political influence, Hungarian competition culture is weak. Companies generally follow an aggressive marketing strategy that often infringes regulations, and frequently deceive consumers. In this field most abuses occur in the financial sector, banks often misinform their clients. Retail chains typically pay their suppliers only after a considerable delay thus causing liquidity problems to SMEs.

In the situation of unfair competition not all managers have the courage to stand against their competitors. Some fear for their personal security but there are managers who do not want to use illegal methods in order to improve their business's competitive position. In the latter category, companies sometimes opt to change their profile but there is an increasing number of companies that are thinking of leaving the Hungarian market.

No one will fight against it. It happened that company B knew that experts trained by it have been lured by company A that employs them in part illegally. Thus A developed a competitive edge on the market but B did not report to the police, because its head was afraid of revenge actions against him or his family thus he preferred to leave this market.

The assessment of multinational companies is mixed. Based on the requirements imposed on them by their foreign owners their internal control rules and their ethics serve fair competition and thus they provide a driving force in creating and spreading conditions for fair competition."...The domination of foreign strategic investors establishes a superior company and even public culture in transition economies by enforcing in the long run competition based on more or less equal opportunities and on employing similar and fair methods. It does not allow the oligarchy, continuously reproducing itself, to regularly capture the politically (and morally) weak governments and legislatures of the raw and fragile democracies – leading to state capture".<sup>89</sup>

However, a considerable portion of large companies are involved with state orders, and thus a different picture of them also developed, suggesting that their domestic management is playing a double game. On the one hand, they make the foreign management believe that the only way of getting a business in Hungary is by playing tricks in bidding and accounting, and on the other hand they use the opportunity to imply to others that they have the "approval" of the foreign management on these- not entirely fair - tricks.

Multinational companies have "double" accounting: if they inform management abroad that 100 was spent on corruption then probably half of it goes into the pocket of the manager in

Hungary. If a problem emerges then the management abroad calls the management in Hungary to account. That is when they turn to their embassies to complain.

For multinational companies there are advantages if internationally recognised organisations classify a country as corrupt, because the higher the risk the lower the number of competitors entering the market. Leaders of multinational companies that are in the forefront of the fight against corruption were often involved in not entirely fair privatisation cases 10-15 years ago.

## **SMEs**

Our interviewees unequivocally said that Hungarian SMEs suffer competitive disadvantage compared to companies in which foreign owners are also present and have no power against them. The SME sector is characterised by subsistence corruption. These businesses are not able to make enough profits to pay for the high taxes and social contributions thus countering illegal activities may result in SME closures due to insolvency. In addition, SMEs are often dependent on only one large order (from a company or from a local government) thus they accept conditions dictated by the purchaser.

The head of the business development department of a large company also works for a small company as a sub-contractor maintaining machinery. The machinery to be maintained by the small company come from the large company since the large company contracted the small one for general machinery maintenance activities. Being head of the business development department he receives claims for replacement of these machinery from the various departments of the large company. Because he has an interest in maintenance work rather than in replacement, when listing regions where the replacements should be made he gives priority to the ones from where the most products were sent for maintenance – meaning a higher income for him.

In the case of larger construction projects, SMEs often refrain from appealing against the results of public procurement processes that they believe were unfair, because they are afraid of losing future orders.

Those companies in the SME sector that did not opt for simplified taxes are characterised by trading in fake invoices. This, according to some, is because they cannot make enough profits to pay proper taxes on wages. It often happens that they set up companies under the names of homeless persons and that companies issue invoices, and there are many micro companies that have the functions of an invoice issuing centre and just one simple construction worker. Claims against "invoice factories" are impossible to collect because they generally have no assets at all. The Tax Authority (APEH) can identify unpaid taxes amounting to billions of forints but only the "CEO" can be sent to prison - at most.

Global trends indicate that there is increased concentration underway in the retail industry, and as a consequence large retail chains play a 'gate-keeper' function in accessing the consumer, thus suppliers increasingly depend on them." <sup>90</sup> There is sharp competition to become a supplier of a larger chain leading to the so-called shelf money typically paid by the supplier to the chain.

In the business sector the payment of a 10 per cent kickback from the purchase price to the person making the decision concerning the order is typical. This is a common feature over a wide range of services, its essence being that the company getting the order almost automatically pays a "bonus" to the purchaser rewarding his or her choice. In most of the cases the "commission" paid becomes the personal gain of the purchaser. In the case of large projects, this kickback can push prices up considerably.

In the case of construction projects the actual work is often done by the last – generally smaller – company in the chain of subcontractors. In addition to this corruption mechanism pushing up prices it also has the negative consequence of producing a worsening quality of the work, because the company actually completing the task does not receive the full market price for its work.

The competition limiting behaviour of SMEs with 10-30 employees is also generally driven by survival. These companies are not necessarily aware that their price cartels violate the law – they consider their unified pricing as a solution dictated by common sense. They are not afraid of sanctions levied by the Competition Office (GVH), because their size and the damage caused is not big enough to attract the attention of the competition authority.

Companies producing and distributing comestibles whose production has natural limits regularly harmonize the timing of their price increases for deliveries to larger retail chains, thus these chains cannot drop any of their suppliers and all companies distributing this comestible can make a living on the market.

In our research we have not found cases where small companies have agreed to split the order of a larger company to guarantee survival for all of them in this limited market but the general operating mechanisms in this sector makes this behaviour likely.

## The size and extent of corruption

According to most of our interviewees, corruption in Hungary has been unquestionably on the rise over the past 5-10 years. On a scale of one to ten where ten is strong infection by corruption, our respondents rated business corruption at 3-4 and the level of corruption at the intersection of the business and (local) government sectors at 7-9.

The Economic and Enterprise Research Institute (GVI) of the Hungarian Chamber of Commerce and Industry, the business weekly "Figyelő" and the Hungarian subsidiary of Volksbank together launched a quarterly survey in January 2005 to study the business situation and outlook of SMEs, as well as the economic and institutional factors influencing them. According to their findings, corruption has spread among SMEs over the past two years. It seems that SME managers are increasingly certain that it is bribery that helps them to reach their goals in matters related to public administration – and they have also developed better skills in paying the bribes.<sup>91</sup>

Corruption mechanisms within the business sector are primarily defined by the structure of this sector. SMEs with little capital are characterised by "subsistence" corruption with its most typical forms being illegal employment, tax fraud, fake invoice transactions, "kickbacks" on orders and cartel agreements. With larger companies the aim of corruption is generally to seek higher profits (through unfair market behaviour, cartel agreements, and tax optimisation), or the individual gain of an employee of the company.

Respondents felt corruption between the business and government sectors increasingly serious, something that could be the result of the increasing number of cases, or of the increasing sensitivity of our interviewees towards this topic. They see pure business corruption weakening, because economic growth has slowed down, opportunities have become scarcer, and business players have become more cautious and pay more attention to situations inducing corruption (procurement, debt collection, court case management etc.).

The level of institutional corruption related to party financing is probably lower than that of private purpose corruption but the lack of credibility of the political elite generates private purpose corruption mechanisms.

Observing the advantage or service offered and the fee of corruption transactions in the media we came to the conclusion that in the overwhelming majority of cases the advantage or service provided was not one of a financial nature while the fee offered in exchange was typically money.

In many cases no money transfer is involved in corruption. Depending on the type of corruption the gain offered can be to give jobs to the relatives of the passive agents of corruption, providing free



entertainment (holiday, cultural events, dinner invitation), or invitation to a conference, holiday vouchers and so on.

When money transfer is involved in the corruption mechanism information on the size of the bribe – as a result of the methodology of the research – is based exclusively on estimates, developed by our interviewees through their perception and from individual cases they are aware of. They estimate that corruption fees range between 3-25 per cent of the value of the given transaction – both within the business sector and at the intersection of the business and (local) government sectors. Our interviewees see corruption fees on the rise which they explain by the need to meet increasing individual interests in addition to party financing requirements.

*Corruption fees mentioned by our interviewees:*

- In 2001, on a HUF 160 million tender the fee was HUF 20 million (12.5 per cent).
- In car insurance fraud, the agent of the insurance company received a bribe of 10 per cent of the reported claim and paid damages that were higher than the actual damage.
- In larger tender projects the kickback is 10 per cent of the project value.
- In local government procurements the kickback to mayors is 3-10 per cent of the value of the order.
- Concerning multinationals, the interviewee observed on one occasion that persons evaluating ordinary tenders received an expensive car each after a "good decision".
- The central government loses annually HUF 40-50 billion due to corruption and the total of local government level corruption can be two to three times higher.

## Tracking the money

In the case of classic bribery, the corruption fee becomes part of the price of the service delivered by the active agent of corruption, and this fee should be transferred to the passive agent by a transaction disguised as payment for a plausible service. According to our interviewees, one of the methods is the application of a chain of consultancy and legal services as well as foundations that makes tracking of the money transfer impossible, and proving that the payment was made to companies that can be associated with a politician very difficult.

There are cash payments and transfers between personal bank accounts, as our interviewees said, but the persons involved are careful to make the transfer chain difficult to trace and to separate by a lengthy period the payment of corruption fees from the securing of a benefit for the passive agent. Sophisticated techniques have also been developed for creating, managing and organising corruption situations like using a piece of paper showing the place and time of a meeting in writing – in case the dialogue is recorded.

It can happen that the company offering a bribe has a bank account abroad and a messenger is sent abroad to get the cash in a bag and bring it to Hungary. ("The corrupting company should have a suitable infrastructure.")

One interviewee said: the brutal and simple techniques, like handing over cash in an envelope or briefcase, have been replaced by more sophisticated techniques – "pain is becoming more refined".

Today corruption does not involve suitcases handed over under the table thus what happened 15 years ago when the representative of the State Privatisation Agency (ÁPV) said plainly that he wanted HUF 200,000 for a certain action can no longer happen. Now, the serious companies employ subcontractors and consultants and it is known who is to be approached.

The known ways of laundering corruption fees are: (1) the owner of the company hands it over in cash from his own dividends, because even this is worthwhile (2) the money is paid as "income" to a member of the staff who then returns it (3) the money travels via off-shore companies, a cost saving solution for

getting the cash.

Several of our interviewees confirmed that illegal income is spent abroad or kept in bank accounts abroad, out of reach of asset accumulation inspections by the Hungarian authorities.

Although the methodology of our research does not allow us to draw general conclusions it seems that corruption is becoming institutionalised. Based on the results of our media content study, of the 107 cases examined only one could not be classified as simple two-player corruption (with a "purchaser-seller" transaction) or multi-player corruption (with a chain of transactions). Simple cases contributed 62 per cent of the total and multi-player cases 38 per cent. We have concluded from in-depth interviews that corruption transactions mostly involved several players who help to transfer the fee to the final addressee.

**These results point to the fact that the significance of institutionalised corruption is not negligible in present day Hungarian business life. It has an important role to play in placing orders, allocating resources, in regulation and also in neutralising unfavourable economic consequences for certain business players.**

## Evaluation

Corruption and business corruption is a widespread phenomenon of Hungarian society. However we have limited knowledge about its scale and mechanisms, or indeed concrete examples (How does it exactly happen?). The fact that each respondent was able to mention at least one (generally more) case from recent years happening to him/her or to his/her acquaintances clearly indicates the range of corruption. In the case of certain transactions it is characteristic and widespread in business life.

Business corruption is a multifaceted, heterogeneous phenomenon. It can not be linked to a special sector and its distribution is most probably very unequal. Businesspeople have a clear picture of the phenomenon of corruption, on its roots, procedures and consequences. They are willing to report on it and have expressed numerous recommendations to counter it.

Business corruption poses a larger problem for businesspeople at the intersection of the business and public sectors than within the business sector itself. The high administrative burden on businesses, state sector orders dominating a large part of the economy and the intertwining of the political and business elites all show signs of excessive state influence.

Several government initiatives have shown progress in curbing corruption in the business sector. Due to the high corruption risks rooted in the symbiosis of the business and political elite anti-corruption initiatives can only be effective if they are accompanied by real political will and commitment.

The main problems related to business sector corruption risks

1. Regulations on the broader environment of business operations such as tax and lobby laws and the public procurement and party acts establish favourable conditions for business corruption because they do not provide the conditions for reliable, easily predictable, transparent and unbiased business administration.
2. Non predictable economic and tax policy bears high corruption risks.
3. As in all other pillars of the NIS grave deficiencies were identified in the areas of accountability and law enforcement. The effectiveness of uncovering cases of abuse within companies and in state administration is low. Court rulings do not reflect the strictness of the law resulting in a lenient judgment of business crimes and corruption offences, and they do not deter players involved in corruption cases.
4. Hungarian business culture does not focus on fair competition. The state sector dominates among

purchasers in the Hungarian economy. Only a fraction of the business sphere is aware of the positive effect of ethical business behaviour resulting in long-term profit making and risk reduction. Historical-cultural traditions give preference to networks of confidential relations in social transactions.

5. According to businesspeople corruption risks represent a bigger problem at the intersection of the public and business sectors than within a business sector itself. Most typical areas of corruption are public procurements, state and government assets, state and EU grants, licences and permits and inspections.

## Recommendations

The political elite and the government have a decisive role in limiting the range of, and the fight against, corruption. Countering corruption in the business sector cannot be successful without the real commitment of the political elite and without placing business ethics at the forefront of business thinking.

Measures to curb corruption will only be successful if they intervene in typical corruption situations by using institutional and regulatory tools.

We have developed the following recommendations which we believe would facilitate the transparent co-operation between the public and private sectors:

In the area of public awareness

- To apply, make known and spread codes of conduct in the business sector – focusing on the responsibility of large companies.
- To apply, make known and spread the idea and institutions of Corporate Social Responsibility in the business sector.
- To encourage and facilitate whistleblowing and the establishment of whistleblowing protection systems.
- To foster the promotion of ethical and law-abiding behavior with the personal example and support of the political and business elite.
- To introduce and promote integrity pacts in public procurements.<sup>92</sup>
- To introduce codes of ethics in the public sector

In the area of legislation

- To establish a clear definition of the activities and responsibilities of the state and introduce a reduction in the state budget.
- To simplify the Public Procurement Act, reducing opportunities for influence and establishing personal responsibility.
- To reform the party and campaign financing system by adopting the T/4190 bill as soon as possible. Content of the bill might change during discussions in the Parliament. The new legislation will only be efficient if it is based on the recommendations elaborated by Eötvös Károly Public Policy Institute on this topic.<sup>93</sup>
- To modify the Bankruptcy Act and regulate conflicts of interests.

In the area of law enforcement

- To establish coherent law enforcement, increasing the efficiency of investigations into corruption cases and applying tough sanctions on abuses.
- To apply solid and predictable court practices in legal actions related to business life.

- To train the employees of law enforcement agencies and courts.
- To establish strict control over the implementation of the Lobby Act.
- To file compensation lawsuits following fines levied on cartel agreements.

In the area of access to information

- To make the contract of a winner in a public procurement procedure public, to enhance the monitoring of the implementation.
- To make the finances of foundations more transparent.
- To facilitate the legal and practical conditions for investigative journalism.

In the area of procedures

- To simplify and computerise the system of taxes, licences and permits.
- To make the granting of permissions automatic: if the authority breaks its own deadline the application for a license or permit gets automatic approval. This requires a strengthening of the internal control of the licensing or permitting authorities.

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<sup>3</sup> Different approaches and methods (official statistics, media analysis, in-depth interviews, risk analysis) are applied by Zoltán Szente for the research on corruption in local governments. Szente:2007

<sup>4</sup> Distribution of interviewees: 20 people from the business sector, 8 persons from the public sector and 2 research experts. Most of the businesspeople (80%) represented big companies and 20% of them were from SMEs.

<sup>5</sup> Methodology of in-depth interviews and media analysis was elaborated by the research group of the Corvinus University of Budapest. Detailed descriptions can be found in the introduction of the background studies.

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- <sup>6</sup> Cserpes Tünde, Szántó Zoltán and Tóth István János: *Korrupciógyanús esetek a médiában. Tartalomelemzés és a korrupció típusai*, 2008, study prepared for Transparency International Hungary  
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- <sup>7</sup> Tóth István and János Szántó Zoltán: *Üzleti korrupció Magyarországon többféle nézőpontból*, 2008, study prepared for Transparency International Hungary
- <sup>8</sup> For detailed definition of corruption see Cserpes Tünde, Szántó Zoltán and Tóth István János: *Korrupciógyanús esetek a médiában. Tartalomelemzés és a korrupció típusai*, 2008, study prepared for Transparency International Hungary
- <sup>9</sup> See Szántó, 1997 for more details
- <sup>10</sup> The agent (e.g. a tax reviser) employed by a principal (e.g. leader of a tax authority) gets into contact with the client (e.g. tax payer). According to the model the agent will opt for corruption if the profit gained from corruption is higher than the profit s/he gains with fair behaviour. The client will try to bribe the agent if his/her profit would be higher than the profit gained without applying corruption. While gaining personal profit the corrupt agent imposes expenses on the principal, since his/her activities have negative external economic consequences – to reduce them requires time and resources. The aim of the principal is to encourage the agent to carry out the optimal scale of productive and unproductive, i.e. corrupt practices. Problem of the principal is rooted in the asymmetric nature of their relationship.
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- <sup>12</sup> Act XX of 1949. The Constitution of the Republic of Hungary, Article 9
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- <sup>16</sup> The Act contains the ban on unfair competition, the ban on unfair influence on consumer choices, the ban on agreements hindering competition, the ban on abusing market power and the control on joint influence in companies.
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