



# **Government Favouritism in Europe**

## **The Anticorruption Report**

**Volume 3**

**Alina Mungiu-Pippidi (editor)**

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## **The Anticorruption Report 3**

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# Contents

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

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# Abbreviations

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

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

## 5. Political Favouritism in Croatian Public Procurement

MUNIR PODUMLJAK AND ELIZABETH DÁVID-BARRETT

Despite having a strong law which aims to set high standards, a large share of public procurement in Croatia is executed by contracting authorities that are highly vulnerable to political influence. This creates opportunities for politicians to influence the allocation of contracts in a particularistic manner, rather than allowing market conditions and competition to determine allocations. The potential for corruption is exacerbated because senior and mid-level managers in these contracting authorities have considerable discretionary power to shape public procurement procedures, and are weakly constrained by other institutional controls or oversight. That is, there are considerable *opportunities* for corruption while *constraints* are inadequate, an environment in which particularism might be expected to flourish (Mungiu-Pippidi et al. 2011). Moreover, our empirical analysis of public procurement in the construction sector over 2011-13 reveals evidence consistent with favouritism and political influence in both procedures and outcomes. This raises questions about why such a pattern has emerged and been allowed to continue.

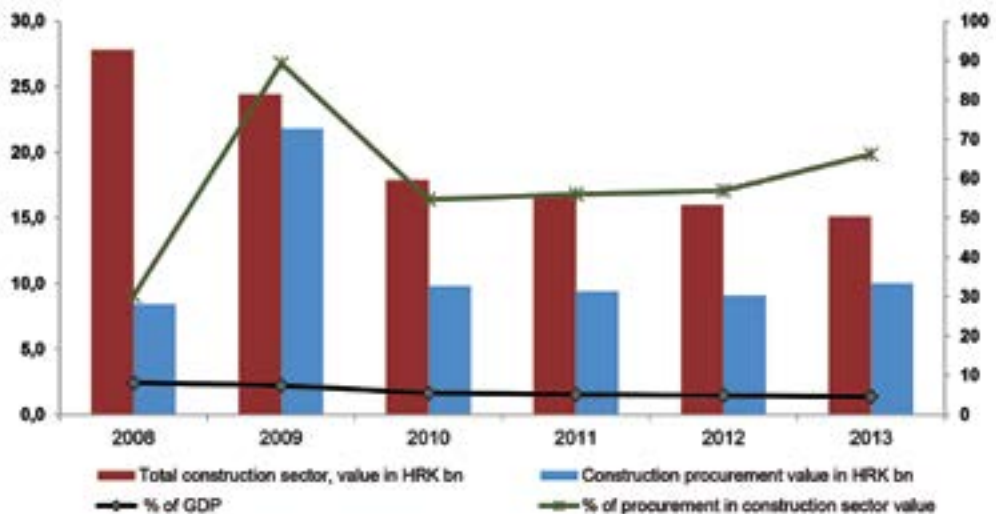
### Introduction

Public procurement in Croatia accounted for 9.7% of GDP on average over 2011-13, comparable to Cyprus (10.5% in 2010) and Greece (10.8%) from the European Union Member States. A considerable share of total public procurement is spent on construction; in 2010, just the ten highest-value contracts and framework agreements in the construction sector accounted for one-quarter of the total value of public procurement. Indeed, the construction sector has become increasingly dependent on government contracts in recent years. In decline since 2008, the sector lost 45.7% of its value over 2008-13, while its share in GDP collapsed from 8.1% in 2008 to 4.6% in 2013. The sector was, however, buoyed by an increase in public investment in infrastructure in 2009 as part of a government plan to stimulate an economic recovery. A change in public procurement laws in the same year prompted many contracting authorities to invite tenders for large framework agreements, also benefiting the sector, which saw the total value of public contracts that year reach HRK 21.8bn, more than double the previous year's HRK 8.4bn. Thus, by 2013, public contracts accounted for two-thirds of the total value of construction works in Croatia (see Figure 1).

Our focus on the construction sector reflects the fact that the industry is a major recipient of public procurement contracts, as well as the observation that construction works are typically prone to corruption (Transparency International 2011). Research suggests that the procurement of major infrastructure is often associated with irregularities including extensive re-negotiations of contracts in the post-award implementation phase (Guasch 2009), as well as mis-forecasting of costs and demand, which may in some cases be explained by 'strategic deception' (Flyvbjerg and Molloy 2011).



**Figure 1 Total value of executed construction works, Croatia 2008-13**  
(left axis, HRK bn; right axis, % of GDP)



Source: author's calculations based on data from the Croatian Bureau of Statistics and the Directorate for Public Procurement System

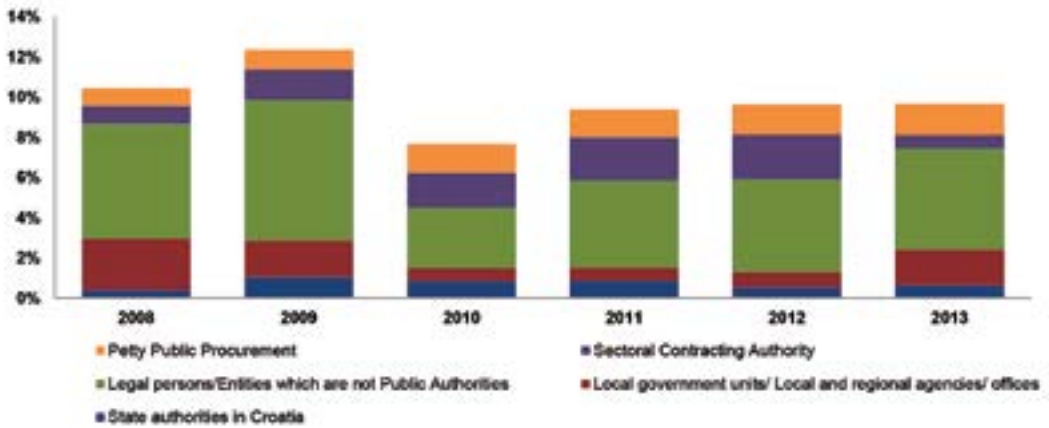
## 1. Political influence over public procurement

One way in which favouritism can be practiced in the allocation of contracts is through political influence over the managers of contracting authorities. This is a significant risk area in Croatia because a large share of public procurement is executed by types of contracting authorities which are subject to political control and have rather weak governance structures. Legal entities which undertake public procurement in Croatia are classified in four different ways. The first type, which we term Type A, includes central government bodies such as ministries, departments, state agencies and other public bodies, are under the direct rule of the Government, or ministries. A second type, Type B, comprises local and regional government, local and regional agencies, and offices consisting of counties, cities and municipalities, and agencies and offices under the purview of local and regional government. For Type A and Type B authorities, public procurement is relatively tightly regulated and subject to a number of oversight and control mechanisms.

However, around one-half of public procurement in Croatia - and 90% of the contract value in our sample of construction contracting - is executed by other types of authorities which are subject to political control. Type C contracting authorities include legal persons other than public authorities, including public companies other than sectoral contracting authorities in the ownership of central, regional and local government, institutions under their ownership and other legal entities that are not directly subordinate to public authorities, but come under the indirect influence of public authorities pursuant to their founding rights. This category includes many organisations which play a major role in construction, including Croatian Roads Ltd, the Croatian water management company, and county road administrations. Finally, Type D organisations are 'sectoral contracting authorities', which are companies owned at least partly by the central, regional or local government, and characterised by a special position in

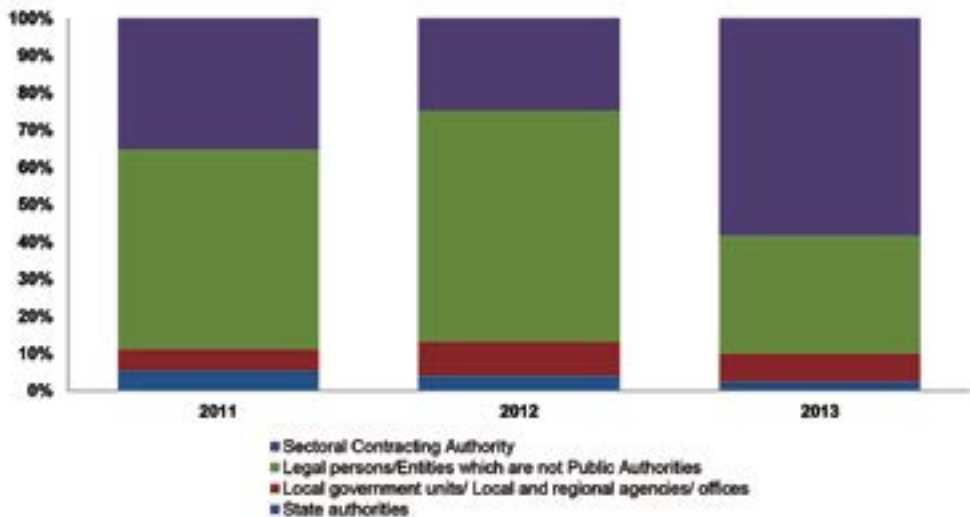
the economy (e.g., providers of public goods such electricity, gas and transport). Around one-half of total public procurement contracting value in Croatia during the period 2008-13 was executed by contracting authorities in categories C and D (see Figure 2). In the construction sector, the predominance of procurement by Type C and D authorities is yet more striking, with around 90% of contract value in our sample awarded by these types (see Figure 3).

**Figure 2 Structure of total public procurement (works, goods and services) by type of contracting authorities and as % of GDP (in current prices), 2008-13**



Source: Author's calculations based on data from Croatian Bureau of Statistics and Directorate for Public Procurement System

**Figure 3 Structure of public procurement of works (construction) contracts exceeding HRK 7,452,830 (1mln euros), by type of contracting authority, 2011-13**



Source: author's calculations based on data from the Directorate for Public Procurement System

The dominant role in public contracting afforded to such authorities creates opportunities for corruption in several ways. First, these types of authorities are subject to political influence, because their top managers are appointed by political leaders. According to the Act on the Management and Disposal of Assets owned by the Republic of Croatia and Act on Local and Regional Self-government, the heads of Type C and Type D authorities are to be appointed by the national, local, or regional branches of government which ‘own’ the organisations, i.e., by government ministers, or political heads of local and regional government.

Second, these types of authorities typically have poor management, reflected in weak profit and loss accounts, and are highly dependent on budget subsidies (Crnković et al., 2011). This arguably makes them more prone to informal influence and means that they are likely to be sensitive to maintaining favourable relations with their political ‘owners’.

Third, these types of authorities are formally subject to weaker institutional controls than other types of authorities. For example, the public procurement law requires a weaker justification for the use of restrictive procedures in public procurement undertaken by these authorities.

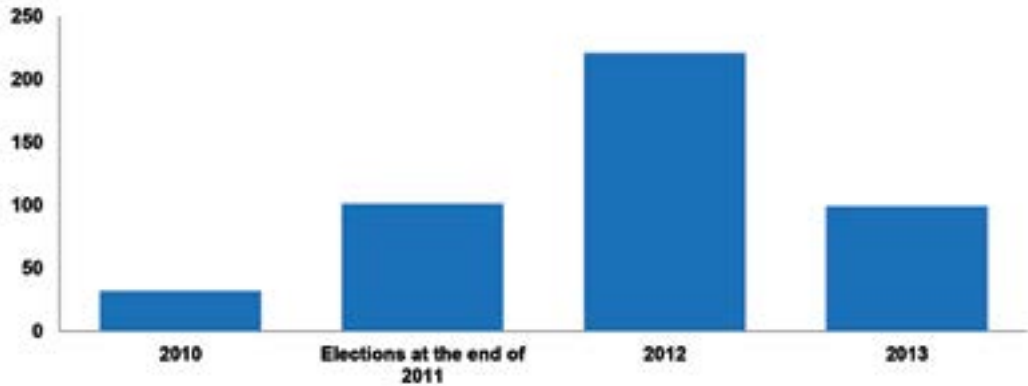
Fourth, their lack of resources and capacity might mean that they lack the technical capacity to conduct complex public procurement procedures; while that is not equivalent to corruption, weak governance creates vulnerabilities to corruption risk. The main body of our analysis examines the procedures and outcomes of public procurement in the construction sector in Croatia, over the period 2011-13, to assess whether there is evidence that these risks – or opportunities – of corruption are realised.

## **2. Political appointments to contracting authorities**

Political leaders might replace incumbent managers of contracting authorities for perfectly legitimate reasons, e.g., if they regard an incumbent as unfit for the job and wish to replace him or her with a better-qualified candidate. Equally though, they might wish to use their power of appointment to appoint a ‘puppet’ manager over whom they can exert informal influence so as to facilitate corrupt transactions for their own private gain or that of their political party, or to reward a crony (who might then use his or her power over procurement decisions for private gain).

By tracking the number and timing of appointments to the boards of contracting authorities, we can measure the extent to which incoming political leaders use their powers of appointment over the heads of Type C and D authorities, an indicator of *potential* political influence. The results indicate an increase in appointments following elections, as expected. For contracting authorities owned by the central government, the number of management changes increased significantly in the year following the December 2011 general election, with 24 out of 28 seeing at least one change in management (see figure 4). The number of changes in management personnel in the first year following the election, 2012, accounted for almost half (49%) of all changes observed in the four-year 2010-13 period.

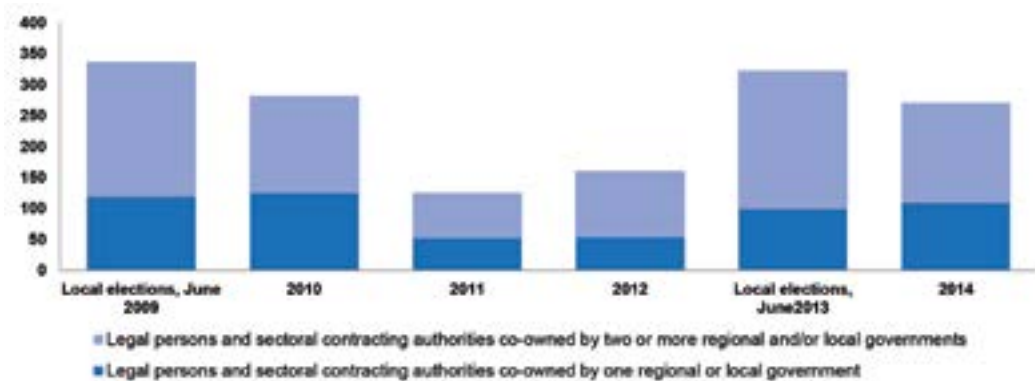
**Figure 4** Number of managerial changes in legal persons and sectoral (Type C and D) contracting authorities owned by central government, Croatia 2010-2013 (N=28)



Source: author's calculations based on data from the Commercial Court of Zagreb

For our sample of 95 contracting authorities owned by local government, changes in management were analysed in relation to two elections, in 2009 and 2013. Since local and regional elections are usually held mid-year, before the summer vacation, we expect political appointments of management board members to occur both in the election year and in the first post-election year. The number of changes in management does indeed increase at the expected times (see figure 5).

**Figure 5** Number of managerial changes in Type C and Type D contracting authorities owned by regional and local government, 2009-14 (N=95)



Source: author's calculations based on data from the Commercial Court of Zagreb

Some entities have more than one governmental owner. For these authorities, there is an increased likelihood of elections – and of political change - in one of the owning government units in a given year. Since all owners have rights to make appointments to management boards, this also increases the probability that there will be management changes following elections. The evidence confirms this prediction: the number of changes in management in those authorities with more than one owner was 68.2% higher than in those owned by a single

unit. All of our analysis suggests that political leaders use their powers of appointment over contracting authorities extensively.

An additional check was conducted by focusing on 13 contracting authorities in which no managerial changes were recorded in the observed period. If managerial changes are largely a result of changes in the political control of the owning government unit, we would expect that a lack of change in management would be associated with the absence of political change in the relevant local and regional governments in the period covered. Of 26 possible cases (13 authorities in two election cycles), a change of political leadership in the founding entity (local/regional government), was observed in only four.

### **3. The Discretionary Power of Managers of Contracting Authorities**

Control over the appointment of the manager of a contracting authority can only facilitate favouritism if the appointed manager has significant discretionary power over the procurement process. This is indeed provided for in law. According to the 2011 Public Procurement Act, the head of a contracting authority is responsible for:

- establishing the entire procurement plan;
- appointing the Certified Procurement Officers, the authorized representatives of the authority responsible for executing the process;
- appointing the members of the selection committees – whether ad hoc or permanent - who make contract award decisions;
- signing all documents in the public procurement process, including the final contract; and
- supervising the execution of the contract.

The heads of contracting authorities thus have considerable resources and opportunities to influence the process to serve private interests, if they wish. Given that they in turn rely on political leaders for their initial appointment, their continuance in office, and often for state financial support for their institution, they may also be susceptible to political influence. In short, political leaders at central, regional and local government level appear to have significant informal power over public procurement through their patronage powers.

Political influence might easily extend to fine details of the procurement process, because the head of the contracting authority has the power to appoint the Central Procurement Officer (CPO), who deals with all of the day-to-day aspects of a procurement procedure, stretching from the preparation of the tender and conduct of the procedure through to the signing of the contract. If the CPO is influenced by his or her boss, either directly or indirectly, then it would be possible to manipulate almost any aspect of the public procurement procedure so as to favour a particular bidder. One potential institutional check on this is the fact that CPOs must be qualified professionals: they must hold a valid certificate from a special training programme, and this must be renewed on the basis of ongoing education or training. However, this practice may indirectly create another risk area. Since there is a paucity of qualified individuals, there might easily be only one accredited CPO in a contracting authority. In such situations, nobody else in the organisation is qualified to check or oversee the CPO's work, creating a form of monopoly power or yet another opportunity for corruption to flourish.

The overall governance structure potentially allows for one political leader to exert considerable control over the details of individual procurements, while there is scant provision or incentive to carry out internal checks and balances. Poor governance structures do not, of course, con-

stitute evidence that corruption occurs, but they do indicate that there is significant *potential* for political leaders to collude with or exercise power over the managers and officers of contracting authorities, with the objective of ensuring favouritism in the allocation of contracts, to benefit themselves or others. The following case study demonstrates that such political influence over the procurement process has indeed been used to channel public money to private interests.

#### **4. Case Study: Political influence over Public Procurement in the FIMI Media case<sup>1</sup>**

The highest-level corruption case ever prosecuted in Croatia concerns political influence over the allocation of public procurement contracts to benefit a company called FIMI Media. Several members of the political elite were prosecuted, including former prime minister Ivo Sanader, three other high-ranking members of the ruling Croatian Democratic Union (HDZ), and one of the owners of the company, as well as the HDZ itself. Sanader and the HDZ were found guilty of extracting money from state institutions and companies via the marketing agency. However, the non-binding decision has been appealed; the Supreme Court will discuss the case again in September 2015.

According to the trial verdict, Sanader and other members of the HDZ collected financial donations from both individuals and legal entities to finance the party's political activities and, in exchange, promised that state contracts would be channelled to companies which the donors owned or controlled. The judge emphasised the role played by public companies (entities of Types C and D) in abusing public procurement procedures to extract money from the state during the period from the end of 2004 until 2nd July 2009.

The verdict found that the first accused (Sanader), as the Prime Minister of the Government of Croatia, had engaged the second accused (Mladen Barišić, Head of the Customs Service) to act on his orders. Together they had attended a meeting held on 4th April 2007 in the premises of the Croatian Government, with representatives of several companies that were solely or majority-owned by the state and public institutions (i.e., Type C and D authorities). The meeting was also attended by the third accused, Ratko Maček (chief spokesman of Ivo Sanader, and chief of the electoral campaigns of the HDZ). Sanader personally proposed to the leaders of some government bodies, CEOs and others responsible for commercial companies which were exclusively or partly state-owned, using his authority as Prime Minister, and exploiting their relation of dependency (since the Croatian Government appointed their management), that they engage the services of Fimi Media (the seventh accused) for the procurement of certain goods and services. In short, several high-ranking politicians and officials in the government systematically abused their formal and informal powers over public companies and entities to influence the public procurement process.

The scope and reach of the scheme, and the relative openness with which Sanader exerted his influence, suggests that these events may be indicative of widespread corrupt practices in Croatian public procurement. The scheme involved an extensive range of state-owned entities<sup>2</sup>,

<sup>1</sup> This case study is based on the first-instance verdict in the case against former Prime Minister Ivo Sanader, the HDZ and four other persons. The case is currently under the appeal procedure before the Supreme Court, and this research makes no judgement on the guilt or innocence of those indicted. The verdict is based on thousands of pages of evidence and numerous testimonials gathered during a two-year investigation and trial. Source: County Court of Zagreb, First-instance verdict, Reference number: 13 K-US-8/12, March 11th 2014.

<sup>2</sup> The list of public companies involved includes: Hrvatske šume d.o.o., Hrvatska elektroprivreda d.d., Hrvatska poštanska banka d.d., Hrvatske autoceste d.o.o., Autocesta Rijeka-Zagreb d.d., Environment Protection and Energetic Efficiency Fund, Ministry of Interior Affairs, Hrvatska HŽ group – Hrvatske željeznice d.o.o.,

including two government ministries, and it appears that political influence over such bodies was used to further private and party interests. Moreover, the mechanisms for internal and external monitoring of public procurement that existed at the time did not detect these operations. Sanader and the HDZ were prosecuted only after the prime minister had resigned, apparently voluntarily. It is unclear whether he would have been prosecuted if he had remained in power.

The court verdict also provides evidence about the gains made by the HDZ party, politicians, and the individuals associated with these state-owned entities. Nine prominent individuals are identified as having made cash donations to the HDZ and the prime minister, while many of them subsequently won contracts from companies owned by the state (Type C and D contracting authorities), for example:

- **Marijan Primorac** donated EUR 322,368 and paid for Sanader's BMW. His company 'Primorka' benefited from a lucrative contract to rent office space to the Croatian Lottery (public company).
- **Marinko Mikulić** donated EUR 171,052. As the owner of the privatized 'PAN' company, there was no evidence proving that he did illicit business with the state, although questions were raised about how he amassed his personal wealth.
- **Miha Zrnić Marinović** donated EUR 263,157. He owned 'Odlagalište sirovina' (Raw Material Landfill) which, with the Fund for Environmental Protection (state entity), drained the state budget of millions.
- **Božidar Longin** donated EUR 36,000. From 2003 to 2012, he was a board member in charge of legal affairs, including public procurement, in Hrvatske šume (Croatian Forests).

In addition to the five individuals and one political party charged, 30 other members of the HDZ were given cash by the organisers of the scheme, including individuals at all staff levels, from doormen and bodyguards to secretaries and ministers.

## 5. Procedural indicators of favouritism: Restricted and weak competition

### 5.1. Restricted competition

The use of restrictive procedures, in which contracts are negotiated directly with selected companies rather than publicly announced and awarded by open tender, is one way in which government agents may seek to restrict competition in the public procurement process, thereby benefiting cronies or allies. The use of such procedures is, in theory, strictly regulated by Croatian law: their use is permitted, for example, in emergency conditions or in specialist areas. However, public officials seeking to allocate resources in a particularistic manner may abuse the rules. The pattern of usage of such procedures can therefore serve as a probabilistic indicator of particularism. In our construction-sector sample, contracts representing 27% of the total value were awarded through negotiated procedures, as shown in Table 1.

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Croatian National Tourist Board, Proplin d.o.o., Viadukt d.d., Hidroelektra niskogradnja d.d., Konstruktor inženjering d.d., Hrvatske ceste d.d., Croatia airlines d.d., Croatia osiguranje d.d., Narodne novine d.d., Ecos trgovina d.o.o., Financial Agency, Ministry of Sea, Transport and Infrastructure, Ministry of Foreign Affairs and European Integration, ACI d.d.



**Table 1. Public procurement of works (construction) by type of procedure, contracts valued over HRK 7,452,830, 2012-13**

	Number of contracts	Value of contracts (HRK)	% of total value of all contracts
Open procedure	214	4,222,463,130	72.63
Negotiated without prior publication	15	1,578,072,839	27.14
Not defined by law - exempted	1	13,040,449	0.22
<b>Total</b>	<b>230</b>	<b>5,813,576,417</b>	<b>100.00</b>

Source: author's calculations based on data from the Integrity Observers database.

## 5.2. Competition for contracts and the prevalence of sole bidders

The number of bidders for a tender may also serve as an indicator of favouritism. In a highly competitive market with many competitors for every contract, it is more difficult for corrupt government agents to manipulate the process because it is under greater scrutiny – at the very least, from interested parties such as the competing tenderers. In conditions where favouritism is rife, by contrast, competition may be low. Where companies expect a particular contract to be allocated in a particularistic way, they will not incur the costs of tendering and hence will opt out of the market themselves. Thus, systematic favouritism over a long period drives companies which are unable to win contracts out of the market. Equally, though, a low number of tenderers might reflect legitimate reasons such as a lack of available expertise.

The majority of contracts in our sample (63.8%) were acquired in an environment of relatively low competition, with three or fewer tenderers (see Table 2). Almost 40% of these large tenders had one single bidder, despite 43 of the 58 being tendered on open procedures. Competition for Framework Agreements was also surprisingly low, with 60.4% of the contract value the result of processes with three or fewer tenderers, while 40% of the value of FAs in 2012 and 2013 attracted only one bidder. Given the extensive pressures on the construction sector in Croatia during this period, this lack of competition is surprising.

**Table 2. Public procurement of works (construction) by number of tenders received, contracts valued over HRK 7,452,830 (EUR1mn), 2012-13**

	Number of contracts	Value of contract signed (in HRK)	% of total sum of contracts ≥ EUR 1m
1 tender received	58	2,317,775,476	39.87
2 tenders received	40	732,320,272	12.60
3 tenders received	38	654,920,160	11.27
≥ 4 tenders received	94	2,108,560,508	36.27
<b>Total</b>	<b>230</b>	<b>5,813,576,417</b>	<b>100.00</b>

Source: author's calculations based on data from the Integrity Observers database.



### 5.3. Outcome indicators of favouritism: Analysis of winning bidders

Further indicators of favouritism in public procurement derive from studying the characteristics of companies that win tenders. If there are very few winners, or the winners appear to have links with political leaders, this is indicative of favouritism in the procurement process. In addition, if winning bidders exhibit unusually good financial performance relative to other market actors, this is suggestive of public contracts having been designed or awarded in ways that did not achieve the best value for money for the public, which may indicate corruption.

Overall, the contracts and FAs in our sample were won by a reasonable number of tenderers (175 different entities) and accounted for only 17.3% of the tenderers' total revenue. However, the data reveal one highly unusual characteristic: for contracts amounting to almost one-half (46.5%) of the total value, the winning bidders were state-owned companies in the same legal category as Type C and D contracting authorities. Almost half of public procurement in construction represents contracts where both the contracting authority and the winning tenderer are state entities under the control of political principals. Thus, politicians have the *potential* to control both ends of the process, from the design of the contract notice to the writing of tender documents by the winning bidder. This amplifies the potential for political influence, or indeed control, over procurement.

To probe further, we separated the winning tenderers into profitable and loss-making companies (see Tables 3a and 3b). The state-owned companies which won procurement contracts recorded higher cumulative profits (from a lower total value of contracts) than tenderers from the private sector. Privately owned companies recorded higher cumulative losses, despite the higher value of signed contracts. Perhaps public sector tenderers are simply more efficient and therefore extract more profits from less revenue? We analysed whether the proportion of public contracts in total revenue, i.e., the dependence on government contracts, is relevant to performance. The publicly owned contractors which recorded cumulative profits were reliant on public procurement contracts for an average 24.2% of their revenues, while public contractors which recorded losses on average received only 8.4% of revenues from procurement contracts. This relationship - the higher the proportion of procurement contracts, the greater the profits - applies to private contractors as well. Profitable private contractors receive an average of 19.5% of their revenues from public contracts, while the average proportion for loss-making private contractors is only 16%. This may not seem a great difference, but more in depth study shows that public contractors have higher salaries on the average (approx. 25%) and higher number of employees per company. Not even in theory then public companies cannot be more efficient than private companies, raising questions as to the quality of their work.

**Table 3a and 3b. Analysis of tenderers with contract(s) above HRK 7,452,830 in public procurement of works, 2011-13**

Table 3a. Tenderers with net profit					
	Value of public procurement, works contract/s (in bn HRK)	Cumulative revenue of tenderers (in bn HRK)	% of value of work contracts in cumulative revenue of tenderers	Cumulative number of tenderers with profit	Profit (in bn HRK)
State owned enterprises	5,4	22,4	<b>24,2</b>	29	1,8
Private enterprises	6,2	32,1	<b>19,5</b>	95	1,4
TOTAL	11,7	54,5	<b>21,4</b>	124	3,2

Table 3b. Tenderers with net loss					
	Value of public procurement, works contract/s (in bn HRK)	Cumulative revenue of tenderers (in bn HRK)	% of value of work contracts in cumulative revenue of tenderers	Cumulative number of tenderers with loss	Loss (in bn HRK)
State owned enterprises	1,9	23,1	<b>8,4</b>	20	-2,1
Private enterprises	2,3	14,3	<b>16,1</b>	31	-2,4
TOTAL	4,2	37,4	<b>11,3</b>	51	-4,5

### *State-Owned Winning Bidders*

The next phase of analysis focused on the ten most successful state-owned tenderers, measured in terms of the value of contracts won through public procurement. This revealed that the top three contractors, which won almost 20% of the total sum of contracts in our sample, were members of one group, Croatian Railways, while the contracting authority which awarded these contracts was also from the same entity, Croatian Railways. One-fifth of public contracts awarded in the construction sector represented circular exchanges from one part of a (state-owned) industry group to another. This represents an unusual deviation from international standards for public procurement, and is indicative of high levels of political control – and potential influence – over a large share of public contracting.

### *'Private' Winning Bidders*

Analysis of the private companies that were the most successful tenderers, in terms of the highest aggregate value of contracts, indicates similar patterns. Of the top ten, nine were former state-owned companies that had been privatized. This is relevant because the privatisation process in Croatia was associated with well-documented and serious weaknesses in terms of fairness, transparency and procedure (Bajo, 2011, Grubišić et al., 2009, Bendeković, 2000). Several scholars have characterized the process as one in which resources were allocated according to favouritism and cronyism, with political principals distributing resources so as to extend their political control over the emerging private sector (Čučković 2002, Franičević 1999). The new owners were often successful in securing assets not because of their business competence or financial resources, but because they had fruitful connections to the political elite (Franičević 1999; Petričić). Our analysis suggests that many of those companies have continued to prosper for similar reasons, and remain reliant on public contracts, possibly allocated to them via their political connections, for a large share of their revenues.

## **6. Inadequate Control of Public Procurement**

Several institutions have responsibilities for regulating public procurement. However, these institutions are poorly equipped – and motivated – to investigate allegations of favouritism or to identify systemic weaknesses. Potentially the most powerful institution, the State Commission for Supervision of Public Procurement Procedure (SCSPPP) is charged with investigating alleged breaches of the law in connection with the rights and interests of interested parties or competing tenderers (Kolar, Loboja, Vuić, 2011). As such, it is the key legal protection mechanism for the interests of tenderers (Pejaković, 2008). If it finds irregularities, the SCSPPP may cancel a procedure, annul a contract or, in some cases, levy an administrative fine on the contracting authority, or file motions for indictment in relation to misdemeanours.

However, the SCSPPP may act only at the request of tenderers or those considering submitting tenders, and its enquiries are limited to issues raised by the complainant. In restrictive procedures, since there are no other interested parties, no one can make a complaint. In open procedures, competitors could make a complaint, but in a system characterised by high levels of political favouritism, they might lack confidence in the ability of the SCSPPP to conduct an independent investigation or correct deficiencies. Losing bidders might consider it more profitable to seek to enter the market by building political connections.

The Directorate for the Public Procurement System (DPPS) is responsible for supervising all aspects of the PP system and initiating procedures before the Misdemeanour Court for violations of legal provisions prescribed in the PP Act (*ex ante* and *ex post* supervision) such as failures by a contracting authority to comply with the necessary procedures. However, given the weak nature of the governance structures for Type C and Type D authorities, they can engage in a number of high-corruption-risk activities without violating any relevant procedures. Moreover, the DPPS treats potentially serious criminal activity (conflicts of interest, disregard for competitive procedures and direct contracting) as administrative investigations, within the (non-criminal) misdemeanour framework, which means that serious infringements tend to remain beyond the reach of the punitive justice system. In addition, the organisation lacks the capacity to monitor and adequately supervise the very large number of contracting authorities and contracts.

The DPPS has the potential to improve professional standards in public contracting through its role in providing the obligatory training and certification of CPOs. However, reliant as it is on revenue from training and certifying CPOs, it arguably faces disincentives to fail trainees or find evidence of misconduct among CPOs. Perhaps the most serious weakness of the DPPS as a potential check on corrupt behaviour though is the fact that it lacks independence. DPPS staff have discretion to decide on the targets of pro-active investigations but, as a department of the Ministry of Economy, they may be reluctant to initiate investigations that challenge the government or ruling party.

The State Audit Office (SAO) verifies whether the financial statements issued by an audited entity, including statements on public procurement, are true and accurate and verifies whether the correct PP procedure has been applied in areas where it is obligatory. However, the SAO audits only a fraction of contracting authorities. Type C and D contracting authorities might only very rarely be subject to audits. Moreover, the SAO cannot impose remedies or sanctions on an audited entity but simply publishes reports or, if criminal activity is indicated, may forward a report to the prosecutor's office.

In theory, political influence over public procurement for private gain should be regulated by rules about conflicts of interest, enforced by the Commission for Conflict of Interest (CCI). The Public Procurement Act also defines situations in which a conflict of interest may arise, e.g., if the representative of the contracting authority simultaneously performs managerial duties for a participating company, or if the representative of the contracting authority holds shares, stocks or other rights in the economic operator. Any action in breach of the law would void the contract and criminal charges could be filed with the State Attorney's Office.

However, the Act does not specify who is responsible for monitoring compliance with this provision and our research revealed that even experts in this field were unsure about where responsibility lies. The CCI's mandate does not stretch to cover many personnel involved in the public procurement process, including CPOs, the senior managers of public companies owned by regional and local governments and heads of contracting authorities that are appointed by ministers, mayors or city councils.

The police may also initiate investigations into public procurement where criminal acts are alleged. However, while Croatia's Office for the Prevention of Corruption and Organised Crime (USKOK) and associated institutional framework is advanced in terms of the fight against corruption, the lack of public procurement expertise in prosecutors' offices and police departments means that they depend on other state bodies for expertise in understanding violations of the PP Act.

The 2011 Public Procurement Act also introduced new instruments designed to increase transparency and enhance civil society scrutiny of procurement procedures. For example, the Act obliges contracting authorities to adopt and publish procurement plans for the budget or business year and to publish a six-monthly register of contracts and FAs awarded. However, few of these rules apply to Type C and D contracting authorities. Indeed, Bajo (2012) has questioned the ability of the public or civil society to scrutinise the financial operations and performance of Type C and D entities in any way, because the official data that is provided on their revenues, expenditure, assets and liabilities lacks adequate explanations of methodology. The ability for civil society to hold these institutions to account is further undermined by their governance structure. For many such authorities, it is only the political owners that have the power to impose sanctions on managers. Any internal accountability mechanisms are ultimately controlled by the political patrons which appointed those managers.

## Conclusions

The integrity of public procurement in Croatia is still undermined by the common practice of contracting through entities which are subject to political influence and outside the scope of many the institutional controls. The scope of this problem is extensive. In 2012, around 85% of the total value of public procurement was carried out under weak control mechanisms, either by Type C and D authorities or through petty procurement for which there is no obligation to observe specific procedures. Political leaders use their patronage powers over the heads of contracting authorities extensively and, in the construction sector, which was the focus of our in-depth analysis, around one-half of contract value is won by tenderers which are also owned by the state and thus subject to political control. A further large share of contracts is won by companies that have been privatised, a process which was itself characterised by high levels of cronyism resulting in the creation of an economic elite of company owners with close connections to politicians and, arguably, a tendency to rely on those connections to keep their companies afloat.

Overall, this builds up a portrait of Croatia as an environment in which political leaders and parties have great potential to influence the procurement process for the eventual benefit of themselves or third parties. Evidence from the FIMI Media case, involving the most senior politicians in a scheme that used public procurement to trade political donations for contracts, shows how such favouritism works.

Our analysis of procurement in the construction sector further found that, whilst use of restrictive procedures is not excessive, competition for public contracts is surprisingly weak in a sector under considerable economic pressure. Moreover, many of the companies which are most successful in winning public contracts are highly reliant on such revenues, and greater reliance on public contracts is associated with higher levels of profitability.

Croatia's public procurement law and the institutional framework of control mechanisms provide for a good system in theory. In practice, a large share of public procurement is conducted by contracting authorities which are either formally beyond the reach of these mechanisms or, in an environment characterised by extensive political control and particularism, highly unlikely to be challenged by institutions that are poorly resourced and lack independence.

First, the priority for Croatia is to reduce the potential for political control over public procurement. A first step would be to introduce seven-year terms for the heads of Type C and D contracting authorities, making them more independent of their political owners. In addition, the corporate governance structures of these authorities should be reformed to reduce the monopoly and discretionary power of the heads of Type C and D authorities, and the activities of these organisations should be brought under the remit of other institutional checks. In the longer term, it may be preferable to transfer Type C and D authorities into the private sector, but there is traditionally significant public resistance to such privatisation in Croatia.

1.

Second, the accountability of the public procurement process should be increased by improving the monitoring of contract implementation. This would help to ensure that contracts achieve good value for money and deliver the works, goods or services intended to an appropriate quality standard. This alone would help to curb the potential for money to be channelled out of the public procurement process for private gain. State audits should include integrity matters rather than simply financial audits, which often fail to identify corruption. The Netherlands national integrity agency provides an instructive example; this organisation has the power to randomly select public authorities for audits which check the integrity of procedures and make recommendations to correct systemic weaknesses. The State Audit Office in Croatia should be given powers to conduct such checks, make appropriate recommendations, and to impose sanctions on authorities that fail to act on their suggestions.

2.

Third, measures should be taken to improve the degree of competition for contracts, not only in Croatia, but at the EU level. This is a complex task which requires context-sensitive interventions. Simply requiring procurement to be conducted through open procedures is insufficient to promote competition, particularly in a context characterised by particularism. Instead, this objective should be pursued through a combination of regulation to force competition, e.g., by requiring a minimum number of bidders for contracts above a certain value, and capacity-building, by assisting SMEs in competing for large contracts. In Croatia, the latter goal might be best achieved through designing clusters of SMEs and encouraging them to pool resources to purchase advice on aspects of the tender process or to establish joint bids. By contrast, a recent change in Croatian public procurement law which increased the threshold value at which contracts are regulated – from 10,000 euros to 35,000 euros - risks facilitating corruption whilst failing to ready companies for market conditions. The percentage of contracts classed as petty procurement in Croatia has grown dramatically following this change, and now represents 16-17% of all public procurement.

3.

Finally, the integrity of public procurement is best ensured in systems where there is a high degree of transparency about how public contracts are allocated and how they perform. It is of key importance, therefore, to improve the collection of data about public procurement and to expand tools which allow for cross-checking among datasets to identify risk factors such as conflicts of interest and political connections. The Integrity Observers tools established by Croatian NGO Partnership for Social Development, with the support of the EU Commission and the Embassy of Switzerland in Croatia, provide significant insights into public procurement. However, a lack

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of integrated data management policies in other aspects of governance – e.g., conflicts of interest, commercial registries, financial registries, concessions, investments and urban planning - limit the utility of such data for tracking integrity in public procurement. Significant improvements in transparency and accountability could be achieved with further development and integration of such databases.

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

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