

FINANCIAL (STATE) AUDIT AND THE FIGHT AGAINST CORRUPTION

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Abstract

Corruption today, amplified by globalisation, is one of the most serious phenomena threatening the security of public finances and hindering development¹. It is commonly known that in the global economical competition corruption can be interpreted as a result of several factors. One of them, the risk of corruption is a special, growing factor.

Supreme Audit Institutions' duties² are not limited to protecting the financial positions of public finance, a more recent and an increasingly decisive task, also from the point of view of fighting corruption, it is also to investigate the effectiveness and expediency of the services provided from public finance resources in a broader sense, by taking into account the social and public finance interests on a longer run and not only by taking into account vulgar economic efficiency calculations. Based on this, in addition to initiating actual steps in the cases of discovered corrupt practices, errors and actual felony, to make prognoses, it will be possible, to draw the attention to harmful phenomena and to the potential possibilities of 'tapping' the resources of public finance.

¹The concept of corruption is used by jurisprudence, legal theory, sociology and economic literature, but substantive law cannot deal with this concept. The concept of corruption cannot be found in the legal system in force as a named actual circumstance; the criminal offences of this nature, as we shall see in the legal references at a later stage, exist in narrower contents. We can find innumerable, more or less exact, general or narrower definitions of this concept. For example, Elemér Hankiss very aptly identified it as a 'public evil'. According to the dictionary of foreignisms, corruption is *bribery, bribability*; 2. *general depravity in public life*. (Ferenc Bakos, Akadémiai Kiadó, 1989, p. 463.) The Magyar Értelmező Kéziszótár [*Concise Hungarian Explanatory Dictionary*] offers a similar definition: 1. (in the press) *public bribability*; 2. (in literature) *moral depravity in public life*. (József Juhász – István Szőke – Gábor O. Nagy – Miklós Kovalovszky, Akadémiai Kiadó, Budapest, 1989, p. 765.) The Decision No. (97)24 of the Committee of Ministers of the Council of Europe containing guidelines for the fight against corruption which define the concept of corruption as the *accessibility (the influencing) of decision-making*; in the following passages we make a separate reference to this decision.

²State Audit Offices, as the supreme audit institutions are operated in every democratic country and state of the world, and the EU also has a similar institution, named European Court of Auditors. Inside of the state regimes, their function and role are more and wider than a simplified professional financial supervision. Their independence and relationship to the Parliament is a key factor of the defence of a democratic and constitutional state regime. The Hungarian State Audit office was founded in 1870, during the communist period (inside of the so called 'party state') (1949-1990) did not operate, and in 1989 it was reactivated together with the Court of Constitution, as a guarantor institution of the change of political and economic system.

1. Damage Caused by Corruption and Motives for Corruption in the World

Recently, in the fields of the economy and state management corruption has become 'public enemy' number one requiring whole series of measures because it has been getting apparent that corruption can increase the expenditures of administration to an extent, render the decisions incalculable and non-transparent, thus indirectly impeding the increase of competitiveness or even its very existence, to a proportion that it has become, both nationally and internationally, a factor endangering economic relations. In the field of taxation, corruption can reduce the revenues, and in the field of state expenditures it can increase the expenses to a degree that it might change the focal points of budgetary financing. Corruption can distort the results of public procurement tenders to an extent that in comparison to the possibilities inherent in the financial resources only a lower quality of infrastructure development and service provision can be achieved. It can promote non-productive investments in economically nonviable projects to a proportion that it could considerably increase the indebtedness of countries. The result of all this is *a global risk factor of such magnitude that it already considerably disturbs and impedes the economies of the countries, thus the development of the whole world economy*³.

The qualification of the level of corruption given by semi-state, international institutional and civil organisations support the development of commercial relations and international investments. The objectivity of their orders of precedence, despite their asserted endeavours, is not always reassuring. Factors of attitude, distrust and prejudices can just be found among the reasons of distortion as the uncertainties as well due to the limits of competence and to the scarcity of available information. In addition to these subjective elements and incertitude of quantification, there is no denying that judgements distorted by short- and long-term political and economic considerations – investors policy, subsidy policy, or other considerations – also appear(ed) in the technical literature and in the information given by the public-opinion polls made among businessmen⁴.

³It is worthwhile to cite a few data to demonstrate the material burdens of corruption, indicating some internationally accepted estimations of some orders of magnitude. For example, 30 billion US dollars of the aid extended to African countries landed in foreign private accounts, as these countries were obliged to endure the systematic looting exercised by their own leaders. In East Asia the losses attributable to corruption are estimated to be around 50 billion dollars. In the whole region of Asia, the public procurements are at least 20% more expensive than justifiable, but this level could, not infrequently, reach even 100%. Some 200 billion dollars of the amount of state debts accumulated by European countries can be attributed to the effects of corruption. According to the Anti-Fraud Organisation of the European Union, in 1998 the fraud related to the European budget reached 265 million euros equalling some 300 million dollars. It is worthwhile to recall here that at a EURO-AMERICAN conference held in Colombia in 2000, one of the American Development Bank representatives explained that, in South America, 11% of the budgetary expenditures is from the outset put to 'illegal' purposes. World Bank President James D. Wolfensohn stated that the cost of corruption reduces the level of investments like some kind of a special tax, thereby impeding economic growth, and that this phenomenon especially threatens the economically weaker countries.

⁴This can be seen if in their process we compare the qualifications on corruption given in the

There is a good deal of latency world-wide, while the number of known corruption cases is small. According to a Spanish technical journal, 59% of the discovered cases – if we take the total number of discovered frauds 100% – are due to a thoughtfully developed internal institutional regulation (and audit), i.e. to an appropriately developed system, to which the accidental discoveries and anonymous denunciations add a further 25%, and only 15% can be attributed to external regulation, and audit⁵.

Comparing the statistical empirical investigations, analysing the reasons and the outcome of corruption and the qualifications applying different means (including sociological ones) and, furthermore, the country orders of precedence, the interrelations between the reasons of corruption and the measures of contamination, concentrating on their substance, can be described by assigning them into the following three categories:

The first factor of this nature, which was largely emphasised both in the statements made at the ICGFM conference⁶ held in spring of 2001, and in the ensuing discussion, is the phenomenon that the penetration of corruption is not a marked accompanying feature of a lower level of development only but, mostly in parallel with it, *it is also extremely frequent in places where the social-political conditions are characterised by a 'deficit of democracy'*. Corruption in these cases surfaces not only in the field of the economy, the world of benefits, but it is also present in the dimension of human existence, the daily subsistence; it attaches the means of bribery to these fields. It creates a multiple burden both to society and to the national economy. The different country statistics, the evaluations based on

so-called 'country reports' qualifying the preparation of Hungary towards accession to the European Union, and take into account how the summary judgements related to various years are supported by sometimes meaningless explorations of the prevailing conditions. It appears that in their qualifications related to corruption, the various documents contain on the one hand general statements reflecting and creating distrust, which are not adequately supported, and which, due to the lack of supporting facts, are questionable in their justification. In this respect, the 'Regular Report on Hungary's Progress Towards Accession', released in 2002 (Brussels, 9 October 2002) leaves a feeling of want. It fills two pages enumerating the steps that, according to previously expressed views, were taken and the results achieved and then, without any substantive evidence, and moreover, attributing the responsibility of the statement to an unspecified Hungarian public opinion [pollster], states in two and a half lines that no progress has been made and, in fact, the judgement has become even worse. On the other hand, the judgements are not in line with other 'orders of precedence' (such as the one made by Transparency International). According to such qualifications, the situation in Hungary is more favourable than, or almost identical with, the judgement of a number of EU Member Countries. No mention is made of the fact that it was exactly the investors from EU countries who had referred to the risks of corruption in the transforming economies of newly democratic countries where, due to the decisive order of magnitude of their participation in the process of economic transformation, they could be the only active bribers, and where, in the process of their privatisation purchases, it is in their interest that the country should be qualified as a worst possible corruption country, as the 'country risk' factor leads to influencing the market price of the various pieces of property.

⁵Revista Technica, 2000/17

⁶The International Consortium on Governmental Financial Management as an international professional organisation (association) supported by the World Bank.

such statistics and the orders of precedence show that the most favourable situation exists, and the proportion of the so-called ‘active’ cases of criminal offence related to corruption, that is to say, the proportion of situations where the civil servant, the policeman or the employee of some authority themselves initiate bribery practically establishing its tariff, is the smallest at places where it is not necessary to buy human liberties (freedom of travel, permission to reside, police measures, etc.) and where the prestige of public officials and civil servants does not depend on their power positions, but rather on honour that cannot be expressed in terms of salary or material parameters. Approaching the phenomenon from another side, it can also be clearly seen that *corruption is smaller at places where true democracy exists and where political rotation and reforms are introduced*⁷; where there is a chance for changes and no one can be sure that their actions, their corrupt practices would remain hidden forever.

Secondly, based on a comparison of analyses, we are faced with the fact that in a great majority of countries *the index values of corruption and bribery are correlated to a considerable extent with the level of economic development and, in the longer term, with its ascending or descending trends*. As, based on the research work done by SAO experts, we demonstrated at the following conference of the ICGFM held in spring 2002, that *the extent of corruption can be closely linked with the per capita annual economic indicators*⁸, and similar interrelationships can be pointed out with respect to trade restrictions and the forms of price control. *Accordingly, the more open and transparent an economy is, the smaller the temptation for corruption, the more reliable the screening out of corruption risks and the more efficient the utilisation of direct and indirect (financial) audit tools are.*

⁷See World Bank study entitled *Transition, The First Ten Years, Analysis and Lessons for Eastern Europe and the Former Soviet Union* published on 14 January, 2002 regarding the first ten years of economic transformation. According to this study: ‘In the effectiveness of transition [in respect of the post-socialist countries] the disciplined implementation of reforms and their depth had a greater role to play than the relationships that had existed directly before the transition’... [according to the World Bank study] ‘The [earlier] view, according to which inequality within society grew to a larger extent in places where more reforms had been implemented, proved to be mistaken. The report states the contrary. On the other hand, a high correlation was clearly demonstrated between corruption and inequality.’

⁸Resources of the Hungarian State Audit Office was made by Gusztáv Báger. A Spanish expert establishes negative correlations between corruption, market economy, the growth of the GDP, the efficiency of bureaucracy and the level of training. According to another expert, the establishment of the level of a country’s sensitivity to corruption (C) requires a knowledge of the level of monopolisation of that country’s economy (M), the exclusive nature of public administration (D) and the transparency of financial reports (T); thus $C = M + D - T$. (Revista Technical 2000/17.) Dr. Árpád Kovács: lecture entitled ‘Possibilities for the Control at Audit Office in the Fight against Corruption’ delivered in the *Investigation of Fraud and Anti-Corruption Fighting Section* of the ICGFM Conference on ‘International Crisis: The Role of the Government Financial Manager’ held at the School of Accounting, Florida, International University (Miami, 11 April 2002). (The SAO has put the written Hungarian version of the lecture at the disposal of the National Assembly and the competent persons of the Government.) In this topic block, Tamás Sepsey has joined the lecture by introducing, in a form of a case study, the investigations made by the Government Control Office.

The third category of interrelations can be best characterised by indicating the level of the social acceptance of the corruption phenomena and the forms and directions of their changes. Despite the increasing rejection [of corruption] and the recognition of the losses and risks attributable to it, it is still undeniable that there exist certain socially accepted or tolerated forms of actions falling under the concept of corruption, which are tolerated by public opinion as a function of their aims and final results. *One of the risk factors is the fact that the myth of 'positive' corruption still exists.*

The transforming societies, where the old rules have already ceased to operate, but the new ones have not been crystallised yet, offer favourable possibilities for corruption. This is especially true when the authoritarian systems begin to decay (like for example in the case of the Eastern European countries with state socialist regimes in the decade of the 80s), as well as in the period of 'wild capitalism', the period of original capital accumulation and the period of privatising public property and services. The so-called 'new market economies' provide some elbow-room for corruption also as a result of the economic and financial control and the attitudinal errors and mistakes ascribable to the professional and the political elite. Illusions were entertained of a very rapid strengthening of civic discipline and civil servant integrity following the liberation from dictatorship and, – in the first years of transformation, due to a lack of experience, to the omnipotence of the fully liberalised market, as well as to the idea that the control of state financial audits is unnecessary in the fields falling outside the framework of public finance, – even though co-operation takes place at many levels and the state is an economic player at the same time⁹.

If we compare the different categories and 'scales' of corruption, and if we study these three groups of factors, the trend will become clear: *the size and expansion of corruption are inversely proportional to the level of development and directly proportional to the autocratic character of the state order.* What follows from all this is not only the fact that in developed countries corruption is inevitably smaller, but also the fact, and this is very important, that in countries undertaking social and economic transformation, the suppression of corruption and the increasing honesty of public finance management can be one of the guarantees of economic growth¹⁰.

By relying upon earlier methods, public administration as developed historically in nation-states finds it increasingly difficult to deal with the new requirements and effects of globalisation. However, the management-administration deficit is regrettably typical not only in the economies in transition, but also in the developed countries. It also becomes ever more apparent that in the competitive sphere the so-

⁹Private companies are being sustained by state orders, not to mention that by the coming into prominence of the functioning of the financial system and issues related to efficiency are getting closer to the mechanisms of giant enterprises of the private sector. A mutual influence is in effect.

¹⁰Elemér Hankiss: *A korrupció játéka Közép-Kelet-Európában 1945–1990, Korrupció Magyarországon [The Games of Corruption in Central Eastern Europe 1945–1990, Corruption in Hungary]* (Pécs-Baranya Intellectual Association and the Faculty of Political and Legal Sciences, University of Pécs, Pécs, 2001, and the publication of the Hungarian Gallup Institute, July 2000.)

called 'new economy' requires new types of strategies, co-operative methodology, management and audit tools and methods. This work carried out by a compulsion of co-operation and adaptation both at the national and increasingly at the international levels requires not only a substantive transformation of the regulatory (financing) and auditing activities of the state, but it also presupposes changes in the operation of organisations and institutions carrying out public duties. On the other hand, more and more competitive elements and quality requirements are embodied in the operation of public authorities and the performance of public administration duties. This process also introduces significant changes in the management of public finance, and it is becoming ever more typical that the state performs its service-providing duties by increasingly relying on the private sphere, by making purchases from that sector. Consequently, today it is not the question of who provides the services that is decisive, *but rather the question of whom, at what level and against what costs finances it. In the absence of appropriate audit activity, the modernisation of public finance is also a significant factor for increasing the risk of corruption.*

Both the system of interests attached to provide community services in a sector-neutral and efficiency-centred way, and the security system of interests attached to social operations gradually reshape the boundaries of the private and public spheres. This requires the reshaping of the institutional powers, as well as the entitlements for auditing and for the collecting of information. In the frameworks of changing administrative and control mechanisms, stability and security are model-operating factors of increasing importance.

2. Corruption Phenomena in Hungary

In the distribution and obtainment of public money, the economic management system of the bygone decades, *the state organisation existing prior to the transformation of political and economic systems in 1990*, offered broad possibilities to enforcing the interests of individuals and smaller or larger groups of people in forms deviating from the announced norms. The primary field for this was the system of informal bargains and mutual favours, which operated in a practically institutionalised form at the various levels of state and party control. It was the economy of shortages that played a decisive role among the reasons producing the corruption phenomena.

During a period of ten to twelve years, beginning with 1990 Hungarian society has experienced a period burdened with transitional, transformational recession, not only in a political-social context but also in respect of the economy and the organisation of public finances.¹¹ *Certain corruption sources, risks – like bribery initiated*

¹¹We consider the transition completed with the general elections of 2002 – the third elections following the transformation of the political system. The new governments is not burdened anymore by the problems of transforming the ownership structure, i.e. the privatisation and the necessity of establishing the new state organisation.

by an 'active' bureaucrat – have disappeared or been driven back¹², but newer situations, offering even wider opportunities for corrupt practices have emerged. Although the peculiar social traps, phenomena, concerning competitiveness that was reflected also in the devaluation of the assets were familiar, yet – it is obvious now – professional and public opinion have also undervalued *the real measure of the social, economic risk*. As in other, post-socialist countries, such a judgement-element was *the opinion that tolerated the existence of grey economy, acknowledged its 'oiling', 'accelerating' role, or saw it as a means of asserting the so-called contact-capital, or made difference between 'small' and 'heavyweight' corruption* while emphasising the rapidity of the social-economic transition process, as *an interest that lessened the security risk*, proved to be well founded.

3. Privatisation and Corruption

This is how in the midst of evolving market economy conditions the substantive realignment of corruption and its new 'Lebensraum' were created when, following the political transformation the '*privatisation*' of the enterprises operating previously in other than company forms and that of the state assets embodied in them were put on the agenda¹³, and here the given expression has a special, *literal* mean-

¹²The crime statistics of the investigated corruption crimes can be accepted only as an orientation. The number of such crimes (bribery, misuse of influence) has declined from 879 per year before the transformation of the system to 335 per year by 1990. For a longer period this number has stagnated then – very likely due to the improving transparency of the institutional system and the more effective investigation – it is growing again (this growth in 2001 was 50%) but these approximately 1000 cases represent a more moderate number and only a fragment of the total number of the known total of economic crimes. Within this number the proportion of bribery cases initiated by active officials is very modest and predominantly connected to police fines for traffic violations.

¹³The economy with a mixed ownership system built predominantly on private property was established by way of transforming the ownership system on the one hand through founding large business enterprises based on private – in the first decade of the transformation mostly foreign – green-field investments, which was shortly followed by the foundation of a hundred thousand domestic private enterprises, as a result of the collapse of the 'socialist large-scale farming establishments' and private farming becoming dominant and, on the other hand, through the selling of the business property and operating assets belonging to the various sub-systems of public finance. The study speaks first of all about the dominant changes in the ownership system, meaning the privatisation of state-owned enterprises belonging to the central sub-system of public finance. At the beginning of the privatisation process, in 1990, this represented a value of 25 to 30 billion dollars, and was embodied in business enterprises operating in other than company forms and in related marketable real estates, where the representatives (institutions) of the Government exercised the ownership rights. The segment of public property belonging to various public foundations and the local governments of different settlements forms another category, where the local government property represented a decisive share with a size of about 10 to 15 billion dollars, which was basically available in real estates and landed property that could be mobilised for green-field investments too. Due to the continual revaluations and devaluations of property and in view of the fact that at the beginning of the process only the so-called 'book value' (containing the balance of expenditures, investment expenses and amortisation) was available, which

ing, because *its possibilities also existed when* the acquisition of property became a personal interest and an aim. The chance of growing rich and belonging to the upper layer of the new social order, the attraction that the good fortune of the family can be established for generations has brought along a rather strong corruption risk. In the first years of the political and economic transformation, as a result of the heritage devolving upon us, the new rules were not always taken seriously even by the company managers who were called upon to guard over them.

‘Special’ techniques were developed for ‘seizing opportunities’. While it was with dismay that public opinion referred to this raw assertion of interests as ‘spontaneous privatisation’¹⁴, in view of the then valid, encouraging rules it could hardly be objected, it was regarded by the opinion of the influential majority of economists as a ‘natural concomitant’ of transformation; however, in this case it was not about privatisation but rather its tendentious preparation in support of group and managerial interests. *Finally, the process fraught with risks of corruption triggered the so-called bank-consolidations¹⁵ burdening the budget with several hundred billion Hungarian forints.*

In this first period of introducing the reforms of economic transformation the legal regulations, the ones on competition, conflict of interests, accounting, public procurements and on updating the outdated legal norms passed earlier, before the political transformation, as a result of which the different transactions could be more transparent, thereby permitting their qualification in a more objective way,

could not be interpreted from a market point of view, more accurate value data are not available on property. Thus it was possible that at the time of closing the process of privatisation (i.e. ten years later, at the end of the 90s, when more than 80% of the GDP was produced by private companies), by selling almost 90% of the state-owned enterprises and as a result of the improving selling prices, public finance obtained much more revenues than could be estimated in view of the data that were characteristic for the beginning of privatisation.

¹⁴Árpád Kovács: *Számvetés a számvevésreől* (Magyarország Évtizedkönyve, 1998. Demokrácia Kutatások Magyar Központja Közalapítvány [Account on auditing (A Decade Book of Hungary, 1998. Hungarian Centre for Democracy Research Public Foundation)] pp. 179–204. In substance, ‘spontaneous privatisation’ meant that the formerly monolithic state-owned enterprises were allowed to form companies, even in co-operation with each other; they were allowed to export property to these companies and they could leave the burdens with the parent company, they could empty the parent company by taking away the profitable technologies and market possibilities. The enterprises tried to conceal their organisational non-viability and their financial problems by transformation. According to the faulty regulation valid then, the new companies were relieved of the obligations of their founders. This has brought about a special torso of state restructuring, as a result of which company centres came into existence burdened by substantial debts, practically ‘emptied’ in their functions and left in the hands of the state.

¹⁵In the course of economic transformation, as a result of companies going bankrupt or their financial positions becoming instable the banking system, which still was state property, also came to the verge of bankruptcy. State intervention, consolidation was needed to preserve their operational capabilities. The series of steps raising a burden of nearly 500 billion Hungarian forints (2–2.5 billion USD) and implemented by various techniques is called ‘bank-consolidation’. The operational capability of the thus saved banks has, as a result, been preserved, and the banks subsequently, mostly through the intervention of strategic investors, went to private hands.

were non-existent. It is clear now that in this system of conditions excessive illusions were entertained as to the guaranteeing role of audits, to the objectivity and professional skill of international consulting firms, while the administrative, 'self-protective' mechanisms of the state, which tried to conquer the group interests and the inter-penetrations aiming to assert these interests, for example by delegating 'commissioners' considered reliable, have failed one after the other¹⁶.

The loss that can directly be quantified and attributed to losing the earlier invested value, to the profit and tax revenues missed and to the unemployment expenditures, and which influences competitiveness, general and proportionate sharing in taxation and social security is estimated to be about 4 billion dollars. The damage caused to social morale and future prospects, however, can hardly be quantified. At the same time it is also a fact that in addition to the establishment of new ventures and the organised sale of operational companies, that is, in addition to the centrally organised privatisation, this process also had an important role to play in the formation of the rank of new owners and in transforming the ownership system.

In the following period of privatisation beginning in 1991 and extending up to the middle of the decade, that was led centrally (in an agency form), and implemented with the participation of strategic partners, foreign investors who considered the acquisition of companies a secondary aim, whose primary endeavour was to acquire the markets together with or through the acquisition of the companies, assets of enormous value (for the Hungarian economy) were moved. It was in this period when the privatisation of the service providing companies (water and canal works) in the property of the local governments of settlements (towns and larger-sized villages), as well as the privatisation of the real estate property (plots, buildings, resort houses) began in earnest. In this process corruption gained a new breeding ground due to the fact that the institutional system necessary for handling the hitherto unknown task related to the dismantling of state property, to its privatisation, necessarily developed only gradually. The real, comparable market value of the assets was totally unknown because neither a capital market nor an evaluating system existed. Under these conditions there were the investors who dictated¹⁷.

¹⁶The findings of the audits performed by the State Audit Office accurately recorded the events leading to the collapse of companies, the obstructive conditions and, of course, the problems of financial management, the bad decisions, the errors in undertaking risks, judging markets and making investments. In more than two-dozen cases, the auditors got as far as initiating criminal charges for negligence or mismanagement, falsification of documents or for some other corrupt practices.

¹⁷The fact that the difference between the income position of the managers and other leading personalities employed in business life and that of the civil servants and public officials is markedly large and increasing is only a detail from this point of view, but on the side of the potential possibilities for corruption it is decisive. The actors of the public sphere are (were), therefore, defenceless against the temptation of corruption coming from the competitive sphere, the world of money. These experiences were also instrumental in promoting the process that in 2001 the National Assembly, taking into account the anti-corruption governmental package referred to before, amended the act on the legal status of civil servants passed in 1992. The amendment has brought about significant, favourable changes in the material and moral rewarding of the civil servants and, at the same time,

In a later, third stage of privatisation, the sale of the large systems of infrastructure, the energy sector and telecommunication, were put on the agenda followed by the privatisation of commercial banks. This time, the selling techniques also relied on the participation of strategic partners and investors. Despite the results achieved which, in comparison to the similar processes taking place in neighbouring countries, could be considered significant as a 'success story', rumours on corrupt practices began to spread regarding the privatisation of state assets. Although privatisation cannot in any way be equated with corruption, this cast a shadow on the whole privatisation process, on the management work of the organisations commanding, and participating in this process. One illustration of the Hungarian experience is an example of the phenomena demonstrated by American researchers, according to which matters practically known as gossip, matters that are 'suspicious of corruption' and that raise ethical questions, make up about 40% of cases of corruption. Due to the inaccuracies of regulation and to the shortcomings of a developed audit system, in our case verifiability was extremely difficult, as a result of which investigations have not been initiated and sanctioning under criminal law did not happen¹⁸.

By the end of the nineties, the process of privatisation in respect of the so-called 'entrepreneurial' assets of the state practically came to an end. In respect of the local governments the process started later and it has just arrived to the point of completion.

*By the contraction of the state- and local government-owned assets operating in the business sphere and by a gradual elimination of the weaknesses inherent in the regulation and the institutional-organisational system, that is, as a result of prevention and the economic achievements, the chances for corrupt practices have considerably diminished in these fields. The (partial and well-considered) privatisation of the large social provision systems – health-care, education and other fields – is still to be done that is to take place along with the modernisation of public finance (and that, we hope, is free from the pressures of budgetary revenues). If it is carried out efficiently, by asserting longer-run interests and not just daily, vulgar cost-benefit considerations, the validity of the findings cited earlier from international analyses, namely that *the contamination of corruption is inversely**

obliged them to account for their property situation and make it transparent. The basic principle of transparency, the 'glass pocket' principle, prescribes similar accounting duties for the Members of Parliament and the other leading personalities of public life, among them the elected officers of SAO. Act XXXVI of 2001 amending Act XXIII of 1992 on the legal status of civil servants and several other acts. Valid as of 1 July 2001.

¹⁸Paradoxically, one of the greatest scandals, which came to light years later and led to the replacement of one minister and the whole management of privatisation, is connected to the privatisation organisation. And this has cast a shadow on the whole process of privatisation, although the scandal was not connected to the sale of assets, but rather to the sharing in the revenues with settlements. The corruption case of the 'success fee' referring to 'interests' instead of distribution in compliance with the law, which was audited by the State Audit Office and led to penal proceedings, and which was connected to the financing of a political party, has brought about radical changes in the patience and tolerance of public opinion.

proportional to the level of economic development and that it is expedient to perform the system-oriented utilisation of financial audits, can also be proven in Hungary.

4. Corruption Risks Today

The situation of public finance has been consolidated by the turn of the millennium; at that time the performance of Hungarian economy exceeded the level of the same ten years earlier. The further stabilisation of the economic situation and the strengthening of the position of public finance were promoted and are being promoted even today by the steps of regulation and institutional development, that in the interest of ‘whitening’ the black economy and reducing the chances of corruption, were establishing links between the field of criminal investigation and the anti-corruption package adopted in spring 2001 and that, most lately, have been forming part of the so-called ‘glass-pocket’ programme¹⁹.

In Hungary the corruption risks are smaller today than they were at the beginning of the economic transformation prior to the changing of the political system²⁰. Taking the data regarding the corruption indices given by Transparency International on the countries transforming their political systems as a basis, one can draw a favourable conclusion regarding the transformation in Hungary. The indices indicating mediocre corruption contamination in Hungary show a slight decrease, as a result of which the classification of Hungary fluctuates between the relatively favourable 28th to 33rd ranks in a longer run depending on the changes of this index number in the given year regarding the countries being in a similar position on the ‘list’. At the same time, countries like Poland and the Czech Republic, which were in this respect in a more favourable position at the time of political transformation, paid dearly, lost a number of benefits, for lagging with privatisation, and postponed several reform steps in the field of public finance, where they had opportunities

¹⁹The Centre for Fighting Organised Crimes was established by Act CXXVI of 2000 and has been operating as an independent central office within the organisational system of the Ministry of the Interior, whereas the package of laws on the ‘glass pocket programme’ is under preparation. In accordance with the chapter contained in the programme of the government now in office entitled ‘Corruption-free Public Life’ (commonly known as the ‘glass pocket’ programme), if it is implemented, an overall system of rules will be developed. Its aim is to promote the auditing of the utilisation of budgetary resources, to ensure the transparency of the system of public assets, the elimination of possibilities for corruption and the appropriate openness of data of public interest. According to legislative intentions, the planned regulation will regulate the relations between the openness of data of public interest and business secrets, creating thereby the harmony of proportionate implementation of constitutional rights; it will strengthen the role and powers of the State Audit Office, as the highest organ of state control; it will render the operation of budgetary organs more transparent and delimit their undertaking of economic roles; it will expand the system for accessing the data of business companies, included in publicly authentic records, and the publicity of firms; it will regulate the rules related to the internal control of state-owned firms and the provisions serving the transparency of their operations; it will ensure the transparent operation of the non-profit organisations established using public resources.

²⁰See the corruption index numbers given by Transparency International

similar to Hungary (e.g. treasury system, net financing, etc.). This has a knock-on effect on a number of valuation orders that influence capital flow.

However, the risk of losing the relatively good ranking of Hungary and, of course, the risk of losing positions that are important also in respect of the chances for catching up, are increasing year by year. The introduction of various programmes and regulations for their elimination, although they are also important, are not enough. These dangers can be discovered right in the processes of public finance and the economy themselves, in the postponement of decisions, in different forms of governmental, political attitude and in the problem management mechanisms that can be traced back to the shortfalls of co-operation, the presence of which is in itself a factor for increasing the risk of corruption.

In the following passages we shall lay special emphasis on four significant interrelationships presenting corruption risks in the operation of public finance. They are the following: the development and structural transformation of community services including the contra-selection operation of the related public procurement and subsidy-application systems; the contradictions of financing political parties and the election system; the shortcomings of internal control due to their special relations, and the problem management attitude influencing the environment of the audits.

5. Public Procurement

In view of the experiences gained in the course of more than 6 years one can pass a judgement on the operation of the Act on Public Procurement²¹ (adopted in 1995, first in Hungary among the countries implementing a transformation of the political system) which was amended *in detail and not only along closed concepts* in 1999 and then in 2001 in order to help transparency and the purity of competition and in accordance with the programme of legal harmonisation undertaken in relation to the EU, and on the possibilities reducing and creating corruption risks. The value of public procurements, that has been growing steadily, has increased three-and-a-half-fold since the start. The openness of the procedures has broadened. The share of the local governments and their institutions, as well as that of the central budgetary organs administrating the procedures, increased alike. In this process broader possibilities have opened up for the small- and medium enterprises to obtain orders financed from public resources²². An evaluation of the experiences related to the application of the legal act, also revealed a number of operational shortcomings in addition to the favourable developments. It is typical even today that the internal, institutional regulations promoting the local application and prac-

²¹ Act XL of 1995 on public procurement.

²² The system of public procurement includes a steadily growing field of investments and services connected to the operation of public finance. In 2002 nearly 5000 public procurement procedures were implemented and the utilisation of more than 700 billion Hungarian forints (~ 3 billion US dollars) was decided in this form. In 2001 small and medium-sized enterprises won 61% of the total value of open procedures and the result was the same in last year.

tical implementation of the law are incomplete and out of date. The personal and material conditions are insufficient, the handling of the documents related to public procurements is inappropriate and there is a lack of discipline of those concerned in the field of complying with the law, due to a lack of appropriate motivation and obligation. The registration of the participation of economic organisations is unsatisfactory. The implementation criteria of the concluded contracts are not concrete enough, and sometimes even the definition of the subject and the framework amount of the contract are also vague, as a result of which unjustified supplier positions develop. No breakthrough was achieved in reducing the level of prices; improvements in the level of quality and in the field of observing deadlines also fell short of expectations. The activities of internal control were unsatisfactory in relation to public procurements. At the same time, these findings touch upon the risks of corruption too.

Public procurement spread more slowly and with more contradictions than desired, and recurring mistakes were made: this can primarily be traced back to the lack of skill of those applying the law, to reasons of attitude and, basically, to the *successful assertion of group interests and to interests running counter to transparency*. On the other hand, the experience confirmed that the problems originate from the contradictions of other provisions connected to the regulation of public finance, from other legal provisions and from the uneven character of their practical solutions (a lack of synchronisation, accounting limitations, etc.). Workshop activity had already started during the previous government cycle on creating and developing the public procurement rules and the application conditions for the different subsidy categories (labelled and targeted local government resources, environmental protection, enterprise development, EU resources, etc.), including the establishment of temporal harmony in the field of the possibilities for utilisation, which seems to be a simple matter on paper. *The regulation, as it was recognised also by the latest country report of the EU²³ has changed at a number of points.* It is clear that further legislative steps, and *the speeding up of the work* would be needed in order to be able to report actual changes²⁴ in 2003.

²³Regular Report on Hungary's Progress Towards Accession (Brussels, 9 October 2002.)

²⁴The Hungarian SAO presses primarily for regulatory refinements that aimed not to render the general legal regulations more stringent, not to narrow the elbowroom for the application of the legal regulations, but rather to stimulate full and consistent compliance with the provisions in force even today. The National Assembly has already utilised several of the SAO's proposals. The ones that related to the judgement procedure and the requirements were incorporated into the text of the Act as amended at the end of 2001. The auditors considered it very important that the Government should establish harmony between the rules related to public procurement and the conditions related to the application for, and the utilisation of the different kinds of subsidies. In the course of such actions, the possibilities for departmental interventions that violate the decision-making independence of those calling for tenders, and actions that do not ensure equal opportunities for the applicants, should be abolished. In the case if these initiations became a reality, 'mutual favours', interdependence, 'postponed payments', background agreements, belonging to the range of direct payola, trafficking with influence, and bribing, would become needless or very risky. It seems that by harmonising the rules of the economic management exercised by budgetary institutions, and by rendering the financial

Up to now²⁵ the moderation of corruption risks has also been impeded by the fact that the limits of competence, the bulwarks of protection of business secrets, practically raising senseless walls, have created a 'one-sided' situation. Under such circumstances it was not possible to monitor the travel of public money up to the final beneficiary. All this developed in a way which revealed that the institutions of the budgetary and non-profit spheres purchased an ever-growing proportion of community services from the business companies of the private sector; and, with the economic upswing, increasing investments were executed in the field of infrastructure. Financial audit was able to examine officially everything at the state organs that issued invitations for tenders, but practically it could not audit the bidders, the co-operating contractors and subcontractors; moreover, in 2000–2001 a number of fields were withdrawn from the competence of financial audit. The situation that has developed is simultaneously both the cause and the effect of the disputes between economic organisations and the leaders of budgetary institutions. These disputes are frequent about the justification of giving such an emphasis in certain fields to the preferences of social policy, of the entrepreneurs; that it should be able to overwrite – using a fashionable expression – the interest system of the invitations for bidding in public procurements.

Steps were taken to eliminate the former risks. Having in mind the solutions related to EU supports, the contractual possibility of auditing the utilisation of subsidies, in the autumn of 2002 solutions were elaborated, that would make financial audit possible also in cases where private businesses and their partners worked for state orders²⁶. Consequently, financial audit, in principle has, at present the possibility to discover the actual shortcomings and professional errors, the prevention or the elimination of which would represent an important step in establishing the purity of procedures, in narrowing the hotbed of corruption. Together with meeting other demands, training and financing requirements, this could contribute to improving the transparency of public finance operations. As a prediction, one can state that along the lines of the realised initiations there is a chance now to en-

situation of the different organisations more balanced, a considerable portion of corruption risks to be found in the field of public procurement can be eliminated. The threats of corruption are especially great in the investment process of the local governments of towns and villages. The purity of the public procurement steps made in this field is often disputed. The difficulties could be diminished if harmony was established in the process of applying for what are known as targeted government subsidies broken down for individual budgetary years and attached to definite investment targets and in the process of applying for different subsidies available as supplementary resources (e.g. in the field of environmental protection). The local government would not have to conclude 'background' agreements with the entrepreneurs, to give up their possibilities to assert their local interests in order to realise their investment projects and to solve their temporary funding problems and to automatically throw doubts on the purity of the invited public procurement bids. By co-ordinating the processes, considerable results could be achieved.

²⁵The date of closing the manuscript was 15 January 2003.

²⁶A government decree stipulates that in their private contracts for service provision, construction activities, supplies, etc. made with businesses, the budgetary organs should lay down the requirement to tolerate the SAO and KEHI [*Government Control Office*] audits as a condition.

sure that the Hungarian economy and public finance should achieve an improving competitiveness in the longer run also in this respect.

Parallel with this positive improvement, it became evident that half of the suddenly increasing civil organisations, the estimated number of which reaches some 60 thousand (!) today – without making any differentiation of principle among them – are institutions undertaking to provide interest assertion and community services belonging to the non-profit sphere, institutions discharging the widest range of community services (health-care, charity or even the popularisation of the European Union), which do not provide adequate information about the proper, regular and efficient utilisation of the financial resources they are provided for such purposes, that is to say, about the question of which part of the means of public finance was used inadequately, by diverting them to private pockets. The situation that has developed is a fresh and a rapidly growing field for corruption.

6. Corruption Risks in the Financing of Political Parties

At its time, the act on the operation of political parties, passed at the time of the political transformation in 1989 and modified in 1992, was a progressive one and helped ensuring transparency in the financing of the system of political institutions²⁷. At the same time, the audits have drawn attention to a number of problems and the gradual obsolescence of the stipulations in the act, and the situation is similar in respect of the operative texts regulating the financial questions of the Parliamentary and local authority elections.

The audit findings summarising the present practice also indicate a considerable proportion of corruption risks and the limits of competence related to the audits of the State Audit Office. These risks originate primarily in the limited transparency of the supporting role of the private sector and in technical-regulatory shortcomings.

These risks are summarised, sometimes verbally recalling the proposals of SAO made earlier and reaffirmed on several occasions, by the anti-corruption Government strategy²⁸ adopted in March 2001. In the background of the problems lies

²⁷Act XXXIII of 1989 on the operation and financing of parties. The Hungarian party act burdened by a number of contradictions and inaccuracies has remained unchanged in its basic principles as far as the financial operation of the political structure of a multi-party democracy is concerned, and in this respect it is by far ahead of the 'usual' European level. According to its provisions the State Audit Office has to audit, once in every 2 years, from a regularity point of view, the activities of all the parties that obtained more than 1% of the votes during the general elections or whose representatives won seats in the Parliament and, therefore, receive budgetary subsidies to their operations in proportion of the number of their parliamentary seats.

²⁸Government Decree No. 1023/2001. (III. 14.) Korm. states that: *'The Government does not consider it desirable that subsidies of an uncertain origin should be attached to the operation of parties. The sources of the wealth of, and material support extended to, the parties must be audited more effectively than so far. The legal conditions necessary for more effective audits have to be created. It is justified to put an end to those regulations of the economic activities of the parties which*

the fact that a special, 'grey' zone developed around the political parties, which is non-transparent for the audits operating with the current authorisation. *Despite all of its shortcomings, the Hungarian regulation on the operation of political parties can be considered to be a pioneering and a progressive one in international terms, because in respect of the party at least as a special economic institution operating under limited conditions, it lays down in unambiguous terms against what election results it is entitled to receive budgetary support and in general what kind of financial and in kind benefits are that it can accept.* Nevertheless, the State Audit Office does not have, thus neither does the Parliament, nor the public opinion, an overview of the broader dimensions of the economic activities of parties that do not come at present under the operation of the law; furthermore, the technical rules of financial accounting are not always unambiguous and they provide for loopholes and differing interpretations. The economic processes of the economic companies established by political parties and those of their partners, as well as economic activities of the resource-collecting foundations organised in the private sector for political support are non-transparent and non-regulated.

In view of the fact that at present there is no lobby act in force in Hungary, and the rendering of the different financial transactions transparent in this sphere would indicate special political courage undertaken against short-term interests from a corruption point of view, this field can be considered the most fragile within the democratic institutional system. *It is a question of principle requiring political consideration and touching upon the functioning of democracy – a step which, in respect of reducing the risks of corruption, is very important in this field too – to clarify that the private companies established by parties, and the companies in connection with them, inasmuch as they use budgetary subsidies, should become subjects of the (financial) audits carried out by the State Audit Office embodying the controlling role of the Parliament.*

The electoral law is contradictory in a similar way.²⁹ With respect to the

deviate from the general system. It is necessary to study the possibilities for a solution, as a result of which the economic organisations belonging to the sphere of party interests could not take part in public procurement procedures. Harmony should be established between the accounting rules and the regulations related to the economic activities of parties. In the course of the preparatory work, it is necessary to study the possibility of a solution, according to which the parties should receive subsidies exclusively from the central budget, and no support should reach them from natural persons or other legal entities. In the interest of all this, the act on the operation and economic activities of parties should be revised, and the draft of the required legal amendment should be submitted to the Government.'

²⁹Act C of 1997 on the election procedure. Following its earlier audits, the State Audit Office pointed out the shortcomings of the law, and these made the auditing task difficult. Neither the enactment of the new law, nor the amendment of the old one has taken place yet. Therefore, the interim elections, as well as the parliamentary and the local government elections of 2002 had to be executed in accordance with the earlier incomplete regulation. From a financial aspect the concept of the election campaign, the expenses that belong to the concept of the election expenditures, the election period itself have not been worked out yet and the regulations concerning the publication of the report need to be amended and be more accurate. Even today campaign expenditure is what any of

conditions and circumstances of the audits, it should be noted that the Act on the Election Procedure and those on the operation and economic activities of parties do not ensure at present the complete transparency of the origin and the utilisation of campaign money. *The shortcomings of the act impede the transparency of election financing and give grounds to corrupt relations, which will exert their destructive effects in the following years.*

7. The Efficient Operation of Internal Control as a Factor Reducing Corruption Risks

Following the political transformation, the previously developed system of internal control got into a critical situation in Hungary. Parallel with this, *hopes were attached to the disciplinary force of audits creating transparency and to the possibilities of external financial audit in creating direct prevention, as well as to the self-regulating mechanism of the economy in a process of getting more and more liberalised; hopes, which later proved to be unfounded.* The independence of supervisors and auditors seemed to be self-evident (although this was an illusion), while it happened exactly in the same period that the so-called ‘creative’ audit, which lent a helping hand to the falsification of balance sheets, grew to full proportions in the USA³⁰. In Hungary, like elsewhere in the countries of East Europe where political systems had changed, we did not have the faintest idea about this. Under such circumstances, even if not being happy about the situation, but taking note of it, gradually, the political and economic transition opened a market worth of nearly one hundred billion forints to audit firms of world-wide reputation³¹.

Under the given circumstances, and partly also due to this, *the organisational system of internal control that would be adequate to the new market economy requirements, developed even more slowly than the possibilities had allowed it, and as far as its operational level was concerned, it developed with great shortcomings.* All this carries high risks of corruption even today. Moreover, due to the unfolding co-operation between the public and private sectors, to their not always transparent relationships – as it was pointed out in the above sections – new dangers have also

the nominating organisations qualify as such and what appeared in the records before the accounting deadline.

³⁰A lecture of József Roóz, entitled *Könyvvizsgálat és pénzügyi ellenőrzés az ezredfordulón [Audits and financial audits at the turn of the millennium]* delivered at the 4th National Conference of Hungarian Financial-Economic Auditors (Miskolc, 11 October 2002) Its concept: manipulation of the accounting data, processes, techniques, arriving at favourable results in reports. Its technique: financing outside the frameworks of accounting and what is known as ‘window dressing’.

³¹In every case when the determination and accounting of real Hungarian property value had to be verified or certified in international business and even in public finance relations (e.g. PHARE), they were commissioned. That is to say, we yielded to the temptation or rather the pressure of their international goodwill, their ability to assert interests and their skill, which was ahead of ours from a procedural technique point of view, in the field of applying such standards.

emerged in this field³². The organisation operating as a control mechanism of the Government was developed with delay, during the terms of different governments and along different concepts. The development of internal (governmental) control is an EU requirement. Changing the situation is of primary importance – or at least deciding if an internal audit administration belonging to a central, *government cabinet* gets a focal role or, *rather* they will strengthen the supervisory (internal control) organisations, *according to the EU recommendations* – not only with respect to the transparent operation of public finance, but also from the viewpoint of directly reducing the risks of corruption.³³.

8. Summary

Campaigns in the fight against corruption, which are usually generated by political interests, impatience and the pressure or the reflex to give in to the burden of proof determined by different interests are factors themselves, that increase the risks of corruption. In addition, we must also be aware that this qualification is *not always objective either*. In the course of operating and modernising the audit system it has also to be taken into account as a special environmental condition that corruption itself, including its international judgement, works itself into the collection of means for asserting interest. It is against the national interests if the leading elite of a given country – giving in to short-term internal political interests and its political and

³²In connection with this, the report of the European Commission on Hungary's Progress Towards Accession issued for the year 2001 states the following: 'Internal control across public administration is understaffed and inadequately prepared for its future role. The functional independence of internal auditors should be guaranteed and developed. A detailed needs analysis should be carried out in order to clarify the role and competencies of the Ministry of Finance, the Treasury and the GCO especially regarding internal control area. In addition, the line ministries' internal control capacities should be strengthened.' (Brussels, 2001, or www.kum.hu)

³³In respect of the corruption risks a new phenomenon in Hungary, primarily in fields of companies and local governments, is the fact that instead of developing the machinery of internal control, external private audit firms are commissioned to do the job, as a service, firms that subsequently also audit the financial reports and economic achievements of the company. This phenomenon has a number of reasons. On the one hand, the endeavours of the private audit firms to tap the market, to 'broaden the range' of their services, and the consideration held by those resorting to such services that this way it is 'more economical' to comply with the rules and requirements stipulated and audited by the external organisations of public finance operation and state control. On the other hand, there is a prevailing belief, only partially acceptable in our view, according to which this way the realisation of the audit experiences is simpler and competence is also of a higher standard. Although the larger audit firms, by applying various rules and internal organisational separation, endeavour to avoid auditors qualifying themselves, and the personal independence of the auditors is also guaranteed, sooner or later the audit firms have to face the fact that at the very end, at the level of the firm, they qualify their own recommendations. As they contracted with the same management, they are affected financially too. *All this has a bearing on objectivity, or rather its convincing verifiability, and constitutes an increasing corruption risk in Hungary too. It calls for the setting up of requirements regarding regulation and the conflict of interests.*

election battles – allows the development of a picture about itself that is worse than the realities and the possibilities would justify, if it does not evaluate the serious consequences in terms of capital flow, commerce, interest assertion, public finance and borrowing, of the country being listed among the strongly contaminated societies.

The safe functioning of financial systems has become an especially specific value, a condition influencing international co-operation and thus it also became a part of the fight against corruption and a part of global relations that is functioning now world-wide. One of the very important and – in our opinion a more and more – decisive factors of the general integration and of *the competitiveness* of the national economy *in the widest possible sense* is the stability and reliability of the economy and the functioning of the financial system. *This is unimaginable without the decrease of the infection by corruption* and this is true for the world and our domestic situation alike. Realistic assessment, the precise consideration of the situation using international comparisons are also necessary to act in such circumstances. In the fight against corruption it is a recognition that results are yielded by *prevention, by reducing the 'Lebensraum', and that the institutions of financial audit and their international co-operation are playing an important role in this fight.*

The need to strengthen world-wide co-operation against corruption is expressed by the fact that an *ad hoc* committee of the UN has been set up to prepare an anti-corruption agreement of the United Nations, and the decision of the Council of Europe deals with this question in 20 points including a number of points dealing with prevention and the role played in this by the audit. *However, the fight against corruption is less and less limited to legal and police means.* However, the new, preventive steps will only be effective, *if societies and especially their economic and political elite taken in a broader sense, ensure suitable conditions for their application.*