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# Detecting and Reducing Corruption Risk and Fraud in the Public Sector

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# Content

Introduction	9
<b>1. Theoretical Framework</b>	11
1.1 Public expenditures and potential threats to corruption	11
1.2 Interdisciplinary approaches for the examination of corruption	13
<b>2. Corruption Risk</b>	32
<b>3. Factors Influencing the Detection of Corruption and Fraud Risk</b>	37
3.1 Principles of Economy, Efficiency and Effectiveness – a Tool to Reduce Corruption Risk	37
3.2 Non-compliance with the Principle of Economy – a Signal of Possible Fraud in the Management of Public Resources	40
3.3 Non-compliance with the Principle of Efficiency – a Signal of Possible Fraud in the Management of Public Resources	42
3.4 Non-compliance with the principle of effectiveness – a possible signal of corrupt handling of public resources	45
<b>4. Analysis of corruption risk according to the FMEA method (Fault Mode and Effect Analysis)</b>	50
4.1 The FMEA method	51
4.2 Method for calculating corruption risk or fraud, according to the FMEA	52
4.2.1 Calculating Corruption Risk	52
4.2.2 Determination of the scale (score) for the frequency of corruption opportunities	56
4.2.3 Determining the scale (score) for the benefit of the corrupt actor, compared with the monthly salary	57
4.2.4 Determining the scale (score) for the budget impact	59

4.2.5 Determination of the scale (score) for detectability of corruption	60
4.3 File of corruption risk indicators	61
<b>5. Criterion 1 according to the FMEA method: the frequency of opportunities for corruption</b>	63
5.1 Definition of “corruption opportunity”	63
5.2 Determining the frequency of corruption opportunities	64
<b>6. Criterion 2 according to the FMEA method: the degree of detectability of corruption risks</b>	67
6.1 Determining the degree of detectability of corruption	67
6.2 Transparency as a factor influencing the detectability of corruption	69
6.2.1 Transparency in decision-making	69
6.2.2 Transparency in budgeting and management according to it	71
6.2.3 Transparency in strategic and community planning	72
6.2.4 Transparency in Public Procurement	72
6.2.5 Transparency in contractual relations	73
6.2.6 Transparent selection of employees	73
6.3 Internal control system, controlling, reporting as a tool for strengthening the detection of corruption risk	74
6.3.1 Controlling, reporting	76
6.4 Benchmarking as a tool for increasing transparency	77
6.5 Mathematical and statistical methods as a tool for detecting fraud	78
6.6 Effective human resource management – a tool to reduce corruption risk	79
6.7 Management Model “doing the right things right” as a tool for empowering detection of corruption risks	81
<b>7. Criterion 3 according to the FMEA method: the impact on the budget</b>	86
7.1 Determining the impact on the budget	86
7.2 Applying the principles of sound financial management for the government as a tool to reduce corruption risks	88
7.3 Knowledge of the processes of government budgeting as a factor for reducing corruption risk	91
7.3.1 Basic information about the budgets as a factor in reducing corruption risk	91
7.3.2 Publicly available information on the budget process, the preparation and approval of the budget as a factor for strengthening budget transparency	95

7.3.3 Management according to budget amendments, breaching budgetary discipline – Phase 3	98
7.3.4 Billing, economic review, the final account – the last stage of the budgetary process	100
7.4 Selection of the appropriate budgetary method – a tool to enhance the transparent and efficient use of public resources	101
7.5 Use of financial data for financial analysis and prevention against fraud and corruption	106
<b>8. Criterion 3 according to the FMEA method: benefit for the corrupt actor</b>	110
<b>9. Limits of the FMEA method</b>	113
<b>10. Case studies</b>	115
10.1 Calculating corruption risk according to FMEA – Monument care (regions)	115
10.2 Examining effectiveness regarding investment acquisition and asset management as a factor in reducing fraud	120
11. Conclusion	122
12. Bibliography	124
13. Summary	135
14. Index	136





# Introduction

The problem of corruption is one of the most topical issues of the day. The question of corruption is reflected in a number of works by major institutions dealing with corruption (Transparency International, 2006; EU, 2013; OECD, 2009a, 2009b, 2013a, 2013b) and has also been examined by a number of authors (Ackerman and Søreide, eds., 2011; Mo, 2001; Nye, 1967; Persson, Rothstein, and Teorell, 2013). Publications which deal with the problem of corruption focus on, for example, ranking countries in terms of the perceptions of corruption (CPI) investigating corruption in public procurement (EU, 2013; Piga, 1986, 2011), and engaging in a sociological analysis of corruption (Frič, 2001, 2012; Langr, 2014; Langr and Ochrana, 2015) in terms of individual conduct (individual corruption) or systemic action (systemic corruption). There is rather significantly less emphasis on the issue of choices for anti-corruption strategies and very little has been done on the issue of reducing corruption within the contexts of identifying corruption risk and detecting fraud. It is on these areas, which until now have been neglected, that our work is targeted. The underlying motive for the work on this book is the fact that to combat corruption effectively requires a search for appropriate instruments which will detect corruption, and prevent it.

From the viewpoint of the management and leadership of the state, municipality or region (Klitgaard, 2012; Petersen and Strachota, 1991), there are two very effective tools in the fight against corruption and fraud. The first is an actual functioning system of financial control (Ramkumar, 2008). This, however, fails to capture corruption and fraud in all areas (particularly in those areas which are not related to the handling of funds or property). A second key measure to prevent corruption is risk analysis (Půček and Matochová et al., 2007). This tool is used insufficiently by the Czech public administration, or if it is used at all, it is

used just formally. Both instruments (financial control and risk analysis) are the basis for the formulation of an effective anti-corruption strategy concerning the conditions in the Czech Republic. When analyzing existing anti-corruption government documents, we discovered that their common weakness in the fight against corruption and fraud currently is an inadequate, or a completely missing risk analysis of corruption and fraud. Therefore, we have focused on this problem for this book. This publication as a whole relates to the public sector. More accurately, however, it focuses on government and its organizations. The book also offers a new perspective on investigating corruption in the contexts of waste and fraud. Corruption itself is waste and fraud (Frič et al., 1999). Waste is not necessarily associated with corruption, but it may be a signal that corruption and fraud are occurring. We will focus on this overlooked relationship in our work. Its primary objective is designed to develop the concept of corruption risk analysis and fraudulent practices, to formulate the theoretical and methodological basis for the creation of an effective anti-corruption strategy, and to detect fraud in the management of public expenditures. This objective is present in the logic of the research, and the content and structure of the publication. We endeavor to show that corruption is a complex social phenomenon, which can be examined from the perspective of various disciplines. The purpose is to show the need for an interdisciplinary analysis of corruption. The focus of the investigation and a major contribution of the book is an analysis of the factors affecting the detectability of corruption risk and the fraudulent use of public resources. Based on the analysis of FMEA (Fault Mode and Effect Analysis – see Carbone and Donald, 2004; Chen, 2007; Chrysler Corporation, 1995; Franke, 1993; Fritzsche, 2011, Lipol and Haq, 2011, Liu et al., 2012) we introduce our own approach to working with corruption risk in public administration. We develop a modified FMEA and design algorithms to uncover corruption and fraud risk in public administration regarding the handling of public resources.

# 1. Theoretical Framework

## 1.1 Public expenditures and potential threats to corruption

The theme of this publication is the issue of corruption and the fraud of resources in the public sector (with an emphasis on government). Public spending is becoming an object of corruption and waste (Kopits-Craig, 1998). Society utilizes a significant amount of public expenditures. According to Eurostat data (2015) total government expenditures in the EU-28 amounted to 49.1% of GDP in 2013. In the Czech Republic, these expenses amounted to 42.3% of GDP in 2013. By comparison, in the Slovak Republic, these expenses were 38.7% of GDP, in Poland 41.9% of GDP, Germany 44.7% of GDP, and in Austria 51.3% of GDP. Additionally, a large amount of public resources were allocated through public expenditures at the level of local governments. Total spending at the local government level (according to EUROSTAT methodology, this includes spending by “local authorities, governments” – i.e., municipalities, regions, and their organizations) in the EU-28 amounted to 11.6% of GDP in 2013 and in the Czech Republic 10.2% of GDP for the same year. By comparison, in the Slovak Republic, the expenses for local governments amounted to 6.3% of GDP, in Poland 13.1% of GDP, in Germany 7.8% of GDP, and in Austria, 8.0% of GDP<sup>1</sup>.

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1 These differences are caused by the system of fiscal federalism, which is characteristic for the individual states. The theory of “fiscal federalism”, exploring the relationships between different levels of budgets, trying to find the optimum degree of fiscal autonomy of individual levels of public budgets, in order to achieve the highest allocation efficiency. Another purpose of the theory of fiscal federalism is to improve the democratic process of decision making on finances in the budgetary system, increase transparency and public and civil control. The theory recognizes centralized, decentralized and mixed models of fiscal federalism. In practice, the most frequently applied is the mixed model. According to an analysis of corruption, corruption is more prone with the centralized model, where local governments are dependent

A significant volume of public spending creates a great temptation for corrupt actors to misuse public funds (Grochová and Otáhal, 2011; Rijckeghem and Weder, 2001). Corruption is perceived as a negative social phenomenon that causes the moral devastation of society and financial losses that can be quantified monetarily as sources that were “diverted” towards the bounty of corrupt actors<sup>2</sup>. Economically speaking, this loss represents a waste of public resources. A waste of public resources by means of such usage of public resources, leads to their wasteful, ineffective, and inefficient use. In the case of corruption, this conduct has the character of a conscious illegal redistribution of public resources towards corrupt actors. The size of this loss can be expressed as the “corrupt differential”.

We understand the corruption differential to be the part of the public resources that are “wasted” because of deliberately wasteful, inefficient, and socially ineffective management. From an economic point of view, the corruption differential represents the social loss. Therefore:

$$KD = VZ - POZ$$

*KD* corruption “differential”

*VZ* actual expended public resources including corruption increases

*POZ* potentially optimal expended resources

The indicator „potentially optimal expended resources” represents a level of resources that is the best possible option with respect to the objectives and the conditions. This means that the allocation of resources meets the criteria of economy, efficiency and effectiveness (3E); the lowest possible cost within the specified targets, while at the appointed time reached the expected quality and quantity of the procured goods and services. POZ above represents a volume of resources for the given circumstances and set goals is not possible to achieve any savings in resource allocation (Bailey, 1995). It’s a case where all the actors meet the “allocation optimization conditions”. They are honest (from a moral standpoint), and are professionally and managerially competent (from

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on subsidies from the center. Conversely, a decentralized model should be more democratic and transparent. It should also achieve greater allocative efficiency (Oates, 1998). Centralization, however, speaks to the opportunities to achieve economies of scale (Matějová, Plaček, Křápek, Půček, Ochrana, 2014). The total volume of public spending, however, depends on the extent of the public services and goods, which the state ensures.

2 To illustrate the size of definite social losses due to corruption, it is possible to use information from the indictment against the former governor of Central Bohemia D. Rath (July 2015), when in court, the total volume of corruption for a rigged procurement was 10% of the value of public procurement which was diverted to the corrupt actors.

a skill standpoint). If any of these conditions are not met, there will be a waste of resources (Ochrana and Půček, 2012).

Corruption present itself as a case of wasting public funds. It is also accompanied by an uneconomical, ineffective, and inefficient handling of resources, but this waste does have its peculiarities, however. This lack of economy, ineffectiveness and inefficiency is deliberate and is accompanied by illicit (illegal) behavior and morally-bankrupt conduct. From an institutional standpoint, it takes the form of individual corruption (Nye, 1967) or systemic corruption (Vanucci, 2009).

The expected result of corrupt conduct is a “planned loss”. Its level is expressed by the corruption differential. The corruption differential is given by the difference between the amount of real (“waste”) expended resources and the amount of resources, where the given allocation of resources corresponds to the optimal allocation. It is generally accepted that the amount of resources actually expended is “planned” by the corrupt actors. They consciously incorporate their expected gains from the corrupt practice into their decision-making practices, and it is from this that we use the term “corruption differential” in the given equation. Detecting corruption and having an effective strategy for eliminating corruption risks can prevent or at least minimize the size of the corruption differential.

## 1.2 Interdisciplinary approaches for the examination of corruption

The problem of corruption is of interest to various scientific disciplines. In this part of the publication, we will try to systemize some approaches on how to investigate corruption. The purpose of this section is not an exhaustive overview of how each discipline of science investigates corruption, nor is it to develop the issue of corruption from the perspectives of all of these approaches. The aim of this part, however, is to create a basis for analyzing the risk of corruption and fraud.

An analysis of the literature shows that corruption is a complex social phenomenon (Caiden and Caiden, 1977; Frič, 2001, 2012). Regarding this, there is no doubt. However, this does beg a series of questions such as what is the cause (s) of this effect, and what factors influence their formation. A number of responses to this problem exist in contemporary literature (Caiden and Caiden, 1977; Klitgaard et al., 2000; Piga, 2011; Person et al., 2013; Mookherjee and Png, 1995; Vanucci, 2009; Volejníková, 2007). Existing views on corruption can be clearly summed up in Figure 1.