

SUMMARY

Government failures, rent-seeking and corruption risks in the Hungarian electricity sector¹

Good governance is a common good, and thus contributes to the welfare of a nation both in the long and the short run. Our research investigates how state regulation in Hungary after the millennium on the special electricity market is intertwined with phenomena described by economic sciences as rent-seeking, corruption and government failure.

Our analysis primarily reconstructs the history of regulations based on two case studies using currently available documents and interviews conducted with participants and experts. One of them is about the so-called “energy market liberalization”, while the other covers the distribution of wind farming quotas. For detailed results we have used socio-economic and economic analysis tools as well as attempted to restore historic events.

Numerous experts, mostly economists, have evaluated the electricity market regulations of the 2004 to 2008 time period in different ways. Analyses of the institutional requirements determining the market’s regulation have however been scarce. Our study attempts to fill this gap.

It is important to point out that this sector is characterized by what economic textbooks call the spiral of silence. Everyone who comes into connection with this field treats corruption in the energy sector as an empirical constant and talks about it only in private settings, but this common knowledge is made specific, the wall of silence is not broken down, and the public does not find out about specific issues and the motives behind them. While this corruption is “common knowledge”, individuals “know nothing”.

We did not aim to investigate the single stories told by our interviewees in detail while reconstructing the studied regulation-related events. Our goal was rather to call attention with the help of these anecdotes to the fact that certain institutional and regulatory conditions determine the behavior of both market players and legislators, that these relations usually encourage rent-seeking and corruption, and lead to government failures not necessarily directly linked to the above. Our purpose was also to point out what economic and welfare consequences are brought on by certain regulatory methods and institutional conditions, and to contribute to breaking the spiral of silence with our tools.

State capture

The analysis on “market opening” reveals that the press debate on government measures revolved around the necessity of the step and the role of the European Union therein. Companies seeking free market, however, were faced with much more practical problems. The success of changing service providers depended in most cases on specifics of the regulation. We will show that the opinion of consumers was largely determined by the practical experiences they had during their attempts to switch to a new service provider, therefore the main reason for consumer disillusionment from the “liberalization” lies within the implemented regulation.

The analysis of the regulation of the energy industry revealed that this case is the phenomenon of state capture well-known from economic literature. Due to the lack of transparency, to openly including

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market players into government decision-making, and to the failure of lobbying in Hungary, the country's electricity market is characterized by great corruption demand closely followed by supply of the same.

According to our estimates, the implemented regulation and the simulation market run by market players provided the central player in producing and distributing electricity, the state-owned Hungarian Power Companies Ltd. (Magyar Villamos Művek Zrt.), with the opportunity to collect approximately HUF 26-38 billion in rent in 2008. The further path of this money is unknown.

The results of the research indicate that the demand and practice of directly influencing and "controlling" the regulation is present on the side of the business circles afflicted by these regulations (rent-seeking lobby groups), and furthermore that this is accepted and encouraged by the regulators, and in certain cases corruption services are forced by them. This can present itself at three points in administration policies: a) in the phase of codification; b) at the administrative debate of decisions; or c) when parliamentary decisions are made.

The wind is not strong enough

Experts studying energy markets predict the dynamic development of renewable energies, including wind energy-based energetics solutions for the next few years. But the incalculability of the regulation and the costly and sometimes lengthy procedure of authorization in Hungary put the initial enthusiasm of investors interested in wind energy to a halt.

We follow the construction process of wind farms from the beginnings through the phases of realization. The relatively high number of approvals necessary for the construction and maintenance of wind turbines leads to the assumed risk of corruption transactions when the regulation-maker sets too tight deadlines for investors to apply for the creation of wind energy capacity.

The research includes regulation on the production of renewable energy beside the existing regulation on wind farms. In order to encourage the production of renewable energy, the regulation-maker focused on enabling renewable energy producers to set a feed-in tariff (kötelező átvételi tarifa, KÁT) higher than the market price.

The demand for corruption is high

The given institutional and regulatory environment – the option and practice of regulatory authority capture observed earlier – produced a significant corruption demand and provided the opportunity to increase rent-seeking in accordance with the lobby interests of those falling under the feed-in tariff scheme, in a way that even technologies that are not categorized as "renewable energy sources" (so-called cogeneration energy production) anywhere else in the world are included by now.

The rate of the latter energy production within the supported circle was approximately 72-74% in 2009, and the rent so acquired by the business groups using such technologies amounted to approximately HUF 50 billion in 2008, and 60 billion in 2009.

This indicates a typical case of rent-seeking, leading to four consequences:

- a) The rent-seeking intent of business groups is increased. Seeing the success of efforts made towards rent-seeking, other business groups attempt to enter this attractive market; and their efforts are not necessarily limited to the production of "renewable energy" or even to the electricity market.
- b) It leads to an increasing corruption supply on the part of the regulatory or the government, thus augmenting corruption risks arising from it. Seeing that it can make legislation encouraging corrupt behavior, the legislator will take the option of corruption into account among other potential benefits.
- c) This will result in the increase of electricity prices already in the short term regardless of market effects, distributing the extra costs up to the extent of the rent among the various consumer groups (including the population, the public sector and the private sector). As these consumer groups are numerous, the extra cost arising from rent-seeking per consumer is low. And this produces a situation complying with the theory: "counter-lobby" groups to moderate rent-seeking are formed with difficulty.

- d) It increases social loss with the appearance of “counter-lobby” groups that appear with some delay (six months, one year) and are organized primarily among companies with great electricity consumption. These are formed in order to minimize or “compensate for” the rents produced by the feed-in tariff scheme. In the second case “compensating” means rent-seeking in other fields (for example employment-related costs). According to the economic theory, successful rent-seeking attitude on one market leads to rent-seeking behavior on other markets.

Thus the method of supporting renewable energy consumption applied in Hungary – within the current Hungarian regulatory and institutional environment – is fundamentally questionable and becomes yet another example of government failure in Hungary.

State regulation

As several areas of the electricity market (network, cross-border transfer capacities, raw materials serving energy production, sites of energy production investments in several cases) are characterized by natural monopolies, it is inevitably necessary to impose a level of state regulation on this market. This market would not be able to efficiently allocate resources without state regulation, it would face market failures.

The electricity market, with its given characteristics, is a favorable field for rent-seeking and corruption. There are few sellers, therefore rent-seeking is profitable for a single player even if the majority of energy production is held by two or three players and only this one displays rent-seeking behavior. There are numerous buyers; there are many players on the buyer side as opposed to the seller side: public institutions, enterprises, members of the public. This alone leads to two things: the losses incurred because of rent-seeking on the buyer side are distributed among a large pool of players who hardly notice this extra cost arising from rent-seeking (a), and it is hard to organize counter-lobbies because of the number of players that could effectively step up against rent-seeking behavior (b).

Favourable field

The average loss per buyer is meager: the extra cost of the price increase brought on by rent-seeking is distributed among numerous consumers (buyers) who do not or only hardly experience this. But so is the case with decision-makers as well who allow this rent-seeking behavior at the end of the day: “This is just pocket change, this decision will only increase the price of electricity by a few cents”. These “few cents” incorporated into the prices will result in large sums of extra profit on the other (seller) side, amounting up to tens or hundreds of billion forints.

A counter-lobby group could step up against rent-seeking and force the redistribution of goods among the competing interest groups according to the social welfare optimum, but can be organized with great difficulty because of the large number of players. Furthermore, the expenses undertaken by organizers are almost always higher than the advantages achievable by them.

Information asymmetry

Even though electricity is a homogenous product, the technology and distribution of energy production consist of complex processes. Furthermore, electric energy cannot be stored without the use of expensive technologies. The existence of these complicated requirements and procedures leads to an unusually unbalanced information asymmetry between electricity producers, electricity system maintenance players, operators, decision-makers in electricity production and system development, and the consumers who are afflicted by the decisions at the end of the day.

As the creation and maintenance of information asymmetry is a basic need of all rent-seeking lobby groups, the electricity market where technological characteristics directly contribute to information asymmetry is explicitly favorable for rent-seeking.

When it comes to maximizing corruption-related rent, the electricity market may be more attractive for a corrupt politician or office-holder as single regulation decisions influence the distribution of huge amounts. It is more profitable to offer corruption services on this market than on other ones.

Small risk

The risk of detection of corruption is also lower on the energy market and on the electricity market within for two reasons.

The existence of rent-seeking lobby groups and their obvious activities predictable for the future are guarantees that these groups, as parties involved in the corruption on the buyer side, will not reveal the issue. And the parties involved in the corruption meet on a regular basis, building close, often personal relationships, thus the transaction costs of preparing corruption transactions are minimal.

On the other hand, great information asymmetry provides very little risk of detection, and the opportunity of “cheap” corruption. Only a few have all information necessary to comprehend decisions and those who bear this knowledge are among the corrupt decision-makers, or paid experts for lobby groups, or administration experts who remain silent in their own well-perceived interest. Obtaining such specific information for an unprofessional is a relatively big investment, thus there are few who attempt it. This is where the cycle closes.

Common knowledge

The electricity market regulation in Hungary in the period between 2003 and 2009 was characterized by the lack of a comprehensive and consistent government strategy. According to the results of the research study, this observation is a general experience, common knowledge among the market players.

The ambiguous institutional and regulatory environment directly diminishes social welfare by discouraging some of the potential investors and by making electricity market investments more expensive.

All this makes it more difficult to detect rent-seeking and to organize counter-lobbies.

Secrecy

One of the requirements for actions against rent-seeking and corruption is that the analyses and calculations government decisions are based on should be made public (if such analyses exist at all), and that the data on the impacts and consequences of government decisions should be accessible and analyzable. Our research revealed that the requirement of publicity of data and background analyses normally classified as common good has not been fulfilled in several cases in electricity market regulations in Hungary.

The government has not made sufficient efforts to collect data that can measure the expected or actual impacts of its decisions on specific groups of the market players, or, if it possesses such data, the publicity of these is not guaranteed.

Lack of transparency

The processes of legislation and regulation concerning the electricity market are done along predefined procedures that are not transparent to external observers and often not even to employees of the institutions partaking in the regulation. It has happened more than once that a government institution deliberately excluded another afflicted administrative body in the preparation of a decision concerning the energy market despite its legal obligations because the latter would have probably expressed its opposition to the given decision.

Those preparing decisions are always pressured by the time during the process of legislation and regulation making, and therefore often use ad hoc solutions. Risks of corruption are increased when the process of legislation is unpredictable for those involved in it, or when uncertainty about the realization of expert reconciliation is a basic characteristic of the preparation of the regulation.

The government pretends that there are no corruption risks related to legislation in Hungary. Failing to assess these risks can have a stronger effect on the electricity market than on other ones as risks of corruption are generally higher on this market.

Responsibilities of the legislation

Corruption risks must be taken into account also on the level of legislation, as shown by our research. It is not our task to investigate actual and possible cases, but we must point out that certain institutional and regulatory conditions determine the behavior of market players and legislators as well, allowing for corruption transactions. The general characteristics of the energy market, the great supplier concentration of the Hungarian market, the uncertainty created by Hungarian regulation and government attitude, and the implemented legislation methods all point to the fact that lobby groups and allocation coalitions can play an important role in determining the laws, rules and procedures afflicting them, and that their such activities meet the expectations of a part of the legislators.

Rent-seeking and corruption are not independent from each other, but strengthen each other and are closely interrelated. If rent-seeking lobbies “make the legislation” the legislator politician has a basis to request something. And the size of the rent makes it possible for this politician to forward a significant corruption rent to fellow corrupt politicians and his/her party.

Encoded government failures

The law on legislation in effect during the research (2003 to 2009) and on the present day (Act No. 11/1987 on Legislation) is completely unable as a legislative framework to contribute to a rational economic governance increasing social welfare. It is not only obsolete in the legal and constitutional senses – the realization of which led the Constitutional Court of Hungary to abate it from December 31, 2010 – but also when it comes to efficient governance.

No preliminary impact analyses have been performed or commissioned by the government in basic cases, and no impact analyses were carried out after the implementation of the regulation investigating the actual reactions of market players and the economic effects of the regulation.

This fact and the discovered methods of market regulation and the standard procedures of legislation contributed to the government increasing the opportunity of rent-seeking and corruption along the above detailed factors as well as determined and even encoded government failures in regulation decisions independently from those factors.