How does the Kleptocratic State Work in Hungary?

A research note based on Hungarian public procurement data

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Abstract

In this research note, we use the public procurement database built by CRCB, which contains data from more than 200,000 public tenders from 1997 to 2017. The analysis is based on data from 126,330 public procurement contracts from 2010 to 2016. The focus of the analysis is public tenders (without framework agreements) won by companies related to cronies and family members of Hungarian Prime Minister Viktor Orbán: Lőrincz Mészáros, István Garancsi, István Tiborcz and Lajos Simicska (we will refer to this group with the abbreviation MGTS). During the analysis, we make a statistical comparison of the strength of price competition among tenders won by crony companies and that among tenders won by other, ordinary Hungarian firms. We use an indicator (the relative price drop, RPRD) to measure price competition, RPRD being the difference between the estimated value and the contract value divided by the contract value and multiplied by 100. RPRD thus characterizes the price competition for a public tender: a higher value indicates more intense competition, a lower magnitude of overpricing and thereby a lower rate of corruption rents, while a lower value shows a lower intensity of competition and higher level of corruption risks. Our results point out the existence of political favouritism in Hungarian public procurement during the period under examination. The median RPRD values of tenders won by MGST firms are very close to the median value of tenders with the highest corruption risks and lowest intensity of competition.

Keywords: corruption, kleptocracy, public procurement, empirical analysis, big data, Hungary

Introduction

The kleptocratic state has been developing and operating in Hungary since 2010. This can be considered as an extreme case of cronyism, when the resources of the country are no longer distributed to cronies selected by the political leader; instead, political leaders, their fronts and their families become the beneficiaries par excellence. The state then becomes an extortionary state or a kleptocratic state (Rose-Ackerman, 1999). In such cases, the political leader treats companies in the private sector as his own; if he sees a very successful company, he raises the possibility of 'getting involved' – by forcing the owner to pass on their stake (http://bit.ly/2nu2PMq). In extreme cases, tax revenues are spent indirectly for the political leader's own amusement (e.g. the construction of football stadiums, http://bit.ly/2qXYSnx), or he or his friends indirectly acquire shares in state-owned companies, whose profits are then channelled into his family's businesses. Sometimes, he assists by introducing a law that enables become rich his close friends and family members (Rijkers et al., 2014, Nucifora et al., 2015, http://bit.ly/2Eavtfe, Magyar and Vásárhelyi, 2017, http://bit.ly/1q8oGXQ: 75-82). Public procurement is another commonly used channel for transferring tax revenues to family members and/or cronies (Søreide, 2006, Piga, 2011, Gürakar and Bircan, 2016). The functioning of cronyism has mostly been analysed using examples from Africa, Asia and South America (http://hvr.co/1pOI0tY; http://bit.ly/2aLilPP; http://bit.ly/2aLk9s4; http://bit.ly/2b3dmbS; Kang, 2002). We will discuss it briefly through the case of Hungary. In the analysis we use a methodology developed by us which is based on objective indicators to detect corrupt behaviour of actors of public procurement (Fazekas, et al. 2016, Fazekas and Toth, 2016; Fazekas and Toth, 2017, Toth and Hajdu, 2017)[1].

Data

We use the public procurement database built by the CRCB and take into consideration procurement between 2010 and 2016; the following analysis is based on data from 126,330 public procurement contracts. The focus of the analysis is public procurement (not including framework agreements) won by companies tied to cronies and family members of Hungarian Prime Minister Viktor Orbán: Lőrincz Mészáros, István Garancsi, István Tiborcz and Lajos Simicska (we will refer to this group with the abbreviation MGTS, see the Annex for more detailed information). During the period under examination, they won 510 contracts and Hungarian public institutions spent $49.3 billion on public procurement, of which MGTS companies received $2.5 billion, thus accounting for 5.1% of the total value of public procurement. Between 2010 and 2016, this percentage significantly changed by year (see Table 1).

Table 1. The share of the value of procurement won by MGTS companies of the total value of public procurement, 2010–2016, N=126,330

	%
2010	0.8
2011	1.6
2012	3.4
2013	11.8
2014	5.6
2015	4.8
2016	1.3

Note: tenders without framework agreements
Source: CRCB

Strength of price competition

To measure the strength of price competition, we compare the estimated value of contracts with the final contract value. The estimated value is determined by the issuer and indicates the highest price that was estimated based on a market analysis for a particular product, and sometimes it could also signal how much money was available to implement the project. First, we calculated the difference between the estimated value and the final contract value, then we divided it by the contract value, and finally we multiplied these results by 100. We can thereby analyse the percentage rate of decline in the estimated value as a percentage, the relative price drop (RPRD). We calculate it in the following way:

$$RPRD = \frac{(P^* - P)}{P} * 100$$

if $P^* > P$ and RPRD < 100

(cases in which RPRD≥100 were excluded from the calculations because we assume that they are affected by data inconsistencies)

where P^* is the estimated net value and P is the net contract value.

The P^* (the estimated net value) is determined by experts for the issuers. If they act in accordance with Hungarian regulations, they indicate the maximum market price known to them or the value obtained based on preliminary market research, or, if they do not follow the official rules, it simply corresponds to how much funding is available for the project or how much money they could negotiate with ministries or state institutions that deal with managing EU funds. P is the net price given by the successful tenderer (the net contract price). If RPRD=0 or its value is close to zero, then this means that the public procurement contract was basically concluded at the estimated value. This happens when the final winner knew the estimated value in advance, and he was informed in advance that there would be no competition or that the 'competing' companies were predictably 'loser companies': they had only submitted a tender to cover for the crony company.[2] It is the issuer or predetermined winner that arranges for the 'loser companies' to submit a tender.

According to an internationally accepted interpretation, if contract prices are close to the estimated value, then this should be interpreted as a 'red flag', a sign of possible corruption (http://bit.ly/2n1shZp).

The RPRD thus characterizes the price competition for a single public procurement: the higher value indicates more intense competition and cheaper public procurement, a lower magnitude of overpricing and thereby a lower rate of corruption rents (http://bit.ly/2prJVsW), and the lower value shows the higher level of corruption risks and lower level of intensity of competition. During the period under examination, MGTS companies concluded 330 construction contracts as individual tenderers or consortium members with a total value of

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[2]In the Hungarian corruption jargon, the actors call this cover company a 'loser company' or 'loser bidder'. The regular request made to a company manager by a corrupt issuer is as follows: 'Then it's a deal. Your company will be the winner, but please bring two bidders so they can be the losers.'

Ft564 billion, which amounted to 9.6% of the total value of all construction contracts, excluding framework agreements.

Results

Figure 1 compares the RPRD values in construction contracts won by MGTS companies, two multinational companies (Strabag and Swietelsky) and simple (non-crony) Hungarian companies between 2010 and 2016 (a total of 20,740 contracts). The figure shows the median values of the relative price drop (RPRD) in the different groups of tenders. The ideal case is public procurement with zero corruption risks and strong competition (at least six competitors; 1,182 such tenders were found): in such cases, the median price drop was 21%. Thus, in the case of public procurement conducted within ideal circumstances – with strong market competition – contract prices are typically 21% lower than the estimated value. In such cases, there is no social loss as public procurement prices are set after strong market competition and a minimum risk of corruption. Under less stringent conditions (at least four bidders and less than the maximum risks of corruption), the median price drop was 8.4% (5,032 such tenders were found). The other extreme case is when there was no competition (only one bidder submitted an offer) and the corruption risks reached the highest possible level (we measure this with a corruption risk indicator, which has a minimum value of zero and a maximum value of one). In such cases (533 tenders), the final contract prices practically matched the price previously estimated by the contracting authority. Prices did not fall because the winner, the crony, understood there would be no competition, knew in advance that he was guaranteed to win, and thus indicated the estimated value as the bid price. Thereby, the social loss is maximized: contract prices contain huge corruption rents as they have been set without competition. Values related to the other three groups of tenders speak for themselves: if Strabag or Swietelsky (two Austrian owned construction companies[3]) won alone, then the price drop was the closest to tenders with strong market competition (5.8%). By contrast, in the case of public procurement won by MGTS companies, the contract prices practically equalled the estimated value. These tenders (107 such tenders) were characterized by a 0.5% price drop rate. Therefore, as with tenders with high corruption risks and no competition, prices for tenders won by MGTS companies exceeded real market prices and thereby resulted in a maximum social loss.

What does this say about the future of the Hungarian economy? In the short term, the development and operation of cronyism may have no noticeable effects on the competitiveness of an economy. However, in the medium and long run, there will be severe consequences. Both theoretical and empirical economic research concludes that cronyism, fuelled by rent-seeking, can ultimately only gain ground through the destruction of the market economy, and, in the meantime, it results in a less efficient allocation of resources. Societies based on rent-seeking and corruption become uncompetitive and fall behind developed

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[3] See: http://bit.ly/2BvnlUz and http://bit.ly/2EtBOiN

market economies in the long term (see http://bit.ly/2C1apGV and Acemoglu and Robinson, 2012).

Figure 1. The median value of the relative price drop (RPRD) in tenders won by different groups of winners, construction tenders, 2010–2016, N=20,740
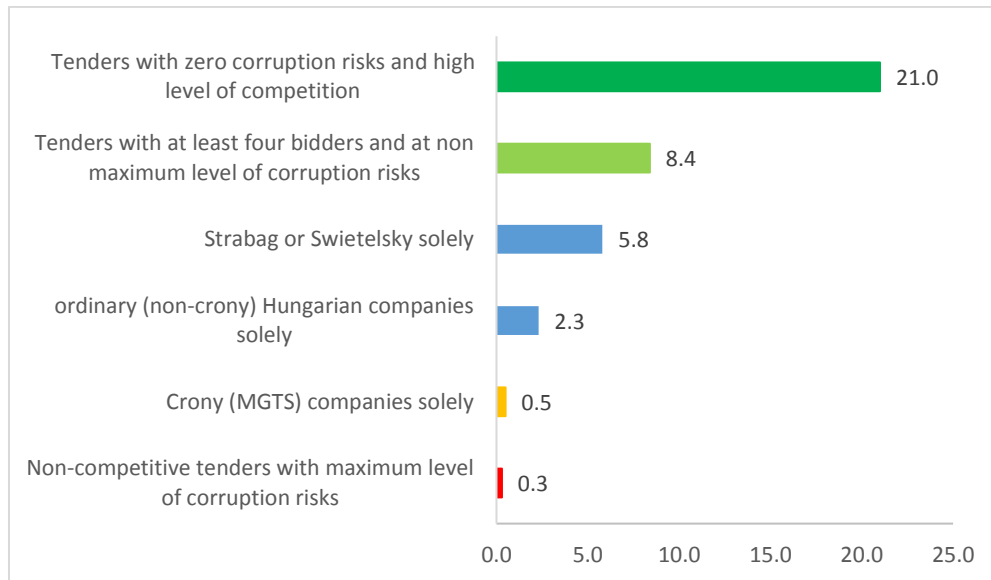
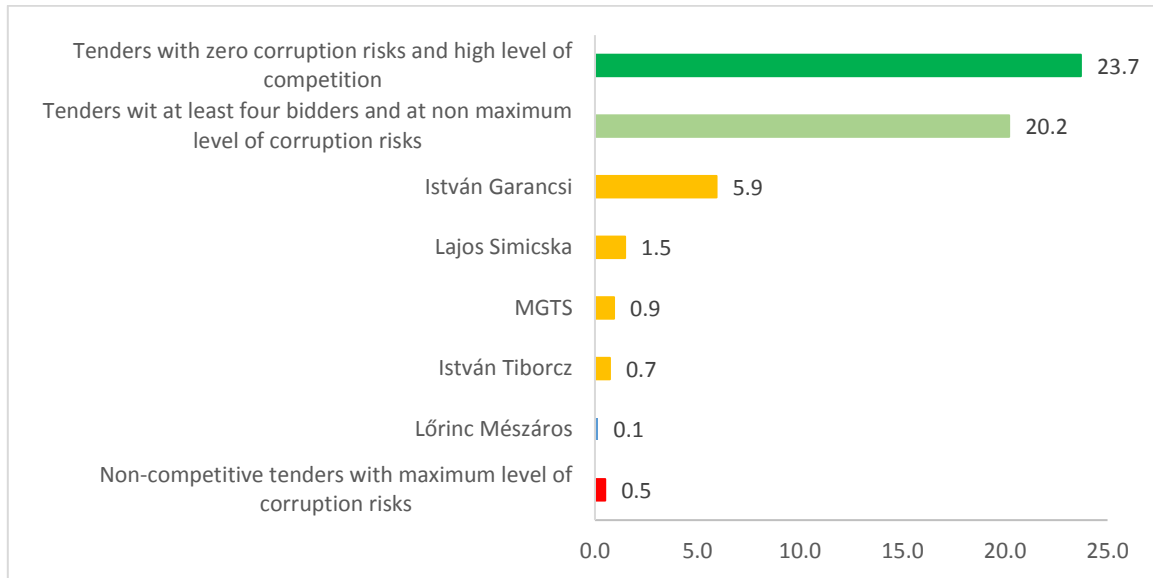*Source: CRCB, tenders without framework agreements and only for contracts with RPRD≥0*

The OLAF's investigation into Viktor Orban's son-in-law

According to an article in The Wall Street Journal from 12th January 2018 (http://on.wsj.com/2FyEIDI), the European Union's antifraud office (OLAF) discovered 'serious irregularities' in projects carried out by Elios Innovative S.A. in 2015–2016. At that time, that company was owned by István Tiborcz, Hungarian Prime Minister Viktor Orbán's son-in-law. Tiborcz is one of the most important figures in Hungary's new emerging elite (http://on.ft.com/2BSL2qp). The case of Elios was discovered first and analysed in depth by the Hungarian investigative portal Direkt36 (http://bit.ly/2D86NDA, http://bit.ly/2FbIYI7 and http://bit.ly/2rEaaNW).

As economic researchers engaged in analysing corrupt behaviour among the actors in public procurement and in measuring corruption risks and the intensity of competition in public tenders, we can contribute important information toward full disclosure of this case. Using one of our proposed indicators that we developed to measure the level of competition, we calculated the relative price drop (RPRD) in tenders won by every member of the MGTS group. We used a total of 69,010 tenders, including 253 tenders won by MGTS firms, for this analysis. Thus, we calculated this indicator separately for tenders won by Mészáros, Garancsi, Tiborcz and Simicska (see Figure 2).

In this figure, we can see that while the median RPRD value was 0.9% for tenders won by companies in the MGTS group in 2010–2016, the median RPRD value was 5.9% for tenders won by business organisations owned by István Garancsi (18 tenders), 1.4% for tenders won by Lajos Simicska's businesses (146 tenders), only 0.1% (!) for tenders won by Lőrinc Mészáros' firms (26 tenders), and, finally, only 0.7% (!) for tenders won by Istvan Tiborcz's concerns (63 tenders). We must add another important result: with the calculation by the CRCB, the value of the RPRD was 27.4% for tenders with a minimum level of corruption risks and a high level of competition (these are tenders with more than six bidders), while it was only 0.5% (!) for non-competitive tenders with a maximum level of corruption risks. These results may provide information on the possible magnitude of rent created by corruption as well.

Figure 2. The median value of the relative price drop (RPRD) by intensity of competition and in tenders won by companies owned by members of the MGST group, 2010–2016, N=69,010, %

Source: CRCB, tenders without framework agreements, where RPRD≥0

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Annex

The players: members of the MGTS group

Lőrinc Mészáros

A close childhood friend of the Hungarian Prime Minister; a gas fitter; the mayor of Felcsút (the village where Viktor Orbán spent his childhood). A Hungarian billionaire since 2013 (http://bit.ly/1nKficQ). Many experts assume that he serves as a front (straw man) for Viktor Orban's business dealings (http://on.ft.com/2BSL2qp and http://bit.ly/2Dy7R09). While he was an ordinary citizen without any considerable wealth in 2009, according to estimates by Forbes Hungary in 2017, his wealth had reached $392 million (http://bit.ly/2DBEeLq, http://bit.ly/2DAnk05, http://bit.ly/2E7pEMZ and http://bit.ly/2GeKF97).

Istvan Garancsi

Hungarian businessman, owner of the Videoton FC football team, president of the Hungarian Association of Hikers; close friend of Viktor Orbán's (http://bit.ly/2DIKt3p). Many assume that he serves as a front for Viktor Orban's business dealings (http://bit.ly/2DMIprv and http://bit.ly/2Bs57jc).

István Tiborcz

Hungarian lawyer and businessman; son-in-law of Viktor Orbán, Hungary's prime minister (http://bit.ly/2DxhgoN).

Lajos Simicska

Hungarian businessman, owner of Hungarian TV news channel *Hír TV* and one of Hungary's leading dailies, *Magyar Nemzet*; Hungary's 11th richest person estimated by napi.hu on its list of the 100 richest Hungarians; Viktor Orbán's dormitory roommate. Later, he held several positions: Fidesz treasurer, President of the Hungarian Tax Office, and general manager and CEO of Mahir, one of the market leaders in advertising in Hungary. He fell out with Viktor Orbán on 6th February 2015 (http://politi.co/2rBxFap and http://bit.ly/2dY2TA4).