Policy failure and the advent of organized crime in post-socialist Hungary

How the state subsidy of domestic heating oil resulted in organised criminal network formation[1]

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Abstract

The paper analyzes the 1990-1995 price fixing scheme of domestic heating oil in relation to the governance functions of providing welfare and legitimacy in the newly established Hungarian democracy. The case provides a unique opportunity to explore a policy 'disaster' which aimed at increasing welfare of an increasingly poor section of the Hungarian society, but finally contributed to the strengthening of organized crime. Given the elusive nature of the topic the research is mainly based on police reports, court rulings, newspaper articles, and less on academic sources. The main findings suggest that the policy was reasonable from a welfare perspective, though not the best among the available policy options; however, from a legitimacy angle it weakened input and output legitimacy alike. Given the apparent failure of the policy together with its adverse side effects, it is still open to discussion why abolishment was avoided for almost 5 years.

Introduction

The move from state socialism to liberal democracy was accompanied by a number of policy failures and 'disasters' in Hungary at the end of the 80's and the beginning of the 90's. Usually, the majority of government measures are analysed through narrow lenses: economic policies in the light of economic changes, welfare policies in terms of social equity, equality, etc. However, this paper takes a broad look at a unique case in which an ill-targeted welfare policy significantly altered the development of Hungarian organized crime, contributed to weakening the legitimacy of the newly established Hungarian democracy, and potentially allowed for forming ties between the political elite and organised criminal networks.

The issue at a glance contributes to the understanding of most recent political debates in Hungary since it still shapes the level of popular trust in the government and political elite. On the level of accusations and ongoing trials virtually every influential party is involved. Even in summer 2007, a journalist – Irén Kármán – was beaten up by criminals (Karancsi 2007) admittedly because she investigated crimes

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in connection with 'oil-bleaching'[2]. As a response to growing public pressure the government established a working group in 2007 to examine the confidential documents of the original investigations of the early 1990's. This resulted in partial disclosure of the files[3]. Furthermore, by analyzing the government's actions in the first few years after the transformation, governance functions and their interconnections can be understood from a unique angle.

The following analysis concentrates on the governance functions of welfare provision and democratic legitimacy. More precisely, the paper focuses on the price fixing scheme of domestic heating oil (DHO) between 1990 and 1995 and its consequences.[4] And it intends to answer the question:

> *How did the price fixing policy affect the welfare function and the legitimacy of the Hungarian state*?

The links between the policy and the governance functions are evaluated according to 5 criteria – 3 of these are welfare related:

1) the relevance of the policy problem within the domain of welfare and social policies;
2) the appropriateness of the government objectives given the problem definition;
3) the efficiency of the intervention tool designed to achieve the proposed objectives (Varian 1999, Cullis-Jones 1998, Stiglitz 1988);

and 2 are legitimacy related:

4) acceptance created by democratic procedures, i.e. input legitimacy; and
5) the acceptance created by effectiveness of government intervention, i.e. output legitimacy (Zürn 2000; Scharpf 1997).

Furthermore, a straightforward follow-up problem is briefly discussed due to its complexity: why and how could a policy obviously causing severe side effects be in force for so long? Was it because private interests overrode the public good? Did the lack of administrative capacity of the state cause a four-year lag in effective response?

Given the elusive nature of the results and causes of the policy, the investigation must be based on a wide set of sources which range from court rulings, police reports to newspaper articles and official statistics. To be sure, the reliability,

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[2] The Hungarian media named this whole issue 'oil-bleaching' referring to the technique through which criminal groups transformed DHO into diesel oil used in motor vehicles.

[3] The files were accessible on the homepage of the national police (http://www.police.hu/kozadat/nyilv_dok/olajugyek01) for 3 months. After this short timeframe the files were removed from the internet.

[4] The price of DHO was fixed from the early 1970's, but the opportunity of misuse arose when private companies were granted the right to import oil products (year 1990. XXII. law 54.§). The government statute: 64/1990. (X. 9.) defined the legal purposes of use for DHO, thus declared the legal framework for importing diesel oil and reselling it as DHO.

precision and coherence of the data is problematic in some cases which is specifically highlighted at the relevant places.

In order to evaluate the price fixing scheme of DHO and its consequences, first, a brief description of the economic, social and political circumstances of the early 90's in Hungary must be outlined with particular focus on the population segments affected by the policy. Second, after a detailed description of the policy, it can be evaluated. Finally, conclusions and suggestions for further research are discussed.

Background

Hungary after the Transition

After the transition of 1989, Hungary found itself in *a series of crises in the economic, social and political spheres*, just like the other Central and Eastern European post-socialist countries (Crane 1991, Hare 1991, Pogany 1993, Svejnar 2002, Elster et al 1998). Unlike, for instance, the Polish transition, the process in Hungary was largely administered by the old political elite (Bihari 2005, Bozóki 2002); this characteristic defined the political landscape of the country for decades but also secured a peaceful democratisation. The Hungarian population before and after 1989, associated democracy with prosperity and high living standards, meaning that it saw the transition not only as a political change but also as a substantial improvement in living standards (Ferge 1995). This established a strong link between democracy and capitalism, thus between welfare and legitimacy.

Between 1990 and 1994 Hungary fell into a deep recession, virtually every main economic and social indicator worsened. The country lost 12,6% of its *overall GDP* within 4 years, the economic output reached its pre-transition level only in 1999 (www.ksh.hu). This steep downturn was unexpected for observers from developed democracies' and transition countries alike, and was largely due to difficulties in restructuring the economy and the low initial competitiveness of the domestic production sector compared to international standards.

Falling GDP was mirrored by rising *unemployment* reaching as high as 13% in the early 90's (www.ksh.hu) and falling activity rate which caused serious social tension and an increased need for a strong welfare state. As a result of decreasing employment and falling GDP per capita, *living standards fell* for the biggest part of the population. The greater availability of western brands and a wider variety of consumption goods strengthened the perception of falling standards of living.

The transition created 'winners' and 'losers' between whom disparities have increased compared with the socialist era (Atkinson-Mickleright 1992, Materju 1995). The newly established societal divides became deeper than that of the socialist times implying that those on the bottom of the society had almost no chance for moving upwards – in particular the Roma minority and people living in the countryside lost prospects.

Democracy and political institutions were weak in the early 90's, voter turnout rates varied from 45% to 65% (http://valtor.valasztas.hu/valtort/jsp/) and nostalgia for the socialist regime remained strong throughout the whole decade. For instance, in 1995 an absolute majority (51%) of the population considered socialism as a better system than the new one which is striking – particularly when compared with popular opinion in the Czech Republic and East Germany (Ferge 1995). In line with the widespread nostalgia, a strong preference for state paternalism prevailed in the population. However, this need was difficult to meet because the state aimed at liberalisation and downsizing itself due to economic problems and liberal economic ideology.

To sum up, in the early 90's the population faced socio-economic problems, thus falling real incomes. This, accompanied by strong preferences for state paternalism, created widespread expectations for welfare policies. These policies served not only as a remedy to societal tensions but also as a source of legitimacy since capitalism and democracy was strongly associated with prosperity and wealth (Ferge 1995).

The Subsidy Scheme for Consumers of Domestic Heating Oil

Due to the worsening economic and social circumstances discussed above, a substantial portion of the Hungarian population had problems with purchasing even the most essential goods and services. One of the most pressing problems was the increasing price of various oil products among which DHO was a crucial one for it was the heating resource for many poor households. The DHO policy was launched in order to help families in such need, although its roots go back as early as the 70's.

The price of DHO was regulated by the government from the early 1970's meaning that the importers of such oil product[5] and the end-consumers could acquire it at a relatively low price which was increased by the government only occasionally in small increments (Parliamentary Committee on Examining Corruption in Relation to Oil Manipulation and Organized Crime 2000). This price-system remained in place until 1995. However, the opportunity of earning profit illegally had arisen when the monopoly of oil-import was abolished and private companies were granted the right to import oil products in 1991 (1990. XXII.Law 54.§).

The opportunity of arbitrage stemmed from the fact that the diesel oil and DHO were physically the same except for one element which could be relatively easily removed. The interesting momentum was that this element was added to the imported diesel oil at the custom-house as part of the product categorization process. The government recognized the possibility of selling DHO as diesel oil so it obliged custom-houses to add a colourful, distinguishing element to imported diesel oil resold as DHO to prevent misuse.[6] The scope of earning profit illegally depended on the

[5] Hungary had to and still has to import virtually every type of oil products since the country is poor in oil resources.

[6] There were already cases of diesel oil and DHO misuse in the late 80's, thus the pre-transition Hungarian government already had 'experience' with the issue.

price differential of the two products. Throughout the period in question the price of DHO was significantly lower than the price of diesel oil, for example in January 1990 DHO cost 9,20 Forint/litre whereas diesel oil was valued at 13,30 Forint/litre. The price differential increased over time; at its peak it reached 44 Forints – 138% of the price of DHO (Élet és Irodalom 2000).

Thus, criminal groups could import DHO at a low price and remove the added element through a chemical process which could be organized with a little scientific expertise.[7] The complexity of the whole operation ranging from importing, through 'bleaching' to illegal transporting required some level of organization which, together with unbelievable profit opportunities, motivated criminal groups to organize themselves and institutionalize their activities to secure the regular functioning of 'business'.

Another possibility of criminal action was to bribe customs officers before they added the distinguishing element to the imported diesel oil. By doing so, the imported product was categorized as DHO, thus could be purchased at a lower price. However, there was no need for chemical removal of the added element. This was also a frequently used technique.

To sum up, the *criminal groups* were motivated by the opportunity of arbitrage stemming from the price differential between two types of oil products whose physical properties were almost identical. At the same time, the *Hungarian government* – officially – intended to help poor households amidst turbulent economic and social changes by holding the price of DHO significantly below its market price. This scheme obviously benefited the *target population* – the rationale behind the policy. Furthermore, *agents of the state*, such as customs officers, were actively involved in the implementation of the policy, and therefore, perhaps in these criminal organizations. For without collaboration, surely such widespread illegal activity could not go undetected.

Evaluation of the policy

Evaluation Criteria

Five criteria – three welfare and two legitimacy based – will be used to analyze the case at hand. *Welfare* as a governance function evolved in response to the challenges of industrialization and the consequent falling apart of traditional social structures (Rimlinger 1971). Although the development of welfare state followed a somewhat unique path in the Austro-Hungarian Monarchy it resembles the general model up until the early 20th century. After the Second World War Hungary followed

[7] It must be noted that the process of removal was not perfect most of the times, thus weaker car engines were damaged by the bad quality diesel oil to a considerable extent. Many car producers considered pulling out of Hungary due to the chaotic diesel oil situation – even Shell announced the company was leaving the market because of corrupt market conditions. (Élet és Irodalom 2000)

the USSR model which meant widespread socialization and expansion of state provision to virtually every sphere of social and economic life (Kornai 1992).

Although Hungary faced the transformation of 1989-1990 with a significantly different type of welfare state than the western democracies, the welfare criteria developed on democratic and capitalist experiences are the most relevant for the purposes of the paper. The reason is that throughout the transformation and particularly after it the underlying economic, social and political goals by and large resembled that of western liberal democracies (Elster et al 1998).

From the welfare point of view, first, the relevance of the problem will be discussed within the domain of welfare and social policies, implying a comparison between competing problems as orchestrated in the political debate (Werner-Wegrich 2006). Second, the policy will be evaluated on the basis of the appropriateness of the government objectives given the problem definition. And, third, the efficiency of the chosen intervention tool will be appraised, though efficiency is a complicated and ambiguous concept particularly in the welfare domain. The analysis will be aided by the principles and findings of modern welfare economics (Varian 1999, Cullis-Jones 1998, Stiglitz 1988).

Legitimacy of democratic capitalism rests on the balance between market mechanisms and social protection (Moravcsik 2002 refers to Polanyi 1944 and Schumpeter 1942). These two dimensions are often in conflict with each other so that democratic institutions must secure a generally accepted compromise. In Hungary the transition itself was initiated partially by welfare considerations, namely stagnating living standards and unsustainable economic growth. Moreover, the economic depression of the early 90's disappointed a substantial part of the population in their expectations (Ferge 1995). Thus, the legitimacy of the freshly established system relied upon the capability of creating and dissipating wealth amongst the people as highlighted above.

Accordingly, in the analysis two criteria of evaluation must be applied. On the one hand, acceptance created by democratic institutions and procedures will be discussed, constituting the concept of *input legitimacy* (Zürn 2000; Scharpf 1997). On the other hand, acceptance created by effectiveness, that is, delivered output or *output legitimacy* (Zürn 2000; Scharpf 1997), will be used in the evaluation.

Findings

1) In terms of the **relevance of the policy problem**, it is reasonable to design a policy to support those who are too poor to have sufficient means to heat their houses, particularly because the transition worsened the living conditions and decreased the income of the poorest households. Therefore, these households became excluded from the labour market around 1990. Accordingly, these people probably suffered the most from the fall of socialism. Even though no systematic comparison of competing welfare related problems was carried out before the policy was formulated, it is plausible that devoting considerable government attention and public resources to improving the living standards of the poorest is

justifiable particularly in severe economic and social circumstances. Thus, the policy appears to be appropriate according to the first welfare criteria.

2) **The government's objective** was to support the heating of poor households, though acquiring a number of other basic services and goods was also a serious problem in these households. Again, the systematic appraisal of policy aims was missing,[8] meaning that the justification of the policy was intuitive, based on the notion that heating is an essential element of the minimally acceptable living conditions and one of poor households' major costs. However, from the point of view of welfare economics (Varian 1999, Cullis-Jones 1998, Stiglitz 1988) the policy choice is problematic since it (i) interferes with the internal decision-structure of households, and (ii) it distorts the price system on which decisions are based. Furthermore, the targeting is inaccurate because not every poor household heats with heating oil; this implies that, those who used this type of heating were privileged over those who did not; but clearly the type of heating system should not be a basis for welfare policies. The latter should be based on need. Nevertheless, this policy had the inevitable advantage that it was relatively easy to administer. This was crucial for the government which was under severe pressure to modernize in virtually all spheres of government intervention (Elster et al 1998). Thus, the policy seems to be questionable according to the second welfare criteria because of its unjustified differentiation within the neediest of societal groups.
3) The **effectiveness of the intervention tool** for decreasing heating costs for poor households has never been systematically evaluated. However, one can argue that a price fixing scheme is (i) costly in terms of price distortions, and (ii) backward oriented since heating costs can be effectively decreased in the short term by modernizing heating systems. Furthermore, any sort of price fixing scheme necessarily distorts the overall price system, thus affecting the decisions of individual households. This, in principle, leads to socially desirable outcomes (Varian 1999, Cullis-Jones 1998, Stiglitz 1988). The latter argument is identical to the one concerning the choice of policy aim and is the direct the result of that choice.

In order to understand the effects of the policy on democratic legitimacy, first, the *behaviour of criminal groups* and the exact methods of criminal action must be described in greater detail. Between 1990 and 1995 criminal groups achieved a revenue[9] between 100 and 1000 billion Forint in 1995 terms (Index 2007), that is,

[8] The Hungarian policy-making mechanisms followed a somewhat chaotic, ad hoc manner in the early 1990's because a number of serious and imminent reforms arose at the same time and because public administration did not have sufficient experience in policy-making among the new, democratic circumstances (Elster et al 1998). Obviously many other explanations of the then prevailing policy-making techniques can be elaborated.

[9] Our calculations did not take into account the cost of doing the 'oil-business', meaning the cost of importing oil, transforming and transporting it. Data was not possible to acquire; in addition, it is conceptually unclear whether money spent on bribing public officials and building up extensive criminal networks is a running cost of a criminal organization or it is an investment in the organization itself.

between 16 and 160 million Euro in 2008 terms. This huge amount of profit came partially from the price differential between DHO and diesel oil and partially from the lower tax rate of DHO compared to diesel oil. Accordingly, the amount of DHO sold each month was slightly below 1 million litres at peak times, whereas this amount dropped to a few thousand litres per month right after the price fixing scheme was abolished. In order to move and refine this amount of material secretly, a considerable proportion of border-guards, customs officials, railwaymen and policemen were most probably involved and/or bribed (Index 2007; ONS 2008).

Given the methods and scope of 'oil-bleaching' as described above, it is logical to question whether the issue at hand could cause a significant damage to the *legitimacy of the state* and the new political system. Democratic legitimacy, thus trust in democratic institutions, like customs authorities, police, courts and even political parties might have been weakened because the majority of the population believed and still believes that they were involved in illegal activities.[10] Furthermore, there are still ongoing court trials against key politicians of the early 90's who are still members of parliament today. For example, the first Minister of Home Affairs is accused of corruption and involvement in the 'oil-business' (Index 2000). The inconclusive court cases have not prevented citizens from accusing the political elite of corruption (Index 2007). Also, the slow proceeding of the trials typically strengthens the popular view that there are a 'lot of dubious actions behind the scenes', and that 'politicians can get away with impunity'. As the only criminals convicted of involvement in 'oil-bleaching' were small players, and committed petty crimes, the public is critical towards the impeccability of courts.

4) It is difficult to explain how an obviously ill-targeted policy which produced a number of adverse side effects could avoid being abolished for almost 5 years. Already in the first year of the policy's implementation, it was clear that organized criminal groups took advantage of the policy and damaged the state budget (ONS 2008). Thus, the minimal government response to claims by the public can be called into question.[11] All these factors imply that *input legitimacy*, the acceptance created by democratic procedures was seriously weakened. Taken into account that the democratic procedures themselves were fragile in the early 1990's one may conclude that the adverse effects of the policy were one among the number of legitimacy problems of the then newly established Hungarian democracy. These problems amplified each other.
5) *Output legitimacy* can be understood in an indirect manner: the tax avoidance created by 'oil-bleaching' and the corruption injected into the various spheres of state bureaucracy necessarily decreased the ability of the state to act effectively. This implies that the slow response of the government indirectly decreased the effectiveness of state action. Thus, it weakened output legitimacy.

[10] Unfortunately, there have been no systematic study carried out on the opinion of the population, consequently the above statement rests upon anecdotic evidence and newspaper reports.

[11] It is an open question whether the state responded slowly because it was overwhelmed by other, more imminent reforms, issues, or the state was involved in the 'oil-business' to an extent that criminal groups could 'lobby' efficiently enough to slow down the pace of response.

As it was mentioned earlier, the ‘oil-bleaching’ affairs have repercussions even nowadays. Although these repercussions are difficult to evaluate rigorously, it can be argued that they contributed to the general distrust of the state, which is apparent in many spheres of social, economic and political life.

Conclusions

Throughout the paper a symptomatic policy failure in Hungary of the early 90’s was analyzed from several perspectives, which allowed for its detailed description in connection with the politico-economic circumstances of the time. After developing the evaluation criteria based on the relevant literature and crafting its general statements to the specific context, the described policy and its consequences were reassessed.

The main conclusion is that from a welfare stance, the policy was justified as it helped those households in greatest need, though not targeted precisely enough. Also, the policy did not make use of the most efficient tools to achieve the proposed aim. However, the welfare implications were mainly positive, and administering the system was cheap compared to better targeted and more efficient techniques. From a legitimacy point of view, the policy suffered from a number of flaws which have repercussions to this day. The unintended side effect of the policy was that organized crime had been greatly strengthened, whilst the state had become more corrupted and intertwined with criminal groups. These had decreased the input and output legitimacy of the Hungarian democracy alike through weakening the trust in democratic institutions and limiting state capacity.

Consequently, abolishing the price fixing scheme of DHO in 1995 must be considered as a positive step towards stabilizing and strengthening the state. However, in 1995 this step came at the price of the positive welfare effects, lessening the living conditions of a number of poor households. Thus, a better policy mix could have been to substitute the price fixing scheme with a direct income support system. In fact, such a scheme was established, albeit much later.

The most intriguing characteristic of the case, namely how such a policy, which produced a number of serious adverse side effects, could avoid abolishment for almost 5 years, could not be elaborated sufficiently due to the lack of reliable data. Nevertheless, the results of the analysis suggest a number of competing hypotheses for further research building on more extensive data. (i) The obvious interests of street level – and possibly also higher level – civil servants significantly slowed down the government’s appropriate response mainly by insufficient information flows from the bottom level to the top level (i.e. diminishing state capacity); (ii) the possible interests and involvement of higher circles of the Hungarian political elite prevented the government from taking effective counter measures even in the presence of adequate evidence on criminal actions and the misuse of public money; (iii) because the decision makers did not benefit from ‘oil-bleaching’, thus were not motivated to support the scheme, the logical reason for such a prolonged DHO support scheme is some sort of ‘government information overload’, the malfunctioning of agenda setting.

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