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# User charges and subsidies in Budapest

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This paper offers a short overview of the user charge and subsidy policies introduced in the Municipality of Budapest during the 1990s (i.e. the first decade of the Transition).

In 1990 in Budapest the newly elected municipal leadership inherited the utilities from the former socialist period. Socialist infrastructure development policies of utilities were clearly supply-driven (i.e. the “predict and provide” method) resulting in large networks, in often inappropriate design and deteriorated quality of assets due to postponed maintenance. At the same time charges for utility services were very low, often resulting in frivolous consumption, not supplying cost coverage for the service and causing low accountability of providers. The symbolic charges users paid meant massive subsidies for all social layers.

In the early 1990s the responsibility for the service provision (in 1990), the core utility assets (1991) and the price setting authority<sup>1</sup> (1994) was allocated to the local governments in Hungary. In this new situation the challenge in the redesign of utility policies was threefold: (1) increase the efficiency and quality of the service delivery; (2) secure financial resources for the provision of the service; and (3) rationalize consumption. The answer to all three challenges could be a shift from the supply-driven to a demand-driven infrastructure policy and introduce the related cost covering charges.

As a policy result the 1990s witnessed the gradual increase of user charges and a (in some services the interior structure of the charge has also changed: the one time connection fee has relatively decreased, while the use related part of the service has increased reflecting, or approaching the real costs of both). Increased charges had important effects both on the users and the providers. They increased cost awareness of users that in turn modified

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<sup>1</sup> This is true (i.e. price setting authority) for all utility services mentioned in this paper with the exception of the gas. Pricing of the energy sector was maintained at the central government level.

consumption patterns, increased accountability of providers and created more revenue for the service, hence furnished the conditions for improving service delivery.

Increasing cost coverage of prices gradually eliminated the general subsidization of users. At the same time, increased prices became unaffordable for the poor. A process that necessitated the introduction of targeted subsidies to maintain willingness to pay. In 1995 in Budapest the so called Compensation Fund was created to distribute aid for those who could demonstrate their inability to pay the full price. Thus considerations related to service delivery and social assistance functions got finally separated. As it will be demonstrated through the data, a small fragment of the revenue increase of the service was enough as well targeted subsidy to keep the poor in the service and maintain general paying discipline.

The separation of the service provision and the social assistance function and the decent revenue of the companies due to the increased charges had one more important effect. It rendered privatization possible. The privatization revenue supplied sources for infrastructure improvements for better service quality, while the involvement of the private partners helped to rationalize the company increasing efficiency and decreasing the unit cost of service. The transparent process and the strong competition at the privatization tender decreased opportunities for corruption.

## **USER CHARGES FOR UTILITIES**

The inherited symbolic charge for waste containers were replaced by a volumetric charge for households waste in Budapest in 1996. The inflexibility of the container based volumetric charges scheme was attacked by lively criticism in the course of a few month after its introduction. Later – as the users got familiar with the new system – some 20 percent of containers were returned, and both the collected volume and charges reached a balanced level in the course of one year. The major fear before the introduction was that illegal dumping would increase, but similarly to other countries' experiences, no evidence has occurred on this matter.

Since 1997, in consequence of the charging policy, only the development expenses of waste management have debited the budget of the Municipality.

On the field of water services the socialist heritage was a relatively well-developed, but poorly maintained network of both water supply (with 97.5 percent coverage) and sewage

collection network (with 90.2 percent coverage). The rate of waste water treatment, however, was very low (25 percent in 1999). At the same time, in consequence of symbolic prices, water consumption well surpassed Western European standards.

The gradual increase of user charges not only decreased household consumption by 20%, (arriving to a level similar to EU average), but allowed a nearly full cost recovery. The increase of the charges has multiple consequences: it rationalized consumption (i.e. decrease frivolous consumption), improved cost coverage<sup>2</sup> and made privatization possible.

The price increase has clearly eliminated the massive subsidy of all users by the symbolic prices. At the same time it made some services hardly affordable for some social strata, creating the need for targeted subsidies for the poor. (Description and explanation of the subsidy system can be found below)

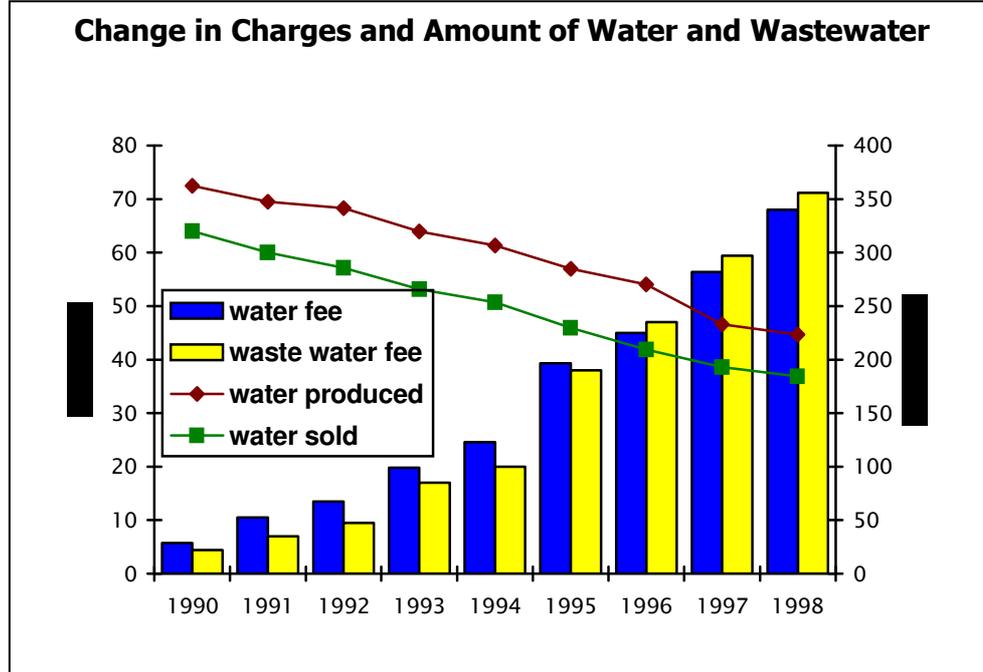
The pricing system has further changed with the privatization. Multi-part tariffs are applied for water charges. They consist of a one-time connection fee, an access fee and there is a use related charge that is calculated on a volumetric basis. The volumetric charge is based on average accounted costs determined by a cash flow based formula that is set in the privatization contract<sup>3</sup>.

Though the pricing is based on an average cost rather than marginal cost type charge, it still affected users' behavior as it can be seen in on the chart below. The present system provides for an adequate information about the demand which help introducing further rationalization steps in service delivery. The plan of the city for waste water treatment capacity development was 1.5 million cubic meter in 1993, it was cut back to 600 thousand cubic meter per year in 1999 and the process of adjustment of plans to demand continues. This process enables to save huge development costs on wastewater services and operating costs both on water and wastewater services.

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<sup>2</sup> Water charges cover the costs, while in the wastewater system some investment subsidy is still needed. The wastewater figures, however, can not be used as comparative data due to the low share of the existing treatment capacity.

<sup>3</sup> Before the privatization the charge was decided yearly by the municipal assembly on the basis of direct accounting cost estimates prepared by the companies.



## 1.1 SOCIAL SUBSIDIES FOR UTILITY CHARGES

During the socialist times user charges for public utility services were very low. All citizens were subsidized by the charges kept on a symbolic level. User charges have permanently increased since the beginning of the 1990s, still the clear change in the charging strategy was decided only in the mid 1990s in the frame of the financial reforms. In 1995 drastic increase started and charges started to better reflect production costs. In consequence user charges started to rapidly approach cost recovery, but at the same time they also became hardly affordable for certain social groups.

To treat the social problem the Municipality established a Compensation Fund in 1996. All citizens with demonstrated needs can apply for aid to the Compensation Fund. The amount received depends on the social condition and income of the applicant family. The subsidy is not directly paid to the families but the due amount is automatically decreased by it.

**Table 1 : The Compensation Fund**

		1995	1996	1997	1998	1999
<b>Amount paid by:</b> (in Million HUF)	District Heating Co	250	300	400	450	450
	Water Works	125	150	200	230	260
	Waste Water Works	125	150	200	230	260
	Public Cleaniness Co		100	125	145	145
<b>Total resources of the</b>	<b>Compensation Fund</b>	<b>500</b>	<b>700</b>	<b>925</b>	<b>1055</b>	<b>1115</b>
<b>Number of recipients for:</b>	District heating		28037	28542	23991	

Solid waste collection		36718	40028	38931	
Water and Waste water		39003	43253	42076	

Source: Hálózat Alapítvány, Budapest

In 1999 the Compensation Fund helped 70,000 families with maximum 18,000 HUF / year for heating, 10,200 for water charges and 3,000 HUF for solid waste collection charges.

The money distributed through the Fund is supplied by the public utility companies. The company's justification for contributing to the support fund is not so much social as the need to ensure solvent demand and willingness to pay in the market. As it can be seen from the table 2 below, only a small fragment of the revenue is fed back to the Compensation Fund and experience shows that this can keep paying discipline at a good level.

**Table 2 : The Compensation Fund**

		1995	1996	1997
<b>Water:</b>	User charge revenue	8.868	10.188	12.069
(in Million HUF)	Contribution to Compensation Fund	125	150	200
<b>Waste water:</b>	User charge revenue	7.323	9.196	12.878
(in Million HUF)	Contribution to Compensation Fund	125	150	200
<b>Compensated families</b>		39003	43253	42076

#### Further reading:

- Ebel – Simon (1995): *Financing a large municipality: Budapest*, in: Decentralization of the Socialist State, ed: Bird - Ebel – Wallich, The World Bank
- Ebel – Várfalvi – Varga (1998): *Sorting Out Intergovernmental Roles and Responsibilities*, in: Bokros – Dethier: Public Finance Reform During the Transition: The Experience of Hungary, The World Bank
- Pallai (2001): *"Local financial management reform: The case of the Municipality of Budapest"*, In: Sub-national Modernization Challenges, The World Bank, (in print)