

# Hungary

## Water privatisation in the context of transition

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Privatisation was to be the key to creating a healthy economy with competent companies that provide jobs for people and pay taxes, rather than being dependent upon state policies and subsidies. Just a few years into the transition to a market economy, however, Hungarians have discovered that private ownership does not necessarily mean efficiency, and that the argument of additional investment is also questionable. The process of water privatisation well illustrates the pitfalls of privatisation.

When talking about the privatisation of public utilities in Central and Eastern European (CEE), including water works, a more general contextualisation is necessary. Privatisation happened in an era of general political and economic transformation, and was itself an important element of this transformation. The importance attached to privatisation is understandable given the specificity of the formerly centrally planned economies, where almost all productive assets were in the possession – or under the tight control – of the state, and where official ideology did not question the predominance of collective ownership.

Privatisation in the CEE countries is unique in many respects, and not *just* due to the political importance assigned to it. The number of assets that changed owners is huge and touched upon almost all sectors of the economy. The speed of the process, especially in countries leading the reforms, like Hungary, was extremely fast compared to Western European cases. The privatisation process is also unique because it happened in a dynamically changing environment. In Western Europe, privatisation is defined to a major extent by the existing legal, political, cultural and economic conditions. But in CEE these social framework conditions were not well defined.

Laws and institutions regulating the privatisation process itself, as well as the functioning of a market economy had to be created.

Privatisation promised to increase efficiency through the creation of real ownership. In other words, privatisation was considered the key factor in creating a healthy economy with competitive companies that provide jobs for people and pay taxes, rather than being dependent upon state policies and subsidies – which was the case for many of the old socialist, state-owned firms. Looking back at the history of fifteen years of transition, it can be concluded that privatisation should not be the only factor and measure of economic success, and that many other conditions have influenced the development path of different countries. Privatisation in itself proved to be a necessary but not sufficient condition for creating efficient corporate governance in formerly communist countries. The resulting ownership structure, as well as state policies and the surrounding social and market environment (including the quality of the legal system and the ‘mentality’ and quality of human resources) are factors that have also influenced the emergence of competitive firms in Hungary and elsewhere.

Another very important argument for privatisation

was the necessity to increase budgetary income. This seems to be a short-term goal. The methods, the speed and the depth of privatisation, however, have been largely influenced by it. Hungary had the most pressing macro-economic problems in the early nineties and it was the first country in CEE to undertake privatisation measures and to create the proper legal environment for private businesses, as well as for the entry of foreign direct investment (FDI). The other countries of the regions privatised at a slower pace, turned to mass (voucher) privatisation schemes, and limited considerably the role of foreign companies in the economy. However, the macroeconomic problems experienced in 1997, such as the growing deficit of the current accounts, forced these countries to speed up privatisation. In privatisation policy, the absolute preference for local owners had to be abandoned and foreign investors invited in. After 1997, FDI-friendly policies were introduced in Bulgaria, Czech Republic, Poland and Romania, among other formerly communist countries.

This was the context too, more or less, for water privatisation in Hungary. In the climate of support for privatisation, many utilities which have been traditionally publicly owned in Western Europe, were privatised in Hungary. Given that in Hungary general support (or at least a lack of criticism) existed for privatisation, no real debate arose around the privatisation of public utilities until recently. Apathy was mostly the case throughout the nineties, but in 2004 a referendum was organised against the privatisation of health care and the majority of people indeed voted for public ownership. Since then, a debate has begun over the role of the state as an administrator, manager and regulator of basic services. The arguments for privatisation were efficiency, revenue and additional investments. Nowadays, however, Hungarian citizens are realising that private ownership does not necessarily mean efficiency, and that the argument of additional investment is also questionable. The next section will look at the short history of water privatisation in more detail.

### **The state of water supply and sanitation**

Hungary belongs to the luckier part of the world, considering that a high number of houses are connected to water. The state of sewerage is worse, although huge public investments are going into that sector. The role of private investment has been marginal until now, but the

intention of the planners is to change this. Improvements after the transition have been mainly financed by the state with co-financing from the EU or the World Bank.

### **Efficiency and price**

A general trend worth mentioning is the decrease in water consumption leading to loss of efficiency, a common complaint of both public and private companies. As described in the *WaterTime* report on Hungary (Péter, 2004),

*The length of the water supply pipeline had been growing between 1996 and 2002 from 59,709 to 63,149km, the number of households connected increased from 3.628 million to 3.815 million, that is from 90.9 percent to 93 percent. Water supplied decreased from 581.497 million m<sup>3</sup>/year to 546.327 million m<sup>3</sup>/year. The same figures for sanitation show that the length of sewers had changed from 16,974 to 30,536, connected households 1.802 million to 2.299 million; that is an increase from 45.2 percent to 56 percent. By 2002, 65.2 percent of the collected sewage was treated, the rest of it was discharged untreated. 61 percent went through biological treatment and 32.3 percent of the total number of households sewage was treated.*

Looking at the price structure we can say, on the one hand, that prices are insufficient to cover operational and environmental costs. On the other hand, the proportion of household income spent on water compared to the EU-15 level is already high. This situation creates a tension between consumers and providers, as consumers barely tolerate any increase in their spending on public utilities, whereas the principle of full cost recovery would suggest significant price increase. The utilities are dependent upon state subsidies and cross-financing. Any further move towards the neo-liberal model therefore necessarily creates social tensions.

### **Ownership of the waterworks**

After the political regime changed, the ownership structure of water systems mutated considerably. In the eighties, only 33 companies (28 owned by municipalities called 'councils' at that time, and 5 state-owned) managed the water systems in Hungary, in most cases being in charge of both water supply and sanitation. In 1990, the Act on Local Governments transferred the responsibility for drinking water supply to local authorities. As a



result, ownership of the ‘council’ water companies and part of the waterworks of the state-owned companies was transferred to local governments. Municipalities had the right to refuse the transfer, however, and did in some cases. Moreover, many municipalities tried to create their own water system where it was technically feasible: independence and autonomy was highly valued, sometimes even despite economic and efficiency considerations. Since the number of local governments is high (each settlement has its own local government, about 3,600 in total), all the changes meant that ownership of the water system became fragmented. Currently, there are about 350 water companies providing drinking water in a country of 10 million inhabitants. (For a good overview of the administrative and legal background, see Péter, 2004.)

The ownership structure is not only fragmented but also blurred. In some regions, state ownership remained in place. A new development is that the city of Esztergom turned to the Constitutional Court to preserve ownership of the water utilities. The city council argues that if they have the responsibility of providing drinking water, they should have municipal ownership as well. The background to the dispute is that the city wants to restructure the water system for environmental reasons and cannot do this without ownership rights.

A further complication in management was created by introducing privatisation to the water sector at the local level and the signing of concession agreements for management purposes. In 1994, the city of Szeged was the first to negotiate a concession and several other cities and regions followed. Approximately 40 percent of the water is distributed by private companies or joint ventures. Some companies are Hungarian (like the private company operating in the city of Szolnok), but well-known multinational companies have also been very active in Hungary: Veolia, SUEZ, RWE, E-on, and Berlinwaters, amongst others.

Currently, the picture of the privatisation process is unclear for several reasons. One is that there is no national public authority in charge of water-related policy issues to monitor the privatisation process. The existing water authority deals only with technical, environmental and quality issues related to water management. Economic and financial aspects are not monitored, and this is a real problem. Local governments have a high degree of autonomy to make decisions, but do not necessarily have the expertise or the relevant information required. For

instance, the transfer of ownership from the state to local governments was done without a proper evaluation of the value of the assets, and/or a careful inventory of state ownership. Local governments do not even know the value and the physical status of the assets they possess.

Another reason for the fuzzy picture of the state of privatisation in the Hungarian water sector is that even those companies not privatised were still formally transformed into public corporations or limited liability companies, with the local government in question being the only owner. That is, formally these companies resemble and behave as private companies. On being corporatised it is, in principle, very easy to privatise them – or for private companies to control minority shares in them, as this is allowed legally.

Local governments cannot sell all their assets so following the example of Szeged, cities such as Budapest, Pécs and several other municipalities or regions opted for the following formula: in the privatisation arrangement only a minority (less than 50 percent) stake of the company is transferred to private hands, making it a ‘partial privatisation’. This affords the municipality some control, potentially giving them the power to protect the public interest. This is mitigated, however, by the privatisation agreement which gives management rights to the private partners, thus limiting the authority of the municipality. The minority owners – typically a multinational company or a consortium of companies – get management rights on the basis of a long term concession contract for fifteen (as in the case of Budapest) to twenty-five years.

It is to be noted that the legality of this contract is somewhat dubious as the private partners gain management rights over assets which could not be privatised otherwise. Nevertheless, the formula was not challenged by the attorney general, so it may be regarded as legal. The following section will explore briefly the main issues that have been raised by water privatisation.

## The debate around water privatisation

### Budgetary income

As in the case of privatisation in general, water work privatisation has been largely influenced by budgetary consideration. For instance, experts say that when the Budapest Waterworks were (partially) privatised, the company was in good shape. No huge and pressing investment needs existed and the company was well managed. The main reason for selling 25 percent of it

(plus the management rights) was that budgetary income could be realised. After all, the water utilities cannot be taken away: private owners have to operate them where they are. Why not generate some income by selling off parts of them?

Some income was certainly created through this kind of deal, but it should be noted that partial privatisation by definition reduces the income the government can make off the sale.

## New Investments

Another argument for privatisation was the potential for investment by private owners. This seemed to be plausible as the water sector, and especially the sewage systems, are in bad shape in Hungary generally and additional investments are needed for renewal or further development. Expectations of large capital investments have not necessarily been met in reality, however. Again, partial privatisation itself diminishes the willingness of minority interests to make important investments in the operation.

The case of the Budapest Sewage Work perfectly illustrates the point (see Juras and Schenk, 2005). The most important investments were financed from the budget of the central government or the city. Miklos Szalka, Vice-President of the municipal maintenance committee at the time, was quoted in the *Nepszabadsag* newspaper on 16 December 1998:

*The sewerage company has proposed a 25–30 per cent price increase, and the main argument for this is the cost of development... Unfortunately, it is now clear that these powerful foreign companies do not want to make investments using their own capital – on the contrary, they take as much money as possible from the country, including their management fees* (quoted in Hall and Lobina, 2004).

Another example is that of the city of Pécs. In December 2004, the mayor of the city announced that they were considering the re-nationalisation of the water works (partially privatised in 1997 to the French-based Suez corporation), mainly because the price of water was increasing, on the one hand, and investments were not forthcoming, on the other. Since the municipal water network is partly privatised, the city cannot have access to EU funds for water infrastructure development. That is, privatisation did not bring the benefits of cheap additional investments. Pécs is an interesting example

because some years ago the city took back the previously privatised waste collection company on similar grounds: i.e. that prices had increased and infrastructure development had become more difficult to finance.

## Efficiency and quality

As mentioned above, one of the most important arguments used for supporting privatisation in general is the expected rise of efficiency. *The state is a bad owner*, as the slogan goes: private investors are expected to bring efficient ownership and good management.

The question of good management can be separated into two others: whether efficiency gains can be identified, and whether the quality of the service has improved.

As already mentioned, there is no overarching body in charge of water policy and regulation in Hungary, such as a public national authority, which would provide benchmarks to evaluate the performance of the water companies. We are unable, therefore, to judge clearly the efficiency of individual water companies. The available facts suggest, however, that the efficiency gains either do not exist, or have been appropriated by the companies to bolster their own profitability.

For sure, the old state-owned companies were not well managed. A painful transformation process happened in all of them: for instance, the number of employees has been substantially reduced. Evidence suggests, however, that this process started well before privatisation. For instance, in ten years the number of employees was halved in the Debrecen Waterworks, which was not privatised. Similarly, the Budapest Waters was consolidated before privatisation.

The question is whether privatisation accelerated this process, and whether efficiency gains were higher in privatised water companies. Answers would require detailed analysis, a difficult task as management contracts are kept secret. It is simply impossible to know the level of management fees private operators earn. Since conflicts arose over high water prices in several cities where waterworks were privatised, however, it is fair to assume that either there were no efficiency gains, or if there were that these were appropriated by the private companies.

Hungary has not experienced the kind of conflicts about the quality of water observed in other countries where privatisation went wrong and could be clearly traced back to the private operators. At present, there is no published data about deteriorating water quality. Again, the lack of reliable benchmarks makes it impossi-



ble to evaluate the role of private companies in quality improvements. That is, we do not have comparable information on whether the quality improvements – which certainly happened in some cases – are explained by good management or additional investments, and if the latter, whether these investments were made by private companies or by the municipalities.

An Operation Performance Evaluation Review (OPER) of the European Bank for Reconstruction and Development (EBRD) conducted in 2003 for the Budapest Sewage Works, seems to have reached the conclusion, however, that service improvements have been minimal. The OPER summary states that *“the range and scope of services has not been markedly increased, at least from a consumer’s perspective, since the wastewater coverage area remained basically the same ‘with’ and ‘without’ the project”* (Juras and Schenk, 2005:36). This is, of course, just one example, but it suggests that quality improvements are not necessarily happening in privatised companies.

Talking about quality, we should mention an additional concern. Some fear that under-investment may happen in the water systems – after all, this is the easiest way to realize ‘efficiency’ gains. Private operators generally won management rights for a long period: fifteen to twenty-five years. This is long enough for the system to be substantially over-used, especially if maintenance costs are kept low and investments minimised. Of course, private companies still have a duty to properly maintain the system, but this is very difficult to control, especially, if – as in Hungary – the municipalities do not have a proper inventory or evaluation of the assets before privatisation. The motivations of private company managers are different from those of a publicly-owned company manager. The latter typically seeks to remain in his/her job until retirement (having a long-term vision of the company), while the former spends only a few years at the company, and seeks to maximise profits under his/her direction.

Of course, under-investment can happen in the case of state- or municipal-owned companies too. Politicians may try to tighten their budgets. Here, at least in principle, there is a possibility for transparency and democratic control. City budgets are public documents and political opposition in the city council may draw the attention of the public to systemic under-investment. With this, we are touching upon the democracy problems attached to water privatisation.

### Democratic control

Water privatisation, and its specific Hungarian form, raises concerns about society’s weakening democratic control over decisions. First, the details of the privatisation agreement are not public for reasons of commercial confidentiality. This is unacceptable.

Second, long-term management contracts may impede any change in the water policy of a given city. A good example is that of Esztergom, where the city council decided to redesign the city’s water policy for environmental reasons. This is difficult because the city does not own the water works (although this is not a privatisation case *stricto sensu*: the company in question is a state-owned regional waterworks). That is, ownership and control over water utilities may be a prerequisite for designing sustainable water policies.

### Political debates and the voice of civil society

As already pointed out, debates around the privatisation of public services have started only recently. The most important actor in these debates is the conservative party (FIDESZ – Young Democrats), currently in opposition. They have decided to support the initiative of the leftist Workers’ Party against the privatisation of hospitals introduced by the socialist-liberal government, which kicked off a major political debate. Seeing the popularity of anti-privatisation arguments amongst voters, FIDESZ launched a ‘stop privatisation’ campaign a few months ago against the sell-off of the remaining state-owned companies. In post-socialist Hungary, the traditional meanings of *left and right* are somewhat twisted. On the side of the governing parties and their intellectual backers, this created confusion. The majority within these parties vehemently support privatisation, while more radical leftist thinkers try to debunk right wing anti-privatisation arguments.

Articulating a critical position in the current situation is therefore a difficult task. If we add the young age of Hungarian democracy and the relative immaturity of the civil sector to this, we can understand why the voice of NGOs is weak. Trade unions are weak all over CEE and raise their voice only if there is an attempt to cut wages. The traditionally stronger human rights groups are focused on basic rights and discrimination, sidelining economic and social rights, including the right to water. Environmental NGOs are focused on classical environmentalist issues rather than on the bigger issues of globalisation, including the restructuring of public services.

*Védegylet* (Protect the Future) and ATTAC Hungary are the two groups that took up the issue of water privatisation. *Védegylet* launched its political and research project on the GATS agreement in 2003, attaining a more general focus in 2005. Another relevant civil society organisation is the Independent Ecological Center (FÖK), one of the oldest NGOs in Hungary, which has been involved in alternative city planning since the early nineties. They do not deal with the question of privatisation as such, but within the framework of their 'Autonomous Township and Region Project', they have created a valuable knowledge-base about sustainable alternatives.

Although it is not directly connected to the privatisation of water utilities, it is important to point out the progressive position of some small municipalities. The situation of local governments has been worsening since the early nineties. Their revenues are cut year by year by the central government, forcing local authorities to decrease their spending, close schools or privatise their assets. An important moment in this story was when the government decided to close the post offices in villages with less than 600 inhabitants. Some mayors formed a coalition to campaign against the decision but were unsuccessful. Nevertheless, this debate did create a critical atmosphere amongst small municipalities towards public services restructuring and the rhetoric of 'reforms and modernisation'. They are potential carriers of alternative solutions and policies.

The following section will analyse how the aforementioned problems surfaced in Budapest.

## The case of Budapest

In the spring of 1997, the local government of Budapest decided to privatise the city's water system. The buyer was a French-German consortium (RWE-Thames with Suez in the case of water, and RWE-Thames with Vivendi in the case of sewerage) that paid 15.5 billion forint (approximately 75 million dollars) for a 25+1 percent share of the water utility, and with that received management rights for a period of twenty-five years. Learning from the experience of electricity privatisation, no profit is guaranteed in the contract, only a 20 million forint management fee. The revenue of the new owners is calculated in accordance with the level of investments they make, the quality improvements they achieve, and their success in exacting debts, reducing operational costs and enhancing cost-efficiency – 75 percent of the savings is

guaranteed them. Raising tariffs is not a basis for exacting extra profit. Water prices were raised annually over the level of inflation, worsening the situation of especially poorer households.

At the beginning, the deals seemed to be successful due to the conditions set – but problems soon emerged. Although the water utility closed in 1998 with a loss of 1,5 billion forint, the new management decided to allocate itself a management fee of 2 billion forint. They could do this as the fee was not bound to the profit of the utility, but to the reduction in costs. During the first years the government tolerated this absurd situation, saying there had been significant improvements in efficiency. The relationship between the city and the company worsened in 1999, however, when the local government had to break part of a contract with the French owner as the company was unable to meet its investment duties even after a year's delay.

During the next twelve months, the situation worsened as the private management of the water utility set itself a management fee equivalent to the record high loss of the year. Another source of conflict was that the government did not accept the business plan for that year. At this point the city launched a counter-campaign, the mayor denounced the privatisation as a failure, and his deputy for economic affairs stated that the new owners "do not use some points of the contract properly". The mayor and his fellow councillors realised that it would be hard to explain to the voters the extremely high management fees, at the same time as water prices were rising above the rate of inflation rate year on year.

After the elections, the debate calmed and the relationship now seems to have improved. This little case study, however, sheds light on some typical problems of water privatisation: that consumers also have to pay the management fees or profits of the investors; that the private owners may only be interested in reducing costs; that only the local government may be sensitive to social issues, especially before elections, while private investors tend not to be and, perhaps most importantly, that a contract previously considered 'shell-proof' can turn out to be faulty.

## Conclusion

The only apparent benefit flowing from water privatisation is some short-term budgetary income for the municipality or the state. The evidence suggests that additional



investments should not necessarily be expected from privatisation – the example of Budapest and Pécs shows that quite the contrary may transpire. Prices may increase and the parent company will likely take money from the subsidiary in the form of profit and management fees. Under-investment may happen. Democracy is weakened.

Without reliable data and benchmarks about the per-

formance of water companies in Hungary, it is very difficult to compare the quality of the management of the different companies. Some examples of efficient management of water as a public service, like that of the municipal Debrecen Waterworks, however, suggest that good management and efficient functioning can be achieved without privatisation.

## References

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