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Chapter 13

Fostering Local Development in Bulgaria: The Need of Fiscal Decentralisation

by
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Although local authorities in Bulgaria have been assigned various responsibilities over the past 15 years, state transfer flows toward municipal budgets have not increased in the same proportion. Only a degree of local financial independence and fiscal decentralisation can contribute to the development of a favourable investment climate and foster sustainable development. A gradual delegation of taxation power to local authorities as well as the development and adoption of a stable legal framework for the principles and mechanisms of the intergovernmental transfer system would contribute to greater financial independence of municipalities.

Introduction

The purpose of this chapter is to study the current framework of local development financing in Bulgaria, and suggest solutions for some of the impediments, constraints or gaps in regulations that presently exist. As a result of purposeful effort, the current system of revenue assignment in our country is closer to the European standards, and therefore to the objectives of local finance reform. Despite the undoubted achievements in the scope of fiscal decentralisation, some challenges and constraints persist. Analysis is focused on the main revenue sources at the local level, estimated in the context of European accession process. Promoting local own-revenues, as a basic pillar for financing municipal budgets requires constitutional amendments, intended to foster local tax authority and fiscal autonomy. At the same time, the intergovernmental transfer system is a crucial mechanism for horizontal and vertical fiscal equalisation. Introducing municipal borrowing as an attractive and flexible tool for supporting municipal investment projects implies setting up a new institution in Bulgaria, namely the municipal credit market. Solving the problems that local governments face in common and fostering interaction contributes to development of a favourable investment climate, and allows municipalities to undergo a transformation to become the main organisers of the public productive capacity within their jurisdiction and, as structural units, heralds of sustainable development and growth of national importance.

Fiscal decentralisation and local governance

During the last fourteen years, Bulgaria has undergone a process of gradual political, administrative, and financial decentralisation. The process of smooth transfer of power and responsibility for public functions from the central to the local level started in 1991, when the Local Self-Government and Local Administration Act was adopted. According to this Law, Bulgaria has two tiers of sub-national administrative government – regions and municipalities. The region is an administrative unit of the central government, which comprises several neighbouring municipalities. It performs three main functions: to manage state property located on the regional territory, to monitor the compliance of local decisions with the law, and to implement state policy at local level. In addition to the controlling functions, mainly intended to combat and curtail corruption, the regions are supposed to foster

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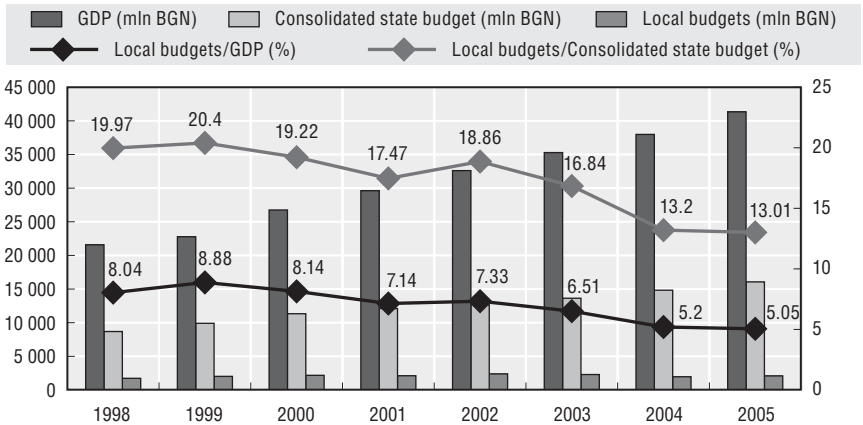
local development and to encourage municipalities to unite to work together on large-scale projects. Despite the fact that the regions co-ordinate national and local interests, they do not perform executive functions. As mediators between the central and local authorities, regions do not enjoy financial autonomy, and do not provide public services to the population. Regional government is performed by regional governors and administrations and financed from the central budget. The budget of the regional administrations accounts for 0.1% of the consolidated public expenditures and 0.04% of the general domestic product (GDP).[1] Presently there are 28 regions. They were established in 1999 by splitting up the 9 regions, which existed at that time.

According to the Constitution, the municipality – a legal entity – is the only tier of local self-government in the country. It has the right of ownership and an independent municipal budget, which must be used for serving the local population's interests. The bodies of local government – municipal council and mayor – are elected directly by the local population every 4 years. They determine and implement municipal development policy. Despite the fact that Bulgaria is a small country, with a territory of approximately 111 000 km^2, 264 municipalities exist at present. Although the legal possibility for dividing or merging of municipalities exists, their number varies little. The main features of Bulgarian municipalities are as follows: average territory is approximately 422 sq. km, average population is approximately 30 000 people, and average number of settlements is approximately 20.

In fact, gradual decentralisation results in growing local self-governance and ever-increasing responsibility for the municipalities to meet rising demands of the population, ranging from transportation to cultural events and leisure. Local authorities are also assigned some state mandates in the fields of education, health care, and social assistance. Municipalities are partially responsible for services related to cultural advancement (local libraries, museums, and theatres), environment protection, housing construction supervision, and some economic activities. They are fully responsible for the local utilities such as water supply, sewerage, heating, gas supply, construction of local roads and streets, urban development and infrastructure. One of the main achievements of the fiscal decentralisation process in Bulgaria is the clarification of the respective responsibilities of the central and local authorities, defined by the State Budget Acts for fiscal years 2003, 2004, and 2005, as well as their applications. Moreover, according to the legislation in force, when municipalities are assigned to undertake a state mandate, the central government must provide appropriate grants.

According to recent data, Bulgarian municipalities provide up to 30% of public sector services in the country. At the same time, regardless of the financial stabilisation and economic growth achieved during the recent past, the share of, local budgets in GDP has been reduced to 5.05% in 2005 against

Figure 13.1. **Bulgaria: Basic macroeconomic and budgetary indicators**



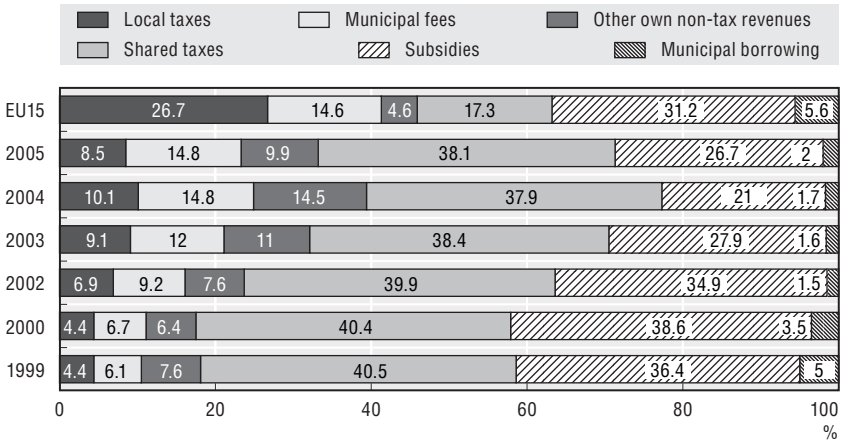
Note: BGN is the abbreviation of Bulgarian currency. The Currency Board has fixed the exchange rate at 1.95583 BGN per euro.

Source: The Ministry of Finance and own calculations.

12.3% in 1991, and 8.9% in 1999. The same clear downward trend can be observed in the local budgets' share of the consolidated state budget.

To a large extent, this is due to the fact, that although local authorities have been assigned various responsibilities, state transfers to municipal budgets have not increased significantly, and so have tended to decline in real and relative terms. Moreover, by virtue of the current legislation, municipalities are restricted to influencing the local revenues.

Figure 13.2. **Municipal revenue assignment (% of total local revenues)**



Source: Ministry of Finance Database and own calculations.

It can be seen that the local revenue structure in Bulgaria comprises several standard components, namely own-source revenues, intergovernmental transfers, and municipal borrowing.

Local own-source revenues

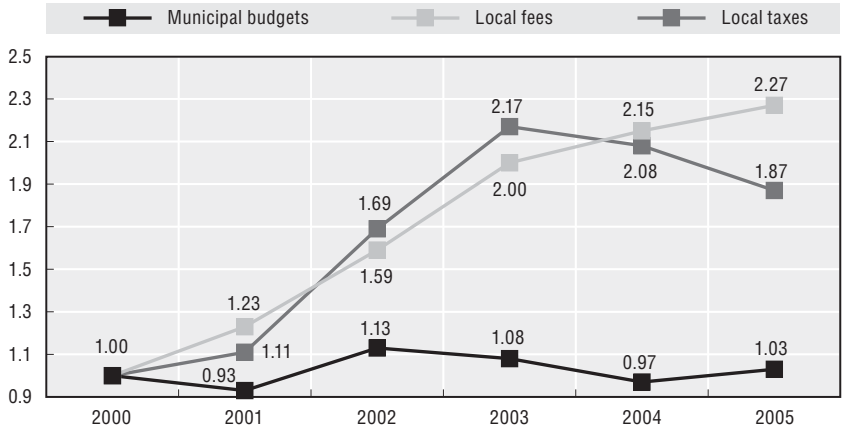
Basically, local own-source revenues include local taxes, municipal fees and other local revenues, mainly from municipal property management, such as rents, sales, concessions, fines and interest. According to the recent data, local own-source revenues have tended to increase gradually, from approximately 10% of total municipal revenues in 1997 toward almost 40% in 2004. Obviously, this is an important step toward fiscal decentralisation and real local budget independence. It can be viewed as a satisfactory result, having in mind that the central governmental level covers the totality of state-delegated activities. However, in order to define and discuss the significance of local taxes accurately, it is useful to clarify the system.

Actually, Bulgarian local governments do not have the power to determine the type, the rate or the base of local taxes. In fact, the only reason for calling them "local" is that they are stated in the Local Taxes and Fees Act. Property tax, motor vehicle tax, inheritance tax, gift tax, and tax on the purchase of real estate and movable property, which are recognised as local taxes, are entirely regulated by the central government. In terms of modern public finance, if local governments do not have any say in the "design" of the local tax, that tax should not be considered as a local tax, but as a special transfer, based on the location of taxable property.[2] Thus, reviewing the elements listed, up to 75% of the municipal budgets are formed by transfers and are determined directly by the central government.

Because the Bulgarian Constitution now prohibits municipalities from fixing the local tax base and rates, they are allowed only to receive the local tax proceeds. This regulation conflicts with article 9.3 of the European Chart of Local Self-Government, signed by the Republic of Bulgaria in 1995. Consequently, there is an urgent need to find political consensus for constitutional amendment, intended to delegate real tax power to local governments, because local tax autonomy can only be gained through full local governmental control over the tax levy.

At the end of 2002, in line with the Fiscal Decentralisation Programme, the Local Taxes and Fees Act was amended and local authorities were assigned full legal rights to determine the base and size of local fees by application of the cost-recovery principle, as well as to implement local social and economic policy by providing appropriate tax exemptions to certain taxpayers. Actually, this legislative amendment is an extremely important achievement in the field of fiscal decentralisation reform.

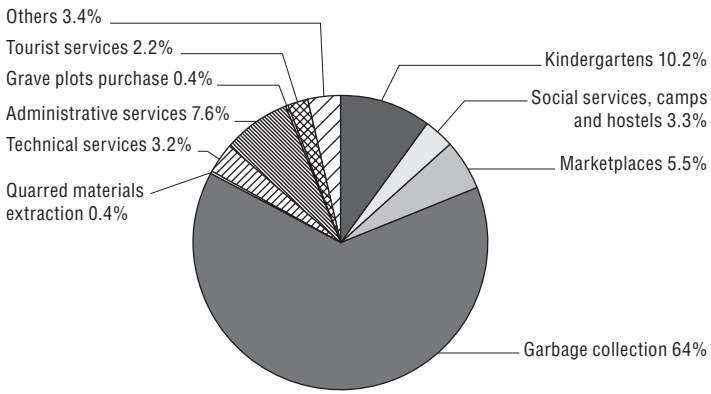
Figure 13.3. **Rates of local taxes and fees proceeds increase in comparison with local budgets increase**



Note: The proceeds in 2000 are used as a base.
Source: The Ministry of Finance of the Republic of Bulgaria and own calculations.

According to the available data, local fees form a gradually increasing share of the local revenue base, with an average relative share in own-source revenues up to 38%, ranging from 6% to 60% in any particular municipality.[3] Since the start of fiscal decentralisation reform, the proceeds of local fees have more than doubled. Over the same period, municipal budgets rose by only 3%. One of the main reasons for this growth is that in accordance with the cost-recovery principle, local fees have to be calculated as prices of public services, and must cover the full prime cost of local service provision. It should be pointed out that the growth potential of local fees has not been

Figure 13.4. **Local fees structure in FY 2004**



Source: The National Association of Municipalities in the Republic of Bulgaria.

reached yet, so that an additional expansion in the size and proceeds of local fees can be expected in the medium term.

Besides local taxes and fees, local authorities can rely on revenues from local property management. Given the current scarcity of financial resources in the public sector, and the limited local tax base, a possible solution for promoting local fiscal autonomy is the efficient use of municipal property by establishing municipal companies and public-private sector business partnerships. Improvement of local capacity in the field of property management can foster the expansion of municipal own-source revenues and influence considerably the quantity and quality of local services.

Intergovernmental transfer system: Financial dependence of local governments

Intergovernmental transfers as specific financial flows from the central to the local governmental level have two basic forms: revenue sharing and grants. The main purpose of the transfer system is to "soften" vertical and horizontal fiscal imbalance, and compensate local governments for financial disparities and spillover effects.

Actually, the intergovernmental transfer system in Bulgaria plays the dominant role in financing local governments. Governmental transfers form the dominant element of municipal revenues – up to 60% in recent years. Due to the gradual decline in their relative share in total local revenues, from 90% in 1999 to 76,3% in 2002, and 59% in 2004, the Bulgarian intergovernmental transfer system is approaching the European standards. Although there is no absolute rule, it is accepted that local fiscal autonomy is properly secured when local own-source revenues compare in amount to the governmental transfers. From an economic and financial point of view, the dominant role of the transfers allows local governments to be compensated for vertical imbalance, horizontal imbalance and spillover effects, but from a political and institutional standpoint, such a proportion gives the central government more political and financial control over the local level than is acceptable in a modern revenue assignment system.

The intergovernmental transfers in Bulgaria are not competitive and comprise shared taxes and state subsidies. The most important shared tax is the personal income tax. It used to be shared among the State and municipalities in a 50:50 ratio. Since the beginning of 2003 personal income tax has been classified as an entirely municipal revenue, intended to cover delegated state responsibilities at the local level. However, significant interregional disparities are inescapable because personal income tax is progressive, collected by withholding at source, and the tax base is unevenly distributed, favouring the richest local governments. For this reason, certain

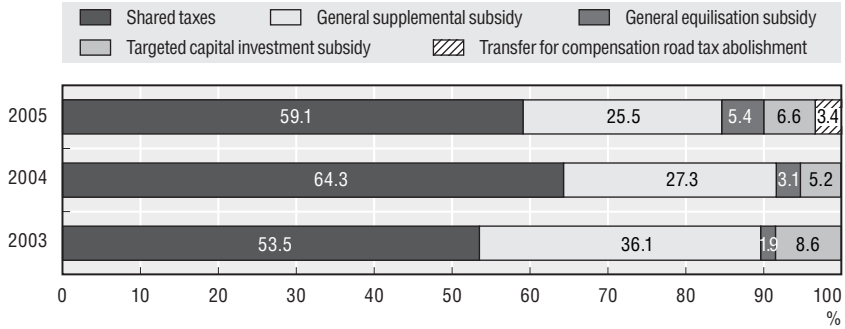
normative expenditure standards for delegated state activities have been developed and, concomitantly, the shared tax proceeds of any particular municipality have been limited to the amount of these standards.

In addition to the shared personal income tax, Bulgarian municipalities can count on three types of state subsidies: general, targeted, and extraordinary. According to the legislation in force, a general subsidy is provided to municipalities without restrictions. It is unconditional, so no strings are attached to the use of the money. Target subsidy is conditional. It is provided for a preliminary set of purposes, usually for social assistance, health care, ecological recovery or capital investment projects. Extraordinary subsidy is an unconditional, unplanned financial flow, granted to municipalities in a difficult financial situation.

Total intergovernmental subsidies are allocated based on a formula which is set forth in the Annual State Budget Act. Since its introduction in 1993 it has been changed almost every year. Basically, the formula takes into account the expenditure needs and revenue capacity of the local governments. The *general supplemental subsidy* is calculated by a "gap-filling" method, as the difference between the full cost of all state mandates imposed on municipal budgets, and the amount of the shared tax revenues. Actually, the general supplemental subsidy plays an equalisation role as well, and compensates for the uneven distribution of the personal income tax base. The right to receive a *general equalisation subsidy* is extended only to a municipality whose proceeds from local taxes in the previous fiscal year have been under the average local tax proceeds at the national level. This governmental transfer brings the revenue capacity of the below-average municipalities up to the national average level. The annual equalisation transfer pool must equal at least 10% of the total municipal own-source revenues in the previous fiscal year. The *targeted capital investment subsidy* is a very important financial flow, because a wide range of infrastructure capital investments and ecological recovery projects is assigned to the local governments. It is allocated on an ad hoc basis and seems to bear no relationship to the general subsidy criteria. The *extraordinary subsidy* is an unconditional, unplanned financial flow, granted to the local governments in the course of the fiscal year, based on vague criteria and generally aimed at supporting municipalities in a difficult financial situation.

The structure of intergovernmental transfers in fiscal 2003, 2004 and 2005 is presented in the figure above. Obviously, the main transfer flow is the personal income tax, whose significance has been tending to increase, especially in the last few years. Another visible point is the substantial growth of the equalisation subsidy which, however, has relatively little influence, because of the dispersal effect – up to 240 municipalities (90% of all municipalities in the country) were subsidised in 2004. Although the target

Figure 13.5. **Intergovernmental transfer system**

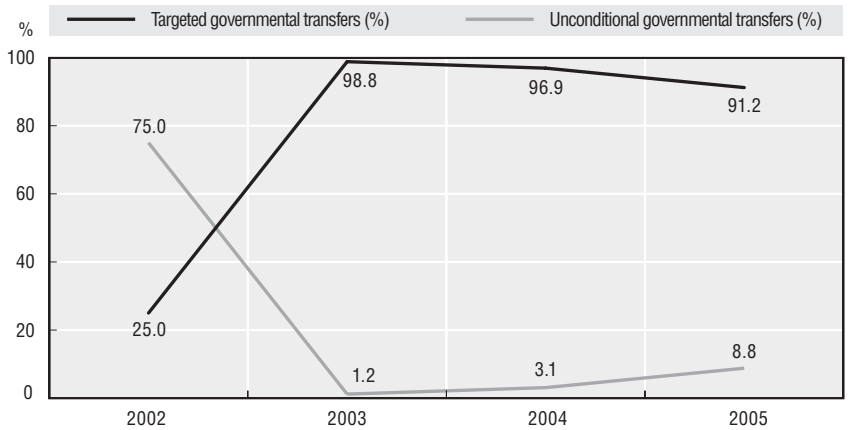


Source: The Ministry of Finance and own calculations.

subsidy for capital investments seems to remain almost unaffected, it is one of the most debatable points in the transfer system. The lack of a clear mechanism for its allocation is one of the fundamental challenges in intergovernmental fiscal relations. It is still unresolved.

A more alarming problem in the system is the obvious centralisation of the recourse to transfer funds, which has been clearly visible during the last three years. Contrary to expectations and logic, shared tax revenues and the general supplemental subsidy have been transmuted into strictly targeted funds, so that since 2003 up to 90% of the intergovernmental transfers have been targeted.

Figure 13.6. **Intergovernmental transfer structure**



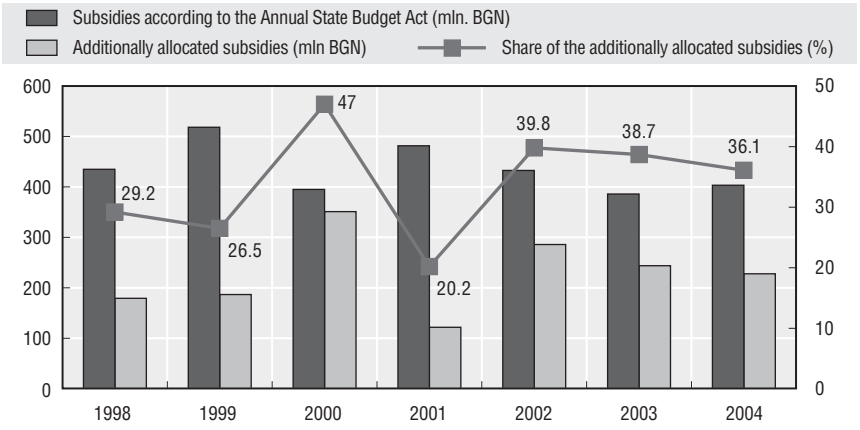
Source: The Ministry of Finance and own calculations.

Actually, the favourable change in the proportion between own revenues and governmental transfers mentioned above mainly reflects the significant reduction of delegated mandates – 130 million BGN in recent years – rather than a considerable increase in local own-source revenue. Moreover, according to the most recent legislative amendments, at the beginning of fiscal year 2005 one local tax, namely road tax, was abolished. In order to compensate local governments for the ineluctable fall in tax revenues, the Annual State Budget Act for fiscal 2005 provides for a special governmental transfer. Such an approach can be considered as a regression to the earlier highly centralised intergovernmental financial relations.

A really important issue regarding the scope of the intergovernmental transfer system is the inaccurate planning of the transfer flows, and as a consequence, the additional reallocation of funds among the municipalities. According to the available data, the relative share of additionally allocated funds, during recent years has absorbed up to 35% of the total governmental subsidy. This practice is a step back from the fiscal decentralisation concept, since it ignores both the allocation formula and normative criteria.

Actually, depending on transfers would not be a problem for local governments, but reliance on "ad hoc" or strictly centralised funds could undermine effective budgetary decision-making at the local level, while fostering a strongly political determination of intergovernmental resource allocation. Moreover, the lack of longstanding and stable legislation on the scope of intergovernmental transfer allocation is a cause of unfairness, unpredictability, and instability of local finance, and renders the local budgetary process opaque.

Figure 13.7. **Additionally allocated subsidies**



Source: Ministry of Finance and own calculations.

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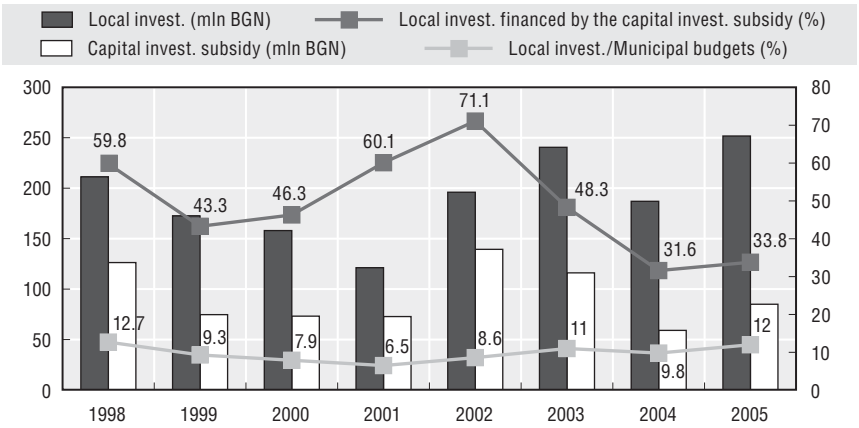
Municipal borrowing and local investment financing

Since the transition, investment spending by Bulgarian municipalities has been extremely low and insufficient to meet the economic and development needs of local governments. Obviously, municipal investment expenditures have recently absorbed a relatively moderate share of local budgets. These outlays are mostly for the delegated state activities; actually targeted state investment subsidy is the main source of local investments financing. Although local investments tend to increase, the fiscal year 1998 level (12.7%) has not yet been reached; moreover, the upward trend was interrupted in 2004.

At all events this share does not compare favourably with other CEE countries such as Hungary (18%), Poland (more than 20%) and the Czech Republic (more than 30%). At the same time, available sources for investment financing are quite limited and consist mainly of targeted capital investment subsidy and revenues from sales of municipal property. Local governments could not rely only on the State for important municipal investment needs and one of the most alarming trends is the increased use of sales of municipal property as a source for local investment financing, in parallel to a decrease in of local own-source revenues. The scarcity of capital funding sources for local infrastructure projects during the transition period has been due to the lack of an appropriate legal framework defining the scope of local borrowing capacity. For this reason municipalities have only limited experience in raising and managing funds.

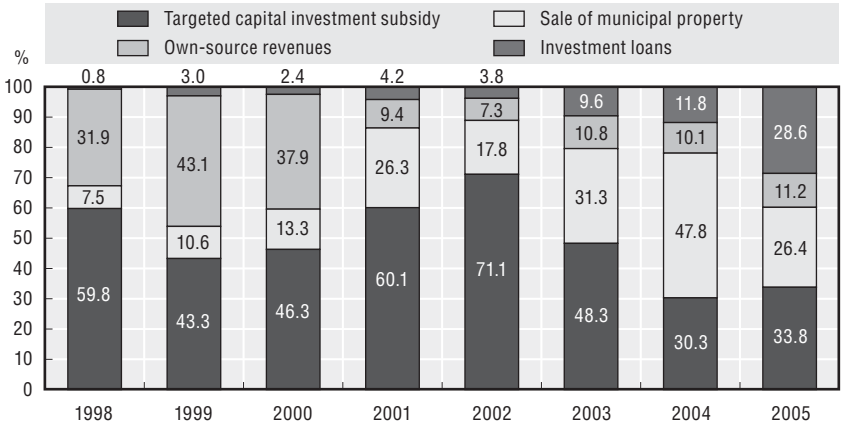
Instead of selling municipal property, and consequently reducing own-source revenues, local governments could use borrowed funds in order to

Figure 13.8. **Local investments relative share in municipal budgets**



Source: The Ministry of Finance and own calculations.

Figure 13.9. **Sources for local investment financing**



Source: The Ministry of Finance and own calculations

finance local investment projects. The advantages of local borrowing as a source for investment financing can be summarised as follows:

- Inter-temporal and inter-generational equity.
- A closer relationship between those who benefit from the investment project and those who pay for its completion, which supports optimal resource allocation.
- Benefits from the acceleration of local development accruing from the borrowed funds quite often exceed the cost of debt service.
- A reduction of operational costs due to the fact, that expenses related to borrowing are often lower than the costs of maintaining the old infrastructure for longer. If local infrastructure is too old it will be more profitable to borrow funds and build new and more reliable facilities, instead of repairing them. The benefits are higher reliability, as well as savings in the cost of repairs and the employment of service staff.
- Access to the grants from European and other development funds is one more rationale for borrowing, specific to Central and Eastern European countries. There are several investment grants available to local authorities, subject to the condition that the borrower must provide matching funds usually equal to at least 25% of the total project costs (as in the case of SAPARD, PHARE or ISPA projects). Borrowing can be a useful tool for increasing local capacity to apply for these development grants.

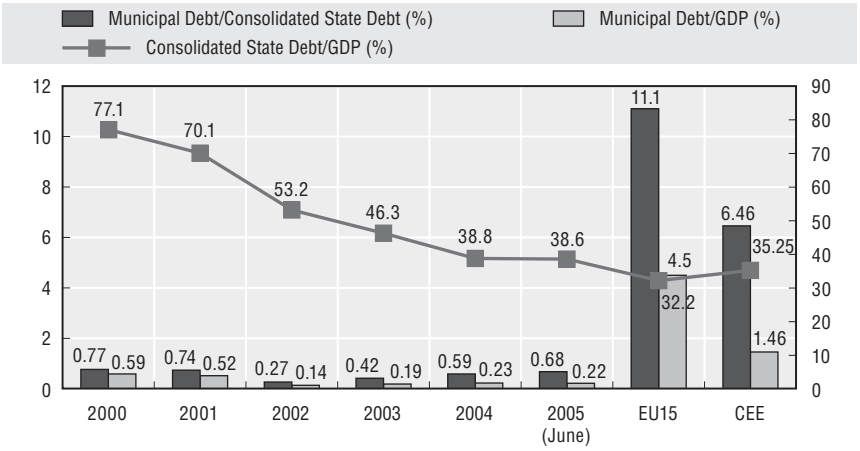
The conclusion is that there is a considerable need to improve, rehabilitate and extend local government infrastructure and networks, and to repair essential buildings and equipment. This effort cannot be implemented

without increased access to capital markets and improved local government ability to repay such borrowing.

However, local budgetary deficits and debt are part of the consolidated state deficit and debt. Because of the forthcoming accession to the European Union, public debt in Bulgaria is limited by the legislation in force[4] to 60% of GDP, in accordance with the Maastricht criteria. Moreover, the central government has the legal right to propose a cap on municipal debt, should consolidated debt exceed the proportion approved. Fortunately, this is not a problem at this time. Thanks to the purposeful efforts of the last few years, consolidated state debt has been gradually reduced to 38,6% of GDP – a level comparable to the European standards. At the same time, the local debt level in our country is negligible by comparison with its level in the developed countries, and even in some of the former socialist countries. Obviously, local debt potential has not been reached yet, so that in the medium and long term context, an increase in the recourse to debt instruments at local level can be expected.

Under the legislation in force,[5] the borrowing sources available to Bulgarian municipalities are the issue of municipal bonds, loans from banks and other financial institutions, interest-free loans from the central budget, and inter-municipal loans. Basically, borrowing is not a significant local source of funds, and its relative share in the total local revenues has not exceeded 1-2% in recent years. Moreover, local debt has been reduced from 157.9 million. BGN in 2000 to 88.4 million BGN at end 2004 – a decrease of almost 55%. In practice, the best part of the borrowed funds has been used by

Figure 13.10. **Public sector debt indicators**



Note: Debt indicators for Central and Eastern European countries comprise data for the Czech Republic, Poland, Slovakia and Hungary.

Sofia (the capital city) and the largest municipalities. At the same time, small and medium size local authorities are short of funds for capital investment, especially in local infrastructure. Due to the lack of an appropriate legal framework, they have not enjoyed the same access as the other participants who have operated in the capital markets for a long time. For this reason, adoption of the new Law on Municipal Debt, which entered into force in June 2005, is one of the main achievements in this area. In order to achieve strong fiscal discipline, the law limits municipal annual debt service to 25% of own-source revenues plus the annual equalisation subsidy. Despite its restrictive role, this statement is not an obstacle. To the contrary, it is an important guarantee against municipal default and a vital precondition for fostering the growth of a market in municipal credit.

Conclusions and issues for consideration

- The degree of fiscal decentralisation in Bulgaria is below European standards. During recent years, municipal budgets' share in the consolidated state budget has been substantially reduced to 13-14%, and no more than 5-6% of GDP has been redistributed through the local budgets. In comparison, the average levels of the specified indicators in the European countries are more than double these values.
- The basic parameters of local revenue structure are comparable to the prevalent European model. Municipal own-source revenues have increased gradually, from approximately 10% of total municipal revenues in 1997 to not far short of 40% in 2004. Obviously, this is an important advance towards fiscal decentralisation and real local financial autonomy.
- At the same time, local tax revenues are tending to decline. In order to foster local financial autonomy, it is necessary to expand the local tax base. Possible approaches that could be recommended: update the property tax base or delegate new local tax revenue sources.
- Municipalities do not enjoy real tax authority. In the OECD classification, local taxes in Bulgaria are defined as a special kind of governmental transfer. In the context, a gradual delegation of taxation power to the local authorities is an absolutely necessary and urgent task.
- Development and adoption of a stable legal framework for the principles and mechanisms of the intergovernmental transfer system is a precondition for stable, predictable, and transparent local revenue allocation. The ability of the central government to neglect the normative methodology and allocate additional subsidies during the fiscal year at will must be ended.
- Development and adoption of an appropriate framework for regulating capital investment subsidies is necessary. A gradual transition is required to

a model of financing, based on robust investment projects that municipalities can refer to in order to apply for targeted subsidies, applying competitive principles, from the national investment fund.

- A clear distinction is required between local operations and capital budgets, as a precondition for achieving municipal creditworthiness.
- The Law on Municipal Debt now in force must be followed by development of a municipal credit rating system, as a base for fostering development of a market in municipal credit.

In conclusion, hard and purposeful efforts have brought the revenue distribution system in Bulgaria closer to the European standards, and therefore to the objectives of local finance reform. As can be seen from the discussion above, there are many achievements, but also many challenges in the fiscal decentralisation process. The conclusions and recommendations summarised here are aimed at helping local governments to solve the totality of the problems they face. Only real local financial independence can contribute to the development of a favourable investment climate, and allow municipalities to transform themselves into the main organisers of public production facilities within their jurisdiction, as well as structural units, heralds of sustainable development and growth of national importance.

Notes

1. Ministry of Finance Database in *www.minfin.bg*.
2. See Working Party on Tax Policy Analysis and Tax Statistics of the OECD Committee on Fiscal Affairs, 1999.
3. See *www.narmb.org/database*.
4. The State Debt Act, published by the State Official Journal, Issue 93/2002, Art. 10 and 11.
5. The Municipal Budgets Act, published by The State Official Journal, Issue 33/1998, Final Additions and Amendments in Issue 107/2003, Chapter 8.

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ANNEX

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