

# DECENTRALIZATION OF THE GOVERNMENT IN BULGARIA – FORMER DECISIONS, RECENT REFORMS, FUTURE CONSEQUENCES

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## **Abstract:**

Bulgaria is one of the first countries from the former socialist block, which adopted a new democratic Constitution as early as 1991. The Constitution affirms the model of modern democratic state and outlines the principle of decentralization, admitting the right of self-government to the municipalities. Development of the legal frame of the local self-government and the enlargement of its functions, including the regulation of the financial independence of the municipalities, were accepted as a good perspective for further development of the local self-government.

Based on the above mentioned the paper analyses:

- Financial decentralization in Bulgaria as an integral part of the process of making public institutions more efficient, responsive and accountable to citizens;
- Historical background of the decentralization process - undertaken reforms, amendments of legal texts, Constitutional amendment for providing local authorities with taxation powers, establishment of a joint Working Group on Financial Decentralization; adoption of a Concept and a Program for Financial Decentralization; creation of a system of incentives which target higher local revenues, consolidated financial management potential, and maximum level of local autonomy; division of municipal budget financed public services into two groups (state delegated and local); development of Strategy for decentralization and a Program for its implementation;
- The impact of the reforms in the municipal financial system and the measures, envisaged for the period 2010-2013.

The purpose of the paper is not only to reveal the past reforms, but to stress on the present results and to examine the intergovernmental fiscal relations and local financial management. Unfortunately despite the positive changes, made in the first years after the period of centralized economy and governance, nowadays the local finance system is almost unchanged. Some of the ascertained problems might be summarized in the following:

- Insufficient financing of delegated responsibilities;
- Structural deficit in the municipal budgets;
- Reduction of the recourses for municipal investments.

The experience in our country shows that a number of former decisions and initial intentions in the sphere of decentralization end with stabilization of the centralization. In this respect the paper searches arguments, connected with the reasons for the above described situation – is it a result from:

- the unpreparedness of local government institutions and local stakeholders to operate in a reformed environment and the limited capacity to design, implement and monitor decentralization policies;
- or the wish for realizing a lot of changes for very short period of time;
- or the reason is in the lack of political will.

## **1. First steps towards financial decentralization in Bulgaria**

The process of decentralization began with the adoption of the new Constitution of Republic of Bulgaria. The process proceeds at different rates, often accompanied by conflicting assessments and results.

From 1991 until 2002, decentralization was not very high on the political agenda of the country, although a number of important laws were passed which prepared the ground for a greater autonomy of local government (The Municipal Property Act -1996, The Act on Local Taxes and Fees – 1997, The Municipal Budgets Act). Despite the positive changes and the legislative amendments, made in the first years after the period of centralized economy and governance, the subnational financial system stayed almost unchanged. Like most countries in transition, one of the most severe problems that Bulgarian local governments were facing was the discrepancy between the responsibilities and powers of municipalities. For that period there was no clear distinction between local governments' responsibilities and responsibilities delegated from central government tasks. The financial system was highly centralized, with complete control over expenditures in municipal budgets, limits on local revenues and priorities of local governance regulated by the State Budget. Municipalities could not determine the local taxes and charges on their own. Local taxes were determined by law, and

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constraints were set for local charges. According to reported data for 1999, Bulgarian municipalities were free to influence in some way about to 15-18% of their total revenue base and about to 20% of their expenditures. In other words the central government defined/ set and spends/ spent 4/5 of the municipal budgets without taking responsibility to the local population.<sup>2</sup> At 1989 in USA 65% of the local expenditures were financed with local revenues, in Europe this percentage varies from 16% in Holland to 87% in Switzerland. Researches in 18 developing countries shows, that this share also varies – from 30 to 90%. In Bulgaria local revenues generated 5-6% from the total budget revenues of the municipalities<sup>3</sup>.

The share of the state transfers<sup>4</sup> in the total amount of the municipal revenues is presented in Table 1<sup>5</sup>.

**Table 1. Share of the state transfers in the total amount of the municipal revenues:**

	1998	1999	2000	2001	2002
<b>Total revenues</b>	1683,1	1860,2	2011,6	2018,8	2326,8
<b>State transfers</b>	1395,5	1428,5	1597,6	1657,3	1789,9
<b>Share of the state transfers</b>	82,9	76,8	79,0	82,1	76,9

The main conclusions of the data in Table 1 are that for the period 1998-2002 there was a strongly dominating share of the state transfers in the municipal revenues. The bigger share of the state transfers is a sign for low socio-economic development and impossibility for formation of own revenues.

It was only in 2002 that one can really start speaking about more decisive actions on decentralization. On 11<sup>th</sup> March 2002 the Council of Ministers established a joint Working group on Financial Decentralization<sup>6</sup>. In June 2002 the working group developed and the Council of Ministers adopted a Concept for Fiscal Decentralization and an Action Plan for the period 2002-2005, which marked the start of the reform of local finance system with the purpose to increase the financial independence of municipalities and redefine the regulatory framework of intergovernmental relations. The implementation of the Action Plan led to the amendment of the Local Self-Government and Local Administration Act (2003) and to a number of other acts including that on Municipal Property, Local Taxes and Fees, Municipal Budgets etc. A new Act on Municipal Borrowing was adopted in 2005.

The basic long-term objective of the Concept is “to provide public services in quantities, of quality, and at prices corresponding to the needs of and affordable to the people, on the basis of long-term balancing of municipal expenditure responsibilities with stable revenue sources and effective civil control”. Bulgarian municipalities and the Government agreed that this objective requires observation of the following principles:

- Creating a system of incentives which target higher local revenues, consolidated financial management potential, and the maximum level of local autonomy to determine the type, scope and provision of municipal services;
- Adopting simple financial relationship structure;
- Strict financial discipline followed by central and local governance;
- Monitoring and assessing the decentralization process by central governance;
- Considering municipal differences in terms of financial resources and management competence, and enabling municipalities with different potential to develop in accordance with their characteristics;
- Generating conditions suitable effective civil control.

The first steps towards financial decentralization in Bulgaria brought to division of all municipal-budget-financed public services into 3 groups:

- *State-delegated* services refer to those of the education, healthcare, and social establishment sectors, as well as, to some degree, services in the cultural sector. Operating expenses of State-delegated activities are calculated according to standards including personnel number, amount of salaries and insurance payments, and cost amount. The State serves to provide necessary financial resources for this group of activities, utilizing two sources: shared taxes and complementary subsidies. According to implemented changes, municipalities are deprived of revenues from corporate profit taxation at the expense of receiving 100% of the revenues from the Personal income tax (PIT). Additionally, the financing of State-delegated activities

<sup>2</sup> Report “Fiscal decentralization” prepared for the Local self-government forum by a working group on fiscal decentralization, 2001, Sofia

<sup>3</sup> Bird, Richard. 2000. *Setting the stage: Municipal finance and Intergovernmental Finance*. Washington DC. World Bank Institute

<sup>4</sup> State transfers are formed from 2 main kind of revenues – shared taxes and state subsidies

<sup>5</sup> Fiscal decentralization in Bulgaria – bigger independence for the local authorities, LGI, CED, Sofia, 2005

<sup>6</sup> with members: the Deputy Prime Ministers (of finance and of regional development and public works), representatives of other ministries (of education and science, labor and social policy, healthcare), the Audit Office, the Council of Ministers, the National Association of Municipalities in the Republic of Bulgaria, the Foundation for Local Government Reform

expenditures is determined by calculating their amount according to standards. Where revenues from PIT exceed the amount of expenditures, the municipality receives a percentage of PIT up to this amount and does not receive any complementary subsidies.

- *Local activities* include public works, maintenance of country roads, cost of kindergartens and nursery homes, and most activities in the cultural sector. Municipalities incur expenses for local activities up to the amount of their own revenues, which formed by local taxes, local charges and other non-tax revenues (municipal property management, fines, and so on).
- *Activities having mixed financing* include kindergartens and nursery homes. The cost of such establishments is financed from municipal revenues, whereas salary and social security expenditures are financed from government transfers.

After the implementation of the financial reform Bulgarian municipal governments received four sources of revenue: own revenues, state transfers, municipal property, and issuance of debt. The Constitution requires the Parliament to approve all taxes and tax rates, including at the local level. Data from the National Association of Municipalities in Republic of Bulgaria (NAMRB) indicate that between 7 and 10 percent of all tax revenues are devoted strictly to local governments. Once the municipalities receive their subsidies from the central government, they have complete control over their own budgets. The only exception applies to money received for targeted national programs.

At the end of 2002, in line with the Fiscal Decentralization Concept, the Local Taxes and Fees Act was amended and the municipalities were allowed to receive the proceeds of local taxes but not to determine their type, rate and base. However, 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. 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.

Since January 2003 a new system of intergovernmental transfers was established. The intergovernmental transfers in Bulgaria were not competitive and comprise shared taxes and state subsidies. The most important shared tax is the personal income tax (PIT). It used to be shared among the State and municipalities (50/50 ratio). Since the beginning of 2003 personal income tax has been classified as municipal revenue intended to cover delegated state responsibilities at the local level. However, significant interregional disparities were inevitable because personal income tax is progressive, collected by withholding at source, and the tax base is unevenly distributed. For this reason the personal income tax proceeds of any particular municipality have been limited to the amount of the standards set for the delegated responsibilities.

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. Target subsidy is conditional and is usually provided 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 equalization role as well, and compensates for the uneven distribution of the personal income tax base. The right to receive a *general equalization 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 equalization 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.

Despite the absence of an officially adopted overall Decentralization Strategy, fiscal decentralization proceeded through the State Budget Acts for fiscal years 2003, 2004, and 2005. These acts clarified the respective responsibilities of the central and local authorities and the system of intergovernmental transfers. The system envisages a number of “mandated” or delegated responsibilities which are financed through transfers based on costing standards for the delegated services. These include state mandates in the fields of education, health care, and social assistance. The new system envisages full municipal responsibility for a number of services financed by local own revenue sources. These services include local utilities such as water supply, sewerage, heating, gas

supply, construction of local roads and streets, urban development and infrastructure. Municipalities are partially responsible for services related to cultural advancement (local libraries, museums, and theatres), environment protection, housing construction supervision, and some economic activities.

Throughout the period 2003-2005 there was a tendency for faster growth of own municipal revenues. This leads to an increase of their share in municipal budgets from 22.5% in 2002 (the last year before the reform) to 32.5% in 2005.

The share of government transfers constantly declined. Compared to all the revenue it reduced to 63.3% in 2004 and in 2005 it was 57.3%. This was due to faster growth of municipal own revenues. In depth qualitative analysis shows differences in the local authorities' responsibilities in terms of both their own revenue and the state transfers.

The share of own revenues in the total amount of all municipal revenues is a key indicator of financial autonomy of municipalities. The analysis results show that own revenues increased at a faster rate than other municipal revenues. Meanwhile, the share of government transfers fell, as in 2003 eliminated funding for welfare benefits, and in 2004 dropped the financing of municipal hospitals. Both factors combined lead to increased share of own revenues in total municipal revenues. In 2004 this share was 30.5 percent and in 2005 increased to 32.5%<sup>7</sup>.

The share of municipal revenues, determined independently by local authorities gives an idea how the own revenues of municipalities meet European criteria set out in the European Charter of Local government. It is known that the municipalities in Bulgaria have no powers for determination of local taxes. From this perspective, the indicator is a proportion between non-tax revenues and the sum of own revenue (tax and non-tax).

The results show an increase in this share from 72.6% in 2004 to 73.9 percent in 2005 This is a consequence of faster growth of revenues from property and sales over that of local taxes. Deprivation of the municipalities partly by revenues from road tax has led to relatively lower growth of the local taxes in 2004, which reduced their share from 9.1% to 8.9% in 2004 and 8.5% in 2005 from the total amount of municipal revenues. In 2004, municipalities were compensated with the provision of transfer in the amount of 13.5 million for the partial lifting of road tax. In 2005 the compensating subsidy reached 43.7 million. Further steps for enhancing the amount of this indicator is amendments of the Constitution and subsequent granting tax responsibilities to local authorities.

The share of municipal revenues, determined independently by local authorities is an indicator giving more accurate information about the powers of local authorities in respect of their revenue base. In 2003, mainly due to increased local powers over the municipal fees, this share jumps to 21.6% percent. In 2004, it continues to increase - 23.7% and in 2005 reached 24.0%. This indicates increased financial autonomy of the municipalities.

The share of the expenditures over which municipalities have full authority<sup>8</sup> increased in 2004- from 41.0% in 2003 to 45.3% of total municipal expenditures. In 2005 its share was 50.9%. Increasing the share of these costs is mainly due to the faster growth of own revenues municipalities.

Table 2 presents the main groups of municipal revenues characterizing their vitality for 2002-2005. The data shows that in 2005 there was a large increase in municipal revenues compared to the previous year - 7.2%. This dynamic is a consequence of the changes in the amount of state transfers and own revenues of municipalities. State transfers, despite their larger size continuously decreased. Own revenues increased by relatively high rates, leading to lasting positive changes in revenue structure. As a result, the ratio of own revenue to state transfers changes from 51.6% in 2004 to 56.8% in 2005<sup>9</sup>.

**Table 2. Main groups of municipal revenues for 2002-2005<sup>10</sup>**

	Amount /in million leva/			Growth /%/	
	2003	2004	2005	2004/03	2005/04
<b>State transfers</b>	1 493.2	1 529.1	1 481.5	2.4%	-3.1%
<b>Own revenues</b>	691.3	788.7	842.2	14.1%	6.8%
<b>Total revenues</b>	2 256.0	2 414.7	2587.4	7.0%	7.2%

Comparative analysis of the results shows that there was growth in all indicators excluding state transfers, which can be treated as positive result. The findings of the monitoring of financial decentralization reform are summarized into three groups:

**1. Qualitative positive changes;**

- Adopted Municipal Debt Act;

<sup>7</sup> Council of Ministers. 2006. *Monitoring of the reform towards financial decentralization in 2005*. Sofia

<sup>8</sup> It is assumed that expenditures over which municipalities have full authority consists of the expenditures for local services and expenditures for additional financing of state delegated activities.

<sup>9</sup> It should be borne in mind that state transfers include subsidies and transfers from the central budget and budget / extra budgetary accounts.

<sup>10</sup> Council of Ministers. 2006. *Monitoring of the reform towards financial decentralization in 2005*. Sofia

- Rule came into force to regulate the total amount of the *equalization* subsidy;
- Municipalities received the right to administer local taxes and fees;
- decision to update the database of real estate tax from the beginning of 2006;
- growth of own revenues with 119.4 million leva compared to the previous year;
- The share of local activities increased from 44.3% in 2004 to 49.2% in 2005.

## **2. Unrealized changes:**

- The practice municipalities to be compensated for the drop-road tax with a subsidy, instead of defining new own source of income continued;
- There wasn't a decision taken about the right of the municipalities to plan the expenditures for delegated services, according to their own priorities;
- Not provided powers to municipalities in terms of their revenues, obtained by transfer accounts.

Amendments of the legal framework were carried out slowly and chaotically and didn't create prerequisites for stability in the municipal sector. The assignment of new responsibilities to local governments was not accompanied by appropriate provisioning (an example was the commitments of local authorities under the Health and Safety at Work Act, Crisis Management Act and others).

The Action Plan for Fiscal decentralization in Bulgaria completed in 2005. The overall assessment is that from the 37 measures envisaged the majority were accomplished. Some of the outstanding measures were:

- Amendment of the Constitution of the Republic of Bulgaria, aimed at submitting right to municipal councils to determine independently the size of local taxes;
- Development of legal regulation to address the specifics of the Municipality of Sofia - the Capital city Act;
- Development of methodology for allocation of funds to for reconstruction of the municipal road infrastructure.

## **3. Quantitative changes (positive and negative):**

- The reduction trend of the municipal expenditures in GDP and CSB was stopped.
- Improving the structure of revenues, increase of own revenues;
- Changes in positive direction regarding the share of the revenues and expenditures on which municipalities have the power to make decisions;
- The share of investment expenditure and borrowings increased by highest rate;
- The share of local taxes in the total amount of municipal own revenues decreased - from 28.6% in 2003 to 26.5% for 2004 and 25.6% for 2005. In the period until 2004 municipalities were forced to sell municipal property to cover the structural deficit, but this resource has been exhausted and there is deleveraging. It should be borne in mind that tax revenue and revenues from property are the main source of funding for infrastructure;
- Analysis of the share of municipal tax revenues in total municipal revenues also shows reduction in the period 2002-2005. The difference between local authorities in Bulgaria and other European countries in this respect is enormous. In Denmark, for example, the share of local tax revenues of the municipalities is about 53%, the average size for European countries is about 36% and in Bulgaria in 2005 this share was 8.4%. A survey of NAMRB showed that if keeping the trends at which the reform of local finances were implemented until 2005, Bulgaria will take 33 years to reach current average level of financial autonomy of local government in Europe, and around 47 years to reach the current level of European countries with decentralized systems.

## **2. The adoption of a Decentralization Strategy and the reforms, envisaged in it**

### **2.1. Key features of the Strategy**

It is only in 2006 that the government adopted a Decentralization Strategy and Action Plan for the period 2006-2015. The Strategy was developed in implementation of the task under p. 2.4 "Develop a Decentralization strategy for Bulgaria, to incorporate the decentralization of authorities and the financial decentralization" from Section "Decentralization of Government" of the Program for implementation of the Strategy for Modernization of the State Administration – from Accession to Integration, 2003-2006. The adoption of the Strategy was a response to the monitoring report of the European Commission for 2005 which recommends to further step up the decentralization process, which requires rapid, coordinated and focused actions. The new strategic approach to decentralization requires implementing it in conjunction with the remaining reforms and processes in the country, laying a special emphasis on:

- Linking the process of decentralization with the modernization and de-concentration of state administration;
- Unifying the processes of decentralization of powers and functions with the financial decentralization, which have been developing separately so far;

- Linking more closely the process of decentralization and the policy of regional development in the country, including the effort for strengthening the administrative and programming capacity to absorb EU funds at the municipal and regional level.

The Strategy is based on the priorities of the European policies for decentralization, sustainable and balanced development of the regions. It creates the prerequisites for implementation of the principles of the Lisbon Strategy in the regional policy in Bulgaria. The Strategy reflects the commitments made in the Executive Tenure Program for European Integration, Economic Growth and Social Responsibility for 2005 – 2009 to further step up the decentralization process, promote the expanding of the municipal own revenue sources, improve the quality of services and raise the living standards of the citizens.

The Decentralization Strategy is an integral document, which unifies the sectoral policies and their coordination at the different levels of government. Its task is to highlight the main directions for changing the interrelations between the public institutions, which will raise the efficiency of their functioning and result in better service delivery. The main objects of the Decentralization Strategy are the relations between the central and local government. Besides, the Strategy also tackles the internal relations between:

- The central executive bodies, their regional structures and the regional governors;
- The mayors of municipalities and municipal councils on one hand and mayors of mayoralities and service units on the other hand.

The Decentralization Strategy is a document with a long-term time horizon – 2006-2015. Thus, in terms of time-frame it is bound with the planning and programming documents in the field of regional policies and with the National Strategy for Regional Development, the implementation of which will be completed in 2015. This will ensure a closer link between the processes of decentralization and of regional development.

The implementation of the Strategy is performed by a new body established by the Council of Ministers in 2006: the Council for Decentralization of State Government. It is chaired by a minister, and its members are deputy ministers, regional governors, representatives of the National Association of Municipalities in the Republic of Bulgaria. Local and central government have an equal number of representatives in the Council.

One of the first tasks related to the implementation of the Strategy was the adoption in early 2007 of a constitutional change which granted taxing powers to the municipalities and full powers with respect to municipal fees.

The progress made in the implementation of the action plan is very slow and unsatisfactory according to the NAMRB. In the Implementation Report of 2006 which was prepared by the Council for Decentralization a lot of the measures envisaged to be taken were reported as partially implemented with the description the measure taken merely stating: “report prepared”. The NAMRB has openly stated its dissatisfaction with the implementation of the Decentralization Strategy in 2006.

Over the years, the Bulgarian municipalities have considerably increased their capacities. However, as in the central public administration, the quality of public service delivery remains low to very low. As stated in the Administrative Capacity Operational Program: “A large share of the municipal administrations, especially the smaller ones, as well as the territorial units of the central executive power do not have a sufficient capacity to perform their functions, despite increases in their staff locally. Therefore, attention must be paid to optimisation of the structure, qualifications and respectively activities of their employees”<sup>11</sup>. The Administrative Capacity Operational Program particularly stresses the limited capacity of the small municipalities. Public private partnerships or the outsourcing of some municipal services in general, are regarded as possible solutions to the issue of poor quality public service delivery. However, the Bulgarian municipalities still do not what services to outsource and how to outsource.

The country’s decentralization priorities of the Decentralization Strategy 2006-2015 are:

- Strategic objective 1: Step up the transfer of powers and resources from the state bodies to the municipalities with a view to strengthening local government.
- Strategic objective 2: Optimize the functional competences of the regional governor and the regional structures of the central executive bodies for coordination of the sector policies at the regional level.
- Strategic objective 3: Develop local self-government within the municipality by raising the financial and managerial autonomy of the mayoralities and service units and establishments.

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<sup>11</sup> Operational program “Administrative capacity” for the period 2007-2013. 2007. Sofia. Also available online at <http://www.opac.government.bg/>

## 2.2. Indicators for municipal financial independence and capacity

*Table 3. Share of municipal expenditures in the GDP and in the public expenditures (CSB)<sup>12</sup>:*

Indicator	2002	2003	2004	2005	2006	2007	2008
<b>Share of CSB in GDP %</b>	39.4	40.9	40.0	39.8	39.1	39.1	39.1
<b>Share of municipal expenditures in GDP%</b>	7.1	6.3	6.1	6.4	7.0	7.2	7.5
<b>Share of municipal expenditures in CSB</b>	18.0	15.5	15.4	16.2	18.0	19.2	20.2

In the first two years - 2003-2004, a decline in the municipal expenditure is observed due to restructuring of services between the municipality and the state (welfare benefits, hospitals and land commissions were centralized). The next four years - 2004-2008, there was a municipal expansion (increasing the share of municipal expenditures in GDP and CSB).

*Table 4. Local and general government budgets - share of municipal revenues in GDP and CSB<sup>13</sup>:*

Indicator	2002	2003	2004	2005	2006	2007	2008
<b>Local revenues in percentage of GDP</b>	1.62	1.92	2.01	2.24	2.64	2.94	2.67
<b>Local revenues in percentage of general government expenditures (%) – CSB</b>	4.12	4.68	5.03	5.64	6.75	7.83	7.24
<b>Local tax revenues in percentage of GDP</b>	0.49	0.60	0.59	0.59	0.78	0.91	0.97
<b>Local tax revenues in percentage of CSB</b>	1.26	1.46	1.48	1.47	2.00	2.41	2.63

Data in the table 4 shows that local revenues increased significantly in the last three years. Enduring is the trend of increasing tax revenues in absolute terms, and as a share in GDP and CSB. The conclusion that can be made is that the trends of increasing municipal share in GDP and CSB are maintained in respect of own local revenues and local tax revenues of the municipalities. Since 01.01.2003 municipal councils have the right to determine local taxes and the prices of services. The increase of 125.76% of local revenues compared to 2002 is due to this legislative amendment. The amendment of Local taxes and fees Act since 01.01.2006 give the right to all Bulgarian municipalities to administer local taxes and fees themselves. This amendment has had positive effect on the amount of revenues and the share of own (local) revenues of the municipalities. From the observed period, only 2008 is a year in which the municipal councils have powers to determine the size of local taxes within limits prescribed by LTFA. Generally Bulgarian municipalities have advantage of this right, as the table shows that in 2008 there is an increase in the amount of revenues from local taxes.

For the period 2002-2008 there were realized positive structural changes in the system of local finance. The share of own revenues reached 35.8% (2007), but due to the financial crisis in the last quarter of 2008 decreased to 32.4%. Investments reached 28.6% of total municipal expenditures. Together with the positive changes there was a decrease in the rate of municipal expenditures growth compared to the rate of public costs. The share of the state transfers that are not planned in municipal budgets and are allocated in nontransparent rules increased. The expenditures for financing delegated services, determined by the central government lag behind inflation, forcing municipalities to divert increasing amounts from the local revenues for additional financing. As a result from the financial crisis reduction of own municipal revenues and an increase in the state transfers began. In 2009 amount of their revenues fell to 29.32 percent at 32.44 percent in 2008<sup>14</sup> (Table 6).

<sup>12</sup> Impact assessment of the Local Taxes and Fees Act. 2009. Sofia

<sup>13</sup> Ibid

<sup>14</sup> Council of Ministers. 2009. Program for decentralization 2010-2013. Sofia

*Table 5. Structure of local own revenues<sup>15</sup>:*

Indicator	2002	2003	2004	2005	2006	2007	2008
<b>Local taxes in percentage</b>	30.53 <sup>16</sup>	31.26	29.41	26.04	29.63	30.83	36.38
<b>Local fees in percentage</b>	41.03	41.12	41.83	36.66	34.33	33.59	36.72
<b>Non tax revenues in percentage</b>	28.44	27.62	28.76	37.30	36.04	35.58	26.90
<b>Total local revenues in percentage</b>	100	100	100	100	100	100	100

In structural terms, the three main groups forming the local revenue municipal budgets (taxes, fees and other non-tax revenues) have close size unit. This is due to faster growth of revenues from local taxes in the last three years (Table 5). Data on the changes in the structure of local revenues, show that on one hand, local authorities made efforts primarily to increase the collection of tax revenues and to increase the size of local taxes (although not with the expected growths). On the other hand municipalities continued to offset their deficit by higher revenues from property, especially with sales of municipal property. The reduction in growth of revenues from property in 2008 is due to the sharp drop in transactions in the fourth quarter, when for the first time the real estate market felt the impact of global economic crisis.

The analysis of the above information gives rise to the following conclusions:

- There is growth in the share of revenues from property in the total amount of municipal own tax revenues, as well as in the total municipal revenues. From 8.49% in 2005, their share in percentage increased, respectively to 9.92% in 2006, 11.04% in 2007 and to 11.81% in 2008.
- Notwithstanding the growth in property tax revenues, the places that occupy Bulgarian municipalities is much lower than the average in other European countries. Local taxes are the main revenues forming municipal own revenues of municipalities in Europe. For example, local taxes for the business are paid in 10 EU countries. As shared taxes there are PIT in 15 EU countries, local corporate income tax in 9 countries and VAT in 6 countries. In 5 EU countries there is a local PIT. Property taxes are paid in all European countries. In Bulgaria only property taxes and the negligible in size patent tax are local.
- Local authorities are forced to sell municipal property and to seek other borrowed funds to increase and in many cases even to maintain the quality levels and types of public service and construction of municipal infrastructure.

*Table 6. Structure of municipal revenues<sup>17</sup>:*

Indicator	2002	2003	2004	2005	2006	2007	2008
<b>State transfers in percentage</b>	76.9	67.6	65.6	57.4	59.4	52.8	56.0
<b>Own revenues in percentage</b>	22.5	29.2	30.4	32.5	33.5	35.8	32.4
<b>Other</b>	0.5	3.1	4.0	10.1	7.2	11.5	11.6
<b>Total revenues in percentage</b>	100	100	100	100	100	100	100

The share of municipal revenues from state transfers, and especially the way of their provision, gives information about the financial dependence of the municipalities from the central government. In 2006 the share of state transfers in all municipal revenues was 59.4%, in 2007 decreased to 52.8% percent, and in 2008 the share increased to 56.0%. Negative changes are connected also to the reduction of the share of expenditures for local services and the relative decline of the costs for public works, which are results of financial crisis, which affected Bulgarian municipalities in the last quarter of 2008. The crisis affected the municipal revenues. For the first time since 2003 a decreased proportion of own revenues was observed. The biggest decline occurred in the revenues from sale of municipal property. The share of the state transfers increased;

The most significant change in 2008 was the provision of taxing powers. Municipalities determine the rates of local taxes within limits set in the Local Taxes and fees Act.

Main findings of the analysis are:

- The share of the municipal revenues and expenditures in GDP and CSB increased;
- Municipal revenues increased;
- the amount of funds whose size depends on the local level decisions increased;

<sup>15</sup> Impact assessment of the Local Taxes and Fees Act. 2009. Sofia

<sup>16</sup> Significant revenues in municipal budgets had the road tax, but he lasted only three years – from 2002 to 2004

<sup>17</sup> Impact assessment of the Local Taxes and Fees Act. 2009. Sofia

- Patent tax became local tax.

This means that the ongoing reform and decentralization changes in LTFA influenced positively on the financial situation of municipalities. Notwithstanding the positive changes Bulgarian municipalities have limited powers to plan, manage and control the expenditures for delegated services, which are financed through state transfers and full rights to the expenditures for local services. Still significantly high share of the municipal revenues is accounted for state transfers. Although the share of own revenue increases, it is still too small. Given this, can not be said that the primary objective of the amendments in LTFA is achieved - to decentralize municipal budgets in terms of their revenues.

### **3. The program for the implementation of the Decentralization Strategy in the period 2010-2013 – forthcoming steps of the reform**

Bulgarian Decentralization Strategy is implemented through four programs, which provide concrete measures to achieve the strategic goals and priorities. In the period 2006 - 2009 was realized the first program to implement the strategy. The overall quantitative estimate is that they met about half of targeted measures for decentralization. The main positive change was the provision of tax powers to municipalities. Overall, in terms of quantity there is redistribution of resources in favor of municipalities. There are also positive structural changes in the system of the local finances. The share of own revenues reached 35.8% (2007), but owing to the crisis in the last quarter of 2008 decreased to 32.4%. Investments reached 28.6% of total municipal expenditures. The first Program for implementation of the Decentralization Strategy expanded the range of the relations in the public sphere. It set the processes of deconcentration (between central and regional authorities) and decentralization within the municipality (between the municipality, municipalities and service providers). The most common assessment of their performance unfortunately is almost no change at the regional level and weak positive results in the granting of powers to local structural units and in attracting external providers to ensure municipal social services. Contradictory are the results concerning the decentralization of municipalities. The estimates for civil control and citizens' participation in local decision making are extremely low.

Among the positive changes are detected unresolved problems and trends of concern. For example, for several years a decline in the rate of increase in municipal spending growth over the corresponding public expenditure have been reported. The share of government transfers that are not planned in municipal budgets and that are allocated in nontransparent rules is increasing. State determined expenditures for delegated services lag behind inflation, forcing municipalities to divert increasing amounts of local revenue for additional financing them, while limiting the powers of municipalities to manage these funds.

The economic crisis had a negative effect on the municipal finances in 2008. As a result municipal own revenues decreased from 35.8% in 2007 to 32.4%, while government transfers increased from 52.8% to 56% in 2008. In 2009, the expected share of own revenues fell below 30%.

The analysis of trends in local finance and international comparisons give grounds to conclude that to attain real steps towards decentralization in Bulgaria it is necessary to set a clear objective to achieve over the medium term (until 2013): getting closer to the EU average in key macroeconomic indicators characterizing the degree of decentralization in Bulgaria. Achieving this goal requires a focused effort to continue the reform of decentralization in the following guidelines:

- Transfer of public services from central government to municipalities;
- Restructuring of municipal public services;
- Increase of local powers;
- Increase of own revenues of municipalities;
- Accelerated development of local decentralization and local democracy.

Analysis of the results of the reform towards decentralization shows that the increase of own revenues is key to its further continuation. This might be realized through increased revenue local taxes, restructuring the tax system and introduction of new local taxes.

In this respect and as future measures in the program for the implementation of the Decentralization Strategy for the period 2010-2013 the following steps are envisaged:

- Transformation of part of Personal income tax PIT into a local tax;
- Establish fiscal contact business application of Municipalities incentives and other mechanisms;
- Supplementing the property taxes for exempt until property;
- Expanding the powers of municipal councils to introduce tax incentives and burdens;
- Adapting the system of local fees to legally assigned to municipal local services;
- Improve mechanism determining the tax base in accordance with market values.

Unlike the previous documents in this program the following quantitative goals which have to be achieved until the end of 2013 are placed:

- Share of the municipal revenues to GDP - 12%;
- Percentage of the municipal expenditures in CSB - 30%;

- Percentage of the municipal investments in the investment in CSB - 50%;
- Share of the own revenue in the total revenue of the municipalities - 50%.

## Conclusions

Bulgarian municipalities are assigned responsibilities for expenditures, which are secured with revenues – both own and transferred. In most municipalities revenues from taxes and charges are insufficient to cover the costs of delivered municipal services. That is why sub-national government bodies (municipalities) receive governmental transfers. The reform in the financial system introduced in 2003:

- Defined strictly municipal and state expenditure responsibilities as a first step towards proper structuring of municipal budget balances and gradually overcoming the fiscal imbalance of municipalities formed over time.
- Provided solution to the problem of calculating the total amount of the funds for the total complementary subsidy, i.e. the vertical distribution of the financial resources between the central and local government in respect of State-delegated activities;
- Established clear and transparent rules for horizontal leveling of the capacity of municipalities to generate incomes.

At the same time as a whole the level of financial decentralization in Bulgaria might be estimated as low. In the country the huge part of the tax revenues are collected in the republic budget. The share of the local taxes in the aggregated tax revenues is extremely low than the other European countries – in Germany, Sweden, Poland and Hungary the revenues from local taxes (and respectively the incomings in the budgets of municipalities) amount to about 30% from the total sum of all tax revenues; in Spain and Czech Republic this percentage is 20, and the country with higher share of the revenues from local taxes assigned to all tax revenues is Switzerland with more than 60%. The high level of centralization in the public sector, in particular the sphere of public services and taxation policy, make municipalities financially dependent on the state budget. 8 years after the reform in the sphere of the subnational finances and the start of the financial decentralization, the major part of local tax revenues in Bulgaria comes from shared taxes and state subsidies which are under full central government control. More local authorities have to rely directly or indirectly on reallocated funds and the more they need authorization on how to use own and reallocated funds, the higher is their financial dependence on the central government. That is why Local government representatives believe that fiscal decentralization is being “dictated” by the higher level and goes top-down instead of bottom-up.

The centralized model in the process of forming and distribution of budget resources for the municipalities does not ensure effectiveness in the consumption of public goods on the territory of the country. Frequently due to political reasons some municipalities do not receive enough resources from the central government, which in fact is kind of penalty for the citizens’ political choice.

The consequences of these problems might be summarized in the following:

- Presence of permanent structural deficit in the municipal budgets, caused by the discrepancy between expenditure responsibilities and the income base;
- Inadequacy between the structural changes in the country and decrease of the financial interrelations between municipalities and the state;
- Tax revenues are not enough to cover the cost of the delivered municipal services;
- The most profitable taxes (on consumption and incomes) are fully controlled by the central government.

Perhaps the biggest challenge, and the distinctive feature of Bulgaria’s experience in the sphere of financial decentralization, was the lack of political will at the central level to genuinely decentralize. Real fiscal decentralization in Bulgaria was only introduced as a practical response to enable Bulgaria to take better advantage of EU membership, that it : 1) To have a more effective regional and local policy in an EU membership context; 2) To ensure municipal co-financing for the Structural Funds. The fact that a Decentralization Strategy was only adopted in 2006 and that the constitutional amendment allowing the municipalities to set local taxes was adopted just after accession to the EU (in early 2007) are illustrative of the Bulgaria’s central authorities resistance to decentralization “until the last minute”.

Recommendations as to the improvement of legislation:

- adequate information on future changes in legislation and about financing and expenditure control, aimed at a realistic evaluation of municipality’s procurement of resources, future revenues, participation in projects and own investments, which could guarantee the fulfillment of delegated responsibilities;
- Delegating greater tax autonomy to the local authorities regarding the local taxes and charges
- Completion of the reform of state transfers. Two measures are essential to achieve this objective, the consolidation of state transfers and transparency in their allocation.

- introduction of new local taxes by restructuring the tax system - placing under the administration of local authorities taxes like the business tax, the agricultural land tax, etc. and some national taxes, for example those under PITA (rental income tax, patent taxes, liberal profession income tax)
- Updating the rates of the property tax and/or changing the tax basis on the basis of the market value of real estates. Creating property registers and sales database.

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