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GROWTH, FINANCE AND REGULATION

ACHIEVEMENTS, CHALLENGES AND PERSPECTIVES OF FINANCIAL DECENTRALIZATION IN BULGARIA

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Key words: Financial decentralization, local finance, intergovernmental fiscal relations.

Abstract: The process of gradual administrative and political decentralization in Bulgaria started in 1991, but the real financial decentralization process started in the beginning of 2003 with the adoption of a comparatively clear expenditure assignment and introduction of a transparent and predictable intergovernmental transfer system. Step by step, local governments have been given full control over some of the own-source revenues (local fees, service prices and revenues from municipal asset management) and limited control over the local tax levy.

This study is intended to examine and critically analyze the financial decentralization reform in Bulgaria, outlining the key achievements and basic weaknesses of expenditure assignment, local taxation and intergovernmental fiscal relations. The results indicate that local governments gradually became powerful component of the public sector. Although reducing financial resources of the public sector, worldwide economic and financial crisis can turn into an opportunity for some of the local governments in the country to gain financial independence and concentrate the efforts on strengthening local tax capacity.

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Introduction

Bulgaria is a unitary state with 7.9 millions population¹ and territory of 111 000 km². Administrative-territorial structure of the country includes 6 planning regions, defined as level NUTS II, 28 administrative districts corresponding to level NUTS III, and 264 municipalities, which represent the level LAU 1.² The planning regions are merely statistical units, created in compliance with the requirements of the EU for allocation of regional development funds. The districts are deconcentrated administrative units of the central government, which neither enjoy financial autonomy, nor provide public services to the population. Actually, municipalities form the only one tier of really autonomous subnational government in the country. They are legal entities, which have the right of ownership and adopt independent budgets. The bodies of local government - Municipal Councils and Mayors - are elected directly by the local population for a 4-year mandate with the purpose to make and perform governmental decisions.

The process of gradual political, administrative, and financial decentralization in the country started in 1991, parallel to the transition from the centrally planned, socialist type economy towards a market based economy. During the

period 1991-2009 Bulgaria has made a remarkable progress in reforming the system of intergovernmental fiscal relations. First of all, the most important pillars of the legal base of local self-government have been adopted, providing a stable background of financial decentralization. Secondly, the importance of local governments has increased relatively to the GDP and consolidated public sector. Thirdly, expenditure assignment and intergovernmental transfer system have been put on a clear and transparent basis. Fourthly, local governments have been given full control over some of the own-source revenues (local fees, service prices and revenues from municipal asset management) and limited control over the local tax levy. As a result local governments became powerful component of the public sector.

Decentralization process was inspired by the adoption of the new Constitution of the Republic of Bulgaria (1991), which provided protection for the basic principles of local self-government. In addition, a package of laws has been adopted, shaping the legal grounds of decentralization. For example, organization and functions of local governments are regulated by the Local Self-Government and Local Administration Act (1991), legal criteria and procedures for establishing, merging, splitting and liquidating administrative units are determined by the Act on Administrative and Territorial Structure of the Republic of Bulgaria (1995), rules for citizens' participation in the political process at local level are prescribed by the Local Elections Act (1995) and the Referendum Act (1996). The issues of acquiring and managing municipal property are solved by the Municipal Property Act (1996), while procedure and organization of the municipal budgeting process are formalized by the Municipal

¹ Last census on 01.03.2001, source: National Statistical Institute, available at <http://www.nsi.bg/Census/Census.htm>

² NUTS II and NUTS III are the abbreviations respectively of the level II and III of the Nomenclature of Territorial Statistical Units within the meaning of Regulation (EC) No 1059/2003 of the European Parliament and of the Council of 26 May 2003. LAU 1 is denotation for local administrative unit.

Budgets Act (1998). Some important financial issues as type, base, and rate of local taxes and fees are specified in accordance with the Local Taxes and Fees Act (1997), whereas the procedure, conditions and limits of local debt service are determined by the Municipal Debt Act (2005).

Evolution of financial decentralization

Financial decentralization process in Bulgaria comprises of several distinct periods. In the beginning of transition (1991- 1993) the highly centralized system was preserved and there was not a sensible dialogue between local and central authorities. In 1993, the independence of municipal budgets within the consolidated state budget was acknowledged, meaning that the State abandoned the centralization of local budget surplus and the financing of local deficit. Moreover, the intergovernmental fiscal relations were organized on the base of a newly introduced formula for distribution of the state subsidies to the municipal budgets. Although adopted with good intention, the allocation formula became exceptionally complicated and difficult to predict. Since its introduction it has been changed each year, becoming more and more complex with each change. Moreover, the original legislative rationale for the general state subsidy, namely to meet differing expenditure needs based on objective criteria, has been converted into a redistributive mandate based largely on ad hoc decisions of the central government (Thecvdarova et al, 2000).

Typical for the period 1994 - 2002 has been the process of gradually building the capacities of local authorities. The National Association of Municipalities in Republic of Bulgaria (NAMRB) and regional associations of municipalities emerged as main champions of the financial decentralization. Several changes in intergovernmental relations have been provoked, gradually eliminating mandatory priorities in the allocation of municipal expenditures. However, to the end of this period, the intergovernmental fiscal relations remained centralized as far as the central government established a model of almost complete control over the municipal budgets.

The real financial decentralization in Bulgaria started in 2003, based on the Cooperation Agreement, signed by the Council of Ministers and the NAMRB in 2002, whereby both parties agreed to decentralize local government and to increase financial independence of municipalities. Moreover, both the Financial Decentralization Concept and the program for its implementation were adopted. As a result, one of the main achievements in the scope of intergovernmental fiscal relations became a reality, namely the clear division between the local and central responsibilities for the public services. Provided for the first time by the annual State Budget Act for 2003 it was continued and improved during the following years. Additionally, this law provided a framework for regulating a new, simple and transparent model of assigning government subsidies. Now subsidies allocation is based on a formula, which takes into account the expenditure needs and revenue capacity of local governments.

A fundamental weakness of the revenue assignment system in Bulgaria during the transition period has been the

lack of local tax autonomy. Before the Constitutional amendments in the beginning of 2007 Bulgarian municipalities were prohibited from setting either rates or bases of local taxes. Property tax, motor vehicle tax, inheritance tax, donation tax, and tax on the real estate and movable property purchase, recognized as local taxes, were entirely regulated by the central governmental level. In terms of modern public finance, if local governments do not participate in the design of the local tax, it should be considered as a special transfer, based on the location of taxable property. Moreover, this regulation conflicted with article 9.3 of the European Chart of Local Self-Government, ratified by the Republic of Bulgaria in 1995.

In the beginning of 2008 two important legislative changes considerably influenced local taxation. Firstly, municipalities were given the authority to set local tax rates within certain legal limits. However, they are still disallowed to define local tax base and provide additional (or remove the existing) legal alleviations for certain taxpayers. Secondly, the patent tax was reassigned as a local tax. Basically, the patent tax is a net annual income tax, which is collected from the craftsmen and the owners of small enterprises, who offer hand-made products, trade activities, and a variety of services. The patent tax replaces the payment of personal income tax or corporate income tax, so it has the potential to become an important part of local revenues and powerful instrument of the municipal tax policy.

Expenditure assignment

In response to the fast-changing legal and financial environment during the transition period, public sector expenditures have been very dynamic. Due to the economic stagnation, financial instability, and vertical imbalance in the last decade of 20th century the relative importance of local governments within the governmental system decreased. Moreover, regardless of the financial stabilization and economic growth, achieved during the first years of the new century, the downward tendency has proved its persistency. Local budgets' relative share in the GDP has been reduced to 7.5% in 2000 and 6.1% in 2004 by comparison with 12.3% in 1990. At the same time expenditures of the local governments, which formed 21.5% of the total expenditures in the consolidated state budget in 1991, reached respectively 17.9% in 2000 and 15.7% in 2004.

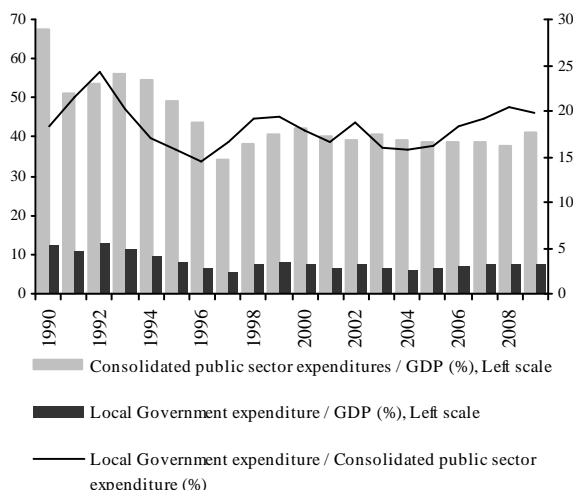
This negative trend was reversed in 2005, due to the ongoing process of financial decentralization during the period 2003 - 2008, which has considerably influenced intergovernmental fiscal relations. As a result, financial autonomy of municipal level of government increased. Now, local governments are an important part of the public sector in the country, accounting for about 20% of total government spending. In 2008 consolidated public sector expenditure represents 38% of GDP, while local government share is 7.6% of GDP. In 2009 local government expenditures tend to decrease, due to the influence of economic crisis (Figure 1).

This positive dynamics is accelerated by the clear expenditure assignment. Public services in Bulgaria are organized in nine major functions, each of them containing a

number of activities. Both central and local governments provide services in each of these functions, but their shares in the consolidated public expenditures vary for the different functions. Logically, prevailing state functions are defence, public order and security (98.4%), social insurance and social

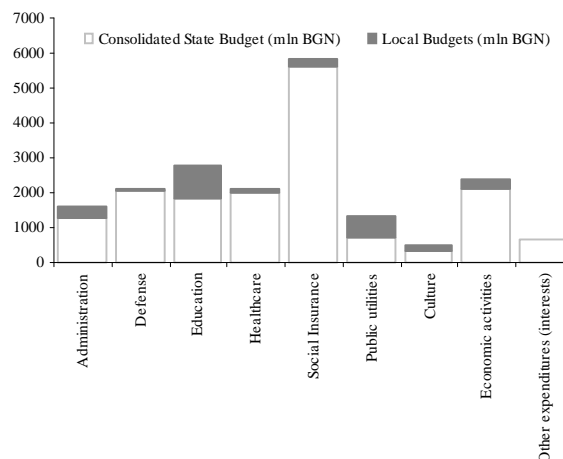
care (96.7%), healthcare (93.6%), and economic activities (87.6%). Prevailing municipal functions include housing and public utilities (87.1%), while functions as education, culture and administration are mixed (Figure 2).

FIGURE 1. DYNAMICS OF PUBLIC SECTOR EXPENDITURES IN BULGARIA (1990-2009)



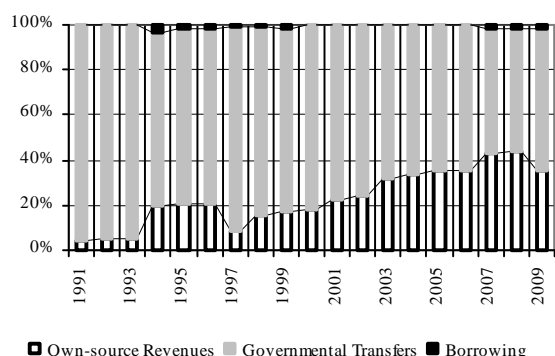
Source: Calculations based on the Ministry of Finance database
Note: Data for 2009 are based on prognosis.

FIGURE 2. EXPENDITURE ASSIGNMENT IN BULGARIA (2008)



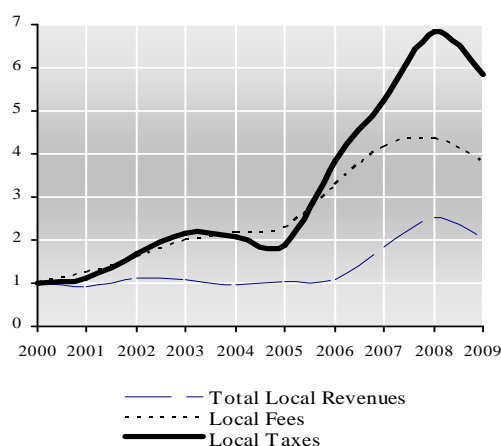
Source: Calculations based on the Ministry of Finance database
Notes: Data labels indicate the relative share of state and local expenditures into consolidated public sector expenditures. BGN is the abbreviation of Bulgarian currency. According the Currency Board provisions 1 EURO is equal to 1.95583 BGN.

FIGURE 3. STRUCTURE OF LOCAL GOVERNMENTS REVENUES (%)



Source: Calculations based on the Ministry of Finance database
Note: Data for 2009 are based on prognosis.

FIGURE 4. DYNAMICS COEFFICIENTS OF OWN-SOURCE REVENUE



Source: Calculations based on the Ministry of Finance database
Note: Values for 2000 are used as basis. 2/ Data for 2009 are based on prognosis.

Consequently, municipalities provide services connected to state delegated activities and local activities. State delegated activities are entirely financed through the intergovernmental transfer system, mainly by proceeds from the shared tax (until 2007) and a supplemental subsidy to the amount of expenditures calculated according to standards, which take into account quantitative indicators, such as the personnel number, the necessary salaries and insurance payments, the number of users, etc. Local activities are referred to the provision of local services, with type, amount, quantity, and quality independently determined by the municipalities. These expenditures are only financed by own revenues and equalization subsidy.

Intergovernmental transfer system

Besides the expenditure assignment, one of the key pillars of financial decentralization is the financing of subnational governments. Because of the advantages of taxation at the central level and spending at the decentralized level during the transition period Bulgaria have often ended up with vertical and horizontal fiscal imbalance. Although the dominant role of transfers allows local governments to be entirely compensated for the vertical and horizontal imbalances, such a proportion gives the central government more political and financial control over the local level, than the acceptable for a modern decentralized system. There is not an absolute rule, but it is accepted that local fiscal autonomy is ensured, when local own-source revenues are comparable to the governmental transfers.

Presently, governmental transfers' allocation is based on a formula, which includes three main components. The first element is the general supplemental subsidy, which is equivalent to the full cost of all state mandates imposed on municipal budget. It is the main financial flow, providing more than 80% of the total amount of the governmental transfers to the municipalities. The second element is the general equalization subsidy, which is transferred to the municipalities with per capita local tax proceeds and per capita expenditures for local activities lower than the country's average. Basically, the equalization subsidy is intended to bring the revenue capacity of the below-average municipalities up to the national average level. The last element of the allocation formula is the capital investment subsidy. It is very important financial flow, targeted at a wide range of infrastructure capital investments and ecologic recovery projects, assigned to the local governments. The main part of this grant is still allocated on an ad hoc basis and seems to bear no relationship to the general subsidy criteria (Figure 3).

At the present time, transfer system still plays the dominant role in financing local governments in Bulgaria, as far as subsidies form the prevalent part of municipal revenues. During the analyzed period, a gradual decrease of transfers' relative share in the total local revenues has been recorded, from 96.1% in 1991, 91.4% in 1997, and 81.9% in 2000 toward 55.1% in 2007 and 54.5% in 2008. The positive trend was interrupted in 2009 by the world-wide crisis, which caused economic slump and negatively influenced financial resources in the public sector. As a result, local government

dependence on the transfers increased to 63.2% of the total revenues in 2009. Moreover, having in mind the great difference between the fiscal capacity in several richest municipalities and the rest of the local governments in Bulgaria, for the present the strong intergovernmental transfer system has no effective alternative.

Dynamics of the own-source revenues

One of the main reasons for the decrease of the share of governmental transfers in the local revenue structure is the significant increase of the own-source revenues. In the beginning of transition period several problems had a decisive influence over the own-source local revenues, causing a significant decline of their relative share, especially during the 1990s. First of all, the difficult interrelation of the local governments and the tax administration, which in 1991 became subordinated to the Ministry of Finance. As a result, the efforts of centrally dependent officers were aimed at collecting taxes from the larger taxpayers, resulting in the delayed collection of the local taxes and fees and even in waste of local revenues. In a dynamic inflationary environment any postponement led to additional losses for the municipal budgets.

Another serious problem was the outdated tax base for the property tax, which was also used for the calculation of inheritance tax, donation tax, and tax on the property purchase. Moreover, it was beyond the municipal competence to solve the problem. Although autonomous on paper, municipalities did not have any possibility to considerably influence own-source revenues. This was the reason why in 1990s own-source revenues accounted for only 12.8% of the local revenues on the average.

As a whole, during the period 2000-2008 local own-source revenues tend to increase gradually, from 18.1% toward 43.5% of the total municipal revenues, provoked by the expanding financial decentralization. Since 2003 local governments have been given full discretion over local fees and service prices, which have quadrupled their importance in real and relative terms. Especially high is the growth of local taxes in 2007 and 2008, when dynamic coefficients reached respectively 5.2 and 6.8 of 2000 value, due to the considerable revaluation of the property tax base on the one hand and the newly assigned municipal responsibilities over the local taxation on the other hand (Figure 4).

It is interesting to note, that since 2003 the process of strengthening fiscal decentralization has been accompanied and significantly influenced by an average annual economic growth of 5-6%, increasing economic activity, low levels of unemployment (6-7%) and consolidated budget surpluses equal to approximately 3% of the GDP. This process was broken in 2009, due to a new and deep worldwide financial and economic crisis. Because of the currency board Bulgaria faced the crisis later than most of the EU countries. However, the consequences are decreasing economic activity, which strongly affects public finance including local government finance by decreasing government revenues (both at central and local level) and increasing social pressure (fast growing unemployment rate). As a result own revenues hardly reached

35.1% of the total local revenues in the first half of 2009. The economic crisis both sharply reduced local governments' own revenues and - via budget constraints at the central level – increased pressure on the grant system. At the same time, crisis can turn into an opportunity, especially for some of the local governments with strong fiscal capacity, to test their newly assigned competences in order to stimulate local economic development.

Conclusion

During the transition period, local governments have suffered more than the central government from the decreased financial capacity of the public sector in the country. Since 1991 the legislation in the scope of local finance has been subject to continuous changes, but the real decentralization of local revenues has proved to be a very long and difficult process. Local governments have had limited possibilities to influence the size of local revenues and therefore to project local budgets. The little importance of own-source revenues in the local budgets and the prevailing share of the state transfers resulted in dependence of local governments on the consolidated state budget. In general, the above mentioned factors resulted in local governments, the majority of which continue to focus its efforts on the approaches for increase of transfer payments, than to the possibilities of strengthening local tax capacity.

The continuous evolution of the intergovernmental fiscal relations produced significant achievements, most importantly the clear expenditure assignment, transparent and efficient transfer system. It is expected that the positive amendments in the tax legislation for 2008, namely the new tax competences of the local governments to set local tax rates within legal limits, and the reassignment of the patent tax as a local tax, should promote a gradually increasing local tax independence and concentrate the efforts on strengthening local tax capacity.

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