MID-COURSE REVIEW OF FISCAL DECENTRALIZATION:

THE UNFINISHED AGENDA

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1. Overview

Bulgaria's fiscal decentralization program is well underway and substantial progress has been made. Most notably, the Fiscal Decentralization Working Group (FDWG) appointed by the Council of Ministers has crafted a far-sighted agenda and legislative reform is underway although not yet completed. The government has adopted a new system of intergovernmental transfers that is straightforward, transparent and linked directly to expenditure needs of assigned services. The new system is predicated on a clear division of service responsibility between municipal services that are "mandated" by the central government and those that are "local option"—i.e., provided at the discretion of the local government.

The FDWG has developed costing standards for the mandated services that set the level of transfers going to each municipality. While the costing standards are a good first step, they were developed hastily and with some serious data gaps. Furthermore, there are serious misunderstandings about how the standards should be used in terms of budget guidance. The FDWG is considering a proposal to further upgrade the initial standards. One contentious issue is that the costing standards do not include provision for the capital investment requirements of the services, an omission that further strains the municipal budgets and results in under-investment in facilities and infrastructure.

The new system of municipal finance places the responsibility for funding local option services on local own source revenues. Over the past five years, the growth in own source revenues has been very strong but municipalities still only have partial control over determining those revenues. The revenue base, especially the local tax base, remains rather narrow and the municipalities cannot set their own tax rates. Despite the trend in rapidly increasing local revenues, there is evidence that a large number municipalities do not have sufficient own source revenues to fund their local option services. In this report we diagnose this looming deficit in local option services funding and identify different strategies to resolve it.

The past eighteen months has seen a concentrated effort to resolve the problem of accumulated arrears in municipal accounts going back to 1999. The central government and municipalities have taken aggressive action to resolve this issue in 2002. The situation has been greatly improved by the end of 2002 although the problem has not yet been completely cleared up.

While progress was being made on these important fronts, the municipalities have been experiencing a downward trend in overall levels of capital investment. The level of capital investment in municipalities has been declining for most of the past decade. The level of municipal capital investment is quite low by international standards and there is evidence of a substantial backlog of unmet investment needs. The central government has committed to increasing capital investment at all levels and the EU accession will place a significant burden on Bulgarian municipalities to upgrade municipal infrastructure. Even with the planned support from the EU pre-Accession grants, municipalities will still have to increase their own levels of investment considerably. A large part of this increased

investment will have to come from local own source revenues, both to pay for increased current outlays and to support borrowing for capital projects. We suggest ways that the level of municipal capital investment can be doubled but that requires a combination of (a) increased local revenue generation, (b) enactment of municipal credit legislation and (c) a commitment to use some grant funds (both central government and EU) to leverage municipal borrowing.

We conclude this paper with a series of recommendations on ways to increase local revenue generation. These include both additions to the municipal tax base and, more importantly, ways to exploit the tax base already assigned to municipal governments. Further strengthening local revenue generation will be a fitting capstone to Bulgaria's fiscal decentralization efforts.

2. Municipal Expenditure Assignment

2.1 Background on the Current Situation

The starting point of the government's Fiscal Decentralization Concept and detailed Work Program is to clarify the assignment of expenditure responsibility at the municipal level. In order to establish a sound basis for the new system of intergovernmental finances, the Government of Bulgaria has accepted the concept that all municipal expenditures are defined as either (a) "mandated by the national government" or (b) provided at the discretion, or local option, of the municipal government[1]. In addition, virtually all municipal services have both annual operating costs and capital investment costs in their provision.

The FDWG has applied costing standards to determine the minimum funding levels for mandated services in four sectors: education, health, culture and social welfare. The estimates of the funding requirement of mandated services in 2003 is approximately BGN 1,124 million[2]. We should note that this figure is a negotiated estimate based on past expenditure patterns and not an analysis of spending needed to reach some specified level of performance in those services. Nevertheless, it represents a figure which the municipal sector representatives and the central government representatives agree is a workable number.

The concept of a minimum funding level is important since it connotes that municipal governments can actually spend more of their own resources on mandated services or shift spending among services if they so choose. It is also important to note that this is a minimum funding level and not expenditure dictate. The minimum State funding levels only determine the level at which the State budget must provide transfers to the individual municipal budgets—the municipal government still has the discretion to set its own spending levels on different services depending on local need.

SERVICE COSTS STANDARDS

The mandated service standards set a minimum funding level and not expenditure dictate. The minimum State funding levels only determine the level at which the State budget must provide transfers to the individual municipal budgets— municipal governments should still have the discretion to set their own spending levels on the different services depending on local need.

While the estimate of mandated service costs is tied to national standards, the estimate of costs for municipal local option services is not. Rather, spending on local option services is driven by the availability of local revenue and not on an estimate of needs.

[1] See "Concept and Program for Fiscal Decentralization" as prepared by the Fiscal Decentralization Working Group and approved by the Council of Ministers in June 2002.

[2] While the central government is committed to fully funding the standards, the State Budget Act did not obligate the full amount but left BGN 155 million to be "funded later in the year". The Ministry of Finance has agreed in May 2003 to fund the balance in August and November 2003.

Municipalities that have historically had high levels of revenues have spent heavily on non-mandated services and also have had higher spending on mandated services as well[3]. Much of the differences in municipal spending were the result of differences in shared taxes and subsidies received as well as differences in own source revenue collections.

Under the proposed new structure of municipal finances, all local option services will be funded by local own source revenues. This shift places much greater emphasis on the level of own source revenues and the ability of local governments to tap the local economic base in order to generate local revenues.

The FDWG has recognized that not all municipalities have the local economic base to support an adequate level of local revenue generation. It has proposed a special subsidy program—titled the Equalization Subsidy—to provide a minimum level of revenues, apart from the mandated services funding. The Equalization Subsidy is intended to guarantee that all municipalities have some funds for local discretionary spending (including capital investment). Unfortunately, in 2003 the central government has been unable to fund this Equalization Subsidy at the level recommended by the FDWG although the grant program has been formally established in the revised legislation of the Municipal Budget Act[4]. The FDWG proposed about BGN 90 million be allocated for 2003; The State Budget Act provides for only BGN 15 million.

While a significant percentage of municipalities do not have good local revenue potential, overall the municipalities have been increasing local revenue generation at a healthy pace over the past five years. Across the sum of all municipalities, local revenues have risen at an average annual rate of 20% (in current leva), rising more than 70% from 1999 to 2002. Receipts from local taxes and local fees have both doubled in that period.

2.2 Remaining Problems in Expenditure Assignment

The FDWG has gone a long way toward resolving the expenditure assignment issues. However, there remain several significant problems that require further attention:

- Have all municipal services been appropriately classified?
- How will the costing standards for mandated services be updated and used?
- How should capital costs of mandated services be incorporated into the costing standards?
- How can stability be ensured in the expenditure and revenue assignment?

The following sections discuss each of these issues in order.

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[3] National legislation has historically placed a low ceiling on the percentage of municipal budget revenues that could be devoted to capital investment, effectively forcing even rich municipalities to forego significant capital investment outlays even if they had the resources to invest.

[4] The revised Municipal Budget Act is still under Parliamentary review as of May 2003 but the State Budget Act of 2003 has a special provision establishing the Equalization Subsidy.

2.2.1. Have all municipal services been appropriately classified?

There was general agreement within the FDWG on the assignment of municipal service expenditures into the two sub-groupings but with one exception: should "municipal administration" be a mandated or local option service. The argument for classifying municipal administration as a mandated service rests on three points: (a) It is a required "overhead" cost of providing municipal services, most of which are in fact mandated services; (b) local municipal administration is the cost of having local democracy which is national policy and (c) the costs of municipal administration cannot drop below some minimum level no matter how small the municipality—this means that very small municipalities will have high per capita costs at the same time that they are likely to have the lowest level of own source revenues. The argument for excluding municipal administration as a mandated service is that its costs are largely a matter of local discretion and that it basically provides services of a local nature. In the end, the FDWG decided to make municipal administration a "shared" service with the labor costs included in the mandated cost standards and the maintenance support costs assigned as a local option cost.

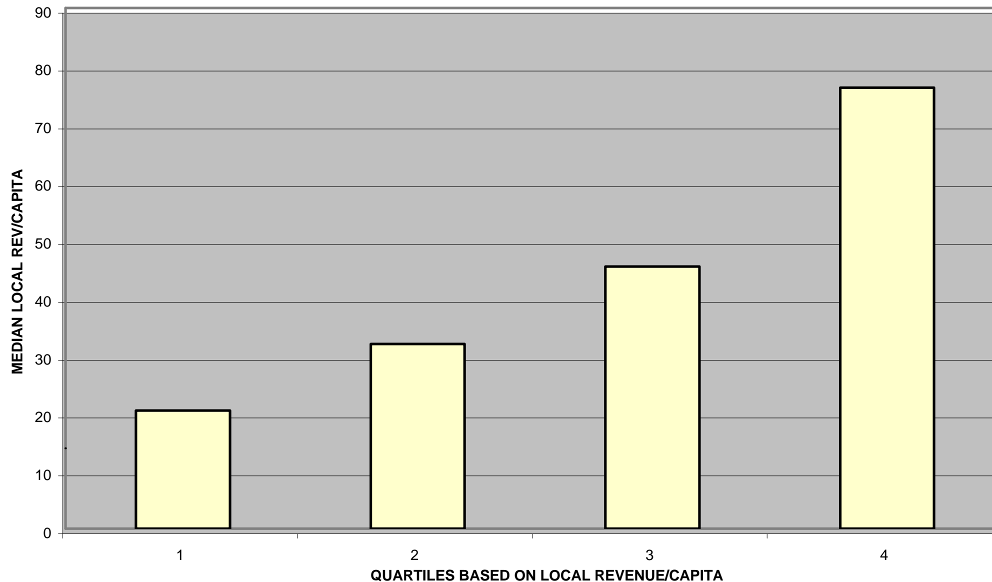
As a practical matter, evidence from analysis of the 2002 municipal expenditure data shows that there is a substantial "floor level" of maintenance costs required for municipal administration no matter how small the locality. In 2002, the average level of maintenance expenditures for municipal administration was about BGN 10 per capita across all municipalities. For the municipalities that fall in the bottom quartile of all municipalities in terms of own source revenues per capita, this represents almost half of the median value of their local revenue collections (see Exhibit 1.) In fact for very small municipalities, the per capita cost for maintenance support to municipal administration often rises above the BGN 10 average figure.

This analysis suggests that supporting municipal administration is a serious burden for the very poor municipalities and that some form of relief should be considered. This may take several forms. First, all municipal administration expenditures may be shifted into the mandated services category. Second, poor municipalities may be specifically targeted by an increase in the Equalization Subsidy. However, the Equalization Subsidy needs to be funded at a level adequate to provide for this as well as an overall basic level of local option services.

If we examine the experience of the poorest half of all Bulgarian municipalities, we see that they spent an average of 40% of their local own source revenues on municipal administration maintenance in 2002. The average per capita expenditure was BGN 11 and the local revenue per capita was BGN 27. The total expenditure on municipal administration maintenance support for this group was BGN 44.7 million in 2002. While there is some variation from place to place in the actual expenditures per capita, it appears that BGN 10-11 per capita is a reasonable target level for municipal administration maintenance. If we take BGN 10 per capita as the target and assume that this function were shifted from the local option to mandated service category, then the

increase in mandated services funding for all municipalities would be about BGN 82 million in 2003 (allowing for a 4% inflation adjustment.)

EXHIBIT 1. Median Levels of Own Source Revenues per Capita by Quartile for All Municipalities in 2002



2.2.2. How will the costing standards for mandated services be updated?

The Fiscal Decentralization Program created the costing standards for the mandated services but made no specific provision for updating or refining the initial standards. The FDWG is no considering a revision to the Program which will update the standards.

The main reason for updating is that the first standards constructed were done under extreme time pressure and simply used historical data on expenditures from 2001 adjusted to 2003. In a strict sense, they are not really standards –i.e., the level of expenditure required to reach a desired output. They are actually a reallocation of existing expenditure patterns to make them conform to more reasonable unit costs of services based on characteristics of the service populations. There was an attempt to take account of differing cost factors across different types of localities but those adjustment factors were based on fairly crude data.

Given the manner in which the current standards were developed, it is prudent to evaluate how well they are performing as 2003 progresses and to see how well they actually fit the circumstances in the municipalities. Given the importance of education expenditures in the municipal budgets, it would be best to start with a review of the education costing standards.

One critical issue is the continuing confusion over the use of the costing standards to guide budgeting decisions at the local level. The original concept of the costing standards was to determine what an adequate level of central government financial support should be to the municipal level. Unfortunately, some in the government have also taken this to mean that the standards should become spending mandates to guide municipal budgeting. Clearly the local governments need information on what reasonable spending levels are but the issuing of expenditure dictates is counter-productive. If the municipal governments have no flexibility in making local spending choices, then they cannot achieve any of the efficiencies of fiscal decentralization. This completely negates the rationale for fiscal decentralization and will merely perpetuate the financial dependency of the municipalities. This virtually guarantees that the municipalities will return for future central government bailouts since they will not be in control of two thirds of their local budgets.

2.2.3. How should capital costs of mandated services be incorporated into the costing standards?

During the past decade of economic transition the assignment of all capital expenditure has remained the responsibility of the central government, independently of the level of government responsible for the provision of the services associated with the capital infrastructure. This assignment has been guided either by the capacity to finance large projects or by the belief that only central government officials are qualified to make capital investment decisions.

The issue of capital investment has not, in fact, been a high priority topic in the policy debate on local government finance. Rather, the discussion over fiscal decentralization in Bulgaria has largely focused on the issues of expenditure assignment (mandated versus local option costs) and overall levels of funding while largely ignoring the question of operating versus capital costs. In fact, the debates and negotiations have centered on determining what the annual operating costs of mandated municipal services should be as a basis for setting the level of central-local transfers. Implicit in these negotiations is that the capital costs of all municipal services (both mandated and local option) will be funded by local own source revenues supplemented by some level of capital grants.

As we discuss in the subsequent sections of this report, there is evidence that overall capital investment at the municipal level is too low and in long term decline. Furthermore, it appears that mandated services, while accounting for two thirds of the operating costs of local government are receiving a very small fraction of total municipal investment. If the capital costs of mandated services are not provided for in the mandated service standards, then where will the resources come from?

2.2.4 How can stability be ensured in the expenditure and revenue assignment?

One of the main problems tackled by the FDWG has been the frequent changing of expenditure and revenue assignment to municipalities. These changes have been caused either by overall sectoral reforms (healthcare in 1999[5] and social welfare funding in 2003), or by ad hoc budget decisions that add or remove certain costs of individual programs (e.g., transportation of students.)

The table below presents the value of changes in expenditure and revenue assignments of municipalities in the period 1999-2003, with 1998 as a baseline. The data for each year constitutes the changes as compared to the preceding year. FY 2002 is the only year in which expenditure assignments of municipalities are similar to the previous year.

The changes in the expenditure structure of municipalities are due to various reasons. What is common between them is that:

- They have been imposed by the central government (have not been a local choice) and
- They have affected only the mandated expenditure responsibilities.

EXHIBIT 2. CHANGES IN EXPENDITURE AND REVENUE ASSIGNMENTSTO MUNICIPAL GOVERNMENTS, 1998 TO 2003

(Thous. BGN)

	1999	2000	2001	2002	2003 Est.
Total budget expenditures[6]	**2 022 316**	**2 178 114**	**2 113 850**	**2 388 488**	**1 941 000**
Additional expenditure responsibilities	30 578	26 865	101 231		
Additional revenue sources	61 874			104 483	
Dropped-out expenditure responsibilities	3 382	72 597	260 538		335 000
Dropped-out revenue sources	7 965		77 184	47 163	335 000

Such frequent changes cause a number of negative consequences including: impeding budget planning, inequitably treating the users of basic services, and diverting the attention of local governments to "plugging financial leaks" rather than providing

[5] The introduction of a health insurance system began in 1999 ?. due to which a big portion of expenditure responsibilities borne by the municipalities till then, were taken over by the National Health Insurance Fund. The expected expenditures, that were supposed to drop out of the municipal budgets step-by-step, were therefore deducted from the municipal revenues, while no account was taken of the chronic municipal budget deficit and the remaining expenditure responsibilities were not clearly identified. As a result, the financial problems of the municipalities were further aggravated and the operating budget deficit jumped up.

[6] Data about municipal expenditures is valid for information purposes only.

efficient services. Such instability also impedes the development of a municipal credit market since potential lenders find it hard to assess financial conditions and obligations in a constantly changing environment. It is hoped that, with the major change in funding social welfare services completed in 2003, the level of municipal expenditure assignment will attain some degree stability for the foreseeable future.

3. Funding Local Option Services

3.1. Analysis of the Current Situation

The new system of intergovernmental finance requires that local option expenditures be funded by local own source revenues. One complicating factor in this new alignment is the treatment of capital investment. The current funding of mandated services only includes operating costs so the central government has continued the practice of providing separate targeted capital investment subsidies. However, those subsidies are not tied to the level of mandated services and, in fact, appear to be inadequate to meet the basic capital costs of the mandated services. Furthermore, their allocation is based on a totally different allocation scheme apart from the funding of mandated services operating costs, so there is no linkage between the two (see below for an explanation of the allocation of the targeted capital subsidies.)

The first question is whether local own source revenues will be adequate to meet the costs of local option services. An examination of 2002 actual expenditure data reveals some disturbing patterns. If we compare the 2002 local own source revenues and expenditures on local option services, we find that about half of the municipalities would be running a deficit that totals BGN 135 million (see Exhibit 3.)

EXHIBIT 3. DEFICITS BETWEEN LOCAL OPTION EXPENDITURES AND LOCAL OWN SOURCE REVENUES IN 2002 BY SUB-GROUP QUINTILES (BGN millions)

Number in ( ) is number municipalities in cell

		EXPENDITURE LEVEL					
		HIGH		MEDIUM		LOW	
OWN REV LEVEL		A	B	C	D	E	DEFICIT
HIGH	1	(18) 58.8	(4) 2.9	(0) 0	(0) 0	(0) 0	61.7
	2	(6) 12.2	(12) 10.4	(17) 4.4	(3) 0.2	(0) 0	27.2
	3	(9) 5.9	(8) 2.3	(12) 4.7	(11) 1.5	(5) 0.4	14.8
	4	(4) 2.0	(8) 2.8	(5) 2.6	(16) 4.0	(14) 1.7	13.1
LOW	5	(8) 4.5	(6) 2.8	(14) 4.1	(13) 4.6	(11) 2.2	18.2
DEFICIT		83.4	21.2	15.8	10.3	4.3	135.0

Exhibit 3 shows the pattern of deficits clearly by dividing all the municipalities into subgroups in terms of their relative performance on levels of local revenue collection per capita and local service expenditure per capita. Each of the cells then shows how many municipalities fall into that cell and the total of the deficit generated between local revenues and local service expenditures for the municipalities in each cell. The Exhibit clearly shows that the problem has different dimensions for different groups. Overall, the group with the highest revenues and highest expenditures (cell A1) accounts for over 40% of the total municipal deficit. These are municipalities who have very high revenues per capita but their spending exceeds even those high revenues. Clearly this group needs to bring their expenditures in line with their (already high) local revenues.

A second problematic group is found in the cluster of cells A4, A5 and B5 in the lower lefthand corner. These are the very poorest municipalities in terms of revenue but have high expenditures per capita. These municipalities, because they tend to be small, do not account for a large proportion of the total deficit but clearly their shortfalls cannot be solved simply by providing a modest level of additional revenue. This group contains a number of localities in the mountainous regions of the southeast where service costs per capita are high.

3.2 Avoiding Deficits in 2003

The figures in Exhibit 3 show the "implied" deficits in the funding of local services—i.e., what the deficit would have been if the municipalities had been operating under the rules of the new system put in place beginning with 2003. In fact, deficits were reduced in the aggregate across all municipalities in 2002 by increased subsidies from the central government to settle the accumulated unpaid bills. The implied deficits in local services funding was caused by the simple fact that expenditures on local services exceeded local own source revenues. The question remains, can local own source revenue grow fast enough to cover the expenditures in 2003? And what happens to the municipalities who have limited own source revenue potential?

Exhibit 4 shows a comparison of the sum of 2002 municipal expenditures with 2003 municipal budgets—the figures have been made comparable by removing expenditures from 2002 which are being reassigned in 2003. The main revision, as noted above, is the removal of social welfare payments from the municipal budgets. That, together with several minor other adjustments, is removing BGN 335 million from the municipal expenditure assignment in 2003.

There are several items in Exhibit 4 which deserve comment. Overall growth in total municipal expenditures is kept to a very modest level (one half of one percent which is well below the rate of inflation of 4%). This is done by actually reducing the operating expenditures in local option services while increasing the capital investment. Given the pattern of annual increases in local operating costs over the past few years, this may prove to be too optimistic. On the other hand, as noted in Exhibit 3 above, we see there

are a number of high income municipalities that appear to be spending lavishly on some local services. Certainly there appears to be room for some spending reductions.

EXHIBIT 4. COMPARISON OF 2003 MUNICIPAL BUDGETS WITH 2002 ACTUAL EXPENDITURES

MUNICIPAL EXPENDITURES	2002 ACTUAL	2003 BUDGET
A. MANDATED SERVICES	**1,146**	**1,173**
A.1 OPERATING COSTS	**1,080**	**1,148**
A.2. CAPITAL COSTS	**66**	**25**
B. LOCAL SERVICES	**783**	**768**
B.1. OPERATING COSTS	**653**	**595**
B.2. CAPITAL COSTS	**130**	**173**
TOTAL EXPENDITURES	**1,929**	**1,941**

Notes on Ex. 4: 2002 Actual data from Ministry of Finance adjusted by (a) reduction of service expenditures that are removed from 2003 municipal expenditure assignment and (b) expenditures on unpaid bills from previous years. 2003 Budget data from 257 of 263 municipalities reporting to National Association of Municipalities, adjusted to add the missing 6 municipalities by their relative weight in total municipal expenditures in 2002.

Exhibit 4 contains capital costs allocation between mandated and local services that are somewhat speculative. We do know the total expenditures on mandated and local services and the total capital costs by municipalities are but we do not have a breakdown of capital and operating costs between mandated and local services in the 2002 actual data. In 2002 we estimated the breakdown of capital costs by applying the operating costs standards of the FDWG to determine the estimated operating costs of mandated services; we then subtracted this from the total costs of mandated services to estimate the residual capital costs. For 2003, we use the reported amounts from the municipal budgets. We should note that the budgeted amount for capital investment for mandated services in 2003 appears to be very low.

The changing assumptions about capital costs of the mandated and local services should not be taken too seriously at this time. However, as we discuss below, the fact that capital costs have been omitted from the costing standards of the mandated services is likely to produce a serious shortfall in both the level of capital investment in those services and a shortfall in municipal budgets overall. We address this issue is the next section.

Exhibit 5 shows a comparison of municipal revenues and expenditures in the 2003 budgets. The revenues are comprised of the transfers from the central government to cover the operating costs of the mandated services, local own source revenues (local taxes, local fees and other local revenue), targeted capital grants and Equalization Subsidy for poor municipalities.

EXHIBIT 5. COMPARISON OF REVENUE AND EXPENDITURES IN 2003 MUNICIPAL BUDGETS

EXPEND/REV TYPE		EXPENDITURE	REVENUE
A. MANDATED SERVICES (TOTAL)		1,173	1,124
A.1 OPERATING COSTS		1,148	1124
A.2. CAPITAL COSTS		25	(inc. below)
B. LOCAL SERVICES (TOTAL)		768	817
B.1. OPERATING COSTS		595	
B.2. CAPITAL COSTS		173	
OWN SOURCE REVENUE			623
CAPITAL GRANTS			100
EQUALIZATION GRANTS			15
BORROWING			79
TOTAL		1,941	1,941

On the surface, it looks as if the municipal budgets are in balance. However, this "balance" has been achieved by making two dubious assumptions: (a) the operating costs of local option services can be significantly reduced from 2002 levels and (b) revenues can be augmented by loans totaling almost BGN 80 million. In addition, the municipalities forecast a continued strong growth in own source revenues amounting to a 12% increase over the 2002 level. While this is certainly consistent with recent trends in local revenue growth, we should note that no new revenue sources have been assigned to municipalities in 2003 so that growth will have to come largely from increases in local fees and other non-tax revenues—local tax revenues are expected to grow no more than about 5-6% in 2003.

If we subtract the municipal loans from the revenue side and revise the operating costs of local services to be the same as 2002 (with 4% inflation), then we would have a potential deficit in the local services of BGN 163 million. We are not predicting that this deficit will occur but this must be considered as a possibility based on past performance.

The potential funding gap is one of the reasons that municipalities need the flexibility to adjust their spending across different services. Any efficiencies gained in expenditures on

the mandated services can be used to offset higher expenditures on the local option services. This potential funding gap is also a good reason to focus attention on the sub-group of municipalities that have the highest potential for incurring substantial deficits – the group with high local revenues and even higher local expenditures per capita as identified in Exhibit 3 above. This group accounts for over 40% of the "implied" deficit in 2002 and should be the target for operating cost reductions.

3.3 The Relationship between Operating Costs and Capital Investment

All of the growth in local own source revenues over the past few years has gone into meeting the operating costs of local option and mandated services. A review of municipal budget data from 1998 to 2002 shows that municipal own source revenues devoted to capital investment declined steadily from 1998 through 2001 and began to rebound only in 2002—see Exhibit 6 below. This means that the operating cost requirements of municipal services have been growing faster than revenues overall, in effect decreasing the amounts available for new capital investment. We discuss the impacts of this decline in capital investment in the following section.

EXHIBIT 6
COMPOSITION OF MUNICIPAL CAPITAL INVESTMENT
(BGN MILLIONS)

SOURCE	*1998*	*1999*	*2000*	*2001*	*2002*
Muni Own Revenue	144	98	82	48	57
Central Grants	68	75	76	74	139
TOTAL	212	173	158	122	196`

SOURCE: REPORTED EXPENDITURES OF ALL MUNICIPALITIES

3.4 The Problem of Capital Investment

Exhibit 6 above shows that municipalities have been able to devote less and less resources to capital investment over the past five years. In fact, capital investment at the municipal level has been declining for most of the past decade. Ignoring the capital investment requirements of municipal services can be dangerous. It is the nature of capital costs that, while they can often be deferred, they do not go away but continue to

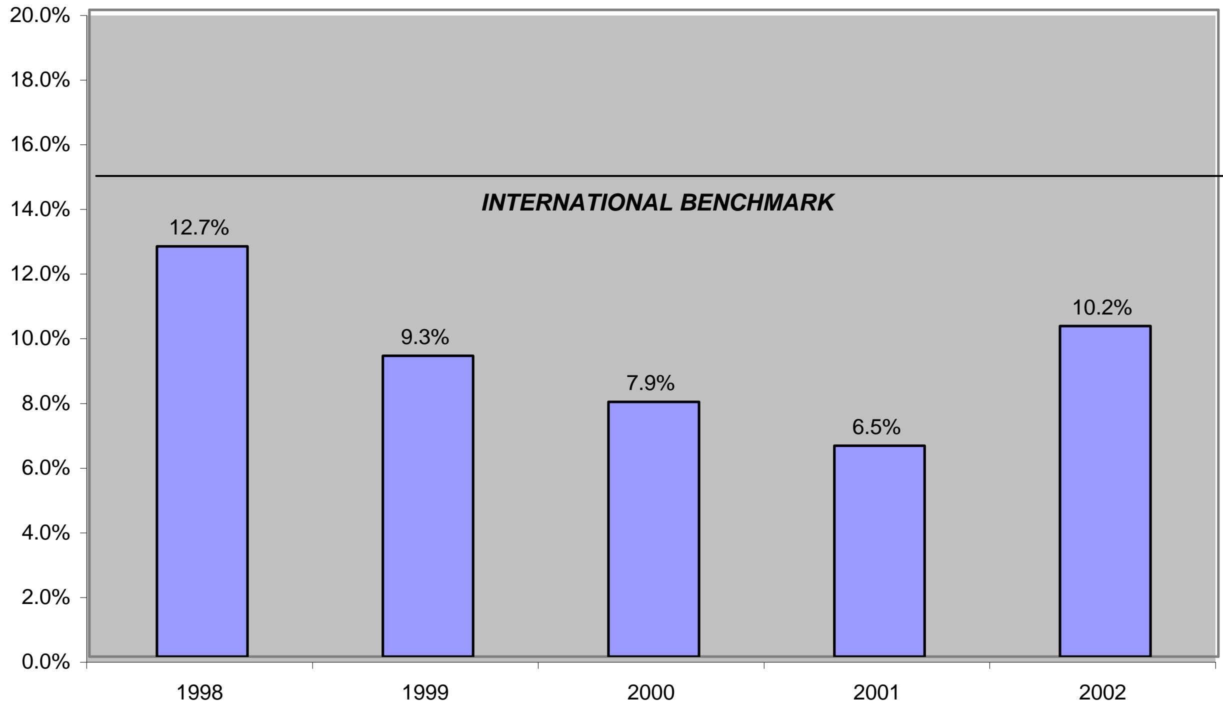
accumulate. There is strong evidence that Bulgarian municipalities have been systematically under-funding their capital infrastructure for a number of years.

While there is no comprehensive study of municipal capital investment needs today, there is ample evidence that the level of municipal capital investment has been too low for a number of years and that a sizeable backlog of investment needs has accumulated. The World Bank has completed a study to estimate the financing requirements for Bulgaria to meet the environmental standards of the EU Accession, covering both capital and operating costs—at the municipal and national levels[7]. The World Bank study produced a range of estimates from low to high. The Bank's low estimate for the municipalities to upgrade environmental infrastructure to the EU standards amounted to just over BGN 1,000 million per year in capital costs—an amount almost equivalent to the total of the operating costs of all mandated municipal services in 2003. The World Bank's high estimate is about BGN1,850 million in capital costs per year or close to the forecasted total of all municipal budgets in 2003. This is a staggering amount, given that total municipal capital investment in 2002 was not quite BGN 200 million—or about one fifth of the World Bank's **low** estimate.

Exhibit 6 above showed that the level of municipal capital investment has been in long term decline. That level was low to begin with by international standards and by comparison to other eastern European countries. In general, we would expect to see about 15-20% of total municipal budgets devoted to capital investment on average if Bulgaria was meeting the benchmark of other countries. We should note that in some of the countries of the CEE region, that figure has been higher as municipalities have made up for past investment shortfalls. Exhibit 7 shows the declining percentage of municipal budgets devoted to capital investment over the past five years compared to the international benchmark. Even the increase in 2002 has only brought Bulgaria up to the 10% mark, still considerably below the 15% benchmark.

[7] World Bank, **Bulgaria: The Dual Challenge of Transition and Accession.** A World Bank Country Study, February 2001.

Exhibit 7
PERCENTAGE OF MUNICIPAL BUDGETS DEVOTED
TO CAPITAL INVESTMENT
IN 2003 (BGN Millions)



In summary, the level of capital investment in Bulgarian municipalities is low and has been falling. It is clear, as shown by the World Bank study, that this has produced a substantial deficit in the capital infrastructure at the local level that must be made up in some way. The question now is whether we can estimate what an adequate level of capital investment should be at the municipal level.

There is no really scientific way to determine the capital investment needs across municipalities short of a thorough analysis such as the World Bank study cited above. However, we can derive some general estimates by simpler means in order to tell us the general magnitude of the problem. We do this by using as a starting point the international benchmark of 15% of municipal budgets that would normally be devoted to capital investment. If we assume that the operating cost estimates for 2003 shown in Exhibit 5 above are reasonable, then we can derive the capital investment requirements as a function of the operating costs (see Exhibit 8).

The figures derived in Exhibit 8 are the annual investment levels that we would expect to see across all municipalities if the 15% benchmark were met. It does not address any backlog in capital investment that may have accumulated as a result of prior years' under-investment. Since we know that investment levels have been falling for a number of years, we can safely assume that this backlog is substantial. In an earlier report, the authors have estimated that the backlog to be at least BGN 1,700 million just by examining the imputed shortfall in municipal capital investment over the past decade[8]. If we combine the results of Exhibit 8 above with an acknowledgement that the capital investment backlog needs to be reduced incrementally, then we must conclude that capital investment spending at the municipal level should at least be doubled—i.e., at a level of about BGN 400 million per year. A more precise (and probably higher) figure can undoubtedly be calculated but for our purposes now, the target of doubling municipal capital investment is a reasonable conclusion. The next question is, where will the funding come from to make that goal possible?

EXHIBIT 8
CAPITAL INVESTMENT ESTIMATE
FOR 2003

1. OPERATING COST = BGN 1743 M
2. CAP. COST = 15/85 or 17.65% of OPERATING COSTS
3. CAP COSTS = BGN 308 M

3.5. Funding Greatly Increased Capital Investment at the Municipal Level

Financial resources for funding additional capital investment at the municipal level are quite limited under current conditions. The central government was not able to fully fund the agreed upon mandated service costs in the State Budget Act for 2003 nor was it able to fund the Equalization Grants for poor municipalities at a level even close to that recommended by the FDWG. On the other hand, the IMF and Ministry of Finance forecast a continued improvement in economic growth which should produce a robust growth in Personal Income Tax receipts – now the primary source of transfers to

[8] This estimate is the accumulated capital investment backlog associated with routine municipal operations and does not include major upgrading of the local infrastructure networks. See James S. McCullough, "Municipal Capital Investment Policy Considerations" Local Government Initiative, Sofia. March 2003.

municipalities. However, proposed cuts in tax rates are likely to keep the PIT yields from growing very fast although it is difficult to know just what the rate cuts will be and what the overall yields will actually be in the future.

Increased funding from the central government is most likely to be devoted first to fully funding the operating costs of mandated services and the Equalization Subsidy for the poor municipalities. There is a good argument to be made that the costs of mandated services should include capital costs as well as operating costs. If we apply our 15% rule of thumb in estimating the annual capital costs that attend the mandated services costs of approximately BGN 1,124 million in 2003, then the transfers would have to be increased by about BGN 195 million to incorporate capital costs. This alone would almost double the capital investment levels in the municipalities. However, given the shortfalls in funding the lower, agreed-upon levels of mandated service costs in 2003, such increased funding is probably not likely to be forthcoming.

Many municipal officials place their hopes for increased capital investment on two new sources: borrowing and EU pre-Accession grants. As we have noted in another report[9], the EU grants will mainly go to (a) large scale environmental infrastructure and transport projects in some selected locations and (b) small scale infrastructure projects in the poor, rural municipalities. The EU grant funding, as currently designed, is not really intended to support general capital investment programming across the municipal spectrum.

There is the potential for municipal borrowing but the main problem is on the demand side: municipal governments are generally not credit worthy because of their poor financial conditions. As we documented above, municipalities have been devoting more and more of their own source revenues simply to cover annual operating expenses. Until municipalities can begin to generate operating revenue **surpluses** for new investment and debt service, they will not be credit worthy and hence unable to borrow.
Clearly, if municipal borrowing is to become an important source of capital investment funding, then the municipalities must accelerate their own source revenue generation.

The central government now has some fairly clear-cut policy options with respect to financing an increased level of capital investment by municipalities:

- The central government can increase transfers and/or
- The municipal governments can increase local own source revenues going into capital investment.

To make this policy choice it is important to distinguish between those municipalities that have good revenue raising capacity and those that do not. The poorer municipalities are not good candidates for greatly increasing local revenue generation and should not be expected to generate substantial own source revenues for capital investment. They should

[9] See James S. McCullough, Ibid.

certainly not be encouraged to borrow[10]. Since these municipalities do need access to capital investment funding, some provision must be made to provide those funds, possibly through the Equalization Grant mechanism already proposed. In the near term, additional grant funding from the EU SAPARD program and the new World Bank Social Investment Fund will be directing a substantial amount of infrastructure investment into the poor, rural municipalities. If evenly spread across the very poorest municipalities, these two programs will provide a large measure of the capital investment "safety net" for those municipalities over the next 4-5 years. Beyond that, the central government does need a national policy on how the capital investment funding needs of that group will be met once the donor programs are finished.

The second grouping of municipalities—those with local revenue raising potential—present a strategic opportunity for the government. This is the group where increased capital investment can be funded by increased own source revenues on three conditions:

- The municipalities receive increased revenue raising authority covering both taxes and fees;
- The proposed municipal credit legislation be put in place to permit development of the municipal credit market; and
- The central government utilize the central grants and donor grant funds strategically to stimulate municipal borrowing.

The first element of the strategy is to have increased own source revenue that can be dedicated to additional capital investment. The increased revenue will be needed for additional "pay-as-you-go" investments plus debt service on borrowed funds. This means that municipalities must have increased own source revenue raising authority.

The second element of the strategy is to facilitate municipal borrowing through adoption of the proposed municipal credit legislation[11]. The main question now is whether additional steps need to be taken beyond adopting the legal foundation – such steps can range from a fairly modest program to facilitate the initial learning process between borrowers and lenders to a much more interventionist approach such as creating a municipal lending agency.

The third element of the strategy is to use the central government and donor grants to stimulate use of credit by municipalities with revenue raising potential. Tying grants and loans together can have the advantage of 'leveraging" the grant funds—that is, the grants may make the total project financially feasible and therefore enable the recipient municipality to borrow the needed funds to undertake the project.

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[10] Experience with municipal loan programs elsewhere in the world shows that when non-credit worthy municipalities are encouraged to borrow, they rapidly undercut the whole system.

[11] See Michael DeAngelis, Ronald W. Johnson, & Christopher Z. Kaczmarski***, Building the Municipal Credit Market for Infrastructure Finance.*** **RTI International,** September 2002.

The strategy can use different mixes of grant funds and own source revenues to fund capital investment at the local level. What is important is the principle that central grant funds should be used strategically. If grant funds are provided to municipalities with untapped local revenue raising potential, then those grants should be used to stimulate local revenue generation.

4. Options for Increasing Municipal Own Source Revenues

4.1 Overview

Bulgarian municipalities are assigned local revenue sources that fall into three main groups:

- Local taxes
- Local fees, and
- Non-tax revenues.

As noted earlier, all of these revenue sources have been growing rapidly over the past five years and now constitute almost a quarter of total municipal budgets (see Exhibit 9). However, if the municipalities are to fund their local option services and generate increased capital investment, local own source revenues will have to grow even more.

EXHIBIT 9. Structure of Municipal Own Source Revenue in 2002

Revenue Type	Share of total revenue	Share of local revenue
Local taxes	7.0 %	30.5 %
Local fees	9.4 %	41.0 %
Non-tax revenues	6.5 %	28.5 %
Total:	**22.9 %**	**100.0 %**

The structure of own source revenue found in Bulgarian municipalities is quite different from that of most other European countries. On average, western European municipalities receive over one third of their total revenues from local taxes while local fees make up about one sixth[12]. Bulgaria is unusual in both the low contribution made by local taxes and the fact that local fees outweigh local tax receipts.

The central government has recently taken steps to turn over control of local fees entirely to the municipal governments. An amendment to the Local Taxes and Fees Act, effective from January 1, 2003, gives the municipalities the authority to set the amount of fees, the methodology for determining the fee schedules, the definition of exemptions and the collection procedures.

[12]Jeanine Corvetto**, *Tax and Fee Authority of Local Governments in Western Europe.*** Research Triangle Institute. May 2000.

Non-tax revenues are generated mainly through transactions in municipal property (rentals, sales, concessions) and are used as a rule to finance capital expenditures. Given their nature, they cannot be viewed as stable revenues—either in size or future growth potential.

Local taxes are comprised of five separate taxes as defined in the Local Taxes and Fees Act. They include: property tax, vehicle tax, inheritance tax, gift tax and a new (in 2002) "Road Tax". The Road Tax is actually a surcharge placed on the vehicle tax but its purpose is to help fund road repairs so it is treated as a separate levy. We should also note that the highest yielding local "fee"—the garbage collection fee on residential households—is actually a surcharge on the property tax so there is some mixing of the local tax and fee base in this instance.

The most notable aspect of the local taxes, aside from their low contribution to municipal revenues is the fact that local governments have no control over them. Municipalities cannot define the tax base, have no say in setting the tax rates and play no role in tax collection. In effect, local taxes are "local" primarily in name only and the fact that their proceeds can be spent as the municipal council sees fit.

Local taxes are the subject of the remainder of this section since that is the area of local revenue collection where attention needs to be focused. If local revenues are to be substantially increased, then local taxes should play a much greater role. Control over fees has already been decentralized to the municipal governments.

4.2. Targets for Improving Local Tax Yields

There are several issues with respect to the local taxes that deserve attention. First, the local tax base is rather narrow since there are no taxes assigned to municipal government that are related specifically to local economic activity. This means that the tax base is not very buoyant—i.e., it grows as economic activity in the locality grows.

A second problem with the Bulgarian municipal tax base is that the tax rates, especially the property tax, are very low. Municipal governments around the world tend to rely on the property tax as the major local tax. The property tax is a "good" local tax for several important reasons. It is stable from years to year. The tax base is readily identifiable and the computation of tax liability can be quite straightforward. In the USA and some European countries, the property tax is the main source of debt repayment for general obligation borrowing—the stability of property tax revenue makes it a solid base for local government credit worthiness. In Bulgaria, the property tax is a minor revenue source. Because of this, Bulgarian municipalities overall receive a relatively small share of their total revenues from local taxes.

The third main problem with the local tax system in Bulgaria is the fact that local governments cannot adjust the tax bases or rate schedules to local conditions. The central government has, in fact, attempted to grant greater local control over taxation to

municipalities but has been blocked by the Constitutional Court. In an effort to keep tax rates acceptable across the entire country, the central government has set the rates too low for many localities.

If Bulgarian municipalities are to continue their growth in local own source revenues, then these three sets of problems must be resolved. In the following sections, we address them each in turn.

4.3. Narrowness and Lack of Buoyancy in the Municipal Tax Base

Bulgarian municipalities need a broader and more buoyant tax base. This can be readily accomplished by two means. First, the Patent Tax, which is now part of the Personal Income Tax , can be transferred to the municipal own source revenue base. Second, municipalities can be allowed to place a surcharge on one of the national tax bases which is buoyant such as the VAT or Personal Income Tax.

Transferring the Patent Tax—which is a tax on various categories of small business activity—into a municipal tax would increase the local revenue base by approximately BGN 60 million. As a result, the revenues from the Patent Tax would comprise 10% of the aggregate municipal own source revenues, while for some municipalities this share could constitute up to about 20%.

The Patent Tax , by its nature, is well suited to be a local rather than national tax. Indeed, when the Patent Tax was originally introduced in 1997, it was intended to be a locally administered tax. However, the Constitutional Court declared this as unconstitutional[13] in 1998 and it was incorporated into the national income tax code. The Patent Tax rates are set uniformly across the nation on small businesses. The rates are not adjusted for differences in local conditions. This lack of adaptability has resulted in some instances of over-taxation and, much more frequently, under-taxation in specific localities. Since the Patent Tax is now part of the Personal Income Tax, revising the Patent Tax schedules requires revising the income tax law in the national Parliament.

Shifting the Patent Tax to municipal control would increase local tax revenues but would not resolve the rate setting dilemma until a Constitutional Amendment is approved. In the meantime, the National Parliament could follow the letter of the law by granting blanket approval to locally set tax rates in the annual State Budget Act. Such a process would have to be streamlined so that the Parliament could adopt local rate schedules en masse rather than have to take up each submission individually. In some countries where the latter has been tried, the process has become so cumbersome that it has ground to a halt.

A second way to broaden the municipal tax base is to grant local governments the limited ability to apply surcharges on the national taxes of VAT and/or personal income tax. We recognize that such authority runs against the current stated policies of the central

[13] Finding No 6 of the Constitutional Court of 1998.

government to reduce those tax rates[14]. However, in the interest of full consideration of alternatives, we suggest that these options should be examined. Furthermore, we should point out that such surcharges are common among western European countries and should not be dismissed out of hand.

Under the surcharge approach, the central government defines the tax base and collects both its own tax and surcharges set by the local governments. This approach ideally avoids the problems that occur when different governments define the tax base in conflicting ways and administer the tax in different ways. Because of their power to set surcharge rates, the local government retains the most important attribute of fiscal sovereignty in the tax field—i.e., the ability to set the tax rate. Of course, to effect the surcharge system would require adopting the Constitutional Amendment to permit municipalities to set their own tax rates.

All discussion of tax rate setting inevitably comes back to the issue of the Constitutional Amendment. At this point, we should note that it would be wise to construct the Constitutional Amendment in such a way as to permit a wide range of possible types of local taxing authority in the future. That is, the Amendment should not be so narrowly drawn that it precludes practices in local taxation that are common today among the European countries.

4.4. Local Tax Rates, especially the Property Tax, are Low

The need to maintain a set of national tax rates for municipal taxes has resulted in rates that are too low for many municipalities. Those municipalities that have stronger economic bases and higher income citizens should be able to raise more revenues locally. The property tax is a good case in point. Earlier studies have shown that the tax rates for the property tax are extremely low by international standards[15]. Furthermore, because of the high level of exemptions, these low rates are effectively reduced to an even lower level when the actual tax liability is calculated.

Clearly, the Constitutional Amendment is needed to allow municipal governments some discretion in setting local tax rates. This is the highest priority. The Amendment should cover both the setting of the rates and the ability to define the tax base, especially the limiting of exemptions.

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[14] See "Supplementary Memorandum of Economic Policies of the Government of Bulgaria and the Bulgarian National Bank" submitted by the Minister of Finance to the IMF. Contained as an Appendix in the IMF Report ***Bulgaria: Second Review under the Stand-by Arrangement and Request for Waiver of Applicability of Performance Criteria***. Washington, DC. January 22, 2003.) We note that government policy to reduce tax rates and shrink the government sector relative to GDP does not mean that government revenues will decline—see NOTE at end of this paper.

[15] See Stefan Ivanov and James S. McCullough, "The Potential and Performance of the Property Tax", **Plovdiv (Bulgaria) Fiscal Decentralization Study**. East European Housing Sector Assistance Project (USAID) under subcontract to The Urban Institute, Washington, DC. October 1998.

The property tax deserves special attention because it is such an underutilized revenue source at present. The property tax also should become more important as the municipal credit market develops. As noted earlier, property tax revenues are often a prime source for debt repayment of general obligation borrowing by municipal governments in other countries. If Bulgaria embarks on a serious municipal credit program, then the property tax could become a critical revenue source for guaranteeing repayment.

Making the property tax a more important revenue source begins with increasing the tax rates but goes well beyond that first step. Indeed, the strategy for increasing property tax yields should not start with a single large tax increase but with adoption of a long term strategy of gradually raising rates over a number of years. Our earlier study of the property tax performance in Plovdiv has revealed that the property tax rolls are relatively complete and that the rate of tax collection is very high[16]. There is room for improvement in keeping the tax rolls up-to-date –i.e., recording modifications to property that increases its taxable value (see Box below). And, there is some indication now that in the larger cities, property values are rising fast and that the increased value is not being captured by the property tax system.

Using Spot Inspections to Improve Property Tax Listings

The Plovdiv Property Tax Study team developed a cost-effective sample survey (inspection) approach which could be used in other cities to identify properties not on the tax rolls as well as errors in the tax listings. The sample inspection covered a n area of the city which contained slightly less than 1% of the total households and cost BGN 1,100 to carry out.

We estimate that a set of 10 similar sample inspections would cost approximately BGN 6,500 and should produce a minimum of BGN 45,000 in additional tax revenues alone for Plovdiv. In addition, since the garbage collection fee for households is also based on the property tax base, any increase in property valuation results in a higher yield of the garbage fee. For Plovdiv, the impact of the proposed sample inspection program should achieve a payoff ratio of more than one to twenty - i.e., for every one leva spent on inspections, the increase in property tax and garbage fee revenue combined would be twenty leva..

The property tax is currently being administered by the Regional Tax Offices as are all of the municipal taxes. To transfer administration to the municipal governments will require the creation of new tax records systems (property registry, assessment/valuation, billing and collection) that will likely strain the existing capabilities of municipal finance offices. The cost of such transfers will not be small and that is one more reason that property tax rates should rise—without increased yield from the tax, the cost of transferring the administration to the municipality will likely exceed any benefit from

[16] Ivanov and McCullough, Ibid.

increased tax collection[17].

Because the property tax has the potential for becoming a much more important tax and could play a critical role in development of the municipal credit system, the government should consider a pilot program in this area. Such a program would develop prototype tax administration systems for municipal administration and strategies for popular acceptance. Such a pilot program could be logically linked to a municipal credit program as noted above. There is a great deal of experience worldwide with the design and implementation of property tax programs. Since the experience is quite varied in terms of success and failure, the design of such a program for Bulgaria should pay careful attention to the lessons learned in the other programs.

4.5. Lack of Local Control over Own Source Taxes

The issue of local control should really be viewed as three separate issues:

- control over defining the tax base (including the granting of exemptions);
- control over setting the tax rates; and
- responsibility for administering the tax systems.

Much of the debate to-date has focused on the second issue—rate setting—with the assumption that all three issues are an inseparable package. In fact, there is no reason that municipal governments should not be granted varying levels of control at present. For example, municipalities could be granted immediate control over the granting of exemptions in the property tax and deciding when revaluation of the property tax base is appropriate.

Clearly, the granting of authority for tax rate setting will require the Constitutional Amendment. However, even in this area, we have noted earlier that the Parliament could devise systems for allowing municipalities to set some tax rates as long as Parliament ratified those rates in national legislation.

The transfer of tax administration from the Regional Tax Offices to the municipalities can also be done on a piecemeal basis. That is, there is no reason that the transfer has to happen simultaneously in all municipalities. Indeed, for many small municipalities it may not be cost effective for them to take over tax administration at all. This is a function that can be done at local government discretion.

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[17] See Ivanov and McCullough, Ibid. for an analysis of these costs and tradeoffs.

4.6. A Note on Macro Economic and Fiscal Policy

One of the stated policies of the central government is to reduce the size of government spending relative to GDP. The recent IMF report cited above contains the policy targets of the government in reducing the percentage of government revenues to GDP from 36% in 2002 to 34.9% in 2006[18]. This does not mean that government revenues will decrease during that period. Since real GDP growth is predicted fairly strong at 5.5% over that period, the growth in GDP will more than compensate for the decrease in share of GDP accounted for by the government. Indeed, government revenues are forecasted to grow between 4-5% annually in real terms during that period (or about 8-9 % in nominal terms.)

[18] See previously cited IMF Report, Table 7: Bulgaria. Macro-economic Framework 2002-2007.