

**FINANCIAL DECENTRALIZATION IN BULGARIA:  
WHICH ARE THE MOST IMPORTANT ACHIEVEMENTS OF THE TRANSITION  
PERIOD AND HOW TO MOVE FORWARD?**

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**Abstract**

*The process of gradual administrative and political decentralization in Bulgaria started in 1991 with the adoption of the Local Self-Government and Local Administration Act, 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. Basically, a key issue in the design of fiscal federalism 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 has often ended up with vertical and horizontal fiscal imbalances. In most of the fiscal years the decentralization of expenditures was not accompanied by equivalent revenue-raising responsibilities and the taxable base was unevenly distributed within the country territory. The purpose of this paper is to study and critically analyze the financial decentralization reform in Bulgaria, outlining the key achievements and basic weaknesses of the local taxation and the intergovernmental fiscal relations.*

**Key words:** financial decentralization, local finance, intergovernmental fiscal relations, local government, local taxation

**JEL classification:** H71, H77

**1. Introduction**

The process of gradual political, administrative, and financial decentralization in Bulgaria started in 1991, inspired by the adoption of the new Constitution of the Republic of Bulgaria. The Constitution legally grounds and protects the local self-government principles. In addition, the Local Self-Government and Local Administration Act (1991) concretizes the guidelines provided by the Constitution, regulates the administrative-territorial structure of the country and prescribes the organization and functions of local self-government in conformity with the formulations of the European Charter on Local Self-Government, ratified by the Republic of Bulgaria in 1995. Important component of the legal base of the local self-government is the Act on Administrative and Territorial Structure of the Republic of Bulgaria (1995), which determines the legal criteria and procedures for establishing, merging, splitting and liquidating administrative units. This law is based on a number of principles, the most important of which are the principle of territorial neighbor-

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hood; compliance between the size of the administrative units and their competencies and resources; the subsidiarity principle; the principle of succession and territorial stability of the administrative structure and democratic choice in decisions that effect the administrative and territorial changes. Although the five administrative reforms, which have been conducted in the last 50 years and consequential transformations in the administrative-territorial units at the different government levels, modern municipal system was initiated with the new Constitution and the first democratic elections. Since 1991, local self-government in Bulgaria has become constitutionally and legally regulated.

Now, classified according to the European standards the administrative-territorial structure of Bulgaria 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<sup>i</sup>. Created according to the Regional Development Act and in compliance with the requirements of the European Union for allocation of regional development funds, the planning regions in Bulgaria are merely statistical units and do not perform administrative, nor financial functions. The districts are deconcentrated administrative units of the central government, which coordinate national and local interests. They do not enjoy financial autonomy, and do not provide public services to the population. Basically, districts are intended to manage the state property on its territory, to monitor the compliance of local decisions with the law, to implement the state policy at local level, to foster local development and unite municipalities to work together on large-scale projects. According to the Constitution, the municipality is the only one tier of really autonomous subnational government in the country. It is a legal entity, which has the right of ownership and adopts independent municipal budget, which must be used in the interests of the local population. The bodies of local government - Municipal Council and Mayor - are elected directly by the local population for a 4-year mandate with the purpose to make and perform governmental decisions. Election procedure is determined by the Local Elections Act (1995).

The municipal council comprises of municipal councilors elected on the basis of proportionate representation. It is the representative body of the local government that determines the policies for development of the municipality, adopts the budget, and ensures the management of municipal property. The mayor performs executive functions, directly manages the municipal administration, and ensures the performance of the municipal budget and the implementation of the municipal council's decisions. The elections for mayor take place in two rounds, based on the majority system. The candidate, who gains the absolute majority of votes in the first round, becomes mayor. A second round is organized a week after the first round if none of the candidates has been elected. Only the first two candidates may participate and the candidate who gains the most votes becomes mayor. The last local elections held in the end of 2007, elected respectively 264 mayors and 264 municipal councils with 5 234 municipal councilors. Men prevailed among the municipal councilor seat takers (75.1%). There is two years lag between the central and local elections in Bulgaria.

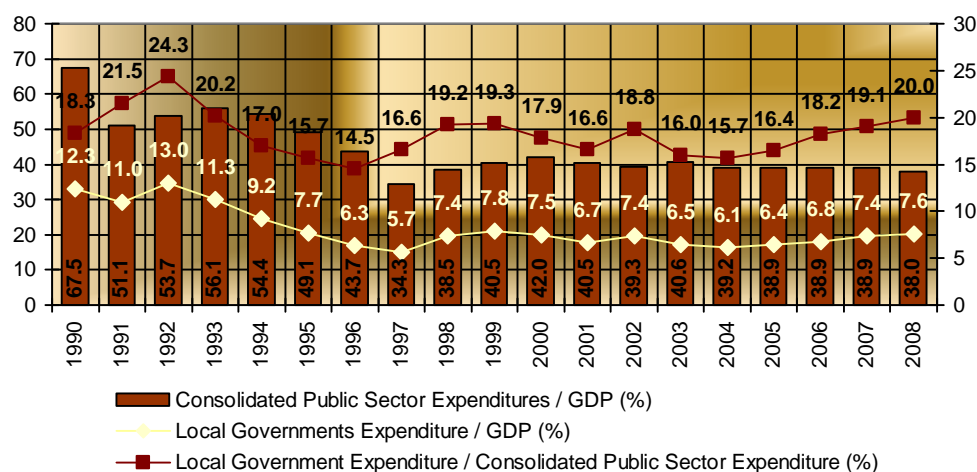
## **2. Evolution of the Intergovernmental Fiscal Relations**

During the period 1991-2008 Bulgaria has achieved a remarkable progress in reforming the system of intergovernmental fiscal relations. In addition to the new Constitution and the Local Self-Government and Local Administration Act, which provide the basic regulation of the local self-government, a package of laws has been adopted in order to regulate the citizens participation in the political process at local level with the Referendum Act



(1996), the issues of acquiring and managing municipal property with the Municipal Property Act (1996), the procedure and organization of the municipal budgeting process with the Municipal 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).

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 20<sup>th</sup> 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 fiscal 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 the consolidated public sector expenditure represents 38% of GDP, while local government share is 7,6% of GDP.



Source: Calculations based on the Ministry of Finance database [MoF, 2009]

**Figure no. 1. Dynamics of Public Sector Expenditures in Bulgaria (1990-2008)**

It is interesting to note that fiscal decentralization process in Bulgaria comprises of several distinct periods. As a whole, the intergovernmental fiscal relations in the period 1991 – 2002 can be characterized by a lack of stability, fairness, and transparency. In the beginning of transition (1991 – 1993) the highly centralized system was preserved and there was not a sign of a sensible dialogue between local and central authorities. In 1993, the independence of municipal budgets within the consolidated state budget was acknowledged,



meaning, in essence, 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 the distribution of the state subsidies to the municipal budgets. However, the reform of local budgetary process and the modernization of municipal financial management were inevitable as a reflection of broader social and economic changes implemented throughout the country.

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. During the series of instructive training, seminars, and discussion forums the efficiency of the legal framework and the financial situation of municipalities have been analyzed, which proved to be helpful for developing common positions on major problems and promoting the necessary reforms. This resulted in several changes in intergovernmental relations, 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.

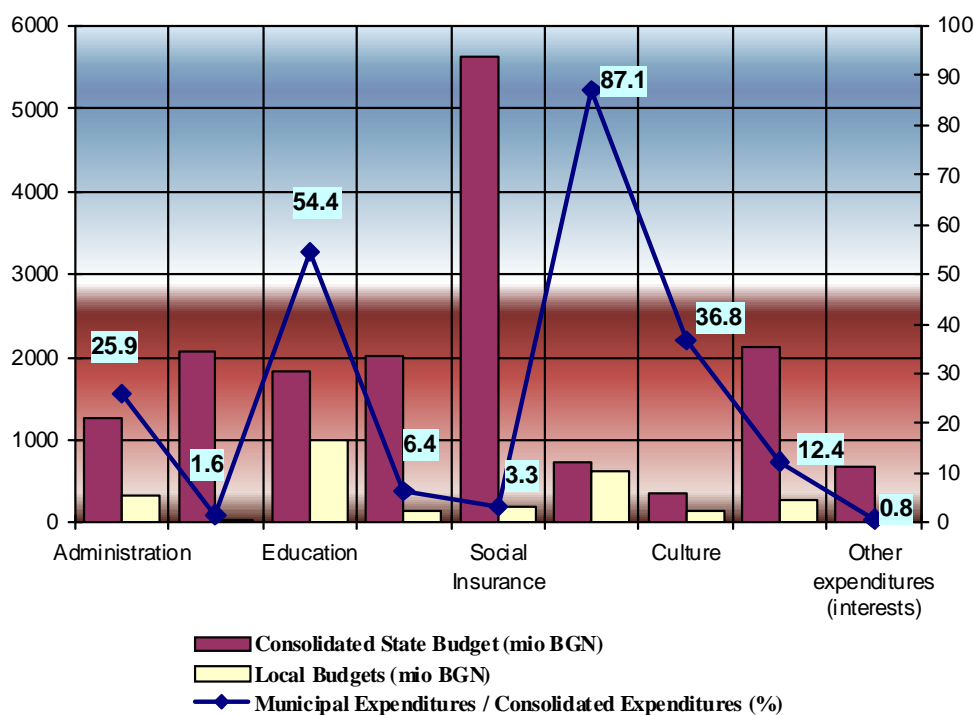
Besides the expenditure assignment, one of the key issues in the design of fiscal federalism is the financing of subnational governments. Because of the advantages of taxation at the central level and spending at the decentralized level during the transition period Bulgaria have often ended up with vertical and horizontal fiscal imbalance. Although autonomous on paper, municipalities have not had any possibility to considerably influence even own-source revenues. Moreover, municipal budgets have been heavily dependent on the intergovernmental transfer system, which has not provided stable, predictable, and satisfactory revenues. As a whole, the transfer system had several basic shortcomings.

Firstly, the overall amount of the transfers was not stable. The share of the subsidies for the entire period (1991-2002) varied widely between 5.2% and 11.0% of the gross domestic product and represented from 10.6% to 29.4% of the central government expenditures in different years. [NAMRB, 2009] Secondly, the formula for the allocation of the state subsidies among the municipalities was exceptionally complicated and difficult to predict. Since its introduction in 1993, 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 Ministry of Finance. The subsidy for capital investment was allocated strictly on an ad hoc basis and seemed to bear no relationship to the general subsidy criteria or other rationale. Whereas the general subsidy has come to operate more and more as a “safety net” for municipalities with low revenues per capita, analyses of its actual allocations indicated numerous instances of unexplained variations across municipalities. [Tchavdarova, 2000, 36] Finally, the continual redistribution of subsidies in the course of fiscal year as well as the end-of-year special subsidy allocations ignored the objective criteria adopted with the annual State Budget Acts. Because the relative share of additionally allocated funds during the period represented from 20.2% to 47.0% of the total governmental subsidy (about 35% on an average), this approach caused unfairness, unpredictability, and instability of local finance and undermined effective budgetary process at the local level, while fostering a strongly political orientation to the intergovernmental resource allocation. [Ivanov, 2004, 15-23]



The real financial decentralization in Bulgaria started in 2003, based on the Cooperation Agreement, signed by the Council of Ministers and the National Association of Municipalities in 2002, whereby both parties agreed to decentralize local government and to increase the financial independence of municipalities. Moreover, both the Fiscal Decentralization Concept and the Program for its implementation were adopted in 2002. 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 2003 it was continued and improved during the following years.

Now, public services in Bulgaria are organized in nine major functions, each of them containing a number of activities. The central and the 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 defense, 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.



Source: Calculations based on the Ministry of Finance database [MoF, 2009]

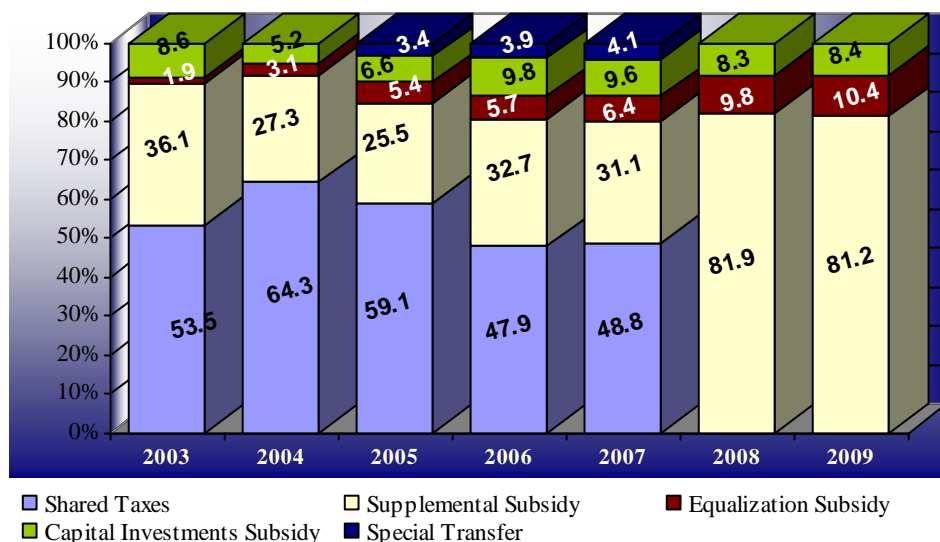
**Figure no. 2. Expenditure Assignment in Bulgaria (2008)**

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.

Additionally, the 2003 State Budget Act provided a framework for regulating a new, simple and transparent model of assigning government subsidies. Basically, the governmental transfers in Bulgaria are not competitive. During the prevalent part of the transition period governmental transfers have comprised shared taxes and state subsidies. The most important shared tax has been the personal income tax. It was divided among the central and local governments in 50:50 ratios, but since the beginning of 2003 the personal income tax has been defined as entirely municipal revenue, intended to cover delegated state activities at the local level. However, significant inter-municipal disparities were inescapable, because the personal income tax was a progressive tax, collected by withholding at source, and the tax base was unevenly distributed, favoring the richest local governments. For this reason, the normative expenditure standards for the delegated state activities have been developed and shared tax proceeds for any particular municipality have been limited to the amount of these standards. In 2008 personal income tax was defined as entirely central revenue source, so it was pull out of the intergovernmental transfer system.



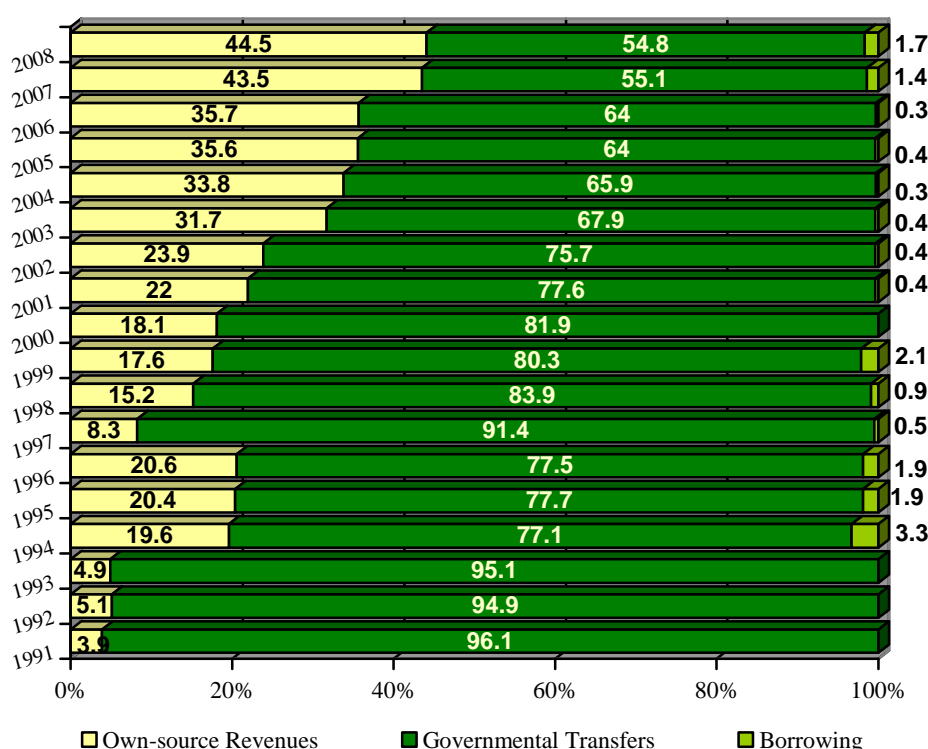
Source: Calculations based on the Ministry of Finance database [MoF, 2009]

**Figure no. 3. Structure of Intergovernmental Transfers (%)**

Now, governmental subsidies allocation is based on a formula, which is stated in the annual State Budget Act. Basically, the formula takes into account the expenditure needs and revenue capacity of the local governments. The first element of the allocation formula is the general supplemental subsidy. In the period 2003-2007 it was calculated by a “gap-filling” method, as a comparison between the full cost of all state mandates imposed on municipal budget and the amount of the shared tax revenues. Actually, the general



supplemental subsidy played an equalization role as well, and compensated for the uneven distribution of the personal income tax base. At the present time, supplemental subsidy 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. At the same time the annual equalization transfer pool must be equal to at least 10% of the total municipal own-source revenues in the fiscal year before previous. 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 targeted financial flow, because a wide range of infrastructure capital investments and ecologic recovery projects is assigned to the local governments. For the present this grant is allocated on an ad hoc basis and seems to bear no relationship to the general subsidy criteria.



Source: Calculations based on the Ministry of Finance database [MoF, 2009]

**Figure no. 4. Structure of Local Governments Revenues (%)**

At the present time, intergovernmental transfer system still plays the dominant role in financing local governments in Bulgaria, as far as governmental transfers form the prevalent part of municipal revenues. Due to the gradual decrease of its relative share in the total local revenues, from 96.1% in 1991, 91.4% in 1997, and 81.9% in 2000 toward 55.1% in 2007



and 54.8% in 2008, Bulgarian intergovernmental transfer system is coming up to the European standards. There is not an absolute rule, but it is accepted that local fiscal autonomy is properly secured, when local own-source revenues are comparable to the governmental transfers. According to the economic and financial point of view, the dominant role of the transfers allows local governments to be entirely compensated for the vertical and horizontal imbalances, but according to the political and institutional point of view, such a proportion gives the central government more political and financial control over the local level, than the acceptable for a modern decentralized system. Having in mind the great difference between the fiscal capacity in several richest municipalities and the rest of the local governments in the country, for the present the strong intergovernmental transfer system has no effective alternative.

### 3. 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. Regulated by the Local Taxes and Fees Act, the Municipal Property Act, and the annual State Budget Acts own-source revenues comprise local taxes, municipal fees and revenues from municipal property management.

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 have any say in the "design" of the local tax, it could not be considered as a local tax, but 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 addition to the lack of real tax autonomy outlined above, several problems had a decisive influence over the own-source local revenues during the transition, causing a significant decline of their relative share, especially in the period 1991 – 1997. 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 interests and corresponding efforts of the 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. This was the reason why in the analyzed period (1991-1997) local taxes accounted for less than 3% of the local revenues. Especially low was local tax revenue share in 1997 (0.45%), due to the hyperinflation, which additionally devaluated property tax base. In addition, the inability of local governments to impose local fees and to set their rates freely, particularly in the inflationary situation, resulted in a growing gap between their revenue potential and the actual costs in providing the respective services.

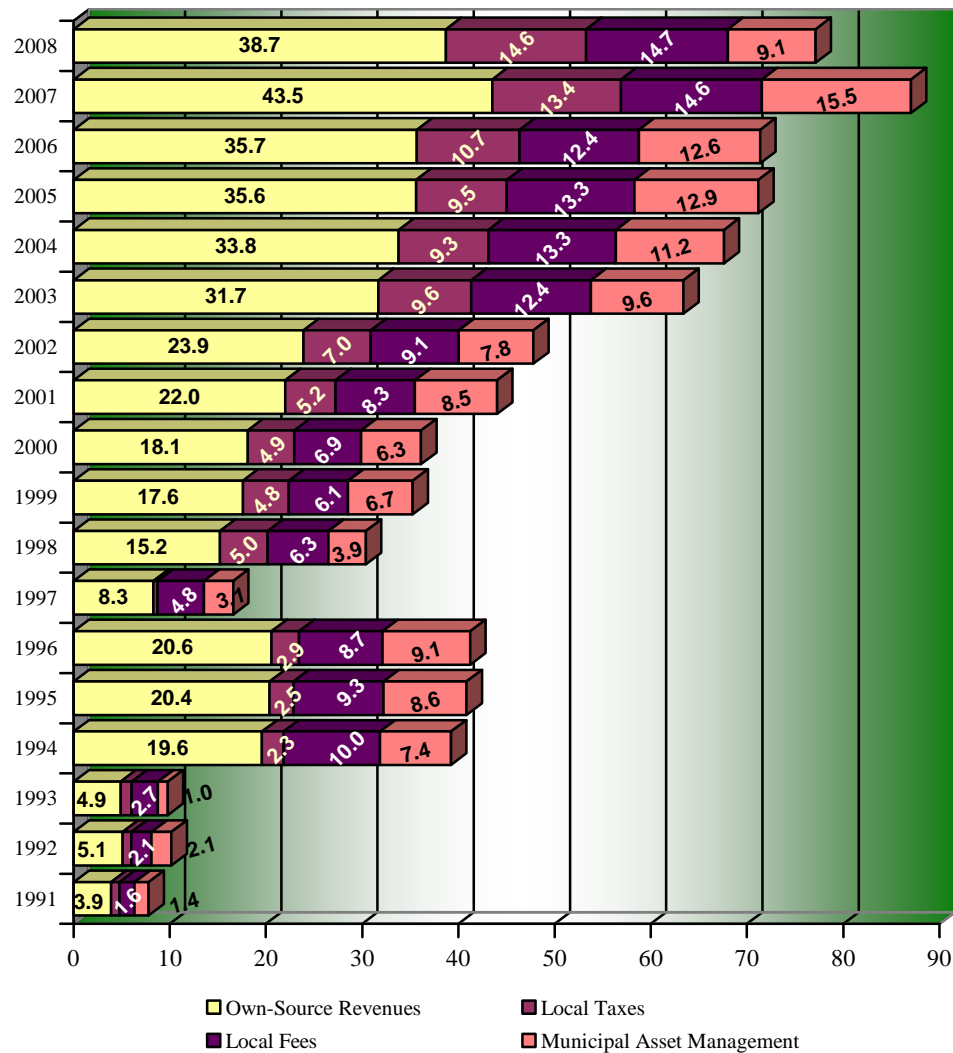


The Local Taxes and Fees Act, in force since the beginning of 1998, updated local tax bases and allowed local governments to set the rates of the local fees within certain legal limits. Consequently, in 1998 local taxes reached 5% of the total revenues, retained and expanded this share in the following years. Especially high is the share of local taxes in 2006 (10.7%) and 2007 (13.4%) due to the considerable revaluation of the property tax base on the one hand and the newly assigned municipal responsibility over the local tax collection on the other hand.

In the beginning of 2008 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. Consequently, legislative amendment is still necessary because local governments' financial autonomy can only be gained through significant control over the local tax levy.

Another important legislative change concerning local taxes was the reassignment of the patent tax as an own revenue source in the beginning of 2008. 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, transport, trade activities, and a variety of services. It is due by legal entities and individuals, who have up to 50 000 BGN<sup>ii</sup> annual turnover for the previous fiscal year, are not registered under the VAT Act, and perform so-called "patent activities", strictly specified by the Local Taxes and Fees Act. The tax size for different types of products and services is based on the quantitative characteristics, such as square meters trade surface for the shops, number of rooms in the hotels, consumption seats in the restaurants, number of seats in Internet clubs, number of installations or workplaces for the craftsmen, etc. The patent tax replaces the payment of personal income tax or corporate income tax. Actually it does not consider the incomes, realized by owners, but the capacity for potential incomes. The patent tax came into force in 1998 to ease the central tax officer's duties and to decrease the expenditures for tax collection, due to its high effectiveness. The tax-obliged persons should declare at the beginning of fiscal year that they would carry out certain activities. From this moment they become liable persons and are obliged to pay full tax size even if they do not work due to illness, absence or death. The patent tax schedule (base and rate limits) is fixed in the legislation. Now the municipalities are free to select annual rates within the legally defined set of ranges. In addition, while the patent tax schedule contains provision for applying rate differentials not only in different municipalities, but in different zones within municipal jurisdiction, it can adjust to the different economic conditions found across the local governments. In order to strengthen fiscal decentralization in our country, municipalities should be gradually given full tax autonomy over the patent tax, in terms of taxable activities, tax bases, and rates. Undoubtedly, the patent tax has the potential to become an important part of local revenues and powerful instrument of the municipal tax policy.





Source: Calculations based on the Ministry of Finance database [MoF, 2009]

**Figure no. 4. Own-Source Revenue Structure in Bulgaria (%)**

As a whole, during the period 1998-2008 local own-source revenues tend to increase gradually, from 15.2% of total municipal revenues in 1998 toward 18.0% in 2000, 43.5% in 2007 and 38.7% in 2008, provoked by the expanding financial decentralization. However, this tendency is mainly due to the increase of local fees and non-tax revenues. Since 2003 local governments have been given full discretion over local fees and service prices, which have tripled their importance in real and relative terms. At present, municipalities can charge local population and business for domestic waste; for use of marketplaces, fairs, sidewalks, and roadbeds; for use of nursery homes, kindergartens, social care homes, camps, hostels, and other municipal social services; for extraction of quarried materials; for technical and



administrative services; for purchase of grave plots. Municipalities can also levy tourist charges and other local charges as regulated by law.

Presently, the system of local fees is based on the several main principles. First of all, municipalities have the authority to determine the services on which they charge fees. Moreover, the calculation of any particular fee is based on the full cost recovery principle and the revenues are mainly dedicated to fund the service for which the fee is imposed. However, municipalities should be given full authority to determine the types of fees to be levied (in addition to the mandatory fees defined above), as they determine the rates, base, exemptions, and collection process.

#### 4. Conclusions

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. Subordinated to the Ministry of Finance, the tax administration had no incentive to perform timely and fully the collection of the local revenues. 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. However, the possibility for real tax autonomy and independent tax policy of Bulgarian local governments still lies in the future.

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## Notes

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<sup>i</sup> 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.

<sup>ii</sup> BGN is the abbreviation of Bulgarian currency. According the Currency Board provisions 1 EURO is equal to 1.95583 BGN.