

## COMPARATIVE ANALYSIS OF THE LOCAL FINANCE SYSTEMS IN THE EU COUNTRIES – CONCLUSIONS AND LESSONS FOR BULGARIA

*The current study presents the essence and goals of the system of local finances. It conducts a comparative analysis and assessment of the types of services, the structure of local expenditures, the main revenue sources for local budgets, the way the system of government transfers functions, and the legal rights of local government in the EU with regard to expenditures and revenue generation. Furthermore, the study draws comparisons and analogies with the practice in Bulgaria. The conclusion presents theoretical and practical summarizations of the international experience and on that basis formulates recommendations for improvement of the system of local finances in Bulgaria.*

*The main formulated recommendations are as follows: Bulgarian municipalities are comparatively large, which is why the creation of a second level of local government is unjustified; conditions for local democracy can be created by transferring legal powers and resources from the municipalities towards their territorial structures – the mayoralities; the municipalities need to receive legal powers to provide services relating to combating everyday crime, local fire protection and protection of the harvest; the scope of social service provision needs to be increased; the municipalities need to receive expenditure powers with regard to delegated services; the municipalities need to be given legal rights to vote on taxation rates up to 2-3% within the general 10% rate of the personal income tax.*

*JEL: H7*

### Introduction

The local finance system includes the expenditures for provision of local public services and the sources of revenue for their financing. The design of the system depends upon various factors, which determine its place the country's public finances, the number of subnational tiers and the size of the municipalities. It is defined by the answers to the following main questions:

- What is the type and scope of the public services provided by the public governments

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- How many tiers need to exist
- What is the optimal size (in terms of territory, population, settlements) of each sub-national level of local government
- What public services need to be provided by local government
- How (and from what sources) do these services need to be financed.
- What legal powers should local authorities have so that they can provide effective and qualitative services, which meet the needs of the users

Regardless of how difficult it is to account for the impact of these factors and dependencies, the essences and the goals of local finances cannot be sought outside of the aforementioned system of links and interrelations.

There is no singular answer to these questions. Neither the theory, nor the practice has identified unconditional demarcation lines, optimal sizes, types of resources, ways of allocating functions and resources between the different levels of public authority. The solutions vary and change historically; they are dependent upon geographic and national specifics, shaped by traditions and national psychology as well as by the challenges stemming from the changes in modern development.

Despite all contingencies, there are several established rules, criteria and foreign practices, which could be used as the basic construction of the national model of local finance and for justification of the necessary transition from its current state towards a superior one. Following that goal, the author defines local government as the object of the present study, while the subject is the system of local finance in the individual countries, its comparative characteristics, the differences and similarities with the practice in Bulgaria.

The present study addresses in logical sequence the questions formulated above; the present study examines the essence of the system of local finance and its goals, presents a comparative analysis and assessment of the types of services provided, of the structure of local expenditures, of the common sources of revenue for local budgets, the way in which the system of government transfers functions and of the revenue and expenditure responsibilities of local government in the EU countries. In parallel, the study draws comparisons and analogies with the practice in Bulgaria. The conclusion presents a theoretical and practical summary of the international experience and on that basis formulates suggestions and recommendations for improvement of the system of local finance in Bulgaria.

### **1. Type and scope of public services**

Public goods, according to the respective classifications (Samuelson, 1954, 1955; Мъсгрейв, Мъсгрейв, 1998, p. 35-40), are ones, whose consumption is not competitive and for which the exclusion of free-riders is impossible or ineffective, since the additional expenditures associated with each subsequent user approach zero. Stancho Cholakov (Чолаковъ, 1936, с. 5) states that “All needs, which by virtue of the local culture are

considered to be of a general nature, fall within the category “public services”. The scope of public services depends on the history, traditions and culture of a given society. There is no singular solution, neither in time, nor in space. With the development of society, this range of public goods changes and the general tendency is towards increase (Derycke, Gilbert, 1988).

Different societies make a different choice. The models of the “social” and the “liberal” states categorically proves that the scope of public goods is determined by relative factors, the type and intensity of which differ across different societies.

In general terms, the liberal state is based on the principle of minimum interference in social life. From a financial standpoint, this means fewer public services and respectively lower taxation. The redistribution functions of the state are minimized. This means that individual initiative and competition are the pinnacle of the system. As a result, such societies are highly polarized. This model is used mainly by USA, Canada, Australia, New Zealand, Brazil, South Africa and others (see Table 1).

Table 1

Share of public expenditures in GDP (%)

	2013	2014	2015
Finland	58	58	58
France	57	57	57
Sweden	52	52	50
Hungary	49	49	50
Netherlands	46	46	45
United Kingdom	45	44	43
Czech Republic	43	42	42
Poland	42	42	42
Bulgaria	38	42	41
Latvia	37	38	37
USA	37	36	36
Romania	35	34	36
Brazil	30	30	35
Switzerland	34	34	34
South Africa	31	31	30
Australia	n.a.	26	26
Canada	15	14	13

Source: for European countries – Eurostat, extracted on 27.10.16; for non-European countries: IMF <http://data.imf.org/?sk=388DFA60-1D26-4ADE-B505-A05A558D9A42>, extracted on 05.12.16.

The social state follows the opposite principle. In such states the public sector is larger, its redistribution role is stronger, and it assumes greater responsibility for the development of society. Its engagement with regard to employment, healthcare, education and social support is stronger. This means smaller social disparities and respectively greater social security and justice. The backbone of this society is the comparatively large middle class. This is the model for development of the countries in Western and Northern Europe.

The quantitative differences between the social and the liberal model can be presented via the share of the public sector in GDP.

The average data for a longer period – 2007-2015 for the EU countries indicate that, given an average share of public expenditures in GDP of 48.1%, 11 countries have a higher share. In the first places are France 55.8%, Denmark 55.3% and Finland 54.3%. From Eastern Europe only Hungary and Slovenia fall within that group. A total of 12 countries have a share between 40% and the EU average. Amongst them are Croatia, Poland, the Czech Republic and Slovakia. The remaining 5 countries have a share of less than 40%. These are the three Baltic republics, Romania and, in the last place, Bulgaria with a share of 37.68%. This means that in terms of purely quantitative parameters, our country gravitates more towards the liberal model as opposed to the declared intention to establish a “social state”.<sup>2</sup>

From a structural standpoint, public expenditures are linked to specific activities, which are grouped into functions. For example, all public services in Bulgaria are represented by the following 9 functions:

- I. General government services
- II. Defense and security
- III. Education
- IV. Healthcare
- V. Social security and welfare
- VI. Housing construction, public works, utilities and environmental protection
- VII. Recreation, culture, religious activities
- VIII. Economic activities and services
- IX. Expenditures, not classified in other functions

The Classification of the Functions of Government (COFOG), used by Eurostat, is quite similar. The difference lies in the division of the second function “Defense and security” into – “Defense” and “Public order and safety” and of function 6 “Housing construction, public works, utilities and environmental protection” into following two separate functions: “Environmental protection” and “Housing construction and utilities”.

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<sup>2</sup> See Preamble to the Constitution of the Republic of Bulgaria

The data presented in Table 2 indicate that disparities in the expenditures by groups of services between the EU countries are not particularly large.

Table 2

Structure of public expenditures in the EU in 2014 (%)

COFOG99	Total	General public services	Defense	Public order and safety	Economic affairs	Environment protection	Housing and community amenities	Recreation, culture and religion	Education	Health	Social protection
EU-28	100	14	3	4	9	2	1	2	10	15	40
max	100	39	5	7	17	4	5	5	16	20	48
min	100	10	1	2	6	0	0	1	8	4	25
Bulgaria	100	15	3	7	12	2	4	4	10	13	32
Czech Republic	100	11	2	4	14	2	2	3	12	18	31
Hungary	100	20	1	4	15	2	2	4	10	10	31
Romania	100	13	2	6	17	2	3	3	9	11	33
Slovenia	100	15	2	3	11	2	2	3	12	13	36
Slovakia	100	14	2	5	11	2	1	2	10	4	48
Poland	100	12	4	5	11	2	2	3	12	11	38
Croatia	100	18	3	4	13	1	1	3	10	14	33
Denmark	100	13	2	2	7	1	0	3	13	16	44
Finland	100	14	2	2	8	0	1	2	11	14	44
Sweden	100	15	3	3	8	1	2	2	13	14	41
Netherlands	100	11	2	4	9	3	1	3	12	17	37
Portugal	100	17	2	4	13	1	1	2	12	12	36
Spain	100	16	2	5	10	2	1	3	9	14	40
France	100	12	3	3	9	2	3	3	10	14	43
United Kingdom	100	12	5	5	7	2	1	2	12	17	37
Italy	100	17	2	4	8	2	1	1	8	14	42
Latvia	100	13	2	5	13	2	3	5	16	10	31
Lithuania	100	13	3	5	9	2	1	3	15	16	33
Estonia	100	10	5	5	13	2	1	5	15	14	31
Luxembourg	100	11	1	2	11	3	2	3	12	12	44
Ireland	100	16	1	4	8	1	2	2	11	20	35
Greece	100	20	5	4	7	3	0	1	9	9	40
Cyprus	100	39	3	4	6	1	5	2	12	5	25
Malta	100	16	2	3	13	4	1	3	13	14	32
Belgium	100	15	2	3	13	2	1	2	11	15	36
Germany	100	14	2	4	7	1	1	2	10	16	42
Austria	100	13	1	3	14	1	1	2	10	15	41

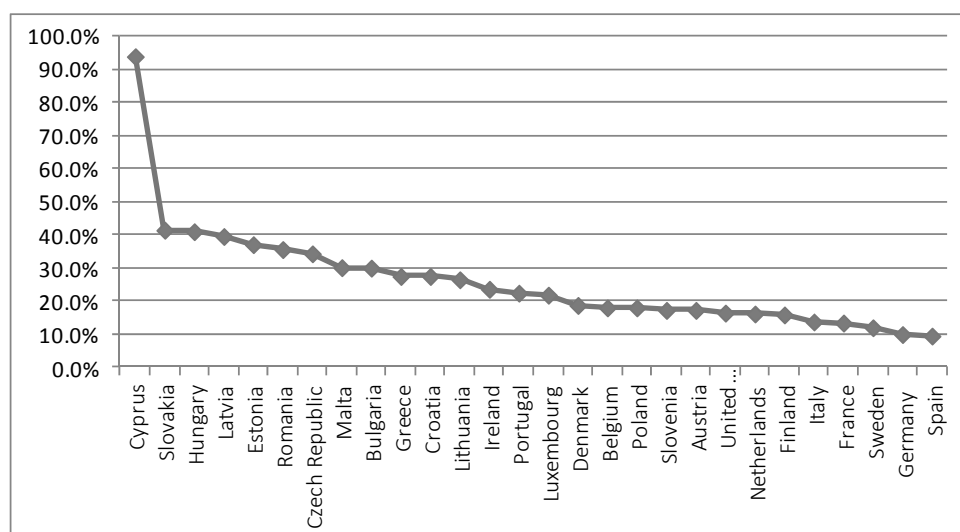
Source of data Eurostat, Extracted on 22.03.16

The results from the comparative analysis of the differences in the structure of expenditures by functions between the individual countries and the EU-28 average, measured via the mean standard deviation „ $\sigma$ “, indicates comparable values. Cyprus is the only exception as its public expenditure structure is characterized by rather extreme values in comparison to the EU average ( $\sigma=10.43\%$ ) for some functions. The comparison between the  $\sigma$  of the individual countries and the  $\sigma_{\max}$  of the “reference” country, whose structure is characterized by the largest differences in the shares registered by the real countries in

comparison to the average for the EU, indicates that Cyprus comprises 93.8% of the reference value, which equals 100.0%, while the relative values for the other countries range from 9.5% for Spain to 41.4% for Slovakia.

Figure 1

Comparative differences in the structure of public expenditures in the EU countries



As the graph indicates the smallest differences in the average values are registered by the countries from Western Europe – Spain, Germany, Sweden, France and others. Amongst them are Slovenia and Poland, whose values of  $\sigma$  comprise 17.2% and 18.0% of the  $\sigma_{max}$ , respectively. The other countries from Eastern Europe register significantly larger comparative values – from 26.5% for Lithuania to 41.4% for Slovakia. Greece with 27.5% and Malta with 30.1% also fall within this group.

The comparison of the differences between the EU countries with regard to the shares of the individual functions indicates that the most significant differences are evidenced by the function “Social protection”  $\sigma= 6.24\%$ , followed by “General government services”  $\sigma= 5.47\%$ , healthcare, economic activities and education. The differences in the shares of the other functions between the countries are minimal.

Against the background of the European palette, Bulgaria has the largest share of expenditures for “Public order and safety” and close to the maximum shares in the fields of public works and culture. In comparison to the EU-28 average, the largest differences are evidenced by the function “Social protection” – 40% for the EU and 32% for Bulgaria. The shares of the expenditures allocated to the functions “Education”, “Environmental protection” and “Security” are equal to the EU average. The mean standard deviation for

Bulgaria compared to the expenditure structure for the EU is  $\sigma = 3.33\%$ , which represents 30.0% of the  $\sigma_{\max}$ .

The comparison of the expenditure structure for the individual public functions of the other countries with Bulgaria's one indicates that the smallest differences are with Croatia, Romania and Slovenia, while the largest one are with Cyprus, Slovakia and Denmark.

## **2. Levels of local government and optimal size of local jurisdictions**

The individual types of public goods have different scopes of action. For example, national security, legislation, monetary policies and other have a national scope, while the benefits from others are territorially limited – for example, street lighting, maintenance of parks, cleaning of settlements, removal and disposal of household waste and others. This conditions provision of the services of national scope by the state and provision of the services, whose benefits are limited to a specific territory by the sub-national (local and regional) government.

If we assume that the different territorial scope of the individual services conditions the need for the existence of several levels of service provision, we need to address the following questions: how many sub-national levels are needed, what should their size be, and which services should be provided by which level of government.

According to R. Musgrave (1998, p.348) “Each jurisdiction needs to provide services, the benefits from which spread within its boundaries, and to use sources of funding that ensure that the expenditures do not exceed those territorial boundaries“. However, this does not answer the question how large should this jurisdiction be. Reflecting on the optimal size of the community, Musgrave reaches the conclusion that it must be determined by equilibrium between the marginal decrease in the cost to the individual consumer, resulting from the increased number of consumers, and the marginal cost of overpopulation to the individual consumer. Even when he take into account the cost of congestion (a consequence of reaching the thresholds levels of utilization of infrastructure), the impact of economies of scale as well as the ways to reach the optimal size – expressing preferences through participation in the electoral process or automatically, via “voting with their feet”, it seems that this reasoning suggests optimization of the population number, given specific territorial boundaries, which coincide with the respective settlement.

If this is to be the starting point, then, other conditions being equal, fewer public services can be provided in the smaller settlements, while a greater number of services, whose benefits extend within their boundaries, can be provided in the larger settlements. If the scope of the community extends to several settlements, this increases the number of services that the respective municipality can provide, since they are supplemented by the ones, whose benefits exceed the boundaries of the settlement, and hence serve several settlements – for example, maintenance of the road network, intercity transport, professional schools and others; in this way the consumer would in some cases also benefit from technical economies of scale. For example, a larger hospital provides higher quality services and could services the population of several settlements.

The conclusion, which may be drawn is that the larger municipalities can provide more public services to their inhabitants, while each service has a lower cost to the individual consumer. i.e. their production is more efficient. Respectively, the smaller jurisdictions will be able to provide fewer public services, which will be comparatively more expensive for the individual consumer.

When elaborating the theoretical construction of the local jurisdiction model Musgrave explicitly states that he is solely driven by economic considerations, not taking into account the political history, which conditions the different number of sub-national levels within a given country. On the other hand, the following two axioms can be formulated on the basis of the logic behind his arguments: the first one is that “services provided to the population and the allocation of the expenditures for them need to comply with the preferences of the inhabitants...” and the second one that “the decisions regarding the specific services need to be made by the residents of the district, since they pay for their use” (P.Мъсгрейв, П.Мъсгрейв, 1998). This leads to the conclusion that the municipality is regarded as an organization for services provision, while the democracy, i.e. the local choice of public services, the understanding that it determines the amount of taxation and that local representatives will take into account the wishes of the electors and tax payers, is presumed granted.

Unlike America, however, in Europe the general picture is more nuanced. In some countries the municipalities are comparatively less dependent upon the central authorities as they receive a larger share of the revenues from their budgets through direct taxation, while in others, the local authorities are institutions, which implement the policies of the central authorities. For example, in the Scandinavian countries local government is more developed, while in Southern Europe as well as in the former socialist states, including Bulgaria, local self-government is comparatively limited. This is why in the European countries, the municipalities are, on the one hand, regarded as institutions, which provide local services, and, on the other hand, as institutions, through which local democracy is ensured. In some European countries, the latter is still being implemented and hence a goal, which is yet to be realized.

In reality, the legitimacy of local authority is determined both by the better results (provision of more and more effective services) and by the democratic nature of local government. For example, the lack of democracy, commonly perceived as the right of the local community to participate in the elaboration, implementation and control over municipal policies, would compromise local government. The conclusion that can be drawn is that the size of the local jurisdictions is conditioned by the opportunities to achieve the following two goals – provision of more and more effective services and the right of the community to determine the policies of the local government.

Without going into the depth of the discussion about the size of the municipalities, the most important arguments of the supporters and large and respectively of the supporters of small municipalities can be summarized in the following way.



*Large municipalities:*

The larger municipalities definitely provide more services and more effective services in the sense that they are cheaper to the individual consumer.

One counterargument to the latter is that the larger municipalities are more heterogeneous, with a larger diversity of interests. This makes the selection of a mix of services more difficult, which increases the inefficiencies and consequently causes non-compliance with the specific interests of the different groups of users.

The share of administrative expenditures in the larger municipalities is comparatively smaller, i.e. governance is cheaper. They provide better opportunities to attract professionals, which leads to higher levels of competence of the representatives of the local authorities.

In the case of the larger municipalities the link between the population and its elected officials is weaker. The citizens have more limited opportunities to influence the decisions of the local authorities. This leads to the following two consequences: the first one relates to the loss of feeling of belonging, a lack of community spirit; in such cases alienation predominates and the people are less interested in public matters; the second one relates to the mediated characteristic of election of local representatives. The people do not personally know their elected officials; they vote for parties, which create a stereotypical perception of their candidates. Oftentimes the latter are not familiar with the specific local problems and deviate debates towards national issues. In this way local elections are transformed into mere rehearsals for the national elections and the results from them become an indication of national attitudes.

One counterargument to this position is that in the larger municipalities organizational participation is stronger due to the availability of numerous unions, non-governmental organizations and other forms alliance of the people, mainly around sectoral problems (education, social problems, ecology and others). Alongside the more extensive participation of the mass media – local newspapers, radio stations, television networks, this contributes to increased engagement of the population in the election of representatives of the local authorities.

In the larger municipalities the possibilities for redistribution of resources are more significant, which increases the equity of utilization of the local public goods. The larger municipalities have more sources and increased opportunities for democratic treatment of minorities.

*Small municipalities:*

They provide comparatively fewer public services. Their governance is more expensive. They often face difficulties in attracting specialists. Local authority in small municipalities is considered to be less competitive.

Other conditions being equal, the cost of the provided services is higher for the individual user, since they are produced for fewer people. On the other hand, the small municipalities are more homogenous and the mix of public services is, to a larger extent, compliant with local preferences. This leads to higher levels of satisfaction with the provided services.

Smaller municipalities are more democratic, because the link between the population and its elected officials in the local authorities is stronger. The people know the officials they vote for personally and can more significantly impact local decision-making. This makes the citizens more engaged in the process of local government and respectively the level of trust in local politicians is higher.

In the small municipalities the people act by themselves and not through social or political organizations. The predominance of individual interests as well as the scarce available resources (in comparison to the ones at the disposal of the large municipalities) leads to limited distribution processes, which oftentimes disrupts the equity of utilization of the services. Fewer people tend to reach an agreement more easily, but this is often at the expense of more categorical disregard for the opinion of some.

Apparently, both types of municipalities have both advantages and shortcomings. This turns the determination of the size of the municipalities into a solution to an optimization problem – one that should combine the advantages of the large and small municipalities whilst creating conditions to decrease/diminish their shortcomings. The latter could be overcome in following ways:

- The large municipalities could engage in internal decentralization, transferring power and resources to their territorial structures (in Bulgaria these are the mayoralties), where conditions for the development of local democracy can be created;
- The small municipalities could improve the effectiveness of the provided services by developing inter-municipal cooperation and by creating municipal associations to provide to their inhabitants specific services, whose scope exceeds the boundaries of the individual municipality.

Table 3 presents the local governments in the countries from the European Union. The data indicate that half of the European countries have small municipalities with a population of less than 10 thousand residents, while one third of the countries as well as the EU average level is below the legal minimum threshold of 6000 residents in Bulgaria. Our country is among the 9 states with large municipalities. In such countries the municipalities ordinarily have sub-municipal structures (mayoralties in Bulgaria, parishes in the UK, freguesias in Portugal, etc.).

In 7 countries there are three tiers. These are ordinarily large countries (France, Poland) or federal states (Germany, Belgium). In 10 countries there are 2 tiers and in 11 countries, incl. in Bulgaria, there only one level of local government.

Historically, the general tendency is towards increase in the size of the municipalities through merging. For example, in 1997 Greece had 5825 municipalities. The respective reform reduced their number to 1034 in 2005. The second stage of the administrative reform (Kallikratis reform) decreased the number of municipalities to 325 in 2010. The second level was created in 1994, when the prefectures – 51 in total, which acted as deconcentrated government structures, were transformed into self-governing institutions. 13 regions were created in their place in 2010.

Table 3  
Number of local institutions in the EU-27 and size of the first level of local government as of 2011

	1 <sup>st</sup> Level	2 <sup>nd</sup> Level	3 <sup>rd</sup> Level	Size of the 1 <sup>st</sup> Level	
				Territory	Population
United Kingdom	406	28	3	601	152.685
Denmark	98	5		440	56.592
Lithuania	60			1088	54.783
Netherlands	418	12		81	39.742
Ireland	114			612	39.263
Greece	325	13		406	34.785
Portugal	308			299	34.542
Sweden	290	20		1552	32.338
Bulgaria	264			420	28.538
Latvia	119			543	18.815
Belgium	589	10	6	52	18.477
Finland	336			1006	15.961
Poland	2479	379	16	126	15.404
Slovenia	210			97	9.757
Croatia	556	21		102	7.638
Italy	8094	110	20	37	7.471
Germany	11553	301	16	31	7.077
Romania	3181	41		75	6.737
Malta	68			5	6.118
Estonia	226			200	5.929
Spain	8116	52	17	62	5.677
EU-28	<b>89149</b>	<b>1126</b>	<b>105</b>	<b>49</b>	<b>5.638</b>
Luxembourg	106			24	4.774
Austria	2357	9		36	3.559
Hungary	3177	19		29	3.148
Cyprus	379			15	2.121
Slovakia	2930	8		17	1.853
France	36697	101	27	15	1.767
Czech Republic	6249	14		13	1.683
max				1551.6	152.685
min				4.6	1.683

Source: Subnational public finance in the European Union, Dexia – CEMR, Summer 2012, p.11. Croatia, which joined the EU later on, was added by the author.

As a result of the reform in Lithuania, as of 2009 the number of municipalities is decreased from 527 to 119 and the second level of local government is eliminated (26 regions).

Until 1970 in Denmark there are 85 urban municipalities and 1300 parishes. 271 municipalities and 14 regions are subsequently created in their place. The reform of 2007 reduced the number of these structures to 98 municipalities and 5 regions.

Administrative reforms aimed at decreasing the number of municipalities are also implemented in: Finland in 2006, as a result of which the number of municipalities is reduced from 431 to 336; Germany in 2007, where the number of municipalities decreases by 900 (from 12456 to 11553); Luxemburg in 2009, where the number of municipalities is reduced from 116 to 106.

An alternative to merging is stimulating inter-municipal cooperation with regard to the provision of specific services within the associated municipalities. Such policies are enforced in Spain, Italy, the Netherlands, Portugal, Finland, Hungary and particularly in France<sup>3</sup>, where 15 thousand inter-municipal syndicates exist (Derycke P.H., Gilbert G., 1988). The more famous ones among them are: around 12 thousand SIVOS (Syndicats Intercommunaux a Vocation Specialisee), which encompass nearly all municipalities and specialize in water supply – 30%, electrification – 13% (particularly in the rural areas), school management and student transport – 4% and others; more than 2 thousand SIVOM (Syndicats Intercommunaux a Vocation Multiple). More than 20 thousand municipalities are part of these syndicates. They provide services in the field of household waste (63%), maintenance of the road infrastructure (61%), water supply (36%), sewerage (55%), sports infrastructure and equipment (37%), tourism development (30%) and student transport (25%).

Exceptions from the prevailing tendency to merge municipalities are Slovenia, where the number of municipalities increases from 60 to more than 200 during the second part of the 90s and Hungary, where in the beginning of the 90s the number of municipalities increased to 3154 from the envisioned 1523 as a reaction of the policy of forced mergers, enforced in the 70s (Gabor Balsh and Joseph Hegedyush, 2002). The same thing happened in the Czech Republic, which surpassed France by the level of fragmentation of the municipalities, and in Slovakia, where, following the political changes of 1989, the number of municipalities increased from 1991 to 2825 (Swianiewicz, P., 2002).

The latest changes<sup>4</sup> indicate that the aforementioned tendencies to restructure the sub-national levels of government continue. During the period 2012-2016 two thirds of EU countries (19 out of 28) have changed the number of municipalities and regions. Most of them have decreased the number of municipalities, while the most significant consolidation is evidenced in Portugal – from 4567 to 3400, in Estonia – from 226 to 213, in Finland – from 336 to 313, in Italy – from 8094 to 8006, in Germany – from 11481 to 11313 and even in France – from 36700 to 36658. Conversely, in the Eastern European countries the fragmentation of the municipalities continues, albeit at a slower rate. For example, the Czech Republic their number has increased by 8 and in Hungary – by 24.

Changes in the number of territorial units from the second, or from the intermediary, level of local government have also been evidenced as follows: in Finland – 18 municipal councils were created that the respective municipalities are required to join. These councils have extremely limited staff and budgets and are responsible for regional development, the

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<sup>3</sup> As of 2014 г. all municipalities are part of inter-municipal structures. The later have limited powers, determined by the respective municipalities, see Local and Regional Governments in Europe, Structure and competences, CEMR, 2016, p.29.

<sup>4</sup> Local and Regional Governments in Europe, Structure and competences, CEMR, 2016.

structural funds, the popularization of regional culture and traditions, and others; in France – the number of departments decreased from 101 to 99, while the number of regions decreased from 27 to 16; in Poland – the number of territorial units from the intermediary level (*powiaty*) increased by 1; in Lithuania – 5 regional councils on development were created, which are elected by the representatives of the respective municipalities and have competences in relation to regional planning and development as well as coordinating functions relating to the restructuring of social services, regional investment policy and others.

For most of the time since the Liberation of Bulgaria there have been three sub-national levels of government – municipalities, districts and regions<sup>5</sup>. The intermediary level – the counties existed since 1880 until they were eliminated in 1959. Their number ranged between 58 and 117. In 1920 Bulgaria was divided into 15 districts, 82 counties and 2391 municipalities. In 1949 there are 2180 municipalities, in 1978 – 1394, incl. 220 urban and 1174 rural municipalities. 291 municipalities (settlement systems) are created in their place in 1979. Their number gradually decreased to 250. Following the political changes of 1989 discussions were held about the number of size of the municipalities. Most of the participants shared the arguments about the comparative advantages of the large municipalities. On the basis of these recommendations, the political decision was made to preserve the existing administrative and territorial structure

The enthusiasm associated with the changes and the existing legal opportunities conditioned local actions to create new municipalities by separating settlements from existing municipalities (as is the case in Hungary and Slovenia). The process of division of the municipalities began with Srednogorie municipality (Ordinance 250/promulgated.12.08.1991), which was divided into 6 municipalities – Anton, Zlatitsa, Pirdop, Mirkovo, Chavdar and Chelopech. Another 9 municipalities are created during the period 1997-2003. Alarmed by the fragmentation of the municipalities, the central authorities amended the legislation by setting a lower threshold of 6 thousand residents as well as other conditions relating to the financial capacity. In this way, they refused to recognize the referendum for the separation of the town of Ahtopol from Tsarevo municipality in 2004. The only exception from since then have been the separation of Surnitsa from Velingrad municipality in 2015.

Currently, there are 265 municipalities in Bulgaria and according to “European standards” they are classified as large municipalities. Taking into account the differences in the size of the municipalities in the EU countries, Bulgarian municipalities can conditionally be divided into three groups – large, medium and small.

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<sup>5</sup> Constitution of Bulgaria from 1897, art. 3. The territory is administratively divided into regions, districts and municipalities. A special law will be created to govern this administrative division on the principle of self-governance of the municipalities.

Table 4

Groups of municipalities according to their population number in 2013

Groups of municipalities	Nr. of municipalities	Relative share	average population nr.	Nr. of settlements	Nr. of mayoralties
Large – more than 30 thousand	45	17%	108391 <sup>6</sup>	33	21
Medium – 10 – 29 thousand	97	37%	17144	20	13
Small – less than 10 thousand	122	46%	5780	13	6
Total/average	264	100%	27446	19	11

The data indicate that nearly half of Bulgarian municipalities have a population number, which corresponds to half of the countries in the EU – less than 10 thousand residents. From them 66 do not meet the legal requirement for a minimum population number. Only 17% of the municipalities in Bulgaria – 45, are actually large. The differences among municipalities range from 1317 thousand residents in the capital to 625 residents in Treklyano municipality. The average territory of the municipalities is 420 km<sup>2</sup>, while the average number of settlements is 19. From them 11 have mayoralties status, while the total number of mayoralties in the country is 2914 in 2013 (Decision of the CoM 327/25.04.2012). A clear correlation is registered between the size of the municipalities and the number of settlements

What is the correlation between the size of the municipalities and the administrative reform, or more specifically, the number of subnational tiers.

When the municipalities are large the establishment of a second level of local government is more difficult and, to a large extent, also unjustified. This is also conditioned by the fact that there are comparatively fewer public services of supra-municipal significance, which can be entrusted to that level. They need to be transferred by the central authorities, which would resist a restructuring of public services that needs to be followed by layoffs and withdrawal of financial resources.

When the municipalities are small the provision of a much greater range of public services “remains” at the second level of local government. In this case, the second level assumes the responsibility to provide supra-municipal services and, depending on its size, some of the services, provided by government structures.

The data presented in Table 3, which indicates the number of levels of local government in the EU countries reinforces these arguments. For example, around half of the countries with small and medium municipalities have one or more levels of local government. The tendency evidenced in Bulgaria is indicative to that effect, since the humble attempts, often inspired from “outside”, for establishment of a second level of local government are faced by more or less direct resistance from all levels of public government.

<sup>6</sup> The average number of residents of the large municipalities excluding Sofia is 81090.

### 3. Local public services

The distribution of public service provision between the central and local authorities needs to be based on the principle of subsidiarity. It is formulated in the following way by the European Charter of Local Self-Government (ECLSG art 4., para. 3): “Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy“.

Referring back to Stancho Cholakov – a forerunner of the European Charter for Local Self-Government, he writes that “...numerous needs and tasks have a local, limited, specific character, which is why it would be better, faster and cheaper for local authorities to address them“ (Станчо Чолаковъ, 1936, с.6). By adding the position of Musgrave cited above that “Each jurisdiction needs to provide services, the benefits from which spread within its boundaries...”, we can formulate the following requirements for local public services:

The services, whose benefits spread within the boundaries of the municipality, can be provided more quickly and in a high-quality fashion by local government; they cost less to the user and, to a larger extend, match their preferences.

The distribution of public services provision between the central and the local governments can be assessed on the basis of the share of expenditures for local services in total expenditures for public services. This distribution, as well as by sectors (according to COFOG), for the EU countries is presented in Table 5.

The share of local expenditures is indicative of the scope of local government and is one of the main indicators of decentralization. The ranking of the EU countries according to its value is presented in Figure 2.

Table 5  
Share of local expenditure<sup>7</sup> in total public expenditure for the EU countries in 2014 (%)

COFOG99	Total	General public services	Public order and safety	Economic affairs	Environment protection	Housing and community amenities	Recreation, culture and religion	Edu-cation	Health	Social protec-tion
EU-28	23.5	23.8	23.3	33.9	71.6	74.1	61.5	39.6	21.3	13.6
max	64.0	44.0	50.0	48.0	95.0	100.0	82.0	81.0	99.0	83.0
min	1.0	3.0	0.0	0.0	4.0	0.0	3.0	0.0	0.0	0.0
Bulgaria	21.3	12.6	3.1	19.9	84.7	93.1	43.6	62.3	18.4	5.0
Czech Republic	27.4	28.6	11.0	36.6	87.2	74.2	69.9	62.5	18.3	6.2
Hungary	15.8	18.6	2.2	18.5	63.4	73.3	35.4	21.8	5.5	6.6
Romania	25.8	19.4	4.5	30.3	60.6	74.5	67.1	60.8	33.3	9.2
Slovenia	19.7	11.5	8.2	20.1	72.4	80.3	45.2	57.7	15.2	6.0
Slovakia	16.1	15.5	3.6	25.8	58.8	72.3	41.8	64.6	8.3	2.6

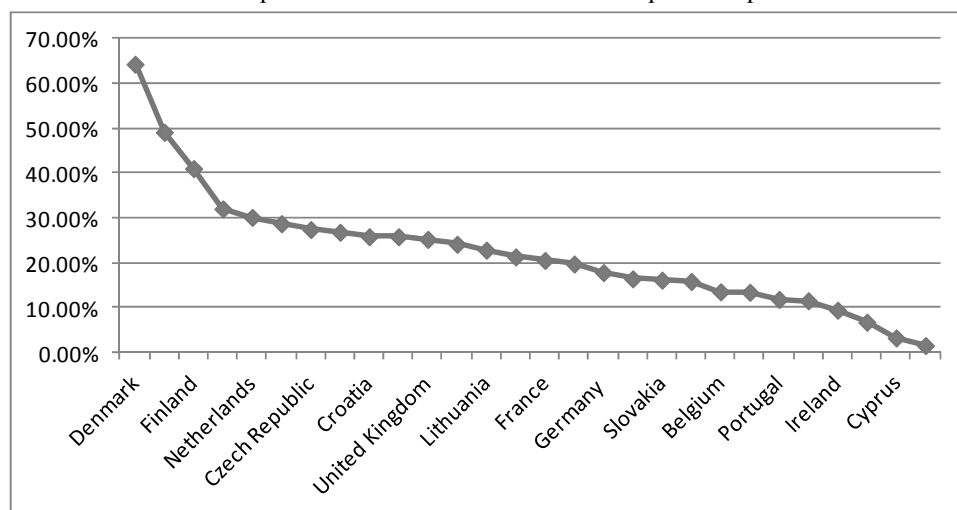
<sup>7</sup> Includes the expenditures of all level of local self-government

Poland	32.0	27.4	12.7	47.3	81.7	82.0	79.9	69.8	44.2	10.5
Croatia	25.8	43.6	7.0	9.8	3.6	5.8	34.6	73.2	36.9	8.7
Denmark	64.3	16.6	9.9	36.4	51.2	58.4	46.1	44.8	98.7	83.0
Finland	41.0	43.9	20.7	34.6	27.6	56.0	56.6	66.1	83.9	23.4
Sweden	49.1	38.7	15.0	35.3	59.5	93.0	78.1	77.2	97.1	33.0
Netherlands	30.1	20.1	20.3	47.8	95.3	75.7	81.6	80.6	3.4	16.9
Portugal	11.8	20.1	12.9	13.0	80.0	81.5	63.0	14.2	6.5	2.5
Spain	13.4	30.8	23.9	22.1	70.4	59.2	56.9	5.1	1.2	3.0
France	20.5	33.8	21.4	42.6	88.9	70.2	79.7	30.8	1.1	8.8
United Kingdom	25.2	16.1	48.9	31.2	54.0	82.6	37.5	59.4	2.2	23.2
Italy	28.7	21.4	13.4	47.9	90.4	87.3	48.0	24.3	97.7	3.6
Latvia	26.8	16.9	8.7	22.2	28.7	93.2	52.4	65.7	24.6	8.8
Lithuania	22.8	13.6	15.5	21.6	51.9	82.5	43.9	54.2	26.4	8.7
Estonia	24.1	19.6	1.3	27.5	43.3	99.8	46.2	58.7	29.1	5.6
Luxembourg	11.5	27.8	11.7	16.1	57.6	32.2	56.0	11.0	0.7	3.0
Ireland	9.4	3.0	8.3	27.0	62.4	69.8	28.4	9.4	0.0	7.3
Greece	6.7	9.5	1.1	16.6	37.3	67.6	45.7	7.6	0.0	2.2
Cyprus	3.2	3.4	0.0	0.0	88.0	20.0	29.8	0.0	0.0	0.0
Malta	1.5	4.2	2.0	2.0	11.4	0.0	2.8	0.0	0.0	0.0
Belgium	13.5	16.1	50.2	9.8	52.6	72.1	51.8	22.5	0.5	7.9
Germany	17.8	22.6	16.6	34.6	57.2	69.6	60.6	28.0	2.3	13.8
Austria	16.4	19.9	11.8	13.9	36.9	43.7	53.1	28.1	24.6	8.6

Source of data Eurostat, Extracted on 22.03.16. The function "Defense" has been excluded, since there the share of expenditures of local authorities is either zero or approaching zero.

Figure 2

Share of expenditures for local services in total public expenditure





The graph indicates that at the top of the list and significantly far removed from the rest are the three Scandinavian countries – Denmark, Sweden and Finland. At the bottom – with a share of local expenditures of less than 10%, are four countries – Ireland, Greece, Cyprus and Malta. An interesting fact about that ranking is that there is no division between the countries from Eastern and Western Europe.

The data indicate that on average for the EU local governments provide 23.5% of all public services. They provide the largest share of public services in the field of public utilities, environmental protection and culture. The share of provided local services in the fields of education and economic activities is comparatively large. Local government powers relating to the fields of healthcare and social protection are more limited.

Contrary to the case of public expenditure (see Table 2), here the differences between the countries are significant – from 64.3% in Denmark to 1.5% in Malta. The conducted analysis by functions indicates that the large share registered by the Scandinavian countries is mainly conditioned by local responsibilities for service provision in the field of education and particularly in the field of social protection and healthcare. It is precisely in those functions that the four countries, which lag behind, register shares of zero or close to 0%. Comparatively differences in the share of local expenditure compared to the EU-28 average are registered in Croatia, where the local governments have a comparatively small share in the provision of services in the fields of environmental protection and public works. The same applies to Italy, where almost all healthcare services are provided by local government. At the other extreme are countries, such as Germany, France, the Czech Republic, Romania and others, where the structural differences compared to the EU-28 average shares of local expenditures in total public expenditures are minimal for all individual functions.

The share of local governments in Bulgaria is 21.3%, which is close to the EU average. More detailed analyses indicate that these data are quite exaggerated as they are the result of the exceptional and accelerated absorption of the resources from the European program in the end of the programming period. If European resources were excluded, the share of local expenditure in total public expenditure would drop to 15.1%, which places the country in one of the last places in the EU.

The results from the comparison of the shares of local expenditures by functions with the EU-28 average indicates that the function “Public order and safety” is characterized by largest gap. The smallest share of local expenditure is registered in the fields of social protection, culture and economic activities. Bulgarian municipalities are characterized by a relatively large share in the provision of educational and community services.

The specific way, in which public services are distributed between the central and local governments creates different structures of local expenditure by functions. The relative share of expenditures by functions of the local governments of the EU countries is presented in the following table.

Table 6

## Structure of the expenditures of local governments in 2014 (%)

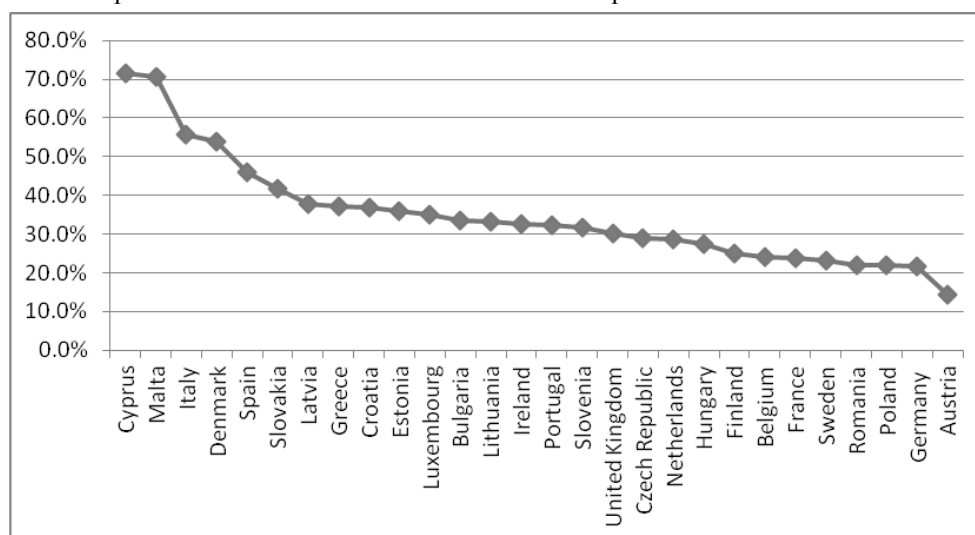
COFOG99	Total	General public services	Public order and safety	Economic affairs	Environment protection	Housing and community amenities	Recreation, culture and religion	Education	Health	Social protection
EU-28	100.0	14.1	3.7	12.6	5.2	4.5	5.5	17.2	13.6	23.4
max	100.0	46.2	12.7	24.1	28.1	28.3	16.4	39.8	47.7	56.5
min	100.0	3.3	0.0	0.0	0.1	0.0	2.2	0.0	0.0	0.0
Bulgaria	100.0	8.8	1.0	10.9	6.5	17.0	7.2	28.4	11.3	7.4
Czech Republic	100.0	11.8	1.6	19.2	7.9	5.6	7.0	27.7	12.1	7.1
Hungary	100.0	24.1	0.5	17.4	9.7	8.3	9.0	14.3	3.5	13.1
Romania	100.0	10.1	1.1	20.1	5.2	9.6	7.1	20.3	14.9	11.7
Slovenia	100.0	8.8	1.4	11.7	7.3	7.3	7.8	34.7	10.1	10.9
Slovakia	100.0	13.1	1.2	17.3	6.2	6.6	5.8	39.8	2.3	7.7
Poland	100.0	10.2	2.1	16.2	5.2	4.4	7.0	27.2	15.2	12.5
Croatia	100.0	31.2	1.2	4.8	0.1	0.3	3.7	27.8	19.9	11.0
Denmark	100.0	3.3	0.3	3.7	0.7	0.4	2.3	8.9	23.9	56.5
Finland	100.0	15.3	1.2	7.0	0.3	0.9	3.4	17.7	29.3	24.9
Sweden	100.0	11.8	0.8	6.0	0.7	2.9	3.4	19.9	26.8	27.6
Netherlands	100.0	7.5	2.8	14.5	10.2	2.6	8.8	31.3	1.9	20.5
Portugal	100.0	28.8	4.7	14.6	5.9	8.0	9.3	14.4	6.6	7.7
Spain	100.0	35.8	8.1	16.5	9.9	4.9	11.0	3.5	1.2	9.0
France	100.0	19.1	2.9	18.4	7.5	8.6	9.9	14.5	0.7	18.5
United Kingdom	100.0	7.8	8.9	8.5	4.1	4.7	2.2	27.8	1.5	34.4
Italy	100.0	13.0	1.7	13.5	5.9	3.9	2.4	6.7	47.7	5.2
Latvia	100.0	8.3	1.7	10.8	2.0	10.3	8.9	38.6	9.4	10.1
Lithuania	100.0	8.0	3.3	8.8	3.7	3.5	4.9	36.8	18.4	12.6
Estonia	100.0	8.5	0.3	14.3	2.8	4.9	10.0	35.7	16.3	7.2
Luxembourg	100.0	26.5	2.4	14.7	13.0	4.9	14.5	11.6	0.7	11.6
Ireland	100.0	5.0	3.3	24.1	9.6	14.0	5.9	11.1	0.0	27.0
Greece	100.0	28.0	0.7	18.3	17.3	4.1	8.3	10.0	0.0	13.2
Cyprus	100.0	40.7	0.0	0.0	14.7	28.3	16.4	0.0	0.0	0.0
Malta	100.0	46.2	4.2	16.9	28.1	0.0	4.8	0.0	0.0	0.0
Belgium	100.0	18.2	12.7	9.3	6.7	3.7	8.8	19.0	0.5	21.1
Germany	100.0	18.1	3.3	14.5	4.3	3.6	6.2	15.2	2.1	32.8
Austria	100.0	15.9	1.8	12.0	2.0	2.0	5.6	16.3	22.6	21.7

Source of data Eurostat, Extracted on 22.03.16. The function "Defense" is turned off.

The assessment of the differences in the structure of the expenditures of local government in the individual countries with the share of expenditures by individual functions on average for the EU-28 follows the same methodology, used for the purposes of comparing the differences in the structure of all expenditures in the EU countries. The resulting ranking are presented on Figure 3.

Figure 3

Comparative differences in the structure of local expenditures of the EU countries



The comparison between the results from the ranking of the structural differences in local expenditures with the ones for public expenditures indicates: firstly, smaller differences and less far removed countries at the top of the list; secondly, relatively larger structural differences in local expenditures with the EU average in comparison to the differences in the structure of public expenditures in the individual countries and thirdly, no division is evidenced between the countries from Eastern and Western Europe.

The above graph shows two pairs of countries, which are relatively far removed from the other states. Cyprus and Malta rank first, with a level of the differences of 71.5% and 70.7%, respectively. The reasons for the structural differences in local expenditure with the EU averages stem, on the one hand, from the lack of provision of local services relating to 5 different functions in Cyprus and to 4 functions in Malta (see Table 6) and, on the other hand, to the exceptionally large share of expenditures for “General public services” – more than 40% of total local expenditures. Italy and Denmark assume the next positions with 55.6% and 53.9% from the maximum possible level of difference. This is mainly due to the exceptionally larger share of local expenditure for healthcare in Italy and for social protection in Denmark. The differences between the other countries are smaller. The last two places, i.e. countries with local expenditure structures closest to the EU average for local authorities, are Germany and Austria.

The comparison of the differences in the share of local expenditures by functions between the EU countries indicates that the most significant differences are evidenced by the function “Social protection”  $\sigma=14.27\%$ , followed by “Healthcare”  $\sigma=12.13\%$ , “Education”  $\sigma=12.00\%$  and “General public services”  $\sigma=11.73\%$ . The differences in these shares between the countries are significantly smaller for the other functions.

Differences with the average EU share of local expenditures by functions and by country are as follows:

- “Social protection” – the Scandinavian countries register a higher share of local expenditures than the EU average, since, besides social services for disadvantage people, they also provide social benefits; Germany and Great Britain also register above average shares. The countries from Southern and Eastern Europe register a lower share of local expenditures for social protection in comparison to the EU average;
- “Healthcare” – shares of local expenditures higher than the EU average are registered by the Scandinavian countries, Italy and Austria. The sub-national governments in these countries finance hospital services. In the other countries local expenditures for healthcare are close or lower than the average share for the EU. They are limited to maintenance of the hospitals, owned by them;
- “Education” – shares of local expenditures higher than the EU average are registered by the former Socialist states as well as by Great Britain and the Netherlands. In the other countries the share of expenditures for education of the local authorities is close to or lower than the EU average;
- “General public services”. The largest shares of local expenditures are registered by Cyprus, Malta, Spain, Portugal, Croatia and others. The smallest share of local expenditures for general public services are evidenced in Denmark, Ireland, the Netherlands, the Baltic countries. The latter challenge the general rule that the smaller municipalities are characterized by higher expenditures for administration and governance. In this case, Lithuania, Latvia and Estonia have respectively small, medium and large municipalities according to their population number, but the share of their expenditures for this function is analogous – around 8%.

The data indicate that local authorities in Bulgaria are characterized by a comparatively diversified expenditure structure, unlike some countries, where the majority of expenditures are allocated to 2-3 functions. In comparison to the average values for the EU, the Bulgarian municipalities are characterized by higher shares of expenditures for education and communal services and by smaller shares of expenditures for public order and safety, healthcare and social services. According to the differences in the structure of local expenditures, compared to the one of the EU-28, Bulgaria ranks in the top of the second half of the ranking of the countries (see Fig. 2). The mean standard deviation for Bulgaria is  $\sigma = 8.56\%$ , which is 33.4% as proportion of  $\sigma_{\max}$ .

The comparison of Bulgaria’s structure of local expenditure by functions with ones of the other countries indicates that the smallest evidenced differences are with the countries from Eastern Europe and, more specifically, with Slovenia, Lithuania, the Czech Republic and others. The largest registered differences are with Denmark, Cyprus, Malta, Spain and Italy.

As noted above (see page 14, footnote 18), local governments comprise all levels of local self-government and in the different countries they range between 1 and 3 subnational tiers. It was determined that theoretically the larger municipalities can provide more services, but if there is more than one level of local self-government, local public services are distributed between and, all other conditions being equal, the services with a more limited scope are

provided by the first level (the municipal level), while the ones with a larger territorial scope, i.e. the supra-municipal services, are provided by the local governments from the second level – the district/regional or other similar level.

The results from the comparative analysis of the actual situation in the EU countries does not seem to reassert the theoretical conclusion about the correlation between the sizes of the municipalities and the scope of the provided public services. The comparison of the data from Table 3 – size of the municipalities and Table 5 – share of the services provided by local authorities in total public services for the 11 countries with one level of local self-government indicates that the comparatively large municipalities in Ireland and Greece do not correspond with a larger share of local in total public expenditures. In reality, the highest level of decentralization is evidenced in Finland, in which the municipalities are medium in size. The comparison of the three Baltic countries – Lithuania, Latvia and Estonia is interesting, since the scope of the local services provided therein is close to the EU average, while the municipalities in the three states are large, medium and small, respectively.

The verification of the other hypothesis that the municipalities provide services, the benefits from which are consumed within the municipality, while the second level provides supra-municipal services, requires the object of the analysis to be countries with two, or even three, levels of local self-government, while the subject would have to be the way the services are distributed between the first and second level.

Generally speaking, the results from the comparison of the services “transferred to the second level” in the individual countries indicates that these are in fact services, utilized by a greater number of people across larger territories.

A typical example are the activities relating to regional development, planning, coordination and others, which service the municipalities within the respective districts/regions. Such is the case in Denmark, Sweden, Romania and Croatia. These are almost all activities performed at the second level in Greece as well as by the newly established regional councils in Finland and Lithuania.

The distribution of the educational services between the different levels of local self-government also reasserts the above hypothesis. The first level – the municipalities, provide pre-school services for children as well as elementary education, while the second level – provides secondary and professional education services. This is how service provision is divided in the Czech Republic, Hungary, Poland, Slovakia, Denmark and France. Naturally, there are exceptions, such as Sweden and Finland, where the municipalities provide all educational services up until secondary education. Such is the case in Bulgaria as well.

In the field of healthcare, when it does not come down to prophylactics, but rather to health services and particularly hospitals, these activities are transferred to the second level – this is the case in Denmark, Italy, Slovakia, Germany, Austria, Sweden and Croatia.

The distribution of service provision is not as clear in the other fields. For example, the services relating to environmental protection are provided at: the first level in Slovakia, Croatia, Hungary, Spain (for the municipalities with a population of more than 20 thousand); the second level in Germany, Austria, the Czech Republic, France and Greece; by both levels in Belgium, Denmark and Poland. A similar distribution of the individual

series between the first and the second level of local self-government applies to the social services provided in Denmark, the Czech Republic, Germany, Slovakia and Spain. In other countries, social services are provided solely by the municipalities – Sweden, Finland, Poland, Hungary, the Netherlands and Croatia.

The principle of distribution of transport-related services, generally speaking, is that the construction and maintenance of the roads is the responsibility of the second level, while urban transport services – of the municipalities. Of course, there are numerous exceptions. For example, in Spain, Hungary, Finland and other countries, the municipalities maintain the roads at the local level. Such is the case in the Czech Republic, where the municipalities maintain local roads, while the regions maintain the second and third class roads and the state maintains the first-class roads and the highways.

The results from the international comparisons indicate that the local authorities in the EU countries provide services, which are not provided by Bulgarian municipalities. These are:

Local police – the Czech Republic, Romania, Spain (for the municipalities with a population of more than 5 thousand), Belgium, Portugal. These services are provided by the first level – the municipalities;

Firefighting services – Hungary, Croatia, Portugal, Spain (for the municipalities with a population of more than 20 thousand), Luxemburg, Ireland and others.

Employment – Denmark, the Netherlands, Belgium, Poland (the second level)

Emergency medical assistance – the local authorities in Sweden and the Czech Republic have specific such functions.

#### **4. Local revenues**

Unlike private goods, whose scope is determined by the amount of revenue, in the public sphere it is quite the opposite. The type of public services and expenditures for their provision need to be determined first. A revenue system is “modelled” on that basis, which needs to ensure sufficient resources for their financing. This means, on the one hand, that the distribution of the revenues from different sources between the central and local governments needs to be adequate from the standpoint of the distribution of the public services and the expenditures for their provision (vertical balance) and, on the other hand, the revenues received by the different local governments need to correspond with the expenditures they incur in the provision of public services (horizontal balance).

The system of local revenues needs to follow several principles, while the individual sources of local revenues need to meet specific requirements.

Requirements for the system of revenue sources

Firstly, it needs to encompass various sources, so that it may more equitably distribute the taxation between the different groups of taxpayers, which form the local community. On

the other hand, significant fragmentation of the local sources of revenue should not be allowed, because this increases the cost of the system for their administration;

Secondly, some of the revenues need to be generated by own sources, while their amount needs to be determined by the local authorities. This creates a level of responsibility in local governments, since they cannot use “the central government” as an excuse; it also creates awareness among local users about the amount of taxation and of utilization;

Thirdly, own sources are those, whose value is predominantly created and determined by local conditions;

Fourth, the sources of revenue need to be comparatively evenly distributed across the territory of the country, i.e. they should not create excessively large inter-municipal disparities.

#### *Principles of the revenue system*

**Stability.** Some of the revenues need to be from sources, which are not influenced by large and abrupt changes in the external environment. Compensation mechanisms need to be elaborated for cases of collapse of local revenues as a result of such changes. Local governments need to accumulate tactical reserves of funds, with which to face expenditures, because revenues entering their budgets are unevenly generated over the course of the year.

**Vitality.** There needs to be a strong correlation between local revenues and the socio-economic development of the territory. Local governments need to be involved and to contribute, within their powers, to the development of the business. On the other hand, they must not directly participate in economic activities, since this would constitute unfair competition against their own tax payers. Participation is solely permissible for activities, associated with local monopolies, where there are no conditions for real competition.

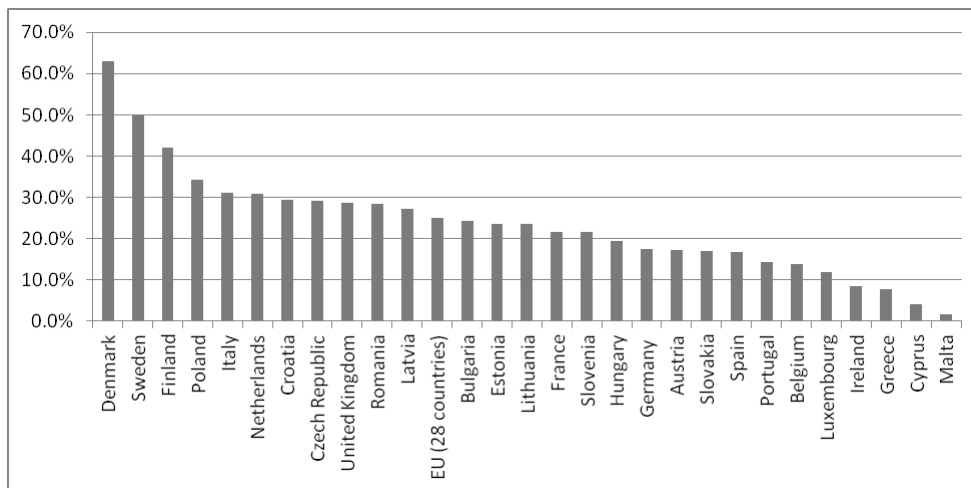
**Fairness.** The system of local revenues needs to contribute to the fair distribution of the resources between: poor and rich users, through free and subsidized services, financed with local fees and taxes; poor and rich municipalities, through the utilization of transfers. The municipalities need to have access to the credit market, wherefrom to accumulate resources for financing of large infrastructural sites, the benefits from whose construction is shared by more than one generation.

The system of local revenues needs to contain stimuli for local authorities to put efforts into increasing the amount of generated revenue and into its rational utilization.

The share of the revenues of local governments in total public revenue in the EU countries is indicative of the way they are distributed between the central and local governments (see Figure 4).

Figure 4

Share the revenues of local governments in the EU countries in total public revenues in 2014



Source of data Eurostat, Extracted on 02.05.16.

It is logical for this distribution to correspond with the distribution of public expenditures. The calculations made are indicative of almost complete consistency – the correlation coefficient is 99.5%. The data indicate that the Scandinavian countries rank high, with Denmark ranking highest, while the last positions in ranking are assumed by Ireland, Greece, Cyprus and Malta with a share of less than 10%. Bulgaria ranks right below the average EU level with a share of 24.4%.

The revenues of local government in the EU are generated by two main sources – taxes and transfers. Other sources of revenue are fees paid by service users and municipal property income. They comprise a comparatively smaller share of total revenue generated by local government.

The share of tax revenue in total revenue for the EU-28 is 35.5%. The largest share of tax revenue generated in 2014 is registered by Latvia – 57.5%, Sweden – 53.6%, Spain – 51.4%, and France – 48.3%. Ranking last, with a share of less than 10% are Bulgaria – 9.6%, Lithuania – 5.7%, Estonia – 3.8% and Malta, whose local authorities do not generate tax revenue.



Table 7

Structure of the revenues generated by local government in the EU in 2014 (%)

	Total Revenues	Of which		
		Tax revenues	Transfers	Other revenues
EU-28	100.0	35.5	48.3	16.3
max	100.0	57.5	95.7	32.6
min	100.0	0.0	30.0	4.3
Bulgaria	100.0	9.6	83.8	6.6
Czech Republic	100.0	42.5	41.3	16.3
Hungary	100.0	23.5	67.8	8.7
Romania	100.0	10.5	84.3	5.2
Slovenia	100.0	39.9	43.8	16.3
Slovakia	100.0	10.9	70.4	18.8
Poland	100.0	32.3	57.1	10.6
Croatia	100.0	36.1	58.6	5.3
Denmark	100.0	34.3	59.4	6.3
Finland	100.0	44.7	30.0	25.3
Sweden	100.0	53.6	31.4	15.0
Netherlands	100.0	10.3	70.9	18.8
Portugal	100.0	38.3	36.2	25.5
Spain	100.0	51.4	40.5	8.1
France	100.0	48.3	33.1	18.5
United Kingdom	100.0	14.3	68.7	17.0
Italy	100.0	44.1	42.5	13.4
Latvia	100.0	57.5	33.3	9.2
Lithuania	100.0	5.7	88.9	5.4
Estonia	100.0	3.8	84.7	11.5
Luxembourg	100.0	24.0	55.1	20.9
Ireland	100.0	24.3	43.1	32.6
Greece	100.0	23.8	66.0	10.2
Cyprus	100.0	30.7	39.3	30.0
Malta	100.0	0.0	95.7	4.3
Belgium	100.0	29.0	49.0	21.9
Germany	100.0	38.2	40.3	21.5
Austria	100.0	14.7	65.0	20.3

Source of data Eurostat, Extracted on 03.05.2016.

There are three main types of taxes, the revenues from which enter the budgets of the local government in the EU, as follows: property, or real estate, taxes – levied on buildings and land; consumption taxes, mainly VAT; and taxes on income and wealth. Income taxes include the taxation of both physical persons and companies.

- Property taxes are the most common. They generate local revenue in all European countries except Malta
- The Value Added Tax generates revenue for the local government in the Czech Republic, Germany, Spain, Italy and Portugal.

- The second most common, yet ranking first in amount for local governments, are the revenues from taxes on income and wealth. The most common of these is the tax on personal income. They are a part of the structure of local taxation in half of the EU countries (Belgium, the Czech Republic, Denmark, Germany, Spain, Croatia, Italy, Latvia, Poland, Portugal, Slovenia, Finland and Sweden). Insignificant amounts of revenues from this form of taxation enter local budgets in Bulgaria and Romania. Revenues from taxes on corporate income are received by local authorities in the Czech Republic, Italy, Luxemburg, Poland, Portugal and Finland. In 2010 the local business tax (taxe professionnelle) was replaced in France by the CET (contribution économique territoriale), which consists of a land tax and a value added tax on corporations.

The share of government transfers is inversely proportional to the share of tax revenue. The data indicate that in 5 countries, including Bulgaria, the share of transfers exceeds 80% of all revenues generated by local governments. This means that the municipalities in Bulgaria dependent, to the largest extent, on the financial support of the state. The lowest relative share of government transfers is registered in Finland – 30.0% and in Sweden – 31.4%.

Sometimes it is difficult to separate the revenues from share taxes from the revenues from government transfers. It is our view that when taxes enter specific funds, while the resources from them are distributed according to specific criteria (of an equalizing or targeted nature) between local authorities, these revenues need to be treated as transfers as opposed to revenues from shared taxes. Such is the case in Greece (PIT and VAT), Hungary and Slovakia (PIT).

## **5. Legal powers of the local government**

The services provided by local government and sources of funding can be examined not only by type/functions and sources, but also from the position of:

- The local legal powers to determine, on the one hand, the policy for provision (quality, access and others) and the operational management of the services and, on the other hand, the taxation powers (rates, bases, exemptions from payment), administration and manner of use of financial resources, i.e. spending powers.
- Their adequacy with regard to the system of local finance, i.e. the extent to which benefits are spread outside of local structures and the extent to which the taxable base of income is formed by local factors.

In theoretical terms, there are three degrees of decentralization of powers to local authorities to provide services:

- Transfer of full power to provide certain services, i.e. local governments have the power to determine the policy and to organize the provision of the services they are responsible for. This applies to services, which meet specific needs of the local population and whose benefits do not exceed the boundaries of the municipality;

- Delegation of power to local authorities for the organization and operational management of the provision of certain services, while the central authority exercises power over the determination of the respective policy, i.e. the content, quality, access and others. This applies to services, which are provided to all municipalities and need to provide relatively equal conditions for utilization to all users, regardless of their residence;
- The state can assign the provision of national services, which are entirely the responsibility of the central government, to local government. In this case the sole goal is cost savings, while local legal power extends merely to abiding by the regulations set forth by central authorities.

Looking at public services from that standpoint, it can be asserted that ordinarily the municipalities have full responsibility for service provision in the fields of public utilities and public works, local infrastructure, water supply, heating, waste management, social housing and others, while in other fields, such as healthcare, education, social protection and others, their legal powers are limited. For example, in Denmark the responsibilities of the local authorities to provide those services mainly relate to their practical provision, while their regulation (access, quality and other requirements) to a large extent are determined by the central government. In Spain the central government has the power to determine the principles of the policy and to execute the general coordination of the provision of services in the field of public order and safety, environmental protection and economic activities, while the expenditure and organization responsibilities relating to service provision are transferred to the regions and the municipalities. Similar mixed responsibilities are evidenced in Austria, Germany, the Netherlands, Portugal and others. In the countries from Eastern Europe municipal services are divided into local and delegate ones (Bulgaria), autonomous and delegated competences (the Czech Republic and Slovakia), original and transferred services (Slovenia). In Romania the responsibilities of the local authorities in the field of education and social protection are very limited. They are mere “post boxes” for financing of schools and for maintenance of the buildings as well as “agents” for central financing of social protection programs.

In the case of revenue, the dividing line is placed between own revenue, on the one hand, and shared taxes and central government transfers on the other. Own revenues are those, for which local authorities have the power to set rates and/or taxable bases and to implement the system of exemption, be it partial or complete, from payment to certain institutions and groups of persons.

Own revenues of local governments in the EU can be divided into three groups according to their significance:

- Own (autonomous) taxes comprise a significant share of the revenues of local government in Sweden, Finland, Spain, Belgium, Italy and France. To a large extent, this also applies to the municipalities in Bulgaria, Poland, the Czech Republic, Hungary, Denmark and Luxembourg.

- The significance of autonomous taxation is more limited for local government in Austria, Lithuania, Estonia, Ireland, Great Britain, the Netherlands, Romania and Portugal.
- The local government in Malta, Slovenia, Greece and Latvia have no tax autonomy.

The most common source of own revenue for the municipalities is the property tax, imposed over the value of buildings and land, owned by physical and legal persons. Greece and Lithuania are exception, despite the fact that some of the revenue from these taxes enters local budgets. The provinces/regions in Germany and Belgium also have the legal right to set the rates for this tax.

Local authorities have legal rights over the corporate income taxes or business taxes in Spain, the Czech Republic, Hungary, Poland, Germany, Portugal and Luxemburg. The revenues from the personal income tax are shared, i.e. do not constitute own revenue, with the exception of the Scandinavian countries – Denmark, Sweden and Finland. The revenues from taxes on personal income can be considered own revenue in Italy and Belgium, where the regional and municipal government can vote on a surtax exceeding the national rate. In the Spain the rate of this tax is separated into two parts – one is determined by the central government, while the other – by the self-governing municipalities. The same applies to the partial or complete exemption from tax payment. Local government has no legal taxation rights over shared revenues from VAT.

Besides revenue from the aforementioned taxes, local authorities generate own revenue from taxation on vehicles, inheritances, donations, gambling and others. Various taxes on service utilization as well as revenues from the management of municipal properties are further sources of revenue for the municipalities.

Government transfers are another main source of revenue for local budgets. There are two groups of transfers: general and earmarked. The general transfers are provided to local authorities and they are not obligated to use them for previously determined purposes, while the provision of earmarked transfers is associated with an obligation to use for precisely determined services or types of expenditures. For example, some of the targeted subsidies in Bulgaria, Poland, Hungary, Slovenia, Latvia, Estonia, France and Great Britain are used to cover the capital expenditures of local authorities. In Poland, the Czech Republic, Slovakia, Latvia, Portugal and other countries, local government receives transfers, which can be used to finance education, while in Portugal, the Czech Republic, the Netherlands and Great Britain they may be use to social expenditures.

In the Czech Republic, Slovakia and Lithuania earmarked transfers are used to finance delegated services, while own resources are used to finance the autonomous functions of the local authorities. The case is similar in Bulgaria, with the difference that (as in the Czech Republic), firstly these services are financed partially and with own resources and secondly that after the provision of the resources the state cannot exercise control over local government in the way these resources are allocated between the types of services. The central government in Finland also provides general transfers that do not impede local expenditure rights to the municipalities for provision of services in the fields of education,

healthcare, social assistance to disabled persons, protection of minors, day-care for children, environmental protection, library operation and others.

The third type of transfer, which can be treated as part of the general transfers, aim at the comparative equalization of the financial capabilities of local authorities with regard to the provision of basic public services, i.e. it is provided to local governments, which lack sufficient capacity to generate revenue. There are two ways to provide such transfers – firstly, through transfers from the central government and secondly through transfers between local governments – from more to less financially capable ones.

Equalization transfers exist in almost all EU countries. Their distribution is based on demographic and economic indicators, territory, length of the road network and others factors, which allow for the calculation of expenditure needs and fiscal capacity of local authorities. The sources of such resources are not solely unidentified transfer fees, but also revenue from shared taxes. Such is the case with revenues from income taxes in Hungary and Slovenia, which are redistributed between local authorities. In other countries (Greece, Spain, Portugal) revenues from shared taxes enter special funds, the resources from which are distributed between local governments. The inter-municipal (horizontal) equalization from municipalities with high fiscal capacity towards ones with low fiscal capacity exists in Germany, Austria and Spain.

When it comes to equalization transfers the way in which they are provided is of chief importance. In any case, it is preferable to have a formula, based on objective socio-economic and demographic indicators, used to calculate the anticipated expenditure needs and revenue generation capacity, adjusted with the taxation efforts of the local authorities, as opposed to merely compensating for the difference between available revenue and spending needs. The latter can be a disincentive for local authorities to put efforts into generating more revenue or into avoiding unnecessary expenditures.

## **Conclusion**

The general conclusions, which may be drawn on the basis of the conducted analyses of practices of EU countries is that, despite the significant diversity in the size of the municipalities, the number of levels of local government, the types of services provided by local authorities, the sources of revenue and expenditures, their level of financial autonomy conditioned by their historical development, the specificity of national traditions and local preferences, some common characteristics may be discerned.

Such a characteristic is the division of revenue between own revenue and transfers, including shared taxes, the division of expenditures between mandatory ones (ones delegated by the state) and local ones (autonomous and optional ones).

Common approaches are used to achieve the dual goal of local self-government – increasing the effectiveness of the provided services and creating conditions for achieving local democracy. The tendencies to increase the size of municipalities, to create inter-municipal associations for joint service provision and to create more than one level of local

self-government can be characterized as such. All these actions can be characterized as an attempt to match territorial scopes with the scope of the benefits created by the provided services.

The approach towards the accumulation of own revenue for the financing of services is also common – revenue is generated by property taxes (on buildings and land), levied to physical and legal persons, fees and user charges, revenue from the management of municipal property. There are successful practices of increasing the revenue base by voting on local rates on national taxes, mainly on income taxes levied on physical persons and taxation of transactions based on the value of assets and others.

The more important conclusions from the comparative analysis of the systems of local finances in the EU countries, which serve as the basis for the formulation of recommendations for its improvement in Bulgaria, are as follows:

**First. The share of public expenditures in Bulgaria** is significantly lower than the EU average. This constitutes the first problem before the public governance of the country – could a liberal approach achieve the goals, which characterize social market economies. The results of this policy are apparent – underfinanced services, which leads to low quality and additional, unregulated expenditures incurred by the users. Society has to make a choice – increase the tax burden or decrease the scope of public services.

**Second. Creating conditions for local democracy in Bulgaria**

In the European countries, the municipalities are regarded, on the one hand, as institutions, which provide local services and, on the other hand, as institutions that ensure local democracy.

Theoretically, larger municipalities have the capacity to provide more numerous and more effective local services, while the smaller ones are more democratic. The prevailing tendency in the EU towards increase in the sizes of the municipalities can be regarded as an attempt to increase the effectiveness of local services. On the other hand, the manifestations of the reverse process – of fragmentation of the municipalities in the former socialist states is a reaction to the artificial merging of municipalities and constitutes an attempt to reinstate democratic values, which were previously suppressed.

The municipalities in Bulgaria can be classified as large. The attempts aimed at their fragmentation during the period 1997-2003 were discontinued via legal amendments. In our opinion, the road to creating conditions for local democracy passes through the implementation of internal decentralization, through transferring powers and resources from the municipalities towards their territorial structures – the mayoralties. Over the last few years the minimum number of residents of the mayoralties ranges between 100 and 500, mainly due to political reasons. If a permanent minimum of 500 residents is set, there will be a total of around 1500 mayoralties in Bulgaria. Besides the number of residents, the status of the mayoralties needs to be regulated – they need to be registered as legal entities, the functions they will perform need to be regulated and they need to transition towards delegated budgets.

When the municipalities are large the creation of a second level of local self-government is more difficult and to a large extent unjustified. This is conditioned by the fact that there are comparatively fewer public services of supra-municipal significance, which can be assigned to that level. The situation in Bulgaria is indicative to that effects, where the timid attempts, often inspired from “outside”, to create a second level of self-government are more or less faced by pronounced resistance from all levels of public governance.

### **Third. Municipal services and spending powers.**

Local authorities in Bulgaria have a comparatively diverse expenditure structure, unlike some countries, where most of the expenditures are focused on 2-3 functions. In comparison to the average values for the EU, Bulgarian municipalities are characterized by higher shares of the expenditures for education and communal services and by lower shares of the expenditures for security and social services.

The lack of local legal power in the latter two fields does not meet the local requirements and contradicts the general spirit of the European Charter for Local Self-Government. The municipalities need to receive legal powers to provide services relating to combating everyday crime, dealing with local fire protection and protecting the harvest. The aging of the population highlights the problem with increasing the scope of the provided local social services.

In many European countries the municipalities finance delegated services with intergovernmental transfers, but only in Bulgaria this is the reason for limiting local powers for allocation of the expenditures. It is necessary for this restriction to be abolished.

**Fourth, increase in the share of own revenues** through new tax revenues in the municipal budgets.

The average share of tax revenue generated by local government in the EU is 36%, while the one of government transfers is 48%. The most common tax revenue for local authorities in the EU are property taxes, while the largest amount of revenue is generated by income taxes. More than half of the local authorities in the EU receive revenue from taxes levied on physical persons, corporate taxes and from VAT.

Local legal powers are linked to own revenue. The most common types of own revenue for the municipalities in the EU are property taxes. In many European countries local government has the legal power to set taxation over corporate incomes or other types of business taxation. The municipalities in the Scandinavian countries have the power to determine the size of income taxes levied on physical persons, as is the case in Italy, Belgium and Spain, where they can levy rates of taxation, which exceed the ones determined by central authorities.

The municipalities in Bulgaria have one of the smallest shares in tax revenue – below 10% and one of the highest shares of transfers. Tax revenues are almost completely generated from property taxes. Revenues from income taxation do not enter local budgets. The share

of own revenue is comparatively small. There is a clear need to finalize the expert analyses<sup>8</sup> from 2014 and to make a political decision for transferring legal powers to municipalities to vote on rates of 2-3% within the general 10% rate of personal income tax. This would, at least partially, enforce the agreement, initiated in 2003, between the central and the local authorities, according to which the revenues from physical persons enter local budgets, while the ones from corporate taxation enter the central budget.

The implementation of the above recommendations would give a boost to the decentralization reform by creating conditions for the provision of more diverse and more effective services, which, to a larger extent, meet local needs.

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<sup>8</sup> Within the Council on Decentralization, a group was formed, consisting of representatives of MF and NAMRB, which elaborated options for allocation to the municipalities of 2 and 3 percent of the 10 percent rate of PIT on an origin basis and in accordance with the residence of the taxpayers.