

Stefan Ivanov, Senior Research Fellow, Ph. D., Yana Buchvarova,
Stanka Mincheva

ANALYSIS AND EVALUATION OF THE FINANCIAL SITUATION OF MUNICIPALITIES IN BULGARIA (1999-2001)

The municipal finance system in Bulgaria is in crisis. The problems have structural nature and result from the lack of correspondence between the expenditure needs for providing the legally regulated municipal services and the financial resources received by the municipalities and the local powers to influence these resources. The local budgets become more and more difficult to understand, intransparent and create unclear picture for the financial situation of municipalities. Changes towards decentralization and improvement of budgetary process are urgently needed. The article makes analysis and evaluation of the financial situation of all 262 Bulgarian municipalities for the period 1999-2001. For this purpose, the municipalities have been divided into groups based on their functional role in the provision of local public services. On this basis 5 municipality groups have been formed: group 1 – Sofia; group 2 – the municipalities – regional centers; group 3 – the municipalities – secondary centers (former okolia centers); group 4 – municipalities paying contributions to central budget (excluding the ones from group 2); group 5 – all the rest municipalities (small and underdeveloped municipalities).

JEL: H72; H74

The municipal finance system in Bulgaria suffers a crisis. The problems are of a structural nature and result from the lack of correspondence between the expenditure needs for providing the legally regulated municipal services and the financial resources received by the municipalities and the local powers to influence these resources. These problems deepened in the recent two years leading to current occurrence of local and trade union conflicts. The difficult financial situation of municipalities became a widely discussed issue in the media.

The main goal of the present article is to present the situation, the trends and the main problems of municipal budgets. In this relation the trends in the municipal finance development in the period 1999–2001 and the situation of municipal finance in 2001 have been analyzed. As a result of this conclusions the main problems of local finance in Bulgaria have been formulated. Based on this in the end of the article recommendations for improving the financial state of municipalities are presented in order to achieve balanced development and provide the main local services.

The budgets of all municipalities in Bulgaria are subjects to the survey. The financial situation of the particular municipality types has also been analyzed. For this purpose, the municipalities have been divided into groups based on their functional role in the provision of local public services. On this basis 5 municipality groups have been formed: group 1 – Sofia; group 2 – the

municipalities – regional centers; group 3 – the municipalities – secondary centers (former okolia centers); group 4 – municipalities paying contributions to central budget (excluding the ones from group 2); group 5 – all the rest (small and underdeveloped municipalities).

The study is based on data from the regular quarterly and annual budget performance reports and the statements for the unpaid bills of municipalities in the period 1999-2001. The database of the National Association of Municipalities in the Republic of Bulgaria (NAMRB) has been used.

Outline of the Financial Condition

Legislative Changes (Changed Powers and Responsibilities of Local Governments in Their Relationships with the Central Authorities)

The following *major changes in the scope of municipal spending responsibilities* took place over the period under review (1999 – 2001):

- The health reform was launched (middle of 1999). The National Health Insurance Fund (NHIF) took over the financing of the municipal pre-hospital health care establishments (polyclinics, health stations, etc.), thus reducing some municipal expenditures and the related responsibilities. At the beginning of 2001, the Ministry of Health (MoH) took over the financing of regional hospitals and orphanages. The NHIF provided partial financing also to some municipal hospitals.

- The mandatory priorities in the budget planning according to the share of the three sectors (education, health and social welfare) were eliminated at the beginning of 1999. The system of mandatory priorities was entirely eliminated at the beginning of 2001.

- At the beginning of 1999, the central government started financing 50 % of the social welfare estimates through special subsidies.

- In 2000, the statutory opportunities for local governments to invest own resources were cut by half from 10 % to 5 %.

- In 2000, local governments started administering the aid from the Rehabilitation Fund also for the purposes of the special energy assistance to the population.

The following changes took place with regard to revenues:

- Local governments were deprived of the right to plan the amount of tax revenues to their budgets. In 2000, local governments had to use the MoF revenue estimates in the drawing up of their budgets. In 2001, para 22 of the 2001 State Budget Act allowed the MoF to take the surplus away and supplement shortages up to the level of its own estimates for tax revenues.

- The mechanism for calculation of the total amount of subsidies and their allocation among municipalities underwent some changes. Nevertheless,

it failed to change the financial relationships between the central and local governments. The MoF continued to plan (“ex lege”) all municipal revenues and expenditures directly for the purposes of establishing the supplemental and levelling amount of subsidies.

- Many extra-budgetary accounts and funds were closed at the local government level. Municipalities had to finance those activities either directly from their budgets or through the registration of business undertakings. That move largely reduced the motivation of the workforce and the efficiency of their performance.

- The initial steps towards the delimitation between delegated and local responsibilities were made during the second half of 2001. The Government and the NAMRB signed a decentralization agreement.

The main conclusion is that the system of local finance remained strongly centralized during the period under review. Changes were rather hectic and indiscriminate. Some of them enhanced local powers, other restricted them. The existing environment failed to guarantee sustainability of the positive changes in the legal framework. At the same time, the Government’s intentions to develop and implement a decentralization program and all changes since the beginning of 2002 have given grounds for optimism and created a favourable environment for the reform process.

Quantitative Characteristics of Municipal Budgets

The implementation of municipal budgets from 1999 to 2001 had several major characteristics (See Tables 1, 2 and 3) as follows:

- Existence of fiscal deficit due to the structural mismatch of revenues and expenditures;

- Unrealistic planning with huge discrepancies between plans and actual performance;

- Stagnation of the real expenditures for the provision of local services.

The structural mismatch is projected as a discrepancy between:

- The necessary expenditures and the revenues planned at the beginning of the year. This is the gross deficit;

- The necessary expenditures and the actual revenues. This is the net deficit in municipal budgets.

The available data come to show that the net deficit tended to decrease during the period under review in both absolute and relative terms. That reduction was accompanied by substantial growth of the gross deficit, which was indicative of the increased efforts of the central authorities to cope with the local budget mismatch for the last two fiscal years. The exclusion of Sofia from the analysis led to reduction of the gross deficit and increase of the net deficit. This reveals that the financial condition of the other municipalities was even worse.

Table 1

General Parameters of Local Budgets (BGL)

		EXPENDITURES			REVENUES		
		1999	2000	2001	1999	2000	2001
I. Municipal Budgets							
1. Plan – All	1	1,859,271,168	1,699,247,455	1,733,331,591	1,859,271,168	1,699,247,455	1,733,331,591
Plan-All except Sofia		1,419,915,786	1,282,377,677	1,351,255,419	1,419,915,786	1,282,377,677	1,351,255,419
2. Report – All	2	2,022,315,726	2,178,114,171	2,119,691,360	1,861,058,482	2,021,567,382	2,024,791,838
Report-All except Sofia		1,599,198,841	1,744,992,968	1,715,560,208	1,455,473,514	1,582,798,871	1,605,397,542
Including:							
2.1. Budget Resources-All	2.1	1,854,706,764	2,005,805,394	1,878,054,888	1,861,058,482	2,021,567,382	1,907,405,469
Budget Resources - All except Sofia		1,449,960,531	1,573,747,513	1,480,351,992	1,455,473,514	1,582,798,871	1,494,439,429
2.2. Additional Resources beyond the Budget-All	2.2			117,386,369			117,386,369
Additional Resources - All except Sofia				110,958,113			110,958,113
2.3. Unpaid Bills - All	2.3	167,608,962	172,308,777	124,250,103			
Unpaid Bills - All except Sofia		149,238,310	171,245,455	124,250,103			
3. Total Growth – All	3=2-1	163,044,558	478,866,716	386,359,769	1,787,314	322,319,927	291,460,247
Total Growth - All except Sofia		179,283,055	462,615,291	364,304,789	35,557,728	300,421,194	254,142,123
II. Gross Deficit – All	4=1 (rev) - 2 (exp)				-163,044,558	-478,866,716	-386,359,769
Gross Deficit - All except Sofia					-179,283,055	-462,615,291	-364,304,789
III. Net Deficit – All	5=3 (rev) - 3 (exp)				-161,257,244	-156,546,789	-94,899,522
Net Deficit - All except Sofia					-143,725,327	-162,194,097	-110,162,666

Table 2

Comparison of Expenditures from 1999 to 2001 (BGL)

	1999	2000	2001
Reported Expenditures	2,022,315,726	2,178,114,171	2,119,691,360
Change of Spending Responsibilities	323,300,000	279,264,640	144,407,526
Inflation Adjustment		197,480,351	290,382,526
Municipal Expenditures (comparable basis)	1,699,015,726	1,701,369,180	1,684,901,308
Growth (1999 = 100)	100.00	100.14	99.17

Table 3

Share of Deficit in Municipal Revenues from 1999 to 2001

	1999	2000	2001
Net Deficit/Reported Revenues (%)	8.66	7.74	4.69
Gross Deficit/Planned Revenues (%)	8.77	28.18	22.29

The central authorities plan the amount of subsidies and tax revenues, while local governments plan the municipal non-tax revenues. The ratio between these two elements is 85 to 15, which is indicative of *the contribution to the unrealistic planning of municipal budgets*. The insufficient revenues make local governments adopt formal budgets with in-built deficit, while the pressure of interest groups and local governments makes the Ministry of Finance allocate additional resources to municipalities in the course of each fiscal year. The growing amount of additional subsidies creates disincentives for good financial management for local governments and it is fraught with threat to the macro-economic stability of the country.

The period under review was characterized by deep-going structural changes in the spending responsibilities of local governments. The adjustment of the amount of expenditures to the base year of 1999 comes to show that *local budgets tend to lag behind the dynamic pattern of the GDP in relative terms*. This fact is a proof that the central government is trying to shift the burden of the reform process on local governments.

Analysis of Municipal Revenues

General Description of Municipal Revenues

Before the analysis of the trends and changes in the structure of municipal revenues, it is necessary to focus on some issues related to the way they are presented in municipal budgets.

- The impact of para 22 on municipal budgets was seen in the reduction/increase of the general subsidy or the contributions to the central government budget respectively;

- Municipal budgets report only the balance of some revenues rather than their turnover. This prevents the reporting of the actual amount of revenues. Transfer accounts and loans create particularly big problems for the reporting of revenues. For example, if a local government borrows one million BGN and repays the debt by the end of the fiscal year, the report will feature zero.

- Local governments are not entitled to plan some revenues that have become quite regular for the last few years. These are the revenues related to transfer accounts and loans from the central government budget. At the same time, local governments use their right to plan some other revenues, although they know perfectly well that these revenues to their budgets will not be generated.

Trends and Structure of Municipal Revenues from 1999 to 2001

Table 4 outlines the summarized information on the dynamic pattern and structure of municipal revenues and the ratio between the actual and planned levels over the period from 1999 to 2001.

Table 4

Municipal Revenues from 1999 to 2001

Types of Revenues	Growth (1999 = 100)			Structure (%)			Share of Actual Results in the Planned Amounts (%)		
	1999	2000	2001	1999	2000	2001	1999	2000	2001
Total Revenues	100.0	108.6	108.8	100.0	100.0	100.0	100.1	119.0	116.8
Central Government Transfers	100.0	103.9	104.4	78.7	75.3	75.6	102.1	128.7	119.5
Including Shared Taxes	100.0	102.0	121.3	40.9	38.4	45.6	82.9	98.3	115.4
Subsidies*	100.0	105.8	86.2	37.9	36.9	30.0	136.1	189.6	126.2
Local Revenues	100.0	104.4	122.3	18.2	17.5	20.4	89.5	87.9	99.5
Including Local Taxes	100.0	107.8	119.8	4.4	4.4	4.9	90.3	104.2	110.3
Local Fees	100.0	118.7	145.8	6.1	6.7	8.2	89.8	99.3	109.6
Other Local Revenues	100.0	90.9	104.9	7.6	6.4	7.3	88.9	71.6	85.3
Other Revenues	100.0	255.1	141.4	3.1	7.3	4.0	124.3	127.4	216.2
Including Transfer Accounts	100.0	1669.8	2924.0	0.2	3.8	6.6	122.6	152475.1	15253.5
Loans	100.0	168.2	-181.9	1.9	2.9	-3.2	83.0	51.4	-174.9
Interest-free Loans from the Central Government Budget	100.0	64.6	71.3	0.9	0.6	0.6		-3196.9	

* The amount of subsidies in 2001 included additional subsidies of BGN 117.3 million which were remitted to local governments through Transfer Account 88 at the end of the year.

The figures in the table above lead to the following major conclusions:

- Municipal revenues increased faster than the GDP in 2000 (especially in the context of the reduced spending responsibilities) as compared to 1999 and retained their level in 2001;
- Local revenues increased faster than central government transfers and thus they increased their share in the total revenues mainly due to the revenues from local fees;
- The total growth of central government transfers was modest to say the least. The various elements of central government transfers behaved in a hectic manner, e.g. revenues from shared taxes increased, while subsidies decreased. One of the reasons was the fact that subsidies were used to balance all other revenues and their recent reduction reflected the reduction of the spending responsibilities of local governments (mainly in the health care system);
- Planning was one of the weaknesses of the local budgeting process. As is seen, planned levels substantially differed from actual results for all items;

- The amount of and revenues from transfer accounts and loans were the most unpredictable.

Analysis of Budget Revenues by Groups of Municipalities in 2001

The major types of revenues by groups of municipalities are presented on Table 5.

Table 5

Per Capita Revenues by Groups of Municipalities in 2001 (BGL)

Group	Total Revenues	Shared Taxes	Subsidies	Local Taxes	Local Fees	Other Local Revenues	Transfer Accounts	Loans	Including those from the Central Government Budget
Group 1	337.89	302.40	-4.83	25.45	36.87	27.24	6.66	-55.89	0.00
Group 2	208.54	94.32	40.53	14.21	22.04	20.17	13.12	4.13	2.91
Group 3	207.31	58.45	93.38	6.62	15.16	14.62	17.57	1.51	1.49
Group 4	335.82	389.85	-154.95	16.07	34.90	24.09	24.92	0.93	1.49
Group 5	221.85	39.61	129.11	4.69	10.04	11.95	25.86	0.59	0.36
Total (except Sofia)	215.73	79.79	71.61	9.76	17.48	16.67	18.02	2.41	1.82
Total	234.05	113.17	60.14	12.12	20.38	18.25	16.32	-6.34	1.55

The conclusions from the table above are as follows:

- Sofia (Group 1) and the municipalities from Group 4 (net contributors) had the largest per capita revenues. The main reason was the revenues from shared taxes. The same two groups of municipalities had the largest revenues from local sources as well;
- Large municipalities (regional centers) and medium-sized municipalities had the lowest level of revenues;
- Small municipalities (accounting for more than 60% of all municipalities in the country) had extremely low own revenue base. They managed to outstrip the foregoing two groups of municipalities in terms of their per capita revenues only because of the large amount of central government subsidies;
- Loans accounted for an insignificant portion of municipal revenues. Leaving Sofia aside, almost 80% of loans came from the central government budget.

Analysis and Assessment of the Individual Groups of Revenues

Revenues from Central Government Transfers

Government transfers include two types of revenues: shared taxes and subsidies.

The revenues from shared taxes result mainly from the personal income tax (50% of the revenues) and the corporate income tax (10% of the taxable base). The findings of this analysis identify several major problems:

Firstly, revenues from shared taxes are quite unpredictable. The only reason for this situation is the corporate income tax, the reported revenues of which exceeded the planned levels 1.5 times in 2001 as compared to a difference of only 1.5% in the case of the personal income tax.

Secondly, shared taxes account for the greatest differences between municipalities in terms of their revenues. The reason again is the corporate income tax. The difference in its levels is 2.3 times greater than that for the personal income tax. Hence one can draw the conclusion that this tax is an inappropriate sources of local revenues.

Thirdly, the results of the application of para 22 (taking away/supplementing of the difference between planned and reported tax revenues) point to the following picture:

Table 6

Results of the Application of para 22 of the 2001 State Budget Act (BGL)

	Plan	Report	Difference	Taken away	Left
Shared Taxes	798,915,700	922,310,049	123,394,349	70,442,959	52,951,390
Local Taxes	89,535,000	98,741,219	9,206,219	6,740,941	2,465,278
Total Taxes	888,450,700	1,021,051,268	132,600,568	77,183,900	55,416,668

The analysis by municipalities comes to show that taxes amounting to BGN 98.2 million were centralized from a total of 204 municipalities, another 47 municipalities were compensated with an increase of the general subsidy by BGN 21 million, and there were no changes in 11 municipalities. The non-application of para 22 for the last quarter led to a loss of BGN 59 million for 151 municipalities, while the tax revenue plan as adjusted in October coincided with the end-of-year reports of 69 municipalities. The too large number of municipalities in that group evokes some doubts that there was some "tampering" of figures to match tax revenues to the reviewed plans of tax offices.

The following arguments give grounds to claim that the application of para 22 cannot resolve the problems in the relationship between the central and local governments:

- There is no application mechanism. It was not until October 2001 that para 22 was applied and nobody had told local governments whether that would really happen. Para 22 was applied only partially. It was not operational during the last quarter of the year, which divided municipalities into winners and losers;
- That situation contravened the provisions of the State Budget Act. Besides, the very application of para 22 violated the provisions of the Municipal Property Act and the Corporate Income Tax Act, specifying the local share of the revenues from those taxes. Para 22 was flagrantly applied to the revenues from local taxes, which violated the Local Taxes and Fees Act;

- That mechanism was not only a violation of the existing laws but it also created conditions for administrative high-handedness in the planning of tax revenues. Table 4 reveals that the tax revenue plans came very close to the actual numbers reported in 2000. When para 22 was introduced, the tax administration started understating the plan by BGN 132.6 million or almost 15 %. This is an obvious case of parochial interest similar to that of local governments in 1999 (when they overstated their tax revenue plans).

Fourthly, mechanisms for taking away legitimate tax revenues from municipalities existed with the contribution system and continue to exist with para 22. In 2001, they were used to centralize a total of BGN 162.5 million or 15.9% of all tax revenues. Those two techniques are suspected to have been supplemented by unlawful taking of tax revenues away from local governments by the tax administration. This can be seen in the continuous reduction of the 50% share of municipalities in the total revenues from the personal income tax.

The amount of the central government subsidies for municipalities is determined by the State Budget Act. Its implementation in the fiscal year of 2001 leads to the following observations and assessments:

In the first place, the Ministry of Finance proposes and Parliament adopts understated subsidy plans on an annual basis. Table 4 shows that the greatest discrepancy between planned and reported levels exists in the case of subsidies. This is a way to create artificial deficit in local budgets. There could be two possible reasons: either there is no capacity at the Ministry of Finance for realistic planning of resources or this is a deliberate move in order to elicit additional subsidies on the basis of other rules going beyond and, in fact, circumventing the provisions of the State Budget Act;

In the second place, as well as the subsidies under the State Budget Act, local governments receive substantial resources that are government subsidies by nature. Their amount and share in municipal revenues are growing. Some of these resources are not even reported as subsidies. For example:

- Additional subsidies. Their share was 36 % of those initially planned in 1999 and 90% in 2000. In 2001, the Ministry of Finance allocated additional subsidies of BGN 117.3 million which were reported in para 88 and, for that reasons, they were never reported as resources received or spent in local budgets;

The phenomenon of “additional subsidies” emerged for the first time in 1998, when the Ministry of Finance allocated BGN 179 million from the surplus in the central government budget among municipalities in a very unfair manner. The same practices persisted in the following years in order to replace the declining influence of the MoF in the allocation of budget expenditures as a result of the eliminated mandatory spending priorities (in 1999 and 2001);

- The resources provided to local governments in the form of interest-free loans from the central government budget can also be treated as a kind of additional subsidies. It is no secret that these loans are written off but it is a strict administrative secret on what basis and how they are allocated by municipalities;

• Local governments receive resources from various central government authorities (Roads Agency, Ministry of Transport, Ministry of Culture, Ministry of Labour and Social Policy, etc.) which are reported through “transfer accounts”. These resources are planned in the budgets of the respective institutions but they are allocated to local governments for the performance of their specific activities. In fact, these are central government subsidies but they are not reported as such. Only the balance is reported for some of them and it must be zero at the end of the year.

The “consolidated amount” of central government subsidies in 2001 is presented quantitatively in the table below.

Table 7

Municipal Revenues Considered to Be Central Government Subsidies (BGL)

	Amount
Central Government Subsidies – Plan	481,292,543
Amount Reported in the Budget	490,142,450
Additional Subsidies under para 88	117,386,369
Revenues from Transfer Accounts	132,967,673
Interest-free Loans from the Central Government Budget	12,596,700
Total	753,093,192
% of Plan	156.47

The effects of these moves are as follows:

• The diversification of the sources of central government subsidies and their allocation on the basis of secondary legislation or administrative instructions mislead the Members of Parliament and the general public, creating unrealistic perceptions of the level of government support to municipalities;

• The non-transparent way, in which these resources are allocated among municipalities, creates conditions for unfairness, hidden political pressure and corruption;

• The expectations of local governments to receive such subsidies are disincentives deviating their efforts from the efficient management of resources to the search for ways to increase the subsidies and to pressurize for coverage of local deficits;

• The actual amount of costs for the provision of local services cannot be established and this will create problems in the development of government standards for services and in the distinction between delegated and local services.

In the third place, the changed amount of central government subsidies leads to substantial increase of the share of special subsidies at the expense of general ones. This limits the powers of local governments to make decisions on the allocation of expenditures by types of services and in accordance with local

priorities. For example, the planned ratio between the general subsidy and the special subsidy was 69 to 31. At the end of the year, it changed into 54 to 46 as a result of the additional subsidies under para 88 (BGN 117.3 million) and the early payment of general subsidies (approximately BGN 13 million by the end of the first nine months), which were accompanied by detailed and strict instructions on their use.

In the fourth place, special subsidies for investment purposes were not appropriated. The reasons were as follows: the continued practices of converting special subsidies into general ones (approximately BGN 370 thousand by the end of the first nine months); the lack of absorption capacity for large-scale environmental and regional projects (about BGN 1.5 million) in several municipalities (Dobrich, Lovech, Razgrad, Lyaskovets, Muglitzh). At the same time, several local governments received greater subsidies for investment purposes (Sofia, Byala – Varna, Knezha).

There is no need to give arguments proving how inappropriate the subsidy allocation formula is for ensuring the performance of the specific local government functions. These arguments are widely discussed in other papers. Another reason is the hope that there exist real chances for fundamental change in 2003, which is being prepared intensively.

Local Revenues

There exist three types of local revenues: local taxes, local fees and other local revenues.

As is seen in Table 4, this group of revenues is characterized by the fastest growth rate and it is subject to the most accurate forecasting from the planning perspective. The plan of local revenues was implemented 99.5 %. Of course, this includes all three types of local revenues. The available data show that local taxes and fees increased faster and the plan for them was exceeded as compared to the other local revenues whose increase was insufficient to attain the planned levels. In fact, the other local revenues were the only sub-group to miss the planned targets. As is seen in Table 4, those revenues fell short of the plan in the previous years as well, which is indicative of their systematic overestimation.

As is known, local governments have different powers with regard to the planning of the three types of local revenues, ranging from no powers with regard to local taxes, limited powers with regard to local fees to full powers with regard to the other local revenues. The third sub-group included also the borrowing opportunities. For all practical purposes, the statutory upper limit of 10 % proves too high and it cannot be considered an obstacle insofar as no local government is able to achieve it (except for Sofia). Loans persistently fall short of borrowing plans.

The differences among the various groups of municipalities in terms of the implementation of their plans for local revenues and loans (except for those from the central government budget) are given in the table below.

Table 8

Percentage of Implementation of the Plan for Local Revenues and Loans in 2001
(Report/Plan*100)

Groups	Local Revenues – Total	Local Taxes	Local Fees	Other Local Revenues	Loans
Group 1	116.22	95.34	156.79	101.43	916.04
Group 2	93.34	121.98	98.41	76.41	66.01
Group 3	98.69	112.40	99.33	92.93	19.43
Group 4	90.06	124.75	104.81	64.82	11.32
Group 5	95.76	111.14	95.73	90.85	11.86
All (except Sofia)	94.66	118.85	98.58	81.54	37.72
Total	99.55	110.28	109.62	85.28	-140.57

As is seen, Sofia has strong influence on the overall implementation of all plans for local revenues. When Sofia is excluded, the plans for local taxes are exceeded to an even greater extent but the capital city is the only contributor to the implementation of the plan for local fees and the only municipality that met the targets for the other local revenues. The planned levels of loans could not be achieved in reverse correlation with the size of municipalities.

The analysis of local revenues and loans reveals that:

- The plans for revenues from local taxes were greatly underestimated in all groups of municipalities. See the comments on the application of para 22;
- Local governments are quite accurate in planning revenues from local fees. Their amounts vary within a close range and there are easily predictable. From this perspective, the elimination of the upper limits for local fees will not drastically change the existing situation. A very moderate and slow trend towards increase of these revenues can be expected;
- When local governments are granted powers to establish local tax rates, initially within a certain range, their behavior is expected to follow the line of conduct with regard to local fees;
- Local governments use the plan for the other local revenues and loans as a way to reduce the revenue deficit when municipal budgets are drawn up. Obviously, these practices point to a specific response to a quite unbalanced situation and loopholes in the legal framework rather than to lack of forecasting capacity.

Analysis and Assessment of Municipal Expenditures

General trends of the change in municipal budget expenditures in the period 1999-2001

The municipal budget reports show an increase of municipal expenditure in 2000 followed by a drop in 2001. According to reported data a growth of 8.15% for

2000 against 1999 is observed, and in 2001 – a drop of 6.4% against 2000. These data, however, create a wrong impression about the municipal expenditures condition. The reason is the cash accounting of municipal budgets, which does not take into consideration the outstanding expenditures, as well as the shortcomings of the budget classification used, where part of the settled expenditures are reported in the revenue side of the budget. The information is also distorted by the use of para 19, which takes account of the VAT paid by the municipality on the revenues on regular budget activities (rents).

Bringing the expenditures to a comparable base (1999) involves excluding the differences in the expenditure responsibilities and taking into account the inflation effect. The results show (See Table 2) minimal changes in municipal expenditures throughout the three-year period – almost zero growth in 2000 compared to 1999, and a slight drop (less than 1 %) in 2001.

The comparison of the budget plan to the actual expenditures in the respective year (including the outstanding expenditures and the additional funds not included in the budget) shows an increasing difference between planned and actual expenditures – 8.77% in 1999, 28.18% in 2000, and 22.29% in 2001. The main reasons for this growth are as follows:

- The difference between planned and actual expenditures for social transfers (mainly social assistance). The large expenditure growth in 2000 is due to including the support for targeted energy assistance and from the Rehabilitation Fund in the municipal budget reports.
- The difference between planned and reported amount of the other budget expenditures – 84.24% from the growth in 2000 and 74.64% of the growth in 2001.

Structure of municipal budget expenditures over the period 1999-2001

Municipal budgets use two types of expenditure classifications. The first one views the budget expenditures as dependant on their economic essence (by expenditure items). In the second classification the expenditures are represented according to their purpose (by functions).

Budget Expenditures Structure by Items

According to their economic essence the municipal expenditures can be generally divided into current and investments expenditures. For the purposes of the present analysis they have been further divided into the following groups: labor expenditures (salaries and social payments), maintenance, social transfers (health insurance of dependants, study grants, and social benefits), and capital investments.

The analysis of the municipal budget expenditures by paragraphs over the period 1999-2001 shows that:

- Labor expenditures constitute a considerable portion of the municipal expenditures structure, and this portion has been constantly reducing in the period 1999-2001. In absolute values the labor costs have dropped by 17.31% over this whole period;

- Maintenance also occupies a significant place in the municipal expenditures structure. In the period 1999-2001 the maintenance expenditures have increased by 9.93% in absolute terms. Their relative share of the municipal expenditures has been smoothly increasing, and in 2001 it even outstripped the share of labor expenditures;

- An increasing relative share in municipal expenditures characterizes social transfers in the period 1999-2001. In absolute terms the amount of social transfers has increased by 110%. These payments are especially sensitive to changes in the social economic situation of municipalities, and their increase is an indicator of impoverishment of the population. An argument in support of this conclusion is the fact that throughout the whole period about 93% of social transfers were allotted to social assistance.

- Capital investments constitute a quite small and decreasing share of municipal expenditures. Capital investments dropped by almost 30% for the period 1999-2001. The major reason for that was the difficult financial situation of the municipalities in Bulgaria, which forced them to allot their budget funds to the maximum possible extent for settling their current priority payments.

- The inclusion of Sofia among the studied municipalities affects the expenditures structure by items (see Table 9). When Sofia is excluded, the share of maintenance and capital investments expenditures decreases, while the share of labor costs and social transfer expenditures increases. The aforementioned fact results in structural modifications in the arranging of expenditure groups – in 1999 the share of capital investments was smaller than that of social transfers, while in 2001 the expenditures for maintenance of municipalities, Sofia excluded, were smaller than the labor costs.

Table 9

Budget Expenditures Structure by Paragraphs for the Period 1999-2001 (%)

Paragraphs	1999		2000		2001	
	Total (Sofia excluded)	Total	Total (Sofia excluded)	Total	Total (Sofia excluded)	Total
Labor expenditures	51.51	45.86	46.31	41.03	41.22	37.45
Maintenance	34.18	37.43	33.54	38.07	34.73	40.64
Social transfers	8.99	7.41	15.66	13.03	18.28	15.39
Capital investments	5.32	9.3	4.49	7.87	5.77	6.52
Total expenditures	100.00	100.00	100.00	100.00	100.00	100.00

2.2. Budget Expenditures Structure by Functions

The budget expenditures structure by functions represents the financing of the main activities carried out by municipalities.

The analysis of the municipal budget expenditures by functions for the period 1999-2001 shows as follows (Table 10).

- As a result of the reform being implemented, the relative share of health care in municipal expenditures has manifested the biggest changes over the period under review – it decreased 2.6 times;
- Education has the biggest relative share of municipal expenditures, and its share has been smoothly increasing throughout the studied period;
- The share of social assistance is the second biggest after that of education and has marked the largest increase over the studied period. With the exception of the structural changes that have been mentioned above, the reason for this is the general deterioration of the municipal economies condition and the growing poverty;
- The relative shares of the expenditures for general government services, defense and security, utility services, culture, etc., have been relatively steady over the studied period;
- When Sofia is excluded from the municipalities under review, this has an insignificant effect on the share of expenditures for general government services, health care, education, culture, defense and security, economic activities and the other expenditures. More substantial differences are observed in the social assistance expenditures whose share increased by 3.17 percentage points in 2001, and especially in the public works and utilities expenditures, which decreased by between 5.7 and 3.4 percentage points during the period under review.

Table 10

Budget Expenditures Structure by Functions in the Period 1999-2001 (%)

Functions	1999		2000		2001	
	Total (Sofia excluded)	Total	Total (Sofia excluded)	Total	Total (Sofia excluded)	Total
General government services	8.18	7.15	8.79	7.63	10.53	9.17
Defense and security	0.57	0.61	0.59	0.68	0.87	0.98
Education	33.50	30.62	33.61	31.22	36.85	34.86
Health care	27.99	25.77	22.40	20.63	9.50	9.81
Social assistance	11.99	12.96	18.46	15.48	21.34	18.17
Utility services	9.68	15.39	9.52	14.83	12.46	15.84
Culture	3.89	3.57	3.04	2.82	3.48	3.2
Economic activities	4.15	3.89	3.59	6.21	4.90	7.41
Other expenditures	0.05	0.04	0.01	0.48	0.08	0.57
Total expenditures	100.00	100.00	100.00	100.00	100.00	100.00

Analysis of 2001 Budget Expenditures per Groups of Municipalities

The Table below shows the municipal expenditures per capita and the correlation between their reported and initially planned amounts for 2001 per groups of municipalities.

Table 11

2001 Budget Expenditures per Groups of Municipalities

Group	Expenditure per capita (BGL)	Budget Implementation (%)	Budget Implementation (+extra subsidies) (%)
Group 1	325.40	104.09	105.77
Group 2	206.84	105.55	113.51
Group 3	205.97	108.75	117.55
Group 4	328.58	128.00	133.69
Group 5	219.19	114.26	122.71
Total (Sofia excluded)	213.70	109.55	117.77
Total	230.45	108.35	115.12

The following more important conclusions can be drawn from the data shown in the Table above:

- The population of Sofia City Municipality and the municipalities in group 4 receives more local services than the population of the municipalities in the other groups. This is illustrated by the higher values of the expenditures per capita in these municipalities. The second and third groups of municipalities are at the opposite extreme. The presence of Sofia considerably increases the average amount of municipal expenditures per capita of the population in the country.

- Unrealistic planning of the expenditures in all groups of municipalities is observed. The budget implementation data shows that the discrepancy between planned and reported values is the smallest in Sofia. If the extra subsidies transferred to the municipalities at the end of the year are also taken into account, then the over-fulfillment becomes still bigger. The reason for this are the unrealistic revenue estimates laid down in the budget plan, which compel municipalities to decrease their expenditure plan.

The following Table shows the 2001 municipal expenditures by items and groups of municipalities. The implementation and expenditures per capita are considered for the different items and groups of municipalities.

Table 12

2001 Municipal Expenditures by Items and Groups of Municipalities

	Expenditures per capita (BGL)				Implementation (%)			
	Labor	Maintenance	Social transfers	Capital investments	Labor	Maintenance	Social transfers	Capital investments
Group 1	76.25	203.80	14.96	30.39	98.49	102.12	183.18	110.68
Group 2	86.29	77.26	31.90	11.39	93.77	105.57	158.87	106.58
Group 3	81.93	75.22	38.30	10.52	93.14	108.77	161.22	123.55
Group 4	107.23	145.03	49.95	26.37	100.69	140.30	166.30	156.97
Group 5	94.98	59.62	50.57	14.02	94.58	117.43	166.23	137.12
Total (Sofia excluded)	88.09	74.22	39.07	12.33	94.09	110.48	162.22	121.01
Total	86.31	93.65	35.45	15.04	94.65	107.61	163.40	117.68

The following more important conclusions can be drawn from the data shown in the above Table:

- Labor expenditures are the only expenditure group, where there is no fulfillment of the plan. All groups of municipalities have failed to fulfill even the initial plan, in spite of the extra subsidies transferred during the year. This is due to the fact that municipalities plan labor costs on the basis of staff numbers according to the average salary, while they report the actual expenditure with excluding the vacant positions.

- A strong connection between the unemployment rate and poverty in municipalities. This is evidenced by the fact that the biggest share of social transfers is observed in the municipalities of groups five and three, while it is the lowest in Sofia.

- Relatively high poverty level, which indicates structural problems in employment in the financially wealthiest municipalities – those in group four. This is evidenced by the fact that they rank second, after the municipalities of group five, in terms of social transfers per capita (BGL 49.95) in spite of the relatively small share of social transfers in their total expenditures.

- The conclusion that social transfers are the strongest destabilizing factor for municipal budgets is confirmed. On one hand, their amount is difficult to predict, on the other hand, their priority position exhausts a large part of the municipal budget. An argument in support of this is the observed large over-fulfillment of the initial budget plan for 2001 – 163.40% on average for the country. When extra subsidies are taken into account, the over-fulfillment increases to 185.05%.

- Maintenance is planned according to the principle “as much as there is left” and the expenditure is strongly underestimated. The actual needs of municipalities per the basic components of maintenance, such as materials, fuel and energy, current repair and contracted services, are 1.5-3 times bigger than the initial annual

budget. At the same time, there is a non-fulfillment in another element of maintenance – subsidies for non-financial entities (subsidies for health care).

- Municipalities' incapability to make even the investments allowed by the state (to invest own and loan funds amounting to 5 % of their own revenue). In 2001 municipalities achieved 73.75% of the stipulated investments ceiling.

- The presence of Sofia among the studied municipalities considerably increases the average for the country expenditures for maintenance and capital investments per capita of the population. The larger amount of these expenditures, which Sofia consumes, affects respectively also their over-fulfillment against the initial plan for 2001.

The Table below shows the 2001 municipal expenditures by functions and groups of municipalities. The performance and the expenditures per capita are shown by functions and groups of municipalities.

Table 13

2001 Per Capita Expenditures by Functions and Plan Implementation by Groups of Municipalities

	Expenditures per capita (BGL)							Implementation (%)						
	Gr. 1	Gr. 2	Gr. 3	Gr. 4	Gr. 5	Total (excl. Sofia)	Total	Gr. 1	Gr. 2	Gr. 3	Gr. 4	Gr. 5	Total (excl. Sofia)	Total
General government services	13.32	16.45	19.83	42.40	32.95	22.50	21.12	94.70	105.76	110.17	124.39	109.38	109.14	107.59
Defense and security	4.50	2.09	1.27	3.07	1.90	1.85	2.25	107.31	119.34	138.86	136.10	128.57	125.79	119.61
Education	89.39	81.38	72.96	100.23	77.54	78.75	80.34	99.76	99.07	99.94	109.18	97.92	99.35	99.42
Health care	35.66	17.88	33.55	36.51	9.13	20.29	22.60	99.56	91.10	99.36	118.00	98.26	96.68	97.35
Social assistance	20.79	36.61	44.76	61.14	59.68	45.60	41.88	143.44	140.36	145.80	151.43	149.12	145.15	145.02
Utility services	92.53	29.65	21.54	52.78	23.48	26.62	36.50	114.30	108.31	113.72	144.09	133.32	116.37	115.57
Culture	6.98	10.00	5.05	14.28	4.71	7.44	7.37	90.68	100.22	104.57	127.09	104.38	102.99	101.04
Economic activities	54.45	12.47	6.93	18.12	9.75	10.47	17.07	100.03	113.28	168.83	200.81	201.29	139.56	117.37
Other expenditures	7.79	0.31	0.07	0.04	0.04	0.17	1.31	68.58	12.67	1.44	11.14	0.86	4.56	27.05

The following more important conclusions may be drawn from the above Table:

- The administrative costs and social assistance expenditures increase with the decrease of municipalities' sizes. This indicates, on one hand, the smaller efficiency of smaller municipalities in delivering local services, and on the other hand – high poverty levels;

- The population of Sofia receives more local services compared to the other municipalities. Sofia's expenditures are bigger in two other sectors especially – public works and utilities, and economic activities;

- Almost equal to Sofia's expenditures per capita are those in the municipalities of group four. In contrast from Sofia, however, their structure is quite different. Beside public works and economic activities, these municipalities allot priority expenditures for education. Their costs for general administration and social assistance are relatively large;

- Non-implementation of the expenditures for health care and education, with the exception of the municipalities of group four. In Sofia alone non-implementation of the general administrative and culture expenditures is observed.

Budget Deficit

The total parameters of budget deficit in 2001 determined on Table 1 are as follows:

Gross deficit	-	BGL 386,359,769
Net deficit	-	BGL 94,899,522

Factor Analysis of Budget Deficit

The gross budget deficit is due to the fact that the municipal budget funds spent during the year are larger than the planned revenues. The deficit amount is defined as the difference between reported expenditures and planned revenues.

At the beginning of 2001 the planned expenditures were equal to the planned revenues – BGL 1,733.3 million.

In the course of the fiscal year budget expenditures increased by BGL 386.4 million.

In the course of the fiscal year the municipal revenues growth affected the gross deficit (caused by the expenditures growth) in two directions – decrease and increase. As it is seen in Table 14, the aggregate effect of revenues is positive and is manifested in decreasing the gross deficit by BGL 291.5 million, which is 75.6%. The 24.6% difference, which is BGL 94.9 million, is the net deficit. It is expressed in outstanding expenditures minus the positive balance as of the end of the year (BGL 124.3 million– BGL 29.4 million). Therefore, the net deficit is due to the faster increase of municipal expenditures compared to the revenues increase.

The effect of the concrete factors influencing the amount of the 2001 budget deficit, is in the following:

- All budget expenditures had an effect towards budget deficit increase. The biggest contribution here came from maintenance – 48.93% and social transfers – 42.51%;

- Again in the same direction – towards deficit increase – was the effect of two types of revenues: loans (excluding those from the Republican Budget) - by 26.14%, and other local revenues – by 6.64%;

- The other budget revenues have a positive growth, i.e. they had an effect towards reducing the misbalance between expenditures and revenues;

- The biggest contribution for budget deficit reduction came from shared taxes, extra subsidies in the end of the year and the revenue under transfer

accounts. Their growth compared to the initially planned amount for them reduces the gross deficit by 31.94%, 30.38%, and 34.19% respectively;

- The small effect of state subsidies is due to the fact that they were reduced by the amount of the centralized in October 2001 amount of revenues from taxes;
- The local taxes and fees, as well as the loans from the central budget, have a relatively small, however positive, effect towards reducing the deficit.

Table 14

Municipal Revenues' and Expenditures' Effect on the Amount of the 2001 Deficit

	Expenditure growth	Share	Revenue growth share of the expenditure growth	Share	Revenue growth	
Total expenditures	386359769	100.00	100.00			
Salaries and social security contributions	9523492	2.46	75.44	100.00	291460247	Total revenue
Maintenance	189057794	48.93	31.94	42.34	123394349	Shared taxes
Social transfers	164255876	42.51	2.29	3.04	8849907	Subsidies
Capital investments	23522607	6.09	30.38	40.28	117386369	Additional funds not included in the budget
			2.38	3.16	9206219	Local taxes
			3.77	5.00	14578937	Local fees
			-6.64	-8.81	-25670226	Other local revenues
			34.19	45.32	132095952	Revenue under transfer accounts
			-26.14	-34.65	-100977960	Credits
			3.26	4.32	12596700	Loans form the central budget

The results of the factorial influence of the different revenues and expenditures on the budget deficit in 2001 may be summarized as follows:

- The subsidies reduction in fulfillment of paragraph 22 of the State Budget Act proves out to be the main factor for the existence of a net deficit in municipal budgets. The extra subsidies' amount was insufficient to compensate for this reduction;
- The method of planning the social assistance (which basically forms the amount of social transfers) – the doubled amount of target subsidies, and its further increase under the pressure of local governments and those entitled, turns out to be a powerful factor for increasing municipal deficit. The Ministry of Finance implanted a deficit in the municipal budgets at the very beginning of the budget year through the planned target subsidies for social assistance;
- When passing the budget local governments are trying to solve the problem with the disbalance between available revenues and required expenditures basically in two ways:

- By boosting the other non-tax revenues and planning for loans, which they know from the outset that will not take;
- By unrealistic decrease of maintenance expenditures.

The reasons for their choices are: lack of expenditure rates; the possibility stipulated in the Municipal Budgets Act for planning a deficit by means of current loans; ambiguous results of the sale of municipal property under the Municipal Councils Act; insufficiently efficient municipal property management;

- The system that has become the routine in the recent years, which tries to reduce in the course of the year the budget deficit laid down in the municipal plans, is improper and does not eliminate the factors, which cause the deficit.

Analysis of Outstanding Expenditures by Municipalities

The total amount of outstanding expenditures, reported by municipalities in compliance with the requirements of the Ministry of Finance, was BGL 162.2 million at the end of 2001. At a meeting held afterwards at the MoF the joint working group under the program for gradual reduction and settlement of outstanding expenditures for 2001, had it specified that the ultimate amount of outstanding expenditures for 2001 was BGL 124.3 million. Out of the expenditures stated in the initial information by municipalities the amount of BGL 36.9 million - for salaries and social assistance in compliance with the Social Assistance Regulation and the Birth Promotion Decree for the month of December - was subdued to reverse operation.

Regretfully we have no information available about the amount of reduction of outstanding expenditures per municipalities. Therefore the present analysis is based on data taken from the information submitted by the municipalities.

Table 15

Outstanding Expenditures per Capita and Share of the Budget Revenues per Groups of Municipalities

Groups	Outstanding expenditures per capita (BGL)	Outstanding expenditures' share of the total revenue (%)
Group 1	0.00	0.00
Group 2	25.20	12.09
Group 3	24.65	11.89
Group 4	23.99	7.14
Group5	19.12	8.62
Average (Sofia excluded)	23.42	10.86
Average for the country	19.91	8.51

As it can be seen from the data on the above Table, the amount of the outstanding expenditures is the biggest in large and medium-size municipalities. Of interest is the fact that in difference from other years, in 2001 the small strongly

industrialized municipalities (paying contributions to the Central Budget) also incurred a considerable amount of outstanding expenditures. This fact is due mostly to Bobovdol, Kozloduy and Sevlievo. Only 4 municipalities in this group closed the year without outstanding expenditures.

The abovementioned fact shows that representing the outstanding expenditures per groups of municipalities is not very indicative. There is a differentiation among the municipalities inside the groups themselves.

The Table below shows the municipalities in terms of the outstanding expenditures amount per capita and in terms of their share of the municipal revenues, i.e. according to their weight.

Table 16

Outstanding Expenditures in 2001

In BGL per capita	Number of municipalities	In % of revenues	Number of municipalities
Over BGL 70 per capita	5	Over 30%	5
BGL 50.00 - 69.99 per capita	11	20.00 - 29.99%	18
BGL 25.00 - 49.99 per capita	73	10.00-19.99%	89
BGL 10.00 - 24.99 per capita	93	5.00-9.99%	56
BGL 0.01-9.99 per capita	52	0.01-4.99%	66
With no outstanding expenditures	28	With no outstanding expenditures	28

The data from the Table show the following:

- A total of 28 municipalities closed the year with no outstanding expenditures;
 - The majority of municipalities had outstanding expenditures up to BGL 50 per capita, this being up to 20% of the obtained budget revenues;
 - The other two groups of municipalities suffer a severe financial condition.
- In our view the share of outstanding expenditures from the municipal revenues is more indicative. From this point of view 5 municipalities are in the worst condition – Bobovdol, Stambolovo, Pernik, Kazanlak and Zemen. Then follows the group of 18 municipalities whose financial condition is extremely bad, too.

Outstanding expenditures have to be considered, beside as being a purely financial problem for local budgets, in a wider aspect, too. They result in loss of confidence in the solvency of local governments, devastation of small business, additional costs for interests on deferred payments, which make local services more expensive.

The general conclusion from the analysis is that outstanding expenditures as of the end of each fiscal year generate a hidden deficit in the next-year budget, and the latter is in turn a prerequisite for the occurrence of deficit. A one-time payment of the outstanding expenditures by the MoF will not resolve the problem. Amendments to the statutory regulations are required, which will eliminate the factors generating outstanding expenditures.

Conclusion

The *general conclusions* from the analysis of municipal budgets for the period 1999-2001 are:

The local finance system is strongly centralized. The changes are chaotic and lack purposefulness. Some of them result in raising local government powers, while others are aimed at restricting them. At the same time the intentions of the Government to develop and implement a decentralization program, as well as all changes that took place in the beginning of 2002 inspire optimism and generate an environment, which is favorable for reforms.

Municipal budgets were characterized by the following during the period under review:

- Existence of budget deficit as a result of structural disbalance between revenues and expenditures;
- Unrealistic planning manifested in a large discrepancy between plans and reports;
- Stagnation of the actual expenditures for delivery of local services.

A general finding, which holds true most strongly of 2001, is that municipal budgets are becoming more and more unintelligible, nontransparent, depicting an unrealistic picture of the financial situation of municipalities. The arguments in support here are: impossibility to report outstanding expenditures; existence of transfer accounts under which only the balance of funds that have passed is reported; granting additional subsidies in this way; loan payments are shown with a "minus" sign in the revenue side of the budget; tax revenues are taken away by means of subsidies reduction, etc.

The analysis of 2001 municipal budgets shows the following main results:

- *Per groups of municipalities:*

Sofia differs considerably from all other municipalities in Bulgaria. Its large share significantly affects the analysis results. If it is excluded, the total revenue and expenditure per capita decrease (by almost 8 %), and so do the investments, maintenance costs and public works expenditures.

The budget revenue and expenditure per capita is the lowest in large municipalities (district centers) and medium-size municipalities. A high level of outstanding expenditures characterizes these two groups of municipalities.

Small municipalities (which comprise over 60 % of all municipalities) have an extremely low local revenue basis. Their revenue is generated exclusively by state subsidies.

Five municipalities enter the fiscal year 2002 with a severely heavy heritage from 2001. They are: Bobovdol, Stambolovo, Pernik, Kazanlak, and Zemen.

- *Per types of revenue and expenditure*

The revenues from taxes are the least predictable for the municipalities and generate the biggest differences among municipalities.

The application of Paragraph 22 of the State Budget Act, is in contradiction with the Municipal Budgets Act, the Corporate Taxation Act and the Local Taxes

and Fees Act. It creates conditions for bureaucratic voluntarism in determining the tax revenues plan. With the introduction of the provision of Paragraph 22 the tax administration presents a deliberately small plan – by BGL 132.6 million, or approximately 15%.

Through the contributions and paragraph 22 mechanisms for taking away legally provided tax revenues from the municipalities are put into effect. In 2001 through them a total of BGL 162.5 million were centralized, which comprises 15.9% of the total tax revenue.

The Ministry of Finance lays down every year, and the Parliament passes, a lowered plan for subsidies. Thus an artificial deficit for municipal budgets is created. This is evident with specific sharpness with regard to social benefits, which are the strongest destabilization factor in municipal budgets. The amount of the target subsidy for years on end has been unrealistically lowered, which causes social tension and transfers from the central government onto the local governments the consequences of the regular non-fulfillment of the national social welfare program.

The additional subsidies granted to the municipalities through different channels aim at bypassing the rules set out in the State Budget Act; they are allocated according to ambiguous rules, create conditions for unfairness, hidden political pressure and corruption, have an effect of a disincentive for efficient management among local governments.

The changes in the amount of state subsidies result in strong increase of the share of target subsidies for the expense of the general subsidies. This restricts the local governments' power in making decisions on allocation of expenditure per types of services and according to the local priorities.

Local revenues are the most dynamic municipal revenues. This is due most of all to the outstripping increase of the revenues from local fees.

A reduction of municipal budget deficit is observed compared to 2000. It may be said that there is a slight, but positive change also in the planning of municipal budget revenues, with the exception of those from taxes.

The areas, which "discredit" the local governments, are: municipal property management, loans planning, and the maintenance costs.

Suggestion for Change

- *Changes with a view to fiscal decentralization*

A major reason for the municipalities' severe financial situation is the set of laws, which grants quite large powers to the central executive power and acts on local governments as a disincentive in efficient local government. The fiscal decentralization – being a process of transferring powers and responsibilities from the central to the local levels, is the only durable solution to the problem.

Some more significant steps towards this end are:

Dividing the expenditure responsibilities into delegated and local ones.
Introduction of rates for basic services delivered by municipalities;

Change in the subsidies formula. The formula should contain two components: a *balancing* component – adding up the revenues from shared taxes to become equal to the expenditures for financing delegated activities; *equalizing* component – submitting subsidies to poor municipalities in reverse proportion to the local capacity of generating revenues. The amount of the equalizing subsidies should take into account the local governments' efforts for increasing the local revenues;

Dropping off the profit tax and municipality tax as revenue sources for municipal budgets;

Making 100% of the revenues from personal income taxes available to the municipal budgets. Change in the method of allocation of the revenue from personal income taxes – shifting from allocation based on the revenue origin towards allocation per capita. The changes in shared taxes will reduce the differences in revenues among municipalities, thus resolving the problem: first, the negative subsidies (contributions to the Central Budget) will decrease, as well as the number of municipalities that pay them; second, the re-distribution function of the state subsidies mechanism will be weakened;

Granting the local governments the powers to set local taxes rates in compliance with the law stipulations, and full powers to set local fees – their types and amount. There are a lot of indications that the municipal authorities will address the setting of local taxes and fees in a responsible way, and will in no way increase unreasonably the tax burden on their electorate.

- *Budgeting Process Improvement*

Other important changes, beyond the fiscal decentralization program, which have to take place in the local finances system, are:

Dividing municipal budgets into two sections: current, and capital;

Prohibition for municipalities to use loan-financing tools for balancing current expenditures;

Extending the budget year until March 1. This will make it possible activities carried out and expenditures incurred in the respective year to be accounted for in the first two months of the following year. This practice exists in Europe and will give a chance to reduce the tension, which causes problem, at the end of each fiscal year;

Even if all deadlines stipulated by law are met, at present the municipalities operate without an adopted budget during the first two months of every fiscal year. This is not normal. Earlier deadlines for passing the state budget, and municipal budgets respectively, have to be set. The municipalities should have more time (more than the 1 month they currently have) for discussing and adopting their budgets;

The practice of systematic refusal by municipal councils to adopt the budget has to be discontinued. The solution of "official budgets" set out in the 2002 State Budget Act causes more problems than provides resolution. Legislative amendments are required, as follows: first, the MoF to approve of an official budget, extending the deadline, and if it is not observed then the date of new elections should be set.

27.V.2002