

TAX DECENTRALIZATION: SOLUTIONS FOR BULGARIA

The study draws on the theory of optimal taxation and the practice in a number of federal and unitary countries to outline the conceptual framework of the allocation of revenue responsibilities among levels of government. A distinction has been made between decentralized tax policy (the power to set tax bases and rates) and tax administration (collection of taxes). Possible solutions for Bulgaria are drawn and formed on this base. It has been justified that, the strengthening of the tax autonomy of local government is the main objective of the reform in local finances but appropriate taxes are few in number and are with a limited revenue potential. Optimization of the real estate tax has been proposed, including taxation on local incomes from rent as well as local patent tax. The revenue potential of these autonomous local taxes especially in small municipalities is not large, which leads to the necessity of a semi-autonomous parallel local tax on personal incomes, as well as substantial central subsidies i.e. re-allocation of tax revenues across municipalities.

JEL: H71, H77, H21

The revenue autonomy of municipalities is among the main issues of fiscal decentralization. Economic literature on this matter associates the benefits of fiscal decentralization with more efficient allocation and utilization of the limited resources of the public sector. According to the subsidiarity principle, the closer to consumers the decisions about the quality and quantity of public goods and service are taken, the closer the link between consumers and suppliers is, i.e. the more precisely they reflect consumers' and voters' choices.

Fiscal decentralization however has its own economic cost. First of all, it is related to some macroeconomic risks and restrictions on the government fiscal and stabilization policy. Furthermore, the financial decentralization limits the effect of the distributive instruments of the central government, which are usually of importance for lessening regional disparities and the struggle with poverty. That is why, the financial decentralization is a matter of balance of costs and benefits and optimal allocation of the functions and responsibilities of the public sector at the different administrative levels.

The allocation of responsibilities for delivery of public services, i.e. for the administration of public expenditure is the starting point in the development of a fiscal decentralization model. The different administrative levels (central and municipal in Bulgaria) could not comply with its part of the public contract with citizens without ensuring adequate financial resources, i.e. without the allocation of the tax authorizations in accordance with the responsibilities for public services provision. The central administration in Bulgaria includes also the district structures of the government. In literature there is a difference between de-concentration of fiscal authorizations on the one hand and fiscal decentralization on the other. The

first term is used in the sense of delegating to the regional and local structures more rights and responsibilities in administrating the public sector. The latter is used in the sense of enlarging the fiscal independence of the local administration and increasing its responsibility and accountability to local voters.

That is why, the tax decentralization laid down particularly as an issue about tax autonomy or about local taxes, cannot be discussed separately from other three important issues concerning the reform of fiscal relations between the central and local authorities. The first one refers to the allocation of *expenditure responsibilities* among the different administrative levels. The second one is the wider issue about the overall *fiscal assurance* of these responsibilities. In most of the unitarian countries the local taxes are of secondary importance in comparison to the transfers from the central administration in the form of shared taxes or free subsidies. The third issue refers to the *administration* (collection) of taxes. The issues of the optimal local taxes are discussed in the following text in the light of these three mutually related components of the fiscal decentralization; as well as the main principals of defining a certain tax as an autonomous local tax from the point of view of the optimal taxation theory; the necessity and possibilities of shared tax examined too. The parallel local taxes have been analyzed and the principals of the decentralized tax administration are presented. Finally, possible solutions for Bulgaria are pointed out in the conceptual framework outlined above. It has been recommended the local revenue autonomy to rely on optimization and increase in the fiscal capacity of the traditional property taxes, to expand the autonomous tax sources with new taxes such as tax on land, income tax on rents and on patent activities, as well as with parallel taxation on personal incomes.

Local Autonomous Taxes

Local taxes mean the taxes that *determine the degree of local tax independence (autonomy)*, not the taxes that form the revenue part of local budgets, i.e. local governments have authority in defining their base and rate. This does not necessary mean that they have to be administered by the local authority. In this context the literature makes a difference between local tax and local tax administration, i.e. between decentralization of tax policy and decentralization of tax administration, which we will refer to later.

The tax decentralization is a process of transfer of powers, responsibilities, and resources from the central to the local authority. It is not a fixed achievement with definite parameters. In international practice there is a wide variety of forms and degrees of revenue autonomy, which are a result of the public choice in the context of specific geographic, national, ethnic, economic and political conditions in each country. There are quite a few examples of the two extremes in the relationships between the different administrative levels.

In the ultimate form of tax decentralization, the taxation is entrusted to local authorities, while they are obliged to transfer to the central authority a part of the revenues (the so called ascending transfers) in order that the latter could cover its

expenditure responsibilities. Such type of decentralisation is applicable to a certain extent to quite free unions of tax jurisdictions with a federative or confederative system. In this ultimate form at a federal level the functions of the central administration usually are very limited and they concern only pure public goods and services, which are common for the whole nation, such as defence, foreign policy, state regulative functions for protection of environment, consumers, competition, etc. The problems in the revenue part are associated with barriers which the tax discretion on a local level places to the free movement of goods, services, labour and capital. The integration of commodity and factor markets usually exerts pressure to harmonize the taxation in order to avoid undesirable tax competition and deviation from the optimal resource allocation as a result of the different tax regimes. Moreover, such system limits the possibilities of the central administration to use efficient fiscal tools for macroeconomic stabilization, as well as for re-allocation of incomes.

In small unitarian countries like Bulgaria where municipalities are bodies of the local authority such ultimate form of tax decentralization is neither desirable, nor applicable. However, the economic heritage of the centralized economy places us closer to the opposite extreme – over-centralization of taxation where all taxes are set and collected by the central government and local responsibilities are financed by transfers and subsidies. An appropriate question arises: if these transfers cover local needs sufficiently, why is the local tax autonomy needed at all? Furthermore, the practice shows that most systems of fiscal relations between the central and local authorities could not function without descending transfers. Here arises the opposite question – is it possible to have quality local services without collecting local taxes, i.e. to finance them only by subsidies from the central authority?

A main postulate in public finance is that the budget is a form of a public agreement between citizens and policy-makers with respect to the quality and quantity of public goods and services consumed by the population (the expenditure part of budget) and ways for their financing (the revenue part). In this context the objective of the tax autonomy is not and only to increase the financial capacity of local authority. It is essential that the portion of re-allocation of revenues among the regions is reduced. The relative tax burden on the local population corresponds to a greater extent to the quantity and quality of the consumed public goods and services and if this is not the case, they could directly hold their representatives responsible for that. In other words, the local taxation is getting closer to the benefit principal in the allocation of tax burden among the regions. Moreover, the local rulers are responsible to their voters for the quantity and quality of these services i.e. they report to them how they spend their money and not to the central administration for how they spend the central budget funds. The horizontal accountability and control displaces the vertical one. At the latter, the local authorities always have an incentive to overestimate their budget needs and the central government to

counter this by granting them less than demanded. The natural outcome is that the money for local administration is never sufficient but the responsibility for this is scattered between underestimation of local expenses by the centre and poor local financial discipline. That is why, some kind of financial independence of the local authority is necessary, so that the direct link between providing public services and their local financing could be activated. This argument is even more in effect in a country like Bulgaria, where local elections reflect the direct majority vote of electorates, whereas the parliamentary elections are proportional and reflect more the internal party selection of members of the parliament (i.e. MPs are responsible to their parties and parliamentary groups and parties are “responsible” to voters).

In most of the countries worldwide the real practice is somewhere between these two extremes with a different degree and structure of allocation of tax authorities among central and local administrations. In general, it means to choose which taxes are the best as local, which are the best as central and which could be shared among the local and central authority, as well as the principals of this sharing.

Optimal Local Tax

The international practice shows that there is not a single answer to the question which the best local taxes are. From local finance theory one could derive several main principals identifying the parameters of the tax decentralizing. The taxes play three substantial roles: fiscal (to finance public expenditure); allocative (to allocate resources based on the economic choices of consumers and suppliers) and distributive (re-allocation of incomes in order to increase public welfare)¹. Within this conceptual framework the optimal local tax should contribute to the best implementation of these functions.

First, this tax should have enough fiscal capacity to ensure the necessary revenues for meeting the local responsibilities and to reduce to the lowest possible level the fiscal dependence upon the central budget. The local financing should meet *benefit* principle, i.e. consumers of local services should participate as much as possible in their financing. This means to cut down the re-allocation of incomes among regions, as well as the related negative incentive for the regional growth.

Second, this tax has to be with a relative constant base, i.e. should not lead to an easy reallocation of production factors from one municipality to other, which could cause tax competition and could undermine its fiscal capacity. The more flexible the base of a certain tax is, the stronger the arguments for assignment the decisions for its structure to the central authority are (Norregaard, 1997, p. 53-55). Let's illustrate this thesis and consider production factors, then land, other real estate and related income (rent) are the most

¹ See Pashev, 2006, p. 9 – 11.

appropriate for local taxation and the capital is more suitable for central taxation. The labour is in the middle. It is more fixed than the capital and could be relatively more successfully levied with a local tax. But the taxation on personal incomes from salaries and wages can influence employers' decisions and cause outflow of capital.

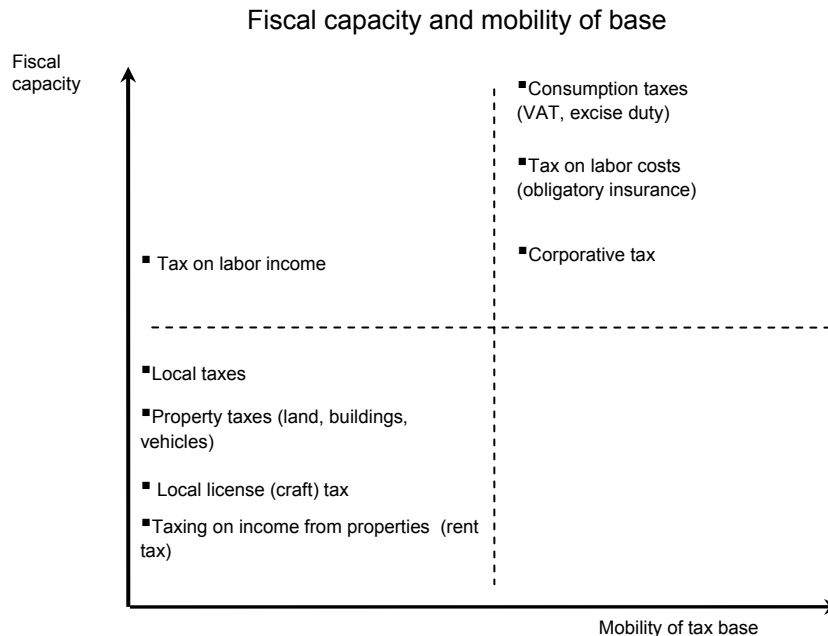
General taxes on consumption are also among those that are definitely considered as not appropriate for local tax autonomy. The reason is that in a small country the consumption can easily be redirected to a neighbour municipality with a lower rate. On the contrary, service charges are a classical example of local taxation according to the benefit principle. They are with low price elasticity of demand. Similar is the case of licence charges on the development of small business or the prices of administrative services. However, if they are high, even though they will not lead to relocation, they could be an effective barrier to starting an economic activity.

Third, in view of the re-allocation functions of the tax in the public finance theory and practice, a principle has been established that if the objective is to overcome poverty and regional disparities at a national scale, then the main responsibility bears the central government. That is why, the social policy is among its main responsibilities. This is even more in effect about the obligatory health and pension insurance as their fiscal efficiency and effectiveness require the maximum possible pool of risks. Thus, the economies of scale make obligatory social and health insurance relatively inappropriate for local taxes and the local (for example municipal) insurance funds not so efficient.

Similar arguments define also the role of personal income tax in the allocation of tax responsibilities among the different administrative levels. It is the main tool of the central government for allocation of tax burden toward taxpayers with higher solvency, i.e. for improving the vertical equity of taxation. That is why, the role of the personal income tax in the local finances is either as an assigned tax or as a parallel local tax, but not as an autonomous local tax.

If we summarize the above criteria and principles, it appears that there is not an ideal local tax. VAT, excises and other taxes on consumption are of high fiscal capacity, but are not suitable for local taxes because they distort competition on the domestic market and lead to relocation of goods flows in accordance with the rate difference which will level the prices at the end. The difference in taxes will be covered by producers which will again lead to relocation of supply. Social taxes have objectives incompatible with local taxes. Taxes which are applicable at a local level, for example property tax, tax on land, license fees and service taxes and charges are relatively suitable from the point of view of allocation effectiveness but have a small fiscal potential. In short, the place of the perfect local tax (Figure 1) should be in the north-western quadrant, i.e. with small mobility of the base and high fiscal potential. As it can be seen, this quadrant is almost empty.

Figure 1



Two conclusions could be drawn from this illustration. First, the possibilities for strengthening the tax independence of the local authority have to be found among the taxes in south-western quadrant (fig.1). Second, they are not sufficient on their own to overcome the local authority dependence on descending transfers from the central government. This determines the relatively large importance of shared taxes in the new unitarian market economies such as Bulgaria. Further more, the inherited regional disparities have aggravated considerably in the years of transition.

Shared Taxes

The shared taxes are a transfer from the central authority to the local authority when the government submits part of the collected central taxes for covering the expenditure needs of the latter.² As other kinds of descending transfers, they aim at overcoming vertical or horizontal local finance imbalances. The *vertical imbalances* are related to discrepancies between the revenue potential of local authority and the mandated expenditure responsibilities. They reflect the structural reasons for a local budget deficit. The *horizontal imbalances* show the differences in the tax potential among local authorities, which may result from natural and demographic factors or past regional economic priorities. Overcoming

² The other transfers are subsidies, which are general (leveraging) or earmarked (related to specific investment projects). They are not covered in this study.

the first one is a matter of macroeconomic stability and ensuring the delivery of public services by the local authority. In other words, it is an unconditional necessity. In contrast to the first imbalance, the second one is a matter of political choice about the level of poverty and about abandoning some regions that society is ready to accept, and hence the minimum standards of services to which the citizens have the right regardless of their place of residence.

The political choice in this case concerns the finding of the optimal balance between the fiscal efficiency and the reallocative objectives of the regional policy. Overcoming the horizontal and vertical discrepancies should not reduce the incentives for effective fiscal administration of local authorities. On the contrary, at a certain level of local fiscal autonomy, it has to increase local tax efforts and prevent spending more than necessary. In other words, tax sharing must be based on clear and transparent principles which account objectively for the revenue potential and expenditure needs of local authority.

The objective is certain; however the tools for its achievement are not clear. In most countries in transition certain central taxes are shared totally or partially on the derivation principle. In the case of the most common shared tax, the personal income tax, the local governments receive that part of the collected tax at a central level which is generated on their territory. The advantages of this approach are in the closer link between the local budget revenues and the results of local economic activity. Furthermore, the financial burden of the local services falls to a greater extent on the local population, i.e. the benefit principal in allocation of fiscal responsibilities is implemented on a regional (if not individual) level to greater extent. Local authorities have an incentive to conduct a policy of improvement of investments and growth conditions which concern directly their fiscal position.

The main disadvantages of the shared tax are that it does not increase the revenue autonomy of local authority and its responsibility and accountability to consumers of local services, respectively. The access to this financial source depends on the decisions at a central level and is not guaranteed. In this respect, the experience in Bulgaria is significant. Shared taxes dropped sharply in the first half in the 1990s without a corresponding increase in local tax authorities. The municipalities were deprived of taxes from state enterprises in 1991 and turnover tax in 1994. In 1993 the share of shared tax on personal income was reduced to 50 percent and remained such till 2003. Local profit tax was also temporally reduced in 1996 (Ivanov, 1999, p. 92) and since 2002 has been abolished. The tax on roads was abolished in 2005.

Another disadvantage of tax sharing based on the derivation principle is that it directs more financial resources from the centre to the richer municipalities and thus aggravates the regional economic inequalities. This is a serious issue in most of the ex-socialist countries, where the regional disparities are considerable. They often reflect the heritage of the central planning and political priorities of the parties' managers. As a result of many years re-allocation of the national income in favour of certain districts, in the beginning of transition from planned to market economy not all municipalities had the possibility for an equal start and later not all of them

are with equal tax opportunities. Therefore, there is a need to reallocate and equalize to some extent the potentials of local authorities to provide public services. Furthermore, it is not only an issue about poverty reduction, but about prevention of lasting migration and demographic changes with a considerable economic cost.

However, the re-allocation of revenues among municipalities has an economic cost too. It does not encourage the developed municipalities to mobilize their full economic and tax potential. For this reason, the amount of the transfer could be linked with the realized own revenues through the so called matching transfers. They are a direct incentive for mobilizing the local revenue potential. However, the problem of matching is the same as with the total or partial sharing on the derivation principal – it causes regional disparities to deepen and not to balance – the better-off municipalities receives more transfers than poorer ones from the central authority. A certain balance between the fiscal incentives for the local authority and the need of reallocation can be achieved by different relations of the proportional transfers.

Most countries seek a balance between fiscal efficiency on one side, and decreasing the regional disparities on the other, by applying formulae to calculate the transfers towards local authorities. In this case the shared taxes are not reduced to total or partial transfer of certain taxes collected on the relevant territory, but they are set by total tax revenues on the base of a number of economic, demographic and infrastructural indicators used to estimate the relative expenditure needs, local revenue potential, degree of regional lagging and so on. For example, population and age structure, the number of hospitalized people, the number of students, the length of road network per person, poverty indicators, etc.

Traditionally during the transition period in Bulgaria the income tax on natural persons has been shared on the derivation principle. The shared part was 50 percent until 2002 and since 2003 the reform in the central and local authority relations has turned it to a supplement subsidy rather than a shared tax. The tax revenues are used to ensure the delegated expenditure responsibilities. Thus, the range of the shared tax is determined by expenditure needs of the delegated responsibilities and can vary within a wide range between 30 and 100 percent. If the whole shared tax is not sufficient to cover the municipalities' engagements towards central government, then they receive an additional subsidy which is a separate one from the leverage subsidiary and earmarked subsidiary for capital expenditures. Since 2003 the shared tax has not being contributing in any way to the tax autonomy of local authorities, but aims at securing the delegated responsibilities with financial resources ensured by the centre. In this sense the transition in 2003 from sharing based on derivation principle toward supplement transfer is rather in the direction of the tax centralization.

For a country like Bulgaria with low average incomes per capita, growth objectives should have a priority over reallocation objectives. Otherwise, there will be nothing left to reallocate. The considerable lagging behind the average

European income levels and the challenges of convergence require simultaneously decreasing poverty in the most underdeveloped regions without reducing incentives for the well-developing municipalities. That is why, the tax decentralization should be targeted mostly at ensuring economic growth and developing regional clusters and to a less extent toward equalization. In other words, during the next 10 – 20 years the reallocation elements must have less importance in the tax decentralization policy, than the economical efficiency. However, efficiency is not achieved by means of unconditional transfers no matter how properly they are directed and measured, but by economic incentives. The municipalities need a considerable increase in tax autonomy in order to react to the stimuli of the central authority and create incentives for the local entrepreneurs.

Taking into account the low fiscal potential of the possible local taxes, the question is whether municipalities are condemned to a “healthy fiscal starvation” as an incentive to mobilize at maximum the local revenue recourses. How could this impact the tax burden locally and on the political chances of local rulers? The possible solution is to find out a kind of a trade-off where the local authority sacrifices partially the tax discretion for more revenues from the typical central taxes, while the central authority sacrifices part of its revenues for reducing the part of the shared taxes. Such compromise could be the parallel local tax, which gives the right to tax concessions from the relevant central tax.

Parallel Taxation

The parallel local taxes are placed in the middle between the local autonomous and shared taxes in the tax decentralization tools. These are local taxes that duplicate the central ones – the local authority imposes them on the tax base of the corresponding central tax and has the right to set the rate. Usually they are collected by the central administration along with the corresponding parallel central tax, so that the economies of scale can be used. The advantage of the parallel tax in comparison with the shared tax is that it grants to local authorities greater tax autonomy and increases their responsibility to local taxpayers.

According to the theory and practical experience in many industrial countries the most appropriate candidate for parallel taxation is the tax on personal income of labour³. There are several theoretical justifications for this. *First*, as it has been already pointed out the mobility of tax base on personal labour income is relatively limited (the labour supply has low elasticity). Therefore, the difference in local rates could not lead to a significant dislocation of labour resources. Beside, the wage incomes of most taxpayers come from the territory of only one municipality, i.e. there is no problem with tax allocation among several local authorities as is the

³ Until 2001 companies in Bulgaria paid a tax for municipalities on a tax base according to the Law of corporate income taxation. It resembles the local parallel tax only in form. The base is set by the center and the tax payments are shared on the base of central tax and thus, it is in the group of shared taxes.

case with the parallel corporate income tax. The main obstacle in applying the personal income tax as an autonomous local tax is that it is one of the main re-allocation instruments of the fiscal and social policies, which are governmental responsibilities. However, its parallel application at a central and a local level increases considerably the revenue autonomy of local authority without depriving the central one of implementing to some extent the progression taxation at a national level.

The international practice is various. In Scandinavian countries local authorities usually apply to the tax base of the central income tax one (flat) rate, whereas in Canada the tax obligation is formed as a percentage of the central tax obligation (i.e. tax on tax). The local tax is collected by the central administration, in Canada it receives a part of the collected sum as a commission and has an interest in collection in favour of the provinces (Bird, Ebel and Wallich, 1995, p. 48-49).

Administrative Decentralization of Taxation

The analyses so far cover mainly the decentralization of tax policy. The allocation of tax responsibilities among different administrative levels includes also allocating of responsibilities for tax collection, which could differ from those that define the tax rates, bases and spending of revenues. Key indicators in allocation of administrative functions should be effectiveness and efficiency and not which administrative level determines or spends the tax at the end. In other words, the tax, whether it is central or local, must be collected by this level of administration, where it is most effective and efficient. Such requirement integrates at least four principals.

First of all, each tax should be administrated by this management level where collection costs per unit revenue are the lowest. If for one BGN collected tax, the costs of central administration are less than those of the local administration, the principle of fiscal effectiveness requires the tax to be collected by the central authority; even it is a local tax. For the municipalities it could be more advantageous to entrust the collection to central administration against some payment.

The costs of collection are not the only efficiency indicator of tax administration in the public sector. Equally important are the costs incurred by taxpayers for paying taxes conscientiously (compliance costs). The second principle is the tax collection to be done at this level of administration where costs are the lowest. This requirement often has consequences for allocation of tax responsibilities that run counter to the first principal. This leads to the third efficiency criterion of administering – the degree of voluntary compliance with the law. For example, the optimization of administrative costs and economies of scale can dictate a certain local tax to be collected by the territorial tax department of the central administration but that requires more time and transport costs for taxpayer in comparison to paying the tax at the local tax office. These costs are important not only because of taxpayers' convenience, but also because they determine the degree of conscientious fulfilment of tax obligations.

Besides the costs for tax collection in public and private sectors, an important indicator of administrative efficiency is the compliance gap, caused by hiding or

delaying payments. A commission can be an incentive for tax collection but a weak one for maximizing it. At 5 percent commission, for example, the marginal benefit for the central administration for every additional BGN is 0.05 BGN, whereas the loss of the local authority for each non-collected BGN is 0.95 GN, i.e. 19 times higher.

Last but not least, the administrative efficiency at each government level depends on the conditions for equal and fair treatment of all taxpayers. They are connected with the possibilities for administrative discretion in applying the laws, professional abilities and ethics of the executing body. In literature about the fiscal decentralization there is no uniform statement on the matter of its effect on tax corruption.⁴

These four principles outline the conceptual framework for allocation of administrative responsibilities of taxation among the different administrative levels. The centralised collection in the new market economies has administrative advantages for most of the major taxes. They are related to several basic reasons. First, the economies of scale, such as common centralised databases enabling the exchange of information, mirror controls and comparisons of declared tax bases with the price of minimum labour costs. Human resources in the form of experience and qualification are usually concentrated in the central and not in the local tax administrations. Not all local administrations have the necessary technological and human recourses for providing quality services to taxpayers, as well as the identification of those who escape from tax responsibilities and the dimension of the tax evasion. Furthermore, for many taxes the base is formed on the territory of several local jurisdictions. In such cases even an experienced and technological well equipped administration could not apply efficiently the law without an exchange of information and cooperation and joint inspections with other local administrations. This leads to increase in administrative costs in comparison to the central tax administrating. The costs for voluntary compliance could be above the optimal level too, if a company applies different tax rates and bases for its operations in different municipalities. The possibilities for the transfer pricing within the companies' supplies increase, which leads to increase in the share of unrealized tax revenues. In connection to the fourth principle the central collection also has some advantages because it imposes common solutions for different controversial cases and has better departments for internal control, appealing, etc. The decentralised administration cannot rely on vertical control and methodical support (from the higher level of government). The prevention against corruption remains mainly in the sphere of horizontal accountability (to local authority) which lacks the necessary professional expertise, accumulated in the internal control system and inspectorate of the central administration.

Even in the developed administrations decentralization usually increases the tax cost for tax offices and taxpayers. This problem is even more strongly expressed in the

⁴ For a literature review and justification that decentralization decreases corruption especially in the unitarian countries see Gurgur and Shah (2005). For the argumentation of the opposite thesis that the corruption on a local level is aggravated by decentralization see Tanzi, 1995, Prud'homme, 1995, Treisman, 2000. For tax corruption in Bulgaria see Pashev, 2005.

new market economies where the differences in the administrative capacities at a central and a local level are larger. If the administrative advantages of centralised collection predominate, then is there a need of administrative decentralisation and why?

First, the tax autonomy and responsibility of local authority could be incomplete without some tax collection responsibilities. Furthermore, even if the central tax service may have higher administrative capacity for collection of a larger part of taxes, it may be possible that it has no incentives to mobilize it at the best for taxes, which revenues go entirely to local budgets (for example, autonomous local and shared taxes). The incentive provided by commissions should not be overestimated.

Besides, the central administration does not have an advantage in all taxes. Local administration is better at imposing property taxes (buildings and land), taxes on rent incomes, as well as taxes on licences and professional fees and some excise duties because it could more precisely verify the circumstances and apply the law. They are not connected so much with accounting reports, they need no tax inspection which cover more than one municipality, but rather an inspection of circumstances. Until now in Bulgaria all municipal revenues including local taxes and service charges were collected by the offices of the central tax administration. Naturally, the collection of central taxes was of a greater priority in the work of tax offices which impacted negatively the services to taxpayers and discouraged voluntary compliance with the local tax law.

The reform in revenue administration and the establishment of National Revenue Agency (NRA) differentiated the local tax collection by allocating it according to the revenue responsibilities of municipalities. In practice, the personnel of the local tax offices was transferred from central to local budgets as a part of the delegated revenue responsibilities of local authority. As it has been already pointed out, the fiscal capacity of these taxes is low. That is why, in principle the collection efficiency of local administration is lower than that of the central one, which at the same time serves also the big taxpayers. After the administrative decentralization of taxation in Bulgaria it is expected the efficiency indicators of NRA to improve considerably. Besides the structural improvements, this will impact to some extent the transfer of administering of the low efficient local taxes to municipal administrations. Shortly, the logic of administrative decentralization in this case is not so much concerned with reducing the costs of the public sector for local tax collection, but with getting closer to taxpayers related to servicing of mass taxes, i.e. cutting the costs of taxpayers for the voluntary compliance.

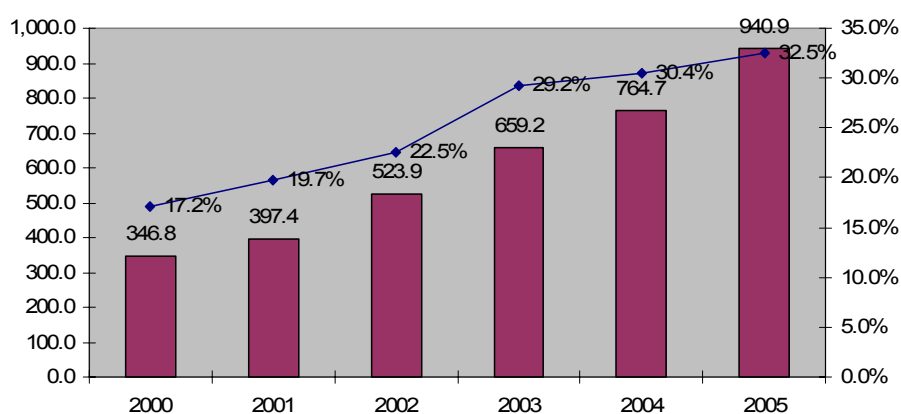
Solutions for Bulgaria

In recent years some indicators of the revenue autonomy of local authorities in Bulgaria show considerable improvements. For example, the part of local revenues of taxes, charges and municipal activities in the total financing of municipalities increased from 17.2 percent in 2003 to 32.5 percent in 2005 (Figure 2). The share of local taxes in these revenues has decreased however by 5 percent since the beginning of the reform in 2003 and in 2005 it was 26 percent (Figure 3). Their share in total tax

revenues of the consolidated budget remains below 2 percent (Figure 4). These indicators show very limited tax autonomy of local authorities. Moreover, local taxes in Bulgaria can only be a nominal measure of the tax autonomy because they do not reflect the local but the central tax policy and administration and are in fact entirely shared taxes.

Figure 2

Own municipal revenues from local taxes, charges and activities 2000-2005
(million BGN and share in the revenue part of municipal budgets)



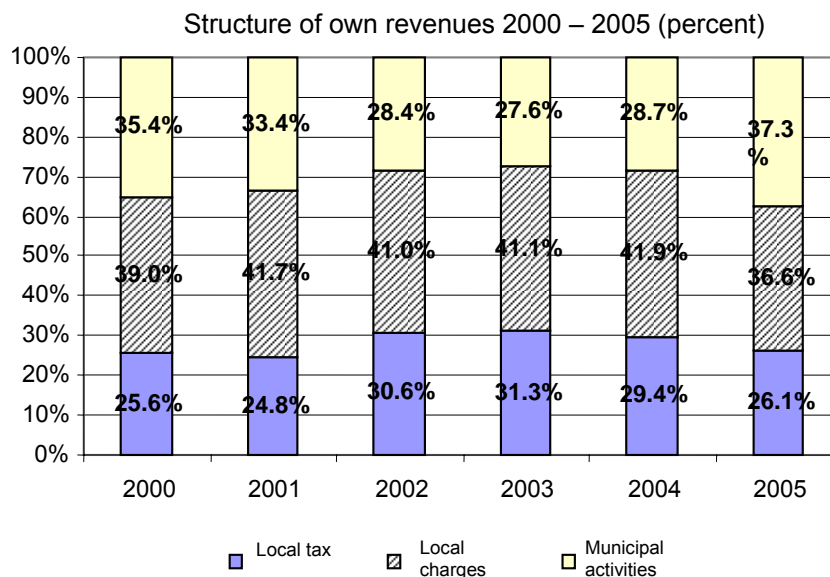
Source. Ministry of Finance.

In this context the increase in the revenue autonomy of local authority in Bulgaria could be found in several directions. The first one is granting legal possibilities to local authority to impose autonomous taxes, i.e. to set the tax rates and bases in order to optimize the local tax system and mobilize its own revenue resources. Second one is the possibility to replace the shared personal income tax with a parallel local tax on personal incomes. Both of them require elimination of some legal restrictions on the local tax independence.

First legal obstacle to the tax autonomy of local administration is a restriction, laid down in the Constitution of Bulgaria, which does not allow local authorities to impose taxes. This leads to a certain legal asymmetry. Municipal expenditure responsibilities can be imposed by a law, whereas the corresponding revenue authority cannot be carried out in accordance with the responsibilities without an amendment in the Constitution. In spite of the seeming public consensus about the necessity of such amendment in the Constitution, it is outside the EU requirements and that is why it remains out of step until now. Besides, its parameters are not clearly outlined. On the one hand, it is necessary the principles of fiscal decentralization (the allocation of expenditure responsibilities and tax authority between central and local governments)

to be fixed in general in the Constitution, so that not to limit the possibilities of the legislative power to drive forward the decentralization. On the other hand, it is necessary to guarantee the authority of the legislative power to define the limits of tax independence of local governments. This could prevent an unitarian country such as Bulgaria from undefined and unlimited local tax autonomy which could cover somewhere taxes on consumption, corporative taxes, health and social insurance through obligatory municipal insurance funds, etc. The centralised setting of the local autonomous taxes would ensure the necessary predictability of the business environment and would prevent the country from a necessity of harmonization of some local taxes and expensive information systems, common inspections and so on in the future.

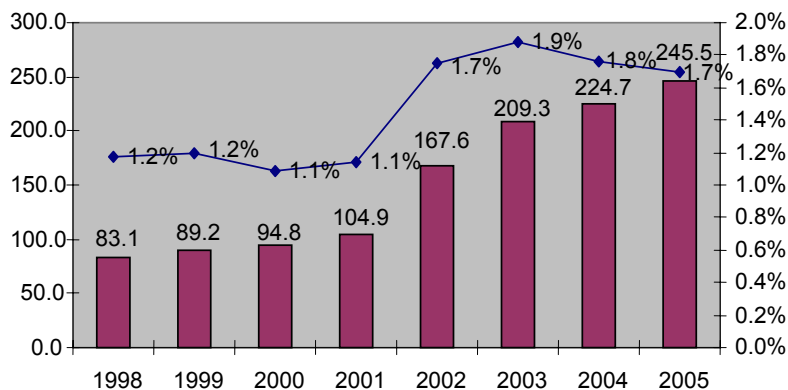
Figure 3



The best option is to fix limits of municipal revenue autonomy in a special law on decentralization. It should specify the concrete allocation of expenditure and revenue responsibilities between the central and local authorities, the principle of leverage and earmarked transfers, as well as the terms for granting them (leverage formula, municipal program budgets, co-financing and other conditions) At present these issues are regulated by the Law on local self-governance, Law on municipal budgets, Law on local taxes and charges, but the specific allocation of responsibilities and funding sources are set annually by the Law on state budget. This places the allocation of expenditure and revenue responsibilities between the central and local authorities on the basis of negotiation in the framework of the annual budget procedure with a very short time horizon (one year) of legislation and planning.

Figure 4

Revenues from local taxes 1998 – 2005
(million BGN and percentage of consolidated tax revenues)

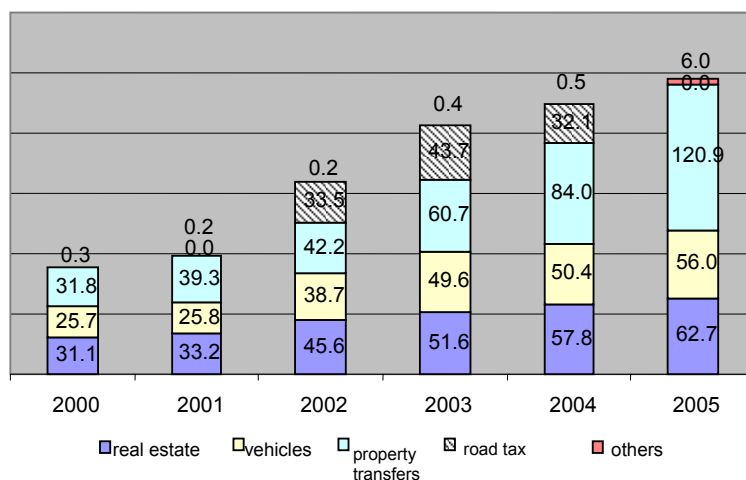


Property Taxes

At present municipalities' own tax revenues come mainly from taxation on property: tax on real estates, tax on vehicles, and tax on transfer of property. The greatest contribution to the growth of local tax revenues has the tax on transfers, which increased about four times in the period 2000 – 2005 (Figure 5).

Figure 5

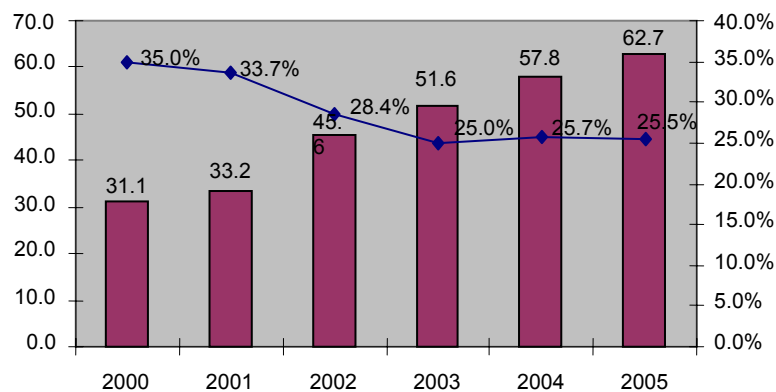
Local taxes revenues by types 2000 – 2005 (million BGN)



Property taxes have increased about twice, but their share in local revenues has dropped considerably from 35 percent in 2000 to 25.5 percent in 2005 even though the road tax was abolished in 2005 (Figure 6).

Figure 6

Revenues from property taxes 2000 – 2005
(million BGN and shares in local tax revenues)



The descending trend is difficult to explain on the background of the construction boom in recent years. In Bulgaria the share of private houses and the value of private real estate are comparatively high. On the one hand, they are a result of the inheritance from the planned economy which purposeful housing policy and limited possibilities for investment and consumption has turned the property ownership into the main objective and measure of individual well-being. The price was either long years of interest-free savings in the big cities, or long years of efforts to build an own house in small settlements. On the other hand, the accumulated individual real estate property during socialism (mainly dwelling) has considerably increased during the years of transition first of all, as a result of restitution and recently, through drastic building expansion in cities. The prices also increased dramatically. As a result, the value of private real estate property increased in times. Practically, in this case there are no possibilities to hide taxes. In this context, the low collection rate of the property tax can be explained by a lack of interest of the central administration in collecting this tax which goes entirely into local budgets. The rates remain low as compared to other counties and tax value of property was not updated until 2006. In fact, there are no efforts to collect overdue property taxes. In contrast to the evasion of other taxes, the evasion of this tax is punished by interest only because Bulgarian criminal law does not pursue non-payment of taxes but only concealing of taxes. The later is impossible regarding the property tax, because the status of ownership and its tax value and liability is determined by the municipality.

Taking into consideration the relatively high share of private housing and the limited possibilities for tax concealing, the local autonomy in defining the rates could

turn the property tax into an essential source of municipal revenues. Furthermore, the municipalities have the advantage in administering property taxes, because they play the main roles according to the Law on territory system – amending of land function, issuing construction licences, etc, which directly influence the tax value of property. Moreover, the benefit principle is met to a great extent in this case, because the evaluation of property depends on the town planning and infrastructure. An indirect indicator for the potential of the real estate market properties is the four time increase in the revenues from taxation on real estate deals.

The local property taxes are not exhausted with the tax on dwellings. An important source of own revenues is also the tax on business real estates. On the one hand, it is closer to taxation on capital and eventual regional differences can affect investment decisions and direct investment flows, i.e. from the point of view of tax base mobility, the business property tax is not among the best local taxes. On the other hand, it is closer to the benefit principle, i.e. the relationship between local conditions and services for the business is closer.

Even greater is the potential of a new tax for Bulgaria – the tax on cultivated land. If the municipalities have the possibility to levy land, they will be interested in speeding the reform on cadastre and the property register; they will be willing even to invest in it, so that they could ensure more revenues from property taxes. Moreover, the land taxation has favourable economic consequences because it would activate the land market and could stimulate more efficient land use. At present, a large number of owners of resituated agricultural land, who live in towns, have no incentive to seek its most efficient use through cultivating, renting or selling the land.

Tax on Rent

An important unused source of own revenues is the tax on rent incomes. It is suitable for local setting and administrating due to the immobility of the tax base and the advantages of local authority in revealing actual circumstances. The restitution and building boom has increased considerably the secondary dwelling and commercial areas on lease. In contrast to business rents, a large part of house rents are not declared and remain outside taxation. Actually their concealing is not so easy because the leasing is made by announcements and through tax obligated brokers, who receive a commission for each executed contract. But under the conditions of tax sharing of personal incomes, the identification of the hidden rent incomes is not among the priorities of the central tax administration.

If there is an appropriate system of additional material incentives for tax officers, the collection of this tax by the local authority can be improved considerably. There are many approaches but we will point out three possibilities:

The first is to strengthen the control and compulsory collection. The documentations and accounting reports of real estate brokers can be used, if they are excluded from the list of patent activities, or receive (which is preferable) stronger incentives (positive as tax concessions or negative as strict penalties) to register in local administration each contract for rent. This approach however requires the most administrative sources. It will decrease mainly the number of cases of undeclared rent contracts, but will increase

registration and declaration of paper rents (partial concealing) which is harder to prove. At the end, in many regions the expenditures for identification of concealed contracts could be more than the collected additional revenues.

It is more efficient to lay down tax incentives for declaration of rents by third parties – in this case tenants. Here the tenant even in case s/he is a natural person gets the possibility to deduct rent costs from his/her taxable income. Thus, s/he has a stimulus to include the full amount of rent in the annual tax declaration together with a copy of the receipts from the lender and the latter could not run the risk to conceal this income. Other thing being equal, this would increase revenues because the rent is transferred from the tenant's tax basis to the lender's base which in most cases means a transfer of lower income and rate on the personal income scale to higher ones. Such local tax however is more suitable for central administrating because personal incomes are declared and collected by the central administration. Moreover, the tenant's and lender's income might be declared in different tax offices.

Of course, this will burden to some extent the central tax administration especially in monitoring the implementation of different local rates but the minimisation of these costs is a matter of software solutions. Meanwhile, such approach means also the submitting of tax declarations by all tenants which already requires additional human resources in the central administration, as well as additional costs for taxpayers.

Comparatively the cheapest and most administrative efficient is the presumption tax on rent. This tax type does not differ considerably from the property tax with only exception being the tax base which is formed not by tax evaluation of the market value of the estate, but by the evaluation of eventual annual rent incomes (so called imputed rent) decreased by agreed normative costs for maintenance and lending and by applying flat income tax. For example, Hong Kong levies personal incomes with 10 percent flat income tax which includes also the imputed rent on owned dwelling.

The tax on property based on imputed rent in Bulgaria could be acceptable mainly in the larger towns where there is a real market for rents and mainly for these estates which are not used as a primary house. That is why, it can be implemented as a local tax only and not as a central one. However, the political opposition against it should not be underestimated. It could affect the lenders in cities, i.e. the favoured by the restitution and new "investors" in real estates and second habitation, as well as building entrepreneurs and banks which in principle have greater influence over tax policy making, than the tenants or promoters of the local tax autonomy. In contrast to the other two approaches, this is the easiest to administer by local authority but relatively harder to be accepted politically. The political opposition could be diminished partially if the presumption local rent tax is combined with tax concessions for these expenditures, i.e. deduction of the local tax from tax base of personal income. The tax concession however would bring some elements of tax sharing, i.e. a tax subsidy from the central to local administration, which would legalize certain claims by central authority to control or determine ceilings of its rates.⁵

⁵ Otherwise the fiscal concessions in the form of tax deductions (deduction of the local tax from the

Patent Tax

The patent tax is a form of presumption taxation on business incomes of small entrepreneurs from certain legally defined business activities. It is a local tax by nature and is known in many countries as a licence tax. It is connected with the labour of self-employed traders and suppliers of professional services and the small business which makes it a tax with limited base mobility. Furthermore, because it taxes not actually realized but potential income on the basis of indirect indicators of profitability, the local authorities have the advantage in its defining and collection because they are best acquainted with local conditions and they could verify the actual circumstances defining the business capacity (for example, commercial area or number of employees). Last but not least, it has strong elements of taxation on the benefit principle, because the small entrepreneurs' incomes are a result to a great extent of infrastructure conditions and public services provided by the local authority.

Initially, the patent tax in Bulgaria was introduced as a local one, but after it has been declared as anti-constitutional it has remained in the central power as a part of Law on income tax of natural persons (in spite of the fact, that the tax is imposed on legal entities). From the very beginning it bears the marks of a somewhat wrong tax. Although the goal of presumption taxation is to reduce costs of tax collection both for taxpayers and the tax administration, the history of Bulgarian patent tax is a long lasting process of amendments and increases in the number and size of rates in order to reach more equitable taxation, i.e. one that more precisely reflects the differences in revenue of the various activities, settlements and production capacities. As a result even though it provides less than 0.5 percent of total tax revenues, the patent tax is the most frequent subject of "legal creativity" – it is discussed, amended and supplemented every year. Moreover, when the municipalities were deprived from this tax, they have introduced similar taxes for categorization of tourist sites and licences for trade activities which in fact duplicate the central patent tax with local licence taxes and increase the burden on small business.

Restoring patent tax to the local authority tax power, where it belongs naturally, could free legislative and administrative resources and could give the local authority an additional source for own revenues. This could be done without amending the Constitution. The taxable firms could be exempt from income tax and the patent tax could be transformed into licence fees which at present duplicate the tax for certain activities at a local level. Furthermore, the main responsibilities for issuing licences for commercial activities and legalizing trade sites, such as construction and sanitation permits and consumer protection regulations lay down on local authority. The licence fee can be enlarged to cover activities not included in the patent tax. It is necessary for the licence fee to be considered as a cost in

central tax base) or the tax credit (deduction of the local tax paid from the tax obligation of the central tax) without limiting the local authorities' discretion would mean possibilities for unlimited "squeezing" of central revenues by local authorities.

calculating the tax base of income, so that it does not lead to increase in the tax burden on small enterprises, which are not patent registered.

If one seeks simplicity and cost minimization in tax implementing, as well as economic incentives for small businesses, the licence local tax is a good solution. However, it is a serious retreat from the principles of justice of taxation because the patent is the same for people with different income levels. Relatively more equitable is the presumption tax based on turnover. Taking into account general obligation for registration of sales in Bulgaria, such solution can be even more administrative efficient, than the annual amendments in the average value of incomes by activities, places and capacity (commercial area) and inspections.⁶

Together with the administration of patent tax the local authorities could accept against some commission certain responsibilities in applying a central tax such as excise duties with relatively low additional administrative costs. These responsibilities can be connected with imposing sanctions in the case of a lack of excise labels in commercial sites. The collected fines and sanctions remain fully at disposal of the local administration even though this is not a local tax and it has no other responsibilities related to it. Information advantages of local administration increase the possibilities to discover violations and have a restrain effect on the sale of alcohol and cigarettes without excise labels, which benefits entirely the central budget. That is why, the central administration should encourage financially such support from the local tax offices. Furthermore, in the case of systematic violations of the Law on excise duties, this should have a consequence for the licence for commercial activities, which is in the of local authority competency.

Parallel Tax on Personal Incomes

The candidates, considered so far, for autonomous local taxes – taxes on real estate property and income from such property, as well as the presumptive taxation of self-employed providers of professional services and the small enterprises, have a limited fiscal capacity and could hardly provide sufficient funds to meet the costs incurred by the local authority. The fiscal potential of the parallel taxation of personal income, i.e. the use of a separate single local rate on the tax base of the government tax and its collection together with the state tax. The advantages of the limited tax autonomy in the form of a local rate consists in the limited mobility of the base in comparison to the other basic taxes with a higher fiscal potential. The advantages of the parallel local income tax to the tax allowance are several: first, it does not lose its fiscal meaning for the central authorities and therefore preserves the stimulus for the central administration to maximize the revenues; second, it is still valid also as a tool for improvement of the vertical equity of taxation, i.e. there is a certain progression in the distribution of the tax burden depending on the paying capacity. What is more, compared to tax allowances, this method increases the responsibility of the local authorities to their constituency with regard to the quantity and quality of the provided public benefits.

⁶ See Pashev, 2006 for details on the advantages and disadvantages of the different types of presumption taxation under the Bulgaria condition

One of the disadvantages of the parallel local taxation of person income in Bulgaria is that the largest share of this tax is levied on the salaries and wages where the advance deduction at source is 100%. Thus the tax is deducted at the workplace but this does not always coincide with the taxpayer's address where s/he consumes most of the public services. This may distance the tax allowance on the person income from the so called principle of benefit tax which is one of its main advantages in the developed countries. The overcoming of this disadvantage requires that the employer pays the taxes by address of residence which would increase business costs and make tax audits more difficult. It would be better if the central administration distributes the collected local tax by taxpayers' address of residence which would mean higher administrative costs and a system for constant updating of the taxpayers' address registration.

In addition to that, in the new market economies, including in Bulgaria, it does not have the relatively high importance to the tax revenues it has for the developed countries. Although higher than the other local taxes, its fiscal capacity is much lower in the countries where it is collected as a local tax. The present system of advance payments by taxpayers, declaring their income, requires that most of the taxes are paid at the year's end. This, however, would lead to irregular tax revenues to the local authorities during the fiscal year with highest revenues in April and May.

To preserve the overall tax burden on the personal income, the central authorities could allow tax credits for the locally paid taxes as it is in the USA. This makes it similar to the tax allowance but the difference is that if the local rates are not limited by the regulatory framework, "the tax allowance" would be determined by the local authorities and the central authorities would not be able to defend their revenues, i.e. in such cases the autonomy of the central tax policy is violated.

As a compromise the local tax liability may be centrally deducted from the personal income tax base and not from the liability but in this case the tax burden may not remain unchanged. The taxpayers should accept the tax burden as the price they have to pay for higher quality public services.

In Bulgaria, the possibility for a comparatively painless introduction of a parallel local tax on the personal income has been facilitated by the considerable reduction of this tax by the central authorities. For example, a flat local income tax of 10% in 2006 under the effective non-taxable income minimum would raise the effective rate of taxable annual income of 5000 BGN by 4.4 percentage points to 16.6%, i.e. it would make it equal to the tax on 5000 BGN for 2004.

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Three types of autonomous taxes are pointed out as the main elements of the municipal tax autonomy in this analysis – tax on the real estate property, tax on the income from real estate property and local patent tax. Due to their limited fiscal capacity it is good also to use one semi-autonomous tax similar to the tax allowance for parallel taxation of personal income where the local authority applies a "flat" rate, determined by the local authority, on the uniform base of the state tax. The two taxes are collected together by the central government and the taxpayer deducts the paid tax from the income taxed by the central authorities.

The international practice shows that even if all of these sources of income give a particular autonomy to the local authority in the sphere of taxation, the income from these sources would hardly be sufficient enough to fund fully the local public benefits and services. Therefore they could not eliminate the need for a balancing transfer which would complement the revenues against the costs (vertical equalizing) and against the capacities of the other local authorities (vertical equalizing). The need for redistribution is even greater in the new market economies due to the lack of balance inherited from the former centrally planned economies which was emphasized even more by the transition to market economy. This continues to predetermine the need for considerable revenue powers of the central authorities. Their main pillars are the tax on consumption (VAT and excise duties) and the taxes on the corporate and on the personal income to a lesser extent. Unlike the developed countries, the relative burden of these taxes in the overall tax revenues in the new market economies is smaller. From an economic point of view this is completely justified as far as the priority of these states should be the growth and the convergence with the developed countries and only after that the redistribution of the national income and the reduction of the social inequality between the regions and the individuals. In other words, poverty should be combated at present mainly with the instruments of the economic policy and afterwards with the instruments of the social policy.

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