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MUNICIPAL BUDGET CAPITAL INVESTMENTS IN BULGARIA IN THE PERIOD 1994 - 2005 – SITUATION, TRENDS AND CHALLENGES

The situation, trends and financing of municipal budget capital investment have been analyzed in the context of municipal finance development in the period 1994-2005. Major conclusions and challenges for the municipal capital investment have been formulated in the light of Bulgaria's membership in the European Union and the need for a new system of municipal capital investment revenues. Recommendations have been formulated based on the analysis of the international experience regarding potential municipal capital investment revenues that could be realized in Bulgarian conditions.

JEL: H72; H77

Municipal budget capital investments are very topical issues nowadays in the light of fiscal decentralization reform and Bulgaria's integration in the European Union.

In the period preceding the fiscal decentralization reform Bulgarian municipalities accumulated serious lag in the construction and maintenance of municipal infrastructure mainly because of the extremely low levels of municipal capital investments. The provision of adequate municipal capital investment revenues is needed to overcome this lag.

The integration of Bulgaria to the European Union also posed serious challenges in regard to municipal capital investments. These challenges are related to the utilization of considerable financial resources that will be provided for capital investment under the Structural and the Cohesion Funds. The utilization of these funds will require the local governments to provide significant amount of own source funds for co-financing of capital investment projects.

The study of the situation, trends and financing of municipal capital investments in the period 1994-2005 provides an answer on the possible directions for developing the system for their financing in order to respond to these challenges. This is a favorable period from a research point of view because it comprises years of financial crisis, as well as years of financial stabilization and completely illustrates the changes in municipal capital investments.

Municipal Capital Investments in the Period 1994 – 2002

The period is characterized by transition to a market economy and decentralization of public services provision. As a result of this, decline in the share of public expenditures in GDP has been monitored. The share of municipal expenditures in the public finance has fluctuated and since 1996 it has stabilized around 17 percent.

Municipal finance in Bulgaria during this period was characterized by the following important features determining the overall context of municipal capital investments development and influencing considerably their situation, dynamics and financing:

- Municipal budget expenditures were determined ad hoc and not based on costing standards and consideration of physical indicators, as local governments in fact managed only about 20 percent of their expenditures.[1]
- The structure of municipal budget revenues was highly unsymmetrical - a considerable share of the central government transfers (about and over 80 percent) and a small share of own source revenues. The dependence on central government transfers was further deteriorated by the lack of stability, fairness and transparency in the allocation of the intergovernmental subsidies.
- Bulgarian municipalities had very small powers regarding their own source revenues. All taxes including the local ones were determined at central level – types, tax basis and tax rates. The local governments had very limited powers for setting the types and the concrete amounts of local fees.
- The local government revenues set by law were lower than the expenditures for provision of the assigned public services. This caused the appearance of structural deficit in the municipal budgets in Bulgaria, practical manifestation of which were the budget arrears.[2]

A number of legal restrictions on municipal capital investments were into force during the period 1994-2002:

Obligation for observing legally determined expenditure priorities, in effect till 2001 and regulated every year by the State Budget Act. Only after covering the priority expenditures (mostly of social nature – wages, social security contributions, etc.) the municipalities were able to spend budget funds for capital investment purposes i.e. the municipal capital investments were done following the “what remains” principle. The legally determined obligatory expenditure priorities were abolished in 2001 as the municipal councils were free to set their own expenditure priorities except for the earmarked funds.

Legal restriction on the amount of municipal capital investments made with own source and borrowed funds, introduced in 1997. Every year the State Budget Act set the amount of a target capital investment subsidy by which the municipalities finance the capital investments on their territories. The municipalities could make additional capital investments over the amount of

[1] Burden of the expenditures for the mandatory services assigned by the central government to the municipalities in Bulgaria. Report of LGI/USAID, 2000, p. 6.

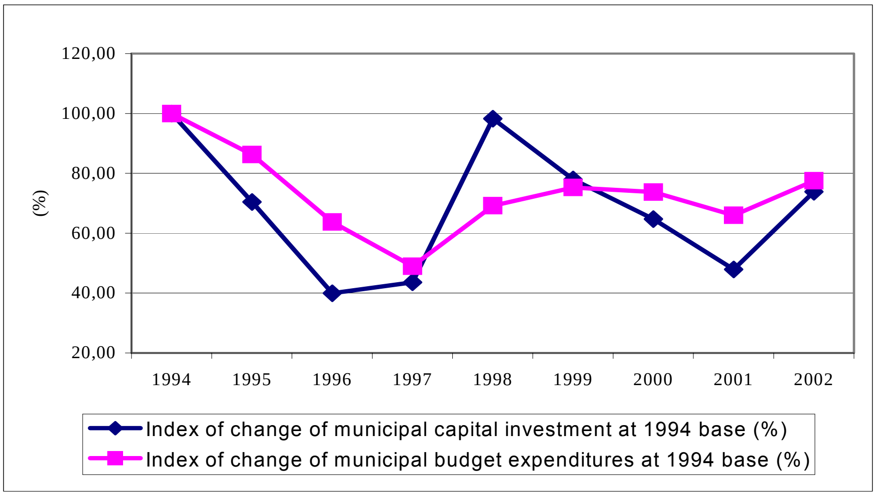
[2] These are actually spent municipal resources, which the municipalities have actually not paid for. They are practically accepted as a real measure of the municipal budget deficit.

that target subsidy. These additional capital investments could be funded by own source and borrowed funds.

Municipal capital investments in Bulgaria during the period under review were characterized by a low share in the total public investments. In 1998 the share of municipal investments in public investments was 32.62 percent, and in 1999 it declined to 19.68 percent. In the same period the share of municipal investments in public investments in the Czech Republic was about 42 percent.[3]

Figure 1

Dynamics of municipal budget expenditures and municipal capital investments in the period 1994-2002 (percent, 1994 =100)



The following features were typical for the dynamics of municipal capital investments during the period 1994-2002:

• The dynamics of municipal capital investments followed the dynamics of total municipal budget expenditures.

• Capital investments are a very sensitive component of the municipal budget expenditures – they are changing at a much higher rate than the rate of the total municipal budget expenditures.

• Two sub-periods are monitored in the dynamics of the municipal capital investment. The first sub-period is 1994-1997 and is characterized by a

[3] The calculations are made based on information from the municipal finance database of the National Association of Municipalities in the Republic of Bulgaria (NAMRB).

continuous decline in the municipal capital investments that ended up in the most crisis year of the transitional period (1997). Fluctuation of municipal capital investments is monitored in the second sub-period - in 1998 they grew to a level close to that of 1994. During the next three years they declined again to reach 74 percent in 2002, the same as in 1994.

During that period the municipalities in Bulgaria had a relatively low share of capital investments in the total budget expenditures (about 8 percent) compared to the other transitional countries in Central and Eastern Europe. The value of this share declines significantly with the exclusion of Sofia from the average value for the country (Table 1). During the same period the value of this indicator in the Czech Republic is about 33 percent, in Hungary – about 18 percent, in Poland – about 22 percent, as in these three countries the values of the indicator remained relatively stable during the years, while they were fluctuating in Bulgaria.

Table 1

Share of capital investments in total municipal budget expenditures (percent)

Years	Average for Bulgaria	Average for Bulgaria (Sofia excluded)
1994	8.98	6.90
1995	7.33	5.47
1996	5.62	3.74
1997	8.00	6.79
1998	12.76	9.88
1999	9.30	5.32
2000	7.87	4.49
2001	6.52	5.77
2002	8.55	8.85

The distribution of capital investments by groups of municipalities in Bulgaria shows high concentration of a large amount of investments in a small number of municipalities. About one third of municipal capital investments in Bulgaria were made in Sofia. In two consecutive years – 1999 and 2000 this share reached over 50 percent. The reason for this is the large amount of revenues from the euro-bond issue that were used for capital investments. The ranking of municipalities in terms of capital investments indicates that in 1994 61 percent of municipal capital investments in the country were made in 30 municipalities. This concentration of municipal capital investments in a small number of municipalities gradually deepened to reach 72 percent in 2001 and 52 percent in 2002.

As it was already pointed above, in the period 1997-2002 the State Budget Act fixed a restriction on the amount of municipal capital investments made by own source and borrowed funds - in 1997, 1998 and 1999 it was 10 percent of the own source revenues, and in 2000 and 2001 – 5 percent of the own source revenues, and in 2002 – 25 percent of the local tax and non-tax revenues. Table 2 presents the percentage of "utilization" of the allowed capital investments in the period 1997-2002 (i.e. to what extent the municipalities managed to make the legally allowed capital investments from own source and borrowed funds).

Table 2

Utilization of the legal restriction on municipal capital investments made with own source and borrowed funds (percent)

	1997	1998	1999	2000	2001	2002
Average for Bulgaria	55.20	83.34	90.51	136.64	68.82	42.25
Average for Bulgaria (Sofia excluded)	60.88	66.49	40.45	24.60	83.70	50.84
Number of municipalities exceeding the limit	30	47	18	11	67	55
Percent from all municipalities in Bulgaria	11.67	17.94	6.87	4.20	25.57	20.91

The results indicate that during the research period the municipalities were generally not able to reach even the allowed by law level of capital investments made by own source revenues and borrowed funds. This illustrates their low capacity for generation of own source revenues and borrowing from the capital market. The municipalities with population up to 10 000 people and 10-20 000 people prevailed among those that exceeded the allowed limit. These are mostly small financially powerful municipalities paying contributions to the central budget, as well as Sofia, which managed to attract a considerable amount of credit resources.

The sources of financing capital investments in the municipal budgets fall in two major groups: *target capital investment subsidies from the central government budget* and *own source and borrowed funds*.

The amount of *target capital investment subsidies* is determined on an annual basis by the State Budget Act. During the period 1994-2002 the overall pool of capital investment subsidies as well as the concrete amount of the subsidy for each municipality was set by the Ministry of Finance on ad hoc basis subjectively and without the application of any criteria. This mode of vertical and horizontal allocation of the subsidy created uncertainty for the local governments because they did not know what amount of funds they would receive each year.

The analysis of data for the period 1994-2002 indicates that the target capital investment subsidies were a major source of investment funds for the municipalities in Bulgaria. After the exclusion of Sofia due to the extremely strong effect of the revenues from the euro-bond issue of 1999, it is evident that the target subsidies formed about and over half of municipal capital investment revenues in Bulgaria. In some years of the research period their share in the local government investments reached over 80 percent (Table 3).

Table 3

Structure of municipal capital investment revenues
in Bulgaria (percent)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Average for Bulgaria									
Target capital investment subsidies	80.24	61.80	51.16	54.67	59.59	43.26	51.45	62.92	71.77
Own source and borrowed funds	19.76	38.20	48.84	45.33	40.41	56.74	48.55	37.08	28.23
Average for Bulgaria (Sofia excluded)									
Target capital investment subsidies	80.98	55.75	43.98	44.19	60.78	59.47	86.68	58.44	70.53
Own source and borrowed funds	19.02	44.25	56.02	55.81	39.22	40.53	13.32	41.56	29.47

The allocation of the target capital investment subsidies formed also inter-municipal disparities, which are illustrated by the per capita revenues from these subsidies in the different municipality groups. The differences were preserved during the entire period 1994-2002. The values of the indicator show that Sofia and the municipalities with population below 10 000 people were favored most by the capital transfers system unlike the municipalities with population 50-100 000 people which were in the most disadvantaged position.

The own source revenues, which the municipalities spend on capital investments, are formed from the difference between the operating revenues (local taxes and fees, revenues from management of municipal property – rents, concessions, etc.) and the operating expenditures for the public services provided by the local governments. The difference between the operating revenues and the operating expenditures of the municipalities is defined as *operating savings*. They can be used by the municipalities for repaying already drawn credits (with operating and investment nature). Only after that, the already *net operating savings* may be used by the local governments to finance their investment expenditures. The net operating savings indicator (as a percentage of the municipal operating revenues) is widely used in the theory and practice as an indicator of the local governments' creditworthiness, i.e. their capacity to invest or repay credits with own funds. The situation of net operating savings of Bulgarian municipalities during the research period is presented in Table 4.

Table 4

Net operating savings of the municipalities in Bulgaria for the period 1996-2002
(percent of operating revenues)

	1996	1997	1998	1999	2000	2001	2002
Average for Bulgaria	-7.39	1.25	-1.08	-11.40	-10.79	-3.48	-3.32
Average for Bulgaria (Sofia excluded)	-10.41	0.80	-3.39	-14.20	-14.07	-10.46	-4.98
Number of municipalities with Net operating savings >0	41	137	86	35	19	51	97
Number of municipalities with Net operating savings =0	0	0	0	1	0	0	0
Number of municipalities with Net operating savings <0	214	120	176	226	243	211	166
Maximum value of the Net operating savings (percent)	47.94 (Chelopech)	47.17 (Radnevo)	27.48 (Suhindol)	49.97 (Georgi Damyanovo)	15.70 (Panagyuriste)	17.41 (Sofia)	28.86 (Beloslav)
Average for Bulgaria (percent)	-48.01 (Kovachevtzi)	-42.60 (Kovachevtzi)	-35.93 (Vratza)	-66.33 (Lovech)	-55.68 (Pernik)	-73.05 (Pernik)	-47.37 (Pernik)

Based on the data from the table a conclusion can be made that the Bulgarian municipalities were not creditworthy during the period 1996-2002. The country average net operating savings had either negative or minimal positive. The values of the indicator become even more unfavorable with the exclusion of Sofia which has a significant influence. This indicates the inability of Bulgarian municipalities during that period to finance capital investments from net savings or to repay long-term credits. The values of the indicator for this period in the Czech Republic were around 40 percent, in Poland and France – 15-22 percent, in Hungary – 2 percent, and in Romania 3-4 percent. Sofia municipality stood out with the highest creditworthiness during the entire research period. During the years the indicator for Sofia shows positive values as in 2001 it was 17.41 percent and was similar to the values of the indicator for other capital cities of transitional countries. Relatively high values of the indicator are monitored in the municipalities paying contributions to the central budget – Devnya, Chelopech, Radnevo, Galabovo, Kozloduy, etc. These are small highly industrialized municipalities with a high revenue basis and lower expenditures for current maintenance of their activities.

Although during the period before the fiscal decentralization reform the municipalities had low creditworthiness, they showed “shy” attempts for credit initiative. If Sofia’s loan from the Japanese Bank for International Co-operation is not considered, then during the period 1998-2002 the municipalities in Bulgaria borrowed about 26 long-term loans for investment purposes amounting to about

BGN 37 million. The relative share of the loans in the total budget revenues of the municipalities borrowing them was rather low – about 3.5 percent. The borrowing process was more active in 1998 – right after the introduction of the currency board when the financial stabilization was tangible. In the next two years the borrowing activity of local governments declined due to their deteriorated financial situation and the growing budget deficit and in 2001 and 2002 it increased insignificantly.

Sofia was the only municipality in Bulgaria that managed to borrow funds from the international credit market with the Eurobond issue in 1999 (50 million Euro) and the loan from the Japanese Bank for International Co-operation (104.03 million US dollars). The loans borrowed by Sofia municipality exceed several times the total amount of credits provided to municipalities in Bulgaria in the period 1998-2002.

The Fiscal Decentralization Reform of 2003

In the beginning of 2003 Bulgaria started the fiscal decentralization reform. The new local finance system is a result of the continuous efforts of all stakeholders. The beginning was laid down with the signing of the Fiscal Decentralization Agreement between the Government of Bulgaria and the National Association of Municipalities in the Republic of Bulgaria (NAMRB) at the end of 2001. A special fiscal decentralization working group was established in 2002, in which all stakeholder ministries, NAMRB, regional associations of municipalities and members of parliament were represented.

The Government adopted a Fiscal Decentralization Concept and Program with specific legislative measures and actions for a period of five years. Amendments were introduced in the Local Taxes and Fees Act, the Local Budgets Act and the Municipal Property Act. A brand new Municipal Debt Act was adopted, which came into force on June 1st,2005.

The most important changes as a result of the fiscal decentralization reform could be summarized as follows:

- The powers and the responsibilities of the central and the local governments regarding the provision of basic public services on a local level were distinguished by dividing them into mandated state services and local option services.
- An entirely new principle for the determination of the expenditures in the mandated state activities was introduced. It is based on costing standards ensuring a basic provision level of the relevant service.
- The overall intergovernmental transfers mechanism was changed, presently guaranteeing the financing of the expenditures for the mandated state activities with revenues from personal incomes tax and general supplementary subsidy and at the same time providing general equalization subsidy for supplementing the own source revenues of the municipalities.
- The municipalities obtained greater powers regarding the local fees – to determine the basis and the rates and provide relieves to certain population groups.

Municipal Capital Investments in 2003-2005

The fiscal decentralization reform brought significant changes in the local finance in Bulgaria, which could be summarized as follows:

- Real increase in municipal expenditures compared to the last year before the reform (28 percent growth of municipal expenditures in 2005 compared to 2002) has been observed.
- Structural changes in the municipal revenues occurred – increase in the share of own source revenues and borrowed funds (42.5 percent in 2005 compared to 23.1 percent in 2002) and decrease in the central government transfer share (57.4 percent in 2005 compared to 76.9 percent in 2002).
- The municipal own source revenues increased at a higher rate compared to their total budget revenues in each of the three years after the start of the reform.
- The inter-municipal disparities in terms of budget revenues per capita were preserved. In the period after the reform Sofia and the municipalities with population up to 10 000 people still demonstrated the highest values of the indicator while the municipalities with population 20-50 000 and 50-100 000 and over 100 000 people had almost equal revenue basis.
- Sustainable decline of municipal arrears was monitored in absolute figures and as a relative share of these arrears in the total municipal budget revenues (respectively BGN 44.9 million and 1.6 percent in 2002 compared to BGN 97.1 million and 4.2 percent in 2002).

The analysis of the structure of municipal own source revenues and the dynamics of their components in the period after the reform has revealed some disturbing symptoms, which could be summarized as follows:

The main component of the own source revenues – the local fees (with relative share of about 1/3) slowed up its growth rate (from an annual average rate of 20 percent in 2003 and 2004 to 5 percent in 2005). This is a signal that their potential starts to get exhausted because some of them have reached a degree that covers the full costs for the provision of the relevant services and these fees cannot be increased any more.

The local tax revenues have preserved a level slightly over the one before the reform due to the legal restrictions on the local governments to have influence on them.

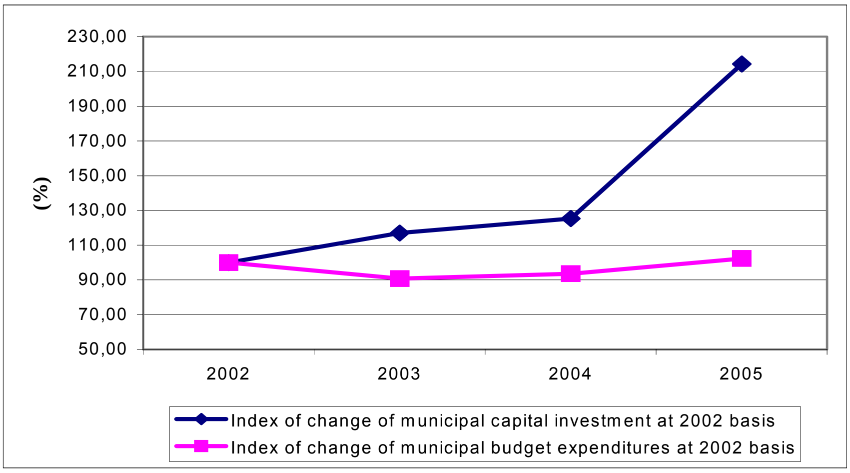
The rapid development of the municipal own source revenues in the period 2003-2005 is due mainly to the component of other local non-tax revenues – revenues from rents and sales of municipal property, etc. A significant part of these revenues have one-time nature and they are not recurring in time. This indicates that under the new conditions the municipalities prefer to sell property and raise the rents of municipal property instead of imposing higher fee rates and thus incur the discontent of the local population.

After the start of the reform the municipalities enjoy much greater legal freedom regarding their investment activity. The legally determined prioritization of municipal expenditures has been abolished, as well as the restriction on the amount of capital investments that can be made with own source and borrowed funds.

The analysis of the dynamics of municipal capital investments in the period 2003-2005 indicates that unlike the pre-reform period when they showed certain fluctuations, now they demonstrate sustainable growth (in 2005 they have increased by 2.14 times compared to 2002). The development of municipal capital investments in the period 2003-2005 proves once again the thesis that they are a very sensitive component of the municipal budgets (Figure 2).

Figure 2

Dynamics of municipal budget expenditures and municipal capital investments in the period 2002-2005 г. (percent, 2002=100)



The study of the dynamics of municipal investment revenues indicates that this growth of investments in the period after the start of the reform is mainly due to the growth of own source revenues and borrowed funds (in 2005 these have increased about 5 times compared to 2002), because the capital investment subsidy has stabilized at a level that is slightly below the one from the pre-reform period (Table 5).

The increased capital investment level has brought an increase in the relative share of capital investments in municipal budget expenditures. During the three years after the start of the reform the average values of the indicator for the country exceeded those from the years before the reform. In 2005 the share of capital investments in the total municipal budget expenditures reached 17.9 percent, i.e. this is commensurate with the values for the Czech Republic, Poland and Hungary, etc.

The concentration of a large amount of capital investments in a small number of municipalities has been preserved after the reform - in 2005 59.5 percent of all investments have been done in 30 out of total 264 municipalities in the country. The difference between the municipality with the highest level of capital investments per capita and the one with the lowest such level is 130 times.

The analysis of the structure of municipal capital investment revenues in the period 2003-2005 indicates changes in the ratio of certain components. Compared to 2002 when the target capital investment subsidies and the borrowed funds were in the ratio of 72:28 percent, in 2005 this ratio was absolutely the opposite (Table 5).

Table 5

Dynamics and structure of components of municipal capital investment revenues in Bulgaria for the period 2002-2005

	Dynamics (percent, 2002 =100)				Structure (percent)			
	2002	2003	2004	2005	2002	2003	2004	2005
Capital investments	100.00	117.09	125.33	214.32	100.00	100.00	100.00	100.00
Target capital investment subsidy	100.00	78.77	79.37	81.25	71.77	48.3	45.4	27.2
Own source and borrowed funds	100.00	214.48	242.17	552.54	28.23	51.7	54.6	72.8

Note. The consumer price index published by the National Statistical Institute in 2002 basis has been used for deflator.

The target capital investment subsidy is used to finance capital investments in the mandated state activities as well as in the local option activities as the allocation is done by a municipal council decision. The average for the country distribution ratio of the target capital investment subsidy is 80:20 percent in favor of the local option services. The analysis of the system of capital transfers for the municipalities indicates that it has remained relatively unchanged compared to the period before 2003. The structure of the target capital investment subsidy has been preserved. The amount of the overall pool for all municipalities in the country continues to be determined on ad hoc basis. Certain positive development has been observed with the introduction of criteria for allocation of the overall pool of capital investment subsidy among the municipalities. The introduced costing standards for the mandated state services include only operating expenditures – wages, social and health insurance contributions and maintenance however they do not include capital investment component. The capital transfers system has become very fragmented – besides the target capital investment subsidy provided by the Ministry of Finance such transfers are also granted by other ministries, for example, the Ministry of Education and Science and the Ministry of Regional Development and Public Works. The most important problem connected with this fragmentation is that there is a lack of consistency and relationship among the capital transfers allocated by the various ministries.

Relative improvement in the values of the net operating savings has been monitored in the period after the reform (Table 6). Nevertheless these values are low in the light of the considerable growth of the own source revenues already discussed. The main reason for this is that the revenues from sales of fixed assets have an investment nature and are not included in the operating revenues that are used for the calculation of the indicator. However, at the same time they are part of the municipal own source revenues.

Table 6

Net operating savings of the municipalities in Bulgaria in 2002 and 2005 (percent of operating revenues)

	2002	2005
Average for Bulgaria	-3.32	0.17
Average for Bulgaria (Sofia excluded)	-4.98	0.68
Number of municipalities with Net operating savings >0	97	148
Number of municipalities with Net operating savings =0	0	0
Number of municipalities with Net operating savings <0	166	116
Maximum value of the Net operating savings (percent)	28.86 (Beloslav)	46.00 (Byala-Varna region)
Minimum value of the Net operating savings (percent)	-47.37 (Pernik)	-104.96 (Svoge)

Compared to the low municipal credit activity in the period before 2003 the local governments became much more active in the search of credit resources for capital investment after the reform. Eighteen municipalities borrowed long-term capital investment credits amounting to about BGN 53 million in 2005 Unlike the period before 2003 when usually large municipalities used credit resources, in 2005 smaller municipalities also ventured (Levski, Lubimetz, etc.). The municipalities that borrowed funds vary in terms of own source revenues per capita. There are municipalities with above the country average per capita own source revenues (Veliko Turnovo, Bourgas, Devnya), as well as municipalities with a lower revenue basis (Rodopi, Gorna Oryahovitza, Assenovgrad). Eight municipalities issued bonds amounting to BGN 36 million for the period 2003-2005. These are large- and medium-sized municipalities – Sliven, Dupnitza, Dobrich, Varna, Shumen, Svilengrad, Popovo and Stara Zagora. The funds raised with municipal bond issues were used mostly for improvement and development of the technical infrastructure of the municipalities – reconstruction of roads and streets, construction of new streets, construction of water supply and sewerage systems, equipment of schools and kindergartens, etc. A guarantee mechanism was established at the end of September 2005 between the United States Agency for International Development and HVB Bank Biochim within an eight-year agreement. This is a new development on the municipal credit market in Bulgaria aiming at supporting the access of small municipalities to the capital market by reducing the costs for the credits.

The Municipal Capital Investment – Challenges and Possible Solutions in the Light of New European Realities

The fiscal decentralization reform created real conditions for the increase of municipal capital investment with the clear sharing out of powers related to the provision of public services. Nevertheless, Bulgarian municipalities accumulated significant lag in the maintenance and construction of their infrastructure as a result of the continuous low capital investment levels. Meanwhile, the membership of Bulgaria in the European Union reveals new opportunities for the municipalities to attract investment resources. However, the mechanism for financing capital investment projects under the Structural and the Cohesion Funds requires co-financing on behalf of municipalities. According to some expert evaluations Bulgarian municipalities may be asked to provide about BGN 250-300 million per year for co-financing. This is around the actual amount of all municipal capital investments in the country in 2004. (BGN 267.2 million.), and about 62 percent of their amount in 2005 (BGN 482.5 million). Therefore they will have to provide new additional funds amounting to the presently spent funds in order to be able fully to participate in the EU programs.

Thus, Bulgaria is presently facing two major advantages related to municipal capital investments:

- How to provide adequate capital investment levels for the municipalities in order to overcome the accumulated lag in the maintenance and construction of municipal infrastructure;
- How to utilize the enormous financial assistance that would be granted by the European Union under the Structural and the Cohesion Funds and which would require significant own source revenues for co-financing from the local governments.

These challenges put ahead the need for a brand new system of municipal capital investment revenue sources because the present ones cannot provide sufficient revenues so that Bulgarian municipalities to be able to respond to the two challenges.

The *capital transfers' system* should be reformed in two major directions:

- Legislative regulation of the total pool and the allocation mode for the capital investment transfers provided to the municipalities by the central government.
- Legislative regulation of the total pool of the target capital investment subsidy and development of a new allocation mechanism.

The first major step for reforming the capital transfers system for the municipalities is to consolidate in one pool the target capital investment subsidy provided by the Ministry of Finance and the capital subsidies provided by the other sector ministries, i.e. the capital transfers should be treated as one identical system and not as a sum of capital programs. The uniting of transfers in one overall pool will enable their allocation according to uniform and consistent criteria and will lead to more efficient utilization of the funds.

The next step following the setting of the overall pool of funds for capital transfers, is the allocation of this pool among the municipalities. Different approaches are possible as for example all municipalities to receive a certain amount of capital subsidy no matter of their financial status. Another possibility is the state to ensure a basic level of investment in all municipalities by incorporating a capital investment component in the costing standards for the mandated services and at the same time to reallocate the remaining part of the capital transfers pool to municipalities with low revenue basis. The well-to-do municipalities should rely to revenues from own sources and borrowed funds.

The second major problem that could be resolved with a new municipal investment system is the issue about the increase of the local revenue basis.

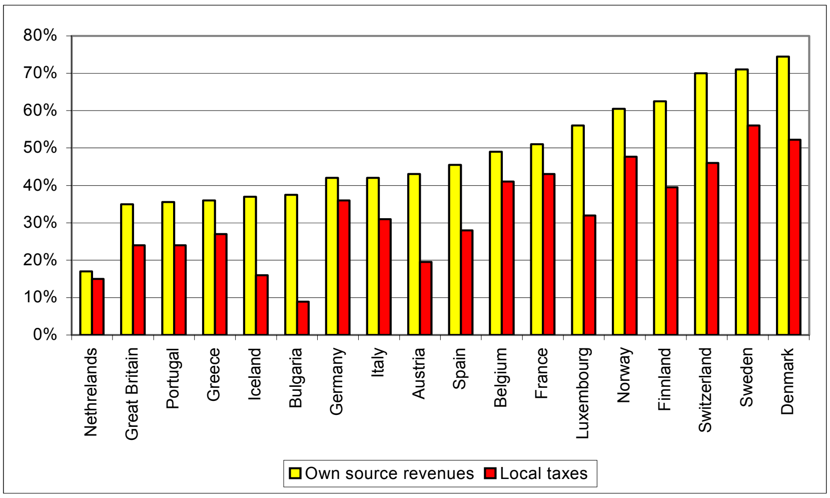
During the period 2003-2005 the *own source revenues* of the municipalities increased considerably compared to the level before the fiscal decentralization reform as their growth rate was higher than the growth rate of the total municipal budget revenues. Despite this positive development there are several problems that may restrict their growth in the next years and will respectively influence the level of municipal capital investment revenues. These problems could be summarized as follows:

- Exhausting the local fees' potential to generate additional revenues. Part of the fees have reached a level that covers the full costs for the provision of the relevant services and they may not be further raised and at the same time the municipalities do not have authorities to introduce new types of local fees.
- The municipalities do not have authorities regarding the local tax revenues. Some of the success stories of the reform are related to the assignment of the local tax collection authorities to the municipalities as well as the planning of these revenues. However, the municipalities still do not have authorities to set the local tax rates and the local tax basis, to decide on the cases of local tax relieves as well as to introduce new types of local taxes.
- The considerable growth of the municipal own source revenues in the recent years is mainly due to the group of the other non-tax revenues. With the exception of the revenues from rents, the other components of this group (mainly sales of municipal property) have one-time nature and do not ensure sustainable and recurring revenues.

The large share of the own source revenues in the municipal budgets is one of the characteristic features of local finance in West Europe (see Figure 3). However, despite its relatively “normal” level of own source revenues, Bulgaria demonstrates an extremely low share of *local tax revenues*, which are determinant for the revenue base's structure of the West European local governments.

Figure 3

Share of own source revenues and local tax revenues in the total municipal budget revenues in selected European countries



Source: Council of Europe. The Financial Resources of Local Authorities in Relation to Their Responsibilities, May 1998. The Bulgaria data are for 2005.

Therefore the changes in the own revenue basis of the municipalities should start with changes in the local tax powers which is associated with changes in the present Constitution of the Republic of Bulgaria. These changes should also comply with the EU practice. The following local government authorities are known in this relation:

• *Setting of local tax types*. This is the "extreme" form of local tax authorities. *Setting of the local tax basis*. This is a lower level of local tax establishment. In the West European countries this goes "hand in hand" with the authorities to set the local tax rates. The local governments in Bulgaria presently have limited authorities to form the basis for the property tax. It depends on the categorization of each municipality and the local governments determine the zones, which the particular settlements in the municipality belong to.

• *Setting of the local tax rate*. This is the most frequently encountered authority of the local governments and provides enough possibilities of the municipalities to influence the amount of their revenues. It may be exercised by itself or along with the power to determine the local tax basis. An OECD survey[4] indicates that from 12 West European countries (Austria, Belgium, Denmark, Finland, Germany, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland

[4] National conference on local tax legislation, Sofia, June 30th 2000, National Association of Municipalities in the Republic of Bulgaria.

and England) in 10 countries the municipalities set either only the tax basis or both the tax rate and the tax basis for over 80 percent of the tax revenues. Sweden, Finland and Denmark independently determine the largest part of their local taxes compared to the other West European countries as their powers concern only setting the tax rates. Meanwhile Portugal and Spain have the largest share of their tax revenues for which they can set the tax basis, as well as the tax rate – respectively 49 and 33 percent.

- *Administration of local taxes*. This authority includes the organization for the collection of local taxes by the municipalities, which is typical for most West European countries.
- *Reduction or exemption of certain population groups from the payment of local taxes*. This is within the powers of local governments enabling them to conduct local social policy. It is a matter of their choice whether to benefit from this or not, developing at the same time a local social support system for the people in need.

Bulgaria has achieved the greatest progress in the administration of local taxes. In the beginning of 2006 the collection of local taxes was assigned as a responsibility to the municipalities. Considering the fact that they have only one year of experience with the exercising of local tax powers, it is most suitable for the changes in Bulgaria to start with the setting of the local tax rates. As a beginning the legislation may impose an upper and lower limit within which the municipalities may set the rates and later on these limits may be abolished. Another option is to start with setting local tax rates without any legislative limits.

Besides the changes in the local tax powers other possible changes may be implemented in the field of *local fees*. One of the great successes of the fiscal decentralization reform was the assignment of full powers to the municipalities to determine without any restrictions the rates and the basis of the local fees as well as the exemption of certain population groups. This resulted in considerable increase of the revenues from local fees and at the same time the municipalities used carefully the assigned authorities. The municipalities in Bulgaria presently do not have any authorities for the introduction of new local fees. When the consumers show a demand for certain service, the municipalities provide this service by using the so called prices of services. The revenues from these prices have grown significantly during the recent years particularly in the large municipalities. If the municipalities are assigned the powers to introduce new types of local fees this may solve the problem. Meanwhile, it could be a test for the assignment of such authorities for the local taxes.

However, the provision of local tax authorities to the municipalities, as well as authorities for the introduction of new types of local fees will lead to limited growth of municipal own source revenues. The highest relative growth of municipal own source revenues might be achieved mostly through the introduction of *new types of local taxes*. Besides the four types of local taxes applied in Bulgaria, there are other types known worldwide, as for example:

Tax on agricultural land (land tax, tax on uncovered real estate). The introduction of such tax has been discussed for a long time but it has been postponed due to various reasons. However, the integration of Bulgaria in the EU will put this issue again on the agenda. Some preliminary estimates show that the revenues from this tax would reach about one percent of all municipal revenues. The advantages of this tax are that it is very easy to be administered and the revenues from it will go mainly to small and rural municipalities, as well as to those with low revenue basis. Thus, it may balance the revenues from eventual local corporate tax as a potential revenue source and reduce the eventual differences between the municipalities in terms of their tax revenues.

The introduction of *local corporate tax* is another opportunity. Before the fiscal decentralization reform the municipalities received part of the corporate income tax, however, presently it goes entirely to the central government budget. Presently there are two opportunities for the local governments to tax the business. The first one is the existing patent tax to become a local tax and the municipalities to be empowered for setting its amount as the revenues from it go entirely to the local budgets. The second opportunity is connected with the abolition of the patent tax and the introduction of a new local corporate tax. This however should be associated with reduction of the corporate tax rates so that the tax burden for the business is not raised. This tax would significantly increase the revenues of the municipalities but it would lead to greater inter-municipal disparities in the revenues because the large and highly developed municipalities would benefit from it. This is also confirmed by the local budget data for the year 2002. Then the revenues per capita from corporate tax (corporate tax that entered the local budgets) of Gurmen (the municipality with the lowest value) were 0.20 percent of those for Devnya (the municipality with the highest value of the indicator).

The introduction of *supplementing rates on the personal incomes tax* is also a possible new local tax revenue source. For this purpose the municipalities impose supplementing rates on the state rate and the revenues generated from these supplements enter the local budgets. This is practiced in a number of Scandinavian countries while in Bulgaria it was the practice during the Ottoman domination. Unlike the land tax and the local corporate tax, this tax has the greatest potential for growth, meanwhile creating relatively small inter-municipal disparities compared to the corporate tax. For example, in 2002 the revenues from personal incomes tax per capita (at that time it was shared in ratio of 50 percent: 50 percent between the state and the municipalities) of Valchedrum (the municipality with the lowest value) were 1.87 percent of the one for Kameno (the municipality with the highest indicator). Like in the case of the local corporate tax the eventual introduction of a new municipal revenue from supplementing rates should not lead to increase in the overall tax burden of the personal incomes tax for the population. The introduction of an upper limit for the supplementing rates may be an opportunity for preventing the taxpayers from an excessive tax burden.

The incomes taxes and the corporate taxes have the largest share in the tax revenues at local level in the West European countries. In some countries they may reach up to 80 percent of the total amount of local tax revenues (Denmark, Finland, Luxembourg, Norway and Sweden). Because these types of taxes are based on incomes that may increase progressively they are thus more flexible in comparison to the property tax and often the revenues from them exceed the revenues from the property tax. Despite its relative inflexibility, the property tax continues to be an important local revenue source.

The adoption of a new Municipal Debt Act in the middle of 2005 is a positive development for the use of *credit resources* by the local governments. Despite the indisputable importance of this Act for the regulation of the general environment and the putting of distinct framework for the operation of municipal crediting, the actual "drivers" for the increased use of borrowed funds by the local governments in Bulgaria are their increased own source revenues. Thus, the use of more borrowed funds as a source of investment funds should be sought in the direction of increasing their own source revenues. Options for ensuring of growing own source revenues with sustainable nature (local taxes and fees), as presented above, will lead to an increase in the municipal operating revenues over their operating expenditures and thus, the local creditworthiness will increase.

If in the future the state ensures increase of municipal own source revenues by assigning more local tax powers to the local governments and introducing new types of revenue sources, then the municipalities with a high revenue base will be able to attract credit resources because they will have sustainable and foreseeable funds for repayment, while the municipalities with a lower revenue basis will rely on the state support within the capital transfers system. If there are enough creditworthy municipalities, the market itself will determine the amount of credit resources for the local governments depending on the demand and the supply. The establishment of institutions like municipal development funds through which the state supports the municipal credit market is typical for the very early stage of development of the local finance system of a country (Czech Republic, Columbia, etc.), which does not correspond to the present stage of the reforms in Bulgaria. Besides, many of these funds cannot manage to go out of the state's shadow and become competitive financial intermediaries.

It is a matter of political choice which of the proposed elements of the new system of municipal capital investment revenues to become reality. Constitutional changes are needed for some of them, which requires broad public consensus.

The implementation of a new system of municipal capital investment revenues in Bulgaria will lead to a direct increase in the level of municipal capital investment, as well as to a number of other positive effects related to the increase of local governments' autonomy and their capacity for independent decision-making and consideration of local comminutes' demands. Inevitably, this will increase the amount and quality of public services for the population and the general prosperity of the municipalities themselves.

10.IV.2007