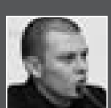
Elusive Road to Fiscal Decentralization in Bulgaria



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Fiscal decentralization is often viewed as a niche issue that mostly concerns administrative and regional development policies. However, it has broader social and economic implications, which are often overlooked, especially in countries with a heavily centralized government structure such as Bulgaria. For decades Bulgarian municipalities have been struggling to carry out their democratic mandate – to observe, identify, and resolve issues of importance to the local community, hindered by an evident lack of own resources.

> FOR DECADES BULGARIAN MUNICIPALITIES HAVE BEEN STRUGGLING TO CARRY OUT THEIR DEMOCRATIC MANDATE

THE STATE OF LOCAL FINANCES IN BULGARIA

While Bulgarian governments have a clear long-term commitment to pursue fiscal decentralization (as stated in the 2004-2015 and the 2016-2025 Decentralization Strategy[1]), the last meaningful changes in this regard were undertaken more than a decade ago. In 2007, Bulgarian municipalities were given the right to set (within pre-defined limits) and collect a wide array of taxes, mostly related to movable and immovable property.

The period that followed has shown clearly that this step – while important at the time – has failed to lead to significant changes in the structure of municipal budgets. The additional tax powers that local governments received in 2007 have failed to produce the desired impact as the revenue of local governments (as % of GDP) has increased modestly – from 6.3% in 2007 to 7.3% in 2017.

This share is more than two times lower than both the EU average (15.7%) and the euro area average (15.3%)[2]. In fact, there are only 8 countries in which this share is lower than the one in Bulgaria. Among those are heavily centralized countries such as Greece, as well as countries that are significantly smaller both in terms of their population, as well as their territory (Luxembourg, Cyprus, and Malta).

With very few notable exceptions[3], Bulgarian municipalities remain[4] highly dependent on transfers from the central government, which has created conditions in which political favoritism has thrived. Examples of the latter are numerous, but none are more telling than the so-called Regional Development Fund of the PM Oresharski's government back in 2014. Under its operation, municipalities were invited to submit proposals for local projects that would be funded by the government. The results of this otherwise "transparent and project-based" approach were striking – municipalities,

[1] The Decentralization Strategy 2016-2025. Available [online]: http://www.strategy.bg/StrategicDocuments/View.aspx?lang=bg-BG&Id=1155 (in Bulgarian).

[2] The cited figures include the revenue of both local and state governments (where such exist).

[3] These exceptions include the capitol city of Sofia, as well as several resort municipalities, and municipalities with large concession deals.

[4] The other countries with lower local government revenue to GDP are Slovakia, Hungary, Portugal, and Ireland.

PROS AND CONS OF FISCAL DECENTRALIZATION

A recent IMF study[1] shows that fiscal decentralization can lead to improved fiscal discipline, resulting in lower deficits and indebtedness, as well as more efficient and transparent allocation of public funds. In line with the principles of local governance and subsidiarity, local governments have an informational advantage[2] when it comes to determining local priorities, which can help them achieve higher effectiveness of public expenditures.

Makreshanska and Petrevski (2016) argue[3] that fiscal decentralization creates conditions that encourage the implementation of innovative, resource-saving approaches to the provision of local administrative services, which suppress corruption practices and support the fiscal position by leading to higher expenditure efficiency and higher economic growth.

In theory, even factors such as the geographic proximity of those who pay the money and those who spend it influence the way in which the expenditure process is facilitated. In contrast, high dependence on common resources (such as transfers from the central government) can lead to low stimuli for combating tax avoidance at the local level and a lack of clear political responsibility, which spurs deficit spending. When both local governments and their constituencies are aware that they are spending someone else's money, political and fiscal accountability issues are easier to overlook.

Most arguments against fiscal decentralization are based on the principle of achieving economies of scale, which are indeed easier to accomplish at the national level. In addition, some models of fiscal decentralization are rightly criticized for resulting in unnecessary multiplication of administrative bodies and procedures, or for creating more opportunities for lobbyist and rent-seeking practices at the local level.

[1] Sow, M. and I.Razafimahefa (2017) *Fiscal Decentralization and Fiscal Policy Performance.* IMF Working Paper WP/17/64.

[2] See Oplotnik, Ž. And M. Finžgar (2013) "EU Member States and Fiscal Decentralization – Empirical Comparison", [in:] *Innovative Issues and Approaches in Social Sciences*, Vol. 6, No. 3, pp. 39-68.

[3] Makreshanska, S. and G. Petrevski (2016) *Fiscal Decentralization and Government Size across Europe.* MPRA Paper No. 82472.

controlled by the then ruling coalition[5] were awarded several times more per capita funds in comparison to municipalities controlled by the opposition.

The lack of sufficient own revenues has led to increasing debts among Bulgarian municipalities, not least due to their efforts to provide co-financing for EU projects. The latter have gradually become the only go-to option for realizing much needed (in some cases) capital investment, but their operation has exposed the seriousness of the issue with the own revenues of municipalities, as many of them have struggled to repay the loans that they have taken out in order to cover their share of the expenditures.

In late 2014, this issue led to some calls for government to fulfill its strategic engagement and provide municipalities with a new revenue stream – and in particular, to give them the right to a share of income taxes. Regrettably, the discussion was quickly turned on its head in two decisive moves by the central government.

[5] The ruling coalition at the time consisted of the Bulgarian Socialist Party (BSP) and the Movement for Rights and Freedoms (MRF).

> LOCAL GOVERNMENTS HAVE AN INFORMATIONAL ADVANTAGE WHEN IT COMES TO DETERMINING LOCAL PRIORITIES, WHICH CAN HELP THEM ACHIEVE HIGHER EFFECTIVENESS OF PUBLIC EXPENDITURES

First, it was proposed that instead of getting a share of the flat 10% income tax already collected, municipalities get the right to set up to 2% additional income tax rate on top of the existing rate. This proposal was loudly rejected by municipalities, but for the wrong reasons – local elections were just around the corner and no one wanted to be seen as supporting higher tax rates. The debate was then shifted, and the central issue was no longer the insufficient own resources of municipalities, but rather – their lack of fiscal responsibility.

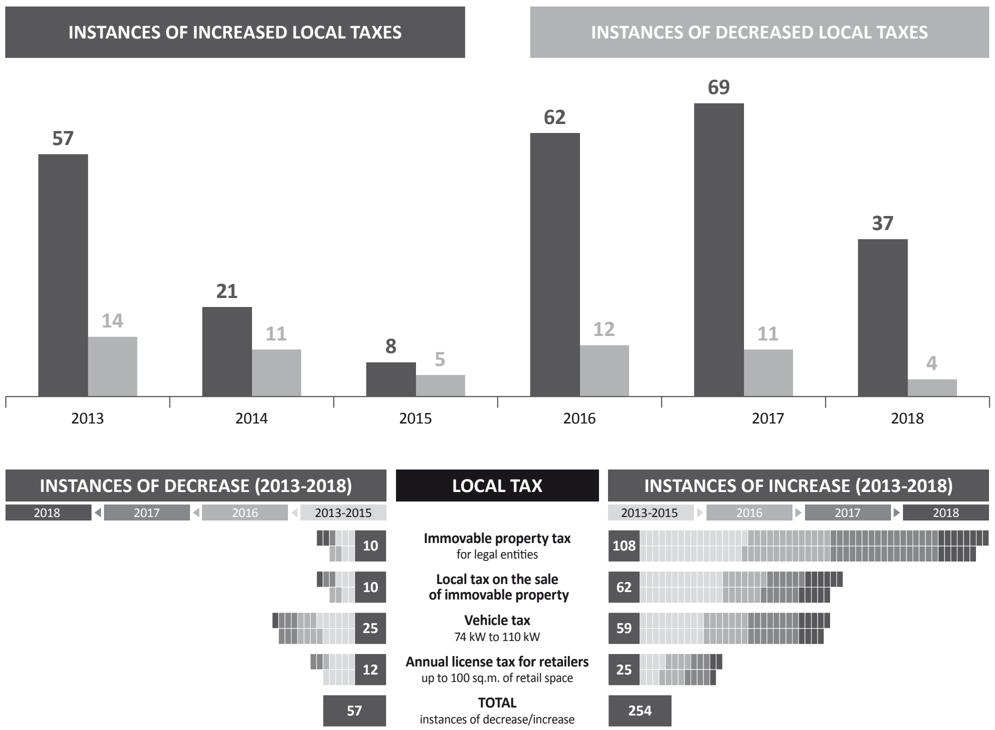
It was evident that the central government had no desire to relinquish a larger part of the fiscal pie to municipalities. Furthermore, if the then proposed approach to fiscal decentralization had been adopted, the negative outcomes would have probably outweighed any positives stemming from the increased revenue flow of local governments. In particular, this approach would have led to:

- loss of international competitiveness due to an overall increase in the tax burden of local businesses;
- limited capacity for further decentralization due to the precedent that would have been set – namely that decentralization is carried out not at the expense of central government revenues, but on top of the already existing tax burden;
- a more insignificant shift in the structure of public finances than would have been achieved if decentralization was carried out through sharing already established revenue streams;

In the wake of this discussion, a dedicated mechanism for support of municipalities with financial difficulties was established. As

> BULGARIAN MUNICIPALITIES REMAIN HIGHLY DEPENDENT ON TRANSFERS FROM THE CENTRAL GOVERNMENT, WHICH HAS CREATED CONDITIONS IN WHICH POLITICAL FAVORITISM HAS THRIVED

Figure 1: Instances of local tax increases and decreases (2013-2018)



Source: IME, based on requests for access to information under the Access to Public Information Act (APIA)

part of its operation, municipalities that do not meet a certain number of fiscal criteria are being put under financial supervision by the Ministry of Finance and are asked to put forward financial stabilization plans in order to receive interest-free loans from the central government, which can even be revoked under certain conditions.

It is no surprise that this instrument, which has arguably put certain municipalities under even stronger dependence from the central government, sparked a previously unseen race for rising taxes – in some cases as a reactive step for meeting requirements and receiving financial support from the government, and in others – as a pre-emptive step away from the scope of the mechanism.

IME has followed this trend closely, as we sent out 1,590 requests for information under the Access to Public Information Act (APIA) in the period between 2013 and 2018, which has allowed us to identify 254 separate cases in which a key local tax has been increased and just 57 cases in which a tax was decreased [See Figure 1]. Since there are many different forms of local taxation[6], we have concentrated our efforts on four of the local taxes that bear the highest fiscal importance for municipalities, while also being related to the local business environment and living conditions.

[6] For instance, while most passenger vehicles fall into the 74-110 kW bracket, there are separate tax rates for vehicles that fall in other ranges. The same is true for the annual license tax for retailers, which can vary depending on the village, town, city and even location within a given municipality.

STARVED FOR CASH MUNICIPALITIES VIEW IMMOVABLE PROPERTY TAXATION AS THEIR MAIN SOURCE OF ADDITIONAL REVENUE

These are the annual immovable property tax for legal entities, the tax on the sale of immovable property, the annual vehicle tax, and the annual license tax for retailers.

As can be clearly seen in Figure 1, instances of tax increases reached 62 in 2016 and a record of 69 in 2017. It is, indeed, no coincidence that these are the two fiscal years that follow the introduction of the stabilization mechanism, nor is it surprising that the general trend has continued in 2018, with the latter being the year with fewest local tax reductions so far. It is evident that starved for cash municipalities view immovable property taxation as their main source of additional revenue – the annual immovable property tax and the sales tax on immovable property have been both the most frequently increased and the least frequently decreased local taxes in the observed period. None of these tax hikes, however, address the underlying issue of the structure of municipal budgets and their dependence on the central government.

THE ALTERNATIVE: FISCAL DECENTRALIZATION

IME has developed a number of recommendations in light of the deteriorating state of Bulgarian municipal finances and the increasing concerns regarding the vitality of local democracies and the capability of local governments to carry out policies in support of the economic and social development of Bulgarian regions.

SHARING PART OF THE INCOME TAX REVENUES WITH MUNICIPALITIES IS THE EASIEST, MOST STRAIGHTFORWARD, AND ECONOMICALLY VIABLE APPROACH TO FISCAL DECENTRALIZATION IN BULGARIA

The proposals are the result of a nearly decade-long work in the field of local finances and regional development, as well as of a six-year effort to monitor and evaluate local tax systems:

- **Sharing part of the income tax revenues with municipalities** is the easiest, most straightforward, and economically viable approach to fiscal decentralization in Bulgaria. While other models do exist[7], most of them create incentives for tax arbitrage and creative accounting and are much harder to administer.

[7] Most notably corporate taxes, but also in some cases taxes on turnover.

- **Income tax revenues** would continue to be collected and administered by the National Revenue Agency (NRA), but tax proceeds would be transferred back to municipalities depending on the permanent residence of the taxpayer (the so-called "money follows the ID" approach).

> THE RESTORATION OF THE LINK BETWEEN TAXATION AND POLITICAL REPRESENTATION ON THE LOCAL LEVEL WILL HELP REVITALIZE LOCAL DEMOCRACIES

- The initial step would see **municipalities receive 1/5th of income tax revenue** that has been received by workers whose permanent address is within their borders. Municipalities will be able to use these revenues as they see fit, but a consolidation period of local finances and prioritization of debt service might be required in some cases.
- In the long run, once the share of **the income tax that municipalities receive is increased to, for instance, 50% of income tax revenues** (which equals 5% of an individuals' gross income after security payments), they could be given the opportunity to decide on the tax rate itself within the allowed boundaries. This will create conditions for real tax competition and could give less attractive regions the edge when it comes to attracting investment.

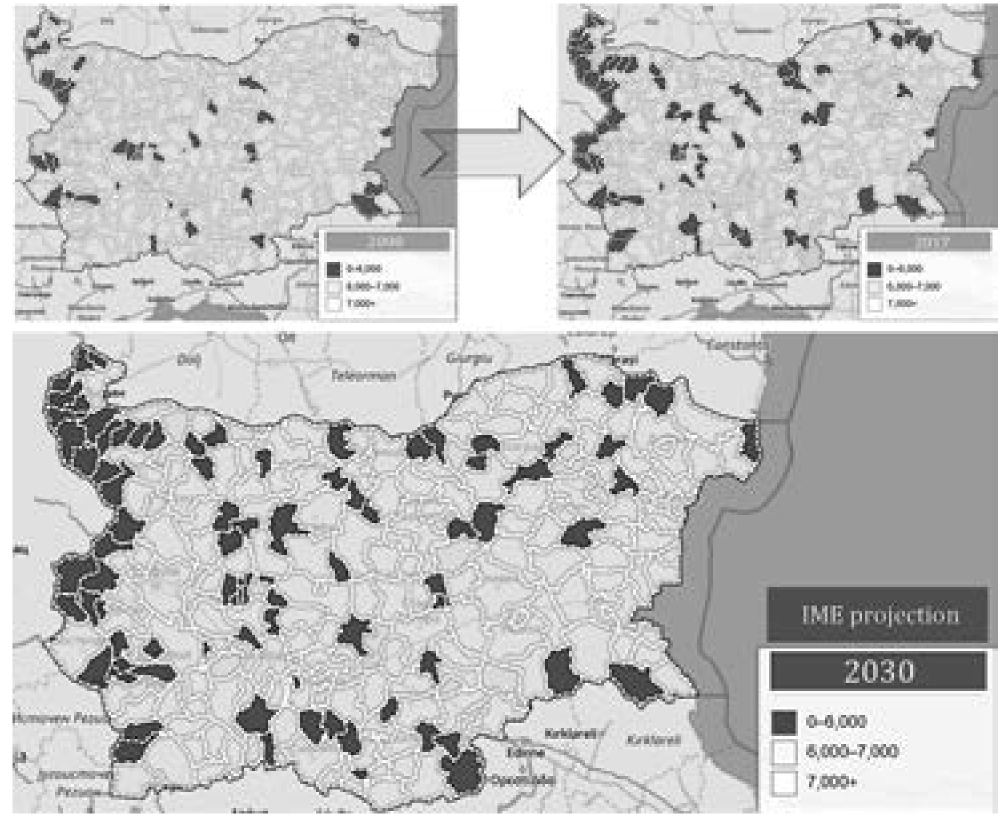
Our calculations show that sharing 1/5th of income tax revenue with municipalities would lead to an overall 30.4% increase in the own revenues of municipalities. In addition, this system would act as a natural cohesion instrument across regions.

> THERE ARE MORE THAN 70 MUNICIPALITIES (OUT OF A TOTAL OF 265) WHICH DO NOT ADHERE TO ONE OF THE INITIAL RULES FOR THE CREATION OF A MUNICIPALITY – A POPULATION OF MORE THAN 6,000 PEOPLE

National Statistical Institute (NSI) data show that as a result of daily labor migration between Bulgarian municipalities, 71% of them are in fact net donors of workers, which means that they are likely to experience an even stronger positive fiscal effect from fiscal decentralization.

The 286 thousand Bulgarian workers that fall into the group of daily commuters between municipalities will see a share of their income taxes go back to the municipality in which they live and in which they vote in local elec-

Figure 2: Municipalities that do not comply with the 6,000 population rule



Source: IME, based on requests for access to information under the Access to Public Information Act (APIA)

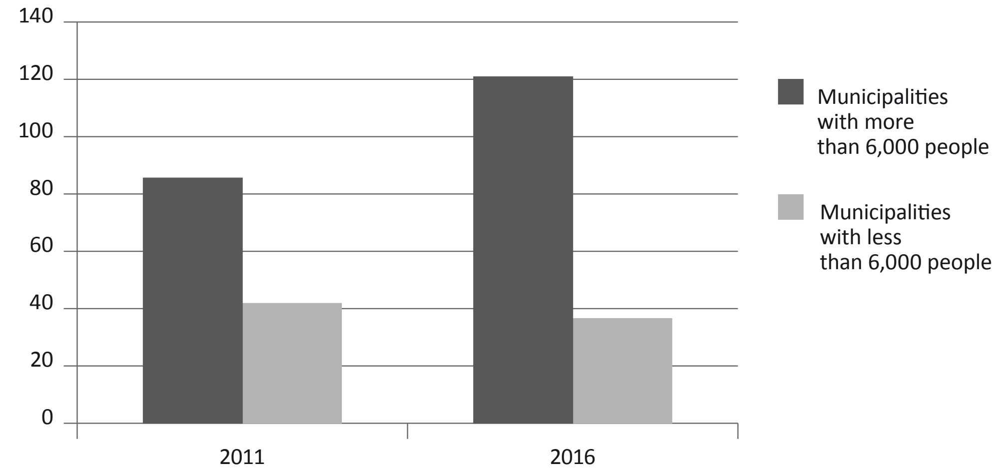
tions. The restoration of the link between taxation and political representation on the local level will help revitalize local democracies by empowering both local governments and local citizens to identify and implement those policies that they feel are most important.

FISCAL DECENTRALIZATION AND TERRITORIAL ADMINISTRATIVE REFORM

The characteristics of Bulgaria's current territorial administrative division mean that even in the case of fiscal decentralization, there will be a number of municipalities that are unlikely to reach higher financial independence from the central government.

As of 2017, there are more than 70 municipalities (out of a total of 265) which do not adhere to one of the initial rules for the creation of a municipality – a population of more than 6,000 people [See Figure 2]. IME's projections, based on NSI's official data, show that by 2030 the number of such municipalities will be somewhere between 87 and 92, while an additional 18 to 22 municipalities would have a population of above 6, but below 7 thousand people. In other words, municipalities that do not adhere to the initial population requirement currently form about 25% of all municipalities and this share is expected to increase to more than 33% by 2030.

Figure 3: Local taxes revenue per capita (BGN)



Source: Municipal budgets, Ministry of Finance of Bulgaria, IME calculations

Most of the smaller municipalities are already struggling financially under the current tax system. In the 2011-2016 period, their per capita tax revenue actually decreased by 14% (from BGN 42 to BGN 36), while municipalities with more than 6 thousand people experienced a 42% increase (from BGN 85 to BGN 121) [See Figure 3].

Apart from the falling population, this is due to a wide array of issues; a low collection rate, the high share of the shadow economy and the non-existent market-to-market procedures, which means that immovable property in particular is significantly undervalued (due to the fact that most value assessments are 2-3 decades old) and thus revenues are low. In addition, a number of these municipalities report highly inadequate ratios of municipal workers to the local population. While in most municipalities there are 3-5 municipal workers per every 1,000 people (and under 2/1,000 in bigger municipalities), this share reaches 40/1,000 in Treklyano (a small municipality in the southwest of the country) and is above 10/1,000 in 40 of the country's 265 municipalities – mostly concentrated in the border regions and the north-west.

Bearing in mind the fact that many such municipalities consist primarily of small settlements inhabited by retirees, the effects of fiscal decentralization would most likely be limited, since the expected stream of own revenues (via the potential transfer of a part of income taxes) would not materialize to a meaningful extent. These municipalities will most likely continue to find it hard to function properly within the new system, which implies that most of them would have to be either included in the territory of larger nearby municipalities or will have to undergo some kind of consolidation. The latter is most likely to be the case in parts of the Northwest and in some border regions, where compact clusters of such municipalities are mostly found[8].

It is advisable that any such changes occur after the upcoming 2021 nationwide census, which will provide much needed information

[8] Since these are areas with 6-7 neighboring small and fiscally powerless municipalities, including them to larger ones may be difficult, as there are none around. This is why we propose both: 1) merging small municipalities in distant areas together, and 2) merging small and distant municipalities.

> WHILE ACCURATE DEMOGRAPHIC DATA IS AN IMPORTANT PREREQUISITE TO THE LONG-TERM SUSTAINABILITY OF ADMINISTRATIVE UNITS, THERE IS NO PRACTICAL REASON TO POSTPONE FISCAL DECENTRALIZATION

regarding their actual demographic state. This is important because current demographic estimates are increasingly inaccurate as the distance to the latest census is growing.

However, there is a case to be made that while accurate demographic data is an important prerequisite to the long-term sustainability of administrative units, there is no practical reason to postpone fiscal decentralization until after the census results have been published. To the contrary – provided the government keeps up its current transfers to municipalities (most of which are for delegated policies anyway) and income tax revenues are an addition and not a substitution for existing transfers, the analysis of the resulting income tax revenue streams can be used as an important indicator for the formation of new territorial units.

For instance, it may well be the case that some small resort municipalities turn out to be capable of fiscal independence, despite having fewer than 6 thousand people. Using income tax revenue data as a starting point, it would be possible to better match the administrative and the natural socio-economic boundaries of local communities.

CONCLUSIONS

Fiscal decentralization is a vital prerequisite for the sustainable development of Bulgarian regions. Sharing income tax revenues with municipalities will help reduce their dependence on transfers from the central government and revitalize local democracies by empowering municipal councils, mayors, and citizens to establish and pursue their own priorities. It will also support the general business environment by creating conditions for tax competition among Bulgarian municipalities, which can result in a lower overall tax burden on businesses and citizens.

> FISCAL DECENTRALIZATION IS A VITAL PREREQUISITE FOR THE SUSTAINABLE DEVELOPMENT OF BULGARIAN REGIONS

Since local governments would in any case have a limited scope within which to determine the income tax rate (even if they receive all of it) and since intra-country mobility is quite high, municipal councils would have an incentive to try and widen their tax base, rather than keep taxes as high as possible.

> SHARING INCOME TAX REVENUES WITH MUNICIPALITIES CANNOT AND SHOULD NOT BE AN ISOLATED AND UNCONDITIONAL CHANGE IN THE TAX SYSTEM

IME's proposal as to how fiscal decentralization should be implemented addresses most of the possible negative effects of fiscal decentralization, such as the spread of bureaucracy. Since the administration of tax revenues would remain in the hands of the National Revenue Agency (NRA), there would be no need for additional administrative bodies, or even employees. This being said, sharing income tax revenues with municipalities cannot and should not be an isolated and unconditional change in the tax system.

Another important issue to be considered is tax collection, and control against tax evasion – potential sharing of responsibility between central and local governments may be considered with the increasing relocation of income taxes back to municipalities.

In light of widespread corruption practices (including at the local level) and the overall lack of traditions in civic participation, fears that in some instances decentralization may actually hurt rather than help local communities are not to be overlooked. This argument, however, is systemic in nature and in no way contradicts any of the established positives of fiscal decentralization itself.

Ongoing efforts aimed at the implementation of effective program budgeting at the local level should be strengthened in order to ensure higher expenditure efficiency and transparency (including municipal enterprises and the management of municipal property). ●

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