

# COMPREHENSIVE ANALYSIS OF THE EXISTING LEGAL, ADMINISTRATIVE AND OPERATIONAL FRAMEWORK FOR MUNICIPALITIES

Technical Report

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## List of abbreviations

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<b>BGN</b>	New Bulgarian leva
<b>CIT</b>	Corporate Income Tax
<b>IMC</b>	Intermunicipal cooperation
<b>LAI</b>	Local Autonomy Index
<b>LoGICA</b>	Local Governance Institutions Comparative Assessment Framework
<b>MoF</b>	Ministry of Finance
<b>MoRDPW</b>	Ministry of Regional Development and Public Works
<b>MP</b>	Member of Parliament
<b>NAMRB</b>	National Association of Municipalities in the Republic of Bulgaria
<b>OGP</b>	Open Government Partnership
<b>PIT</b>	Personal Income Tax
<b>TSI</b>	Technical Support Instrument

## EXECUTIVE SUMMARY

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The project “*Developing fiscal decentralisation and improving local financial management in Bulgaria*” is jointly implemented by the Centre of Expertise for Good Governance of the Council of Europe (CoE) and the European Commission (DG Reform) through the Technical Support Instrument (TSI) which supports reform design and implementation in the EU Member States. This joint CoE-EU project aims at providing tailor-made expertise to Bulgarian authorities on decentralisation, municipal finances and local development issues with a view to improving fiscal decentralisation and financial management at local level. The project is coordinated and administered by the CoE in close collaboration with the main beneficiary, the Ministry of Regional Development and Public Works (MoRDPW) in cooperation with Ministry of Finance (MoF), the National Association of Municipalities of the Republic of Bulgaria (NAMRB) and other key stakeholders.

This technical report is a comprehensive analysis of the existing legal, administrative and fiscal framework of municipalities. It is the first output in a series of project activities and serves as a baseline assessment. At the present stage of situation analysis it builds on desk research; the findings of a field visit; and a public panel discussion in Bulgaria, which took place in January-February 2023. This initial output will be followed by a peer review, training needs analysis, policy advice and capacity development activities.

### Political conditions

Municipalities operate under balanced control of the municipal council and the elected mayor. Both councillors and mayors are mostly political party representatives. However, the **mayor is part of the state administrative subordination structure**, which strengthens the mayor’s intermediating role between local and upper government tiers.

Regulations on local referenda, civil initiatives, general populace meetings and public consultation processes are set in details. **Citizen participation is moderately developed** in Bulgaria (Citizen Participation Index is 3.78 on a six-grade-scale), although surveys proved an improving trend during the past years. Government is ranked low on the list by trust in various public institutions. Additionally, recent crises have deepened distrust towards key national institutions, such as the Parliament or political parties.

The formal institutions of municipal council, mayor and citizen participation, government openness are properly legislated. However, in practice, **local government accountability is dominated by administrative relations** and with a limited role of social accountability mechanisms at local level.

### Administrative-territorial structure

The local level includes 265 municipalities (Obshtina), which is the only decentralised level of elected government. Bulgaria belongs to the group of middle size countries with **relatively large municipalities** (average population size is 25,800). On the average, a municipality covers 21.1 inhabited settlements. The number of small municipalities is high, but their actual weight is not too large. In the 133 municipalities with a population below 10,000 only 11% of the country's population live and 14.4% of total budgets is spent by them. There are significant regional differences: the municipalities are smaller in the North West and in the South West statistical-planning (NUTS2) regions.

Municipalities can establish three legal forms of intermunicipal cooperation for specific projects, as a non-profit association, business or as a non-profit legal entity. The two mandatory forms of cooperation are for municipal waste management and the water and sanitation association.

The **28 districts (Oblast) are deconcentrated state administration units**. They are responsible for legal-administrative control and monitoring of municipal council decisions. The district has coordinating functions towards municipalities and also strategy design responsibilities. A typical district administration controls 9 municipalities. The District Development Council is a corporate body consisting of municipal and labour organisation representatives.

Six statistical and planning regions (NUTS2) were organised primarily for planning and managing the European Union programs. The regional development council is similarly a corporate body, operating with the secretarial support of the Ministry of Regional Development and Public Works.

Wards and mayoralties can be established in the large size municipalities of Bulgaria. The Act on Administrative and Territorial Structure of the Republic of Bulgaria states that municipalities with more than 300,000 inhabitants (namely Sofia, Plovdiv and Varna) shall be subdivided into wards (Rayon v golyam grad). There are currently 24 wards in Sofia, six in Plovdiv and five in Varna. In a typical **mayoralty (Kmetstvo)**, the mayor has dual tasks of managing administrative or technical work and representing the local community at the council meetings.

Two institutions have potential influence on national government decisions about local services and municipal finances. The State Administration Decentralization Council, operating since 2013 is a consultation forum. The National Association of Municipalities of the Republic of Bulgaria (NAMRB) is a more influential organisation with membership of all municipalities (265) and the only association at the national level.

### Local functions - sectoral decentralisation

Bulgaria is a moderately decentralised country: local expenditures represent **8% of GDP and 18% of the general government expenditures**. Among local tasks, the largest one is the public education as a delegated service (40% of total expenditures).

Municipal services are categorised into **two distinct groups: delegated and municipal functions**. The Local Self-government and



Local Administration Act specifies the list of all delegated and municipal functions, but the regulatory practice often overwrites this division.

Sources of financing are also separated by these two groups of local services. The **specific transfers of delegated services put strict limitations on municipal decisions** and leads to declining local autonomy. Municipal services are supposed to be financed by the municipal own revenues. In practice they, together with the minor general equalisation subsidy, are partially also spent on delegated services.

### Fiscal decentralisation

Municipalities in Bulgaria are financed predominantly by national budget grants (71%), local taxes (15%) and fees, rent, fines, as non-tax revenues (14%). **National budget transfers dominate delegated services**, primarily public education (94% of local education expenditures) and social services (85%). Matching delegated functions with the corresponding state budget results low ratio of state transfers to public works and communal services, while **more than half of municipal administration costs is financed by the state budget**.

**Majority of municipal grants, transfers and subsidies** allocated from the national to the local level **are targeted, specific grants**. Fully discretionary grant, the general equalisation subsidy represents only 6.1% of total intergovernmental transfers. State grants to municipal current budget are allocated by detailed service performance indicators. These allocation criteria are considered at municipal level as expenditure standards. **The general equalisation subsidy is allocated by a very complicated method and some of the allocation criteria create wrong incentives for municipalities**.

**The options for improvement are to decrease grant dependency with additional own or shared revenues; to introduce new allocation rules which create local financial incentives and equity; to move towards general grants and to use more service needs indicators.**

Among the own source revenues, local taxes are dominated by property related revenues: tax on property acquisition (38% of all municipal taxes), motor vehicle tax (31%) and real estate tax (29%). In the case of real estate tax, the **unit value and the multipliers hardly changed since their establishment in 1997**.

**Municipalities are moderately active in levying local taxes**. Collection rate of the major municipal taxes is higher in the more affluent regions and in the larger municipalities. During the past period tax revenues doubled in nominal terms, although non-tax revenues always exceeded the total amount of municipal tax revenues. **Local taxes and fees are regulated in great details**.

*Proposals by NAMRB aim to correct the assessment of real estate tax base, include new coefficients (resulting 4.3% increase) and introduce agricultural land taxation (8.7%). The larger municipalities will benefit more from the property tax, while the agricultural land tax increases revenues in the smallest municipalities. In addition, the patent tax can be improved by taxing businesses proportionally to their net turnover or profits.*

**Debt financing was 4.8% of total local expenditures**, primarily used for services funded by own source revenues. This BGN 496 Million debt is almost exclusively financed from domestic sources and it represents only **4% of total public debt**. Municipal debt is highly concentrated: 46% was accumulated in Sofia. Accrued arrears towards suppliers (BGN 118 Million) are usually encountered in municipalities with lower debt.

Municipal borrowing is kept under control by the strict debt regulations. The Public Finance Act regulates the rules on municipalities with financial difficulties (only nine municipalities fell into this category).

### Proposals for revenue sharing

The recent NAMRB proposals plan **to introduce 20% of PIT and 10% of CIT as shared local revenues**, reallocated by their place of origin. These shared revenues would create significant new resources for municipalities: 37% of own revenues or 12.1% of expenditures on delegated functions. The two types of **shared revenues are concentrated in the large urban centers**.

Revenue sharing method for financing municipalities have several advantages: it is a **significant revenue source, PIT (less the CIT) is a stable source and a predictable revenue**. Tax sharing connects – indirectly - the local economy and the municipal budget.

Revenue sharing can be introduced by replacing some of the state grants allocated to delegated services. Sharing method should be based on the actual *place of taxpayer's residence* or by using an alternative method, *the formula-based allocation*. Tax sharing also offers a good *equalisation possibility, based on per capita revenue re-allocation mechanism*. Shared taxes improve local autonomy if they *discretionary local revenue sources*.





## OBJECTIVES AND FOCUS

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This project on developing *fiscal decentralisation* and improving *financial management* aims to strengthen the country's institutional and administrative capacity to facilitate socially inclusive, green and digital transitions through targeted reforms. The specific objective is to support Bulgaria to design, develop and implement reforms with the support of the Technical Support Instrument of the European Commission (TSI). These reforms aim in general to encourage investment, increase competitiveness and assist economic and social convergence.

The project focuses on decentralisation, local finance and development in Bulgaria. As the regional level and local government tier are at the centre of the planned activities, implementation is the joint responsibility of the Council of Europe, *the project main beneficiary* (Ministry of Regional Development and Public Works) and other key stakeholders involved.

This project is being implemented in a *politically challenging period in Bulgaria, which might impact future actions*. The country has been governed by an interim government for several months. Further Parliamentary elections took place in April 2023 and a coalition government was eventually approved by the Bulgarian parliament on 6 June 2023. These were the fifth general elections held during the past two years. Local elections will be organised in October 2023. This politically unstable period has not been favourable for introducing major reforms and decentralisation policy measures. However, it might be the right time to prepare reform proposals and to advocate for decentralisation programs and putting them on the political agenda.

The main focus of the project is to support Bulgaria in *increasing financial autonomy* of Bulgarian municipalities, while in the short or medium term, the project aims to improve the legal and financial framework for fiscal decentralisation. Higher own-source municipal revenues and enhanced local management competences to apply benchmarks and performance measurement would be some of the solutions to an increased financial autonomy at local level.

Local government autonomy, efficient municipal service provision and effective regional development system were already targeted by several reports and recommendation of various international organisations. The monitoring report on the implementation of the European Charter of Local Self-Government and follow-up recommendations made by the Congress of Local and Regional Authorities (CLRACE, 2021) specified the key areas of reforms. They are summarised in Annex 3, as they also represent the foundations of this technical report.

## Project activities

This technical report is one of the initial outputs in a series of project activities. According to the project document, this is a *situation analysis* of the existing legal, administrative financial and operational framework for municipalities. However, it aims not only to provide a baseline assessment, but also to contribute to the other planned project activities.

*Statistical and fiscal data* in this technical report were collected from various information sources. Their bases are the fiscal reports on municipal revenues, available on the Ministry of Finance website (2021 actual data). Here they are combined with information on the regional location of municipalities and the latest population numbers by municipalities (2021). Estimates on shared revenues are based on data from the Ministry of Finance. NAMRB also provided data on local tax revenues by municipalities. All other information sources beyond this compiled dataset are referenced in the tables and charts.

The technical report builds extensively upon the *desk research* on the legislative provisions and policies regulating local finances in Bulgaria (NAMRB, 2023). The desk research was conducted in parallel with this technical

report. A short *fact-finding mission that took place* on 20-24 February 2023 in Bulgaria also helped to identify the key issues related to fiscal decentralisation and to assess the information base of future policy design actions. The project outputs and a first, very tentative list of fiscal decentralisation issues were discussed at the public *panel discussion* during the annual conference of the National Association of Municipalities in the Republic of Bulgaria (NAMRB) in Sofia on 21 February 2023.

This technical report aims to guide the future project activities. It will inform the *Peer Review* team, which intends to provide examples and practices from other European Union member states on relevant decentralisation policy issues. Policy advice will follow, which targets the issues specified by the peer reviewers and proposes measures for promoting fiscal autonomy. These policy components will be supplemented by *capacity building* activities: comprehensive local training needs assessment, piloting on local finance benchmarks and advocating for the standard expenditure needs assessment in intergovernmental fiscal relations.



## Interconnected areas of decentralisation

Due to the comprehensive focus of the situation analysis, this technical report has a broad scope. Limitations of fiscal decentralisation and challenges of financial autonomy are evaluated together with all the key areas of decentralisation. Political conditions determine accountability of local governments, the territorial-administrative structure influences multi-level governance methods and procedures. In the centralised government system of Bulgaria, the sectoral ministries and the regulatory environment control the management of public functions assigned to municipalities. Specific components and issues of

fiscal decentralisation should be evaluated - and later developed - together with these institutional conditions.

This broader framework of political institutions, administrative structure, sectoral regulations and fiscal decentralisation is followed by other comprehensive assessment methods, as well. Scope of decentralisation, strength, autonomy and self-rule powers of subnational governments are usually assessed jointly by these components of decentralisation (see Box 1).

### Box 1 AREAS AND COMPONENTS OF DECENTRALISATION

*Local Autonomy Index.* Self-rule Index for Local Authorities (Local Autonomy Index (LAI), Ladner, *et al*, 2021) measures various aspects of the European Charter of Local Self-governments. The key areas of LAI and the scores for Bulgaria are summarized in Annex 1. There are several indicators beyond each of the aspects of local autonomy.

Bulgaria's total score is 27 in a scale of 0-37. **In the field of local finances, the highest score was awarded to financial self-reliance and borrowing autonomy** (2, in a scale with a maximum score of 3). **Fiscal autonomy was scored lower** (1, in a scale ranging 0-4), while the **fiscal transfer system was evaluated as overwhelmingly conditional** (scored 0). It is important to note that administrative supervision in general is evaluated as interfering and obtrusive (1, on a scale of 0-3). The local policy making autonomy is missing in the case of personnel related decisions for the following municipal functions: education, social assistance and caring services, health care.

*LoGICA Framework.* A similar comprehensive approach is followed by the "Local Governance Institutions Comparative Assessment Framework" (LoGICA, 2022). It uses a scorecard along the critical areas of local institutions and governance practices. LoGICA focuses on the following aspects of decentralisation and multi-level governance: structure (tiers), governance (institutions, leadership), assignment of functions, political mechanisms, administration and management, finances, inclusion and responsiveness. This evaluation method is based on a multi-dimensional framework of decentralisation (Boex, *et al*, 2021). The four key areas are the political, administrative, sectoral and fiscal decentralisation. They are composed of various influencing factors, such as empowerment, inclusion, engagement of civil society. These are important elements of accountability and local public service efficiency. Bulgaria was not assessed in the LoGICA framework, yet.





## POLITICAL CONDITIONS

Legitimacy and accountability of elected local governments are ensured through formal institutions and various procedures. The present municipal structures in Bulgaria were established in a long evolutionary process. This one-and-a-half centuries long development started with the establishment of counties and districts under the influence of the Ottoman rule. The first half of the 20th Century was characterised by creation of fragmented, small municipalities within a three-tier government structure. The large size municipalities – under various forms of intermediary government tier – already operated before the political transition starting in 1990. The modern municipal governance system was established in a wide-ranging legislative process since then. The latest stage of reforms began in 2014.

A Bulgarian municipality operates under the balanced *control of municipal council and elected mayor*. The municipal council and its chair represent the community and formulate policies, while the elected mayor is the leader of the executive authority. The municipal councils are relatively large: up to municipal population of 50 000, one councillor represents less than 1,300 citizens on the average (Table 1.) Municipal councillor is a paid job, the remuneration is connected to council chair's salary (amount maximum 90% of the mayor's) or to the average remuneration of the municipal administration.

Population	Number of councillors	Number of citizens represented by a councillor	Number of municipalities
-5,000	11	290	57
5,000-10,000	13	569	76
10,000-20,000	17	843	64
20,000-30,000	21	1,129	24
30,000-50,000	29	1,297	20
50,000-75,000	33	1,836	10
75,000-100,000	37	2,266	5
100,000-160,000	41	3,099	5
over 160,000	51	5,814	3
Sofia Municipality	61	21,433	1

**Table 1** Municipal council size by population number

Mayors are elected not only at the municipal level, but in the wards and mayoralties (*kmetstvo*) at sub-municipal level. Both municipal councillors and the mayors are elected on (party) lists and not in individual wards. So they are mostly *political party representatives*: for example in 2019 independent candidates of the parties represented in the National Parliament won more than 75% of the mayoral seats and only 6% of elected mayors were independent, that is nominated by initiative committees<sup>1</sup>. (Petrov, 2020)

The mayor's unique status influences the position of municipalities in the multi-level government system. The mayor is *not member of the municipal council* and formally s/he attends the council meetings in an advisory capacity. The mayor is part of the state administrative subordination structure. All these factors strengthen the mayor's intermediating role between local and higher government tiers. Among the 7,400 locally elected mayors and councillors 31% are with executive powers as mayors of muni-

icipalities, wards and mayoralties. Mayors are responsible for 70% of the municipal competencies (in total there are 800 municipal duties). (NAMRB, 2023)

Results of the latest municipal election proved that political party connections and administrative-management position of the mayors *strengthened and stabilised their positions*. Two thirds of mayors were elected in the first round, 75% of them have been re-elected and the number of mayors with three and more mandates is increasing. Share of women-mayors is low (13%), although women are more represented among the councillors (25%, similar to their ratio among MPs). The elected mayors are typically engineers, economists, doctors with higher education qualification (87%) and past managerial experiences. They mostly come from the private sector, or they were former councillors, deputy mayors or worked for the municipal administration. They rarely had other government positions, either in mayoralties or at district level. (Petrov, 2020)

## Social accountability

Other local accountability mechanisms are properly legislated in Bulgaria. Regulations on *local referenda, civil initiatives, general populace meetings and public consultation* processes are set in details. These and other forms of citizen participation are important in the highly centralised legal, administrative and fiscal environment.

*Citizen participation* is moderately developed in Bulgaria, although during the past years, surveys proved an improving trend (Table 2). On a six-grade-scale participation in general is scored at 3.78 and increasing level. (CPF, 2021) The practices of citizen initiatives, active citizens are considered to be more developed

Index	2015	2021
Overall assessment	3.39	3.78
Legal, institutional environment	3.29	3.21
Practice: citizen initiatives, active citizens	3.59	4.38
Effect: results, changes caused	3.35	3.75

Scale: 1-6; Source: <https://index.fgu.bg/en>

**Table 2** Citizen participation, 2015, 2021

1. Information from NAMRB indicates much higher proportion of independent mayors: 78 of 265 present mayors are elected on local community lists.



(4.38) and some results could be achieved (3.75). The legal environment and procedural requirements are less favourable (3.21) and worsened since 2015.

Assessment of citizen participation varies in the surveyed municipalities. Overall scores range from 2,94 (Ruse) to the highest in Sofia (4,33). Conditions have also changed in the studied period, especially during the COVID-19 pandemic, and the attitudes towards voluntary and philanthropic organisations became more positive. Based on the lessons from past surveys, the recommendations towards municipalities on citizen participation target three areas: (i) adaptation and improvement of local regulations, (ii) administrative staff capacity development through incentives and standards, (iii) introduction of new working methods in municipal administration. (CPF, 2021)

The overall role of government and public institutions are reflected by *lower trust* in the government (16%), the political parties (11%) and the National Assembly (9%). (Smilov, 2022) They are at the bottom of the ranking list on trust in institutions, which is led by the Bulgarian Orthodox Church (55%) and the President (54%). The status of municipalities and municipal administration is indirectly indicated by the fact, that they were even not subjects of this survey on trust. Although the municipal councillors are trusted more (32%) than the members of the parliament (21%-29%, fluctuating in the period of 2015-2019)<sup>2</sup>.

Bulgaria is member of the *Open Government Partnership*. The national action plan for 2022-2024 sets several measures for civic participation, which will be highly relevant at municipal level, as well. (OGP, 2022) They target procedural issues of citizen participation law, encourage volunteerism and development of templates for online petition to the government.

Education, as a major local public service, is critical for municipalities. However, the past reforms strengthened more the administrative accountability towards line ministries. Municipal ownership over school network development weakened, due to the unified per student cost standard based financing mechanism. (World Bank, 2010)

The OGP action plan aims to create forums for public discussion of the Education Quality Inspection Framework. This proposed forum proves the need for decentralisation in the public education sector. It will involve all relevant stakeholders, that is representatives of the professional community, scientific circles, nationally represented parents and non-governmental organizations. The framework for evaluating schools will improve objectivity and activate citizen participation in the assessment of preschool and school education quality.

*In sum*, this very brief assessment of selected political conditions of decentralisation indicated important characteristics of the decentralisation status in Bulgaria. The formal institutions of municipal council, mayor and citizen participation, as well as government openness are properly legislated. However, in practice local government accountability is still dominated by the administrative relations. The mayor's position and the low level of trust in government (jointly central and municipal) shows the limited role of social accountability mechanisms at local level. The two dimensions of accountability – administrative and social – supplement each other and they should be developed together for better local service provision and effective municipalities.

The central (administrative) dependence of municipal actions and service provision is justified by strong arguments against decentralisation, among which the potential increase

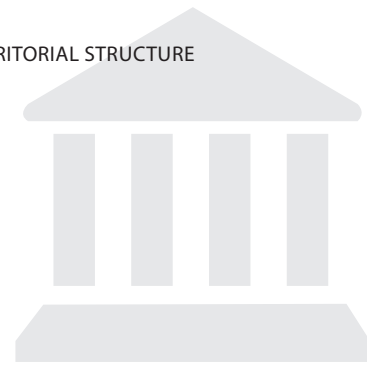
2. Respondents agreed with the following statement "There is at least one representative on my Municipal Council that I trust and know is protecting the interests of people like me and my family"; "There is at least one MP from my constituency in the National Assembly who I trust and know is protecting the interests of people like me and my family".

of the already high regional differences in the country. This argumentation emphasis is not on the options for utilising the favourable local conditions, where a municipality might have comparative advantages, but expresses more the need for equalisation and access to similar level of public services. **The future reform of intergovernmental fiscal relations for fiscal decentralisation should take into account both factors: creating favourable local conditions for municipal development and the public pressure for equity and fairness in local finances.**

#### Key lessons for fiscal decentralisation:

- ▶ elected mayors with executive powers are in a strong position vis-à-vis the large size municipal council;
- ▶ political parties dominate local elections, both for mayors and the councillors;
- ▶ administrative accountability drives municipal management, although the institutions of social accountability are in place;
- ▶ low trust in government coincides with moderate level of social accountability mechanisms (transparency, participation, inclusion) in municipalities.





## ADMINISTRATIVE- TERRITORIAL STRUCTURE

The local level includes 265 municipalities (Obshtina), which is the only decentralised level of elected government. Bulgaria belongs to the group of middle size countries in Europe (population 7 million) with relatively *large municipalities*. The average municipality population size is 25,800, which is similar to other countries in the region, such as the successor states of former Yugoslavia and Greece. One fifth of the country's population is concentrated in the capital city, Sofia. Outside Sofia, the average municipality size is lower, 21,000.

There are significant *regional differences* of municipality population size by the statistical-planning regions (NUTS2 region). The municipalities are smaller in the Northwest (14,600) and in the South West (15,100 if Sofia is not counted). The large municipalities are mostly in the South East region (average population 30,600). The two Western regions are the least urbanized ones (urban population is 65%), while the South and Northeastern ones are more urban: city population share is 72% and 74%.

In half of the Bulgarian municipalities the population is below 10,000 (Table 3). However, here lives only 11% of the country population and 14.4% of total (locally financed and delegated) budgets is spent in these 133 municipalities. Despite the large number of relatively small municipalities, the actual weight of these municipalities by population and budgetwise is not too large. This is an important lesson, when the solutions for managing the potential financing problems of these municipalities will be designed.

Population categories	Number of municipalities	Number of municipalities as % of total	Population as % of total	Local budget as % of total
-5,000	57	21.5%	2.7%	3.9%
5,001-10,000	76	28.7%	8.2%	10.5%
10,001-20,000	64	24.2%	13.4%	13.7%
20,001-30,000	24	9.1%	8.3%	8.1%
30,001-50,000	20	7.5%	11.0%	10.9%
50,001-75,000	10	3.8%	8.9%	7.9%
75,001-100,000	5	1.9%	6.1%	4.9%
100,001-160,000	5	1.9%	9.3%	6.3%
160,001-	4	1.5%	32.1%	33.8%
<b>Total</b>	<b>265</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

**Table 3** Municipalities by population size

The number of municipalities below the 6,000 population limit is constantly increasing: in 1995 only 23 municipalities were below the threshold, in 2011 they were already 60. (Kalfova, 2017) The present 76 small municipalities<sup>3</sup> are located throughout the whole country. (OECD, 2021)

However, the relatively equal and proportional dispersion of less populated municipalities might support access to local services through

intermunicipal cooperation and specific financing schemes.

It should be also taken into account that municipalities cover 21.1 inhabited settlements on average<sup>4</sup>. Some of these settlements at municipal borders might be served by the neighbouring entity if a proper compensation mechanism is introduced. The mayoralties, as sub-municipal entities can also contribute to more flexible forms of service provision.

## Intermunicipal cooperation

Regulations on *intermunicipal cooperation* (IMC) are in place. Municipalities can establish three legal forms: cooperation on a specific project or activity, creation of a non-profit association of municipalities and a business or non-profit legal entity. Municipalities voluntarily cooperate in associations on tourism, regional development programs, accounting services, construction project management and other local actions. There are two mandatory forms of cooperation: in municipal waste management at regional level and the water and sanitation association. These compulsory forms of IMC are also driven by the European Union funding programs. (Kalfova, 2017)

Both of these IMC forms are centrally legislated and regulated by the national programs. There are 55 regional waste management entities with obligatory membership of all municipalities in the governing associations. Municipal mayors form the association and the ownership of assets might take flexible forms.

The more capital intensive water and sanitation service associations operate under, stricter central government control is. They are established by the administrative districts, although the network of 63 water system operators obviously do not follow the district boundaries. In the non-profit water associations, municipalities have dominating voting powers, but the state, represented by the district governor, has also 35% of the votes.

Despite the promised EU funds there are municipalities, which did not join the associations. Their reluctance is explained by the fear of tariff increase and loss of municipal flexibility in managing their local assets, no cross-financing of municipal services and debt forgiveness of municipal service organisations. All these arguments show, that centrally driven, mandatory IMCs do not produce the efficiency gains without local autonomy and proper fiscal incentives.

3. Municipalities with population less than 6,000, which is the minimum population threshold for creating a new municipality.

4. See CEMR (2021) report on Bulgaria: <https://terri.cemr.eu/en/country-profiles/bulgaria.html>

## Districts and regions

Above the municipal tier of elected government there are 28 *district* government units (Oblasts at NUTS3 level). This deconcentrated state administration is responsible for legal-administrative control and monitoring of municipal council decisions. It also has coordinating functions towards municipalities and strategy design responsibilities in various areas, such as road safety, planning of labour market projects, Roma population. District is involved in water association management. District governments have various administrative responsibilities, such as disaster management, management of unused state assets not yet transferred to municipalities or to the private sector. Some of the line ministries also established their parallel territorial administrative structures, often managed from the central town of the district.

The district head is the governor who is appointed by the Council of Ministers. The District Development Council is a corporate body consisting of municipal and labour organisation representatives. A typical district administration is responsible for 9 municipalities. The district administration size is considerable: for example, Lovech district with a

population of 120,000 and 8 municipalities has a staff of 33 civil servants.

The six *statistical and planning regions* were organised primarily for planning and managing the European Union programs (NUTS2). The regional development council - similarly to the district level - is a corporate body operated with the secretarial support of the Ministry of Regional Development and Public Works. The council is led by the elected chairperson. Main task of the region is the design and approval of the Integrated Development Strategy.

Regions are dependent on the national level ministerial decisions. Planning and strategy design practices are still considered to be top-down processes with insufficiently place based focus and lacking integrated allocation of EU funds (see OECD, 2021). The six territorial offices at the regional level are mainly in charge of inspection and payment verification, rather than participating in priority setting and strategic planning.

All these weaknesses of the regional and district level governance system contribute to centralisation and dependence of municipalities on national government decisions<sup>5</sup>.

## Mayorality: the *kmetstvo*

Wards and mayoralties can be established in the large size municipalities of Bulgaria. The regulations on *kmetstvo* (mayorality) combine intra-municipal administrative decentralization and the role of mediator between citizens and the municipal council. There are app. 3,200 mayoralties, which are established primarily for civil and administrative services. (Savov, 2008) The *kmetstvo* mayor is an elected position with rather wide potential competences in implementing decisions of the municipal council and the mayor. They

are as follows: organization of public works, improving the environment, managing kindergarten, disaster management, cultural, transport services or any other tasks assigned by the municipality.

However, all these functions are implemented with the allocated local budget appropriations. The *kmetstvo* collects only fees for the administrative services provided locally. In a typical mayorality, the mayor has dual tasks of managing administrative or technical work and

5. Council of Europe Committee of Ministers' recommendations and guidelines on the types and scope of supervision might help to improve districts' role in these areas: Recommendation CM/Rec(2019)3 of the Committee of Ministers to member States on supervision of local authorities' activities.

representing the local community at the council meetings. In a village *kmetstvo*, it is a one-person administration, while in larger towns staff of 3-5 might be assigned by the municipality. The public employment schemes often provide temporary support to mayoralties.

Combined elected and administrative status of the *kmetstvo* mayor is a good foundation for possible future decentralization at sub-municipal level. The unity of municipal budget is ensured, but with increased administrative capacities the mayoralties might be involved in municipal revenue raising

programs. The mayor has sufficient legitimacy at the *kmetstvo* level. The mayoralty operation is close to the citizens and it is transparent, which enhances local accountability.

The Act on Administrative and Territorial Structure of the Republic of Bulgaria states that municipalities with more than 300,000 inhabitants (namely Sofia, Plovdiv and Varna) shall be subdivided into wards (Rayon v golyam grad). There are currently 24 wards in Sofia, six in Plovdiv and five in Varna. According to Local Government and Local Administration Act the mayors of the wards have the same functions as the mayors of the mayoralty.

## Decentralisation Council and NAMRB

In the centralized administrative system of Bulgaria, there are two institutions with potential influence on national government decisions on local services and municipal finances.

The *State Administration Decentralization Council* was re-established in 2013 for consultation on national policies on decentralization and legislation affecting municipal and governors' functions. It also has roles in monitoring and coordinating the implementation of the Decentralization Strategy. The Council might support legislative changes, as well. The national and the local governments are represented in the Council in equal numbers. The secretarial tasks are implemented by the Ministry of Regional Development and Public Works. Despite the broad mandate of the Council, presently it has limited impact on decentralisation, because no meetings were held recently.

The *National Association of Municipalities of the Republic of Bulgaria* (NAMRB) is a more influential organisation. All municipalities are members of NAMRB and it is the only association representing municipalities at the national level. It not only presents opinion on the draft national budget and the secondary legislation of line ministries, but NAMRB can initiate amendments on regulations affecting

local governments, as well. With its 35 member qualified staff, NAMRB is a capable partner organisation of the national government. As a quasi "municipal ministry" it is not only a lobbying organisation, but also supports municipalities and actively shapes national policies on local matters.

### Key lessons for fiscal decentralisation:

- ▶ relatively large size municipalities in Bulgaria support efficient municipal service provision and create sound local revenue base;
- ▶ number of smaller municipalities (below population 10,000) is high, but their population and budget share is low and they are dispersed among the six regions;
- ▶ the significant regional differences in the country calls for fiscal equalisation mechanisms;
- ▶ weaknesses of intermediary level governance contribute to centralisation and dependence on national government decisions;
- ▶ institutional strengthening at all levels might support fiscal decentralisation through sub-municipal entities, inter-municipal cooperation and effective advocacy-consultation forms.



## ASSIGNMENT OF FUNCTIONS – SECTORAL DECENTRALISATION

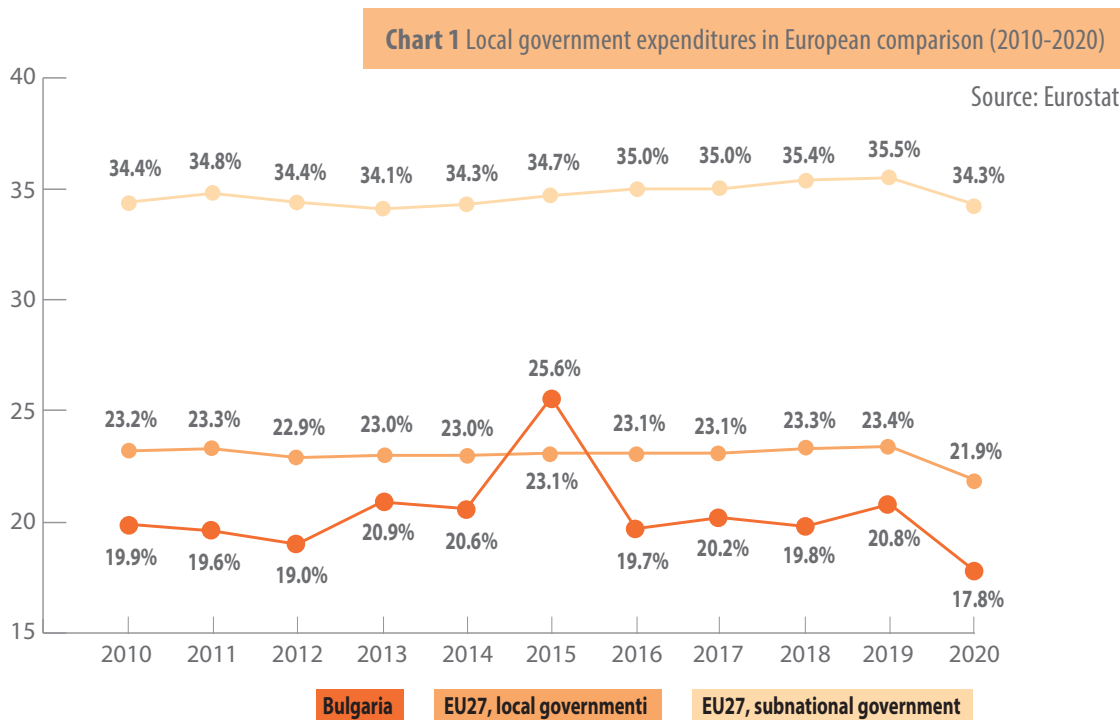
A wide range of public services is assigned to municipalities in Bulgaria (see Box 2 with the list of locally provided services). The financial indicators of decentralisation show that it is a moderately decentralised country. Local expenditures represent approximately 8% of GDP and 18% of the general government expenditures. It is below European Union member State averages (12% and 22% respectively), but higher than in the neighbouring countries of the region.

### Box 2 PUBLIC SERVICES PROVIDED BY MUNICIPALITIES

- 1 Organization and development of municipal territory, communal activities: cleaning services, maintenance of municipal property in the urbanized territory (e.g. parks and green areas), construction and reconstruction of plumbing systems in urbanized areas, organization of parking and traffic safety, video surveillance systems.
- 2 Municipal road and street network: construction, maintenance, repair and reconstruction of road network and of all streets and their adjacent surface and underground infrastructure in populated areas.
- 3 Education: 3,687 institutions in the education system are municipal.
- 4 Health care: 36% of hospitals; 7% of outpatient facilities; all nurseries.
- 5 Social services: homes for adults with disabilities or for the elderly, community day care centers, residential services, home assistance.
- 6 Culture: management and financing of 98% of cultural institutes (museums, theatres, libraries), community centre.
- 7 Recreation, sports and tourism facilities.
- 8 Protection of the environment and rational use of natural resources.
- 9 Disaster protection.
- 10 Municipal property management, municipal enterprises.
- 11 Municipal financial administration.
- 12 Economic activities and services: markets, public transportation, business parks.

However, decentralisation trends during the past decade shows a visible fluctuation of this indicator (Chart 1). The indicator already signals the dependence of municipalities on external factors, that is the lower level of decentralisation and limited real autonomy.

For example, the high ratio of municipal expenditures in general government expenditures in 2015 was due to exceptional flow of EU funds and not systematic accumulation of municipal resources.



Municipal services are categorised into two groups: *delegated and municipal functions*. Among these local tasks, the largest expenditure in municipal budgets is public education (40% of total expenditure) (Table 4). Other delegated services are social services (13%), culture (5%), health care (3%) and some of the municipal administration responsibilities (in total 10%). Traditional local services, such as communal services (street cleaning, road maintenance, public lighting, transportation, waste management, etc.) represent one quarter of municipal expenditures (accounted as public works, communal services (19%) and economic activities (8%)).

**the role of national and local governments varies by these components of service production.** For example, in the case of public education, the labour regulations might be kept at the central level, while service organisation and facility management could be devolved. However, the two aspects of service provision are closely connected (e.g. the number of teachers and classrooms should be harmonised). Real municipal autonomy is determined also by the ownership rules, the freedom in choosing organisational forms of services, setting service performance standards, methods of technical supervision and many other factors.

Despite the formal separation of delegated and municipal own functions, the actual service responsibilities cannot be strictly divided. **Service provision has many elements and**

In Bulgaria, the **Local Self-government and Local Administration Act<sup>6</sup> specifies the list of delegated and municipal functions, but the regulatory practice often overwrites**

6. Promulgated, State Gazette No. 77/17.09.1991.



Education	40.2%
Public works, communal services	18.7%
Social service	12.8%
Municipal administration	9.5%
Economic activities, services	8.3%
Culture	5.2%
Healthcare	3.4%
Defence and security	1.5%
Costs not classified elsewhere	0.3%
<b>Total</b>	<b>100.0%</b>

**Table 4** Expenditures by local public services, 2022

Source: MoF

and further complicates this division<sup>7</sup>. There are 583 normative acts, both laws and secondary regulations, which specify the details of local service provision. (NAMRB, 2023) Even the very approximate separation of public functions contradicts the legal regulations, by introducing the category of “shared” responsibilities<sup>8</sup>.

This problematic issue of strict separation of public functions and responsibilities is further complicated by the financing mechanisms, which also intend to specify the assignment of resources to the two distinct service groups. In Bulgaria, the delegated services are supposed to be funded by earmarked grants, while the municipal competences are financed by own sources revenues and the general equalisation subsidy.

According to the municipal association experts, it causes problems during the planning and annual budget planning. **The constantly changing legislation on service performance is not followed by sufficient increase of financial resources.** It is partly caused by a lack of proper institutional mechanisms, partly by the impossible task to follow each and

every amendment of service regulations in the present grant allocation mechanism.

The critical *missing institutions* are, as follows:

- ▶ lack of legal instruments to evaluate *the impact of normative acts* affecting municipal budgets;
- ▶ there is no procedure for *constitutional appeal* in case of assignment of unfunded commitments to local authorities;
- ▶ Public Finance Act has no provisions *mandatory compensation* of increased municipal expenditures, caused by national policy and regulatory changes. (NAMRB, 2023)

These factors result not only in a high amount of unfunded mandates<sup>9</sup>, but they lead to further centralisation and *local financial dependence on national budgets*. As it will be discussed later, municipalities should contribute to the financing of delegated services, which are supposed to be fully funded by the national budget. The ministries and government agencies also operate under the tight budget constraint, subsequently their only opportunity is to transfer the financing obligation to the lower government tiers, that is to municipalities. As the specific transfer mechanism of delegated services puts strict limitations on municipal decisions, this pressure from the higher government tier leads to declining autonomy at local level.

Similar tendencies were identified in the field of *regional development*. The OECD report stated the high regional differences within the country and poor ranking of three Bulgarian regions in European comparison (OECD, 2021). Measured by GDP per capita they are among the least developed regions, placed between 34% and 36% of the European average. The centralised approach to designing regional development policies contributes to this differentiation and ineffective regional development.

7. For example when a school is closed by the ministerial decision, the municipality has no control over its school building.

8. Municipal have clear responsibilities in disaster risks reduction, urban transportation, theatres, etc., where the national government has a say, as well (see Table 3.1 in OECD, 2021).

9. According to a NAMRB survey these commitments were BGN 952 Million (2015) and BGN 10 Billion is missing in the water sector, annually BGN300 Million is needed for road maintenance (NAMRB, 2023).

The responsible MoRDPW primary question is how to use the centrally provided funds in the most efficient way. The key systemic problems, such as fragmented responsibilities in public service provision, lack of synergies across sectoral policies and coordination for place based development, hinder successful municipal actions and create the “*islands of prosperity*”.

#### **Key lessons for fiscal decentralisation:**

- ▶ municipal services and responsibilities are dominated by delegated functions;
- ▶ sectoral, line ministries have strong control over these delegated functions, which limits the municipal autonomy in service provision and use of local own source revenues;
- ▶ lack of effective consultation mechanisms results in weak municipal position in budgeting and grant allocation;
- ▶ strict separation of delegated services without proper financial regulations and planning methods, leads to further centralisation and unfunded local mandates.

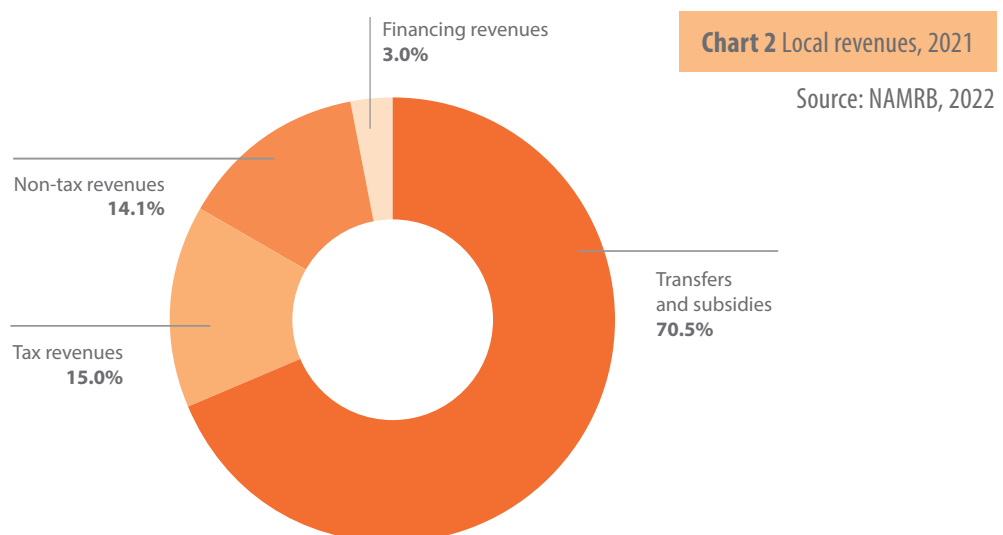




## FISCAL DECENTRALISATION

Municipalities in Bulgaria are financed predominantly by national budget grants and transfers (Chart 2). It is among the countries with *high grant dependency* (measured by ratio of intergovernmental transfers in total local revenues), although there are many - otherwise decentralised - countries with similar ratios (among the unitary states e.g. The Netherlands or the Baltic countries).

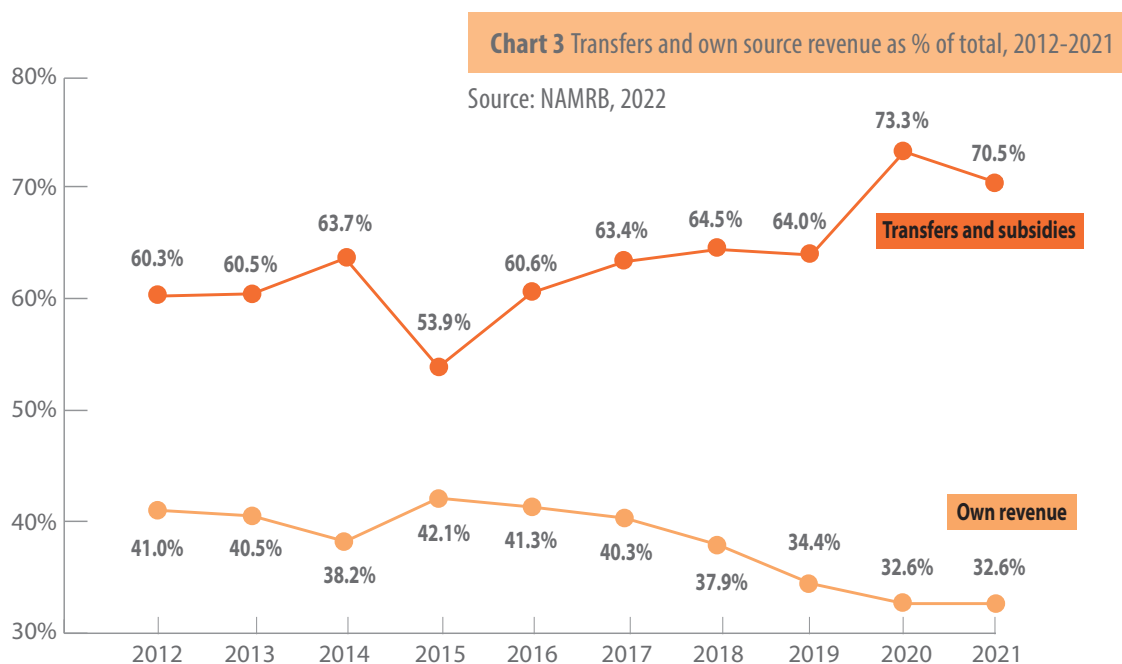
This fact proves, that not only the scale of national budget subsidies, but the *actual method of grant allocation determines* the level of local fiscal autonomy and the scope of real decentralisation. In Bulgaria beyond the state grants the two groups of own revenues, taxes and fees, rent, fines as non-tax revenues have equal share (15% and 14%) among municipal revenues.



## Grant dependency

During the past decade, grant dependency constantly increased (Chart 3). In 2012 intergovernmental transfers and subsidies financed 60% of local budgets (with similar expenditure responsibilities). In the second half of the past decade, weight of national

budget grants increased, culminating in 2020 in the year of pandemic (73%). Subsequently the ratio of own source revenues decreased to a lower level: from 41% to 33% in total revenues<sup>10</sup>.



**National budget transfer dominates in those three sectors where municipalities provide delegated services.** (Table 5) In *public education*, 94% of local expenditures are directly financed by state funds. Education and *social services* are the two major locally provided services (see Table 4), so grant dependency in these two sectors significantly influences municipal autonomy. Healthcare (3.4%) and defence (1.5%) have only marginal weight in the local service portfolio, so high grant dependency does not have a major impact of municipal autonomy.

3. Education	94.3%
5. Social services	85.3%
4. Healthcare	78.0%
2. Defence and security	73.0%
1. Municipal administration	51.0%
7. Culture	34.7%
8. Economic activities and services	20.6%
6. Public works and communal services	0.3%
9. Costs not classified in the other functions	0.1%
<b>Total</b>	<b>61.0%</b>

**Table 5** Ratio of state transfers in financing local services by sectors (%), 2022

Source: MoF

10. Ratios of these two main local revenue groups add up to more than 100%, because the financing revenues (carryover from the previous year) are taken into account with negative value.

Matching of delegated and municipal own functions with the corresponding state budget and own source revenues results in a low ratio of state transfers in the latter group of services. *Public works and communal services*, as the second largest expenditure items in local budgets, do not receive state budget grants (although they benefit from the EU funds).

More than half of *municipal administration* costs are financed by state budget funds. It means that municipal staff implement delegated central government tasks or some state funded services might be accounted under the broad category of “administration”. Public administration employment data show that 40% of the 9 800 staff working in municipal administration is financed by the state budget

Full time employees	Municipalities finance	State finances	Total
Municipal administration	5,862	3,962	9,824
Regional administration		18,245	18,245
<b>Total</b>	<b>5,862</b>	<b>22,207</b>	<b>28,069</b>

**Table 6** Employment in public administration, 2021

Source: NAMRB/NSI

(Table 6) This creates further dependence at municipalities and also shows how deeply connected the two government tiers are.

Municipal expenditures are dominated by salaries, wages and taxes on labour. Most of state grants contribute to these costs: **85% of local labour costs are funded by the state**. (Table 7). Municipalities are obliged to finance the other current expenditures

of locally provided services. The second largest group in municipal budget, *operation and maintenance* is subsidised at a lower rate: state grants contribute only to 27.5% of these expenditures. These two highly distinct types of local expenditures benefit from state grants at a different scale, which threatens the unity of local budget and hinders coordinated municipal fiscal policy.

	Total expenditures by type	Ratio of state grants
Labour costs	57.0%	85.1%
Operation and maintenance	25.2%	27.5%
Subsidies	5.6%	45.6%
Interest payments	0.4%	0.0%
Other current exp.	0.7%	45.0%
Capital expenditures	11.0%	14.4%
<b>Total</b>	<b>100.0%</b>	<b>59.9%</b>

**Table 7** Ratio of state transfers in financing local expenditures (%), 2021

Source: NAMRB, 2022a

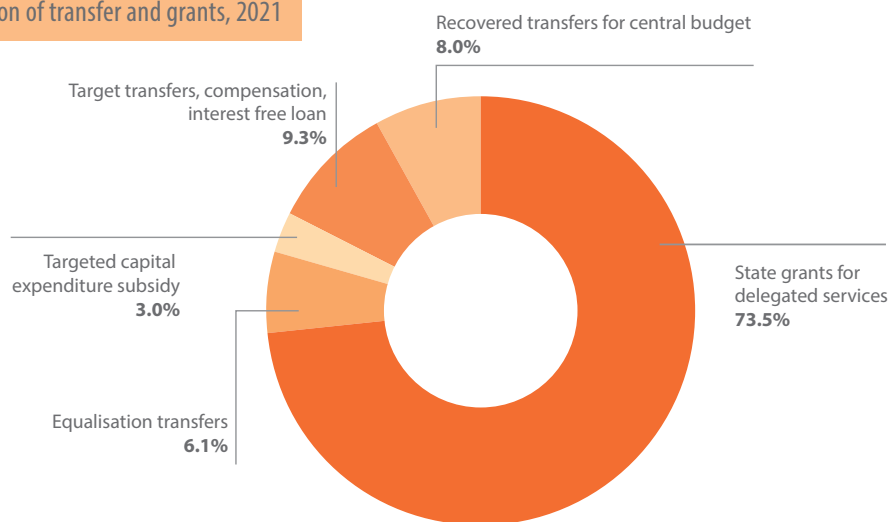
## Types and forms of transfers

Majority of municipal grants, transfers and subsidies allocated from the national to the local level are targeted specific grants. (Chart 4) **State grants for delegated services represent 73.5% as earmarked grants for selected services.** Municipalities have limited autonomy in using these grants. Although they have powers to use the unspent funds in the

following fiscal year, but otherwise the sectoral rules limit the local spending autonomy. The second largest group of transfers are also earmarked, as compensations, interest free loans (9.3%). The group of “other grants” (8%) mostly consists of the European Union funds allocated by the various operational programs, which are also centrally controlled ones.

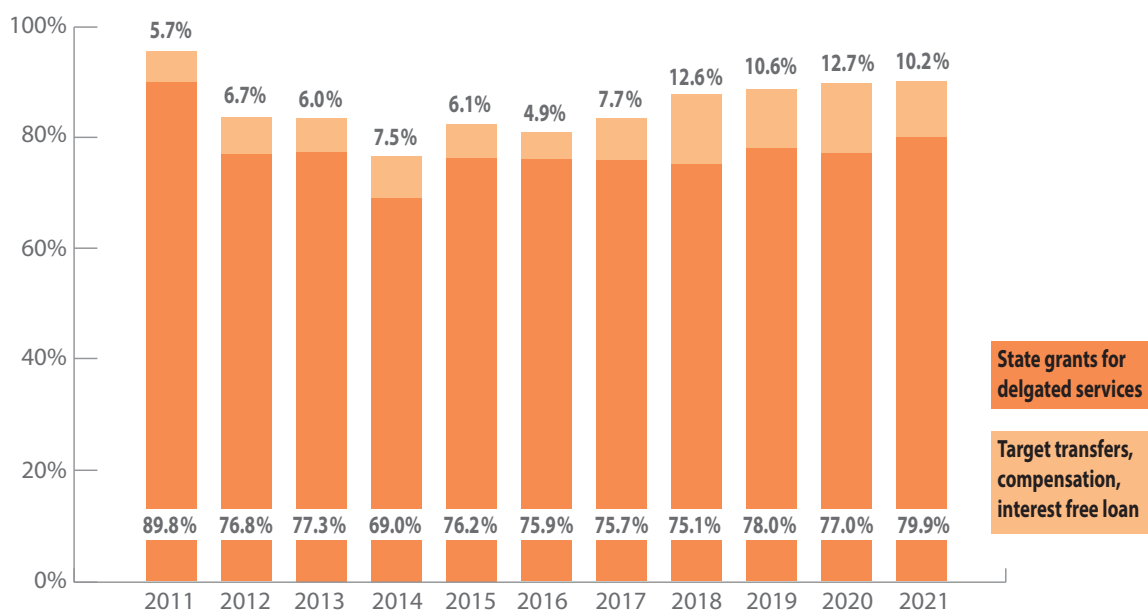
**Chart 4** Composition of transfer and grants, 2021

Source: NAMRB, 2022a



**Chart 5** Targeted current transfers and grants as % of central budget transfers, 2011-2021

Source: NAMRB, 2022a



**Fully discretionary grant represents only 6.1% of total intergovernmental transfers,** it is the general equalisation subsidy.

Since 2014, the importance of the two types of specific grants for current budget purposes increased. (Chart 5). The grants for delegated services have 10% higher share and the weight of other targeted transfers also increased by 3%. Together these two types of national budget transfers dominate: they represent more than 90% of all grants received by the municipalities. The trend also indicates the increasing central dependence of municipalities.

### Financing delegated services

State grants to municipal current budget are allocated by detailed service performance indicators. They are regulated by a Council of Minister decision, while the actual amount of grant per unit of service performance indicator is set by the annual budget. The service indicators follow the users in a given municipality by measuring the number of service institutions, groups (e.g. classes) and individuals (pupils, children, patients, etc.) served.

Service indicators and grant units are differentiated by population size, density and other specific local conditions (e.g. small size schools). The recipient municipalities are also categorised according to their level of development, which is taken into account in the grant design and specification of allocation criteria (see Annex 2.). There are dozens of capacity and financial indicators in each service area, all together their number is 177<sup>11</sup>.

These specific service performance indicators intend to measure the costs of actual form of service organisation and management in a municipality. As these grants for delegated service are supposed to cover the

full costs of each and every municipality, the allocation criteria are considered at municipal level as expenditure standards.

However, local diversity of service needs and service conditions cannot be centrally followed even by the most detailed output indicators. For example, in the social service sector where institutional forms of services are combined with other personalised services, municipalities developed diverse forms of service management. When the output indicators target only one type of service organisation, so developing supplementary home-based services or establishing integrated service centres are funded centrally at a very different level. Here municipal own source revenues determine how the more efficient and effective forms of service provision are established in a municipality.

The state budget grants allocated by service performance indicators aim to guarantee the minimum level of services in every municipality. However, **this uniformity often contradicts the diversity of service conditions.** More importantly, it deteriorates the efficiency at the aggregate, sectoral level. **Funding does not follow the local needs and it creates wrong incentives for municipal service organisation and management.**

### General equalisation subsidy

Municipalities receive a general grant, which is not directly connected to any delegated or municipal service. They are free to use these subsidies, similar to municipal own revenues. The size of this general equalisation subsidy is insignificant: it is only 6% of total allocated grants (see Chart 4.). By law, the amount of general equalisation subsidy (GES) should not be lower than 10% of all municipal own revenues in the previous fiscal year. This provision guaranteed a steady growth of general equalisation subsidy (from BGN 241 Million

11. The intergovernmental fiscal relations are further constrained by other rules. For example two thirds of indicators in education should be pupil based; the line ministries aim to protect their sectoral budget by defining the total amount of education transfers in percentage of GDP, which must not decrease between fiscal years even when the number of school age population is declining; or the social assistance budget is connected to labour costs. The order on annual state budget implementation introduces additional restrictions and requirements for the municipal budgets in an increasing number (NAMRB, 2023).

(2011) to BGN 329 Million (2021)), although its actual share declined in the transfer pool.

The problem with GES is not only its small amount and limited significance in municipal finances, but its *allocation mechanism*, as well. The subsidy is allocated by a very complicated, often changing method. Some of these allocation criteria create wrong incentives for municipal financial management and revenue policy. GES is allocated by five different methods (see Box 3).

Majority of GES is for compensating the differences in municipal own source revenues (Chart 6). All municipalities with per capita revenues below 120% of the national average receive grants up to this level. The second, smaller component aims to follow the expenditure needs by allocating the available GES funds by measurable and objective indicators (population by age groups, municipality area, road length). The other allocation criteria much smaller share and two of them ensure further stability in the system (guarantee minimum 25% of own revenues in total

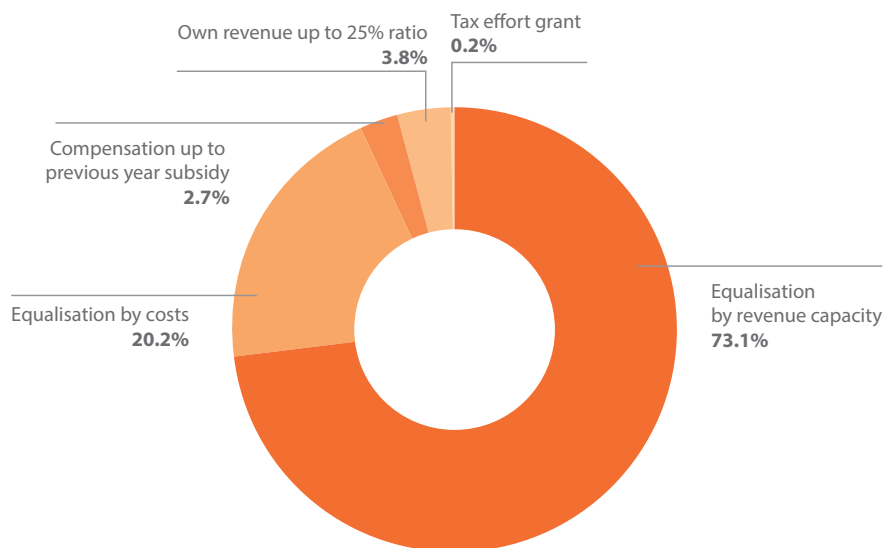
revenues, no decrease in GES between fiscal years). The last tiny component (0.2%) creates proper revenue incentives by allocating some funds for municipalities above the national average tax rates.

**In sum, three out of the five GES allocation criteria create disincentives in municipal finances.** The first criterion does not support local revenue raising, as municipalities receive automatic subsidies even when they levy taxes at low rates. The third one also compensates for a low revenue effort. The fourth one is for avoiding major deficits from one fiscal year to another.

The second condition is the most progressive element of GES, because it *reflects the service needs* and *creates incentives* for economising on budget expenditures. The last one might create revenue raising incentives, although local tax policies usually aim to reach the minimum collection ratios of 77% defined by other pieces of financial management regulations.

**Chart 6** Composition of general equalisation subsidy, 2021

Source: NAMRB, 2022





### Box 3 GENERAL EQUALISATION SUBSIDY ALLOCATION CRITERIA

- 1 **Municipal revenue equalisation:** compensating the difference between tax revenue per resident in a specific municipality and 120% of the national average, multiplied by the number of inhabitants.
- 2 **Municipal current expenditure equalisation:** allocated by number of children up to 5 years old; number of children aged 6-14, number of adults aged 65 and over, territory, length of municipal roads and population weighted by the nationally determined average structure of local service costs.
- 3 **Minimum guaranteed municipal own revenue:** subsidy provided to municipalities with own revenue relative to total receipts is below 25 percent.
- 4 **Supplementary subsidy:** subsidy provided up to the equalisation subsidy received earlier.
- 5 **Revenue incentivising subsidy:** subsidy provided for municipalities with above the national average tax effort. Tax effort is measured by the rates for real estate tax, property acquisition tax, vehicle tax. The subsidy is allocated by the relative share of the difference above the average.

#### Transfer system: assessment and options for improvement

High ratio of grants in financing municipal budget is combined with targeting and heavy sectoral control over these intergovernmental transfers. Grants are especially important in education and social services, the two major locally provided services, where municipal autonomy is needed in service provision. Another related problem is the separation of delegated and municipal functions and matching them with the corresponding state budget and own source revenues.

Almost all labour costs are funded by the state grants, while operation and maintenance are left for the municipal part. Distinction between these two types of local expenditures in the grant system hinders local development and

makes municipalities dependent on line ministry decisions. It threatens the unity of local budget and integrated municipal fiscal policy design.

Allocation methods influence fiscal decentralisation. In the case of delegated functions service indicators follow the users in a given municipality through detailed specific service performance indicators (differentiated by population size, density and other specific conditions). These state budget grants aim to guarantee the minimum level of service in every municipality. However, it creates only uniformity, does not respond on the diversity in service conditions and leads to low efficiency at sectoral level. The size of general equalisation subsidy is marginal and even this low amount does not create proper incentives in municipal finances.

### The intergovernmental transfer system and allocation practices can be improved by the following measures:

- 1 *Grant dependency can be lowered* by increased municipal own source revenues and tax sharing. These reform options are discussed below.
- 2 It is equally important to transform the *rules of grant allocation* for creating better incentives at municipal level and to make the transfer system more equitable.
- 3 There are several competing goals, which can be achieved only by *diverse intergovernmental fiscal mechanisms*. The two basic requirements of a good transfer system is (i) to create incentives for efficient use of the available municipal resources and (ii) to provide equal access to local public services. This latter goal means that transfers guarantee the acceptable (minimum) level of municipal services and ensure sufficient funds to municipalities with similar functions. These fiscal goals target both municipal expenditures and revenues.
- 4 The corresponding grants have diverse forms and they might be *introduced in parallel* by supplementing and supporting each other.
- 5 In Bulgaria it is especially important to move away from the targeted specific grant allocation *towards general transfers*. The allocation method should take into account not only the actual measures of service users, but more the indicators of service needs. It will create greater autonomy in municipal service provision and allow more flexibility in managing a particular service.
- 6 Differences in revenue raising potential should be also taken into account in grant allocation. Municipalities with *lower tax potential should be supported*. The possible (standard) revenue is estimated by levying standard tax rates (for different groups of municipalities) on the assessed local revenue base.
- 7 *Institutional conditions* of more complex intergovernmental transfer system should be developed. With the active cooperation of NAMRB and the relevant ministries in technical preparations, the political coordination mechanisms should be strengthened. The parliamentary debate and approval process should be preceded by consultations at these technical-corporate forums.
- 8 Future reforms should be *introduced gradually*. All parties should be able to learn the new rules and to adjust their actions to the modified conditions.



## Own source revenues

In Bulgaria, **the municipal tax revenues represent only 4.2% of total general government tax revenues**. This ratio is significantly lower than the European Union 27 country average (15.4% in 2020) and **shows the grant dependency of local budgets** (see the local budget ratios in general government expenditures: 17.8% in Bulgaria vs 21.9% as EU27 average on Chart 1).

Local taxes are dominated by three types of revenues: the highest amount is produced by the tax on property acquisition (38% of all municipal tax revenues), the second largest is the motor vehicle tax (31%) with similar amount collected as real estate tax (29%) (see absolute numbers on Chart 7). The remaining two percent is produced by three minor revenues: tourist tax, business (patent) tax and inheritance tax.

In European comparison Bulgaria belongs to the *property related tax* dominated group of countries. Subsequently the local tax structure

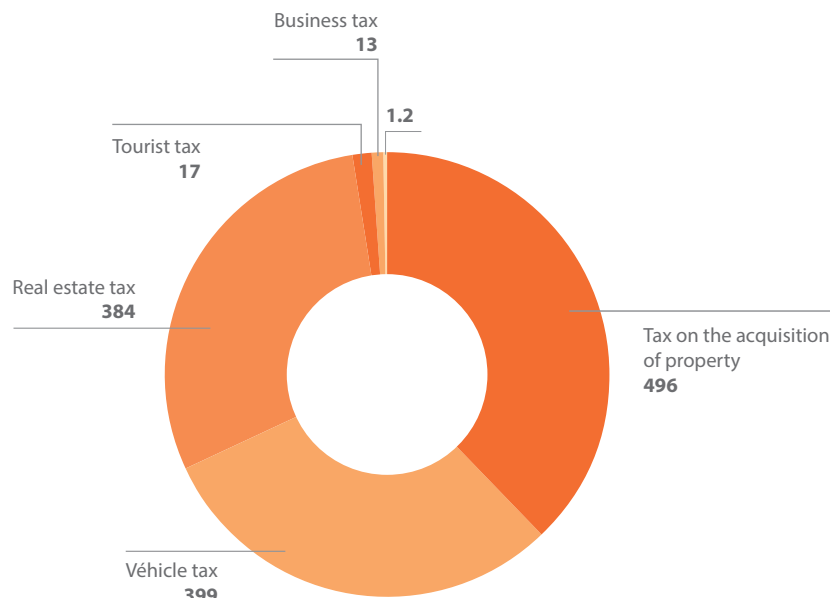
is characterised by lower income related taxes. The size of tax on products, services (that is local tax on businesses) is negligible, while it is more important in the other European countries.

The latest monitoring report on implementation of the Charter recognised gradual changes in the local tax system CG(2021)40-20. The most important positive developments are the introduction of a new local tax on taxi transport, transformation of tourist fee to a local tax and incorporating the environmental component into the vehicle tax.

However, municipalities are *still moderately active in levying local taxes* (Table 8). Only one third of municipalities levy real estate tax above the average rate and the motor vehicle tax is underutilised. Only the property transfer tax is used more progressively by municipalities. The lower municipal activity is explained partly by the missing incentives and the problems of tax regulations.

**Chart 7** Municipal own tax revenues 2021, BGN Million

Source: NAMRB, 2022



Tax	Tax rate limits	Number of municipalities above the avg. rate	Average rate in high tax municipalities
Real estate tax	0.1-4.5%	76	3.02%
Property acquisition tax	0.1-3%	222	2.64%
Motor vehicle tax (55-74kW)	BGN 0.54-1.62 per kW	3	BGN 1.44
Truck (3.5-12t)	BGN 10-30 per 750kg	44	BGN 22
Tourist fee	BGN 0.20-3.00	1	BGN 2.64

**Table 8** Local taxation, 2022

Source: NAMRB, 2022

The *real estate tax* is an area-based tax, with local autonomy in defining various coefficients which all influence property value. They are type of municipality, their categorisation (see Annex 2.), location, age, type of the property, building characteristics and access to communal services. With nationally set value of the real estate unit (m<sup>2</sup>), these multipliers define the assessed value of the property. The problem is that the unit value and the multipliers hardly changed since their establishment in 1997. There are important factors which were not taken into account in calculating the proxy value of the taxed property: access to public transport and other public services, green areas, which all influence the value of the taxed real estate.

*Property acquisition tax* is levied on the transferred or purchased immovable asset. The tax base is the assessed value, calculated by the municipality. The law specifies the list of tax exempt properties (e.g. public purchases, health establishments).

The *motor vehicle tax* is levied according to the engine capacity and the environmental impact of the car and truck. Pollution coefficients are measured by the age and environmental categories of the vehicle.

The *business license fee* (patent tax) is differentiated by types of professions. There are dozens of professions with set tax rate ranges, such as barbers (BGN60-840) or fortune tellers (BGN 2,000-5,600). The actual tax rate is set according to the business location and not its turnover or profitability.

### Tax collection

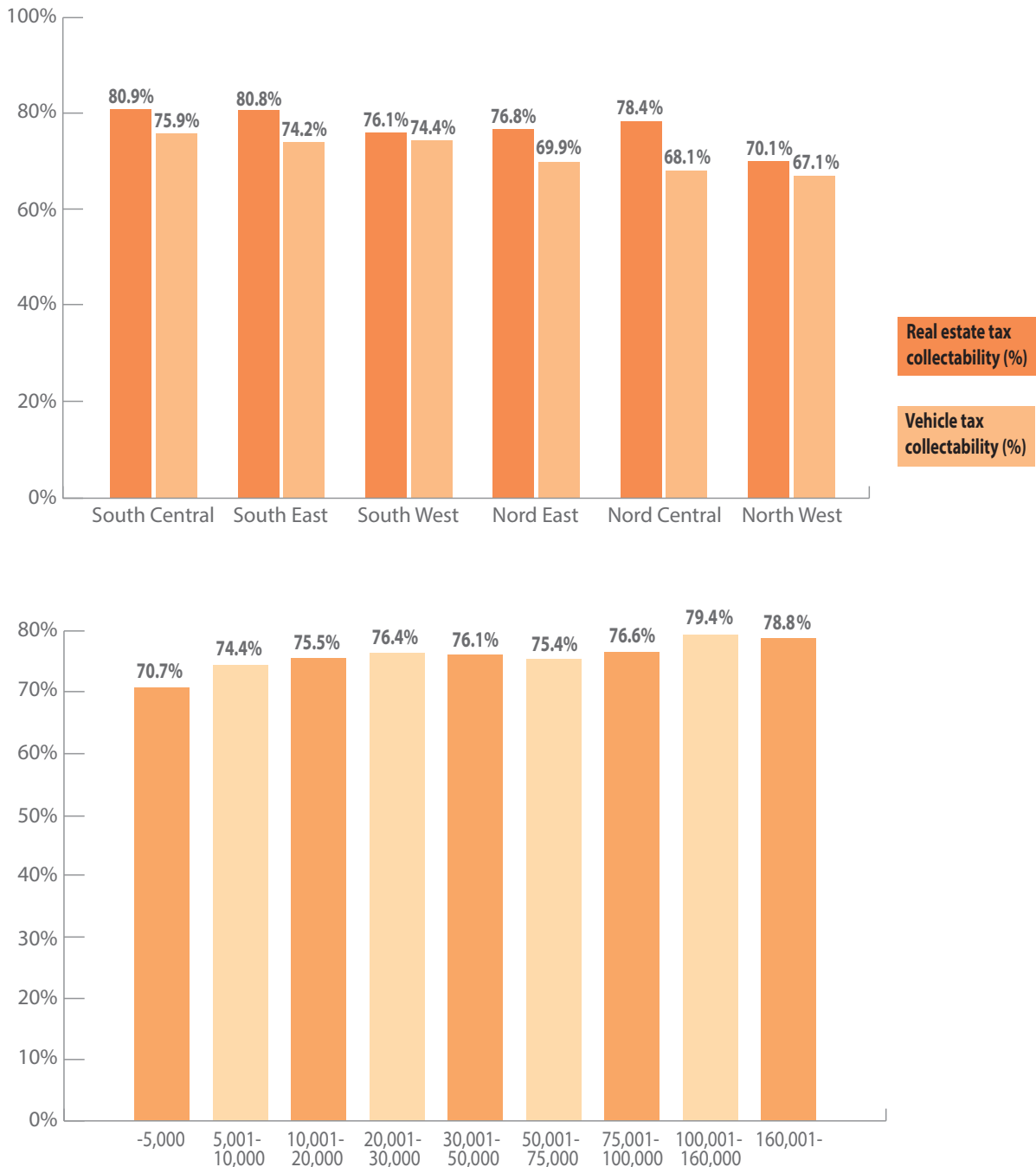
Two taxes are especially important, because they qualify the financial status of the municipality. Municipality in financial difficulty are assessed by the indicators on the average collection ratio of real estate tax and the vehicle tax. Presently this national benchmark is 77% (2021 data on MoF website). Currently the real estate tax collection rate reaches this limit, but the vehicle tax collection is only 72%<sup>12</sup>.

Collection rate of the major municipal taxes is higher in the more affluent regions and in the larger municipalities (Chart 8). Regions in the South are more active in tax collection, partly because they collected two taxes which produce more municipal revenues, than in the Northern regions. Higher collection rates are correlated with urbanization, as it is lower in smaller municipalities, especially in the municipalities with a population below 5,000.

12. In 2022 176 municipalities (66%) have adopted real estate tax rates below the average limits set by the Law on Local Taxes and Fees and all 265 municipalities have adopted a rate below the average limits of motor vehicles tax for the most popular passenger cars (engine power 74 kW-110 kW), with 40% of them adopting the minimum statutory rate. (Information provided by MoF).

**Chart 8** Collection rate of real estate and vehicle tax by regions and by population size, 2021

Source: MoF

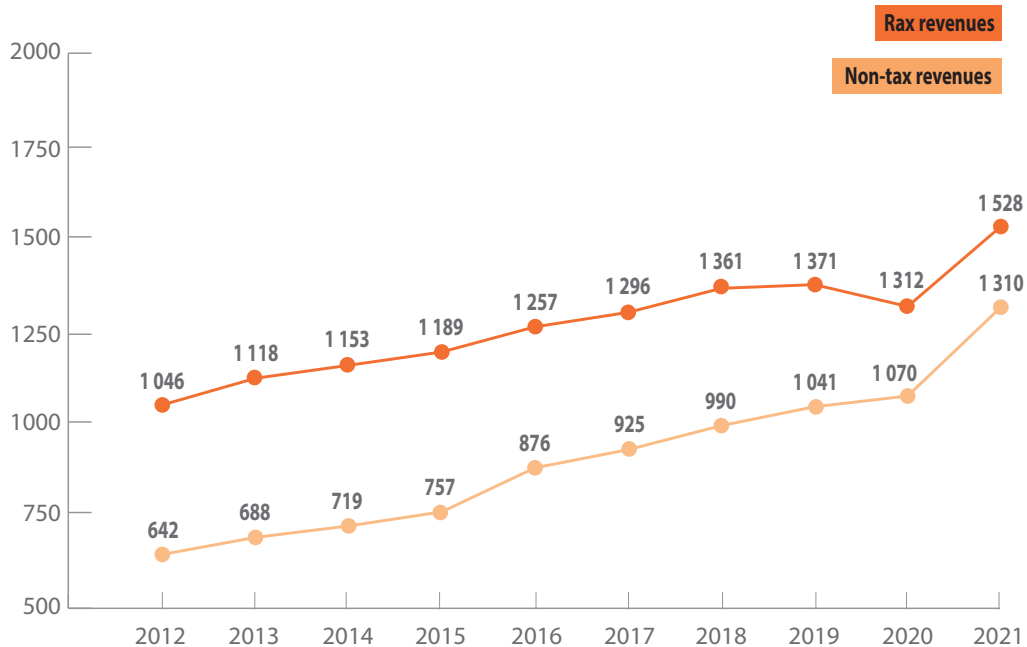


### Non-tax revenues

Various property-related revenues, fee and charges had greater importance among the municipal own source revenues. During the past period, the non-tax revenues exceeded tax revenues in nominal terms. (Chart 9) It shows, that these fees, rent and other charges are more acceptable local revenues, because they are directly connected to the services consumed and the benefits received.

**Chart 9** Composition of own source revenues, 2012-2021, BGN Million

Source: NAMRB, 2022



Majority of non-tax revenues are fees levied by municipalities (60%) (Chart 10). This group of *local fees* is dominated by the household waste fee. Property related revenues represent one third of non-tax revenues: they are mostly rent (20%), sale of assets and partly concession charges collected. Fines are marginal revenues, only 5.5% of total non-tax revenues. This composition of non-tax revenues did not change in the past decade.

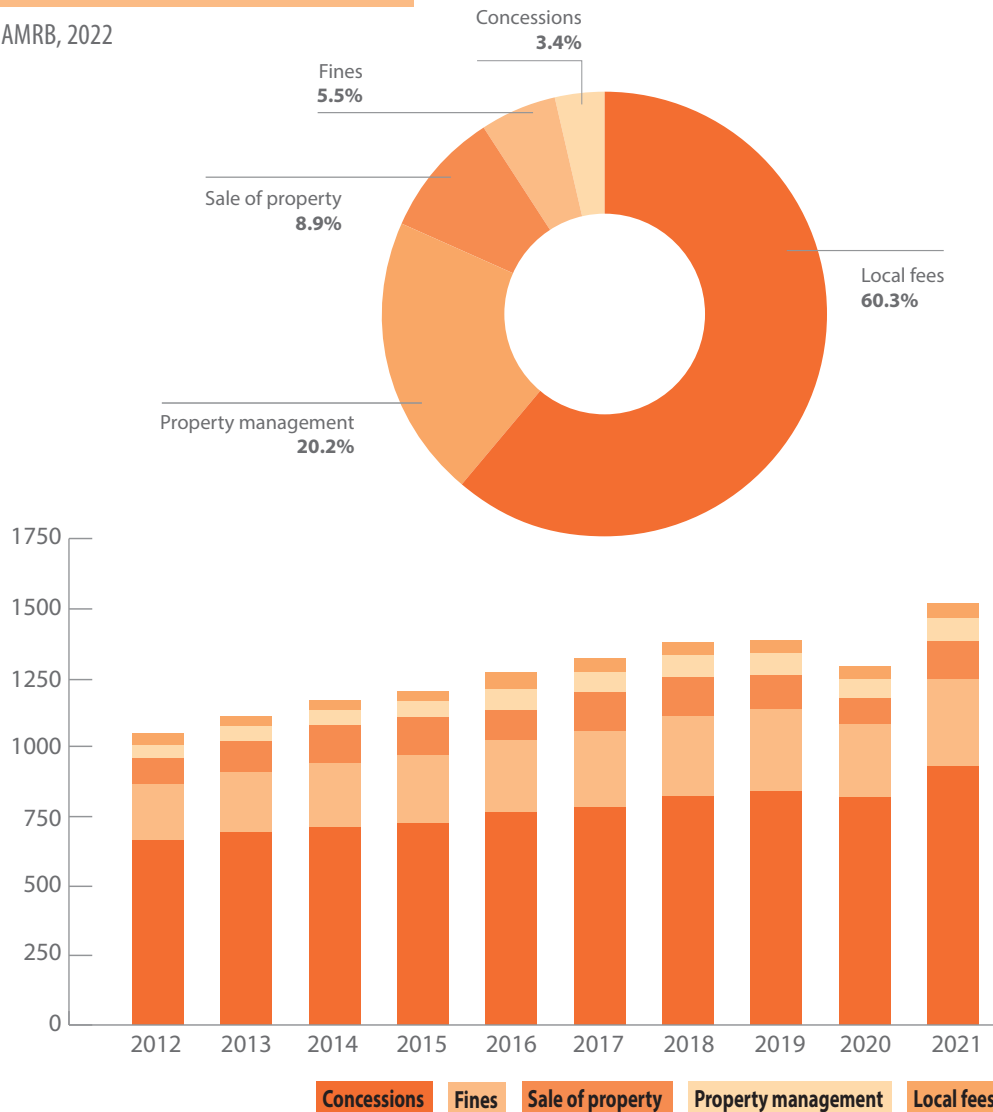
Local taxes and fees are regulated in great detail. The full service costs recovery calculation rule is set by law, for example in the case of *household waste fee*. The legislation requires full cost recovery and defines the volume-based price setting principle for municipalities,

with optional method of levying these charges. According to NAMRB survey, one third of municipalities further differentiates the household waste by settlements within the territory of the municipality. These specific, targeted fees setting rules results that, despite the high number residential units charged (93% of all), majority of household waste fee revenues are collected from non-residential property owner (69%). (NAMRB, 2022)

The fee for another widely used service, the home based social care covers only one fifth of service costs. Municipalities are affected by the abolishment of fees for kindergartens and nurseries since April, 2022.

**Chart 10** Municipal non-tax revenues, 2012-2021

Source: NAMRB, 2022



**Options for improving municipal own revenues**

NAMRB already formulated legitimate proposals on the improvement of local taxation. They aim to correct the *assessment of real estate tax base* by incorporating other factors in property evaluation. Namely, access to public services should be included in the set of coefficients used for defining proxy property value. A 85% increase in the unit value of property tax base is also proposed.

*Agricultural land*, agricultural machinery and self-propelled machinery, properties worth less than BGN 1,680 should be also subject to property taxation (BGN 1/acre). They are predominantly located in villages, where the tax base can be increased by these new, additional property units (NAMRB, 2023)

On average, the proposed reforms will increase property tax by 4.3% and the agricultural land tax by 8.7%. The larger municipalities will benefit more from the property tax, while

Municipality size	Property tax	Agricultural land tax	Region	Property tax	Agricultural land tax
-5,000	3.4%	14.9%	North Central	4.0%	9.4%
5,001-10,000	4.0%	9.2%	North East	4.9%	9.2%
10,001-20,000	4.1%	7.0%	North West	3.9%	13.4%
20,001-30,000	5.0%	7.5%	South Central	4.2%	5.9%
30,001-50,000	5.2%	3.4%	South East	5.3%	7.8%
50,001-75,000	5.1%	1.9%	South West	4.0%	6.6%
75,001-100,000	6.4%	1.3%	<b>Total</b>	<b>4.3%</b>	<b>8.7%</b>
100,001-160,000	6.1%	3.9%			
160,001-	7.9%	0.1%			
85% higher property tax base; agricultural land tax BGN 1/acre					

**Table 9** Impact of proposed tax increase

Source: NAMRB calculation

the agricultural land tax has an opposite impact: it increases more in the smallest municipalities. The regional allocation shows a similar pattern: lower property tax increase is compensated by higher agricultural land tax increase. The two exceptions are the South Western and South Central regions, where both types of taxes increase below the average.

Among local taxes, the *municipal business tax* regulation should be put on a new basis. Presently the flat business patent fee is levied on a centrally defined tax base, which is differentiated by professions and services. Instead of the unified tax base by profession it is recommended to be proportional to the net turnover or profitability of the businesses. The local governments should be authorised to set the tax base and levy the business tax as a percentage of the assessed tax base. Information on business value is available at the national tax authorities by company headquarters. It could be shared among the

municipalities by proxy indicators, such as asset value or number of employees.

The argument for a greater business value tax is that companies enjoy the benefits of specific municipal services, such as local infrastructure, public transportation, social services and urban development in general. These enterprises should contribute to local services proportionally to their outputs and their ability to pay.

Local business taxes are used in some European countries and they produce significant municipal (and regional government) revenues. In Germany, the local business tax (Gewerbesteuer) regulation sets a minimum rate. In France, the Territorial Economic Contribution (CET) combines two taxes levied on the asset value and company turnover. Local tax on businesses' net turnover is levied in Italy (regional production tax, IRAP) and in Hungary, where municipalities have power to define the tax rate within limits set by law.



## Municipal borrowing and debt

Municipal borrowing is actively used for balancing local budgets. Debt financing was 4.8% of total expenditures, primarily used for services funded by own source revenues (16.3% of expenditures) and only 2.4% in the case of delegated budget (Table 10). This BGN 496 Million amount is almost exclusively financed from domestic sources. They are typically bank loans and credit from specialised

national funds, such as the Fund for Local Authorities and Governments, Energy Efficiency and Renewable Sources Fund, loans of Regional Environment and Water Inspectorates. The interest free loan is reported as national budget transfer and the debt of municipally owned corporations is not included in these figures.

	Total funds	Municipal revenues (local activities)	State funds (activities)	Municipal revenues, GES used for delegated services (additional financing)
Expenditures (BGN 1,000)	10 330 464.6	3 760 434.6	6 303 860.0	266 170.3
Budget balance	496 257.7	613 413.2	149 014.3	-266 170.3
as % of expenditures				
Budget balance	4.8%	16.3%	2.4%	-100.0%
External financing (net)	-0.1%	-0.3%	0.0%	0.0%
Domestic financing (net)	-4.7%	-10.0%	-1.8%	0.0%

**Table 10** Municipal budget balance and financing, 2022

Source: MoF

Municipal *debt is kept under control*. The total amount of municipal debt (BGN 1.34 billion in 2021) represent only 4% of total public debt and since 2014 it has always been below 6% of total public debt (Georgieva et al, 2022). Even this amount is highly concentrated: 46% of municipal debt was accumulated in Sofia and an additional 8% is Varna (Table 11). In the other groups of smaller municipalities, the weight of own-source revenues is higher, than the debt in the particular group of municipality.

However, municipalities accrued *arrears* towards suppliers (BGN 118 Million). Half of municipalities reported arrears in 2021, although the amount is decreasing and the number of municipalities where arrears increased was only 55 (Georgieva et al, 2022). Municipalities

are in arrears mostly in the population group of 5,000 - 10,000 and in the medium size cities (population 50,000 - 75,000), The accumulated arrears (e.g. towards energy companies) are usually higher in municipalities with low debt and vice versa (no arrears in the large municipalities, e.g. only BGN 1 Million in Sofia).

Municipal borrowing is kept under control by *strict debt regulations*. Scope of borrowing is defined broadly, although the EU based financial instruments are not measured as part of debt. The borrowing limit is 15% of the annual average amount of own revenue and the general equalisation subsidy for the past three years. The annual budget law might set a higher limit for a municipality. The guarantees issued by the municipality should also meet the similar 15% limit.

	Municipal own revenues	Municipal debt	Budget arrears
-5,000	2.7%	1.4%	6.7%
5,001-10,000	8.0%	6.9%	20.0%
10,001-20,000	11.0%	9.2%	8.9%
20,001-30,000	6.4%	4.8%	9.6%
30,001-50,000	10.4%	6.0%	15.0%
50,001-75,000	6.7%	5.5%	25.1%
75,001-100,000	4.7%	0.8%	4.1%
100,001-160,000	5.8%	4.7%	9.6%
160,001-	44.4%	60.7%	1.0%
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>
of this: Sofia	28.6%	46.4%	0.2%
Varna	6.3%	7.8%	0.0%

**Table 11** Municipal debt and arrears by population size, 2021

The Public Finance Act regulates the rules on *municipalities with financial difficulties*. (Table 12) Three out of seven objective measurable conditions should be met for qualifying a municipality in financial trouble. Beyond the debt and guarantee limits, they are the liabilities (15% of expenditures), commitments made (above 50% of expenditures, four years average), arrears (above 5% of last year expenditures), negative budget balance for the past three years and combined real estate tax, vehicle tax collection rate is below the national average (2021: 77%).

In 2021, only nine municipalities fell into this category. These municipalities represent only 1.5% of population. They are small municipalities: six are below population 10,000 and have a population of more than 20,000. They are located in South Central (4 municipalities) and the Northwest region (3). Only 1.9% of municipal debt was accumulated in these municipalities, but arrears are more significant in these municipalities: 21% of all arrears were created here.

These municipalities are obliged to develop mid-term financial recovery plans and they report quarterly on the implementation of these plans. Subsidies and interest free loan are available for municipalities in financial difficulty status. These central budgets might be available for a longer period, so municipalities could implement active development programs even when they operate under recovery procedures.

These *static and retrospective limits* on borrowing and definition of financial difficulty status do not always qualify properly the creditworthiness and financial stability of a municipality. Real municipal capacity to borrow should be based on the analysis of current and capital budgets separately, forecasting net operational surplus against debt service and projecting trends in capital budget balance.

Selection criteria	Municipal averages (2021)	Number of municipalities above the benchmark
1. Debt payment < 15% of own revenues + balancing subsidy (equalisation grant) (for the past three years)		
2. Guarantees issued < 15% of total revenue + balancing subsidy of the last year		
3. Liabilities > 15% of expenditures (four years average)	5.2%	11
4. Commitments > 50% of expenditures (four years average)	42.5%	51
5. Overdue liabilities (arrears) > 5% of last year expenditures	1.4%	20
6. Budget balance is negative in each of past three years	2.5%	101
7. Real estate tax, motor vehicle tax collection rate < average collection rate (2021: 77%)	74.4%	153

**Table 12** Municipalities in financial difficulties

Source: Public Finance Act, MoF data

## Proposals for revenue sharing

Revenue sharing was already used earlier for financing Bulgarian municipalities. Starting from 1991, the total amount of personal income tax was reallocated to municipalities. Later the municipal share declined to 70% (1992) and to 50% by 2007, when the sharing mechanism was terminated. Corporate profit tax was also shared with municipalities by allocating 10% (later 6.5%) to local budgets. These major national tax revenues were shared with municipalities by their place of origin. Municipalities also received the profit tax of companies with majority municipal ownership. (NAMRB, 2023, Kalcheva, 2022)

The recent NAMRB proposals on municipal financing follow this revenue sharing method. According to these plans, 20% of PIT

will be a municipal revenue (BGN 800 million in 2019) and 10% of CIT (BGN 262 Million) are proposed to be shared. In both cases, the taxes will be reallocated by the place of their origin. These taxes are reported by the companies (employers), so they are shared with the municipality where the company is registered, that is at the location of the company headquarters.

The proposed legal text classifies these shared revenues as *new sources* of the municipal budget (Public Finance Act, Art 45 (1)). But they are also listed under the transfers (Art 52. (1), 1. (c)) as one of the transfers. They are supposed to be allocated by the taxpayer's residence, who is registered on the territory of the respective municipality.

### Distributional impact

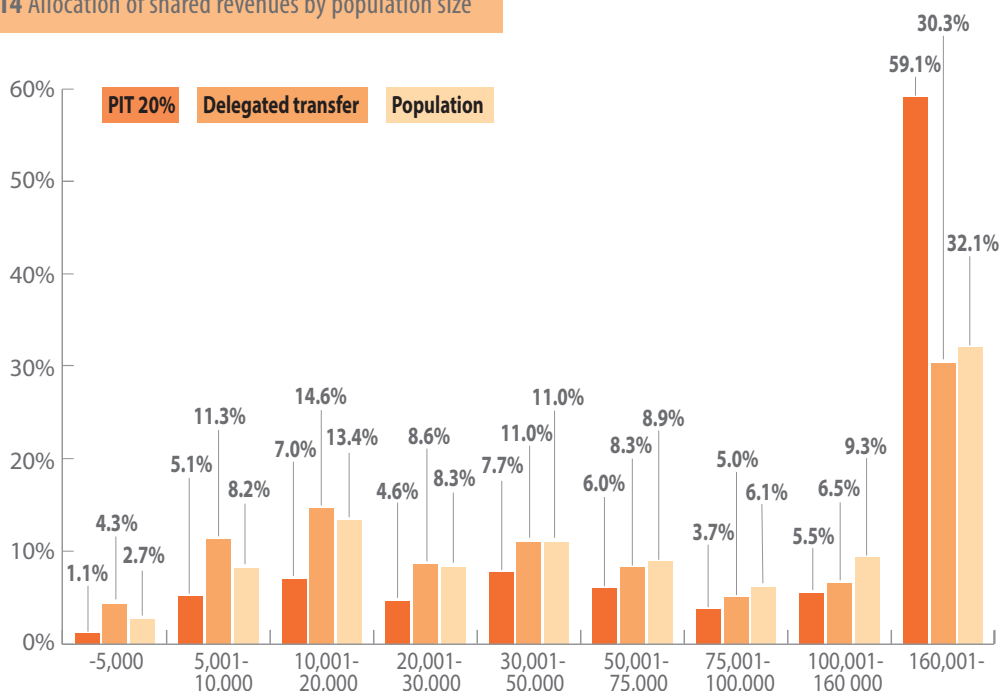
These two proposals on tax sharing would generate significant additional new revenues for municipalities. According to 2019 data, they produce BGN 1.1 billion shared revenues. Compared to municipal data available for 2021, these new shared revenues in total are equal to 37% of municipal own revenues and 12.1% of expenditures on delegated functions (which are covered by state grants)<sup>13</sup> (Table 13).

The two types of shared revenues are concentrated in the large urban centres (Table 14). 61% of the shared PIT and CIT would be raised in the cities with population above 160,000. This high concentration of shared revenues exceeds the relative size of population living in these cities (32%). As the allocation of state grants for delegated services is proportional to population number, they represent a similar weight in the total allocated grants: 30% is concentrated in the large cities.

Revenue sharing	Shared revenues, BGN (2019)	Shared revenue as % of own revenues (2021)	Shared revenue as % of delegated transfers (2021)
PIT 20% + CIT 10%		37.0%	12.1%
PIT 20%	799 793 978	28.0%	9.2%
CIT 10%	256 537 524	9.0%	2.9%

**Table 13** Shared revenues in municipal budget

**Table 14** Allocation of shared revenues by population size



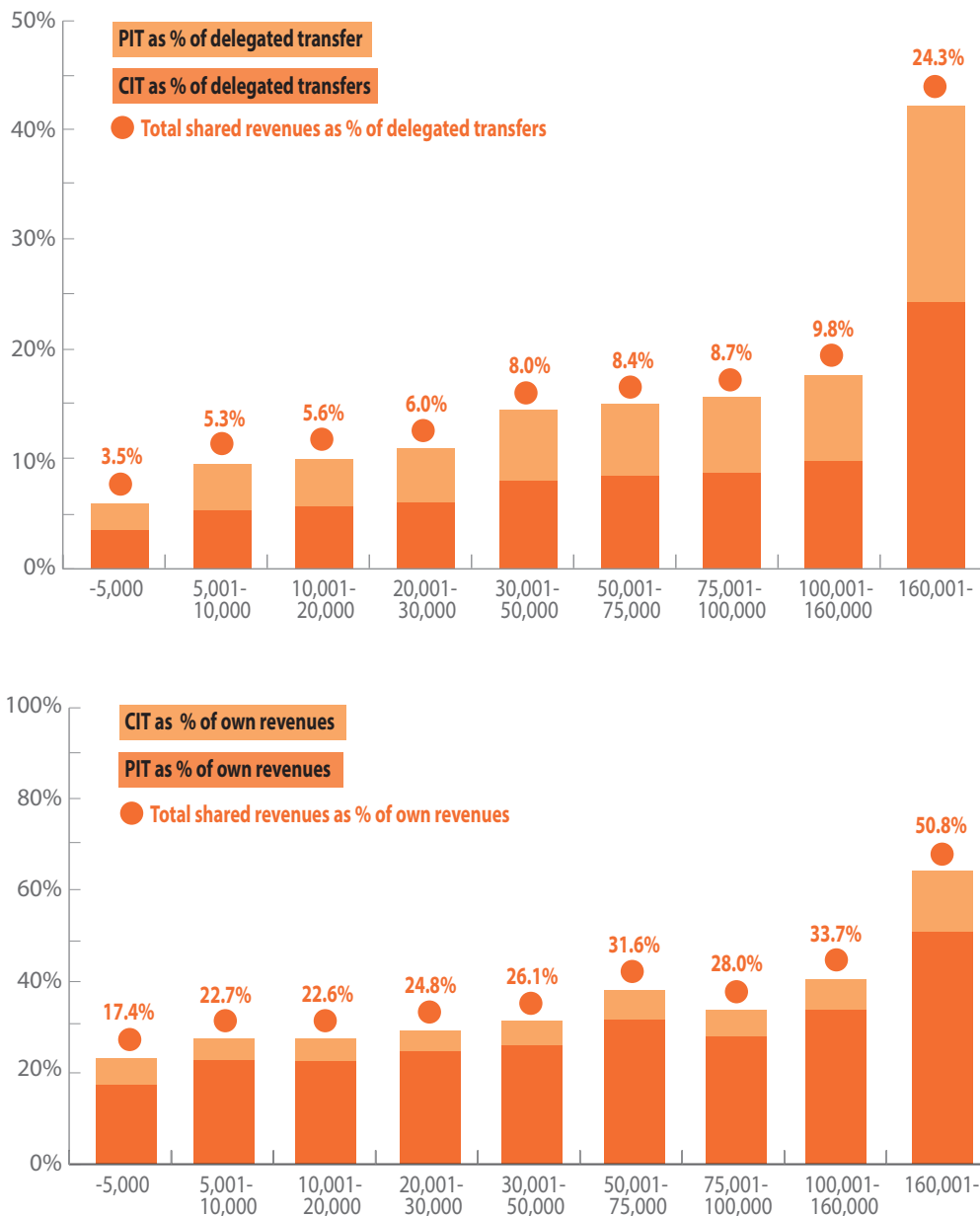
13. Estimated increase of national taxes between 2019 and 2022 is 42.6%, so the present amount would be higher, according to the NAMRB proposal.

Subsequently the *smaller municipalities will benefit less* from the shared revenues: in all other groups of municipalities shared revenues are lower than the ratio of population in that particular group of municipalities (the grants for delegated functions follow a similar pattern). The regional allocation of shared revenues shows a similar concentration: the South Western region with Sofia would get

54% of shared PIT and CIT, while only 30% of population is located here (the weight of state grants for delegated functions have a similar share in this region).

The large amount of shared revenues will affect local budgets differently in the various groups of municipalities. On average, they represent 12% of state grants of delegated

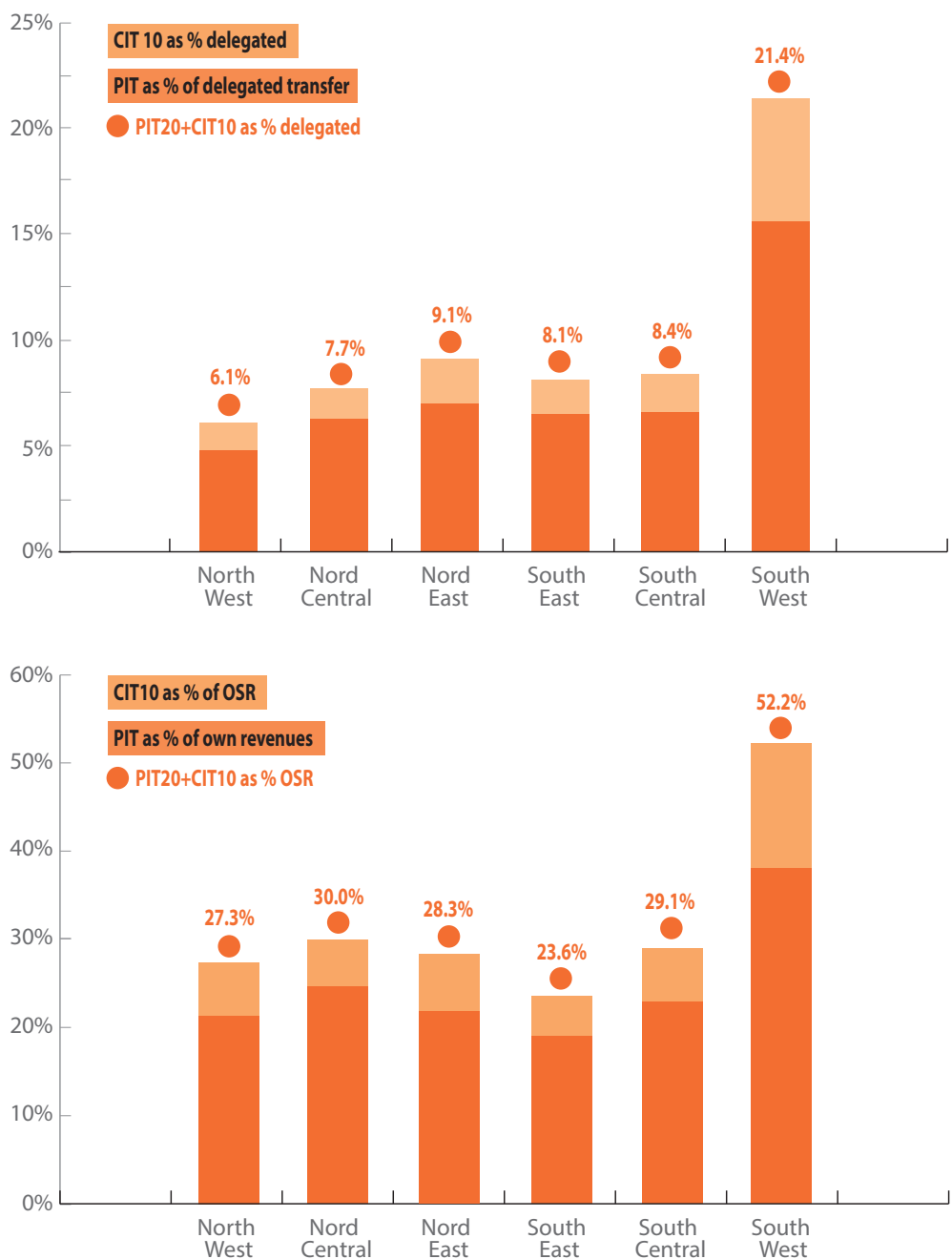
**Table 15** Proposed shared revenues by population size



functions but, due to the high concentration of PIT and CIT, shared revenues will represent only 3% in the municipalities below with a population of less than 5000. (Table 15) This ratio gradually increases with population size, but remains below 10% even in the larger municipalities.

The shared taxes compared to own source revenues represent 37%. This ratio is higher in the large cities (51% in municipalities with population above 160,000). There are differences by population size, but they are less striking than in the case of state grants: shared revenues represent 17% of own

**Table 16** Proposed shared revenues by regions



sources in the small municipalities and 34% in the larger ones.

Diversity of municipalities by population size influences *regional differences* of shared revenues (Table 16). In the Northwest region shared revenues are 6.1% of delegated transfers, while in the other regions – outside the South West – only 8-9%. Compared shared taxes to own source revenues the differences are greater: ratio is the lowest in South East (23.6%) and the highest in the North Central region (30%). Again, the Southwest region is an outlier with its 52.2% ratio.

These revenue sharing patterns characterize the allocation of shared revenues by place of their origin. The already high concentration of shared taxes is further increased by the fact, that taxes are reported by the location of the company centers. This distribution of the proposed shared revenues calls for the need for an *effective equalisation mechanism* in intergovernmental fiscal relations. Large cities would benefit the most from this tax sharing rule, which would further increase the differences by municipal population size. Subsequently, the Southwest region of the capital city will increase its advantage compared to the other regions of Bulgaria.

### Revenue sharing options

Revenue sharing is often used for financing municipalities. This intergovernmental fiscal mechanism produces significant local budget revenue. It is characterized by four main criteria (Blöchliger-Petzold, 2009). Firstly, through revenue sharing, local governments bear the *risk of tax revenue fluctuation*. Secondly, the local use of shared revenue is *unconditional*, that is municipalities have high autonomy in spending the tax allocated to their budgets. Revenues are shared by set rules, which are preferably *regulated by law* without any changes during the fiscal year and rarely being modified between years. Lastly, the

local portion of shared tax is connected to the revenue *generated in the territory of the local government*.

If not all these criteria are met, then shared taxes are closer to the national grants or could be regarded as local taxes. For example, when the last condition is not met, that is the tax is not allocated to the municipality (or region) where it was raised, then it is more classified as a grant. Revenue sharing is often combined with an equalisation mechanism, when the shared tax is reallocated horizontally among municipalities (the first condition is not met).

The revenue sharing method for financing municipalities has several advantages. As usually major national taxes are shared with municipalities, they produce *significant revenues* for the local governments. A proper shared tax is a *stable revenue*, so this is why PIT or VAT is preferred for revenue sharing. CIT is regarded as a more volatile tax with fluctuation within and among fiscal years. When the tax sharing rules are legislated by law, then the local portion will be *predictable* for the recipient municipalities.

It creates an *indirect connection* between the local economy and the municipal budget. More prosperous businesses pay higher taxes, which will support infrastructure development that leads to favourable economic conditions for investors. This feedback mechanism creates local incentives for efficient use of municipal resources.

When municipalities have power to levy a surcharge on the national part of the shared tax, it increases local financial autonomy. The tax sharing is *understandable* for the decision makers, so it is a preferred mechanism during budget negotiations and planning.

Revenue sharing is only one component of intergovernmental finances. Within a broader framework it can be combined with various types of grants, transfers and local taxes to

meet all the conditions of an effective and efficient system of municipal finances.

The following dimensions of revenue sharing should be at the center of the future Bulgarian regulations:

#### **a) Size of shared taxes to be regulated by law**

For defining the actual size of shared taxes, the purposes of revenue sharing should be decided. The present NAMRB proposal aims to *add new resources* to municipalities. However, a 20% PIT (and the 10% CIT) cut in the national budget by revenue sharing will create a high pressure on the national budget. To balance the national budget, a realistic and financially neutral proposal should be drafted. Additional resources for compensating the shared taxes are hardly available and there is always limited room for decreasing national expenditures.

Advantages of revenue sharing can be realised if it only *replaces some of the state grants*. It will have limited impact on the national budget in the first year, but later might create new basis for financing municipalities. There are several state grants, where municipalities would benefit from the less targeted shared revenues. Two options as to how shared PIT (with an estimated value of BGN 800 Million) might replace grants of similar total amount:

- ▶ state grants of BGN 794 million, representing 12.6% of total (2021): municipal administration (BGN 500 million); economic activities and services (BGN 175 million); defence and security (BGN 113 million); public works and communal services (BGN 6 million);
- ▶ discretionary specific grants and subsidies allocated by non-transparent criteria (app. BGN 1 Billion).

Shared revenues are not necessarily connected to specific municipal services. They create an additional, new basis of municipal financing without specifying the targeted group of local functions. This way shared revenues can be used in a more flexible way for municipal staff financial motivation and for decreasing high turnover in municipal employment. The remaining, major part of state grants will finance the other essential local services, such as education, social services, health care, etc.

If other national budget revenues are incorporated in the shared revenue pool, then the scope of the services financed by shared taxes will be increased. As it was already mentioned, CIT is not a good candidate for revenue sharing, because of its volatility and high differences of tax revenues among municipalities.

#### **b) Allocation methods**

Shared revenues are usually allocated by their place of origin or by using a formula for reallocation (similar to a grant scheme). In the first case, the critical issue is how accurately the *place of origin* can be specified. PIT, paid by the location of company headquarters creates high regional differences, especially when businesses are concentrated in large cities (such as in Sofia). But when the actual place of residence can be identified for each taxpayer, then it will make the local PIT revenue more equitable. The computerised tax administration usually stores this information, so the taxes paid by a company can be accounted by municipality, where the company employee actually lives.

An alternative method is the *formula based allocation* of shared revenues. It can be specific or general grant, allocated by need or performance based indicators, similarly to the present state grants for delegated functions.



Tax sharing also offers a good *revenue equalisation possibility*, based on per capita re-allocation mechanism: municipalities below a certain percentage of the national average receive equalisation funds. The sources of revenue equalisation might be provided by the municipalities with the highest shared PIT per capita. This way the equalisation will be kept within the framework of local government budget, there is no need for external funds.

The origin-based tax sharing can be combined with *formula based allocation* methods. Diversity in revenue sharing will increase the fairness and will lower the differences among municipalities. Fiscal equalisation can be achieved also by differentiating the sharing ratio by type of municipalities (e.g. in Moldova the capital city gets lower percentage of shared PIT).

#### c) Local autonomy and discretion

Shared taxes create a *stable base* of municipal finances and leave *high discretion in using* the revenues made available for municipalities. When the national tax policy determines the total amount of shared revenues, then local governments can influence their share only indirectly.

However, in some countries, such as Denmark or Croatia, Montenegro local governments are authorised *to levy an additional local tax* on the same tax base (or to get a locally defined portion of the national tax). This surcharging mechanism is limited, so the minimum and the maximum local tax rate is regulated. Municipalities have no other taxing powers (e.g. giving tax allowances), so the unity of national tax system is protected.

Shared taxes are typically discretionary local revenue sources. Municipalities are autonomous in using them, even when they are allocated as grant (in the form of general purpose local revenues).

#### d) Administrative requirements

As it was already discussed the derivation-based revenue sharing system requires proper information on the taxpayer's place of residence. In Bulgaria, the regional tax administration with IT support should be able to produce information on the taxpayers' addresses. Using this *payroll information on the PIT collected* from companies can be directed towards the real beneficiaries, that is the municipality where the company employee's residence is registered. Tax collection from self-employed is already localised.

Other types of shared taxes might be allocated among the company branches in various municipalities by the asset value, the number of employees or the labour costs.





# CONCLUSIONS

## OPTIONS FOR AN INCREASED FISCAL DECENTRALISATION

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Several reform proposals have already been drafted by domestic and international organisations for fiscal decentralisation and to enhance local financial autonomy in Bulgaria. The key issues and critical policy recommendations specified by local stakeholders (NAMRB, 2023; MORDPW, 2021) and other bodies (CLRACE, 2021; OECD, 2021) on fiscal decentralisation are summarized in Annex 3. Their grouping follows the approach of this technical paper: decentralisation has several dimensions and they should be developed in parallel. They support each other for improving the multi-level government system, which ultimately will contribute to a better local public service provision.

Bulgaria can benefit from fiscal decentralisation and enhanced fiscal autonomy if the *political conditions are further improved* for **making local decisions more open and inclusive. A more accountable municipal leadership will focus on efficient local resource management.** Central budget dependence and control of state organisations should be balanced by social accountability mechanisms. The role of elected bodies should be strengthened vis-à-vis the strong mayor's administrative power. An increased citizen participation in local matters will improve trust in municipalities and more broadly, in all government actions. Stronger councils and citizen's influence will lead to autonomous municipal decision making, which supports effective and efficient service provision.

**The administrative-territorial structure with large size municipalities creates a good basis for local service management.** Benefits of economies-of-scale are partially offset by regional differentiation and the highly concentrated urban structure. They call for intermunicipal forms of cooperation, transformation of the regional government tier with stronger downward accountability and strengthened sub-municipal entities. Institutional forms of consultation with all national government partners on municipal matters and decentralisation policies should be made operational.

The scope and forms of *sectoral decentralisation* determine autonomy in municipal service management. The present strict separation of delegated versus own municipal functions with the distinct parallel **fund allocation mechanisms work counter to local autonomy by limiting integrated and locally accountable decision making.** Municipalities have moderately broad service responsibilities, which should be accompanied by local autonomy in all aspects of service regulation and management (e.g. personnel, ownership, organisational forms, funding).

The fourth component of municipal autonomy and improved local service provision, the *fiscal decentralisation*, needs specific actions within the transforming political, territorial and sectoral framework. The first key element of these reforms is to move towards a **new state grant allocation mechanism**. Scope of grant dependency should be decreased, the allocation criteria should reflect service needs and higher municipal discretion is needed by increasing the role of general grants.

There are options to **enhance own-source revenue** in municipal financing. The centrally regulated real estate tax base assessment should include other coefficients on access to municipal services and regular update of the base unit value. Property taxation can be broadened by introducing agricultural land tax. Connection between local businesses and the municipal budget might be improved by transforming the patent tax system to a proper business value tax. Instead of simple differentiation of a fee by profession, it should take into account the net turnover of local taxpayers.

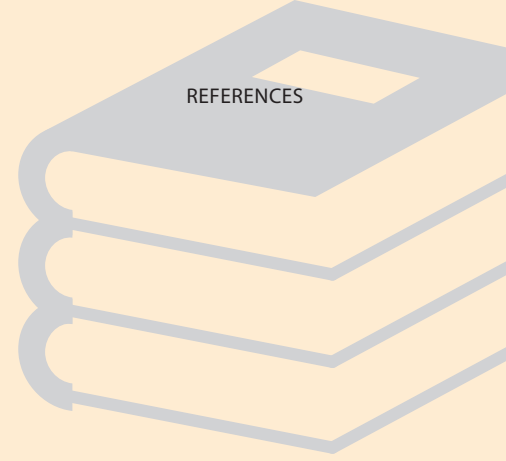
The most significant change in municipal finances is the **re-introduction of shared revenues**. Among the draft proposals, the *shared personal income tax* is the most suitable option in the present intergovernmental finance system of Bulgaria. The actual

sharing ratio and method should be decided in a simulation-based planning process.

The *requirement for a balanced national budget* also has to be taken into account. That is, shared revenues might replace some of the present state grants allocated for delegated local services of primary municipal importance (administration, communal-urban services, etc.).

The method for revenue sharing should support municipal financial autonomy, so it is preferably *allocated by the place of taxpayers' residence*. It might be combined with formula-based revenue sharing by using service needs indicators. Shared PIT also offers effective forms of revenue equalisation by targeting municipalities with lower per capita tax potential (assuming a standard rate on the estimated local tax base).

Most of these fiscal decentralisation reform options can be *introduced in parallel* through a coordinated set of actions. They should be **designed and developed gradually**, in a process which allows sufficient time for adjustment both at national and municipal level. Local governments also need capacity development and support to learn the new rules and to improve local policies, management practices.



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## ANNEXES

### ANNEX 1. Self-rule index for local authorities

Local Autonomy Index	Shared revenues, BGN (2019)
<b>I. Self-rule (0-28)</b>	14
1. Institutional depth: the extent to which local government is formally autonomous and can choose the tasks they want to perform (0-3)	2
2. Policy scope: range of functions (tasks) where local government assumes responsibility for the delivery of the services (0-4)	2
3. Effective political discretion: the extent to which local government can make final decisions over these functions (0-4)	2
4. Fiscal autonomy: the extent to which local government can independently tax its population (0-4)	1
5. Financial transfer system: the proportion of unconditional financial transfers to total financial transfers received by the local government (0-3)	0
6. Financial self-reliance: the proportion of local government revenues derived from own/ local sources (i.e. taxes, fees, charges over which local government has influence) (0-3)	2
7. Borrowing autonomy: the extent to which local government can borrow (0-3)	2
8. Organisational autonomy: the extent to which local government is free to decide about its own organisation and electoral system (0-4)	3
<b>II. Interactive rule (0-9)</b>	7
1. Legal protection: existence of constitutional or legal means to assert local autonomy (0-3)	3
2. Administrative supervision: the extent to which administrative supervision of local government is (un)obtrusive (0-3)	1
3. Central or regional access: the extent to which local authorities have channels to influence higher level governments' policymaking (0-3)	3
<b>III. Additional information by fields of services</b>	
<b>IV. Satisfaction with local governments, trust</b>	

Source: Ladner, et al, 2021

## **ANNEX 2.** Categorisation of municipalities

Source: Ministry of Regional Development and Public Works

Municipalities and sub-municipal entities are categorized by the Ministry of Regional Development and Public Works by their level of development. The municipalities are qualified into five categories, the wards, mayoralities are further classified into eight groups. This categorization of municipalities and settlements is used for the following purposes:

- 1) determining the additional component of the targeted subsidy to support municipalities of the 4th and 5th categories to improve their condition of the social and technical infrastructure on the territory of the municipality (component B2; Mechanism for determining the main budgetary relationships between the central budget and the budgets of municipalities in the form of subsidies for 2022, Law on the State Budget of the Republic of Bulgaria for 2022);
- 2) calculating the tax assessments of buildings, land within construction boundaries, built-up yards and land outside construction boundaries, agricultural land;
- 3) categorization for partial financial support for the development of projects of general development plans of municipalities;
- 4) price subsidies for public passenger transport, for subsidizing public passenger transport on unprofitable bus lines in intra-city transport and transport in mountainous and other regions, for issuing transport documents for transport;
- 5) fees paid when the agricultural land use purpose is changed.

Categorization of the municipalities and sub-municipal entities is carried out on the basis of officially published data once every 10 years by using the following types of indicators:

- a) Demographic status (6 indicators)
- b) Economic potential (7 indicators)
- c) Infrastructural development (21 indicators)
- d) Development and potential of the territory (8 indicators)



## ANNEX 3. Current reform proposals and recommendations on local finance and financial management

This is a summary of key issues and critical policy proposals specified by local stakeholders (NAMRB, 2023; MORDPW, 2021) and international organisations (CLRACE, 2021; OECD, 2021) on fiscal decentralisation.

Issues, problems to be solved	Proposals, recommendations
<b>Political decentralisation</b>	
Local democracy needs to be strengthened within municipalities	<p>Strengthening "intra-municipal decentralisation" and promoting the participation of civil society</p> <hr/> <p>Developing a stronger understanding of stakeholder engagement framework</p> <p>Building capacity among civil servants and decision-makers to engage with citizens</p>
<b>Administrative decentralisation</b>	
Encourage inter-municipal co-operation in rural, urban and metropolitan areas, improving urban-rural linkages	<p>Integrated partnership as public law entity, with specialised or territorial scope</p> <p>Support by special subsidies and technical assistance</p> <hr/> <p>Consolidating the decentralisation of municipalities, regionalisation and regional development</p>
<b>Assignment of functions and responsibilities</b>	
Overlapping competences and fragmentation of responsibilities reduces decision-making powers of local authorities in delivering the public services under their own responsibility	<p>Clarify the distribution of competences allocated to different levels of government in order to eliminate overlapping of responsibilities</p> <hr/> <p>Review of responsibilities and functions assigned to the different levels of government</p> <hr/> <p>Identify areas where municipalities could be involved as partners and "co-providers" (shared responsibilities)</p> <hr/> <p>Creation of legal guarantees against the transfer of financially unsecured responsibilities to the municipalities</p>
Lack of discretion of local authorities with regard to adapting the exercise of delegated powers to local conditions Municipal expenditure is managed to a large extent by the central government (targeted transfers, additional conditions established by regulatory framework, etc.)	Increase local authorities' discretion to adapt the exercise of delegated powers to local conditions
Lack of municipalities' discretion in defining spending priorities when the relevant activities are financed through the State transfers	Improving coordination mechanisms between the levels of government

Fiscal decentralisation	
<i>Underfunded mandates, lack of local resources</i>	
Lack of commensurate financial resources available to local authorities to perform their functions. In practice the municipalities carry a heavy burden of tasks without sufficient funding	In-depth review of financing needs for all delegated functions, including those that are transferred by secondary legislation
System of local finances is not buoyant enough to ensure that delegated tasks are matched with necessary funds	National governments should contribute to the local government system when devolving new tasks or when additional costs arise from a change in national legislation or due to extraordinary events and crises that are out of the control of local governments
	All transfers of additional functions should be negotiated with the NAMRB to assess its relevance and find adequate fiscal and sometimes technical compensation
<i>Grant dependency, allocation mechanisms of transfers, subsidies</i>	
Low level of local financial autonomy as a result of a strong dependence of Bulgarian municipalities on financial transfers from the State budget	Reduce local authorities' dependence on financial transfers from the State budget
	Introduce an objective, adaptive, reliable and accurate system to calculate resources commensurate with the cost of performing municipal tasks
	Creation of a methodology for assessment of municipal road maintenance needs
More freedom in deciding how to use grant funding, without being excessively constrained by strict guidelines, norms and control from the central government	Shifting from earmarked grants to general purpose grants in some sectors, more flexibility in the use of grants
Further fiscal decentralisation also calls for better equalisation mechanisms and fiscal rules	Optimisation of the criteria for access of municipalities to the general equalisation subsidy
	Combine vertical and horizontal transfers (from wealthy jurisdictions to the poorer ones)
General equalisation subsidy targets mostly municipalities with low fiscal capacity	Target revenue equalisation and reduce differences in the cost of providing public services
<i>Capital investment financing</i>	
Silos generated by specific grants which are not conducive to effective public investment	Legally established mechanism for determining the total amount of the capital subsidy
	Adopting general capital grants based on a formula
<i>Access to significant state revenues through tax sharing</i>	
Municipal revenues are not connected to the dynamics of economic development.	Restructuring of the tax system to strengthen the role and diversify local taxes, transforming some of the national taxes (PIT, CIT, VAT, fuel excise rates) into taxes shared by formula or through surtaxes
<i>Increase of own source revenues</i>	
Low share of municipal resources deriving from local taxes and charges	Increase the share of local taxes
	Revise legislation to increase local government fiscal autonomy by enlarging local tax-levying powers. Giving more power to municipalities to set the local tax base and provide tax breaks, preferences
	Increase charges in the local revenue pool

Missing link between local growth and municipal revenue, giving local government incentives to attract investment and boost local growth	Cleaning tax or a street lighting tax; parking taxes or taxes on ride-sharing service; license taxes on advertising, gambling, entertainment, personal services
Reforming the property tax system is particularly complex but also politically risky for municipalities, as property taxation is particularly unpopular with taxpayers	Updating the real estate tax assessments in view of the real market conditions, and creating a mechanism for periodic automatic updates
	Using indicators that capture the drivers of the real estate market, such as accessibility to public transport or services
	A fair approach to real estate ownership taxation (including agricultural land and forests)
<i>External financing</i>	
Borrowing remains underutilised because of borrowing constraints and weak creditworthiness	Reviewing prudential rules, encouraging joint borrowing, facilitating the access to capital market, developing a rating system, enlarging the scope of the Fund for Local Authorities and Governments in Bulgaria (FLAG), developing municipal development funds, encouraging subnational pooled finance mechanisms
PPP is used mostly for municipal property management (624 municipal concessions)	Programme on subnational PPPs to build municipal sector capacity; establish a PPP unit dedicated to supporting municipalities and providing financial resources to municipalities to access technical support
<i>Public financial management</i>	
Structural deficiencies of the centralised local finance system: municipalities do not have sufficient control over their revenues, not fully able to analyse the effectiveness of their activities	Improved transparency and accountability through disclosure, monitoring and transparency of municipal functioning; reinforcing accountability to guarantee fiscal sustainability
Restrictive rules applied to local budgeting that constrains budgetary autonomy of local self-government	Simplified rules applied to local budgeting in order to lighten the budgetary supervision and to provide more budgetary autonomy
Need for efficient, transparent procurement system	Guidance and IT support to municipalities for procurement; encouraging purchasing alliances
Effective internal and external audits	Strengthened oversight role of municipal councils, civil society over the municipal budget
Lack of specialised qualified staff in particular in smaller municipalities	Efficient and accessible system for training of local employees to strengthen the administrative capacity of municipalities
Municipalities lack the administrative capacity and tools to collect tax receipts, to fight against tax evasion and avoidance	Central government support is needed: i) favouring inter-municipal co-operation to establish common tax offices; ii) improving co-ordination and co-operation between municipalities and national agencies, iii) optimising the system for central-local information management; iv) increasing the delegation of rights to local authorities concerning tax collection enforcement
<i>Decentralisation reform process management</i>	
No national vision or ambition for large-scale and comprehensive local finance reform	Design decentralisation strategy based on informed dialogue with key stakeholders; multi-level governance “forum”; developing tools for monitoring and assessing the implementation; pilot programmes for change on a larger scale.
Not sufficiently effective Council for Decentralisation of State Governance	

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