Co-funded
by the European Union

EUROPEAN UNION

COUNCIL OF EUROPE

CONSEIL DE L'EUROPE

Co-funded and implemented
by the Council of Europe

22BG07 – Developing fiscal decentralisation and improving local financial management in Bulgaria

# Policy Advice Document

**CEGGPAD(2023)12**

# Fiscal autonomy and financial management of local administrations in Bulgaria

13 December 2023

This document was prepared by the Centre of Expertise for Good Governance, Council of Europe in cooperation with the CoE international experts Vieri Ceriani and Gábor Péteri.

This document was produced with the financial support of the European Union and the Council of Europe.

The elaboration of this document would have not been possible without the cooperation and the consultation with the Bulgarian Ministry of Regional Development and Public Works and Ministry of Finance, the National Association of Municipalities in the Republic of Bulgaria, and the civil society organisations FLGR and CPF.

# Table of contents

# Table of boxes, charts, table

# Acronyms

| | |
|---|---|
| **BGN** | New Bulgarian leva |
| **CEGG** | Centre of Expertise for Good Governance |
| **CPF** | Citizen Participation Forum |
| **CPI** | Citizen Participation Index |
| **CIT** | Corporate Income Tax |
| **DG Reform** | Directorate-General for Structural Reform Support |
| **FLGR** | Foundation of Local Government Reform |
| **FG** | Fiscal Gap |
| **IRAP** | Regional Value-Added Tax (in Italy) |
| **LBVT** | Local Business Value Tax |
| **MoF** | Ministry of Finance |
| **MoRDPW** | Ministry of Regional Development and Public Works |
| **NAMRB** | National Association of Municipalities in the Republic of Bulgaria |
| **PIT** | Personal Income Tax |
| **RTS** | Representative Tax System |
| **SEN** | Standard Expenditure Need |
| **SFC** | Standard Fiscal Capacity |
| **SLO** | Standard Level of Output |
| **TSI** | Technical Support Instrument |
| **VAT** | Value-Added Tax |

# EXECUTIVE SUMMARY

The Policy Advice document was elaborated in line with the Council of Europe Committee of Ministers' recommendations to member States on the principles of good democratic governance (CM/Rec(2023)5), on the financial resources of local and regional authorities (Rec(2005)1), on financial and budgetary management at local and regional levels (Rec(2004)1) and the European Charter of Local Self-Government.

This document has two main parts. After setting the objectives of policy advice, the first part (Chapter 2) is an evaluation of the **critical issues** in local governments finances. It is based on the previous analytical reports and findings from the meetings with government officials and other project partners. A factual description of these selected aspects of local government finance is attached in Appendix 1 of this document. The assessment of the current municipal finance system highlights the scarce autonomy of Bulgarian municipalities, concentrating on the following main critical areas: (i) the excessive reliance on State grants and the limited role of own resources; (ii) the separate financing of own and delegated functions; (iii) the excessive reliance on earmarked grants; (iv) the limited role of the equalisation system, its fragmentation, the inadequacy of the revenue equalisation, which produces wrong incentives for the tax effort of the municipalities; (v) the lack of a benchmarking and monitoring system of the actual provision of public services; (vi) the inadequacies of the tax base of the real estate tax; (vii) the need to modernise the business patent tax; (viii) the lack of revenue sharing; and (ix) the need to improve social accountability and transparency of municipal finances.

The second main part proposes two **policy scenarios** (Chapter 3). The comprehensive one discusses several specific proposals targeting all the main issues of local government financing. From this longer list, the most urgent proposals are prioritised for an alternative – minimalist – reform package to be introduced in the initial stage. This second part of the policy advice document is supported by the description of specific methods, country cases and best practices: Appendix 2 deals with the equalisation system and Appendix 3 advances proposals for a system of benchmarking and monitoring the actual provision of local services.

In particular, the **comprehensive scenario** advances the following proposals (Box 1):

**Box 1. Policy proposals under the comprehensive scenario**

**A new approach to financing all municipal functions**

1) Unify the municipal budget, eliminating the distinction between "own" and "delegated" functions and the related separation in the sources and methods of financing;
2) Equip central government with other fiscal tools and techniques to orientate municipalities, like block grants, performance based grants;
3) Earmarked grants should be abolished (or drastically reduced) and consolidated into a new system of equalisation grants;
4) The new equalisation system should consider the fiscal gaps, i.e., the difference between the standard expenditure needs and the standard fiscal capacities;

5) Standard expenditure needs should be calculated using statistical methods/econometric models;
6) The calculation of the fiscal capacity should be based on standard revenues, i.e., standard (average) tax rates applied to standard (potential) tax bases, instead of the actual revenues currently in use;
7) A system of benchmarking and monitoring the actual provision of public services should be introduced.
8) Change the composition of revenues, increasing the role of own source and shared revenues and reducing the dependency on State grants
9) Reform the real estate tax, better adjusting the tax base to market values and including agricultural land and forests;
10) Reintroduce revenue sharing of the PIT, considering alternative methods of origin-based tax sharing or a municipal surcharge on the national PIT;
11) Reform also the business patent tax: the existing lump-sum patent fee, that suits micro and small size businesses, should be supplemented with a modern new business tax for medium and large enterprises, based on value added;

**Accompanying actions**

12) Avoid the devolution of additional functions to the municipalities without providing additional financial resources;
13) The practice of "non-budgeted" transfers at the end of the year should be abandoned, or at least drastically reduced, and carried out in a more transparent way;

**Enhance social accountability and improve transparency in municipal finances and financial management**

14) Develop public participation practices for all major municipal decisions;
15) Strengthen the role of mayoralties in municipal planning and service management;
16) Improve social accountability through information sharing and customer orientation;
17) Support open fiscal planning procedures and participatory budgeting practices.

The main objective, terminating the rigid separation of financing delegated and own functions, and strongly reducing the scope of earmarked grants, can be achieved by introducing block grants and developing a general equalisation grant based on the fiscal gap approach. Also, improved techniques for determining the expenditure needs could be used to orientate municipal expenditures toward selected local services.

Reforming the equalisation grants on the revenue side will eliminate the current disincentives to the fiscal effort of the municipalities. Better utilisation of the local tax bases should be supported by enhanced own source revenue raising autonomy. Monitoring the performance of municipalities in producing local services will contribute to transparency and accountability.

Revenue sharing options should be designed to keep the national budget balanced: enhanced funds allocated to municipal budgets through PIT sharing should be compensated by lower national budget grants: the impact on general government budget would be neutral and only the allocation between the two levels of government will be modified. The accompanying actions would pre-empt practices that should be avoided or carried out in a more transparent way. Enhancing social accountability and transparency is a necessary complement to the reform process.

These proposed reforms would support each other for building equitable and efficient intergovernmental fiscal relations between the national and local government tiers. They should be introduced in parallel and in a coordinated way. However, not all the changes should be legislated at the same time. Various combinations of the proposed actions might be implemented.

The **alternative (minimalist) reform package** specifies those critical elements of the comprehensive reform which are proposed to be developed in the initial stage. It differs in some respects from the comprehensive scenario. It indicates some priority actions, while some other proposals are mentioned just for consideration (see Box 2).

**Box 2. Policy proposals under the gradual reform package**

**Steps toward a new approach to financing all municipal functions**

1) The current distinction between "own" and "delegated" functions and the related separation in the sources and methods of financing are maintained;
2) But the calculation of the earmarked grants for delegated functions through statistical/econometric methods is experimented;
3) A new system of monitoring the actual provision of public services is developed;
4) The equalisation system is reformed, but limited to the revenue side: i) replacing the actual revenues currently in use with the standard fiscal capacity (standard tax rates applied to standard tax bases); ii) eliminating the diverse criteria resulting in fragmentation between the funds for fiscal capacity, for "poor" municipalities and for rewarding the fiscal effort.

**Raising own source and shared revenues**

5) The real estate tax is reformed, adjusting the tax base to market values and including agricultural land and forests;
6) Reintroducing revenue sharing of the PIT is considered;
7) Reforming the local business patent tax is considered.

**Accompanying actions**

8) Avoid the devolution of additional functions to the municipalities without providing additional financial resources;
9) The practice of "non-budgeted" transfers at the end of the year should be abolished, or at least drastically reduced and carried out in a more transparent way.

**Enhance social accountability and improve transparency in municipal finances and financial management**

10) Develop public participation practices for all major municipal decisions;
11) Strengthen the role of mayoralties in municipal planning and service management;
12) Improve social accountability through information sharing and customer orientation;
13) Support open fiscal planning procedures and participatory budgeting practices.

The gradual approach package differs from the comprehensive reform mainly because it maintains the current distinction between delegated and own functions and the related separation in the methods of financing. But it recommends as a priority to experiment a pilot exercise on the calculation of expenditure needs for delegated functions. It also recommends developing a new system of benchmarking and monitoring the performance of the municipalities in the actual provision of services: it would greatly contribute to the transparency and accountability of municipal policies and to citizens' participation and awareness. On the equalisation system, it is highly recommended as a priority to reform the revenue side and overcome the current flaws that create disincentives to the fiscal effort of the municipalities.

Another priority would be the reform of the real estate tax, which is already under discussion, while reintroducing revenue sharing for the PIT and also reforming the local business tax should be considered and evaluated. The package is completed with the accompanying measures and with recommendations to improve social accountability and transparency.

Even under this more limited scenario the proposed reforms should be planned in parallel, but introduced sequentially. They all **need sound preparations**:

- The new method for calculating earmarked grants (i.e., standard expenditure needs), the new equalisation fund, and their allocation mechanisms must be developed with evidence-based policy design. Alternative options should be tested and experimented through simulations based on the available fiscal and statistical municipal data.
- The tax reforms must be carefully designed, calculating their potential revenue yield and the impact on taxpayers and the economy in general. Administrative burden on tax administration and on central and local governments should also be assessed. Different options must be evaluated. The same considerations hold for revenue sharing of the PIT.
- Improvements in local accountability and transparency require organisational support and development in municipal management and staff capacities.

# 1. OBJECTIVES OF THE POLICY ADVICE

This policy advice document is one of the key outputs of the project on *“Developing fiscal decentralisation and improving local financial management in Bulgaria*”[1], financed by the European Union through the Technical Support Instrument (DG Reform) and the Council of Europe, and implemented by the Centre of Expertise for Good Governance (CEGG) of the Council of Europe. The Technical Support Instrument (TSI) project assists decentralisation reform design and implementation by providing tailor-made expertise to the main beneficiary, the Ministry of Regional Development and Public Works (MoRDPW), in cooperation with the Ministry of Finance (MoF), the National Association of Municipalities in the Republic of Bulgaria (NAMRB) and other key stakeholders.

The proposals on comprehensive reform areas and the specific recommendations on the initial steps of this report were drafted by building on the related TSI project activities and other fiscal reports[2]. The CEGG expert team had several opportunities to discuss the critical fiscal reform issues with the local counterparts. This information exchange with the Bulgarian authorities, local partners, consultation with the civil society organisations and the other TSI project activities laid the foundations of these policy proposals. The key reports identifying the reform areas are, as follows:

(i) desk research and situation analysis on policy and legislative provisions regulating fiscal decentralisation and their practical implications for Bulgarian municipalities[3];

(ii) technical report with the comprehensive analysis of the existing legal, administrative and operational framework for municipalities[4] (CEGG, 2023);

(iii) draft report produced by the Peer Review team;

(iv) training needs analysis of local governments in Bulgaria[5].

The specific objective of this policy advice document on fiscal autonomy and financial management of local administrations in Bulgaria is to draft a set of reform proposals centred on intergovernmental fiscal relations. It focuses on the critical issues of allocation of intergovernmental fiscal transfers and own revenue raising autonomy. These recommendations all aim to: (i) create a more efficient system of managing delegated and own functions of municipalities; ii) improve the efficiency and accountability of grants and transfers from the State; iii) reform the equalisation grants and create incentives for their efficient use; iv) increase local accountability through greater own source and shared revenues; (v) improve equity and fairness in local finances; and (vi) enhance social accountability in municipal finances.

[1] https://www.coe.int/en/web/good-governance/bulgaria

[2] Current reform proposals and recommendations from local stakeholders and international organisations on local finance and financial management are summarised in Annex 3 of the project Technical Report.

[3] NAMRB, 2023: Desk research and situation analysis on policy and legislative provisions regulating fiscal decentralisation and their practical implications for Bulgarian municipalities.

[4] CEGG, 2023: Comprehensive analysis of the existing legal, administrative and operational framework for municipalities. Technical Report.

[5] FLGR, 2023: Training needs analysis of local government in Bulgaria (draft).

Many of these fiscal issues are closely connected to other conditions of an effective and efficient local government system. However, these related issues of successful decentralisation, such as the territorial-administrative structure, the allocation of public services between government tiers, financial management practices, political and participatory mechanisms will not be discussed here in details. They are beyond the scope of this document. However, some reference is made to the improvement of municipal social accountability and transparency.

The policy proposals advanced in this document take account of the findings of the above-mentioned reports (in particular, the Technical Report CEGGPAD (2023)8, and the Peer Review report CEGGPAD (2023)9) and of the public consultations organised by the CPF, the opinion of the TSI project partners, and the discussion with the Project Advisory Board.

# 2. EVALUATION: CRITICAL ISSUES

## 2.1 Municipal financing relies too much on State grants

Bulgarian municipalities are excessively dependent on State grants and their access to own revenues (local taxes) is too limited. They rely for more than 70% of their revenues on grants from the central government (or the EU). Own taxes account only for 15%. Other own revenues are roughly 15% (mainly fees for waste disposal and other uses or concessions). Municipal tax revenues represent only 4.2% of total general government tax revenues, a ratio significantly lower than the European Union average (15.4% in 2020).

As highlighted in the Peer Review report, this composition of revenues, unbalanced in favour of grants and disfavour of own taxes, does not conform with the experience of other European countries[6].

## 2.2 Delegated functions and their financing

The budget of Bulgarian municipalities is split: the delegated functions (mainly in the fields of education, social services, health, and culture) are almost entirely financed by state grants, which are earmarked, with a very detailed division in sub-functions. Their spending is subject to controls and audits by the central authorities. Delegated functions account for 75% of the municipal expenditure[7]. Hence Bulgarian municipalities, for the prevailing part of their functions, act as local branches of the central government, with very limited autonomy. The system is directed from the centre.

This is at odds with the practices adopted in other countries and recommended by the CoE[8]. What is the rationale of this system? It seems inspired to the concept of a "omniscient benevolent dictator"[9] who is capable of (or tries its best to) identifying the needs of the population over the entire country and adapts the financial needs of the different municipalities according to the characteristics of the local situation, taking account of variables like the size and composition of the population, differences in production costs, geography, socio-economic factors, etc. This system simultaneously determines the

[6] It seems also worth mentioning the following recommendation of the Council of Europe: "*The overall system of local and regional finance should aim at striking a suitable balance between financial transfers, including grants and shares of nationally determined taxes on the one hand, and locally determined taxes and charges on the other*". (Council of Europe (2004), CM/Rec(2004)1 - Recommendation of the Committee of Ministers to member States on financial and budgetary management at local and regional levels, para 2).

[7] The same considerations apply to the grants for investment projects and for winter road maintenance and snow removal, which are also earmarked and subject to controls. However, they have limited relevance: they account for only 2% of total grants.

[8] Council of Europe (2005), "CM/Rec(2005)1 - Recommendation of the Committee of Ministers to member States on the principles of good democratic governance", particularly Artt. 3, 13, and 14.

[9] The 'omniscient benevolent dictator' is a theoretical figure used in public economics to deliver 'optimal' solutions in a general equilibrium model with provision of public goods. With perfect knowledge of individual needs and preferences, natural endowments, production functions and costs, etc., the 'optimal' solution would maximize welfare in a Pareto-efficient way. Leaving aside theoretical models, in practice no such solution can be achieved: information is incomplete, often unavailable; governments may not be benevolent towards general welfare, rather towards specific constituencies; and even the most 'dictatorial' regimes make their decisions on the basis of a balance of different and often contrasting objectives (See: Holcombe, R. G. (2012), *Make Economics Policy Relevant - Depose the Omniscient Benevolent Dictator,* The Independent Review, Volume 17, N. 2, Fall 2012).

expenditure needs of each municipality and provides the grants for financing them. This system does not require own revenues nor equalisation grants. It is self-contained and self-sufficient.

The critical point is that the "omniscient benevolent dictator" is an abstract figure, familiar to the scholars of public finance, but difficult (or impossible) to implement in practice. Anyway, the myth of the 'omniscient benevolent dictator' is contradicted by the reality. Municipalities are forced to use their own revenues and the General Equalisation Subsidy for financing the delegated function. In addition every year, towards **the end of the budget** period, the Council of Ministers, upon requests from municipalities, decides a redistribution of the allotments that are likely to go unspent, and gives additional funds to some municipalities (mostly for preventing, controlling and overcoming the consequences of disasters and for investments repairs, reconstructions and construction of public buildings), with an allocation procedure which is found not fully transparent by the municipalities. In the last years (2018-2022) these "non-budgeted" transfers have ranged between BGN 174 million (for 136 municipalities 2021) and 513 million (for 241 municipalities in 2022), with an average of BGN 330 million[10]: a quite significant amount in comparison with the ordinary "in-budget" transfers (around BGN 6 billion in 2021).

The legal distinction between delegated and own functions does not reflect a distinction in the relative importance of the different functions. It simply determines the methods of financing: on delegated functions the State keeps a tight control. This is officially justified by the (not unfounded) preoccupations on the insufficient administrative and managerial capacities of many municipalities, especially the smallest. Nevertheless, this financing environment is itself an impediment to the development of efficient local managerial capacities and creates serious limitations to the local autonomy. The survey implemented by the TSI project on municipal training needs clearly showed the local preferences and attitudes[11]. The main obstacles for municipalities (beyond insufficient revenues, inadequate funds) are the lack of personnel, legal restrictions in local decision making and frequent changes in legislation. All these factors lead to poor level of independence of the local administration, which limits innovative thinking, employee engagement and results in low motivation[12].

As a final remark, monitoring of the general quantity and quality of the services produced, and its evolution over time, is not very well developed. **Benchmarking and monitoring** the effects of the expenses on the actual quality of the services provided seems to be lacking[13].

## 2.3 Local "own" functions and their financing

At the opposite of the delegated functions, the financing of the "own" functions (road maintenance, lightning, waste disposal, water supply, sewage, defence, and security) is based on own taxes, fees, and non-earmarked equalisation grants. This is broadly speaking in line with the international (and recommended) practices, but regards only a minor fraction of the budget of the municipalities.

Municipalities may use the own revenues and the equalisation grants also for financing the delegated functions, while the opposite (i.e., using earmarked grants for "own" functions) is not possible. Over the years, the scope of delegated functions has been widened using secondary legislation, without

[10] Data received from NAMRB

[11] FLGR, 2023: Training Needs Analysis of Local Governments in Bulgaria. Council of Europe, TSI project, Sofia

[12] See Table 3. and Table 4. of TNA report – *draft version* (FLGR, 2023)

[13] OECD (2021), *Decentralisation and Regionalisation in Bulgaria: Towards Balanced Regional Development*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/b5ab8109-en, pp. 84-87

providing additional grants. Hence, a share of own revenues and equalisation funds has been used to cover delegated functions. Consequently, total financial resources have tended to fall short of actual expenditure needs.

Furthermore, there are some specific critical points as regards the existing local taxes and the equalisation system.

### 2.3.1. The municipal taxes

The **real estate tax** is the typical own tax of local administration. The Bulgarian tax has some shortcomings. The basic value component of the tax valuation formula has not been updated to the market values. The consequence is a loss of revenues and the perception of unfairness and dissatisfaction among taxpayers. Agricultural land is exempt, but typically it should be taxed under this type of tax, as well as forests. Due also to the shortcomings of the equalisation system (see paragraph 3.4 and Appendix 2), many municipalities are reluctant to enforce the tax. Only one third of the municipalities levy the real estate tax above the average rate.

The shortcomings of the equalisation system also lead to laxity in the enforcement of the **vehicle tax**, which is also underutilised.

In Bulgaria the property related taxes dominate, while the taxation of economic activities is negligible. Local small businesses are taxed only by a license fee. This **patent tax** is a lump-sum fee levied on a centrally defined tax base, differentiated by type of economic activity. It ignores the economic dimension, i.e. the taxpayer's actual turnover or profitability.

As the economy grows and more structured business increase their presence, more sophisticated forms of local business taxes become appropriate. Generally, these consider as the tax base an economic indicator, like the sales (turnover), profits, or the net value of the production (sales minus intermediate costs). As a policy indication, the current lump-sum patent tax should not be abandoned, because it suits well micro and small size businesses widely present in the Bulgarian economy. But it should be accompanied by a local business tax based on the value of production (like in Hungary, Italy, Germany, and France), to be applied to medium-large size companies (above a certain dimensional threshold). This latter tax could reward municipalities in their effort to attract new businesses. International examples (see Box 3) suggest that municipalities in Bulgaria might benefit from taxing local business value more actively.

**Box 3. Examples of local business taxes**

**Local business tax** is an important revenue source for local governments in some European countries. A properly designed business tax meets the requirements of a good local tax[14]. It is a contribution to the public services consumed by the local companies. It finances municipal services, such as local infrastructure, environmental protection and other services preferred by investors (housing, culture, city marketing, etc.). Tax levied on net turnover (by deducting input costs) will

[14] Bird, M. R. (2013): *The VAT as a Local Business Tax*. Tax Notes International 2013, Volume 72, No. 5., Péteri, G. (2021): T*axing local economy: international cases, lessons* (*A gazdaság helyi adóztatása: nemzetközi példák, tanulságok*) Comitatus, 2021. Summer-Autumn, Volume XXXI., Issue 238. http://www.mrtt.hu/files/comitatus/comitatus_2021_nyar.pdf

minimise the economic distortions and create incentives for attracting modern businesses producing higher added value. This tax base is less volatile than company profit, so it creates a stabile local revenue source. The costs of tax administration can be shared with the national tax authority, which manages the company income tax. In Europe taxes on local business are usually levied on added value (revenues minus purchases of intermediate goods and services).

In **Italy,** the tax base and the standard rates of the regional value added tax (*IRAP*) are set by law. The regions can modify the tax rate within limits around the standard. The collected IRAP is reallocated among the regions.

In **Hungary,** a similar tax on net turnover of local business activities is widely used by local governments. It produces approximately one third of municipal revenues. The maximum tax rate is set by law and an equalisation mechanism aims to lower regional differences in tax base.

In **Germany,** the local business tax (*Gewerbesteuer*) is an important municipal revenue source. The tax base is similar to the company profit tax, it is levied on the company income by deducting some costs. The minimum rate is 3.5% and municipalities set their rates within the limit regulated by the state governments.

In **France,** after the 2008/2009 economic crisis, the local business tax (*Tax professionnelle*) was replaced by two *contributions of local businesses*. One of them is based on company assets and the other on added value. Asset valuation follows rent capitalisation method, and the maximum rates are regulated progressively. The added value component is levied on companies with larger turnover, and its revenue accrues to intermediary tier governments (Départment, Region).

### 2.3.2 Shared taxes

Revenues shared between national and local budgets have mixed characteristics. They could be qualified as locally controlled revenues if they meet three criteria: i) sharing ratio and rules are fixed for a long period (several years); ii) the amounts of the shared tax accrue where the revenue was generated (origin-based allocation); iii) risks of revenue raising are shared (no immediate equalisation exists). If these conditions are not met, then the shared tax should qualify as a grant.

In the past in Bulgaria revenue sharing was used for financing municipalities. Alike some other Central-Eastern European countries, the total amount of personal income tax was reallocated to municipalities since 1991. 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.

Recently there have been several proposals to reintroduce revenue sharing for financing municipalities. NAMRB plans are to share 20% of PIT and 10% of CIT with municipalities by the place of origin according to the location of the company headquarters. There was a government counterproposal in 2015 to authorise municipalities to levy a 2% local surcharge on PIT base. Both sets of proposals were rejected by the other party, so no further policy design (nor modelling and simulations) were made. Renewed attention on the issue of revenue sharing, particularly for the PIT, has been recently raised by NAMRB, with new proposals.

## 2.4 The equalisation system

Local governments are financed by a combination of own source revenues and shared taxes or grants provided by the higher government tiers. These intergovernmental transfers are always necessary to complement own revenues, that are commonly insufficient to finance the general public services that local governments must provide for.

The **intergovernmental transfer system has three – sometimes competing – basic objectives**.

**Firstly**, grants should guarantee at national level a *minimum (or average, standard) level of services* for local governments that are in different positions. Differences in minimum (or standard) per-capita costs are caused by various factors, such as special needs, differentials in service costs, different size and composition of the population, different geographical conditions, differences in the economic environment, etc. Service costs among local governments of similar types and with comparable functions should be equalised.

**Secondly**, the fiscal capacity, i.e., the revenue raising potential diverges among municipalities, due to differences in local tax bases and related economic development. The grant system must recognise not only the objective variations in the scope and unit costs of local services, but at the same time consider the *unequal distribution of the revenue bases*, as well.

However, special local demand for public services or the underutilisation of the revenue bases should not be fully compensated by the intergovernmental transfers. On the contrary, the **third** objective of the equalisation grants is to *create incentives* for rational municipal spending, promoting efficient local service provision, and stimulate (or not discourage) municipalities to increase their tax effort in own source revenue raising.

These three objectives should be balanced in a properly designed intergovernmental transfer system.

In Bulgaria the *specific earmarked grants* of delegated functions serve primarily the first objective, that is the provision of minimum (average) services. The system is designed to be self-sufficient: the minimum standards for delegated functions are directly financed through earmarked grants, hence there is no need for equalising the revenues (nor the expenditures). This part of the financing system aims to achieve simultaneously the equalisation of expenditure needs and fiscal capacity. Whether it succeeds in doing so is a different story. However, even in the case it was successful, it has the very strong drawback that it excessively curtails the fiscal autonomy and accountability of the municipalities.

As for the “own” municipal functions, one critical point of the Bulgarian equalisation system, taken as a whole, is its **fragmentation**: the funds for fiscal capacity, for expenditure needs, for “poor” municipalities and for rewarding the fiscal effort are calculated separately and added up. The best international practices equalise the **fiscal gap**, i.e., the difference between the standard fiscal capacity and the standard expenditure needs.

The current Bulgarian equalisation system for the revenue side fails the third objective, i.e., it does not create the financial incentive for efficient use of available fiscal capacity: at the opposite, it creates the wrong incentives/disincentives for the tax effort on own source revenue raising.

This is because the **equalisation of fiscal capacity is based on actual revenues**. This method has a strong drawback: it generates incentives for the local authorities to reduce their fiscal effort. In fact, if local governments collect "less" revenue, because of setting low tax rates and granting generous exemptions and rebates (if they are allowed some autonomy in these area) or because of laxity in enforcement (this seems to be the case for the property tax and vehicle tax), they find compensation in higher equalisation grants. If they raise "more" tax revenue, their equalisation grants are reduced. In particular, the equalisation of actual tax revenues discourages raising local taxes up to 120% of the national average. There is no incentive for municipalities to increase their taxes, because they would suffer an equivalent loss of equalisation grants. While if they reduce the tax revenues, they are fully compensated by State grants. The same considerations apply to the special funding for "poor" municipalities: it creates an incentive for these municipalities to remain below the 25% threshold of own tax revenues on their total revenues.

The Bulgarian system is apparently aware of these drawbacks. As a correction, the special fund to reward for the tax effort has been introduced. But this fund is quantitively negligible and, from a systemic point of view, it seems just a patch that pays lip service to the correction of a fundamental flaw in the equalisation system. The special fund for 'poor' municipalities is also a signal of the unsatisfactory performance of the current system of equalisation of fiscal capacity.

The best method for equalising the fiscal capacity is to apply the standard tax rates to the potential tax base. This method, known as the Representative Tax System (RTS) is commonly preferred to the actual revenue approach and is recommended by CoE[15] as a best practice.

The **equalisation of the expenditure needs** of the "own" functions is based on the general characteristics of the municipality and seems to follow common international practices. Since it deals only with the "own" functions, its size is quite limited in an international comparison.

As noted, the equalisation funds, considered in their entirety, play a marginal role in financing the municipalities: they cover only 5% of total revenues (in 2021). Their capability of equalising expenditure needs and fiscal capacity, today limited to the "own" functions, is low in an international comparison. Other countries tend to rely less on earmarked grants and more on own taxes: hence, they need more developed equalisation mechanisms.

Overall, the existing equalisation system is very complex, creates wrong incentives and is not very intelligible. Its functioning is hardly comprehensible, and its effects are not clearly understandable by decision makers and the general public.

## 2.5 Accountability and transparency

Accountability of local public service provision and municipal operation and management is influenced by several factors. In Bulgaria a critical condition is that sizeable municipalities are managed by relatively large elected councils. Up to municipal population of 50,000, one councillor on the average represents less than 1,300 citizens. It creates a good basis of political accountability, as – in principle – it brings the councillors closer to their electorates.

[15] Council of Europe (2005), "CM/Rec (2005)1 - Recommendation of the Committee of Ministers to member States on the financial resources of local and regional authorities", para. 46 and 57.

However, both municipal councillors and the mayors are elected on (party) lists and not in individual wards on a territorial basis. 75% of mayoral seats were won by the candidates representing the parties in National Parliament and only 6% were independent, that is nominated by initiative committees (2019). This political party influence on municipal elections resulted that most of the mayors have been re-elected and the number of mayors with three and more mandates is increasing.

Government in general is ranked low by trust among various public institutions, although municipal councillors are trusted more (32%) than the members of the parliament (21%-29% in the period of 2015-2019)[16].

Mayors have an intermediating role between local and higher government tiers, which influences also the municipalities' position. The mayor has a unique status, as s/he is not member of the municipal council, but part of the state administrative subordination structure. Among the 7,400 locally elected mayors and councillors 31% are with executive powers as mayors of municipalities, wards and mayoralties. Mayors are responsible for 70% of the numerous municipal competencies. These factors strengthen the administrative dependence of municipal management.

Social accountability mechanisms at municipalities are in place. Regulations on local referenda, civic initiatives, general populace meetings and public consultation processes are set in details. However, citizen participation surveys showed a slightly declining trend during the past two years: the Citizen Participation Index (CPI) is 3.59 on a six-grade-scale, compared to 3.78 two years before[17]. Key indicators of CPI show that the legal environment and procedural requirements are less favourable (3.10) and effects of citizen participation is scored low (3,45). While the practices of citizen initiatives and active citizenry are considered to be more developed (4.25).

The results of the *Local Finance Benchmark survey* (implemented in the framework of the TSI project) proved rather favourable conditions of municipal information sharing and budget openness. Self-assessment in the six pilot municipalities resulted average score of 4.52 (on a 5 point scale). Local strategies and programs for an election term exist, the multi-annual budgets are prepared, major fiscal decisions are properly explained and discussed at open meetings. However, beyond this average score - even in this small sample of tested municipalities - there are significant differences between municipalities of various sizes and types. It indicates the diverging municipal practices and diverse local capacities.

The *Peer Review report* indicated that the level of knowledge among the wider public about municipal budget is low. The main problems are the complicated format in which local budgets are presented and the brief calendar window in which the draft budgets are available for consultation.

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

---

[16] Smilov, D. (2022): "Democracy and Civic Participation. Public attitudes towards democracy, rule of law and human right", Open Society Institute - Sofia and Centre for Liberal Strategies, Sofia

[17] *Source*: https://index.fgu.bg/en

In this organisational and regulatory environment improvements of municipal accountability should focus on the following issues:

1) developing local political mechanism, which would compensate political party influence in municipal decisions and finances;
2) strengthening social accountability through higher information sharing, citizen awareness and inclusion;
3) introducing and disseminating financial management methods for greater transparency and public control over municipal finances.

# 3. POLICY SCENARIOS

In the prospect of advancing recommendations, it seems useful to identify two policy scenarios. The first scenario envisages a comprehensive radical reform, that adopts the best international practices and is in tune with CoE recommendations. The second is a gradualist step-by-step approach, that assumes the political unfeasibility of the comprehensive approach, at present, and addresses some most relevant and urgent shortcomings.

As it was discussed by the project *Technical Report*, fiscal decentralisation should be supported by a comprehensive set of actions, encompassing the legal, political, administrative and fiscal framework of municipalities. Here, this policy advice document focuses on one component, the municipal finances. It is assumed that starting a reform process in the field of local finances will create incentives for changes in the other related areas, such as reallocation of functions and increase in the administrative and managerial capacities of the municipalities. Nevertheless, this report also advances proposals for improving social accountability and transparency.

The general objective of both policy scenarios is to reinforce the fiscal autonomy of Bulgarian municipalities: reducing the dependency on State grants and modifying their composition, in favour of non-earmarked grants; improving the equalisation system; expanding the scope of own taxation.

Many of the proposals of this report are common to those advanced in the *Peer Review report*.

## 3.1 The comprehensive reform

In order to conform with the best international practices and apply CoE's principles of good governance[18] and the recommendations on the financial resources of local and regional authorities[19], many fundamental changes should be introduced. As follows:

### A new approach to financing municipal functions

1. **The municipal budget should be unified, eliminating the distinction between "own" and "delegated" functions.**

The strict separation of delegated versus own municipal functions limits integrated and locally accountable decision making, hence it is against local autonomy. Legal provisions cannot specify all the details of centrally controlled but locally provided – that is delegated – services. In the daily municipal

[18] Council of Europe (2023) "CM/Rec(2023)5 - Recommendation of the Committee of Ministers to member States on the principles of good democratic governance"

[19] Council of Europe (2005), "CM/Rec(2005)1 - Recommendation of the Committee of Ministers to member States on the financial resources of local and regional authorities".

practice service responsibilities are shared. For example, education is part of the broader local human development strategy, school buildings are integrated in the municipal asset management; while the services regarded as own functions, such as public transportation, disaster control, culture always depend on the national government regulations and policies. Separation of financing mechanisms for these two groups of locally provided public services does not automatically guarantee the required municipal resources.

There is wide evidence that own source revenues and the general equalisation subsidy are used for funding the delegated services. The delegated service with earmarked grants does not automatically mean proper financing of diverse local needs and service performances. Public services of local significance are typically shared responsibilities financed through multiple funding channels. Other mechanisms are needed for stable, equitable and efficient financing of municipalities.

## 2. In a multi-channel system of local government finances, central government agencies and ministries can be equipped with other fiscal tools and techniques.

Diversion from earmarked, specific grants of delegated services does not mean that line ministries will be deprived of fiscal instruments completely. First, they remain influential actors in national budget planning. Line ministries assess service performance, develop sectoral policies and programs, they evaluate adequacy of available resources. Beyond the sector ministries influence on grant allocation methods, they can develop specific financing techniques for promoting the sectoral objectives.

Block grants constrain municipalities to use grants received for pre-determined group of services. National government policies and specific objectives can be financed by special budgetary programs, which are in force for the period of a targeted action. These temporary programs with a clearly defined outcome and timing (sunset clause) are usually supported by the counterpart Ministry of Finance. Fiscal policy makers tend to accept more the performance-based grant schemes, because the service outputs are well connected to the appropriated funds.

Furthermore, reducing earmarked grants will necessarily imply increasing equalisation grants, that must take into account the definition of standard expenditure needs. In the definition of these needs, appropriate consideration may be given to specific services which are considered as priorities, applying appropriate weights to the relevant variables.

Summarily, limiting the scope of delegated services and making unified budgets will not decrease the power of sectoral ministries when other fiscal tools are developed.

## 3. Earmarked grants should be abolished (at least radically reduced) and consolidated into a new system of equalisation grants, that would replace the current equalisation system[20].

Earmarked grants are at odds with local autonomy and accountability. In the Bulgarian case they are extremely widespread and pervasive. As highlighted, for the “delegated” functions they intend to simultaneously determine for each municipality the expenditure needs and the grants that finance them: the system does not need equalisation nor own revenues, is self-contained. On the contrary, the

[20] For more details on the equalisation system, see Appendix 2.

expenditure needs should be financed through non-earmarked equalisation grants and own resources. Hence, the earmarked grants should be abolished, or drastically reduced, and limited to very few cases in which national policies deem important to foster local expenditure. They should be absorbed into a new equalisation system.

### 4. The new equalisation system should be based on the fiscal gaps, i.e., the difference between standard expenditure needs and standard fiscal capacities[21].

The equalisation on the revenue side intends to reduce the differences in fiscal capacity of the local administrations, while the equalisation of expenditures has the purpose of reducing differences in the cost of providing public services that do not depend on local policy. The highest level of efficiency and fairness in the redistribution of equalisation grants can be achieved with the equalisation of the fiscal gap, i.e., the difference between standard expenditure needs and standard fiscal capacities. The *European Charter of Local Self-Government* (par. 5, art. 9)[22] and the CoE's recommendations[23] support the adoption of the combination of both revenue and expenditure equalisation.

Usually a **top-down approach** is adopted in implementing the equalisation systems. Under this approach, in the first place the funds to be distributed from the State budget are determined, and then apportioned among the local governments using the share of their fiscal gaps (or standard expenditure needs) on the national total. This system is commonly preferred because it allows the central government to keep stricter financial control on the total amount of transfers to local governments. Also in Bulgaria the overall amount of State grants is currently determined with a top-down approach and decided with the annual State budget. This approach should be maintained in the reformed equalisation system.

### 5. Standard expenditure needs should be calculated using statistical methods/econometric models[24].

Standard expenditure needs (SENs) are calculated using formulae which apply weights to relevant indicators. The formulae should be understandable and promote accountability, but also complete and precise enough to be reliable. The indicators should capture the differences in the costs of providing local services and in the amounts of services (for example, because of different number of residents entitled to the services). The weighting should be set on the basis of objective evidence about spending variations generated by the municipal differences of these indicators.

The weights may be calculated applying *a priori* considerations. This seems to be the case in Bulgaria, in a different context, i.e., for the determination of the parameters used to decide the earmarked grants for delegated functions (and for investment and winter road maintenance). In several developed

[21] For more details on the equalisation system, see Appendix 2.

[22] "The protection of financially weaker local authorities calls for the institution of financial equalisation procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility".

[23] Council of Europe (2005), "CM/Rec(2005)1 - Recommendation of the Committee of Ministers to member States on the financial resources of local and regional authorities", para. 46 and 57.

[24] For more details on the equalisation system, see Appendix 2.

countries [25] SENs are evaluated using statistical methods: expenditure needs of each local administration are computed as the expected value of an econometric model derived from cost/expenditure functions. Regression analysis is usually applied.

## 6. The calculation of the fiscal capacity should be based on standard revenues, i.e., standard tax rates applied to potential tax bases, instead of the actual revenues currently in use[26].

The shortcomings of the current system based on the actual revenues has been highlighted. It produces wrong incentives, because discourages the tax effort and does not penalize laxity in enforcement. Therefore, applying standard tax rates to potential tax bases (known as the Representative Tax System (RTS)) is to be preferred: all the extra revenue above the standard rate will not be considered in the equalisation formula and will be fully available to finance local services. On the opposite, if a municipality decides to set its tax rate below the standard rate or gives exemptions and rebates (when allowed by the national law), it will not be compensated through higher equalisation grants. Also, using the standard tax base, in place of the actual, discourages laxity in enforcement.

All own revenues should be considered in the evaluation of fiscal capacity: besides own taxes, also fees and charges on which the municipalities have discretion in fixing the rates. Such a comprehensive system of equalisation of the fiscal capacity should replace the existing system and overcome its current fragmentation between the funds for fiscal capacity, for “poor” municipalities and for rewarding the fiscal effort, which are calculated separately and added up.

## 7. A system of benchmarking and monitoring the actual provision of public services should be introduced[27]

As highlighted, while the expenditure of earmarked grants is closely monitored and controlled, an effective monitoring of the general quantity and quality of the services produced seems not well developed. Therefore, it could be useful to evaluate the performance of each municipality in the actual production of services, in respect of a reference point (the national average, or a standard level). Using the methodology applied for calculating the SENs and an appropriate set of variables it would be possible to calculate standard levels of output (SLOs), which can be compared with the actual levels of output. The difference between actual outputs and SLOs could supplement the *expenditure gap* (the difference between actual expenditures and SENs) and provide an indicator of municipal performance.

This kind of analysis would not enter the system of inter-governmental financial relations, nor the budgeting system. It would be used for benchmarking, to identify best practices and to stimulate inefficient local administrators to improve their performance. It could greatly contribute to the transparency and accountability of municipal policies and to citizens’ participation and awareness.

---

[25] Good examples are Denmark, Finland, Norway, Sweden, Portugal, Japan, Australia, and Italy. See selected country cases in Appendix 2.

[26] For more details on the equalisation system, see Appendix 2.

[27] For more details on this monitoring system, see Appendix 3.

## Local autonomy requires raising own source and shared revenues

### 8. Enhanced role of own source revenues.

Transforming the intergovernmental transfers should be combined with changes in the municipal revenues. A reduced relative importance of grants is accompanied by a strengthened role of local own taxes.

As it was already discussed, the **real estate tax** should be reformed, adjusting the tax base to the market values, and including land (both agricultural land and forests). According to the NAMRB proposals assessment of real estate tax base can be corrected by incorporating other factors in property evaluation. Access to public transportation should be included in the set of coefficients used for defining proxy property value. According to this policy proposal package, the tax rate might be differentiated by settlements, zones, and property type. It will support fairness in real estate taxation and will open new possibilities for capturing property value increase.

The former NAMRB proposals generate an 85% increase in the unit value of property tax base. Agricultural land, agricultural machinery and self-propelled machinery, properties worth less than BGN 1,680 should be also subject to property taxation. On the average, these 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 higher property tax revenue, while the agricultural land tax will increase more the revenues of the smallest municipalities.

Also the **local business tax** should be reformed. The existing lump-sum patent fee, that suits micro and small size businesses, can be supplemented with a new business tax for medium-large enterprises, based on value added. It would be a significant source of stable revenues and would contribute to the financing of local infrastructures and services, that are used by local companies. In doing so, it might create positive feedbacks between the provision of local services and infrastructures and the development of the local economy. The tax base of business located in more than one municipality could be apportioned among the different jurisdictions using as a key the relative size of labour costs and asset values.

The local business tax will be considered in the system of fiscal capacity equalisation. Fixing limits to the tax rate (minimum and maximum) will allow financial autonomy for the municipalities and avoid excessive burden on companies. The proposed reforms of local business tax should not significantly increase the fiscal burden on businesses. Allowing the deduction of this local business tax from the national tax on company profits would partially compensate the higher local tax burden and reduce the impact on economic competitiveness.

### 9. Additional local revenues should come from shared taxes, primarily from the personal income tax.

PIT is better qualified as a municipal revenue than the corporate income tax, which is a volatile revenue and whose allocation among municipalities is less evenly distributed. Personal income tax as a major national tax would produce significant revenues for the local governments. It is a stable local revenue and when sharing rules are legislated by law it is a predictable source for the recipient municipalities. Revenue sharing reflects the joint responsibility of national and local governments in public services provision. Tax sharing is a preferred mechanism in budget negotiations and for planning purposes, because it is not too complicated and is easy to understand as a funding mechanism. It creates an indirect connection between the local economy and the municipal budget, which produces local incentives for efficient use of municipal resources.

For keeping the national budget balanced, shared PIT should replace some of the present national budget grants (e.g. the earmarked specific grants).

Shared revenues are usually allocated by their place of origin or by using a reallocation formula. In the first case, the place of origin can be specified by the location of the company's headquarters or its branches. However, for PIT it is preferable to adopt the actual place of residence for each taxpayer, because it will direct the revenues of the shared tax to the municipality where the services are consumed. The IT systems of tax administration usually track this information and allow sharing the PIT according to the residence of the taxpayer[28].

Alternatively, local governments can be authorised to levy an additional local tax on the national tax base (or to get a locally defined portion of the national tax). The local surcharge would be limited by the national law, that would establish the minimum and the maximum local tax rates (or the locally defined portions). This way the unity of the tax system would be preserved, and the national tax policy goals achieved.

## Accompanying Actions

### 10. Avoid the devolution of additional functions to the municipalities without providing additional financial resources.

There is evidence that, over the years, the scope of delegated functions has been widened (sometimes using secondary legislation), without providing additional grants. Hence, municipalities have been forced to use own revenues and equalisation funds to cover delegated functions. Devolving centrally performed functions to local administrations without adequate financial compensation contrasts commonly accepted principles in intergovernmental financial relations: some countries forbid it under Constitutional law.

### 11. The practice of "non-budgeted" transfers at the end of the year should be abandoned, or at least drastically limited and carried out in a more transparent way.

As pointed out in the *Peer Review report* (p.14), *"The discretionary "extra-budgetary allocations" would better be avoided, because they generate loose budget constraints at the local level, which is the opposite of the stated goal of MoF; a multi-annual fund to (co)finance capital investments in municipalities could be set up instead, with a clear and transparent mechanism of allocation based on calls and scoring points, and possibly prioritising the co-financing of EU projects in order to improve the absorption rate of EU funds, which is a national priority".*

[28] This holds for the tax withheld by the employers on the remunerations of the employees. It also holds for self-employed taxpayers, whose residence is normally known to the tax authorities.

## Enhancing municipal accountability and citizens’ participation and awareness

### 12. Enhance municipal accountability and transparency.

Outcomes of the proposed fiscal autonomy techniques highly depend on the effectiveness of municipal accountability mechanisms. Our brief evaluation of municipal regulations and practices proved the need for better public participation and improved social accountability with dissemination of effective financial management methods. Within the given legal-administrative framework of local governments greater public control over municipal finances and higher transparency aim to balance administrative accountability of municipal leadership.

The main critical reform area is the ***improvement of local political mechanism***, which would compensate political party-based influence. The local-territorial aspects of municipal elections can be strengthened only in a longer period within a comprehensive reform of election system. It is more realistic to target other public participation mechanisms, which would bring results in a shorter period.

Here Council of Europe recommendations on the principles of good democratic governance[29] offer several practical tools. There is a wide range of tested participatory and deliberative democracy forms, ranging from citizens’ assemblies to referenda. Enhancing the competencies of the *kmetstvo* leader might help to counterbalance the powers of the municipal mayors, while still keeping the unified local policy making and budgeting. Our consultation with civil society organisations proved the need for wider use of public forum/council approach to discuss topics and issues important to the local citizens. In this field - beyond enabling legislation - assistance is also needed through guidance, capacity building, targeted financial support and dissemination of good municipal practices.

***Social accountability*** should be further strengthened through better information sharing, citizen awareness and inclusion in municipal decisions. Accountability can be improved primarily through transparency and openness of municipal operation and management. Municipal performance standards, forms of service management, complaint mechanisms with contact points published by “citizen charters” will bring local governments closer to their customers.

Better informed citizens, local civil society organisations and other groups of interest representation (e.g. business organisations, chambers of commerce, urban/regional development associations, environmental movements) will make the municipal policy design and decision making more inclusive. Technology offers new and easily accessible forms of public information. Municipal administration practices should be developed by introducing local standards for working with citizens and inventing staff incentives for modernisation of local organisation and management practices.

Soft areas of social accountability should be developed through diverse national and local actions. The supportive legal and regulatory environment is critical, but information sharing and awareness-raising campaigns for citizens are also highly needed. The benefits of fiscal decentralisation together with the assessed impact on citizens’ life – both benefits and costs in the form of taxes, fees - should be widely disseminated. It will help to make the available participatory mechanisms more effective, improve inclusion and ultimately will make municipal service provision more responsive to local needs.

[29] CM/Rec(2023)5 of the Committee of Ministers to member States on the principles of good democratic governance.

In the specific field of ***municipal finances and financial management*** budgeting process and local budget allocation mechanisms are the main reform areas. Medium and annual budget planning can be improved through effective public consultation. New approaches are needed to increase the quality of discussions on service performance and planning. The citizen budget presents municipal government priorities in an understandable and easily accessible format, which creates a good basis for public audit of local spending and revenue generation. Another already experimented budgeting technique in Bulgaria is the municipal fund allocated through participatory budgeting. This method, when a specific municipal budget appropriation is allocated for financing civic initiatives, should be promoted and more widely used.

## 3.2 The gradual approach

If the comprehensive approach is considered unfeasible at present, a gradual approach should address some priorities, which need more urgent interventions, and anyway are consistent with a step-by-step approach to the comprehensive reform.

This scenario differs in some respects from the comprehensive scenario. It indicates some priority actions, while some other proposals are mentioned just for consideration.

### Move towards the new approach to financing municipal functions

1. **The current distinction between delegated and own functions is maintained, as well as the current system of earmarked grants for delegated functions.**

For the time being, the current distinction between delegated and own functions (‘split’ budget) would remain in place. Hence, also the current system of earmarked grants for delegated functions, investment, and snow removal would remain in place.

This is a very relevant and the most important difference from the comprehensive approach. In fact, abolishing the ‘split budget’ model and the widespread use of earmarked grants would be a major and deep reform, which needs careful preparation, projection over a prolonged time span, and some preliminary experimentation. The postponement of this important aspect of the overall reform must be accompanied by the individuation of some preliminary steps to be undertaken and some critical aspects to be addressed with some urgency. In other words, some action priorities should be identified. As follows:

## 2. The calculation of earmarked grants through statistical/econometric methods should be experimented, as well as a new system of benchmarking and monitoring the actual provision of public services.[30] (High Priority Action)

The parameters that today are used to determine the grants for the delegated functions mimic the definition of SENs, but with two very relevant differences: they are based on a priori considerations, not on the objective statistical estimation of cost/expenditure functions; they are also completely outside of the equalisation system, because they directly determine the earmarked funds. Of course, as already pointed out (see chapter 2.2), if the logic of the 'omniscient benevolent dictator' is accepted, the earmarked grants would represent *per se* standardized expenditure needs and there would be no need of a separate equalisation system on the expenditure side.

But even if this scenario is accepted, the adoption of a statistical/econometric method for calculating the weights (parameters) should be experimented, following the methodologies described for the calculation of SENs in the comprehensive reform (paragraph 4.1, point 5) and in Appendix 2.

In the same vein, also a new system of benchmarking and monitoring the actual provision of local services should be experimented (as described in point 7 of the comprehensive reform and in Appendix 3).

Experimenting these methodologies is consistent with Activity 4.2 of the Project Description 22BG07, which foresees a "*Pilot exercise to establish benchmarks for local finances and standard expenditure needs",* which should be carried out "*using CEGG Local Finance Benchmarking for central and local authorities and SOSE Standard Expenditure Needs methodology*".

Furthermore, a system of benchmarking and monitoring the actual provision of local services could greatly contribute to the transparency and accountability of municipal policies and to citizens' participation and awareness.

Pilot exercises should be implemented for experimenting the determination of SEN and for benchmarking and monitoring the provision of local services. For both Pilot exercises a special small task force should be set up, with national and international experts. It should closely interact with officials from the relevant Ministries, NAMBR, FLGR, CPF, etc., and implement the following steps (Box 4):

[30] As indicated at point 5 and 7 of the comprehensive approach.

**Box 4. Steps of a pilot exercise for determining SENs and benchmarking local services**

The first preliminary step is to set up a working group, as mentioned. It is crucial that the Pilot exercise is carried out with the greatest transparency, involving the main stakeholders, besides experts at national and international level. Although some technical expertise on statistical methodologies is needed, it is very important to have factual knowledge of the functions performed, of the organisational set-up, and of the actual techniques used for the provision of local services. Local administrators, officials from the relevant central authorities, representatives of the municipalities and their association must be involved and contribute with their experience and knowledge.

*A)* The following steps for the determination of SENs will be implemented (see also Appendix 2):

- Select a Pilot function (e.g., education, health, or some other social function) to be experimented
- Select the relevant explanatory variables, which should cover:
  - quantity of services produced (e.g., pupils, hospital beds)
  - quantity of inputs (premises used, electricity, fuel, etc.)
  - personnel (number, by qualification and task performed)
  - relevant cost variables (prices) for inputs and personnel (salary)
  - context variables, such as number of inhabitants (by age groups), surface of the municipality, length of the roads, number of settlements, altitude, climatic conditions, economic conditions, etc.
- Prepare a data base that collects available statistical data from different existing data sets (central government, NAMBR, national statistical office)
- Carry out statistical analysis (clustering and regressions):
  - clustering will distribute municipalities in groups having similar characteristics (like: cities, agricultural municipalities, industrial municipalities, tourist resorts)
  - regression will calculate the weights to be assigned to the relevant independent variables
- Consider if other variables should be brought in, and how to acquire them
- Carry out a trial-and-error experimentation, comparing the results with those of the existing methodologies for delegated functions
- Evaluate the results and formulate proposals on the implementation of the experimented methodology.

*B)* As for the implementation of a Pilot system of benchmarking and monitoring of local services (see also Appendix 3), for the same function chosen for SENs, the information on SENs and the actual expenditure will be already available. It will be necessary to calculate standard level of outputs and compare them with the actual levels. The same procedure used for the calculation of SENS will be applied, with a main difference in the variables used for benchmarking: additional variables will be included, referring to the quality of the services (as an example, for education, the rate of dropouts from school, the proficiency levels).

The new system for the determination of the parameters for the delegated functions (SENs) would be based on factual evidence, instead of *a priori* considerations. But it could also allow some centrally oriented policies, through the application of “politically mandatory” weights, different from the weights calculated through the regression analysis, and designed to orientate municipal expenditures toward some special functions (or sub-functions) deemed worth to be expanded.

3. **The equalisation of the fiscal capacity is reformed, based on calculation of the standard fiscal capacity, i.e. standard tax rates applied to standard tax bases, instead of the actual revenues currently in use.** [31] **(High Priority Action)**

This new comprehensive system of equalisation of the standard fiscal capacity should replace the existing system, correct its flaws that discourage the tax effort of the municipalities, and overcome the current fragmentation between the funds for fiscal capacity, for “poor” municipalities and for rewarding the fiscal effort. It is a high priority action also because in the envisaged process of intergovernmental financial reform the equalisation system will play a much more relevant role. It is therefore fundamental to start streamlining the current system, to correct the flaws on the revenue side (as indicated at point 6 of the comprehensive approach).

**Box 5. New procedure to calculate the equalisation grants**

- All municipal own source revenues should be considered, that is taxes (property transfer tax, real estate tax, vehicle tax, local business tax, etc.) as well as the fees on which municipalities have autonomy in fixing the rates.[32]
- If there is a possibility for municipalities to manoeuvre the tax rates, the mean value of the range of possible variation should be taken as the standard value. Otherwise, the rate fixed by the national law is considered.
- As for the tax base, wherever a national registrar is available (like for vehicles or immovable property) the sum of the tax base referred to each municipality is taken as the standard tax base. Otherwise, the actual tax base is used and replaces the standard.
- Standard tax rates applied to standard tax bases (or to the actual bases if the standard bases are not available) produce the standard fiscal capacity of each municipality.
- Also shared taxes (eventually the PIT) should be included in the revenue equalisation system, considering the municipal tax base and the sharing ratio.
- Standard fiscal capacities, divided by number of inhabitants, i.e., the per-capita standard fiscal capacities, are the benchmark for equalisation.
- The “richest” municipality(ies), i.e., the one(s) with higher per-capita standard fiscal capacity, does(do) not receive equalisation grants.
- The other municipalities receive equalisation grants, in proportion to their distance from the highest per-capita standard capacity. The proportion sets the rate of inter-municipality solidarity.
- The differences between each municipal per-capita standard capacity and the highest per-capita standard capacity are multiplied by the number of inhabitants in each municipality, determining the equalisation grant for each municipality.

---

[31] As indicated at point 6 of the comprehensive approach.

[32] Fees for waste disposal are a special case. Following EU legislation, the rule applies that each municipality must cover the full cost of the service with the related fees. In this sense, municipalities have no discretion; hence, the common practice is to exclude these fees from the equalization system.

## Raising own source and shared revenues

### 4. The real estate tax is reformed, adjusting the tax base to market values and including agricultural land and forests. [33] (High Priority Action)

This reform is already under discussion in Bulgaria. It is a very important step to improve the fiscal autonomy of municipalities, besides improving the fairness and efficiency of the Bulgarian intergovernmental fiscal relations. It should be prepared carefully with detailed preliminary studies and simulations of its effects. If properly implemented, it could give impulse to the municipal initiatives aimed to promote the local economy through the provision of local services and infrastructures. To achieve this result, as highlighted above at point 3, it would be necessary to remove the drawbacks of the current equalisation system, that create the wrong system of incentives/disincentives for the tax effort of the municipalities.

It is understood that there is a general political concern to avoid tax increases. This step-by-step approach will address in the first place the issue of the unfair distribution of the tax burden, among different municipalities, different areas within the municipalities, and different types of buildings, working on the redefinition of the tax bases by better aligning them with market values. To avoid a drastic increase in the tax due, the levels within which municipalities can set the tax rates could be reduced for a period (e.g. five years), when the maximum rate is increased back to its present level . Instead of producing a general increase of the real estate tax, the burden will be redistributed among taxpayers in relation to the effective value of their properties and in a more progressive way. It is assumed that owners of more valuable property have higher income, so the real estate tax is more aligned to their ability to pay and it will have a more equitable and fair distributive impact. With an adequate margin of autonomy in fixing the tax rates, the municipalities will be free to reach a point of equilibrium between local preferences for better (worse) local services and infrastructures and higher (lower) taxes on the immovable properties of their resident taxpayers.

**Box 6. How to prepare the real estate tax reform?**

NAMRB real estate tax proposals aim to make the property tax assessment closer to the real value of the taxed objects. The amendments target the following components of tax real estate regulations: (i) adjusting the base value in the assessment formula to the house price index and in the case of agricultural land to the reported land transaction price changes; (ii) authorising municipalities to differentiate the real estate tax rate by settlements, areas within them, and type of property. In addition, this policy advice also proposed (iii) to incorporate a new coefficient of the access to public transportation in urban municipalities (Ct).

The **three proposed regulatory amendments** can be evaluated, as follows:

(i) Impact of base value increase in the formula can be assessed by using the cumulated average house price index since its last update. The real estate tax revenue is projected at municipal level with an average rate used for estimating the present base value by municipalities. The

[33] As indicated at point 8 of the comprehensive approach.

differentiated real estate tax rates are under the municipal council's decision, so it will not be taken into account at this aggregate, municipal level assessment.

(ii) The impact of tax rate differentiation can be assessed by municipal samples. It is expected that municipalities will set different rates in large urban municipalities by zones and in other municipalities by localities of different types (e.g., urban center and its rural neighbourhood). It is assumed, that rates will be higher in the centers and remain at the present level (or lowered) in the rural localities. Taking into account the present real estate market prices as tax bases the increase in total municipal tax revenues can be assessed with diverse rates (e.g., maximum in urban, average in rural areas).

(iii) The impact of the coefficient on the access to public transportation (Ct) can be also assessed on a sample basis. Information on present prices of real estate (houses or apartments of similar characteristics) with increasing distance to public transportation should be collected. The public transportation coefficient (Ct) is calculated as the ratio of these square meter prices by real estate groups (e.g., walking distance to public transportation is less than 10 minutes, 10-20 minutes, more than 20 minutes).

Careful impact assessment of these planned amendments of real estate taxation is needed before the proposed changes of the tax law are legislated. The estimated real estate tax revenues should be evaluated along the following aspects:

a) how the updated base value will change the own source revenues in the municipal budgets: by size groups, by regions and by the municipal groups of unified classification of administrative-territorial units;

b) what will be the impact on taxpayers' income in a sample of household income groups (e.g., by income quantiles).

Greater local autonomy in real estate taxation will put higher administrative burden on municipalities. These new local tax administration tasks require support from the central government. It can be provided by sharing more information on real estate prices from the national register, introducing and disseminating computer assisted mass appraisal techniques and providing other forms of capacity development for municipal tax administration.

## 5. Reintroducing revenue sharing of the PIT should be considered.[34]

The proposal is built on the previous personal income tax (PIT) sharing method. According to the present recommendation 20% of PIT will be shared with municipalities and the revenues will be allocated by the taxpayer's place of residence. An alternative plan is to authorise a municipal surcharge on the national tax base with a maximum rate of 2%, levied locally (as indicated at point 9 of the comprehensive approach).

[34] As indicated at point 9 of the comprehensive approach.

**Box 7. How to plan alternative PIT sharing methods?**

The total amount of shared PIT can be calculated from the national budget information statistics. Allocating 20% of the total PIT to municipal budgets will have a significant local impact. For keeping the national budget balanced, national grants should be lowered in compensation of this new municipal revenue source. Some grants (like the specific year-end subsidies and the earmarked grants targeting municipal administration, economic activities, public works and communal services) might be partially decreased.

The municipal impact of revenue sharing will be assessed by measuring the new PIT revenue by municipalities, their groups by population size and by regions. It can be compared to the grants received for delegated functions.

The shared PIT revenue will differentiate municipal budgets, which should be partially compensated. Shared PIT should enter the proposed revenue equalisation scheme (vertical equalisation, see Box 5 above).

Proper PIT sharing by place of taxpayer residence will be supported by information from the national tax administration. Municipal finance departments and tax offices should have a minimal role in administering the shared PIT; the main administrative tasks will be performed by the national tax authority.

## 6. Reforming the business patent tax should be considered[35]

Local patent tax revenues should be increased by introducing a business value tax on larger companies. A properly designed business tax is a contribution to the public services consumed by the local companies. It finances municipal services, such as local infrastructure, environmental protection and other services preferred by investors (housing, culture, city marketing, etc.). Tax levied on net turnover (by deducting input costs) will minimise the economic distortions and create incentives for attracting modern businesses producing higher added value. This tax base is less volatile than company profit, so it creates a stabile local revenue source. The local governments should be authorised to set the tax base and levy the business tax as a percentage of the assessed tax base (as indicated at point 8 of the comprehensive approach).

**Box 8. How to make preparations for the local business tax reform?**

The proposed changes of municipal patent tax target (i) the increase of minimum tax base and changes of the license fee for some professions of patent tax (NAMRB proposal) and (ii) introduction of municipal business value tax for large companies.

The first set of proposals will increase the municipal patent tax revenue levied on local micro and small size businesses. The impact on municipal budget can be assessed by using the present tax

[35] As indicated at point 8 of the comprehensive approach.

administration information sources. The minimum threshold will be doubled and the license fees will be higher in some cases.

The second proposal is to levy a business value tax on entities under the company law, with a net turnover exceeding a minimum threshold. The companies subject to business value tax above a set minimum VAT base will not pay the flat patent tax.

The tax base is the annual turnover, but deducting the input costs. In economic terms, LBVT is a tax on value added, not to be confused with the VAT, which is a tax on consumption. While VAT is applied on each transaction, LBVT is levied once a year; its tax base is calculated from financial reporting data as total sales minus total costs of inputs. After all, a local VAT would be against the EU directives. A LBVT, as the Italian IRAP, is consistent with EU legislation: a ruling of the European Court of Justice has established that it is not a VAT.

The actual regulations on Local Business Value Tax (LBVT) will be developed in an iterative process of modelling and impact assessment. The critical elements of LBVT (minimum threshold on tax bae and the range of local tax rate) should be designed by assessing the impact on the:

(i) total tax burden of companies (CIT/profit tax)

(ii) local budgets of municipalities of different types (sizes)

(iii) by regions, especially the LBVT revenues of municipalities in the South-Western region and in Sofia.

Impact assessment along these dimensions will be based on the information on VAT base, using the average (middle) rate within the tested range of e.g. 0.1%-2%.

Assessment of local business value tax requires simulations for allocating the tax base among municipalities. The tax base should be allocated between the municipalities where the company headquarter is located and the other municipalities outside the registered company centre. The tax base can be shared between the headquarter and company branches by the number of employees and/or asset value.

Local Business Value Taxation should be developed together with the tax administration procedures. Municipalities need support with information from the national tax office, which collects the company income tax. The municipal tax administration costs will be minimised by receiving data on company identification and net turnover from the national tax authorities. Municipalities also need support in establishing joint tax offices and developing transparent, inclusive tax procedures (e.g. involving large taxpayers in tax design and spending of LBVT).

## Accompanying Actions

**7. Avoid the devolution of additional functions to the municipalities without providing additional financial resources.**

(See point 10 of the comprehensive approach)

**8. The practice of "non-budgeted" transfers at the end of the year should be abandoned, or at least drastically limited and carried out in a more transparent way.**

(See point 11 of the comprehensive approach)

## Enhance municipal accountability and transparency

(See point 12 of the comprehensive approach) **(High Priority Action)**

# APPENDIXES

## Appendix 1 - Description of local government finances: selected issues[36]

**Limited local social accountability and low trust in government.** In practice local government accountability is dominated by administrative relations and with a limited role of social accountability mechanisms at local level. The mayor is part of the state administrative subordination structure, which strengthens the mayor's intermediating role between local and upper government tiers. Both councillors and mayors are mostly political party representatives. 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.

**Large size municipalities are good bases for efficient service provision.** Bulgaria belongs to the group of middle size countries with relatively large municipalities (265 Obshtinas with average population of 25.8 thousand, covering 21.1 inhabited settlements). Number of small municipalities is high, but their actual weight is not too large: in the 133 municipalities below population ten thousand live only 11% of the country population. These smaller municipalities are in typically in the Northwest and in the Southwest statistical-planning (NUTS2) regions. Wards and mayoralties can be established in the large size municipalities. 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.

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.

**Municipalities in Bulgaria have very little fiscal autonomy.** They rely for more than 70% of their revenues on grants from the central government (or the EU). Education and social services are the major locally provided services, so grant dependency in these two sectors significantly influences municipal autonomy. In public education 94% of local expenditures are directly financed by state funds. On the contrary, 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 and 85% of all local labour costs are financed by state budget. This creates further dependence of municipalities and also shows how deeply connected the two government tiers are.

[36] For more detailed evaluation of local government finances see "Comprehensive analysis of the existing legal, administrative and operational framework for municipalities". Technical Report, CEGGPAD (2023)8 and the TSI project Peer Review report.

**Own taxes account only for 15%.** Other own revenues are roughly 15% (mainly fees for waste disposal and other uses or concessions).Own taxes are: tax on property acquisition, property tax on real estate (residential and commercial buildings), tax on motor vehicles (cars and trucks), tourist tax, business patent tax, inheritance tax. 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. There are important factors (e.g. access to public transport and other public services) which are not taken into account in calculating the proxy value of the taxed property. The patent tax is a local business tax, i.e., a lump-sum due every year, differentiated according to the type and sector of economic activity. This solution is apt to deal with an economic environment characterized by a large number of micro and small business, and a large presence of informal economy.

**Most of the grants from the central government are earmarked.** These are the grants for financing: a) the delegated functions; b) investment expenditures; c) winter road maintenance and snow removal. Municipalities also receive equalisation grants from the State (which are not earmarked) and funds from the EU for specific programs (which are earmarked). Municipalities receive other funds for compensation of the reduction in municipal taxes (due to the reform of the patent business tax and the cancellation of the road tax decided in the past by the central government) and for temporary interest-free loans.

The delegated functions are the bulk of municipal expenditure. Hence, the grants for the delegated functions are the most important source of revenue (50% of total revenues). All other transfers amount to 20% of total revenues (the equalisation grants account only for 5%, the investment grants for 2%, the compensations and the interest-free loans for 6%, the EU funds for 6%).

**The budget of Bulgarian municipalities is split** both on the expenditure and the revenue side, as well. There is a legal distinction between “own” municipal functions and “delegated” functions. The own functions (basically road maintenance, lightning, waste disposal, water supply, sewage, defence and security) are financed by the municipal own revenues (taxes and fees) and by the general equalisation grant. All other functions (mainly education, health, and social services) are delegated from the central government and are financed by earmarked grants.

Municipalities may use the own revenues and the equalisation grants for financing the delegated functions, but the opposite is not possible: i.e., grants different from those for equalisation can be spent only for the functions for which they are earmarked. Over the years, often the scope of delegated functions has been widened using secondary legislation, without providing additional grants. Hence, a share of own revenues and equalisation funds has been used to cover delegated functions. Also, as a consequence, total financial resources have tended to fall short of actual expenditure needs.

The rationale for separating “delegated” from “own” functions is not clear. Apart from the fact that they are financed differently, both sets of functions encompass equally important, fundamental local services. The rationale seems to be that on delegated functions the State wants to exert a very pervasive control through extensive use of earmarked grants. The **grants for delegated functions** are very detailed, with a thin division in sub-functions, especially for social services, education, health, and culture. For each sub-function specific variables are considered (like the number of inhabitants, pupils, elderly, patients, schools, hospitals, etc.) to which specific parameters are assigned: the amount of the grants for each sub function and for each municipality is calculated applying specific formulas to the variables and the parameters taken into consideration. Parameters are differentiated, if deemed appropriate, according to the size of the municipality, the altitude, or many other variables that are considered relevant. The effort is to calculate, at the level of each municipality, the financial resources needed to provide basic public services to the population, in order to grant uniformity to the basic provision of education, health and social services across the whole country. In other words, the system is intended to pursue the objective of calculating and financing the basic public expenditure needs in each municipality.

The method for calculating the grants for delegated functions (i.e., the choice of the variables, the value of the parameters and the formulas) is established by the government, after consultations among the relevant ministries (Education, Social Security, Health, Development) and with the municipalities (NAMRB). Experts are involved in the consultations. Changes do not occur frequently: the methodology tends to remain stable, with adjustments when deemed appropriate, after consultation.

The overall amount of the grants is adjusted every year to consider inflation and the increase of costs. The MoF has a final say on the amount and distribution of the funds, in order to grant budgetary discipline and the respect of overall financial compatibilities.

Municipalities are subject to controls and audits by the central government (MOF and sector ministries), to check the appropriate use of earmarked grants. If a municipality wants to use funds for a function different from the one for which the funds are earmarked, it must ask and obtain permission. Audits are held to contrast misuses of the funds.

The **grants for capital expenditure** and **winter road maintenance and snow removal** are determined in a similar way, after consultations between the MOF, the MoRDPW, and NAMRB. For the **capital expenditure**, the number of settlements (excluding those with less than 10 inhabitants), the length of municipal roads, the number of resident population, and the size of the territory are considered. The relative weights are: 45% for settlements, 25% for municipal roads, 25% for population, and 5% for territory. As for **winter road maintenance and snow removal**, grants are distributed to municipalities applying the following criteria: 85% according to an indicator of the length of municipal roads (with consideration of geographical and altitude location and parameters for length of municipal roads in mountainous areas, in plain areas and in areas characterized by snowfall and icing); 10% according to an indicator of the number of settlements (excluding the ones without population); 5% according to a population indicator.

**The General Equalisation Subsidy is a non-earmarked local revenue source, but it has limited role in financing municipalities** (only 6.1% of total intergovernmental transfers). This equalisation fund has five components[37]:

(i) equalisation of revenues: it is based on the actual revenues of the municipalities and compensates the difference between per-capita municipal tax revenues and 120% of the national average. All the local tax revenues are considered: property tax, vehicle tax, tourist tax, patent and passenger tax.

(ii) equalisation of expenditure needs (based on the number of inhabitants by age group, the size of territory, and the length of roads). Due to the limitations of available funds, it supports local government expenditures up to 75.25% of the total.

[37] See Annex to Article 51, para 1) Mechanism for determining the main budgetary relations between the central budget and the budgets of the municipalities in the form of subsidies for 2023.

(iii) special fund for ‘poor’ municipalities, i.e. municipalities with own revenues less than 25% of their total revenues.

(iv) special fund for municipalities with low equalisation grants allocated through the channels (i)-(iii) (i.e., lower than the previous year);

(v) a special fund to reward municipalities for their tax efforts, based on the difference between the national average tax rate and the municipal rates of the real estate, property acquisition, and vehicle taxes.

Usually, the highest portion of the general equalisation subsidy is the component (i), the revenue equalisation. In 2021 the weights of the components on the total of the equalisation fund were as follows: revenue equalisation component 73%; expenditure needs 20%; “poor” municipalities 4%; tax effort 0,2%; previous year amount 3%.

The General Equalisation Subsidy has limited significance in municipal finances. As noted, the equalisation funds, taken in their entirety, amount only to 5% of total revenues. They play quite a marginal role in financing the municipalities. Their capability of equalising expenditure needs and fiscal capacity appears very limited, especially if in the future a shift from earmarked grants to own taxes is adopted.

# Appendix 2 - Characteristics of an equalisation system

According to the CoE Committee of Ministers' recommendations[38], "*The equalisation system should compensate, at least in part, for differences in authorities' financial capacity (so as to provide more resources to financial weaker authorities) and spending needs (so as to provide more resources for authorities that either have additional responsibilities or, by virtue of their geographical location, demographic situation, or other factors, are obliged to spend more in order to discharge their responsibilities). It should not compensate for differences in managerial efficiency or differences in cost stemming from the adaptation of service levels to local preferences.*"

*"In all cases, the mechanisms adopted to equalise among jurisdictions should be based on standardised (not actual) levels of revenues and expenditures. The standardisation of costs and revenues acts as a safeguard against implicit financial bail-outs that would otherwise eliminate the local authorities' (and their officials') accountability and result in wasted public resources. It also avoids moral hazard by local authorities because it precludes the manipulation of distribution criteria by recipient governments."*

The objectives of equalisation can be summarized as follow: 1) To ensure that local governments are able to provide public services with similar quantity and possibly quality standards, with constant fiscal effort and efficiency; 2) To ensure an efficient allocation of production factors, preventing the migration of firms and households induced by the net fiscal benefits.

Equalisation is at the foundation of intergovernmental fiscal relations. It is the natural companion to fiscal decentralisation as it aims at correcting the potential imbalances resulting from sub-central autonomy. Without fiscal equalisation, fiscal decentralisation is at stake.

The **equalisation on the revenue** side intends to reduce the differences in fiscal capacity of the local administrations, while the **equalisation of expenditures** has the purpose of reducing differences in the cost of providing public services that do not depend on local policy. The highest level of efficiency and fairness in the redistribution of equalisation grants can be achieved with the equalisation of the fiscal gap, i.e., the difference between standard expenditure needs and fiscal capacity. The *European Charter of Local Self-Government* (par. 5, art. 9) and the CoE's recommendations support the adoption of the combination of both revenue and expenditure equalisation. Therefore, the **equalisation system should equalise the fiscal gap (FG)**, i.e., the difference between the standard expenditure needs (SEN) and the standard fiscal (or financial) capacity (SFC):

[1] FG = SEN – SFC.

### Standard expenditure needs

According to CoE's recommendations[39], "*An authority's "spending need" is the amount theoretically necessary for the authority to produce or provide goods or services or a predetermined set of goods and services at standard level. The differences between authorities' spending needs stem either from differences in the unit costs of the goods and services produced or provided by the authorities in order*

[38] Council of Europe (2005) "CM/Rec(2005)1E - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities", Artt. 39 and 46.

[39] Council of Europe (2005) "CM/Rec(2005)1E - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities", Definitions and Art. 50.

*to meet the quantity and quality minima imposed on them, or from the number of services needed (economies of scale) to attain these minima, or from differences in the number of residents entitled to the services".*

*"The calculation formulae used to estimate spending needs should fulfil the following conditions:*

- *the weight afforded to the various individual indicators should be determined on the basis of objective information about the impact of variations in those indicators on the actual cost of local services;*
- *insofar as the assessment of needs nevertheless entails value judgments as to the weight to be afforded to the various indicators, it is necessary to identify and assess the results of these judgments in conjunction with representatives of the local authorities concerned or their associations;*
- *formulae for evaluating needs (models) should be as simple as possible, so that they are easy to understand and make for openness and accountability, but comprehensive and detailed enough to be reliable;*
- *formulae for evaluating needs should remain as stable as possible, to allow local authorities to make long-term forecasts and so that changes in estimated needs reflect genuine changes in the situation of local authorities over which they have no control."*

Usually, **SENs are estimated separately for blocs of functions, or sub-functions**. Obviously, in selecting the services relevant for the estimation of the SENs it is necessary to consider the fundamental tasks/functions that are in the competence of the municipalities, and the tasks/functions devolved by the State. Some functions might be aggregated, others might be subdivided in a more articulated sub-set. It is a matter of judgement, depending on the relevance of the function, on the availability of data and the accuracy of the estimation of the weights.

**SENs are estimated as per-capita costs**. For each service (i) the relevant $SEN_i$ (dependent variable) should be calculated as follows:

[2] $SEN_i = a_i + [w_{i1} X_{i1} + \ldots + w_{in} X_{in}]$

Where:

$a_i$ = national average per-capita cost of the $i^{th}$ service.

$X_{i1}, \ldots, X_{in}$ = explanatory (independent) variables relevant to correct the national average per-capita cost.

⇨ $w_{i1}, \ldots, w_{in}$ = weights attributed to the explanatory variables.

The amount (value) of expenditure needs of each jurisdiction is calculated multiplying the per-capita $SEN_i$ by the relevant number of residents. Total SEN is the sum of the $SEN_i$ for each function. Hence for each jurisdiction:

[3] $SEN = \sum_{i=1}^{n} SEN_i$

The **explanatory (independent) variables** should take into consideration geographic, demographic, socio-economic, structural, and costs differences among municipalities that significantly affect departures of the municipality's per-capita expenditure needs from the national average.

As an example, the following Table A1 reports the variables used in Lithuania for the calculation of SENs in education.

**Table 1. Variables used for calculating SENs for education in Lithuania**

**DEPENDENT VARIABLE**

Historical average cost per pupil (euro per pupil)

(Total education expenditures, Euro *1000)/ (Number of pupils (age 7-19 year) studying in primary, basic and secondary education program + Number of pupils (age 6 year) studying in pre-school education programs + Number of pupils (age 1-5 year) studying in pre-primary education programs)

**INDEPENDENT (EXPLANATORY) VARIABLES**

**Squared meters area of school premises per pupil**

Total area of school premises ($m^2$) / (Number of pupils (age 7-19 year) studying in primary, basic and secondary education program + Number of pupils (age 6 year) studying in pre-school education programs + Number of pupils (age 1-5 year) studying in pre-primary education programs)

**Number of schools per pupil**

Number of general education schools / (Number of pupils (age 7-19 year) studying in primary, basic and secondary education program + Number of pupils (age 6 year) studying in pre-school education programs + Number of pupils (age 1-5 year) studying in pre-primary education programs)

**Share of special needs pupils**

Percentage of pupils having special needs

**Use of kindergarten places and facilities**

Number of pupils (age 1-5 year) studying in pre-primary education programs / Number of places in kindergarten and school facilities * 100

**Share of teaching staff**

Number of teaching staff / (Number of teaching staff + Non-pedagogical staff in schools of general education) * 100

**Share of educators in kindergartens**

Educators in kindergartens / (Number of teaching staff + Non-pedagogical staff in schools of general education + Educators in kindergartens) * 100

**Labour cost**

Total education salaries expenditure / (Number of teaching staff + Non-pedagogical staff in schools of general education)

**Expenditure in education per-pupil**

(Expenditures out of the pupil basket *1000) / (Number of pupils (age 7-19 year) studying in primary, basic and secondary education program + Number of pupils (age 6 year) studying in pre-school education programs + Number of pupils (age 1-5 year) studying in pre-primary education programs)

| |
|---|
| **Share of net inflow of population in working age population** |
| (Arrivals and immigrants – Departing and emigrating persons) / Number of working age population * 100 |
| **Share of graduate pupils of general education in population aged 0-19** |
| Graduate pupils of general education / Population aged 0-19 * 100 |
| **Share of school-age children not attending school in population aged 0-19** |
| School-age children not attending school / Population aged 0-19 * 100 |
| **Share of children in general education schools who have not completed education on population aged 0-19** |
| Children in general education schools who have not completed education/ Population aged 0-19 * 100 |
| **Area (land) square km** |

The **weights** may be attributed to the explanatory variables on the basis of *a priori* considerations. This seems to be the case in Bulgaria, in a different context, i.e., for the determination of the parameters used to decide the earmarked grants for delegated functions and for investment. In many developed countries [40] SENs are evaluated using statistical methods: expenditure needs of each local administration are computed as the expected value of an econometric model derived from a cost/expenditure function.

Typically, the parameters $a_i$ and $w_{i1}, \dots, w_{in}$ in equation [2] are estimated through statistical methods, namely a linear regression. Equation [2] may be estimated as a cost/expenditure function and the $SEN_i$ of each jurisdiction. The weights would be the fitted values of the regression. Typically, they represent per-capita costs (in monetary values).

Using statistical methods, it could also be possible to differentiate municipalities, grouping them in **clusters having similar characteristics**, in terms of population, geography, and socio-economic activity. Cluster analysis identifies homogeneous groups of jurisdictions, using all available variables. It minimizes the differences between municipalities in the same cluster (intra-cluster variance) and maximizes the difference between clusters (inter-cluster variance)[41].

The effect of belonging to a specific cluster can be taken into consideration in the estimation of the regressions, using dummy variables. Equation [2] may be replaced by the following:

[4] $SEN_i = a_i + [w_{i1} X_{i1} + \dots + w_{in} X_{in} + b_{j1} D_{j1} + \dots + b_{jm} D_{jm}]$

where D are the dummy variables (assuming values 0 or 1) that indicate the presence of the jurisdiction in the $j^{th}$ cluster.

[40] Good examples are Denmark, Finland, Norway, Sweden, United Kingdom, Holland, Portugal, Japan, Australia, and Italy.

[41] As an example, municipalities in Lithuania have been grouped in four clusters: Big cities (6); Predominantly urban (12); Predominantly rural (38); Touristic resort (4). For more details, see: SOSE, *Municipal Debt Restructuring: Design a Tool for the Evaluation of the Long Run Sustainability of LG's Financial Structure in Lithuania*, *Final Report*, https://ppplietuva.lt/uploads/documents/files/Projekto%20ataskaita_Savivaldybių%20paskolų%20restruktūrizavimas%20ir%20efektyvaus%20turto%20valdymo%20priemonių%20sukūrimas.pdf

Using this approach, the system would better reflect the real cost of providing services in different areas of the country and in different types of municipalities. Moreover, it would be possible to take into consideration the economies (or diseconomies) of scale in a more precise way.

The use of equations like [2] and [4] may greatly improve the accuracy and the transparency of the calculation of SEN, if the estimation procedure is correctly applied and the statistical results are robust. The calculated weights are based on factual statistical evidence, not on *a priori* decisions. The contribution of each variable to the overall results is intelligible, the procedure is transparent.

### Standard fiscal capacity

According to CoE's recommendations[42], "*The measurement of financial capacity for equalisation purposes should be based on the assumption that all local authorities levy taxes at the same rates and are equally efficient in assessing and collecting taxes, so that authorities are not penalized for the efforts they make or rewarded for laxity. This assumption should be used solely to calculate equalisation funds and should not undermine the authorities' right to vary the actual rates of the taxes levied. Local authority decisions should not directly affect the amount of equalisation funds received or paid"*.

Therefore, **fiscal capacity should not be based on actual revenues, but on potential revenues:** i.e., applying standard tax rates to potential tax bases. This method, known as the Representative Tax System (RTS) is preferred to the Historical Revenue Approach (HRA) and is recommended by CoE as a best practice that should be adopted to enhance efficiency and fairness of the equalisation system[43].

The reference to the **standard tax rate** avoids discouraging the fiscal effort by local authorities: all the extra revenue above the standard will not be considered in the equalisation formula and will be fully available to finance local services. On the opposite, if a municipality decides to set its tax rate below the standard rate, or gives exemptions and rebates, it will not be compensated through higher equalisation grants.

Also, the tax base should be the **"potential" tax base,** not the actual**.** For example, considering the real estate tax, the potential tax base should be the tax base assessed by the national cadastral system, not the tax base effectively taxed: this is also necessary to avoid rewarding local authorities for laxity in the assessment and collection of the tax and/or generosity in deciding exemptions.

This type of revenue equalisation would be consistent with the principles of fiscal responsibility.

All sources of own revenues should be considered in the evaluation of fiscal capacity: own taxes, and also fees and charges.

[42] Council of Europe (2005) "CM/Rec(2005)1E - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities", Art. 55.

[43] Council of Europe (2005) "CM/Rec(2005)1 - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities", Artt. 46 and 57.

**Box 9. Standard Expenditure Needs/Standard Revenue Capacity approach used in intergovernmental finances, country cases**

**Fiscal equalisation methods in Scandinavian countries**

Local governments in the four Scandinavian countries – Denmark, Finland, Norway, Sweden – have some similar characteristics. They have two-tier local governments with relatively large size municipalities, which have rather broad functions and wide competencies. The local budgets are predominantly financed by personal income tax, allocated as shared revenues often with local surcharges. Various equalisation mechanisms are used for financing the locally provided welfare services, but they are combined with fiscal incentives for own source revenue raising. There is a strong drive for consensus building in budget negotiations and in designing intergovernmental fiscal relations[44].

In *Denmark* the *equalisation grant* used to focus on the difference of estimated expenditure needs and tax revenues calculated with average tax rate. This "structural" deficit (or surplus) based model followed the fiscal conditions of diverse municipality types (e.g. different for the capital city, islands). In 2021 the former structural deficit-based mechanism was replaced by equalisation of expenditures and revenues, separately[45].

*Expenditure needs* are assessed by two main types of indicators. 67% of total expenditure needs is measured by the demographic indicator (15 population age groups) and 33% by a socio-economic index. This latter one is a weighted indicator of seventeen factors influencing the socio-economic development of a municipality. Among them the number of unemployed, low skilled active age population, housing conditions, low-income individuals, children in single parent family have the highest weight.

These two sets of indicators define the expenditure needs of a municipality in the form of per capita amount. Then it is compared to the national average and municipalities above the national average receive equalisation grant up to 93% of the difference. The funds (needs-based expenditure measures) are calculated as contributions from the municipalities below the national average per capita expenditures. This mechanism will create incentives for the municipalities with high per capita expenditures to economise because their costs are not compensated fully, only up to 93% of the distance to the average.

Municipalities with a *tax base below the national average* receive a subsidy of 75% of the difference between the municipality's tax base and the national average. Conversely, municipalities with a tax base above the national average pay a contribution of 75% of the difference between the municipality's tax base and the national average.

It is important that both of these equalisation techniques provide *general purpose grants* for the municipalities, which are autonomous in using these and other non-specific grants freely. The expenditure side grant allocation follows *service needs indicators* (e.g. number of population 65-74 years) and not actual users of a local service (e.g. capacity of homes for elderly). It creates new

[44] See brief summaries of local finance systems in OECD (2019): World Observatory on Subnational Government Finance and Investment. Country profiles. OECD/UCLG,

[45] Kommunal udligning og generelle tilskud, 2023. www.im.dk

incentives for municipalities to find the most efficient form of service provision, instead of financing the existing service organisations.

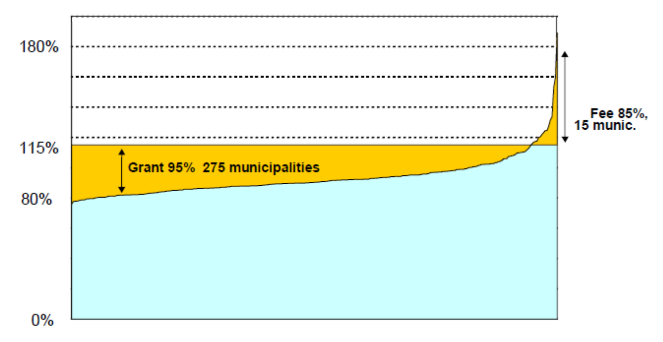
This main expenditure and revenue equalisation grant system is supplemented by three other types of transfers. One of them targets *other differentiating factors* (e.g. additional municipal needs of immigrants, refugees). *Block grants* are provided for the municipalities with financial difficulties, to vulnerable islands and peripheral municipalities. In addition, there are 19 different types of *specific grants*, which are earmarked for managing problems of vulnerable and disadvantaged municipalities, island municipalities, border municipalities, municipalities with high crime rates, etc.

In *Sweden* local government grants are designed separately for municipalities and counties. These intergovernmental transfers are allocated in various forms, such as income equalisation grants (85% of the general grant), cost equalisation grants (9%), structural grants (3%). And a "transition grant".

On the *expenditure side* the grants are allocated by several indicators, which assess the specific municipal service costs[46]. There are nine groups of services (e.g., childcare, schools, care for elderly (and their standardized costs are measured as a function of four different factors. These factors determining the service costs are categorized as population number by age groups, ethnicity, socio-economic conditions, geography. For example, in the case of education age group, children with foreign background, population density are used. Those municipalities receive cost equalisation grant, where the standardized expenditures are above the national average.

Municipalities and county governments are primarily funded by personal income surtax. The *income tax equalisation grant* is calculated with the average income tax rate levied on the difference between the national and local adjusted (per capita) tax capacity multiplied by the population number. The difference compared to the 115% of the national adjusted tax is measured and only 95% of the gap is compensated by the equalisation grant (municipalities with a surplus contribute to the poorer municipalities with 85% of their calculated surplus income tax revenues). (See Table A2.)

Chart 1. **Revenue equalisation by municipal tax capacity**




Source: Tingvall, S. (2007) Local government financial equalisation in Sweden. Finance Ministry, Stockholm

In *Finland* similar models of intergovernmental transfer are used. Revenue equalisation takes into account municipal differences in estimated (standard) tax revenues. Expenditure equalisation focuses on differences in service needs, measured by the factors of service costs population, geographic remoteness, number of pupils, age-specific cost coefficients for services, etc. Transfers are non-earmarked block grants, and they are used predominantly for financing current budgets.

[46] Tingvall, S. (2007) Local government financial equalisation in Sweden. Finance Ministry, Stockholm; MoF (2005): Local government in Sweden.

The municipal grant system in *Norway* combines block (general) grants and specific, conditional ones. The general grants take into account structural cost differences between municipalities and differences in tax bases. These expenditure and income equalisation mechanisms use indicators on demography, population size, population density, social characteristics, rural and urban aspects. The specific purpose grants target the most important services, such as day care, care for elderly and disabled, refugees and immigrants. A discretionary grant supplements these major forms of transfers to compensate unique municipal (and county) conditions.

All these Scandinavian models have the following main characteristics:

1. shared personal income tax creates a sound financial basis for the large size municipalities
2. expenditure side equalisation follows objective statistical indicators service needs
3. revenue equalisation uses standard (average) rates for assessing potential local revenues
4. several types of intergovernmental transfers support local governments, but general purpose grants dominate
5. there are complementary instruments to manage special problems, such as regional differences, specific needs and problems.

### The Italian system of equalisation and financing of municipalities

Italy, although not a federal state, has four layers of government: the State, the regions (20), the provinces (110) and the municipalities (7.900).

Italy has established a system of consultation and co-decision between the State and the regions, the provinces, and the municipalities. The system is based on permanent bodies (Conferenze) formed by representatives of the central government and the local authorities, with a co-decision role in administrative regulations and in the criteria for the allocation of grants.

Municipalities provide basic services: tax office, technical office, civil registry, general services, public roads safety and maintenance, local public transport, land management and planning, waste management, social services, nursery services, local police, complementary services in education.

The municipalities collect own taxes for roughly 45% of their total revenues. The main municipal taxes are the property tax and a surcharge on the personal income tax (PIT). The former was introduced in 1992, the latter in 1998. These two taxes account for most of the municipal own revenue. On both taxes municipalities have a range of manoeuvre in setting the rates (and some exemptions or allowances). Other revenues come from minor taxes (the Hotel tax - Imposta di Soggiorno), fees for waste management, and other fees (like for the occupation of public soil and for local advertising).

Beside own taxes, municipality are financed through grants from the State. In 2013 equalisation grants were established and all other existing grants (mostly earmarked) were consolidated into a single grant (for financing ‘historical’ expenditure). Both types of grants are not earmarked. The equalisation grants will gradually replace the ‘historical’ ones: in 2030 the transition will be completed, and the equalisation grants will completely substitute the ‘historical’ grants (in 2024 the two types of grants will account respectively for 52% and 48% of the total).

The municipal equalisation system is regulated by a state law and is based on the equalisation of the fiscal gap, i.e., the difference between standard expenditure needs (SEN) and standard fiscal capacity (SFC).

Standard fiscal capacity is calculated applying the standard rates to the potential tax base, according to the Representative Tax System (RTS).

Standard expenditure needs are calculated for each function, based on regression analysis. For each function appropriate variables have been selected and weights have been attributed to the variables, as they result from the coefficients of the regression analysis. Municipalities, where appropriate, have been grouped in 'clusters' with similar characteristics (e.g., large cities, touristic resorts, mountain municipalities, etc.).

As for the variables used, information provided by municipal budgets and official sources (National Statistical Institute, Ministry of Education, Registry Office for land and buildings, etc.) have been integrated with other data, provided by the municipalities on the basis of specific questionnaires for each service. The variables taken into consideration consider a wide variety of factors: demography (population, by group age), geography and general physical characteristics (width of the territory, altitude, length of the streets, number of settlements), types and quantities of the outputs, types and quantity of the inputs, costs of the inputs (wages, rents, prices of other inputs), qualitative factors (methods of management, organisational characteristics of the services).

The equalisation system is top-down: the total amount of the equalisation fund is established each year by the State budget law and is distributed to the individual municipalities on the basis of the share of their fiscal gaps on the national total fiscal gap.

The Italian equalisation system is horizontal: municipalities with a positive fiscal gap (standard revenues above standard expenditures) provide financing to the equalisation fund, that redistributes funds to the municipalities with negative fiscal gap (standard expenditure above standard revenues). The horizontal equalisation has created tensions among jurisdictions, because "rich" municipalities are reluctant to finance "poor" municipalities.

A system of benchmarking the performance of municipalities has been introduced (see Appendix 3).

### The structure of the equalisation system: bottom-up or top-down

When the fiscal gaps (FGs) have been calculated for all municipalities, there are two methods to determine the total amount of the equalisation grants that must be financed by the central government. Under the bottom-up approach, the national fund is the sum, at national level, of all the municipal grants. This method is rarely used. Under the alternative top-down approach, in the first place the fund to be distributed from the State budget is fixed, and then it is apportioned among the local governments using the share of their FGs on the national total. This latter system is commonly preferred because it allows the central government to keep stricter financial control on the total amount of transfers to local governments, in line with the need to ensure the respect of the general government budget constraint. After all, this is the system currently applied in Bulgaria: the overall amount of State grants is determined with a top-down approach and decided with the annual State budget.

### The structure of the equalisation system: vertical or horizontal

A fundamental decision concerns the structure of the equalisation system, that can be horizontal or vertical. In the first case 'richer' local administrations directly provide equalisation grants in favour of 'poorer' local administrations: i.e., the administrations whose fiscal capacity exceeds their expenditure needs finance an equalisation fund, which distributes grants to the administrations whose expenditure needs exceed fiscal capacity.

In the case of vertical equalisation, local governments receive grants from the central government. If the fiscal gap is negative (the fiscal capacity exceeds the expenditure needs), the local administration does not receive an equalisation grant. Usually, the system is built in such a way that the 'richest' local administration(s) is (are) in equilibrium, i.e., its (their) expenditure needs meet the fiscal capacity; all other jurisdictions have a positive fiscal gap and receive equalisation grants.

Horizontal equalisation has the merit of transparency, but vertical equalisation is politically more feasible and is usually the preferred option. Although the Council of Europe does not explicitly recommend the adoption of vertical equalisation, it suggests[47] to limit the adoption of horizontal options warning that "*the extent to which local authorities with above average per capita revenues are expected to contribute to horizontal redistribution … should not be so great in order not to discourage them from the exploitation and development of their revenue base*".

### Using the SEN methodology to calculate earmarked grants

In Bulgaria the parameters used to determine the grants for the delegated functions and for investment mimic the definition of SENs, but with two very relevant differences: they are based on a priori considerations, not on the objective statistical estimation of cost/expenditure functions; they are also completely outside of the equalisation system, because they directly determine the earmarked funds. Of course, as pointed out in the text (see para. 3.2.), if the logic of the 'omniscient benevolent dictator' is accepted, the earmarked grants would represent *per se* standardized expenditure needs and there would be no need of a separate equalisation system on the expenditure side. But even if this scenario is accepted, the adoption of a statistical/econometric method for calculating the weights (parameters) should be considered.

[47] Council of Europe (2005), "CM/Rec(2005)1E - Recommendation of the Committee of Ministers to member states on the financial resources of local and regional authorities", Art. 42.

# Appendix 3 - Benchmarking the performance of local governments [48]

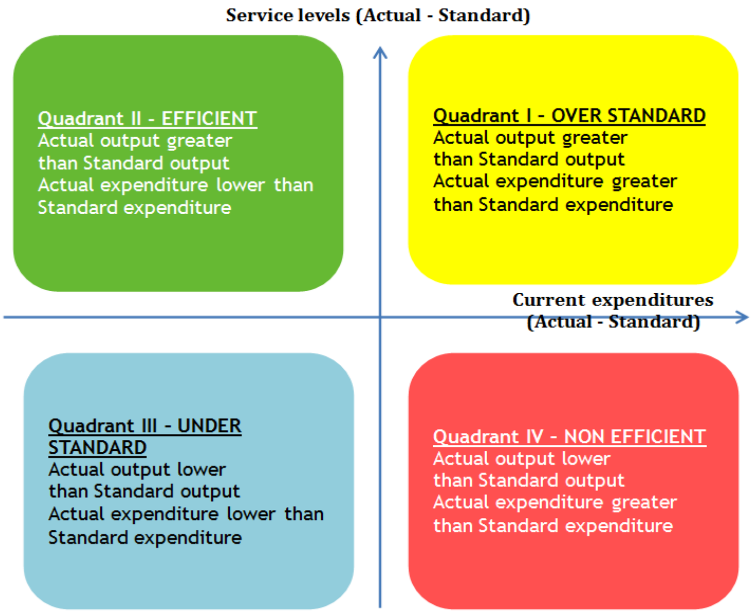
The difference between the standard and the actual per-capita expenditure for each function (or sub-function) provides a good reference point to judge the financial performance of each municipality: municipalities may show per capita costs above (or below, or in line with) the standard expenditure needs. Hence, they spend more (or less, or equal to) the average national standard costs.

But this is not an indicator of local governments' efficiency in the provision of local services. Actual expenditure may be above (below) the standard because the municipality is providing more and better (less and worse) services than the average standard.

Therefore, it is also useful to evaluate the performance of each municipality in the production of services in respect of a reference point (the national average, or a standard level). Using the methodology applied for calculating the SENs and an appropriate set of variables it is possible to calculate **standard levels of output (SLO)**, which can be compared with the **actual levels of output**.

Consequently, a performance evaluation could be based on the **joint analysis** of two indicators: the ***expenditure gap*** (the difference between actual expenditures and SENs) and the ***output gap*** (the difference between actual outputs and the SLOs). This joint analysis can be carried out mapping each local administration into a four quadrants graph like the one reported in Chart 2.

**Chart 2. Performance analysis**




Local authorities in quadrant I (over-standard) are administrations that spend more than the standard and, at the same time, produce more services than the standard; on the opposite, local authorities in quadrant III (under-standard) are spending less than the standard providing also less services than the standard. These cases can be considered as "normal" under the principle that local governments should be free to exercise their autonomy in order to satisfy the local demand for public services.

On the other hand, local authorities located in quadrant II (efficient) can be considered as potential benchmarks for identifying best practices, because they are able to provide services above standard spending less than their standard expenditures needs. Instead, local authorities in quadrant IV (inefficient) are potential

[48] This method of benchmarking the performance of municipalities has been implemented in Italy (see: https://www.opencivitas.it/en/performance-analysis-municipalities) and in Lithuania (see: SOSE, *Municipal Debt Restructuring: Design a Tool for the Evaluation of the Long Run Sustainability of LG's Financial Structure in Lithuania*, *Final Report*, https://ppplietuva.lt/uploads/documents/files/Projekto%20ataskaita_Savivaldybių%20paskolų%20restruktūrizavimas%20ir%20efektyvaus%20turto%20valdymo%20priemonių%20sukūrimas.pdf)

candidates for improvements of their performance, since they show a level of actual services below standard and a level of actual expenditure above their standard expenditure needs.

This kind of analysis can be used for benchmarking, to identify best practices and to stimulate inefficient local administrators to improve their performance. It has not been intended for 'penalising' local administrations that show a poor performance.