

Financing Bulgarian Local Governments through Taxes and User Charges

Asst. Prof. Emil Kalchev, PhD
New Bulgarian University, Sofia

1. General Overview of Local Government System in Bulgaria

The legal and organizational framework of local government system in Bulgaria is based on many legal acts. The most important one is the *constitution*. According to it the municipality is the main (and so far the only) tier of local government in the country. The Constitution ensures the political basis of decentralization in Bulgaria – local government and the mayor are directly elected by the population of the municipality. This regulation is precondition for achieving a considerable independence of communities from the central government. However, municipalities do not have their own independent powers defined in the Constitution - they receive or lose them by law, i.e. powers of municipalities derive from the parliament.

Municipalities have own independent budget and property, which can be used to serve their interests. A *Self-Government and Local Administration Act* defines the legal status of municipalities and municipal institutions. The ability of municipalities to fulfill their duties as self-governed communities results from the fact that they are legal entities. This includes possession of municipal property. The framework for independence of municipal actions and decisions is mandated by the *Municipal Budgets Act* and the *Municipal Property Act*.

According to the present *Administrative and Territorial Division Act* of the Republic of Bulgaria, the country has two-tier administrative structure, including two types of administrative units – regions and municipality. *Regions (oblasty)* are administrative units of the central government. They comprise one or several neighboring municipalities. A region governor is appointed by the Council of Ministers. The region administrations are financed directly by the central government's budget. They do not have their own source of revenues. Presently 28 regions exist. *Municipalities* consist of one or several inhabited areas. Presently there are 264 municipalities, which characteristic features are as follows: average territory – 422 sq. km.; average population – 30,000 people; average number of settlements – 20.¹

The 28 regions (according to the *Administrative and Territorial Division Act*) were aggregated into 6 *planning regions* to facilitate the utilization of EU structural funds.² The *Regional Development Act* defines the planning regions as spatial units created for the purpose of regional development of infrastructure, the creation of enabling environment for investment at the regional and local levels, and the utilization of local, national and foreign resources.

The division between state and municipal activities is not without problems. The main effect of this division is that municipalities are discharged from activities, which they do not have enough money to pay for anyway. On the other hand, this approach secures financial resources for provision of services, which in principle should be equally accessible by all consumers, regardless of the municipality they live in. For instance, municipalities have been released from obligation to finance expenditures that are not typical for their activities such as social benefits, land commissions, etc. In fact, municipalities are responsible for local

¹ Ivanov, S. at. al. *Intergovernmental Capital Transfers for the Municipalities in Bulgaria*. Club “Economica 2000”. Sofia, May 2006, p. 5.

² Vraykova, T. *Effective Implementation of LED Plans in Bulgaria – Barriers versus Opportunities*, p. 9.

transport, garbage disposal, landscaping, roads, street lighting, etc. State-delegated activities are mainly in the sectors of healthcare, education, cultural and social welfare.³

2. Financing System of Local Governments

Public services funded by municipal budgets are divided into two categories: *activities delegated by the state* and *local activities*. The delegated activities are financed by state transfers (grants, subsidies), and the local activities – by local revenues (local taxes, user charges, rents of property, privatization etc.). Local governments can also borrow directly from the financial market, but some restrictions are laid down by legislation. The spending side of municipal budgets is divided into current costs and capital costs.⁴

Bulgarian municipalities can rely on three types of **state subsidies**: general, targeted, and extraordinary. A *general subsidy* is provided to municipalities without restrictions. *Target subsidy* is conditional and is usually provided for social assistance, health care, ecological recovery or capital investment projects. *Extraordinary subsidy* is an unconditional, unplanned financial flow, granted to municipalities in a difficult financial situation.⁵

Municipal borrowing is regulated by the *Local Debt Act* from 2005. According to it local borrowing is possible only on the basis of decision of the Municipal Council. Long-term borrowing is allowed for investments, refinancing of old debts, in cases of absolute necessity, and for payments on municipal guarantee. Short-term borrowing can be used for financing of public goods, in case of shortage at the local budget, of absolute necessity, and for payments on municipal guarantee. The annual debt service cannot exceed 25 per cent of the sum of the total amount of own revenues and general equalisation subsidy.

The two forms of local borrowing - bonds and bank credits, are supervised by the Commission for Financial Supervision (CFS) and the National Bank of Bulgaria. The public offering of bonds is supervised by the CFS. The National Bank of Bulgaria supervises lending banks.

Often Bulgarian municipalities prefer to emit bonds through a private placement and afterward either traded over the counter or listed on the Bulgarian Stock Exchange. A private placement is subject to a shorter issuance process due to simpler rules and less need of official approvals.

Banks prefer to finance municipalities through bonds rather than through bank credits. Bonds are more liquid (they can be sold to others), they can be used as collateral by investors, and they do not require provisions in the balance sheet of the bank. However, investors have not taken an active position with regard to the municipal bonds that are presently outstanding and are likely to hold the bonds until maturity. As a result, secondary market transactions are rare.

Bulgarian municipalities are perceived by the financing community as not being creditworthy. There are three main reasons for this conclusion: financial weakness of the municipalities, lack of financial knowledge of municipal officials, and lack of appropriate collateral. Additionally, municipalities are perceived as riskier than corporate clients due to political risks. That is, there may be political reasons for making investment decisions, as well as the previously discussed changes in political commitment to an investment project by a successor

³ Nenkova, P. *The Mechanism for Determination, Allocation and Management of Capital Transfers in Bulgaria – State of Play, Issues and Improvement Opportunities*. Sofia, April 2006, p. 6.

⁴ Regional Bureau for Europe and the CIS *Progress and Current Status of Decentralisation Reforms*, Bratislava, October 2007, p. 2.

⁵ Закон за държавния бюджет за 2009 г., Приложение №5 към чл. 10, ал. 1.

administration.⁶ Generally, Bulgarian municipalities do not have significant practical experience in borrowing from capital markets. They mainly count on intergovernmental transfers and own revenues.

Starting with the European Union (EU) pre-accession period, Bulgaria benefits from various **EU financial instruments and programs** like PHARE, ISPA and SAPARD. Main problems with the utilization of these funds are: insufficient experience of municipalities when applying for EC-financed programs, lack of funds for co-financing, and generally low credit rating of Bulgarian municipalities. During the period June - July 2006 the United Nations Development Program (UNDP) published a survey titled "Updated Assessment of Municipal and Regional Capacity to Participate in the Planning and Implementation of Structural and Cohesion Funds of the EU", which found that only 23 per cent of Bulgarian municipalities have sufficient knowledge about funding opportunities for projects under the Structural and Cohesion Funds. The survey also showed that less than 40 per cent of municipalities have specialized units dealing with EU funds.

In Bulgaria organizational issues related to the absorption of EU funds became evident in 2007 and intensified in 2008. Due to irregularities and corruption funding for some pre-accession programs was partially frozen. The European Commission revoked accreditation of two Payment agencies - those of the Ministry of Finance and Ministry of Regional Development. At the end of 2008 the Commission confirmed suspension of payments to Bulgaria due to lack of tangible results in fighting corruption. The country lost €220 million. Other €323 million were frozen. Although these problems are not concentrated on the municipalities, they are directly related to them.

The execution of operational programs (OP) for the utilization of funds from EU structural funds continues. Currently there are open procedures for gathering of project proposals under the programs "Regional Development", "Human Resource Development", "Program for Rural Regions", and "Environment" - all are relevant to municipalities. 115 contracts have been signed under OP "Regional Development" for projects totaling €175 million. Proposals for the €1 billion have been submitted under the "Program for Rural Development". The Ministry of Environment and Water has signed contracts with municipalities under OP "Environment" amounting to €555 million. These funds will be used for building facilities for wastewater treatment and waste management.

Fund for Local Governments in Bulgaria was started to support Bulgarian municipalities in the absorption of EU structural funds. UniCredit Bulbank was selected to manage the fund. European Bank for Reconstruction and Development has granted €35 million, while the Bulgarian government has granted an additional €40 million.⁷

2.1 Local Taxes

In the context of reforming local finances, decentralization of local taxation is conspicuously late. Five local taxes were enacted since 1997. However, local municipalities only administered these taxes, acting mostly as tax collection agencies, without the ability to add new taxes or determine the tax rate or the tax base. Since 2008, local municipalities not only collect these taxes, but also determine their size (tax rate). In addition to the already-existing five local taxes, another one was added, the trade license tax (patent tax), which until recently

⁶ De Angelis, M. et al. *Strategy for the Development of the Bulgarian Municipal Credit Market*. Sofia, June 2004.

⁷ Център за икономическо развитие *Икономиката на България*. Януари 2009, с. 61-64.

was a national tax. On the other hand, the central government eliminated the partial transfer of the personal income tax from the central government to the local governments. These specific steps towards fiscal decentralization could only be enacted through changes in the constitution. So far, the constitution forbade determining the local taxation parameters by local authorities; since 2008 the constitution permits the local authorities to determine the size of local taxes according to and within the limits (ranges) provided by law. Changes in the constitution were followed by changes in the *Local Tax and Charges Act*, which empowered the local authorities to determine the effective tax rates within a pre-defined range.

Remarkably, the tax rates may be raised as high as three times the rates effective in 2007, but cannot be lowered at all. After making changes to the Local Tax and Charges Act it is not possible to evaluate precisely the taxing power of Bulgarian municipalities but since 1991 their taxing power is very limited. The central government controls more than 70 per cent of local budget revenue without bearing responsibility for the quantity and quality of the public services provided to local residents. Local authorities in Bulgaria do not enjoy real tax autonomy, can not impact revenue from local taxes, and have in fact limited access to capital markets.

Local taxes are assessed, secured and collected by municipal tax administration officers, who have the rights and obligations of revenue authorities, according to the *Tax and Social Insurance Procedure Code*. The Municipal Council is the authority competent to determine the tax rates in the range given in the *Local Tax and Charges Law*. In Bulgaria local taxes are:

1. Real estate tax;
2. Inheritance tax;
3. Gift tax;
4. Tax on acquisition of property;
5. Vehicle registration tax;
6. Trade license tax (patent tax).

(1) **Real estate tax** is levied on buildings and lots located within the territory of the municipality, where assessed value exceeds BGN 1,680. Agricultural land tracts and forests are exempted from taxation. Owners pay tax, whether they use the real estate or not. The tax is based on the assessed value of the real property. The tax rate for real property is set by the Municipal Council between 1.5 and 3 per mille of the assessed value of the property.

(2) **Inheritance tax** is levied on the estate of descendant Bulgarian citizens, when devolved by legal or testamentary succession. A descendant's estate consists of things movable, immovable, as well as rights and liabilities owned by the predecessor, valued according to the *Local Tax and Charges Law*. Inheritance tax is assessed separately for each heir and tax rates are set by the Municipal Council as follows:

- Applicable to siblings and children of siblings: between 0.7 and 1.4 per cent per portion in excess of BGN 250,000;
- Applicable to any persons: between 5 and 10 per cent per portion in excess of BGN 250,000.

(3) Properties acquired by donation are taxed by **Gift tax**. The tax is payable by the transferee of the property, unless otherwise agreed. The base of the tax is the assessed value of the property. Tax rate is set by the Municipal Council as follows:

- Between 0.7 and 1.4 per cent on donations between siblings and children of siblings;
- Between 5 and 10 per cent on donations between any other persons.

(4) **Tax on acquisition of property** is imposed on real estate and second hand motor vehicles acquired in exchange for money. Tax rate is set by the Municipal Council between 2 and 4 per cent of the assessed value of the transferred property.

(5) **Vehicle registration tax** is levied on motor vehicles, ships, and aircraft. In respect of passenger cars, the amount of tax is determined in conformity with the engine power, adjusted by a coefficient depending on the year of manufacture.

(6) **Trade license tax (patent tax)**. Natural persons carrying out activities from the list of the *Local Tax and Charges Act* are subject to annual trade license tax when their gross revenue for the previous year is less than BGN 50,000 and they are not registered for VAT (Value Added Tax). Income from activities subject to trade license tax is not subject to income tax. The Municipal Council determines the amount of trade license tax in the range specified by law, according to the location of sites on the territory of the respective municipality.

Over the years, the Bulgarian municipalities have considerably increased their administrative capacities. However, similar to the central public administration, the quality of public services remains low to very low. Large share of the municipal administrations, especially smaller ones, do not have sufficient capability to perform their functions, in particular, limited capacity for collecting local taxes and fees.

Rationales for decentralization in Bulgaria are the same as in other countries - decentralized government systems are more efficient and accountable. There are many functions of the state which can be organized more efficiently at the local level.

2.2. Local user charges

In the process of determining the size of user charges the Municipal Council set the price for any service provided by the municipality and user charges should cover its logistical and administrative costs. According to *Local Tax and Charges Law* user charges can be *simple* or *proportional* and they shall conform with the following principles:

- Recovery of the full amount of expenses incurred by the municipality on provision of the service;
- Creation of conditions for expansion of the services provided and for improvement of the quality thereof;
- Achievement of fairness in the determination and payment of local charges;
- Separate charge shall be determined for each distinguishable activity into which a service can be disaggregated;
- The amount of the charge may not recover the full amount of expenses for provision of a specific service that protects the public interest; the difference between such expenses and the amount charged is to be compensated by other municipal revenue.
- There are procedures such that persons who do not use specific services during the entire year are exempt from payment of the respective user charges;

- The municipal administration collects the local charges and the revenues from them accrue to the municipal budget.

Municipalities in Bulgaria collect the following user charges:

1. for disposal of household waste;
2. for use of retail markets, wholesale markets, fairs, sidewalks, squares and street roadways;
3. for attendance at crèches, provision of cooked take-away meals from baby-food kitchens, attendance at kindergartens, residence at public care homes, camps, dormitories, and use of other forms of municipal social services;
4. for quarrying;
5. for technical services;
6. for administrative services;
7. for lease of grave plots;
8. for visitors;
9. for dog ownership.

(1) **Household waste charge** is the largest local charge in Bulgaria. It is charged for collection, removal and safe disposal of household waste as well as for sanitation of areas for public use. The amount of the charge is determined for each service separately: waste collection and waste removal; safe disposal of household waste at sanitary landfills; sanitation of areas for public use. It is paid by the owner of the immovable according to the expenses as approved by the Municipal Council for the relevant year for each of the activities covered.

The amount of the household waste charge is determined in lev terms according to the quantity of household waste. But where the quantity of household waste is not determinable, the amount of the fee is determined in lev terms per user or as a proportion of a base as determined by the Municipal Council.

(2) **Charges for use of retail and wholesale markets, sidewalks, squares etc.** are payable by persons using these facilities upon the issuance of a license and vary by the zone wherein the grounds are located.

(3) **Charges for crèches, kindergartens etc.** are payable by the parents or tutors of the attendees for attendance of crèches and kindergartens per day in an amount as determined by the Municipal Council.

(4) **Quarrying charge** is payable for extraction of pit run by the persons who extract it. The charges are determined separately in respect of each type of material according to the gross output determined.

(5) **Technical service charges** cover expenses for technical services provided by the municipalities and covering activities in connection with regional and urban planning, architecture, construction, urban development, cadastre in settlement and extra settlement spatial-development areas.

(6) **Administrative service charges** are collected for provision of registrar services for:

- Issuance of a certificate for heirship;
- Issuance of a certificate for identity of names;
- Issuance of a certificate for non-entry of a birth record or a death record;
- Issuance of a replacement of a birth certificate, a civil marriage certificate, as well as for re-issuance of an abstract of a death record etc.

The charges are payable for issuance of permits and for practice of activities in amounts determined by the Municipal Council, in compliance with the expenses incurred by the municipality for processing the documents and for verification of compliance with the requirements set for practice of the activity:

- For issuance of a permit for trade of tobacco products;
- Storage, keeping, seasoning and wholesale trade of grape products, alcohol, distillates and spirit drinks;
- Retail trade in grape products, alcohol, distillates and spirit drinks;
- Trade in spirit drinks at mass-catering and amusement establishments.

(7) A lump-sum **charge for the lease of grave plots** for a period exceeding eight years is charged as follows:

- For a period of up to 15 years;
- In perpetuity;
- For use of family grave plots.

(8) **Visitor charge** is payable for use of a collective tourist accommodation establishment and be expended according to a municipal program for development of tourism on:

- Construction and maintenance of the infrastructure servicing tourism within the territory of the municipality;
- Establishment of tourist information centers and arrangement of information services;
- Conservation, maintenance and development of green spaces;
- Sanitation and hygiene measures;
- Promotion of the tourism establishments.

The charge is collected by the persons who supply the service of overnight accommodation credited to the on-budget account of the municipalities.

(9) **Dog owners** shall pay annual charge to the municipality and the proceeds shall be used for measures related to reducing the number of stray dogs.

User charges are a classic tool for financing municipal budgets. In Bulgaria, the most important is charge for disposal of household waste. Depending on the location of the municipality and its resources, charges for quarrying and for visitors can be also significant revenue. For example, the charge for visitors is one of the main sources of revenue to municipalities on the Black Sea coast. In determining the size and amount of user charges local governments have significant powers, but they can not collect fees that are not defined

by law. Thus, opportunities for funding through user charges are limited, but on the other hand, citizens are protected from overcharging by local governments.

3. Quantitative View on Local Taxes and User Charges

To gain more complete understanding of financing Bulgarian municipalities through taxes and user charges, it is necessary along with the statement of the institutional system for their determination and collection to quantify their weight in the operating revenue of the municipalities. To achieve this objective, dynamics of municipal operating revenues for the period 2000 – 2007 will be analyzed (See Table 1). Official data of Ministry of Finance are used, which just cover revenues from *levies* (taxes and user charges), but do not provide a detailed breakdown of these two financial instruments. Data from 2008 are also available, but they are still preliminary since the collection of taxes for 2008 is not complete yet. For this reason, data from 2008 will not be used and only the period 2000 - 2007 considered in the analyses.

Table 1: Operating Revenues of Municipalities in Bulgaria for 2000-2007

| | (In millions of leva) | | | | | | | |
|--|------------------------|---------|---------|---------|---------|---------|---------|---------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| Cash Receipts from Operating Activities | 1 934,9 | 1 987,4 | 2 450,8 | 2 092,8 | 2 302,6 | 2 394,1 | 3 133,5 | 3 652,5 |
| <i>Taxes (incl. User Charges)</i> | 864,5 | 1 020,3 | 1 227,2 | 1 106,8 | 429,1 | 463,6 | 635,4 | 851,3 |
| <i>Government Grants</i> | 836,4 | 673,1 | 1 021,8 | 765,7 | 1 591,5 | 1 665,0 | 2 188,9 | 2 473,7 |
| <i>Other Receipts</i> | 233,8 | 294,0 | 201,8 | 220,3 | 282,0 | 265,6 | 309,3 | 327,5 |

Source: Ministry of Finance

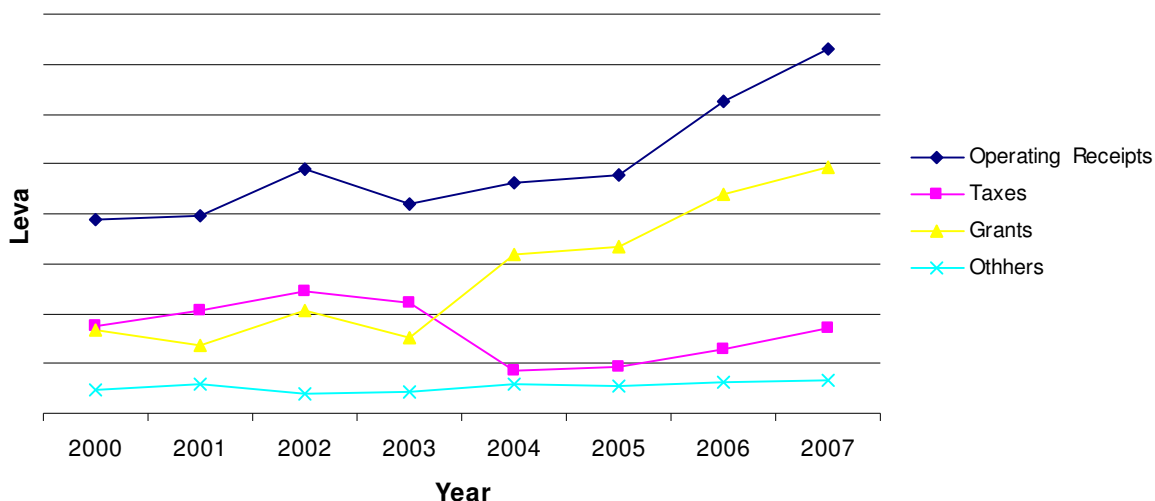
Continuous (nominal) increase in the receipts from operating activities (operating revenues) of Bulgarian municipalities started in 1990 and ended in 2002. In 2003 about 15 per cent less operating revenues were collected; in the next two years they increased slowly, remaining under their value from 2002, and in 2006 decreased again. In 2007 operating revenues grew by nearly 17 per cent reaching an absolute maximum.

Main reason for this dynamics can be found in the dynamics of taxes. They rose continuously from 1990 to 2002, decreased in 2003 by 10 per cent, and "collapsed" in 2004 by further 61 per cent. Their decline is due to the fact that until 2002 municipalities in Bulgaria received part of proceeds of the central profit tax and personal income tax. In 2003 the municipal share in the profit tax were withdrawn, in the next the share in the personal income tax as well. Against the background of continuously growing *other receipts* (mainly rents of real estate) in 2003 declined also the government grant, which then grew intensively.

Graph 1 clearly illustrates this situation. Sharp decline in tax revenue in 2003 and 2004 and "exchange of roles" between taxes and government grants can be identified. It is important to be pointed out once again, that from 2004 onwards, the statistics reflect local taxes. Until then, it includes also the municipal part of central profit tax and personal income tax.

The logic of the exchange of shares in revenues from central taxes for more subsidies is obvious - more flexibility and opportunity to the majority in parliament to influence and control municipalities.

Chart 1: Operating Revenues of Municipalities in Bulgaria for 2000 - 2007



From the situation on the graph after 2004 is clear, that Bulgarian municipalities are financed mainly by government grants, not by own revenues (local taxes, user charges and other receipts) – the weight of own revenues varies around 30 percent, while those of government grants about 70 percent.

The quantitative presentation of funding sources supplemented adequately the general features of fiscal decentralization in Bulgaria and the institutional base for determining and collecting local taxes and user charges. Still unclear, however, is the role of these levies in the total state revenues and their share in gross domestic product (GDP).

Table 2 shows the revenues from local taxes and user charges in percent of governmental taxes and GDP.

Table 2 Local Taxes and User Charges in Per Cent of Government Taxes and GDP for 2000-2007

| | (In per cent) | | | | | | | |
|--|---------------|------|------|------|------|------|------|------|
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
| Local Taxes (incl. Charges)/ Government Taxes | 1,97 | 2,04 | 5,73 | 5,86 | 5,06 | 4,72 | 5,45 | 6,12 |
| Local Taxes (incl. Charges)/GDP | 0,4 | 0,3 | 1,0 | 1,1 | 1,1 | 1,1 | 1,3 | 1,5 |

Source: Ministry of Finance, own calculations

These figures clearly illustrate the very small amount of revenue from local taxes and user charges in Bulgarian context. For 2007 all 264 Bulgarian municipalities collected taxes and user charges at a rate only about 6 percent of taxes collected by the government, which is less than 2 percent of GDP. On basis of such numbers is very difficult to talk seriously about fiscal decentralization in Bulgaria.

4. Conclusions

Fiscal decentralization means not only rights but also duties. The long ago established culture of dependency of central government can not be quickly overcome, neither by central government nor yet by local governments.

The own financial power of Bulgarian municipalities is very limited. Their revenue from local taxes and user charges can not reach 2 percent of GDP. Local governments receive about 70 percent of their revenues as grants from the central government. Remaining 30 percent are their own revenues, but they can not fully manage them because local taxes, user charges, and collecting procedures are prescribed to great extent by law: types of local taxes and user charges, calculations of tax and charges bases, spreads for setting the tax rates, and collection procedures are determined by the parliament. Municipal councils are empowered to evaluate the components of user charges' bases, to determine their rates, and to set the tax rates in the spreads given by law. In 2008 municipalities received a trade license tax (patent tax), which taxes small businesses and handcrafts. With them they have received economic leverage to influence the local economic activity.

The more independence of local bodies by tax collecting is redeemed by duplication of tax administrations in the country, i.e. by more expenses and loss of effectiveness. Local taxes and user charges are much simpler than levies of central government. Nevertheless, municipal tax authorities do not have enough sufficient experience and administrative capacity for effective control and effectiveness over its collection.

Municipalities in Bulgaria are well organized and very active in defending their interests. Against the background of greater powers to determine taxes, at the end of 2008, they strongly requested significantly higher municipal tax rate spreads, what were not well accepted by the public or parliament. The reason for the negative reaction to these claims was the lack of more and better local services, many scandals in distribution of municipal contracts, and inflation of local administrations, often by relatives, friends and acquaintances of the local guides. Not only once the Court of Auditors has ascertained biases and abuses in the use of municipal property and assets.

If Bulgarian municipalities strive towards greater fiscal decentralization and power, they need to address mostly the people and not ultimately their own political and personal interests. If they do not increase the effectiveness and transparency of local budgets and management of local companies and property, they would not receive support for more power, because in that case such power would not lead to positive results.

Accountability of local governments requires publication of key documents on local budgets, costs, contracts, prices etc. On websites of largest Bulgarian municipalities (except Sofia), however, this detailed information can not be found.

The success of fiscal decentralization depends in great extent on the existence of civil society, which is capable to elect the best local guides, to support, and actively to monitor them. Without openness, transparency, active civil position and control fiscal decentralization would lead to "feudalization" of municipalities by their leadership.