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Issues in Intergovernmental Relations

January 27, 2004

Poverty Reduction and Economic Management Unit
South Central Europe Country Unit
Europe and Central Asia Region
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Currency Unit – LEV/1 = 48 US$  

WEIGHTS AND MEASURES
The Metric System is used throughout the report.  

FISCAL YEAR
January 1 to December 31  

ABBREVIATIONS AND ACRONYMS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>BPA</td>
<td>Birth Promotion Act</td>
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<tr>
<td>COM</td>
<td>Council of Ministers</td>
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<td>EFF</td>
<td>Extended Fund Facility</td>
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<td>EU</td>
<td>European Union</td>
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<td>GMI</td>
<td>Guarantee Minimum Income</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>ISPA</td>
<td>Instrument for Structural Policy for Pre-Accession</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<tr>
<td>MES</td>
<td>Ministry of Education and Science</td>
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<td>MLSP</td>
<td>Ministry of Labor and Social Policy</td>
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<tr>
<td>MRDPW</td>
<td>Ministry of Regional Development and Public Works</td>
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<td>NRDP</td>
<td>National Regional Development Plan</td>
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<td>NAMRB</td>
<td>National Association of Municipalities of Bulgaria</td>
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<td>NFC</td>
<td>National Framework Contract</td>
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<td>MEW</td>
<td>Ministry of Environment and Water</td>
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<td>NHIF</td>
<td>National Health Insurance Fund</td>
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<td>NFC</td>
<td>National Framework Contract</td>
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<td>PID</td>
<td>Project Investment Department (MOF)</td>
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<td>PIP</td>
<td>Public Investment Program</td>
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<td>PIT</td>
<td>Personal Income Tax</td>
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<td>RWC</td>
<td>Regional Water Company</td>
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<td>SEBRA</td>
<td>Government payment settlement system</td>
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FOREWORD

This report is based on the findings of a mission to Bulgaria in December 2002. The report was prepared by William Dillinger (Task Manager) with the assistance of Konstantin Pashev. The peer reviewer for this task is Dana Weist.

The report was produced with the participation of a wide range of Bulgarian counterparts. These included officials and staff of the municipalities of Sofia, Plovdiv, Gabrovo, Lovech, Troyan, Pleven, Stara Zagora, Sevlievo, Mezdra, Cherven Briag, and Pazardjik and officials of the Ministry of Finance (including the Department of Local Government Finance and the Directorate of Tax Policy), the Ministry of Labor and Social Policy, the Ministry of Education and Science, the Ministry of Health, the Ministry of Regional Development and Public Works, and the Director of Euro Integration and Relations with IFIs of the Council of Ministers, the National Audit Office, the Association of Municipalities (NAMRB), USAID, the EU, the IMF and several NGOs (including Club Economica 2000, the Foundation for Local Government Reform, and the Local Government Initiative). This report has also benefited from a considerable number of recent reports on Bulgaria, including a recent World Bank Public Expenditure and Institutional Review, the IMF's Bulgaria: Selected Issues and Statistical Appendix (August 2002); USAID's Bulgaria: Comprehensive Municipal Finance and Fiscal Reform Proposal (September 2000), Municipal Credit Market Development in Bulgaria: Policy and Legal Framework (February 2000); Municipal Capital Investment Policy Considerations (March 2003) and Mid-course Review of Fiscal Decentralization: the Unfinished Agenda, as well as several Bank reports arising from lending operations in health, education, and water supply.
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EXECUTIVE SUMMARY

i. Municipalities play a large role in the Bulgarian public sector. They provide primary and secondary education. They own and operate about one-third of the hospitals in the country. Until 2003, they administered all the major social assistance programs (except pensions and unemployment insurance). The municipalities of larger cities own (wholly or partially) the water companies operating within their territories.

ii. Throughout the 1990’s and into the first years of the present decade, problems in the structure of intergovernmental relations undermined efforts to achieve efficiency in public service provision and generate savings for investment in public utilities. Persistent deficits and bailouts undermined fiscal stability at both the central and local levels. A fundamental reform in intergovernmental fiscal relations went into effect in 2003. This has addressed many, although not all, of these problems. The objective of this report is to evaluate the reform, identify major remaining issues and recommend means to resolve them.

iii. Unfunded mandates. The most conspicuous issue in the structure of central-local relations has been a dispute over unfunded mandates. Municipalities charge that the Government imposes costs without sufficient financing. The Government observes that it continues to pay off arrears only to have new ones emerge. Both are right. The Government tightly controls the resources available to local governments and limits their ability to control costs. But municipalities also routinely run up commitments in excess of expected budget receipts in the hope of bailouts from the Government. The Government has traditionally obliged, reinforcing these expectations.

iv. Overstaffing. The structure of intergovernmental relations has also encouraged overstaffing. Excessive staffing is a problem in Bulgaria, particularly in education and health care, due to the legacy of over-dimensioned facilities inherited from the Socialist era and--in the case of schools--declining enrollment. Under the system of intergovernmental relations that existed in 2002, the Government reimbursed 100 percent of municipal wages and social security contributions, providing no incentive to economize on staff.

v. Financing capital investment. Municipalities also face problems in the financing of capital investment. Municipal infrastructure has suffered from a decade of deferred maintenance. Substantial new capital investment—particularly in sewerage—will be required to meet EU accession requirements. At present, municipalities and their enterprises generate virtually no current savings with which to finance capital investment. Except in Sofia, private concessionaires have expressed little interest in investing in municipal utilities. Most capital works are instead financed through the Government’s annual budget, which is in turn funded from domestic taxation, Government borrowing and donor funds. While this is the most likely source of funding for municipal works in the short and medium term, the current capital budgeting process fails to link available resources to highest-priority projects. While the MOF does a creditable job in analyzing the financial aspects of project proposals, its analysis of
economic costs and benefits aspects is weak. And the capital budgeting process gives the Council of Ministers excessive discretion over choice of projects to be funded in the annual budget.

vi. The reform of 2003. A major reform in intergovernmental fiscal relations, effective in 2003, addressed some of these problems. The reform substantially changed the method used to calculate municipal expenditure needs. As a result, the level of funding for so-called delegated functions is now based on a more accurate calculation of costs. The mechanism for distributing funding among municipalities is more transparent. The reform also reduces incentives to overstaffing—most dramatically in the case of health, where salaries will no longer enter into the calculation of the general subsidy.

vii. The remaining agenda. Despite this progress, a substantial unfinished agenda remains. The reform does not eliminate the root cause of the dispute over unfunded mandates. As in the past, the Government will continue to make its own estimate of local spending needs and expected revenues from shared taxes, and provide budget support to fill any resulting gaps. While this calculation will now be limited to so-called delegated functions, municipalities are still likely to dispute the figures. In fact, the elimination of actual salary costs from the calculation of expenditure needs is likely to increase the grounds for dispute. Municipalities may now argue that the Government is not only underfunding non-salary costs, but is underfunding salaries as well. As a result, municipalities are likely to continue to run strategic deficits in the hopes of attracting new bailouts.

viii. In addition, the reform does not provide a means for local government to respond to incentives for staff reductions. While it provides a fiscal incentive to reduce overstaffing, it does not remove the regulatory constraints on doing so.

ix. In the short term, five additional measures therefore bear consideration.

- First, the Government should commit itself to meeting its own budget obligations to local governments\(^1\). It should release subsidies on a timely basis, and should regularly update the factors used to calculate expenditure needs.

- Second, it should assist municipalities in responding to the efficiency incentives embodied in the new general subsidy formula. Rather than resisting downsizing, the Ministry of Education should encourage municipalities to close under enrolled classes, by enforcing rules on minimum class sizes and assisting in the redeployment of redundant teachers. The Ministry of Health should relieve the municipalities of some of the political onus of hospital closings by pursuing its hospital restructuring strategy more aggressively, while at the same time expanding the number of clinical paths eligible for NHIF reimbursements.

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\(^1\) The 2004 draft budget law, now under discussion in Parliament, provides for full funding of the delegated functions. Shortfalls in the funding of delegated functions at the outset of 2003 were covered by budget transfers later in the year.
Third, the National Assembly should give municipalities greater control over property taxes, in order to provide them with a means to respond to constituents’ demands for public services.

Fourth, the Government should harden the budget constraint confronting local governments to rein in their propensity to run up arrears. While budget regulation may be helpful in this regard, cutting off the sources of deficit financing is likely to be more effective. The majority of deficit financing is provided by private suppliers and contractors. They are likely to continue to extend credit to municipalities as long as they have a reasonable expectation of being paid. The Government should puncture this expectation by refusing to provide debt relief in the future.

Finally, the Government will have to find a more effective mechanism to raise resources for investment and link it with high priority projects. One approach would be to rely more on the current account savings of municipal governments and their public enterprises. Certain sectors could be made more attractive to investors willing to bring in capital. The focus of reform, however, should be on the Government’s own capital budgeting process, and should aim at improving the project selection process and improving the quality of projects submitted for donor financing. There is therefore a strong argument for tighter regulation on municipal borrowing. One approach would be to impose quantitative restrictions, such as a minimum level of debt service coverage. An alternative would be to rely on local political accountability. The Government is now considering a proposal that would require a super-majority in the municipal council, or a majority vote in a local referendum as a precondition for contracting of municipal debt. Both approaches should be considered.

In the longer term, the Government should seek a more sustainable solution to the conflict over unfunded mandates. One solution would be to further centralize the financing of certain delegated functions. This has already occurred in social assistance, where the Government has now assumed full responsibility for the financing and administration of income support. In principle, this approach could be extended to the financing of teachers’ salaries. Under such an approach, the Government would directly finance the wage and benefits of authorized teaching positions, rather than incorporating salary funding in the general supplementary subsidy.

Alternatively, the Government could relax its controls over the management of some functions, allowing local governments greater control over the determinants of costs. Municipalities could be permitted to cut excess teaching positions without prior Government approval, for example. Over the long run, the Government should also consider loosening its controls over municipal revenues. Granting municipalities the power to set property tax rates is an important first step. But it will not be sufficient to resolve disputes over the adequacy of

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Debt service coverage can be defined as the ratio of the current surplus to total debt service, where the current surplus is defined as total current revenues less recurrent non-interest expenditures, and debt service includes interest and principal repayments on the total stock of debt.
financing, particularly for delegated functions. One candidate for liberalization would be the personal income tax. It has a number of advantages, not the least of which is the fact that it is already assigned to local government. Liberalization would merely require that local governments be allowed to adjust the rate of the tax imposed within its jurisdiction. Such mechanisms are widely used in other European countries. Like most European countries, Bulgaria is likely to eventually choose a mix of both. The distinction between delegated and autonomous functions, introduced in the 2003 reform, is a positive step in this direction.
INTRODUCTION

1. Municipalities play a large role in the Bulgarian public sector. They provide primary and secondary education. They own and operate about one-third of the hospitals in the country. Until 2003, they administered virtually all social assistance programs except old age pensions and unemployment insurance. Municipalities of larger cities own (wholly or partially) the water companies operating within their territories. Sofia owns its own district heating company. In total, spending by municipalities accounts for about 17 percent of total consolidated public sector spending\(^3\) or about 26 percent of public sector spending net of social security.

2. Problems in the system for financing municipal governments have undermined efforts to achieve efficiency in public education and health, equity in social assistance, and generate savings for investment in public utilities.\(^4\) Schools and hospitals are overstaffed and over dimensioned, wasting resources. Social assistance has been underfunded in poor jurisdictions. Infrastructure is deteriorating, just as EU accession demands massive new investment. And a tight fiscal straight jacket imposed by the Government has been incapable of preventing municipal arrears and bailouts.

3. But the system is constantly under reform. A fundamental reform went into effect in 2003. The object of this report is to evaluate the reform and to identify the next steps required to improve the efficiency of municipal services and achieve local fiscal stability.

4. The territory of Bulgaria is divided into 263 municipalities (obshtini) and 28 oblasts. Municipalities are legal entities, governed by municipal councils whose members are directly elected for four year terms. Executive power is vested in an elected mayor. In accordance with Article 141 of the Constitution, each municipality has its own budget and permanent sources of revenue, as established by law.\(^5\)

5. In territorial terms, municipalities are relatively large by Eastern European standards. The vast majority of municipalities range in population from 5,000-50,000. As shown in Table 1, only 28 municipalities--accounting for ten percent of the total but only one percent of Bulgaria’s population--have populations under 5000. The thirteen largest municipalities--with populations over 100,000--account for about 42 percent of Bulgaria’s population.

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\(^3\) Consolidated budgetary expenditures of central government, plus spending by local governments, net of intergovernmental transfers. Source: MOF website.


\(^5\) Oblast administrations, in contrast, are administrative units of the Government, administered by a governor who is directly appointed by the Council of Ministers. The oblasts are financed by the Government budget.
Functions

6. The Local Self Government Act sets out a lengthy list of functions over which municipalities may exercise competence. These include education (preschool, elementary, primary and secondary); health care (outpatient and hospital care, preventive care, community care, municipal sanitation and hygiene); social assistance (social care and welfare benefits, provision of subsidized housing and other ‘social work of municipal importance’); and public works and utilities (including water supply, sewerage, central heating, solid waste management, streets, and public transit).

7. Education accounts for the largest single item of municipal expenditure. As shown in the figure below and Table 2, it consumed about 35 percent of the total in 2001. Bulgaria’s education system consists of: (i) optional pre-school education; (ii) an eight-year primary cycle; (iii) a secondary cycle which, starting in the 1999/2000 school year, was extended from three years to four years; and (iv) various higher education programs. Primary education is offered either in eight-year primary schools, or in a combination of “junior school”, covering the first four grades, and “middle school”, covering grades 5 through 8. Secondary education is offered in several forms—either as general education or as vocational education in a large number of specializations. Urban areas tend to have large schools offering the complete primary or secondary cycle. Small rural communities often have separate four-year junior and middle schools, with few students in each grade.

8. About 1,000 primary and secondary schools are designated as “national interest schools”, and are financed entirely by the Government budget. These include vocational schools and schools for students with special needs—including orphans, juvenile delinquents, and students with infectious diseases. The remaining public primary and secondary schools—numbering about 2,500 and accounting for the vast majority of enrollment—are the responsibility of the municipalities.

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6 Competence, in the law, is defined as “the right of citizens or of bodies thereby elected, to make decisions, acting within the scope of the competence thereon conferred”.

9. Prior to the 2003 reforms, social assistance was the second largest item of municipal expenditure. Bulgaria has an extensive system of social welfare. During the 1990’s, social protection spending averaged 12 percent of GDP. Over 80 percent of Bulgarians received at least one type of benefit in 2001. Retirement benefits are by far the largest program, accounting for 65 percent of total social assistance spending in 2001 (net of administrative costs). This is followed by unemployment benefits at six percent. Both are financed and administered by the Government. Until 2003, an extensive list of benefits, however, were paid through the budgets of local governments. These included: (i) the Guaranteed Minimum Income (GMI), a means-tested cash benefit paid to low-income households below an income threshold; (ii) family benefits paid under the Birth Promotion Act, including child allowances, maternity leave and birth grants for uninsured households; (iii) energy benefits, paid in cash to low-income households during the winter heating season; and (iv) cash and in-kind benefits for the disabled, including medical and transportation benefits.

| Table 2: Municipal Expenditures (% of total spending, 2001) |
|---------------------------------|----------------|----------------|
| 1997-2001 | 2001 | % Δ  |
| Education | 38% | 35% |  |
| Social Security and Welfare | 163% | 18% |  |
| Housing and Public Works | 59% | 16% |  |
| Health | -55% | 10% |  |
| General Public Service | 75% | 9% |  |
| Transport | 56% | 6% |  |
| Recreation, Culture | 42% | 3% |  |
| Other Economic Services | 210% | 1% |  |
| Police and Public Safety | 139% | 1% |  |
| Other Expenditures | -23% | 2% |  |

Source: MOF, Municipal Fiscal Operations.

10. **Health Care.** The Bulgarian health care system has two major components. Primary care is provided by private practitioners operating under individual contracts with the National Health Insurance Fund (NHIF). They are paid on the basis of patients registered (BGN 1 per patient) plus an additional fee for service rendered. Fees are governed by an annually revised National Framework Contract (NFC) between the NHIF and professional organizations of physicians and dentists.

11. Secondary and tertiary care are provided through a system of national, regional, and municipal hospitals. The hospital system is in the midst of a major reform in both organization and financing. In 2000, Government- and municipally-owned hospitals and clinic facilities were reorganized as commercial enterprises. Ownership of the 28 regional hospitals was divided between the Government (51%) and the municipalities within their respective catchment areas. University hospitals and national centers (20) remained the property of the state. Existing municipal hospitals remained wholly owned by the municipalities in which they were located. As of end-2000, Bulgaria had 385 inpatient health care institutions, with a total of 60,552 beds. Municipalities owned 102 of them, with 27 percent of the beds and 15 percent of the patients.
12. Financing arrangements are also changing. Prior to 2001, hospitals were largely financed through budgetary transfers from their respective owners, supplemented by fees. Since then, the NHIF, financed from earmarked contributions, has taken an increasing role in hospital care financing. The majority of NHIF financing is provided on the basis of diagnostic related groups (clinical paths, in Bulgarian parlance). The NFC identifies treatment regimes eligible for NHIF reimbursement, along with corresponding reimbursement rates. Reimbursements to each health service provider are approved only for those clinical pathways in which it is deemed competent, and for which each provider or hospital has contracted with the NHIF. At present, the health fund covers only 41 procedures (clinical paths, in Bulgarian parlance). This would expand to 71 in 2003, and will eventually cover the entire range of services provided by hospitals.

13. Reforms in the health care system have resulted in a dramatic re-division of funding responsibilities. As shown in Table 3, the municipal share of health care spending dropped from 76% in 1990 to fifteen percent in 2001, and is budgeted to fall to ten percent in 2003. To date, this largely reflects the changing terms of outpatient financing. Outpatient services were formerly provided by doctors affiliated with (and paid through) municipal hospitals. The second stage of the reform—in which NHIF will take over an increasing proportion of in-patient care—has proceeded more slowly.

<table>
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<td>Percent of Total</td>
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<td>MOH</td>
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<td>NHIF</td>
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<tr>
<td>Municipalities</td>
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<td>Total</td>
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14. Water Supply, Sewerage and District Heating. At present, fourteen municipalities operate their own water supply companies. Service in the rest of Bulgaria is provided by 29 regional water and sewerage companies (RWCs), each of which is organized as a limited liability company and delivers water and sewerage services to three to seventeen municipalities. The regional water companies are owned 51 percent by the Government and 49 percent by the municipalities (although municipal ownership does not confer any significant management control). Individual water companies (regional or municipal) have the authority to set their own tariffs. Municipalities are responsible for financing additions to the water distribution network even where service is provided by a regional water company. (The Ministry of Regional Development finances water production facilities and trunk lines). Municipalities are also responsible for extending sewage collection lines, although much of this is financed through earmarked capital grants. Only one municipality has its own district heating company: Sofia. Elsewhere, service is provided by Government enterprises. Tariffs, although high, are not sufficient to cover operating costs (although the Government has approved a sequence of annual ten percent increases in the heating tariff for the next three years). In addition, the Government has often failed to provide sufficient money in the budget to fully fund the heating subsidy that district heating companies are required to provide.

11 Robert Firestine, op. cit.
12 The amount transferred from the NHIF to individual hospitals may be determined by such criteria as the following: length of stay, by diagnostic group; relative weight of the diagnostic group, as measured against the baseline value per inpatient for the hospital accreditation group; number of patients by disease group; and contractual coefficients above or below average caseloads (over performance or underperformance).
As a result, district heating companies have substantial arrears to the Government gas company, Bulgargas.

15. **Urban Housekeeping and Transport.** In addition to these major functions, municipalities are also responsible for a wide range of urban housekeeping functions, including solid waste collection and disposal, street construction and maintenance, public lighting, and traffic management. All municipalities are responsible for construction and maintenance of local roads (i.e., those not part of the state road network) and urban streets. Some provide bus transport, either through municipal companies or private concessionaries.\(^3\) Sofia owns a metro and has shares in a municipal bank, a hotel, a business center, and an exhibition hall, along with numerous smaller enterprises.\(^4\) Some municipalities own housing and commercial enterprises. Stara Zagora owns 1000 apartment units that it rents out to the poor and disabled. Sevlievo owns a construction company, a pharmacy, and a metal processing company.

**Box 1: Measuring The Costs of Urban Housekeeping**

The costs of providing urban housekeeping functions—and their profitability, if any—is difficult to determine. This is in part because they are often organized as municipal enterprises, in which case expenditures financed from own-source revenues are excluded from municipal budget reports. The system of budget classification also obscures the level of expenditures in these sectors. The Ministry of Finance uses the IMF (GFS) classification system to show the functional breakdown of municipal spending, but provides only first-level detail; e.g., “housing and community amenities”, “transport” and “general public services.” Housing, in GFS terms, includes slum clearing, land acquisition, the construction or purchases of housing and the construction and operation of water supply systems (but not sewerage, which appears under “environment”). Transport includes the construction and maintenance of roads, but not subsidies to public or private bus companies. General public services includes tax administration, financial management, and interest payments. It is therefore only mildly illuminating that spending on housing and community services accounted for about 16 percent of total spending in 2001, and that spending on transport consumed about six percent.

qualified for assistance, the municipalities had no role in determining either the level of benefits or number of people who received them.

17. While social assistance is now (as of 2003) a responsibility of the Government, a similar degree of heavy handed control prevails in other sectors. In the case of education, for example, it

\(^3\) Municipal bus companies can be a major financial burden. Plovdiv's municipally-owned bus company is grossly overstaffed. It has 900 drivers but only 150 buses.

is the Ministry of Education and Science (MES) that recruits, evaluates, trains, and promotes schoolmasters and teachers. Salary levels are fixed by the Ministry,\textsuperscript{15} which also has the final say in the dismissal of teachers and the closure of schools. Centrally mandated norms specify, for each level and type of course, the minimum and maximum class size and the minimum (and maximum) number of teaching hours per teacher. Outside of education, the Government also controls the wage levels of higher level administrative staff (civil servants) and approves the salary schedule for staff employed under the general labor code.\textsuperscript{16} In principle, municipalities have a greater degree of control over health care costs. As the hospitals and clinics are organized as enterprises, local governments can reduce staff without Government approval. Changes in the salary structure, however, must be approved by the Ministry of Health.

\textbf{Revenues}

18. \textit{Transfers and Shared Taxes.} Municipal responsibilities are largely financed through a complex system of subsidies and tax sharing. The system essentially aims at calculating the expenditure needs and expected revenues of each municipality, and provides a transfer to cover any gaps. These calculations are made during preparation of the annual Government budget, and consist of three steps.\textsuperscript{17}

19. First, revenue availability is determined by estimating the yield of designated shared taxes. Until 2003, municipalities were assigned shares of two taxes: the personal income tax (PIT) and the corporate income taxes (CIT). Both taxes were administered by the Government. The National Assembly had exclusive authority to define the bases, exemptions, and rates of both. The division of the PIT varied from year to year, as determined by the annual budget act. (In 2002, municipalities were assigned 50 percent of the PIT). The municipal share of the corporate income tax was fixed (at ten percent of the base). As detailed below, the municipal tax on corporate income was abolished in 2003, and the municipal share of the personal income tax was increased to 100\%.\textsuperscript{18}

20. Expenditure needs are then calculated. The methodology for calculating expenditure needs has varied over the last several years. Prior to 1993, the Ministry of Finance calculated the expenditure needs of each municipality on the basis of historical data on staffing and other operating costs. Starting in 1993, the Government attempted to introduce so-called objective factors into the calculation of needs. These were to be introduced gradually over a five year period. The new transfer distribution formula was calculated as the sum of: (i) a declining share

\textsuperscript{15} Teacher salaries are based on three factors: (i) a basic salary, which varies according to qualifications; (ii) years of service (at 0.08 percent per year of service); and (iii) a bonus for in-service training.

\textsuperscript{16} The number of municipal staff subject to civil service regulations appears to be small, however. Forty four of Stara Zagora’s 192 administrative staff are civil servants, with the rest employed under the labor code.

\textsuperscript{17} Note that this section describes the system as it existed in 2002. Reforms introduced in 2003 are described later in this report.

\textsuperscript{18} In principal, revenues from the taxes were returned to municipalities on the basis of origin. The ‘origin’ of the PIT was defined as the taxpayer’s place of work. The origin of the corporate income tax was defined as the location of the company. The law required that CIT revenues be credited to municipalities in proportion to the number of each firm’s employees in each municipality. This required complicated record keeping by the regional tax offices. In practice, CIT revenues were often credited to the municipality in which the headquarters of the firm was located. As a result, there was little correlation between the origin of the tax and location of the taxpayers who bore its ultimate burden.
of the transfer received in the previous year; plus (ii) various so-called objective indicators such as the number of school children and the number of hospital patients in each municipality. This formula was revised and amended annually and became increasingly complex.

21. In 2001, the Government abandoned this approach and reverted to a hybrid of the two previous systems. In 2001 and 2002, the wage bill was based on actual wages and social security contributions of authorized staff in each municipality. Operating costs, however, were calculated on an increasingly arbitrary basis. First, the total amount of the budget to be allocated to municipal operating costs was determined through annual negotiations between the Association of Municipalities (NAMRB) and the Government. This amount was then allocated to individual municipalities on the basis of a 15-variable formula. Of the 15 variables, the most important were: population (33.1% of the weight); number of pupils in secondary schools (13.6%); number of settlements (11.4%), number of beds in social welfare establishments (10%), and territory (8.7%). In total, general factors such as population and territory accounted for 55 percent of the weight; secondary education, 18.6 percent; health, 13.5 percent; and social welfare, 10.5 percent.

22. The third step was the calculation of the general supplementary subsidy. This was calculated as the difference between estimated expenditure needs and estimated revenues from shared taxes and other smaller transfer programs. If estimated expenditures exceeded estimated revenues, the Government provided a general grant to cover 100% of the difference. If estimated expenditures were less than estimated revenues, the surplus was allocated to the Government. In 2001, 34 municipalities had estimated surpluses and thus became net contributors, rather than recipients, of the general supplementary subsidy.19

| Table 4: Sources of Municipal Current Revenue, 2001 |
|----------------|----------------|
|                | BGN mm         |
| Total          | 100%           |
| Shared taxes   | 48%            |
| PIT            | 27%            |
| CTT            | 20%            |
| Subsidies      | 31%            |
| General        |                |
| supplementary  |                |
| subsidy        | 28%            |
| Earmarked social | 4%             |
| Earmarked capital | 4%            |
| Reverse transfers | -4%          |
| Local revenues | 21%            |
| Local taxes    | 5%             |
| Local fees     | 9%             |
| Other local rev | 8%            |

23. In addition to the general supplementary subsidy, municipalities received sector specific earmarked transfers. The most important of these were matching grants for social assistance. Starting in 1999, the Government began paying 50% of the cost of income support (i.e., Guaranteed Minimum Income benefits), child allowances and benefits for the disabled. In 2002, the Government increased in contribution rate to 75%. As discussed below, this share increased to 100% in 2003.

24. **Local taxes** consist of a property tax, inheritance tax, gifts and donations tax, property purchasing tax, vehicle tax, and (as of January 2002) a road tax. Together, these account for only five percent of municipal revenues. Although these are nominally local taxes, local governments neither administer them or have any control over their bases or rates. They do, nevertheless, retain the revenue collected in their jurisdictions.

25. Municipalities also impose a variety of fees, including fees for the use of kindergartens, hostels, welfare homes; for markets and fairs; for household waste collection and for various other municipal services. Municipalities can set the rates for fees within the limits prescribed in the Local Taxes and Fees Act. Until recently,

revenues from local taxes and fees were included in the calculation of the general supplementary subsidy. Increased yields from local taxes therefore reduced the amount of the general supplementary subsidy by a corresponding amount. In 2001, the formula was amended to exclude 50 percent of the yields of local taxes and fees. In the 2002 budget, they were excluded entirely.

26. **Capital Receipts.** In the absence of significant current account savings by municipalities or their enterprises, capital works are now largely financed capital grants from the Government, and donor funds. In addition to the annual capital budgeting process, Bulgaria has a system of capital grants directed specifically at municipalities. The 2003 draft budget fixes the municipal capital expenditure grant at BGN 100 million and divides it into two portions. BGN 30 million is allocated to project-based financing, focusing on ongoing priority environmental projects selected by the MEW (Ministry of Environment and Water). These are explicitly listed in the budget, along with a requirement that municipalities give these projects priority in the use of their capital grants. The second portion, worth BGN 70 million, is allocated to municipalities according to three size-related criteria (population, territory and the number of towns and villages) with weights 0.4, 0.3, and 0.3 respectively. Funding is not automatic—municipalities must submit individual projects for consideration. Municipalities receive the higher of the two grants (project-based or size-based). Excess resources are reallocated according to the size criteria among the municipalities that do not receive project-based financing.

27. The Government also directly finances capital expenditures through the Ministry of Regional Development and acts as an intermediary for donor funds, including EU grants. In addition, local governments now have fairly unrestricted access to domestic and external credit markets. Bulgaria relies on the market to determine the level and conditions of municipal borrowing. To date, the market has been unenthusiastic. Three municipalities have successfully floated bonds. Sofia’s Eurobond has now been retired, with the assistance of the Government. Troyan is in default and is only paying principal.

**ISSUES**

Unfunded Mandates, Arrears, and Fiscal Autonomy

28. The most controversial issue in the structure of central-local relations at the beginning of 2003 was the presence of unfunded mandates, accumulating arrears, and persistent bailouts. Municipalities charged that the Government imposed costs without sufficient financing. The Government observed that it continued to pay off arrears only to have new ones emerge. 20

29. This problem was important for two reasons. First, it undermined municipal management. From a mayor’s perspective, municipalities were locked in a fiscal straightjacket. Municipal revenues were unpredictable. Expenditures were difficult to control.

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20 In late 2003, the Government had transferred 65 million leva to cover unfunded mandates and intended to cover the remainder, subject to fiscal conditions.
30. Second, the cycle of arrears and bailouts was indicative of the Government’s inability to impose hard budget constraint on local governments. For all the Government’s attempts to control local spending, municipalities nevertheless managed to induce the Government into providing last minute debt relief. Given the fiscal constraints imposed by the currency board system and the Government’s agreements with the IMF, these are concessions that it could ill afford to make.

31. How big was the problem? For all the debate over the subject, the nature of deficits and their financing is not very well documented. Because local governments keep their accounts on a cash basis, data from income and expenditure statements do not show obligations that have been accrued but not paid. As a result, reported municipal revenues and expenditure move in lock step (See Figure 2).

32. In principle, it should be possible to measure the size of municipal deficits by comparing the stock of arrears and outstanding debt from one year to the next. All municipalities are required to report their stock of arrears and contractual debt to the Ministry of Finance, which publishes the data periodically. As shown in Table 5, the overall level of the stock has varied over the last several years. At the end of 2000, it stood at BGN 171.2 million, or 8.6 percent of municipal revenues. A year later, the stock had fallen to BGN 124.25 million. By July 2002, it had returned to BGN 169.0 million. According to the most recent figures (February 2003), the stock stands at BGN 113 million. Recent declines in the stock of arrears would suggest that municipalities are running surpluses.

33. But this is not the case. Rather than reflecting the growth or decline of deficits, the year to year changes in the stock of debt largely reflects the impact of Government bailouts. The amount of individual bailouts cannot be precisely determined. The budget item ‘extraordinary
subsidies’ (which includes bailouts along with other forms of *ad hoc* budget support) nevertheless gives an idea of their scale. As shown in Table 6, the volume of extraordinary subsidies has ranged from BGN 179 million in 1998 to BGN 351 million in 2000. Extraordinary subsidies in 2002 totaled BGN 333 million. Comparing the flow of extraordinary subsidies to changes in the stock of arrears suggests that municipal deficits in 2001 totaled BGN 156 million, and rose to BGN 323 million in 2002.

<table>
<thead>
<tr>
<th>Table 6: Trends in Subsidies to Municipalities</th>
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<tr>
<td>Subsidies authorized under State Budget Act</td>
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<tr>
<td>1998</td>
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<td>--------</td>
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<tr>
<td>434.9</td>
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<tr>
<td>Extraordinary subsidies</td>
</tr>
<tr>
<td>179.2</td>
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<tr>
<td>Total municipal revenues</td>
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<tr>
<td>1642.3</td>
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<tr>
<td>Extraordinary subsidies as % revenues</td>
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<td>11%</td>
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34. These deficits were largely financed through arrears. As shown in table below, the largest share of the arrears—18 percent—are owed to the Government-owned electricity company. Arrears to other government utilities—district heating companies and regional water companies—constitute another eleven percent. Thirteen percent are owed to privately owned fuel suppliers. Municipalities have significant arrears to medical suppliers (six percent of the total) and civil works contractors (four percent). The category “other current” accounts for 35 percent of the total. Of this, nearly half is classified under the functional category “housing and community amenities”. This category includes water and sewerage, street lighting, street cleaning, and waste disposal, and environmental protection. Arrears in this category are owed to suppliers of materials and to firms providing these services on a contract basis.

35. The structure of the arrears has remained roughly constant over the last four years, except in the case of social assistance. Arrears on social assistance declined sharply between 2000 and 2003, a period that corresponds to the gradual takeover of social assistance financing by the central Government. Beginning in 2002, the Government began to divide responsibility for the arrears between itself and the municipalities on the basis of functional categories. Responsibility for functions delegated to municipalities—such as education—were assigned to the Government. Municipalities’ own responsibilities (hereafter referred to as autonomous functions)—such as housing and community amenities—were assigned to the local level. On this basis, municipalities were assigned responsibility for sixty percent of the February 2003 stock.

36. Who was responsible for the arrears? Both the central government and the municipalities have played a role. Much of the recent literature on Bulgarian local finance argues that the arrears are the result of unfunded Government mandates. This statement appears in the recent World Bank public expenditure review. It surfaces in the IMF’s recent review of local government finance. The Government itself appears to concur. According to National Accounting Office estimates, about 90 percent of municipal expenditures in 2001 were devoted to public services and functions that are mandated by the national government, and over which local governments have little control. The Government, it is said, imposes these costs on local governments without providing the wherewithal to finance them. This forces local government to

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run deficits, which are financed in the short term through arrears and over the long term through acrimonious Government bailouts.

37. The facts are more complicated. It is true that there is a very high degree of Government control over municipal expenditures. This is particularly true of wages—which constituted about one-third of municipal expenditures in 2002—and social assistance costs. At the same time, municipalities have little control over revenues, particularly those delegated by the State. Shared taxes and transfers account for 80% of current revenues, and local taxes—imposed at centrally determined rates—account for another five percent. As of 2002, the structure of revenue assignment and expenditure controls therefore appeared to leave municipalities in a fiscal straightjacket—unable to reduce costs or increase revenues in response to Government demands or changing economic circumstances.

38. But there is less to this argument than meets the eye. As of 2002, while the Government controlled the wage bill, it also financed it. As noted earlier, the general supplementary subsidy was calculated on the basis of the actual wage bill in each jurisdiction. As a result, it was the Government—not the municipalities—that bore the risk of wage increases. By the same token, the Government also bore the risk of any shortfalls in revenues. If receipts from the PIT (or earlier, the CIT) were below projected levels, the Government was obligated to make up the difference by increasing the general supplementary subsidy.²³

39. Under the system that prevailed in 2002, there were only two clear cut grounds for blaming municipal arrears on the Government. The first was that the Government may have systematically underestimated non-salary costs—i.e. the costs of materials, supplies, contractual services and capital works. As noted earlier, the level of Government funding for non-salary costs was (until 2003) derived through negotiations with the association of municipalities (NAMRB). Funding therefore depended on macroeconomic conditions and the relative bargaining power of the NAMRB and the Government, rather than actual costs per se. By underestimating non-salary costs, the Government could underestimate total municipal expenditure obligations, and therefore underestimate the size of the general supplementary subsidy that it needed to provide in the budget. Since allocations to individual municipalities were based on the arbitrary fifteen variable formula, even if the aggregate allocation to non-salary costs were adequate, it could easily fall short in the case of individual jurisdictions. Second, the Government contributed to municipal arrears by failing to fund its own estimates of municipal expenditure needs on a timely basis. The annual budget law permits the Government to retain a percentage of the general supplementary subsidy as a fiscal buffer, to be released only if specific national fiscal deficit targets are met. In 2001 and 2002, for example, the budget act permitted the Government to retain ten percent of the general supplementary subsidy on this basis. While the Government has been scrupulous in disbursing the remaining 90 percent on a regular monthly basis, it has tended to retain the buffer until the end of the fiscal year. Shortfalls during the course of the budget execution prompt municipalities to run up arrears in the interim.

40. But the municipalities also play their role in building up deficits. While municipalities have limited room to control wages or increase tax revenues, they are not entirely helpless. In

principle, municipalities can cut spending on non-salary items to fit their budget allocations. Rather than simply originating in unfunded mandates, Bulgaria’s municipal deficits are also the result of strategic behavior by local governments—a deliberate policy of accumulating more expenditure commitments than can be financed from expected revenues, in the hope of eventual financial relief from the Government.

41. The Government has inadvertently contributed to this expectation in two ways. First, it is one of the major financiers of arrears. As noted earlier, arrears to Government-owned public utilities constitute 28 percent of the February 2003 stock. Arrears on loans (predominantly from the Government) constitute another nine percent. Second, a history of past Government bailouts encourages private firms to continue to tolerate the accumulation of arrears on goods and services sold to municipalities, secure in the knowledge that these debts will be liquidated once the Government comes to the municipalities’ relief. On at least one occasion in the past, the Government has attempted to discourage this practice by imposing conditions on its debt relief. The 1999 bailout required municipalities to cut administrative staff by ten percent by January 2000, halt unauthorized subsidies to loss-making municipal companies, and convert municipal enterprises into companies organized under the commercial code. Medium-term measures, to be completed in March 2000, included the liquidation or restructuring of loss-making municipal companies. These measures were never enforced, however.

42. The persistence of municipal arrears prior to the 2003 reforms is therefore attributable to the behavior of both the municipalities and the Government. The Government invited municipal deficits by failing to fully fund its own estimates of municipal expenditure needs. Municipalities abused what little budget autonomy they have in making commitments they cannot liquidate. The Government then perpetuated this behavior by providing periodic bailouts.

Incentives to Overstaffing

43. A second problem in Bulgarian intergovernmental relations was the incentive it provided to inefficiency in service delivery—and particularly to overstaffing. As noted earlier, the formula for calculating expenditure needs in 2000-2002 was based on actual wages and social security obligations. It therefore covered 100% of the wage bill, regardless of over or understaffing at the municipal level. And overstaffing clearly exists, most conspicuously in education. Enrollment is falling in both primary and secondary schools. At the primary level, this reflects a decline in the student age population. At the secondary level, it reflects both a decline in the student age population, and a decline in enrollment ratios. Between the 1990/91 school year and the 2001/2002 school year, primary school enrollment dropped by 27.4 percent. Secondary school enrollment dropped by 14.6 percent. This decline in school-age population should have permitted reductions in staff, freeing up resources to raise education quality. This has not occurred. Preschool is the only level at which the decline in enrollments was matched by an equivalent decline in schools and teachers. In primary education, the number of teachers and schools declined, but by considerably less than the decline in enrollments. In secondary

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24 IBRD, August, 2002, *Bulgaria Public Expenditure Issues and Directions for Reform*. Note that National Statistical Institute data show an increase in enrollment ratios at the secondary level. This is contradicted by evidence from the Integrated Household Survey, however.

25 Pre-primary enrollments are falling not because of a drop in the number of eligible students but because parents can no longer pay the required fees.
education, the number of teachers and schools actually increased, in spite of the sizable decline in enrollments. These changes are reflected in student/teacher ratios—by far the most important determinant of education unit costs. Costs of rural schools are excessive due to low levels of enrollment and high teacher pupil ratios.

44. Overstaffing—and excessive scale—is also a problem in the health sector. Compared to the EU countries, Bulgaria shows a relatively high number of hospital beds per 100,000 citizens. In the EU, the average number of beds for active treatment per 100,000 citizens is 410. In Bulgaria, it is 637. At the same time, hospital resources are under-utilized. The bed utilization rate in municipal hospitals is about 55 percent. Although comparative statistics are not available for staffing levels, anecdotal evidence suggests that municipal hospitals are overstaffed. This would certainly be encouraged by the general supplementary subsidy formula that prevailed in 2000-2002. As in the case of education, it covered 100 percent of the staffing costs of municipal health care facilities.

Arbitrary Disparities in Per Capita Revenues

45. Disparities in revenues among municipalites were a potential issue in intergovernmental relations at least until the end of 2002, although not a major one. The system for allocating revenues among jurisdictions was fairly effective in reducing revenue disparities in revenues among municipalities. While per capita revenues from shared taxes varied widely among jurisdictions, this was partly offset by the distribution of general subsidies. As shown in Table 7, the standard deviation in per capita shared taxes (in 2001) was BGN 110, or about 1.5 times the average. But the standard deviation in subsidies was equally wide (BGN 104) and tended to be inversely correlated with shared tax revenues. (The correlation between per capita shared tax revenue and per capita subsidies was -0.83.) As a result, the standard deviation in total revenues was only BGN 83, or about 33 percent of average per capita total revenues. As shown in Figure 3, the vast majority (82 percent) of all municipalities had per capita revenues between BGN 150 and BGN 300. (These account for 78 percent of Bulgaria’s population.) Thirty eight percent (with 36 percent of Bulgaria’s population), fall within the narrower band of BGN 200-BGN 249. There were few stragglers—only five have per capita revenues under BGN 150—and few extremely rich jurisdictions. (Seventeen have per capita revenues above BGN 350).

26 MOH, Strategy for Restructuring Health Care (Sofia, November 2002).
27 Firestein, Robert, and Borislav Tafradjivsky, April 2002, Municipalities and Hospital Capital Spending in Bulgaria; unpublished paper prepared in conjunction with USAID Bulgaria Health Project.
28 As discussed below, reforms in the general equalization transfer, beginning in 2003, will further reduce revenue disparities among individual jurisdictions.
46. Even this much variation can be problematic given the nature of local government expenditure responsibilities. Because of the predominant role local governments played in services with important distributional impacts, including education, health, and particularly social assistance, variations in resources might result in variations in spending in ways that have adverse distributional impacts. It has been charged, for example, that case loads for social assistance were negatively correlated with municipal revenues, such that municipalities with the largest caseloads had the fewest resources to finance them. As a result, benefits were often paid irregularly, late, or in kind. Local governments have been also likely to shortchange some programs more than others. In particular, they were likely to pay family benefits under the Birth Promotion Act (BPA), while the mean-tested Guaranteed Minimum Income Program (GMI) has been consistently under-funded. In recent years, the scale of this problem has declined as the Government’s role in financing social assistance has increased. As noted earlier, the Government is fully funding the majority of social assistance as of 2003. Inter-jurisdictional disparities may soon re-emerge as an issue, however. In 2004, hospitals will cease to be a delegated function. Any costs not covered by the NHIF will have to be financed from municipalities’ own-source revenue.

The Decline of Infrastructure

47. Accession to the European Union (EU) will require a massive investment in environmental repair and improvement, much of it in landfills, incinerators, water treatment plants and other facilities at the local level. As in other countries aspiring to join the EU, the Bulgarian public sector will have to contribute significantly to these investments and to meeting the 25 percent country match required to obtain EU pre-accession subsidies.29 Since 1989, investment spending by Bulgarian local governments has been extremely low and is insufficient to make up for a lack of maintenance of existing infrastructure (such as the very high levels of leakage in the water systems) and begin to meet European standards for environmental protection. Investment requirements in the sector are said to be large—particularly in sewerage. According to a (somewhat dated) survey of water and sewerage companies representing 70 percent of connections, only 18 percent of customers are connected to sewers.30 It is estimated that US$2 billion will be required to achieve adequate coverage.31

48. Whether the enterprises directly responsible for much of the investment can do so is unclear. In general, the financial performance of municipal public utilities is poor. Plovdiv and Stara Zagora (both served by RWCs) complain of large water losses (60 percent in Plovdiv, 67 percent in Stara Zagora) and high tariffs (which are in part attributable to system inefficiency—i.e., large losses.) Although they have the authority to set their own tariffs, current levels are not sufficient

| Table 7: Variations in Per Capita Municipal Revenues (BGN, 2001) |
|-----------------|-------------|-------------|-------------|
|                 | Total revenue | Shared taxes | Subsidies  |
| standard deviation | 83.5        | 110.4       | 104.4      |
| unweighted averages | 247.3       | 70.5        | 41.4       | 27.9       |

31 According to an official communication from the Ministry of Finance, as of January 2003 this problem has been ‘entirely addressed by the Government’.
to cover operating costs (if the term is defined to include routine maintenance) let alone generate current savings for investment.

THE 2003 REFORM

49. The Government is now embarked upon a new round of reform of the system of intergovernmental relations. In March 2002, the Council of Ministers (COM) created a special workgroup to elaborate a fiscal decentralization concept and implementation program. This was approved in June 2002. The *Fiscal Decentralization Concept* sets out a laudable series of reform objectives. These include: (i) consistency between expenditure and revenue assignments and responsibilities; (ii) balance between local discretion and overall hard budget constraints through defining service standards; (iii) transparency and equity in central government’s subnational policies; and (iv) equitable access to public resources for securing a minimum target level of public services. Under the program for *Fiscal Decentralization 2002-2005*, the division of expenditure responsibilities between the Government and the municipality is to be defined, along with a corresponding division of revenues. The proposed reform in municipal revenues, noted earlier, is a first output of this process.

50. **Distinguishing Delegated and Autonomous Functions.** The reform has several main elements. First, it makes a legal distinction between responsibilities delegated to municipalities by the Government, and municipalities’ own responsibilities.

- **Education:** Government will be responsible for general (primary and secondary) schools, vocational schools, and the staffing costs of all day kindergartens. Municipalities will be responsible for half-day kindergartens and the costs of maintaining full day kindergarten buildings.

- **Health care:** The Government will be responsible for municipal general hospitals, and specialized pulmonary, psychiatric, oncological, and venereal disease hospitals. Municipalities will be responsible for drug addiction centers, centers for psychological health, and maintenance of daycare buildings.\(^{32}\)

- **Social assistance:** The Government will assume complete responsibility for most forms of social assistance, including direct income support (the guaranteed minimum income) and the operation of orphanages and other institutions for vulnerable populations. Municipalities will remain responsible for in-home assistance for the elderly (meals-on-wheels) and one-time aid for family emergencies.

- **Roads, water supply, solid waste management:** Municipalities will be solely responsible for most of the urban housing keeping functions, including water supply and sewerage, public lighting, solid waste management, snow removal and street cleaning, as well as cultural activities, transport regulation and construction and maintenance of roads.

\(^{32}\) As of 2002, these functions will be transferred to the municipal list.
51. "Government responsibility" in this case does not mean that the Government will pay these costs directly from the Treasury. Instead, it will continue to transfer funds to the municipalities (except in the case of social assistance), which will continue to be responsible for paying wages to staff, suppliers, etc. In theory, the distinction will affect the system of local finance. Delegated responsibilities are to be financed from shared taxes (the PIT) and a revised general supplementary subsidy. Autonomous functions are to be financed from the local property tax, fees, and property income. Although municipalities are permitted to use local taxes and fees to supplement spending on delegated functions if they so desire, they are not permitted to do the opposite. Government funding for delegated functions cannot be used to finance local responsibilities.

52. **Recalculating the General supplementary subsidy.** The reform also includes fundamental changes in the formula for calculating the general supplementary subsidy. First, in estimating expenditure needs, the new formula will use normative costs and standards, rather than the wage bill and a figure for non-salary costs negotiated with the NAMRB. Second, the calculation of expenditure needs will cover only delegated functions. As before, the estimate of revenues will include only shared taxes and transfers. Thus the new general supplementary subsidy will cover only the gap between the estimated cost of delegated functions and estimated revenues from shared taxes and transfers, leaving municipalities to finance autonomous functions from own-source revenues.

53. For education, the new formula makes a separate calculation for teachers' salaries and operating and maintenance costs. The calculation of teachers' salary costs begins with a set of standards for teacher:pupil ratios. Separate standards for teacher:pupil ratios are established for five categories of municipalities, on the basis of average classroom size. For example, municipalities with small classes (less than 16 pupils per class) are assigned a teacher pupil ratio of .14. Municipalities with larger classroom sizes (over 22.2 pupils per class) are assigned only .0967 teachers per pupil. Based on these standards, a normative (or ‘desired’) number of teachers in each municipality is calculated. This is then multiplied by the average teachers' salary in each municipality in 2001, adjusted for subsequent wage increases, yielding an estimate of the wage bill for teachers in each jurisdiction. The formula used to calculate the non-salary costs of education will be based on aggregate per pupil non-salary expenditures in 2001, adjusted for inflation. This total will be distributed among individual municipalities on the basis of enrollment, with adjustments for classroom size.

54. The new formula also changes the calculation of health care costs. Under the previous general supplementary subsidy formula, the expenditure requirements of municipal health care workers were calculated on the basis of actual salaries. Operating costs were separately calculated under the 15-variable formula described earlier. Ten percent of the amount allocated under the 15-variable formula was distributed according to the number of patients served in general municipal hospitals, skin disease centers or psychiatric centers. Another 3.5 percent was allocated on the basis of the number of patients in other types of hospitals. Under the new general supplementary subsidy formula, health financing will be allocated solely on a per-patient basis, using a standard national unit cost figure to cover both salary and other operating costs.

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33 Although teachers' salaries are based on a standard salary schedule fixed by MES, they can vary according to individual teacher characteristics such as length of service.
costs. Municipalities will receive BGN 281 per patient admitted to general hospitals. Separate per-patient figures will be used to calculate expenditures in the three types of specialized hospitals (lung, ophthalmology, gynecology) and four types of dispensaries (oncological, psychological, pneumonic, and venereal). 34

55. Similar unit cost figures will be used to calculate municipal expenditures in other delegated sectors. According to the 2003 Budget Act, municipalities will receive BGN 1,448 for each place in a municipal home for the elderly, BGN 1,469 for each place in a home for retarded children, and BGN 3,145 for each place in a homeless shelter. In total, the new formula provides non-salary unit cost calculations for 36 separate municipal functions, along with 22 staffing standards to be used in calculating salary requirements in education.

56. **Adjustments in Taxes.** The structure of shared taxes will also change. One hundred percent of the personal income tax will now be assigned to local governments. The local corporate income tax will be abolished. This will have little impact on the net flow of Government resources to individual municipalities, however, as the Government will continue to calculate the amount of the general supplementary subsidy as indicated above. During budget execution, the Government will continue to bear the risk of any shortfall between projected PIT revenues and actual collections. It will guarantee municipalities the level of financing for delegated functions provided for in the budget, making up any shortfall in shared tax revenues through increases in the general supplementary subsidy. Municipalities will, however, be allowed to share in any overrun. Under the 2003 budget law, the municipalities, as a group, are entitled to 80 percent of any surplus of PIT revenues over the amount projected in the budget. (This calculation is based on aggregate national collections, rather than performance in individual municipalities). The amount will be allocated among individual municipalities, on the basis of their respective contribution to the aggregate surplus.

57. To finance autonomous functions, the new system will continue to assign property taxes, fees, and other non-tax revenues to the municipalities. (Municipal councils may choose whether or not to impose these taxes and fees). The rates of property taxes will continue to be fixed by the Government. Because property taxes and fees are no longer included in the calculation of the general supplementary subsidy, 35 revenues from these sources will now contribute to variations in total revenues per capita. To offset this source of variation, the new law establishes a so-called general equalizing subsidy. This requires the Government to transfer sufficient funds to jurisdictions with below-average per capita revenues to bring them up to the national average. The amount of the subsidy is calculated as the difference between each municipality’s per capita local tax revenues and the average for the country as a whole, multiplied by the municipal population. During last-minute negotiations, it was agreed that Sofia would be excluded from the calculation of the national average, and that revenues from fees would not be equalized. This substantially reduces the amount of budget support due from the Government.

34 Beginning in 2004, hospital expenditures will no longer enter into the calculation of the general subsidy as this function will be shifted to the municipal list.

35 Prior to 2001, 100% of revenues from local taxes and fees were included in the calculation of the general supplementary subsidy. The proportion declined to 50 percent in 2001 and zero in 2002.
58. The reforms represent a major advance in several respects. First, the new formula for calculating the general supplementary subsidy will be more accurate (at least with respect to non-salary costs) and less arbitrary than the one it replaces. It employs an empirical basis for the calculation of the costs of each delegated function, and a mechanical and transparent method for distributing funding among jurisdictions. As such, it increases clarity and transparency in the calculation of the subsidy. Second, by eliminating the automatic reimbursement of salaries, it reduces incentives for over staffing. And third, by shifting responsibility for social assistance onto the Government, it ensure that funding will no longer be subject to the vagaries of local tax bases.

59. But several problems remain. To begin with, the reform does not eliminate the fundamental grounds for the dispute over unfunded mandates. Although in principle the Government is to assume responsibility for financing all delegated functions, in fact, Government support in 2003 will continue to take the form it has in the past. The Government will make its own estimate of local spending needs (now based only on delegated functions) and expected revenues from the PIT, and include financing for any resulting gap in the annual budget. But, as in the past, nothing will prevent the Government from making what the municipalities consider to be underestimates of costs. In fact, the elimination of actual salary costs from the calculation of expenditure needs is likely to increase the grounds for dispute. Municipalities may now argue that the Government is not only underfunding non-salary costs, but is underfunding salaries as well—at least in 2003.

60. This problem is likely to be particularly acute in the case of municipal hospitals. As noted earlier, the 2003 general supplementary subsidy formula calculates hospital costs on a standard per-patient basis. In 2004, the Government intends to eliminate hospital care costs from the general subsidy calculation entirely. Municipal hospitals are legally constituted as commercial entities. In principle, municipal governments have the authority to dismiss staff and close facilities they can no longer afford. But mayors have been reluctant to exercise this power. Even the Government has had little success in doing so. It was expected that an HIF accreditation process would result in widespread hospital closings, but this proved not to be the case. The 2002 Strategy for Restructuring Hospital Care reports that between 2001 and 2002, the number of hospital beds (at all levels) has been reduced by 12.65 percent and the number of hospital staff by only six percent.

61. Over the long term, the Government intends to fund municipal hospitals on the basis of clinical paths. As noted earlier, these will specify fixed reimbursement amounts for specific treatment regimes. When fully introduced, this will clearly improve the targeting of health care funding. It will also discourage overstaffing, as hospitals will be forced to cut costs in order to meet NHIF reimbursement ceilings. But full coverage by clinical paths is still a long way off.

62. In the mean time, the transition has been badly handled. As new clinical paths are introduced, funding through the general supplementary subsidy has been reduced proportionately. The per patient standards for 2003, for example, were based on the assumption
that there would be a major expansion in the number of clinical paths this year.\textsuperscript{36} Hospital funding through the general supplementary subsidy was been cut accordingly. It might be expected that these cuts would have been focused on hospitals where the number of clinical paths was expected to increase. Increased funding from the HIF would therefore compensate for reductions in funding from the general supplementary subsidy. But instead the cut has been imposed uniformly on all hospitals. As a result, municipalities whose hospitals do not yet provided clinical path-reimbursable treatments will witness a decline in revenues. With the complete elimination of funding for municipal hospitals from the general subsidy, a new round of disputes over the adequacy of Government funding for health care is likely to emerge.

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<th>Table 8: Summary of Recent Reforms</th>
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<td>Prior to 2001</td>
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<tr>
<td>Shared taxes</td>
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<td>Local share of PIT</td>
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<td>Local share of CIT</td>
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<td>Risk of shortfalls/surpluses during budget execution</td>
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<td>Government</td>
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<td>General transfer: calculation of expenditure need</td>
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<td>Historical share, adjusted by indicator of need</td>
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<td>Central share of social assistance</td>
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<td>% local taxes and fees exempt from revenue gap calculation</td>
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* If budgeted PIT revenues exceed budgeted expenditure needs, the Government retains 100% of the difference.
** If actual collections exceed budgeted amounts, municipalities retain 20% of the surplus.

63. The mismatch in the case of education will be less acute. Because the new formula for calculating education costs explicitly reflects differences in average classroom sizes, it will not have much impact on the level of salary funding in individual jurisdictions. In fact, the formula has been calibrated so as to only affect municipalities with average classroom sizes below sixteen or above 22.2. As shown in Table 8, a municipality with an average class size of 10 would receive about 40% less, per class, than one with an average class size of sixteen. At the opposite end of the scale, a municipality with an average class size of 30 would receive 33% more, per class, than one with an average of sixteen. But within the range of 16-22 students, the level of salary funding per class scarcely varies. A municipality with an average class size of 22 would receive only five percent more than one with an average of 16. (Curiously, the per classroom allocation for non-salary costs will increase steeply with classroom size under the new formula. A classroom of 22 students will receive about 45% more, per classroom, than a classroom of sixteen. But non-salary costs are only a small part of total operating costs. Taking salary and non salary costs together, a municipality with an average classroom size of sixteen

\textsuperscript{36} This has not, in fact materialized, resulting in an unintended drop in overall funding for municipal hospitals. In addition, the Government neglected to include 13 specialized municipal hospitals and several municipal dispensaries in the calculation of the general supplementary subsidy. It has now agreed to directly finance these facilities, and to provide additional budget support to facilities affected by the delay in clinical paths.
would still receive only about five percent more, per classroom, than a municipality with an average classroom size of 22).\textsuperscript{37}

\begin{table}[h]
\centering
\caption{Impact of New Education Formula \hfill Funding per Student and per Class, BGN}
\begin{tabular}{|c|c|c|c|c|c|c|c|}
\hline
& \multicolumn{3}{|c|}{Non-salary operating costs} & Salaries & \multicolumn{2}{|c|}{Total} \\
& per Classroom & Base & Variable & Subtotal per pupil & Normative pupil ratio & Avg. salary + benefits & Salary per pupil & Per pupil Per class \\
\hline
8 & 100.9 & 10.7 & 111.6 & 0.1400 & 50,735 & 7,103 & 7,215 & 57,716 \\
10 & 100.9 & 13.4 & 114.3 & 0.1400 & 50,735 & 7,103 & 7,217 & 72,173 \\
16 & 100.9 & 21.4 & 122.3 & 0.1400 & 50,735 & 7,103 & 7,225 & 115,605 \\
19 & 100.9 & 25.4 & 126.4 & 0.1135 & 50,735 & 5,758 & 5,885 & 111,803 \\
22 & 100.9 & 29.5 & 130.4 & 0.0967 & 50,735 & 4,906 & 5,036 & 110,800 \\
24 & 100.9 & 32.1 & 133.0 & 0.0967 & 50,735 & 4,906 & 5,039 & 120,936 \\
30 & 100.9 & 40.2 & 141.1 & 0.0967 & 50,735 & 4,906 & 5,047 & 151,413 \\
\hline
\end{tabular}
\end{table}

64. While the formula for calculating teachers' salaries will prevent abrupt cuts in revenues for most municipalities, it will also decrease incentives to reduce staff in underenrolled schools. Under the new formula, only municipalities with average classroom sizes of under 16 will have a financial incentive to reduce staffing. And even this incentive to reduce staff may be thwarted by the Ministry of Education. As noted earlier, municipalities cannot dismiss teachers or close schools without the concurrence of the MES. Nor can they reduce wages or teaching hours. If the Ministry were eager to close or consolidate smaller schools, this would not be a problem. But interviews with senior staff at the MES suggest that the Ministry is not eager. Nor is it inclined to relinquish its authority in this area. As a result, municipalities with fewer than 16 children will have difficulty cutting their wage bills to respond to declining support through the general supplementary subsidy.

65. Third, nothing in the reform will prevent the Government from underfunding delegated functions. In principle, the Government has committed itself to fully fund delegated functions, on the basis of the standard cost factors described earlier. But already in 2003, the commitment was honored in the breach. Although the 2003 budget provided full financing for salaries and social security contributions, it only allocated half the amount required for maintenance, health care, medical aid and subsidies for non-profit organizations. According to the budget law, the shortfall was to be paid in two installments but only if doing so would not jeopardize the Government's deficit target. In the event, the first installment was paid on August 15. The second is to be paid by November 15. For 2004, the Government intends to fully fund the costs of delegated functions. But this is a discretionary choice of the Government. It could be violated in subsequent years. The Government, moreover, has continued the practice of retaining a percent of the general supplementary subsidy as a buffer against unexpected macroeconomic events. As in previous years, the Government will release the buffer only after it is clear that Government deficit targets will be met.

66. Finally, the Government remains vulnerable to the charge that it is underfunding municipal autonomous functions. Although the 2003 reform allows municipalities a variety of

\textsuperscript{37} The municipal standard for each of the 263 municipalities is calculated according to the formula: \( S_N = 100.92 + (U_n / 21.09 ) \times 28.24 + K_n \times 3180, \) where \( S_N \) is the standard in BGN applied to the municipality \( N; \) \( U_n \) is average number of students in a class in that municipality; 21.09 is the country average; \( K_n \) is the number of Category IV schools in the municipality.
sources of funding for their autonomous functions, sources outside the Government claim that these will not be sufficient. Figures from the NAMRB, for example, suggest that revenues from local taxes and fees were sufficient to finance only 55%-60% of spending on autonomous functions in 2001 and 2002, and would be sufficient to cover only 65% of spending on autonomous functions in 2003. (Note that figures from the Department of Local Government Finance do not support this allegation.)

Immediate Reforms

67. This suggests four important areas for additional immediate reform. First, the Government should commit itself to meeting its own budget obligations to local governments. It should fully fund delegated expenditures on the basis of standardized costs and should cease the practice of retaining the buffer until the end of each budget year. The Government should also immediately begin regularly updating the factors used to calculate the general supplementary subsidy, so as to provide adequate funding for delegated functions in years to come. This will help ensure that 100 percent of the funds necessary to cover delegated functions are actually allocated.

68. Second, the Government should remove the regulatory and institutional constraints that prevent municipalities from responding to the efficiency incentives contained in the new formula. In the case of education, the support of the Ministry of Education will be required if incentives for closing or consolidating underenrolled schools are to be successful. For the 2002/03 school year the Government developed a redeployment plan for teachers. This plan is intended to reduce overcapacity in the education sector through attrition, rationalization of teaching staff in urban areas, and consolidation of schools. But such efforts have not been entirely successful in the past. Moreover, it is unlikely that a strategy that focuses on attrition and redeployment in urban areas will have a sufficient impact in rural municipalities, where the problem of under enrollment is most acute. The Government could also encourage school consolidation by enforcing existing regulations on minimum class sizes. Norms on minimum class size are set by the MES. In principle, they are enforced by the Ministry of Finance, which reviews each municipality’s annual education budget proposal for conformity with the norms. But the recent PEIR found that the national average student/teacher ratios for each level of education are below the minimum permissible class sizes. This implies that many exceptions are granted to allow class sizes below the norm.

69. In principle, municipalities should be able to adjust to the proposed changes in health care financing on their own. As noted earlier, municipalities have the authority to dismiss hospital staff and close redundant hospitals. But they have been reluctant to do so. The Ministry of Health should relieve the municipalities of some of the onus of hospital closings by pursuing its Strategy for Restructuring Hospital Care more aggressively, and perhaps providing funding

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38 PEIR, op.cit.
39 Between 2001 and 2002, the Government claims to have reduced the number of teaching staff by 11,000. A detailed examination of the evidence suggests that the figure is closer to 2,500, most of whom were either near retirement age or lacked minimum teaching qualifications. The discrepancy is partly explained by the Government’s decision to add a twelfth year of compulsory education in 2002. In many cases, teachers who were dismissed from lower grades were re-hired as twelfth grade teachers.
for severance payments. At the same time, the Government will have to quickly expand the coverage of NHIF-reimbursed services. Otherwise, the planned elimination of health care financing from the calculation of the general subsidy will merely result in new arrears and demands for central government fiscal relief. In the short term, the Government may, in fact, have to reinstate some form of general budgetary support.

70. Third, the Government should give municipalities greater control over property taxes. At present, municipalities rely on strategic deficits to provide budget flexibility. The Government would be better off if municipalities could instead rely on their own taxpayers. As a first step, the Government should expand the base. Second, the Government should expand the role of municipalities in administering the tax. Only two municipalities are now collecting property taxes. This pilot effort should be expanded. Finally, municipalities should have the authority to increase the rate of the tax. As noted earlier, the rate of the property tax is now fixed by the national government. (The rate is derisory: 0.15 percent of taxable value.) Municipalities should be allowed to fix a rate within an overall range set by national legislation. (It is recognized that this will require an amendment to the Constitution.)

71. The Government’s decision to create a general equalization subsidy would complicate the last of these reforms. As noted earlier, the amount of the general equalization subsidy is calculated as the difference between each municipality’s per capita local tax revenues and the average for the country as a whole. Under these circumstances, a municipality that controls its own tax rate would have an incentive to set its rate at zero. This would minimize its own tax burden and maximizes its subsidy. But this incentive can be eliminated though a minor change in the subsidy formula. Rather than calculating the subsidy on the basis of actual revenues (i.e., the tax rate applied to the tax base), it could be calculated by applying an average or normative tax rate to the base.41

72. Finally, the Government should harden the budget constraint confronting local governments in order to rein in their propensity to run up arrears. At present, there is some deliberate softness in the budget constraint. Under the current budget law, municipalities are permitted to budget for a ten percent deficit. Municipalities have often included such a deficit in their budgets without any realistic expectation of contracting a loan to cover it. This loophole would be reduced under an amendment to the Municipal Budget Act now before Parliament, which would prohibit municipalities from budgeting for deficits except to finance capital investments. Since all spending must be authorized by the budget, deficit spending on current account would, in principle, be prohibited.42

73. Balanced budget requirements are used in many countries, and not always successfully. One common way to evade them is to over-estimate revenues. This allows a corresponding over-authorization of expenditures. In principle, this would be difficult in the Bulgarian context. The Government’s annual budget law specifies the amount of revenue each municipality is to receive in general supplementary subsidies. In effect, it also predetermines the revenues from shared

41 Note that under such a system, the Government would have to retain control over property valuation or ensure that uniform valuation standards are employed throughout the country. Otherwise municipalities would have an incentive to deliberately undervalue their tax bases.

42 Note that municipalities would still have the legal authority to run cash flow deficits during budget execution. Only end-of-year deficits would be illegal.
taxes. (As noted earlier, any shortfall between budgeted tax revenue and actual receipts is covered by an increase in the general supplementary subsidy). And the 2003 budget law specifies that even the budget projection for local taxes must be agreed to by the General Revenue Office. As a result, the level of current spending a municipality can authorize in its budget is largely determined by the revenue envelope dictated by the Government.

74. But enforcement of the balanced budget laws is likely to remain a problem. Compliance with the existing budget law is monitored through a system of monthly and quarterly reports and annual audits. These are provided to the Department of Local Government Finance. But the Department has no enforcement powers. It can only bring violations to the attention of the Controller and the State Audit Office. In principle, violations recognized by these organizations can result in jail sentences. But according to the NAMRB, this has never occurred. Instead, mayors are, at most, temporarily removed from office or subject to fines. To date, this has evidently been insufficient to restrain their propensity to run deficits.

75. Instead, the key to reducing local government current deficits is to cut off their sources of financing. The Government itself is a major financier of municipal deficits. As noted above, roughly thirty percent of the arrears (as of February 2003) were owed to Government-owned utilities. In principle, the Government could cut off service to municipalities that are delinquent on their accounts. The Government could also discourage private suppliers and contractors from extending credit to local governments. Private firms are likely to extend credit only as long as they have a reasonable expectation of being paid. In this respect, they have not been disappointed. But the Government can puncture this expectation by refusing to provide debt relief. In the absence of Government assistance, municipalities will be unable to liquidate their arrears to private firms. Both measures will require sustained political commitment on the part of the Government. Despite pressures from unpaid teachers and angry suppliers, the Government will have to scrupulously avoid providing ad hoc financial relief to municipalities that are delinquent on their accounts.

76. The Government has made a good start in this direction during 2003. With respect to the existing stock of arrears, it agreed to assume responsibility for arrears only on delegated functions, requiring the municipalities to retain responsibility for the remainder. In keeping the proportion of relief at less than 100 percent, this will force municipalities to either raise revenues and cut expenditures on their own or--more likely--to default on arrears to suppliers and contractors. This, in turn, will discourage suppliers and contractors from extending credit in the future, cutting off a major source of deficit financing at its origin.

43 Section 30 (2) of the Transitional and Final Arrangements to the 2003 budget stipulates that "municipal budgets shall be prepared on the basis of the budget projections for the taxes remised (i.e., transferred from the central government to local governments) in accordance with Article 8 paragraph 1 of the personal income tax code and the projections agreed with the General Tax Directorate pertaining to local taxes, receipts from the general subsidy, the adjusting subsidy (i.e., the municipal safety net), the subsidy for targeted for capital outlays."

44 One way to make the process less painful (and therefore more likely to occur) would be to establish a municipal bankruptcy procedure which would lay out the rules for allocating losses from unpayable debts among creditors and taxpayers.
Longer-Term Reforms

77. Even with these reforms in place, the root cause of the intergovernmental fiscal relations will remain. The Government will continue to dictate the level of revenues available to local governments (although municipalities will have some authority at the margin to increase property taxes and fees) while expecting municipalities to deliver a broad range of functions over which they have limited management control.

78. Over the medium term, the Government should therefore consider more fundamental changes in the structure of intergovernmental relations. There are several possible approaches. One would be to further centralize the financing of certain delegated functions. This has already occurred in social assistance, where the Government has now assumed full financial responsibility for the GMI and other direct transfers to households. In principle, this approach could be extended to the financing of teachers’ salaries. Under such an approach, the Government would directly finance the wage and benefits of authorized teacher positions, rather than incorporating salary funding in the general supplementary subsidy. This is the practice, for example, in the Czech Republic. There, although primary education is nominally a local responsibility, teachers are central government employees. Decisions about number of positions, as well as wages are made directly by the Government.

Table 10: Education Management Options in Mid-Size European Countries

<table>
<thead>
<tr>
<th></th>
<th>Bulgaria</th>
<th>Czech Rep.</th>
<th>Lithuania</th>
<th>Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appoints school directors</td>
<td>Govt</td>
<td>Govt</td>
<td>Local</td>
<td>Local</td>
</tr>
<tr>
<td>Selects individual teachers</td>
<td>Govt</td>
<td>Govt</td>
<td>Local</td>
<td>Local</td>
</tr>
<tr>
<td>Authorizes changes in number of teaching positions</td>
<td>Govt</td>
<td>Govt</td>
<td>Local*</td>
<td>Local</td>
</tr>
<tr>
<td>Sets teachers’ salaries</td>
<td>Govt</td>
<td>Govt</td>
<td>Govt</td>
<td>Local**</td>
</tr>
<tr>
<td>Decides opening, closing of schools</td>
<td>Govt</td>
<td>Govt</td>
<td>Local*</td>
<td>Local</td>
</tr>
</tbody>
</table>

Financing for teachers

<table>
<thead>
<tr>
<th></th>
<th>General supplementary subsidy</th>
<th>Direct payments to individual teachers</th>
<th>Subsidy earmarked for education</th>
<th>Local personal income tax***</th>
</tr>
</thead>
</table>

*Govt must approve staff redeployment plan.
**Through negotiations between local government association and public employees union.
***Subject to equalization.

Table 10, local governments in Lithuania are permitted to determine their own staffing levels (although the Government must approve staff redeployment plans). They are encouraged to avoid overstaffing by a financing system, which allocates funding among municipalities on the basis of enrollment. (Wage levels, however, are determined by the national government.) Sweden goes a step further. Swedish local governments have the authority to set their own staffing levels without Government approval. As salaries are financed from local personal income taxes, Swedish local governments are under no Government-imposed financial pressure to reduce staff (or increase it). In principle, local governments can also set teachers salaries

79. Alternatively, the Government could relax its controls over the management of delegated functions, allowing local governments greater control over the determinants of costs. Municipalities could be permitted to cut excess teaching positions, for example. This is already the practice in some other European countries. As shown in

(although in practice, salaries are normally negotiated on a nationwide basis through collective bargaining, with the Swedish Association of Local Governments and the Federation of County Councils on one side and the unions representing local government employees on the other).  

80. Over the long run, the Government should also consider loosening its controls over municipal revenues. Local governments should eventually acquire the power to decide for themselves what an adequate level of financing is, based on their constituents willingness to pay. Granting municipalities the power to set property tax rates is an important first step. But it will not be sufficient to resolve disputes over the adequacy of financing, particularly for delegated functions. Even Western European countries, with a long tradition of property taxation, derive relatively little revenue from it. (As shown in Table 11, property taxes generally account for less than three percent of total tax receipts in most of the countries of the continent).

\footnote{Note that the MES is already experimenting with "delegated budgets" which provide school directors with some degree of fiscal autonomy within individual schools. Whether this should include the authority to determine staffing levels and salaries, and whether this authority should be assigned to mayors rather than school directors are issues that lie beyond the scope of this report.}
81. One candidate for liberalization would be the personal income tax. It has a number of advantages, not the least of which is the fact that it is already assigned to local government. Liberalization would merely require that local governments be allowed to adjust the rate of the tax; specifically the rate on that proportion of the tax retained in their jurisdictions. This is already the practice in several Scandinavian countries. In Finland, for example, local governments are allowed to impose a local income tax as well as a property tax. Together these comprise half of municipal revenues. Similarly, in Denmark, local governments are allowed to set the rate of the municipal income tax. Rates currently range from 13 percent to 22 percent. In principal, Sweden also permits local governments to determine the rate of the income tax, although this prerogative has been often overridden by central government manipulation of the tax base and temporary freezes on rates, and is subject to equalization.

82. In Bulgaria, there will continue to be an important role for Government in financing of functions with important distributional implications, such as education and health. But the existing extent of revenue control contributes to the intergovernmental fiscal conflict. Greater local control over revenues, along with greater local control over expenditures, would help defuse it. Financing Capital Investment

83. As noted earlier, Bulgarian infrastructure is suffering from over a decade of deferred maintenance. Accession to the EU will require a massive investment in landfills, incinerators, water treatment plants and other facilities at the local level. Many such investments are said to have attractive economic rates of return. Financing, however, is a constraint. In the absence of current account savings, municipalities and their enterprises largely rely on grants and donor financing to finance investment. These sources are inherently limited. The Government cannot afford to increase the volume of grants that it finances from its own taxes and borrowing, due to its own fiscal constraints. And even donor funding requires counterpart contributions.

84. The Government can pursue two strategies. First, it can attract additional resources, provided they do not increase Bulgaria’s overall debt burden. Second, it can improve the allocation of existing resources, so that the limited funds that are available are linked to the projects with the highest rates of return.

85. Private concessions. In principle, private concessions would be an attractive way of attracting new investment. Direct private investment would not increase the country’s debt

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**Table 11: Property Taxes in Europe**

<table>
<thead>
<tr>
<th>Country</th>
<th>% of Total Tax Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>4.54</td>
</tr>
<tr>
<td>Greece</td>
<td>4.27</td>
</tr>
<tr>
<td>Switzerland</td>
<td>3.53</td>
</tr>
<tr>
<td>Belgium</td>
<td>3.39</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.98</td>
</tr>
<tr>
<td>Finland</td>
<td>2.18</td>
</tr>
<tr>
<td>France</td>
<td>1.97</td>
</tr>
<tr>
<td>Italy</td>
<td>1.66</td>
</tr>
<tr>
<td>Denmark</td>
<td>1.65</td>
</tr>
<tr>
<td>Hungary</td>
<td>1.14</td>
</tr>
<tr>
<td>Norway</td>
<td>1.16</td>
</tr>
<tr>
<td>Czech Rep</td>
<td>0.88</td>
</tr>
<tr>
<td>Croatia</td>
<td>0.43</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.24</td>
</tr>
<tr>
<td>Russia</td>
<td>0.23</td>
</tr>
<tr>
<td>Spain</td>
<td>0.19</td>
</tr>
<tr>
<td>Slovenia</td>
<td>0.17</td>
</tr>
<tr>
<td>Austria</td>
<td>0.12</td>
</tr>
<tr>
<td>Germany</td>
<td>0.03</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-</td>
</tr>
<tr>
<td>Poland</td>
<td>-</td>
</tr>
<tr>
<td>Romania</td>
<td>-</td>
</tr>
<tr>
<td>Ukraine</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: IMF Government Finance Statistics 2002

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48 The Government’s decision to allow municipalities to administer local taxes is an important step in this direction.
burden. And private investors, with their own money at stake, are likely to seek out projects with attractive rates of return. The Government already has a strategy of encouraging private involvement in infrastructure sectors that have strong public sector content. Foreign participation already occurs in electricity, railways, air transport, and telecommunications. Investment in airports, seaports and energy facilities have been taken out of the public investment program in anticipation of being executed by the private sector. Around 40 percent of infrastructure projects involving foreign participation are self financing through concession or BOT-type arrangements.49

86. The prospects for direct private investment in municipal infrastructure is less promising. The Government has taken steps to encourage private investment in the water sector. Under an amendment to the Water Law currently in Parliament, the regional water companies are to be stripped of their assets and converted into management companies. Production and inter-municipal transmission assets would be transferred to the Government. Distribution systems would be transferred to the respective municipalities. In theory, municipalities will have the authority to replace their current concessions with the Government-owned RWCs with other, privately owned operators. (Sofia already has a private concessionaire, and concessions are being prepared for Varna and Shumen.) The poor financial condition of existing water companies, combined with an uncertain regulatory environment, discourage private investors.

87. Regulatory reform could improve the outlook. The Government is now considering legislation that would establish independent regulatory authorities to set tariff guidelines and monitor quality and investment. Under the Government’s proposal, investment costs would be included in the calculation of the tariff, permitting investors to recover their costs directly from consumers. Some mayors, however, insist on retaining control over tariffs, investment decisions, and the authority to cut service to hospitals and schools. As long as they persist in these demands, even large cities will have difficulty finding private investors.

88. **EU Grants.** Bulgaria is eligible for three EU pre-accession grants: PHARE (encompassing a range of institutional, legislative, and infrastructure measures aimed at supporting the transition to a market economy), ISPA (environment and transport infrastructure), and SEPAD (agriculture and rural development). Although PHARE is now funding some capital works, most funding for municipal investment is from ISPA. There are several limitations on ISPA funding. First, the supply of ISPA funding for Bulgaria is fixed. ISPA funding is allocated among accession countries on the basis of population, per capita GDP and land surface, and cannot be increased on demand.50 Second, ISPA funds are limited to specific sectors—principally sewerage, solid waste management, and international transport. Over the last four years (2000-2003), ISPA has disbursed a total of €315.4 million to Bulgaria. Of this amount, only a third was allocated to municipal infrastructure (25 percent to wastewater collection and treatment and eight percent to landfills). Forty percent was allocated to railroads and airports (mostly the former) and 27 percent to motorways. Third, ISPA requires counterpart funding. The recipient government must provide at least 25 percent counterpart funding in order to receive ISPA grants. While ISPA can continue to be instrumental in financing municipal water, sewer,

49 Dixon and Ilieva, op. cit.
and solid waste management projects, it cannot respond to investment demand in local roads, schools, or health care facilities.

89. *Government Current Savings and Borrowing.* Government grants and loans, financed from the Government's own current savings or borrowing, are a third potential source of financing. This source could potentially provide the counterpart funding for ISPA investment, or could finance capital works not eligible for ISPA funding. The Government's ability to generate current savings to fund such programs, however, is limited by its own spending commitments. And its ability to borrow is limited by macroeconomic considerations. EU accession requires that debt remain below 60 percent of GDP. Bulgaria's existing debt, although falling in relation to GDP, is not far below the EU guideline, due to high levels of borrowing in the mid-1980s.51

90. *Improving the allocation of existing funding.* Given these constraints, there is a strong argument to be made for improving the allocation of existing funding, rather than relying solely on increasing its supply. In theory, Bulgaria already has an elaborate system of capital investment planning. In fact, it has three of them: the national economic development plan, the public investment plan and the national regional economic development plan. The Economic Development Plan (the current one covers 2000-2006) was prepared to meet EU requirements for the disbursement of pre-accession funds. It is intended merely to fix a macro envelope for investment. Investment projects are incorporated in the plan up to the macro ceiling without formal investment appraisal.

91. The Public Investment Plan (PIP) was prepared by the Ministry of Finance in 1998 and was intended to cover the period 1998 to 2001. The PIP includes the investment proposals of Government ministries, including those financed from extra-budgetary funds, as well as some larger municipal projects which draw on Government financing (such as Sofia metro) and state owned enterprises. The selection of projects to be included in the PIP was based on a review of the investment intentions of ministries and SOEs. As the proposals far exceeded available funding, the Council of Ministers created an Investment and Concessions Department to select projects for funding. According to a recent IMF report52 the process for screening and prioritization was largely of a political nature. There was no systematic quantification of benefits or cost-benefit analysis of the proposals. As of 2001, the PIP had been lightly updated once and was due for another revision.

92. The National Regional Development Plan is a bottom-up investment plan, based on six regional development plans. These are reportedly drawn from district and municipal investment strategies and are updated annually.53 The process begins at the municipal level. Projects proposed by each municipally are then screened and combined into regional seven-year development plans by each of the 28 districts (oblasts) The NRDP is intended to incorporate: (i) subsidies from the Government budget; (ii) municipal budgets; (iii) extra budgetary funds, including the environment fund and national road network fund; (iv) own-source revenues of

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51 According to the Draft Decision Memorandum to the National Assembly Approving the Report for the Execution of the State Budget for 2002, discussed at the Council of Ministers on July 3, 2003, Bulgaria's debt was equal to 56% of GDP on December 31, 2002. (Foreign debt was equal to 49.5% of GDP.) The ceiling for EU accession is 60%.

52 Tandberg, E.; February 2000; *Bulgaria Budget Reform: Issues Related to the Public Investment Program.*

53 Ibid.
public enterprises; (v) external grants (including EU pre-accession funds); and (vi) state
guaranteed loans and non-guaranteed bank loans, including those from the EIB and the EBRD.
NRDP project selection is not subject to budget ceiling, although projects with secured financing
are grouped separately from those without it.54

93. None of these appears to have a direct influence on actual funding decisions, however.
This is instead accomplished through the annual budget process. In principle, all capital funding
proposals are subject to review by the MOF’s Project Investment Department (PID). While the
PID is able to analyze the financial aspects of these projects, it lacks the capacity to review their
technical and economic aspects. (In mid-2001, it had only 15 staff). The technical aspects of
large projects are instead assessed by committees of the Ministry of Regional Development and
Public Works (MRDPW).55 Projects financed through Government loans and guarantees are
reportedly subject to additional scrutiny. Under recently adopted regulations, such projects, once
approved by the Ministry of Finance, are submitted for approval to the Council of Structural
Policies (CSP) before being submitted to the Council of Ministers. The CSP is headed by the
Deputy Prime Minister and is supported by a Secretariat whose functions are performed by the
EIRIFI Directorate. But it is the Council of Ministers (COM) which makes the ultimate decision
on which projects to finance. This is a jealously guarded prerogative.

94. The result of this process is a capital investment program that is heavily influenced by
inertia. Projects already under way receive priority. Projects for which final design is not yet
complete are normally rejected. It is also influenced by the availability of financing. Projects
with identified sources of funding receive priority over those that do not. And it is influenced by
politics. In the absence of economic analysis, political considerations are said to play a decisive
role in determining the allocation of capital funding.

95. A recent review of the Government’s capital investment budgeting process makes several
recommendations for reform. First, it recommends that the Government establish investment
appraisal guidelines which would have to be met before a project could be considered for
funding. It argues for cost-benefit analyses of individual projects (while conceding that these are
more useful in posing difficult questions than providing definitive rankings). It suggests
improvements in the way projects in the PIP are linked to the annual budgeting process. And it
recommends that the MOF’s PIP be merged with the Ministry of Public Works’ National
Regional Development Plan to form a single, comprehensive, regularly-updated investment
planning data base. These recommendations bear consideration.

96. **Direct Borrowing from the Private Capital Market.** In principle, direct borrowing from
the private capital market would be another means of financing municipal capital investment. It
has some advantages. It would relieve the Government of the burden of financing municipal
infrastructure through grants. And it would permit municipalities to bypass the complex and
politicized process of capital budgeting at the Government level. Municipalities instead would
have a direct relationship with a lender. In theory, this could lead to a more efficient allocation of

54 Ibid.

55 Until recently, ISPA projects were subject to separate evaluations by the Ministry of Regional Development, the
MOF, and the EU Commission itself. The Ministry of Finance has since taken on the MRDPW’s role, while
the EU has attempted to decentralize project appraisal to its local offices.
investment resources. Funds would be allocated on the basis of a municipality’s willingness to borrow and a private investor’s willingness to lend.

97. These advantages are not likely to be achievable for many years, however. There are several important obstacles to development of a private capital market for municipal infrastructure. First, most of the borrowers are not creditworthy. With their extremely thin operating surpluses and their lack of significant autonomy over revenues and expenditures, few municipalities can be considered capable of taking on long-term debt service obligations. Without the ability to increase their own revenues or cut major items of expenditure, municipalities have no means to adjust to changing economic circumstances other than to default. Their track record on the payment of arrears bears this out. Municipalities also present unusual political risks. A recent study, documented lender concerns about the political risks of longer-term lending to municipalities. They were leery of making loans that extend beyond the tenure of the existing mayor and council, fearing that winning candidates would renege on the obligations incurred by their predecessors.

98. Third, the supply of long-term savings is limited. While domestic banks are said to have plenty of liquidity, most of their liabilities are short term. Infrastructure lending requires long maturities. Engaging in infrastructure finance would expose these banks to the risks inherent in term transformation. Long-term capital is of course available in international markets. But it is not clear how enthusiastic international lenders would be about lending to Bulgarian municipalities without a Government guarantee. Municipal borrowing on foreign markets presents a particular risk to the Government, even without an explicit guarantee. International capital markets are not adept at distinguishing between the default of a municipal borrower and a default by its national government. Default by a Bulgarian municipality on a Eurobond, for example, could harm the reputation of the Government in international credit markets, raising the risk premium on its external debt. Some municipalities may use this to their advantage, "blackmailing" the Government into providing debt relief as the price of maintaining its reputation in international markets. The Government should not give them this opportunity.

99. Finally, municipal borrowing would impede the Government’s efforts to comply with EU ceilings on public sector debt. The ceilings imposed by the Maastricht Agreement apply to all public sector debt, not merely that of central Governments. Any growth in municipal debt would make the Government’s targets more difficult to achieve.

100. There are steps the Government can take to facilitate local access to credit over the long term. It could establish disclosure requirements specific to municipal needs that give private lenders confidence that lending to municipalities is a manageable risk and that they can obtain the information needed for sound underwriting of municipal debt. It could allow municipal governments, as legal entities, to perfect pledges of own source future revenues, and thus provide the legal basis for revenue bonds and Government aid intercepts—and, concurrently to move away from reliance on pledges of physical collateral to secure their borrowings. 57

56 Epstein, Peter, op. cit.
57 At present, Bulgarian banks typically require 200 percent collateral, either in cash or marketable municipal properties, such as pharmacies, bakeries, etc.
101. But in the short term there is a strong argument for toughening controls on municipal debt. Bulgaria now relies largely on market forces, rather than Government regulation, to control the level of municipal borrowing.\(^{58}\) Under the Municipal Budgets Act, a resolution of the municipal council is sufficient to permit a municipality to perform "any transaction permitted by law with banks and other financial institutions". Decree 16 regulating the execution of the state budget for 2003, merely requires municipalities that have contracted debt to provide copies of the relevant documentation to the Ministry of Finance. There are some regulations on borrowing procedures. Municipal bond issues are regulated by the general legal procedures for the issue of securities provided in the Public Offering of Securities Act. But these are largely concerned with disclosure. Some Government restrictions on collateral and foreign borrowing also exist. Under the Budgets Act, municipal bank loans must be secured by a mortgage and/or pledge of municipal property, and cannot be settled using Government budget resources. A loan or a bond that creates (or may create) a financial obligation of the Government towards foreign creditors must be approved by the Council of Ministers and the National Assembly.\(^{59}\) But unlike many countries, Bulgaria does not impose quantitative restrictions on municipal debt. There are no ceilings on the total stock of debt, the level of new borrowing, or on debt service.

102. In principle, Government regulation should not be necessary.\(^{60}\) If a loan is a purely commercial transaction between a willing lender and a willing municipality, both parties are presumably aware of the risks and are willing to take them. But international experience suggests otherwise. This experience shows that private lenders and municipalities will willingly collude in risky lending operations if they have a reasonable expectation of Government relief. Bulgaria is in the process of establishing that expectation through its frequent bailouts of municipal arrears.

103. There is therefore a strong argument for tighter regulation on municipal borrowing. One approach would be to impose quantitative restrictions, such as a minimum level of debt service coverage.\(^{61}\) An alternative would be to rely on local political accountability. The Government is now considering a proposal that would require a super-majority in the municipal council, or a majority vote in a local referendum as a precondition for contracting of municipal debt. Both approaches should be considered.

**Priorities**

104. With the reforms of 2003, Bulgaria has taken an important step to address some of the key problems in the relationship between the central and local governments. Transfers will be allocated on a more transparent, and generally more accurate, basis. Social assistance funding will no longer reflect the vagaries of the local tax base. The Government also deserves credit for its approach to municipal arrears during 2003. In assuming responsibility only for arrears on

\(^{58}\) Note that The Government is now drafting a municipal debt act which would establish ceilings on municipal contractual borrowing. Parliament will begin deliberations on the act in March 2004.


\(^{60}\) Except in cases where the Government assumes the risk of default through an explicit guarantee. In Bulgaria’s case, regulation could also be required to ensure compliance with the Maastricht ceilings.

\(^{61}\) Debt service coverage can be defined as the ratio of the current surplus to total debt service, where the current surplus is defined as total current revenues less recurrent non-interest expenditures, and debt service includes interest and principal repayments on the total stock of debt.
delegated functions, it has punctured municipalities' expectations of unlimited Government debt relief.

105. But the Government should take the steps to ensure that deficits do not recur. In the short term, as noted earlier, this could include: (1) providing 100 percent of the general supplementary subsidy on a timely basis\textsuperscript{62}; (2) assisting municipalities to reduce staff (with the support of sectoral ministries); and (3) authorizing local governments to set the rate of the property tax. These measures, backed by a Government commitment to resist further bailouts, will help defuse the conflict between the municipalities and the Government. Longer term reforms, however, should aim at removing the root causes of the conflict, by either fully centralizing some functions (as was recently done for social assistance) or shifting more management and revenue autonomy to the local level.

\textsuperscript{62} The 2004 draft budget law, now under discussion in Parliament, provides for full funding of the delegated functions. Shortfalls in the funding of delegated functions in 2003 have now been eliminated.