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FISCAL DECENTRALIZATION IN BULGARIA

The financial independence of the municipalities in Bulgaria had its beginning in 1991 when the new Constitution and the Law on Local Self-Governance and Local Administration entered into force. According to the Constitution, "The municipality is the basic administrative-territorial unit, in which local self-governance is carried out (article 136, paragraph 1); the municipality is a legal entity, has its own property and independent budget. These main principles are elaborated in the Law on Local Self-Governance and Local Administration which defines the rights of the local council regarding the budget and the structure of municipal receipts and expenditures.

Independent municipal budget

The Constitution and the Law on Local Self-Governance and Local Administration enable the municipality to prepare and vote on its own budget. The Law grants this right to the municipal council, which approves the annual budget, implements control and approves the report on its fulfillment. The municipal council makes forecasts for receipts and expenditures during the coming fiscal year, taking into consideration activities and projects of local importance, which it maintains. It also calculates the expected tax and non-tax receipts and the subsidies from the central budget. Consequently, municipalities pass their budgets after the vote on the government budget by the Parliament. According to the Law on the government budget for 1995, the municipalities are obliged to adopt and submit their budgets for 1995 to the Ministry of Finance one month after the publication of the law. All activities and projects, of which maintenance and development are assigned to the municipality by the law, must be included in the budget structure. For some activities of priority importance the law even specifies the obligatory minimum, which is determined as a relative part of the municipal budget (see article 9, paragraph 4, Law on the government budget of Bulgaria for 1995).

These clear legal postulates which lay the foundations for municipal financial independence contradict the Law on the preparation and fulfillment of the government budget, dating back to 1960. This law is grounded on the principles of unity and centralization of public finance, which seem anachronistic in light of the new legislation. Nowadays, its requirement should be viewed as null and void even though its provisions have not been specifically abrogated. Legal grounds for its non-application can be, for example, article 3, paragraph 1 from the Constitution, stating that the Law, where contradictory to the Constitution, is not applicable. However, in order to become obligatory, such interpretations should be made by the Constitutional Court.

In order to avoid the contradiction between the new legislation and the Law on the preparation and fulfillment of the government budget, one can apply the rule "the new law repeals the old if they are contradictory". This is the basic consideration behind the non-application of the Law on the preparation and fulfillment of the government budget.

The right of the municipality to approve an independent budget in itself does not ensure financial independence if the municipality does not have enough freedom to allot its budget funds. The legislation does not allow the municipality to manage all of its budget funds and in fact, a great part of municipal finance is spent in accordance with instructions from the central administration, represented by the Ministry of Finance. This refers mainly to the so called "subsidies from the central budget with special designation, granted for the financing of particular activities in the municipality". The principal municipal expenditures, such as potable water supply, health care, social affairs, education and ecology, are completely dependent on the subsidies from the central budget with special designation, with the municipality acting as a local representative of the Ministry of Finance. If the subsidy is insufficient (which is often the case), the liabilities remain on the account of the municipality and are shown on the

liabilities' side of its budget. As a result, part of the government budget deficit is transferred to the municipalities' budgets.

This leads us to one of the main weak points of the financial regulation relationship between the central and local authorities, namely: the imbalance between the activities and projects maintained by the municipalities on the one hand, and on the other - the insufficient rights of the municipalities to raise budget receipts for their own accounts. A growing part of the government receipts are channeled into the central budget and a growing number of activities are transferred to the maintenance of the local budgets.

Municipal receipts

The above poses a question related to the municipal receipts and in particular to the municipality's ability to increase them. There is no doubt that the financial independence of the municipalities is to a great extent built upon the conditions which give them the opportunity to raise the biggest part of the resources that they disburse. Provisionally, the structure of the municipal receipts can be divided into two main groups in accordance with their source: first, subsidies from the government budget and second, tax and non-tax receipts.

Having already mentioned government subsidies, there is only one thing to add. In addition to the subsidies with special designation there are also the so called "general subsidies" which are managed at the discretion of the municipal council. The decision of the municipal council to assign these funds depends on the particular needs of the respective municipality. In this case the dependence of the municipality on the government budget becomes apparent in the fact that the Ministry of Finance can delay the transfers or even fail to transfer part of a general subsidy for the respective period.

Another very important source of funds for the municipal budget is that of taxes. Of all taxes, income tax is the greatest. In 1995, the municipalities received 50% of the levied tax.

According to article 53, paragraph 1, point 1 of the Law on Local Self-Governance and Local Administration, "the municipal budget receives the total amount of all local taxes, charges and other local levies, stipulated by the law". The rate of the local taxes is determined by a law or a decree. Only some of the local charges (such as charges for technical services, charges for the use of market-places, sanitation charges) are determined by the municipal council.

All of the enumerated municipal receipts are based on public law. The subsidies from the government budget are transfers from one public structure to another. The taxes and charges are levied on the basis of the administrative liabilities for the account of the physical and legal persons stipulated by the law.

Municipal finances, however, can be raised on the basis of private law. The municipality can carry out economic activity, to co-operate with private law subjects and to earn profit, thus increasing its property. The municipality can carry out all these activities because it is recognized by the law as a legal entity.

1. The municipality as a subject of private law. Legal framework for the municipal investment policy

1. Legal opportunities for the municipality to invest

Bulgarian legislation reform, in the sphere of public finance, faces the complicated task of finding the appropriate balance between the necessity to lessen the tax burden and to provide the needed funds for the exchequer. Upon passing the government budget, the Members of Parliament usually face the politically delicate problem of providing for the "financial health" of the state without "stifling" the

economic entities with an excessive tax burden. It is important to find a way out of this dilemma when solving the problems of municipal financing. The municipality's opportunities to levy taxes and charges on the population are restrained. The right to specify the rate of some local charges can hardly alleviate chronic financial insufficiency. Thus, the limited opportunity of the municipality to raise funds on public-law grounds is compensated for by the ability, stipulated by the law, to carry out economic activities and to cover part of its financial needs with the revenues it has realized. In order to carry out economic activities in the sense of article 51, paragraph 3 from the Law on Local Self-Governance and Local Administration (LLSGLA), the municipality should dispose of funds, which it can invest at its own discretion.

But what is the legal interpretation of the term "municipal investment" and what are the legal limitations for municipal investment policy?

To invest means to choose; to choose where and how to invest your money. From this point of view, the law stipulates the order and conditions for the municipality to manage its own property. Of course, the subsidies from the government budget with special designation are excluded from these regulations (article 51, paragraph 4 from LLSGLA). The municipality's monetary funds and all assets under its ownership remain at its disposal (article 51, paragraph 4 in connection with article 52, paragraph 1). These could be real or personal property, shares, interest in different companies, on the whole all types of property acquired by the municipality as a legal entity (see article 136, paragraph 3 from the Constitution of the Republic of Bulgaria). The municipality may use this property in economic activity, in other words, it may invest it.

The municipality is able to make direct investments: "to put in economic activity possessions and monetary funds" (article 51, paragraph 4 from LLSGLA), as well as to make indirect investments: "to participate in economic activities of joint nature, i. e. to purchase shares and stocks of business firms".

Direct municipal investments are made in the process of spending the monetary funds. They are used to finance projects of local importance, which are not subsidized by the government budget. Given the present rather limited possibilities for central financing, the number of projects, which are to be financed by the municipalities themselves, increases. This means considerable outlay for the municipality. It is obvious that nowadays activities such as building of municipal housing; maintenance of municipal schools; kindergardens and public utilities; upkeep of the local infrastructure; transport and many other undertakings of local importance are in a terrible situation and are in dire need of more funds.

The municipalities have transferred some of these activities - construction, transport and others - to private companies; privatization will free the municipalities from financially supporting activities which are not characteristic of them. However, there will always be economically unattractive activities which cannot be transferred to the private sector and which will have to be subsidized directly from the municipal budget. The existing legislation offers different models for their financing. At present the most adequate model is, perhaps, the establishment and development of municipal funds.

2. Establishment, management and development of municipal funds

Municipal funds include non-budget monies of the municipality set aside to finance certain activities. Usually, the law defines them as "non-budget monies" (article 37 from the Law on the Preparation and Realisation of the Government Budget) or "non-budget accounts" (article 6, paragraph 2 from the Property Law), but more recent legislation uses the term "municipal funds" (see article 6, paragraph 2 from the Law on Transformation and Privatisation of the State- and Municipality-owned Enterprises), which will be used below.

Municipal funds support the development of projects which are important to the municipality, and in fact, are the financial foundation of long-term municipal policy. The advantage of municipal fund financing for the municipal budget is that while budget resources usually depend on the municipality's current financial situation, the fund,

once established, has its own sources of income and is not influenced by temporary shortages in different budget accounts. This relative stability of municipal funds creates an opportunity to plan municipal investments extending beyond the time limits of the annual municipal budget, while the independent turnover of these money is a guarantee toward permanent development of the financed activity. In addition, municipal funds contribute to conscientious management and a clear perception of the effectiveness of a particular economic undertaking. Countries in which this type of municipal financing is well-developed stimulate the purchase of municipal bonds via tax breaks which are intended to exceed the deposit interest rate of the banks. However, in order to introduce these tax breaks, the central government, i.e. the state, should be willing to give up part of its revenues in the government budget and to infringe on the interests of commercial banks, which will forego a certain proportion of their deposits.

However, it is possible to ask the question: don't municipal companies achieve the same goals? The answer is yes, but municipal companies pay taxes and other charges like all private enterprises. For this reason, municipal companies concentrate their efforts on the development of those activities with a high return on investment or, in other words, they are the instrument for municipal participation in purely commercial activities. Thus, in competing with private companies, municipal companies will reap the profits and carry the burdens of the free market.

Given the above, it is possible to draw the following conclusion: investment via municipal funds will find its adequate application in long-term municipal projects, which are unlikely to provide quick returns or big revenues. The specific type of project depends on the economic structure and the particular needs of each municipality, as well as on the priorities of municipal policy. Examples of such projects might be the construction of municipal housing with the intention of selling at relatively low prices; the building of local heating installations; ecological projects; the building of cultural and recreation centres to attract tourists; and maintenance of the local cultural and historical monuments, etc.

The main principles for the establishment, management and financing of the municipal funds can be extracted from their legislative regulation despite the fact that it is incomplete and fragmentary.

II. Establishment of municipal funds

Since the municipal fund is municipal property, it is always necessary to have a municipal council ordinance in order to establish a municipal fund. This is not stated explicitly in the law, but is deduced from the general legitimate rights of the municipal council to pass resolutions for the acquisition, management and command of municipal property. Having the right to manage and command *all* municipal property, the municipal council should naturally have the same right as far as municipal funds are concerned. It is ridiculous to say that the decisions of the municipal council regarding something as specific and inherent to the local self-governance matter as the establishment of municipal funds would be legally void. Moreover, one should keep in mind that the municipal council is a local structure for self-governance with general legitimate rights and they are not, and cannot be enumerated in details in the Law on the Local Self-governance and the Local Administration. The enumeration in article 21 of that law is exemplary and this fact is explicitly expressed in paragraph 2 of the same article, namely: "the municipal council takes decisions regarding other projects of local importance, if they are not among the exclusive rights of other organs".

Thus, the decision of the municipal council is an unavoidable prerequisite for the establishment of municipal funds, regardless of the fact that in most cases it is based on certain private or public legal grounds. When the establishment of the fund is unambiguously stipulated in the law, the decision is based on public grounds. It is governed by private law if the establishment of the fund is the result of a donation or the will of a private person, committing the management of certain funds to the municipality.

1. Establishment of municipal funds under explicit legal regulations

The possibility for the municipal council to take decisions for the establishment of funds under certain legal regulations is stipulated in article 37 of the Law on the Preparation and Realisation of the Government Budget (in force since 1960). According to the law, “non-budget funds are all monies collected and spent by the budget organisations under special laws, decrees and regulations, which are not included in the government budget”. The analysis of the mentioned regulation in connection with article 37, paragraph 1 of the same law, defining the rights of the municipal bodies with regard to the “non-budget funds”, leaves no room for hesitation that the municipalities are also “budget institutions” in the meaning of article 37. This text, as well as the greater part of the regulations of the Law on the Preparation and Realisation of the Government Budget, is an anachronism from the time when the idea for the unity of the state authorities and the state finances was the dominant one.

Of course, even in the absence of the mentioned text, the municipal council is obliged to observe the legal regulations that require the establishment of municipal funds. For example, article 6, paragraph 2 from the Law on Transformation and Privatisation of the State- and Municipality-owned Enterprises stipulates the establishment of a special municipal fund, with part of the revenues from the privatisation of the municipality-owned enterprises. The law explicitly specifies the fund receipts and indicates more generally the expenditures. First of all, the municipality can use the fund resources to pay off non-performing credits to the municipal enterprises, as well as to pay off the credits for unfinished construction and investment projects. There are no legal restrictions concerning the investment projects of the municipality. They are judged by the municipal council in accordance with the priorities of the municipal investment policy. In this case, the legislature regards the right of the municipality “to have the final word” in respect to the disbursement of its own resources, which is, in fact, a sign of respect for its financial autonomy and supports the opinion that the municipality is an independent participant in the free-market economy.

2. Establishment of municipal funds under a private-law act

Being a legal entity, the municipality has the general right to acquire property from a donation or a will. The property obtained in this way, becomes part of the municipal property under article 6, paragraph 2 from the Property Law. According to article 149, paragraph 1 from the Persons and Family Law, the donation and the will are procedures for the establishment of a foundation, and in accordance with the amendment of article 21 from the Law on the Local Self-governance and the Local Administration, to the effect that the municipality can possess its own foundations, there are no obstacles to a person leaving by will or donation certain property to the municipality, defining the purpose of its usage. For example, a resident of the municipality can provide for the maintenance of a given museum or monument.

However, this rarely happens. It is mentioned only because the municipal foundations, despite their different legal regulation from that of the municipal funds, are resources separated from the municipal budget and prove again the validation of fiscal federalism in Bulgarian legislation.

3. Establishment of municipal funds under a decision of the municipal council

Examples from the practice of the Sofia City Court.

III. Management of the municipal funds

The principle of fiscal federalism presumes that the legal framework for municipal investment policy can be determined only in acts of the authorised bodies. Limitations of the municipality's freedom to invest can be stipulated in a law or an ordinance. It is legally impermissible for the government or any other government body to impose individual obligations on a certain municipality to make expenditures from its own property, in other words, from independent resources instead of from budget subsidies.

The municipal council determines the procedures for spending fund resources bearing in mind the legal regulations. Each municipality has the right to direct its own investment policy with regard to unique regional features. Even under article 6, paragraph 2 from the Law on Transformation and Privatisation of the State- and Municipality-owned Enterprises, stipulating that the municipality is obliged to give priority to the repayment of non-performing credits of the municipal companies, the municipality maintains the freedom to choose which credits to repay with regard to the different levels of indebtedness of the companies, the possibilities for future development and the branches with regional importance. Other economic indicators may also be taken into consideration.

The municipal council has the right to command the fund. In some cases this is explicitly stated in the law regulating their establishment - for example: the municipal privatisation fund under article 6, paragraph 2 from the Law on Transformation and Privatisation of the State- and Municipality-owned Enterprises. Regardless of this text, the municipal council manages the municipal property under article 21, paragraph 1 from the Law on the Local Self-governance and the Local Administration.

In order to determine the technique for fund management, the municipal council adopts regulations for its organisation and activities, which usually includes the aims of the fund, its governing bodies, the expenditure rules and so on. The managers of the fund are representatives of the municipal council. They are empowered to act on behalf of the municipality and to assume liabilities on its account not exceeding the fund resources. This authority is conceded firstly to the mayor, because he/she is its executive organ. The municipal council can assign the fulfillment of the fund programme to the mayor on the grounds of article 21, paragraph 1 from the Law on the Local Self-governance and Local Administration giving the right to determine the specific responsibilities of the mayor in connection with the management of the municipal property. But the managers of the fund can be other persons as well, if they are explicitly authorised by the municipal council.

The municipal funds are managed strictly in accordance with their purpose, stipulated more generally in the law, and explained in more detail in the regulations for its organisation and activities. Only the Government Auditing Office has the right to exert direct control over the management of the municipal funds or as the law says "over the implementation of the non-budget accounts" (article 2, paragraph 1 from the Law on the Government Auditing Office). The rights of this central government body for specific financial control are rather broad. It has the right to supervise not only whether the budget and non-budget resources are spent in conformity with the law, but also whether the expenditures are expedient (argument from article 2, paragraph 1 from the Law on the Government Auditing Office). Consequently, the municipal investments are subject to the Government Auditing Office control whether they are economically efficient or not.

Thus, the municipal investment policy is restricted not only by the legal framework, but also by the subtle judgment of one administrative body with respect to the appropriate choice of investment projects, the warrantable economic risk and the capable management of the municipal resources.

IV. Financing of the municipal funds

Upon its establishment, the fund has its receipts and expenditures. Generally speaking, the aim of its existence is to set aside the current or expected receipts from particular local sources. When the fund is established to invest in projects for which the municipality lacks disposable resources, there are two ways to achieve them: 1) reallocation of the free resources from some budget accounts (these are either the municipality's own resources or general subsidies from the government budget) and 2) inducement of credits from independent sources. In the current situation of big budget deficits, the municipalities usually choose the second alternative.

The Law on the Local Self-governance and the Local Administration stipulates two possible ways for municipal financing: 1) bank credits and 2) municipal bond issues (article 53, paragraph 1 and article 21, paragraph 1 from the Law on the Local Self-governance and the Local Administration).

Defining the purpose for the bank credit is an essential clause of the contract. For this reason, the municipality should specify the details and prove the advantages of the planned investment. Thus, the bank can control the activity. Most often, during the negotiations with the crediting bank, the municipality strives to prove that the future investment will ensure a certain rate of return. The bank, on its part, will require guarantees for the repayment of the credit. There are no obstacles to mortgaging municipal real estate or to binding as a pledge the material results of the invested resources. For example - a mortgage on the buildings constructed with loan funds. It is obvious that the negotiations between the municipality and the crediting bank take exactly the same course as do those between profit organisations. The rights and obligations of the parties to the loan contract are administered according to the regulations of the commercial and private law. However, there are some legal peculiarities concerning the realisation of the private liability of the municipality, but they are slightly apart from the matter under discussion and will not be elaborated further.

Another way to attract loan resources to a municipal investment fund is to issue municipal bonds. This is effected after a decision of the municipal council under article 21, paragraph 10 from the Law on the Local Self-governance and the Local Administration. The mentioned text stipulates that the issue of municipal bonds should be made "according to the restrictions and the procedures required by the law". This last requirement was part of the amendments of the Law on the Local Self-governance and the Local Administration, enforced on 5 July 1995. Evidently, the opinion of the legislative body is that the municipality is a specific issuer and the regulations of the Company Law cannot be applied in this case. Probably, the most appropriate legislative solution to the problem would be to pass a law, stipulating restrictions and procedures concerning the issue of both government and municipal bonds. At present, such a law does not exist, which means that the municipal ability to raise funds via bond issues is blocked.

This is the strict interpretation of the law. But the practice will demonstrate the municipal perception and the corresponding application. The opinion of the Government Auditing Office, whether the municipalities have the legal opportunity to issue bonds or not, should be considered as well, because the control over the legitimate and expedient realisation of the municipal budgets is among its rights.

There are already instances in which a municipality has received considerable bond receipts. The municipality of Plovdiv raised 200 mln. Leva from bond issues in 1994, and in 1995 these funds reached 570 mln. Leva.

For the United States and many European countries, bond issues are one of the principal financial sources of the municipalities. They are used mainly for local investment projects, matching the interests of the population to their financial co-operation. In such cases, the most reasonable solution is to invest via municipal funds. The issue is placed in order to raise funds for a particular activity - for example, the construction of municipal housing; the receipts are directed to a special fund; the sums

from the sale of the houses are collected in that same fund and are used for the repayment of the bond credit upon its maturity. Having social goals, the municipal investments usually reap relatively low profits. This is also the reason for the low interest rates on the municipal bond credits.

Moreover, one of the main stimuli for the purchase of municipal bonds would undoubtedly be the confidence that the municipality would repay the loan. This requires enough funds for repayment in case the receipts from the investment turn out to be less than expected, and highly qualified managerial skills for the implementation of the investment.

From everything stated above, it is possible to draw the following conclusions:

- The municipality has relatively broad opportunities to carry out economic activities, investing its free resources, even though they are not ample.
- The easiest way to raise funds is via bond or bank credits.
- Qualified managerial thinking of the municipal counselors, who take decisions for the investment of the municipal resources, is necessary for the effective use of the loan funds.
- Obviously, a more detailed legislative regulation of the statute of the municipal funds will facilitate their activities.