# *FISCAL DECENTRALIZATION IN EUROPE: EFFECTS ON LOCAL GOVERNMENTS' FISCAL AUTONOMY*

**Head Assist. Prof. Mariyana K. Pavlova-Banova, PhD**[1]
*D. A. Tsenov Academy of Economics – Svishtov,*
*Department of Finance and Credit*

**Abstract:** The European Charter of Local Self-Government, which was ratified by almost all European member states, provides for the decentralization of power and the transfer of competences and financial resources to local communities as well as extends local authorities' tax collection and budgetary spending responsibilities. In reality, however, the increased spending responsibilities and the limited self-financing powers of the municipalities in our country raise the question of the degree of their dependence on the central government. This paper presents a survey which aims to measure and assess the degree of tax autonomy of local governments in Bulgaria compared to their counterparts from other EU member states by means of a set of indicators and thus to determine one of the effects of fiscal decentralization – local self-government's tax autonomy.

**Keywords:** municipalities, fiscal autonomy, fiscal decentralization**,** local self-government budget, revenue.

**JEL:** H71, H72.

* * *

Sixty-five years after the establishment of a new system of relationships among the various levels of government in Europe with the adoption of the European Charter of Municipal Liberties, which started the institutional reform, fiscal decentralization is now a fact in Europe. Adopted initially by only 16 countries, the European Charter of Local Self-Government has already been ratified by all European countries except Belarus and Moldova. Its underlying principles extend the powers of local governments to 'manage a substantial part of public affairs' (European Charter of Self-Government, Art.

[1] E-mail: m.pavlova@uni-svishtov.bg

3, 1985) in the interest of the society. This requires a vertical transfer of rights and obligations to the local authorities and the associated extension of their tax collection and budgetary spending responsibilities.

The Republic of Bulgaria adopted a policy for extending the autonomy of local governments and adopting the principles of local self-government by ratifying the European Charter for Local Self-Government, amending its Constitution, enforcing the Local Taxes and Fees Act (LTFA) (Local Taxes and Fees Act, 2017), and adopting a Decentralization Concept and Strategy and other related documents. Followed for more than 25 years, this policy is supposed to have positive effects for both the society in general and for the local self-government and thus result in better public services. The increased spending responsibilities and the limited self-financing powers of the municipalities in our country raise the question of the degree of their dependence on the central government. This is why we conducted survey which aimed to measure and assess the degree of tax autonomy of local governments in Bulgaria compared to their counterparts from other EU member states by means of a set of indicators for the last 10 years (2007-2016). The selected economies (Bulgaria, Estonia, Hungary, Romania and Slovakia) have similar characteristics - they are unitary states with similar political and socio-economic 'history': all of them were members of the former 'Eastern Bloc' and after its dissolution in 1989 set on the path of transition from a highly centralized planning system to a decentralized free-market economy, facing a number of challenges.

According to Bulgaria's Public Finance Act (Public Finance Act, Art. 45 and 52, 2017), municipal budgets shall include revenue from own sources and transfers from the central budget. The latter are made due to the limited sources of own revenues of the municipalities and are intended to ensure a minimum level of local services in municipalities (Vladimirova, T., Naidenov. L., 2011). Logically, the transfers delegated from the central budget, although spent locally, limit the autonomy of the municipal governments to spend these funds at their own discretion. In turn, the revenue from own sources is spent on local activities at the discretion of the City Council regarding their type, quantity and quality. (Zahariev, 2012). Municipalities collect revenue from the following own sources: local taxes; fees; services and rights granted by the municipality; disposal of municipal property; fines and pecuniary sanctions; interest and penalties; other proceeds; aid and donations (Public Finance Act, Art. 45 and 52, 2017). *Therefore, the degree of local governments' independence from the central government depends to a large extent on the capacity of each municipality to accumulate enough own revenues to cover its spending for public goods and services.* We should point out, however, that the degree of fiscal autonomy (independence) does not depend only on the collection of revenue, although it is one of its main aspects. It also depends to a large degree on:

- The right of the municipalities to impose taxes;
- The right of the municipalities to set tax rates;
- The right of the municipalities to set tax deductions, preferences, and exemptions;
- The right of the municipalities to collect taxes (Naidenov, L., 2012, стр. 131)

According to our country's legal framework, municipalities are allowed to set the rates only to local tax observing the lower and upper limits stipulated in the LTFA as well as to collect the taxes specified in the same act via their own tax offices. Moreover, the LTFA specifies the types of tax the municipalities are allowed to levy and prohibits their modification or the imposition of other taxes. This means that regardless of the optimization and the level of collectability of the taxes, municipalities are deprived from sources of own revenue and this applies especially for the smaller and less densely populated municipalities where the standard of living is low (which are predominant in Bulgaria) and are therefore their local governments are highly dependent on the central government.

The degree of tax autonomy (the level of dependence of a local government on the central government) is measured by means of the following indicators: significance of local revenues, significance of local tax revenues and property taxes, tax decentralization coefficient, mobilization of local resources and share of tax revenue in local spending (Naidenov, L., 2012, pp. 143-153) (Aristovnik, 2012). The dynamic and comparative analyses of these indicators would outline the tax autonomy trends in the Republic of Bulgaria compared to other EU member states. It should be noted that the tax systems of the selected five countries are not (and cannot be) identical with regard to their local taxes but nevertheless share some common features: the local governments in these countries have the right to collect certain taxes and receive transfers from the central budget. Without claiming complete comprehensiveness, the table below presents the structure of the local taxes in the five countries:

*Table 1*
***Local taxes in selected EU member states***

| **Bulgaria** ***(unit: obshtina, 264)*** | **Estonia** ***(unit: vald, 193)*** | **Romania** ***(unit: commune, 2861)*** | **Slovakia** ***(unit: obce, 2792)*** | **Hungary** ***(unit: телепуулишек, 3175)*** (Council of European Municipalities and Regions, 2013) |
|---|---|---|---|---|
| Real estate tax | Advertisement tax | Real estate (land and buildings) tax | Real estate tax | Building tax |
| Inheritance tax | Road and street closure tax | Vehicle tax | Tax on rent incomes | Property tax |
| Donation tax | Motor vehicle tax | | Dog ownership tax | Local corporate (business) tax |
| Transfer tax | Animal tax | | Tax on the use of public areas | Tourist tax |
| Vehicle tax | Entertainment tax | | Tax on operation of vending machines | |
| Lump-sum tax<br>Taxi service tax | | | Tax on vehicle parking in historical parts of cities | |
| Tourist tax | | | Nuclear facilities tax | |

**Source:** The Ministries of Finance of Bulgaria, Estonia, Romania, Slovakia, Hungary, http://www.minfin.bg/, https://www.rahandusministeerium.ee/en, http://www.mfinante.gov.ro/trezorengl.html?pagina=domenii, http://www.finance.gov.sk/en/, http://www.kormany.hu/en/ministry-for-national-economy)

The comparison of the local taxes in Bulgaria, Estonia, Romania, Slovakia, and Hungary shown in the table above reveals the following similarities and differences:

- The local taxes levied in Bulgaria and Slovakia have the broadest tax base.

The fiscal systems in our country and in Slovakia are based on eight local taxes which differ in terms of subject, object and tax base. Unlike them, the Hungarian and Romanian fiscal systems are narrower in scope and include four and two local taxes respectively. Therefore we might assume that a broader tax base would ensure more revenue because, ceteris paribus, it would include more tax subjects. This assumption may verified by means of a dynamic correlation comparative analysis.

- Regarding the objects of taxation, property and service taxes are more common than income and turnover taxes.

All the countries included in this study, bar Estonia, have imposed some form of a local tax on the real estate property to generate revenues for the local government's budgets. The same applies to the motor vehicle tax as such a local tax has not been imposed only in Slovakia and Hungary.[2] In Bulgaria, Estonia and Slovakia local taxes are levied to certain services, such as entertainment services, services rendered by self-employed providers, use of public spaces, etc. Local income taxes are levied only in Hungary (local corporate tax) and Slovakia (tax on rent incomes).

- Property taxes are the main source of revenue to the local budgets.

Real estate` property (land, buildings or building permits) is subject to local taxes in all countries bar Estonia. Movable property (vehicles, works of art, gaming machines and vending machines) are subject to different local taxes in the studied countries. It should be noted that the possession of a pet (usually a dog) is taxed in Estonia, Slovakia and Bulgaria (although in our country the tax is qualified as a fee).

- Local governments usually impose taxes on the possession of real estates, transfers of titles, and rendering of services (entertainment, hotel, taxi, repair, sales through vending machines, etc.)

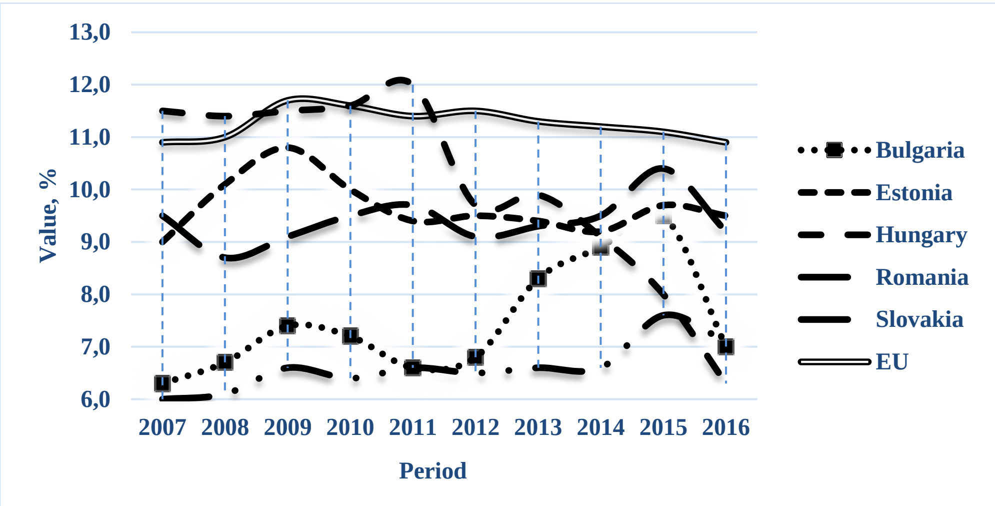
In some of the countries there are some specific taxes, such as the tax on the broadcasting/publishing of advertisements in Estonia, and the tax on the stay of vehicles in historical parts of cities and the tax on nuclear facilities in Slovakia.

The above differences features of the local tax systems provoked our interest to measure the degree of tax autonomy of local governments in terms of defining their priorities and objectives for spending at local level. Their autonomy is an important factor for improving their efficiency in allocation of resources, ensuring social equality and raising the standard of living of their communities.

The '*significance of local revenue'* indicator is the ratio of the local revenue to the national GDP and shows the significance of local redistribution processes for the national economy. Chart 1 clearly shows that during the studied period (2007 – 2016) between 6.3 and 9.5 percent of Bulgaria's GDP were redistributed via municipal budgets. These values are lower than the EU

[2] This does not mean that in these countries the ownership and use of a vehicle is exempt from taxation. Vehicles may be subject to taxes that generate revenue for the central budget or to certain fees. However, such taxes and fees are not covered by this study.

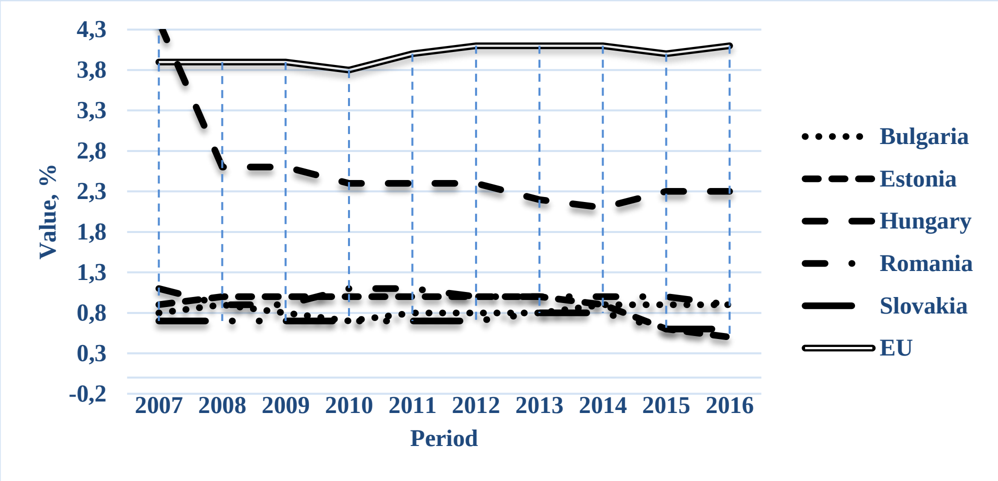
average value as well as the values in Hungary, Estonia and Romania and are higher only than Slovakia's values. During the first half of the studied period only the values of Hungary approximate the EU average, reaching their peak of 12% in 2011 (which is higher than the EU average) and then rapidly declining to 6% in 2016. This is due to the nominal decrease of the financial resources available at local level at relative to the country's GDP growth. In the years after the economic recession, the ratio of local revenue to GDP increased in four of the five surveyed countries, including Bulgaria. Despite the increase of its nominal values, this cannot be considered a reliable indicator for greater regional autonomy because of the annual transfers from the central budget that were made in each country. We would be able to measure their regional autonomy more accurately if we disregard these transfers and take into account only the revenue from own sources, i.e. if we redefine the above indicator as '*significance of local tax revenue*'. Thus the indicator will show the significance of local budget revenues from local taxes for the redistribution processes in the national economy. Higher values are indicative of a greater autonomy of local governments due to the larger amounts of own resources at the disposal of the local parliament (municipal council).




**Source:** Eurostat, author's calculations

*Figure 1.* ***Significance of local tax revenue in selected EU member states***

The analysis of the above indicator reveals an important feature of the local governments in the surveyed countries – the low percentage of local tax revenue, which results in values equal or lower to one percent of the national GDP (see Figure 1.) An exception from this trend is Hungary, where the values are close to the EU average values and vary between 2.1% and 4.4%. The relative share of local tax revenues in our country after our accession to the EU until 2016 varied between 0.7 % and 0.9 % - values that are higher only from those in Slovakia. The trend in Romania is relatively stable with values fluctuating at about 1% of the country's GDP. The same applies to Estonia as well, except for the last three years, when the values were equal or even lower to those in Bulgaria.



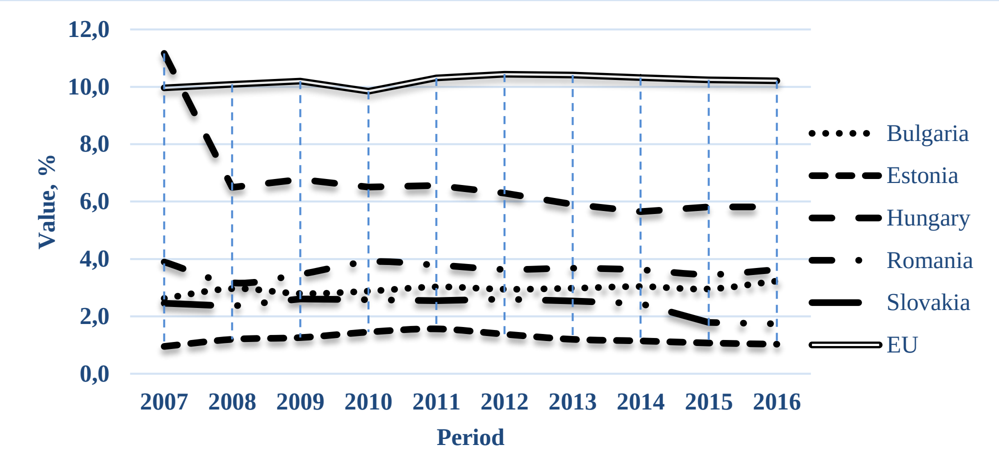

**Source:** Eurostat, author's calculations

*Figure 2.* ***Significance of local tax revenue in selected EU member states***

The comparison of the two indicators ('significance of local revenue' and 'significance of local tax revenue') clearly shows that local governments are strongly dependent on the central government not only in Bulgaria. For example, the revenues of local governments in Bulgaria in 2016 amounted to EUR 3.35 bln., of which the revenue from local taxes was only EUR 447.8 mln. (or 13%). In other words, the value of the 'significance of local revenue' indicator was 7% while the value of the 'significance of local tax revenue' indicator was only 0.9%. In the same year, the local governments in Estonia (considered a role model) had lower tax autonomy than the Bulgarian ones – of EUR 2 billion in revenue only EUR 75 million (3.7%) was from local taxes. The low share of GDP redistributed through local taxes shows not only that the effects of the fiscal decentralization in the selected countries are controversial, but also that municipalities do not have sufficient financial capacity for autonomous provision of sufficient and adequate public services.

Disregarding the central transfers as a source of local revenue lets us measure fiscal decentralization by means of the ratio local revenue to total revenue in the public sector. The results of this dynamic analysis are shown in

Figure 3 and prove the conclusions from the previous analyses. The low amount of revenue accumulated from local taxes, which, except in Hungary, is below one percent of the national GDP, has a substantial impact on the *fiscal decentralization coefficient*. It fluctuates between 0.95% and 6.5% and is continuously below the EU average of about 10 percent.[3] Bulgaria ranks third in terms of local tax revenue compared to total tax revenue – in 2016 its fiscal decentralization coefficient was 3.2%, which is the highest reported value, the lowest being 2.6% in 2007. For our country there is a trend for increase of this value while such a trend is not observed for the other four countries. More pronounced tax autonomy was measured in Romania, where it varies between 3.2% and 3.9% with higher values in the beginning of the survey period, and in Hungary (between 5.6% and 11.2%), where it decreases during the period as well. Compared to the average European values, the dependence of local governments on the central government in the other two countries is even more pronounced - in 2016 in Estonia, for example, the local tax revenue amounted to only EUR 75 million (or 1%) out of EUR 7.2 billion total tax revenue.




**Source:** Eurostat, author's calculations

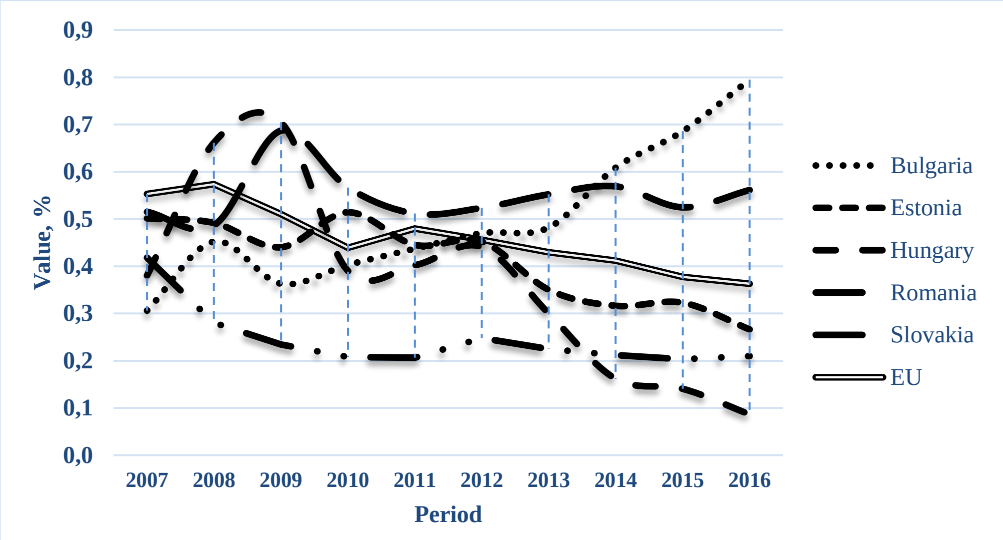
*Figure 3.* ***Fiscal decentralization coefficients of selected EU member states***

The outlined trends regarding the rate of tax decentralization imply that not only in our country, but in all the other countries included in the survey, the tax revenues are highly centralized, which makes the local governments in these countries highly dependent on the central governments in terms

[3] Except in Hungary in 2007.

of their budget spending objectives and casts doubt on the success of the fiscal decentralization with regard to their tax autonomy and the implementation of the LFTA provision that municipalities shall 'manage a substantial part of the public affairs'.

Given the fact that taxes are levied on various tax objects (e.g. income, consumption/turnover, property, assets, etc.), the next stage of our research focused on real estate taxes as a source of revenue for local governments. We measured the ratio of the revenue from property and title transfer taxes to the total tax revenue as an indicator of tax autonomy. Property taxes are sources of local revenue in all the countries included in the survey. In Romania property tax is the only source of revenue for local governments and in Estonia it is the second most important source of all local taxes (see Table 1). These specific characteristics affect the next two indicators ('*significance of property taxes*' and '*mobilization of local resources*') - and should be taken into account when assessing tax autonomy. The significance of property taxes as sources of municipal tax revenue can be evaluated by comparing them to the total local tax revenue, but this goes beyond the scope of this study.

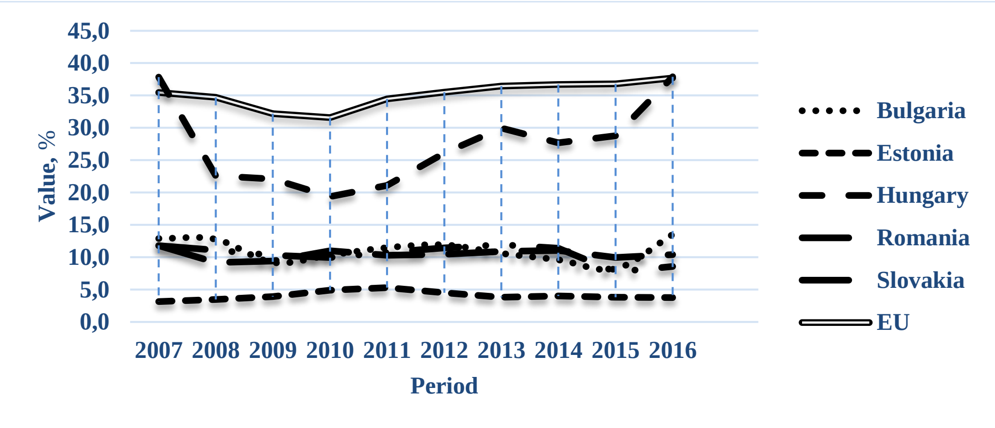



**Source:** Eurostat, author's calculations

*Figure 4.* ***'Mobilization of local resources' coefficient in selected EU member states***

The 'significance of property taxes' indicator, which is the ratio of property tax revenue to the country's GDP, is relatively stable, with values varying from 0.1% to 0.3 % of GDP throughout the studied period, compared to EU average of 0.2%, and indicates good tax autonomy. The second indicator ('mobilization of local resources'), which is the ratio of property tax revenue to the total tax revenue from the public sector, has good values in Romania, Hungary and Bulgaria. In Romania, the coefficient exceeds the average European values in most of the survey years (except in 2007 and 2008) and varies between 0.5 and 0.6 percent, while in Hungary the highest values were reported in the first half of the survey period and in some years the indicator reaches 0.7%. During the second half of the survey period, the coefficient in our country has the highest values compared to the values  results of the other countries as well as the EU average. This shows that property taxes are not very significant for the tax autonomy of local governments due to the low revenues from property taxes, which have low rates, the various  exemptions from this type of taxes, and, in some cases, preference to other forms of taxation.

As it has already become clear, one aspect of local government's tax autonomy is the ability of municipalities (local governments) to have sufficient financial basis for independent spending on activities and projects without the financial support of the central government. Such an autonomy would widen the scope of local activities and/or ensure more financial resources for the existing public services. Therefore, the most adequate measure of the level of tax autonomy the ratio of the revenue from local taxes and the local budget spending. It shows the level of shortage of local tax revenue and the need of transfers from the central budget to cover local spending.




**Source:** Eurostat, author's calculations

*Figure 5.* ***Local spending/tax revenue ratio in selected EU member states***

The result of the analysis (Figure 5) shows the comparison of the selected countries with the other EU members states, where the percentage of local spending covered with local tax revenue is between 31% and 38%. Bulgaria's ratio is far below the EU average varying between 8.2% and 13.5% and is similar to the values in Romania and Slovakia. Hungary ranks first among the five countries in terms of tax autonomy - the lowest reported value was in 2010 (19.4%) and the highest was at the beginning and end of the survey period (37,9%), when it reached the EU average. The lowest values were reported in Estonia, where only 3 to 5 percent of the local spending is covered by local tax revenues. This means that local governments are strongly dependent on the central governments in terms of financial resource to cover their spending.

The coefficient analysis over the period from 2007 to 2016 leads to the following conclusions regarding local governments' tax autonomy in the five selected countries:

*First:* The '*significance of local revenue'* indicator, which shows the significance of local redistribution processes (transfers + taxes) at local level for the national economy, has a positive trend in Bulgaria and Slovakia, due to its marked growth during the survey period. However, the fact that it is calculated including the transfers from the central government, makes it unreliable as a measure of tax autonomy.

*Second:* When the above indicator is redefined as '*significance of local tax revenue'* by excluding those transfers, we could determine an important characteristic of local governments in the selected countries – the amount of their local tax revenues does not exceed one percent of the national GDP compared to the EU average value of about 4% – a clear indicators that the local governments in these countries are strongly dependent on their central governments.

*Third:* The *'tax decentralization' coefficient* ranks Hungary first, followed by Romania. However, both countries' values are lower than the EU average. Such indicator values show that the tax systems in these countries are highly centralized.

*Fourth: Property tax* is the main source of local tax revenue in each of the selected countries although its share of the national GDP and total tax revenue vary among the selected countries. During the second half of the surveyed period it had highest values in Bulgaria and Romania.

*Fifth:* Local governments rely heavily on transfers from the central governments to cover their public spending and thus are not financially independent.

The effects of the implementation of the principles of local self-government should be considered in various aspects: provision of better public services, raising the living standard, administrative, financial and tax efficiency, etc. Although the level of tax autonomy is but one of these effects, it affects all of the above-mentioned effects. The analysis and evaluation of tax autonomy indicators puts into question the effects of the fiscal decentralization in relation to this aspect and the implementation of ECSG's principle of 'managing a substantial part of the public affairs' by municipalities. The strong centralization of tax revenues, the growing spending responsibilities of municipalities and the limited opportunities for self-financing make local governments strongly dependent on the central government to cover their public spending. This requires a reorganization of Bulgaria's current fiscal system and central funding policy through implementation of some good European practices in order to bring the level of its local governments' tax autonomy closer to the EU average level.

## References


Aristovnik, A. (2012). Fiscal decentralization in Eastern Europe: a twenty-year perspective. *Munich Personal RePEc Archive*, *Paper No. 39316*.

Council of European Municipalities and Regions, C. (2013). *Decentralisation at a crossroads - merritorial reforms in Europe in times of crisis.*

*European Charter of Self-Government, Art. 3.* (1985). Strasbourg.

*Local Taxes and Fees Act.* (2017).

Naidenov, L. (2012). Danachna avtonomnost na mestnite vlasti - teoretichni argumenti i natsionalna praktika. Steno.

Naidenov, L. (2012). Danachna avtonomnost na mestnite vlasti - teoretichni argumenti i natsionalna praktika. Steno.

*Public Finance Act, Art. 45 and 52.* (2017).

Vladimirova, T., Naidenov. L. (2011). Mestni Finansi. Steno.

Zahariev, A. (2012). *Fiskalna decentralizatsia i mestno samoupravlenie v Bulgaria.* Svishtov: Biblioteka Obrazovanie i Nauka, vol. 13/2012, Tsenov PH.

# ECONOMIC ARCHIVE

**YEAR LXXI, BOOK 3 – 2018**

*CONTENTS*

**Editorial address:**
2, Emanuil Chakarov street, Svishtov 5250
Prof. Andrey Zahariev, PhD – editor-in-chief
☎ (++359) 889 882 298
Deyana Vesselinova – Technical Secretary
☎ (++359) 631 66 309, e-mail: nsarhiv@uni-svishtov.bg
Blagovesta Borisova – computer graphic design
☎ (++359) 882 552 516, e-mail: b.borisova@uni-svishtov.bg

ISSN 0323-9004

# Economic Archive

Svishtov, Year LXXI, Issue 3 - 2018



D. A. TSENOV ACADEMY OF ECONOMICS
SVISHTOV

Народностопански архив година LXXI, книга 3 - 2018

Economic Archive Year LXXI, Issue 3 - 2018

# Requirements to be met when depositing articles for Narodnostopanski arhiv journal

**1. Number of article pages:** from 12 to 25 standard pages
**2. Deposit of journal articles:** one printout (on paper) and one in electronic form as attached file on E-mail: NSArhiv@uni-svishtov.bg
**3. Technical characteristics:**
- performance Word 2003 (minimum);
- size of page – A4, 29-31 lines and 60-65 characters on each line;
- line spacing 1,5 lines (At least 22 pt);
- font – Times New Roman14 pt;
- margins – Top - 2.54 cm; Bottom - 2.54 cm; Left - 3.17 cm; Right - 3.17 cm;
- page numbering– bottom right;
- footer text– size 10 pt;
- graphs and figures– Word 2003 or Power Point.

**4. Layout:**
- title of article, name of author, academic position and academic degree – font Times New Roman, 14 pt, with capital letters Bold – centered;
- workplace, postal address, telephone and E-mail;
- abstract in Bulgarian up to 15 lines; key words–3 to 5;
- JEL classification of publications on economic topics (http://ideas.repec.org/j/index.html);
- main body ( main text);
- tables, graphs and figures are software inserted in the text (they should allow linguistic corrections and translation in English). Numbers and text in them should be written with font Times New Roman 12 pt;
- formulas are inserted with Equation Editor.

**5. Rules for footnote:** When citing sources, authors should observe the requirements of **APA Style** at http://www.apastyle.org/ or at http://owl.english.purdue.edu/owl/resource/560/01/ or at http://www.calstatela.edu/library/guides/3apa.pdf.

Each author is responsible for promoting ideas, content and technical layout of the text.

6. **Manuscripts of lecturers without an academic** rank should be accompanied by a transcript of the minutes of the Department meeting at which the proposed paper was discussed.

**From 1st of January 2017 the English language title of the journal is changed from "Narodnostopanski archiv" (transliterated from Bulgarian) to "Economic Archive".**

**Authors of papers published in Narodnostopanski arhiv journal are responsible for the authenticity of the materials.**

**From the Editorial Board**

www.uni-svishtov.bg/NSArhiv