

*Survey of Local Government Investments – dynamics and sources of financing: the cases of
Bulgaria and North Macedonia*

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Abstract:

Local and regional authorities play a crucial role in the implementation, maintenance and rehabilitation of public infrastructure. Sub-national governments in the countries of OECD implement 57% of public investments while the implementation in EU countries is over 50%. The investments of local authorities of South and Eastern Europe increased in recent years, but the ratio of local investment to public investments made in many countries is under the EU average.

At the same time, sub-national governments in SEE obliged to cover greater costs for the transportation infrastructure, the energy and road sectors, than the local authorities of Western Europe.

The purpose of the article is to investigate the investment capacity of local authorities in Bulgaria and North Macedonia as representatives of SEE. An analysis of dynamics of capital costs for the period 2013-2017 is performed. The main sources of investment financing and direct investment capacity are researched. Based on a historical review of trends in finding sources of financing of capital costs (own sources, capital transfers from the central government, local expenditures) and current legislation and tendencies in the public investment sector, the possibilities for increasing the number of sources of investment financing and the inter-municipal cooperation are analyzed. Alternative sources of financing are studied due to the increasing investment needs. In addition, the paper provides comparative overview of the ratio of local investment to public investment and local investment and GDP in Bulgaria and North Macedonia and a comparison with the EU countries. The possibilities for introducing new local taxes and alternative sources for capital funding, including expansion of the local debt financing market and inter-municipal cooperation are investigated.

The investment capacity of sub-national authorities is crucial for the absorption of EU funds. Regarding the infrastructure projects, municipalities must ensure own contribution (through own revenue, net operating balance or debt financing). Lack of sources for municipalities' own contribution hampers their participation in EU projects.

Introduction

Public investment and growing investment needs are subject of research by the World Bank, the European Commission, OECD, The European Investment Bank, IMF, NALAS, EBRD as well as by a number of academics. The investment needs are also in the focus of the Multiannual Financial Framework of the European Union, and public infrastructure is the basis for ensuring long-term economic growth, improving welfare, reducing poverty and providing better services and living conditions for the local residents. Adequate and sufficient infrastructure can generate high level of employment, expand national trade, contribute to industrial growth, facilitates trade, connectivity, and improve economic inclusion. (OECD, 2017). Adequate supply of infrastructure is an essential ingredient of economic growth and well-being (EIB, 2017). In addition, expansionary fiscal policy has a stimulating effect on the economic dynamics if it is realized through an increase in capital expenditure rather than a rise in current expenditure (Velichkov, 2016).

Worldwide, public investment costs are estimated at over \$ 2.5 trillion per year, and the most significant investment need is reported in the transport, telecommunications, water and energy sectors (McKinsey Global Institute). The investment needs of EU countries are estimated at over € 435 billion per year, with investment in the energy sector and renewable sources being the most significant investment, followed by investment in the transport and education sectors. At the European Union level, the share of infrastructure investment in terms of GDP is 1.8%, which is close to 20% below the levels recorded before the global economic crisis (EIB 2017). The challenge for the countries in the community is to restore the levels of public investment to pre-crisis levels (2.2% of EU GDP in 2009).

Local and regional authorities in the European Union are responsible for the implementation of a significant part of public investment, and the share of local investment in the total public investment is over 50%. Sub-national authorities in Southeast Europe also have a key

role in the investment process and the share of local investment is over 35% of the total public investment.

The investment needs of the SEE countries are different from those in the EU countries. The SEE's sub-national authorities spend more funds for building new infrastructure and rehabilitation of the existing one, while authorities in the EU spend more funds for maintenance of existing infrastructure and often costs are identified as operational (NALAS, 2018).

The purpose of the current research is to investigate the investment capacity of local authorities in Bulgaria and North Macedonia.

The selection of these two countries is not accidental - on one hand the countries have similar territorial division¹, share the same border and carry out joint local and regional projects under international programs. On the other hand, we have a member state of the European Union and a country, of Southeastern Europe, an EU candidate country. The present study will highlight key differences in the investment capacity of local governments and highlight similarities and differences in municipal finances of the two countries. Major challenge on this endeavor is the potency of the municipalities to employ fiscal transparency tools (Memeti, 2016).

To meet the above objectives, an analysis of the dynamics of capital costs for the period 2013-2017 is conducted. The main sources of investment financing and direct investment capacity are researched. Based on a historical review of trends in finding sources of financing of capital costs (own sources, capital transfers from the central government, local expenditures), current legislation and tendencies in the public investment sector, the possibilities for increasing the number of sources of investment financing are analyzed. Since the results show that the investment needs increase, the alternative sources of financing are researched. In addition, the paper provides comparative overview of the ratio of local investment to public investment and local investment and GDP in Bulgaria and North Macedonia and a comparison with the EU countries. The possibilities for introducing new local taxes and alternative sources for capital funding and inter-municipal cooperation are investigated. The investment capacity of sub-national authorities is crucial for the absorption of EU funds. Regarding the infrastructure projects, municipalities must ensure own contribution (through own revenue, net operating

¹ Although Bulgaria has a two-tier territorial division, the regions do not exercise local self-government.

balance or debt financing). Lack of sources for municipalities' own contribution hampers their participation in EU projects.

Data and methodological issues

The main sources of information for this research are EUROSTAT, the data base of the Ministry of Finance of Bulgaria and the Ministry of Finance of North Macedonia, the data base of the Network of Associations of Local Authorities of South-East Europe, the data base of the National Association of Municipalities in the Republic in Bulgaria, etc. We should point out that the revenue and expenditures, received and incurred as regards the European projects in Bulgaria and in North Macedonia, are not included in the study of direct investment capacity. The reason is that the goal is to explore the investment capacities of local authorities based on their own budget, financial independence and autonomy, as well as the impact of the fiscal decentralization process on municipal finances. Due to its specific characteristics, debt financing is not included in the calculation of direct investment capacity.

In order to compare the importance of the local public sector in both countries, commonly used indicators such as local revenue in the GDP, the share of local revenue in the public revenues, etc. were calculated. Attention is also paid to the dependence of the municipalities on government transfers and their importance in the financing of capital expenditures. The system of shared tax revenues in North Macedonia was studied. The methodology developed and presented by OECD was used as a basis for calculating the direct investment capacity indicator².

²Hulbert, C. and C. Vammalle (2014), "A Sub-national Perspective on Financing Investment for Growth I - Measuring Fiscal Space for Public Investment: Influences, Evolution and Perspectives", OECD Regional Development Working Papers, 2014/02, OECD Publishing. [Online] Available: <http://dx.doi.org/10.1787/5jz5j1qk8fhg-en>. (accessed March, 2019).

Territorial division of Bulgaria and North Macedonia

Bulgaria

The administrative-territorial division of Bulgaria is a two-tier division and has 28 districts divided into 265 municipalities (Administrative and Territorial Structure of the Republic of Bulgaria Act). The municipality is the main administrative territorial unit, where local self-government is being implemented. Districts are established in the capital and in the cities with a population of over 300 000. Districts can be established in cities with a population of more than 100 000 by a decision of the municipal council.

According to EUROSTAT requirements Bulgaria is divided into three reporting levels for statistics: NUTS 1 level – 2 regions; NUTS 2 level – 6 planning regions; NUTS 3 level – 28 administrative districts. Clear definition of the boundaries of planning regions is of utmost importance for the allocation of European funding. The regions with the lowest GDP per capita receive maximum EU funding.

According to the Local Self-Government and Local Administration Act, the municipality is a legal entity and is entitled to hold property rights and adopt an autonomous municipal budget. The activities of the municipal council, of the mayor of the municipality and the mayor of the district is assisted by the municipal administration. Local self-government is substantiated by the right and actual opportunity for citizens and their elective bodies to resolve on their own all issues of local importance that the law has empowered them to resolve in the fields of: municipal properties, municipal enterprises, municipal finance, taxes and fees, and the municipal administration; the planning and development of the territory of the municipality and the settlements therein; education; health; culture; public works and utilities; social welfare services; the protection of the environment and the reasonable use of natural resources; the maintenance and conservation of cultural, historical and architectural monuments; the development of sports, recreation and tourism; protection from disasters. Citizens participate in the governance of the municipalities either through their elective bodies or directly by means of a referendum or a general assembly of the local community.

The Municipal Council is a body of local self-government, and is elected by the population of the municipality under terms and procedures provided for by law

The Mayor is a body of the executive branch of government in the municipality. The bodies of the executive branch of government in the district and the mayoralty shall be the district mayor and the mayoralty mayor. The Municipal Council adopts an autonomous municipal budget, different from the State Budget, on the basis of its own sources of revenue and subsidies from the state, allocated among municipalities according to criteria determined by law.

According to the Public Finance Act the municipal budget should include revenue from: local taxes - as per conditions, procedures and ranges laid down by law; fees - as per conditions and procedures laid down by law; services and rights granted by the municipality; disposal of municipal property; fines and pecuniary sanctions; interest and penalties; other proceeds; aid and donations. Expenditure for activities delegated by the state and for local activities, as well as cross-functional expenditure according to the single budget classification for: staff; subsistence; interest; household benefits and compensations; current subsidies; capital expenditure.

The expenditures of the municipality are made to cover local needs, as well as for such needs which may arise in the performance of state functions. The costs for the performance of state functions are covered by the State Budget. The Municipal Council may give financial assistance to municipal enterprises and companies with municipal participation whose operations address the needs of the community.

Municipalities may cooperate with each other, with regions, with legal or natural persons and establish associations which would achieve objectives of mutual interest and to which the implementation of activities stemming from their powers would be assigned. Municipal cooperation shall aim at improving the quality of administrative services, providing public services to the population and contributing to the development of the respective areas through efficient use of existing resources (Local Self-Government and Local Administration Act).

North Macedonia

Local government is one of the fundamental values of the constitutional order in the Republic of North Macedonia. The Constitution contains a set of provisions that define the concept of local government, ensure the independence of municipalities in the exercise of their powers, and the specific status of the City of Skopje as the capital city of the country. The Republic of North Macedonia has a single level local government. Under the Law on Territorial Organization of Local Government in the Republic of Macedonia («Official Gazette» no. 55/04; 12/05; 98/08; 106/08; 149/14), local government in the Republic of North Macedonia is territorially organized into 80 municipalities and the City of Skopje as a separate Local Government Unit, which results from the character of the City of Skopje as the capital city of the Republic of North Macedonia. 34 Local Government Units are based in cities, while the remaining 46 are based in villages. All municipalities, except a few, have areas with several settlements. Municipalities perform their responsibilities through bodies elected directly by the citizens for a term of four years. Municipal bodies include: the Council and the Mayor. The Municipality may establish forms of local government, such as: in cities - urban communities; in villages - local communities.

Municipalities are responsible for activities in the following areas: urban (urban and rural) planning, the issuance of permits for construction of buildings of local importance as established by law, landscaping and construction land development; environment and nature protection; local economic development; utilities; culture; sport and recreation; social welfare and child protection; primary and secondary education; health care; protection and rescue of citizens and goods; fire protection; and other statutory duties.

Municipalities perform their responsibilities through their municipal administration by establishing local public enterprises and public institutions, and they can also delegate the performance of certain activities to other legal entities or individuals, based on a contract for execution of works in the public interest, in accordance with the law. For more efficient and cost-effective performance of their powers and in order to achieve their common interests and goals, two or more municipalities can establish inter-municipal cooperation.

Macedonia has adopted the Nomenclature of Territorial Units for Statistics (NUTS 3 level) and created eight statistical regions: Vardar, East, South-West, South-East, Pelagonija,

Polog, North-East and Skopje. Regions are not political and administrative units but serve as main units for development planning. Moreover, they have been assigned the role of planning regions entitled for planning process and implementation of a consistent regional development policy and for harmonization with EU regional policy. Each of the planning regions has a Centre for development established for the purposes of carrying out professional tasks relevant for the development of that particular region.

Fiscal indicators in Bulgaria and North Macedonia

Revenue decentralization has a significant impact on the ability of local authorities to invest. When municipalities have revenue power, they can spend more funds for capital costs.

One of the main indicators by which revenue decentralization can be estimated is: local revenue share in the public revenue and local revenue share in the GDP.

The values of the first indicator show the role and importance of the municipalities in the public sector, and the second provides information on the role and importance of the local public sector in the economy of a country.

In addition, since the focus of the research is on investment costs, the local investment costs as compared to the GDP and local investment costs as compared to the total local costs are investigated.

The aim is to highlight similarities and differences between Bulgaria and North Macedonia, between the average indicators in SEE and the EU.

Table 1. Fiscal indicators

2017	Bulgaria	North Macedonia	SEE	EU
Local revenue in GDP	6.60%	4.80%	5.90%	10.70%
Local revenue in Public revenue	18.50%	14.60%	17%	23.50%
Local investments costs in local government expenditures	18%	22%	21%	11%
Local investment as % of GDP	1.10%	1.10%	1.20%	2%

Source: NALAS data base

The share of local revenue in the GDP is the lowest in North Macedonia, but the difference between the average values for the SEE and North Macedonia is smaller than the difference between the average values for the EU and Bulgaria. There is a strong centralization

of tax revenue in Bulgaria, which in turn influences the value of local revenues and their share in the GDP.

Local revenue share in the public revenues in Bulgaria and North Macedonia is close to the EU and SEE average. The share of local investment in the GDP is the same for Bulgaria and North Macedonia and is about one-time lower than the EU average, but close to the average for SEE.

The results for the indicator share of local investment costs in the total local expenditures is interesting. Since the values of Bulgaria and North Macedonia surprisingly are above the EU average. There are several reasons for this. In SEE local authorities pay their investment costs directly from their budget, while in Europe, investment costs often go through utility tariffs.

The SEE and the EU investment needs are different - while in SEE the expenditure is mainly for new infrastructure and rehabilitation of old infrastructure, the EU expenditure is mainly for ongoing repairs of existing infrastructure. However, other indicators show that Bulgaria and North Macedonia report values of the main indicators below the EU and SEE average, which in turn supports the relevance of the research question.

Estimation of sub-national government direct financing capacity

For the purposes of this report, for the calculation of the investment capacity of the municipalities in Bulgaria and Macedonia, we have used an indicator known in practice and presented in a recent OECD – Direct investment capacity indicator. This indicator measures the funds readily available for investment without need for reforms or policy changes, and prior to issuing debt. Direct financing capacity (DFC) does not necessarily reflect the funds that will actually be used for public investment. Indeed, this surplus can also be saved or used to transfer noninvestment capital to households or public companies (for instance, finance the deficits of local public enterprises). But it is a measure of the available funds that could potentially be used for public investment without changes to other policy settings(OECD, 2014, p.14).

The indicator does not cover options for using debt financing and its purpose is to take into account the opportunities provided by the municipal budget to finance capital expenditures.

This indicator is defined as:

Direct financing capacity = current surplus + capital transfers received

Current surplus = Own revenues – expenditures for financing local activities;

Own revenues = revenues from taxes received + user fees + current transfers;

Expenditures for financing local activities expenditures = staff costs + social benefits and other transfers + interests paid + other operating expenditure

Sub-national government direct financing capacity in Bulgaria

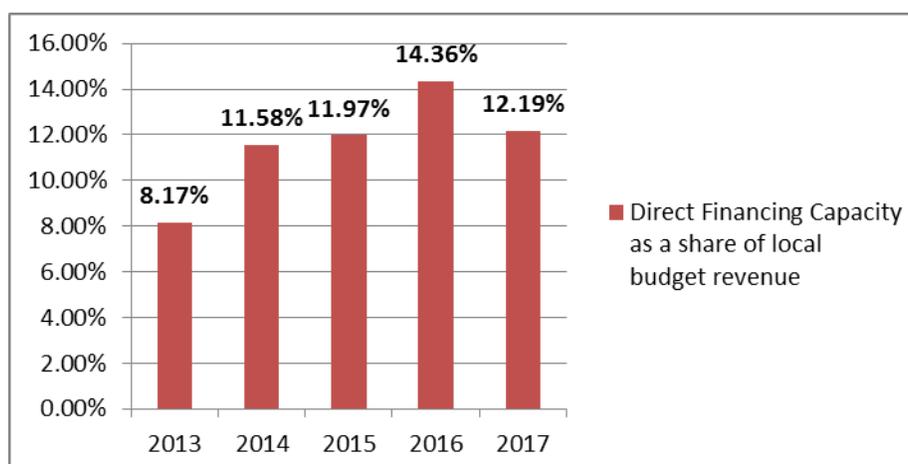
In Bulgarian case, own municipal revenue includes local tax revenue, income from municipal fees, concessions, fines, sanctions and penalty interest, sale of municipal property and the total amount of funds from the general equalizing grant. The equalizing grant must provide unconditional financial aid to municipalities for delivering local public services and to equalize their fiscal capacity.

Current expenditure includes the expenditure under the control of local government, i.e. spending on local activities. Current spending on state delegated activities covered by centrally provided financing in the form of grant and out of local governments' control is not included in the calculation.

The total amount of that grant is determined annually on the basis of accepted standards for state delegated activities with natural and value indicators. Local authorities can influence the determining of the amount of that grant to a very low extent and can submit proposals for changes through the National Association of Municipalities in Bulgaria during the discussions on the draft budget for the respective year. The funds from the general grant for state Bulgarian municipalities' capacity to invest and factors delegated activities can be spent in a strictly targeted manner and cover costs, with a major share of spending concentrated on education, as well as on salaries and social security and health insurance contributions. (Nenkova, Kalcheva, 2018, p. 145).

The indicator Direct Financing Capacity is calculated based on total revenue and expenditure in local sector in Bulgaria. It is present comprehensive picture for investment capacity based on current surplus and capital transfers received in the budgets of 265 municipalities.

Graph 1. Evaluation of sub-national government direct financing capacity for 2013-2016



Source: Ministry of Finance data on consolidated fiscal program (2013-2017), Annual Reports on State Budget Execution; own calculations

The level of direct investment capacity has increased during 2013-2016. The main reasons for this tendency are: the increase in the net operating balance, and the record high amount of capital transfer, which is reported in 2014 (2.5 times higher than in 2013).

The highest level of the indicator has reported in 2016, when the local tax revenue rose by 16% and local non tax revenue rose by 5%. The current expenditure did not report significant changes. This in turn leads to an increase of the net operating balance and increase of the investment opportunities of the municipalities.

In 2017, the level of direct funding capacity decreased by about 2%, due to a minimal increase in own revenues and an increase in total budget revenues.

The main determinants of the direct investment capacity can be separated and analyzed in two main directions – revenue side and expenditure side.

Direct financing capacity for North Macedonia

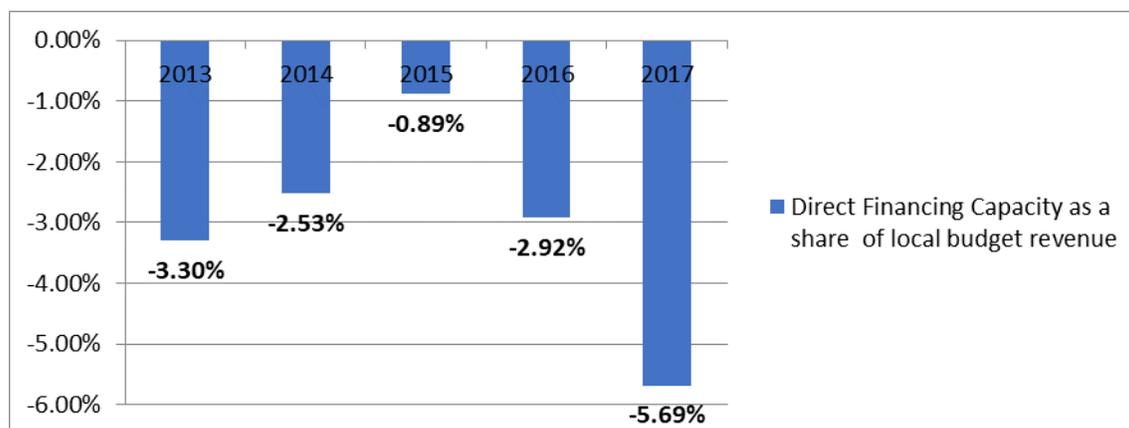
Several determinants ought to be considered when assessing local budgets in Macedonia. First, legislation obliges the LSGU (local self-government units) to divide their budgets into both operational and capital. The operating budget must be balanced and the difference between current revenue and expenditure should be zero. In practice, this obligation is not being respected. The capital budget covers revenue that is determined by law, and can be used to

finance investment costs. The capital budget includes: revenue from local taxes and fees, proceeds from the sale of property, revenue from general transfers and capital transfer revenues and all costs incurred in investment direction.

Second, the budget form for reporting local revenue and expenditures of municipalities in North Macedonia is also separated to a budget for the respective year, grants, self-financing activities, donations and loans. The following Graph (Graph 2) presents the calculation of the direct investment capacity for LSGU in North Macedonia for the period 2013-2017.

The indicator Direct Financing Capacity is calculated based on total revenue and expenditure in local self-government units in North Macedonia. It represents overview that exemplifies the deficit of investment capacity based on current and capital transfers received in the budgets of 80 municipalities plus the city of Skopje.

Graph 2. Evaluation of Local Self-government units direct financing capacity for 2013-2017



Source: Ministry of Finance, Annual Reports on State Budget Execution 2013-2017; own calculations

A contrary to Bulgaria, in the LSGU in North Macedonia have negative operating balance. Moreover, direct financing capacity exemplifies that the LSGU in North Macedonia lack of capacity for capital investments in the local infrastructure and local community.

The highest deficit is vivid in 2017, and this is the case to the fact capital revenues declined by 42.21% in the period 2013-2017 and the share of the capital revenues was lowest in the 2017 with only 4,12%.

In the other hand the lowest deficit is 2015, due to the fact the LSGU had reached the pick from non-tax revenues which are 15% higher than in 2013, similarly capital revenues in

2015 were 39 % higher than in 2017 Municipalities in North Macedonia are heavily dependent on the central government capital investments via programs of specific Ministries (Ministry of Education, Ministry of Transport and Communication, Ministry of Labor and Social Welfare, Ministry of Culture), which creates avenues for political turmoil and dissatisfaction of the LSGU when are governed by opposition parties who argue that central government does not have fair approach in distribution of capital dotations.

Next section describes the main determinants of the direct financing capacity ratio (for Bulgaria and for North Macedonia) and how each of them has evolved in 2013-2017 period.

Investigation of determinants of the investment capacity at local level

In order to understand better the nature of the investment capacity of Bulgarian and North Macedonian municipalities, we need to analyze and evaluate various determinants, which are important for capital expenditure. Own revenues were assessed focusing on the nature of tax revenues, transfers from the state and the composition of municipal expenditures. Key similarities and differences between the local finance systems in both countries are highlighted.

Local Revenue

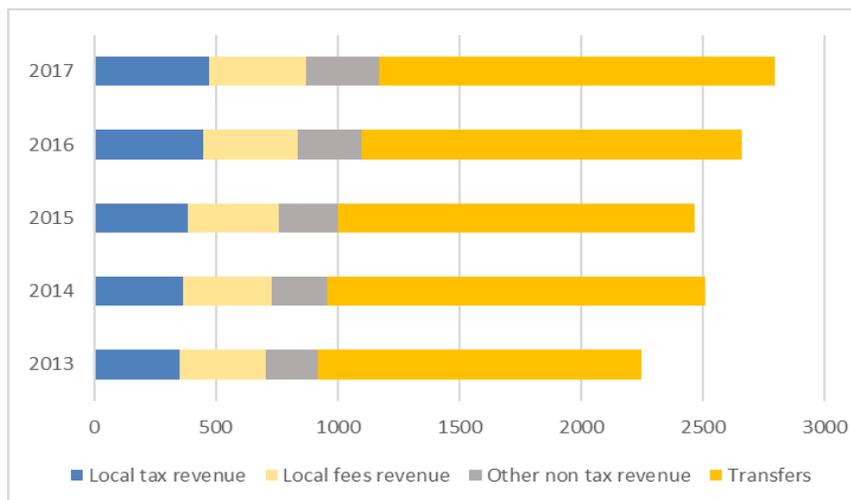
Bulgaria

All revenue components of DIC — own revenue, general equalising grant and capital expenditure grant affected capital spending at local level in Bulgaria in the period under review. Although the reform leading to fiscal decentralization in Bulgaria started more than 15 years ago, local authorities are still heavily dependent on state transfers. During the survey period, transfers amounted to between 58-62% of municipal budget revenues. However, a small part of these subsidies is used according to decisions of the municipal administration. The major part of the municipal transfers is used for financing of state delegated activities (at the end of 2017, 76% of the total amount of state transfers are used for financing state delegated activities). This shows the targeted nature of the funds and the reduced financial opportunities for investment costs. The subsidy for financing capital costs accounts for only 8% of the total amount of transfers.

Local taxes` revenue accounts for 15-17% of municipal revenues, with a gradual increase of their share during the survey period. The improved tax collection rate and increase of the amount of property tax in some of the municipalities in Bulgaria justify this observation. Local fees

revenue is between 14-16% of the local revenue, but a significant part of it is targeted and can not be used to finance local capital expenditures. Other non-tax revenue, which is a source for capital investment costs, accounts for 9-11% of the local revenue.

Graph 3. Structure of municipal revenue for the period 2013-2017 (in million euro)



Source: Ministry of Finance data on consolidated fiscal program (2013-2017), Annual Reports on State Budget Execution; own calculations

The main reason for the dominant share of central government transfers is the tax base centralisation as a result of which municipal tax revenue stands at a mere 3% of consolidated tax revenue of the total public sector tax revenue (EU average - 16.1 %). In the Southeast European countries, on the average, 22 % of the municipal revenue is accruing through shared or assigned tax revenue (NALAS, 2017, p. 24). At present, local governments in Bulgaria do not receive shared tax revenue and this has a negative impact on the volume of tax revenue included in the municipal budgets.

North Macedonia

Similar to the situation in Bulgaria, revenue from state transfers is also dominating in the total local revenue in North Macedonia. The revenue from state transfers is between 62-65% of the total local revenue.

In the period 2013-2017 the share of revenues from transfers and donations consists of 61.41% of total revenues in 2013 and 64.2% in 2017 (an increase of 15.48% in 2017 comparing with 2013).

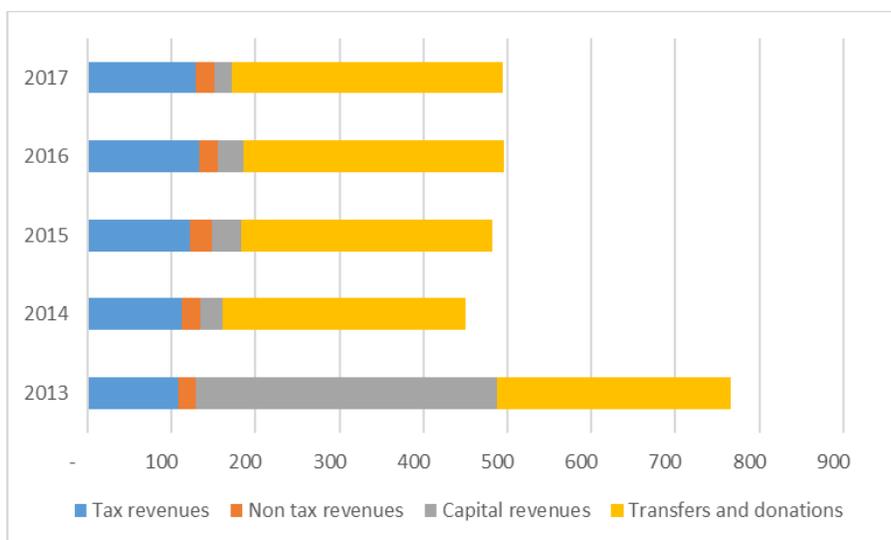
The second largest source of revenues are taxes with a range of 23.9% -26.2% in the period 2013-2017. It ought to be emphasized that tax revenues have highest nominal increase in the revenue side with an increase of 18.97% for the period 2013-2017.

Non-tax revenues increased by 7.35% in the period 2013-2017 and consist of only 4.27% of total revenues in 2017.

The capital revenue includes revenues for financing investment projects based on program established by the Government of the Republic of Macedonia. Investments in specific sectors are managed by the competent Ministries and Fonds who are responsible for allocating the finances and monitor the process of implementation of the investment projects. Beside this component, capital revenues encompass revenues from transactions of privatization (selling) of local infrastructure (land, property...) which is unstable and unpredictable source of revenue for LSGU in Macedonia. It ought to be noted that capital revenues declined by 42.21% in the period 2013-2017 and their share decreased from 7.88% in 2013 to 4.12% in 2017.

Privatization of the local infrastructure may be one of the reasons that percentage of capital revenues is higher in 2013 compare with years to follow. Most of the revenue from transfers is defined as target and do not finance capital expenditure (with an exception of VAT).

Graph 4. Structure of municipal revenue for the period 2013-2017 (in million euro)



Source: Ministry of Finance: Authors calculation

It should be emphasized that total revenue includes VAT which represents a dotation for financing the competences of the LSGU in the Republic of Macedonia. . Put it differently, VAT revenue is part of the total subsidy, which is allocated by formula (4.5% of VAT) according to certain benchmarks and criteria.

Municipalities are eligible of obtaining 3% income tax of the salaries of the natural persons if they are paid in the municipality where person has residence and 100% of the income tax of natural persons if working in the craft industry.

Non-tax revenues are about 5% of municipal revenues and consist mainly of administrative fees, fines and compensation.. The data presented in the graph show that the investment opportunities of the municipalities are decreasing on the basis of the local income trends during the research period.

Tax revenue

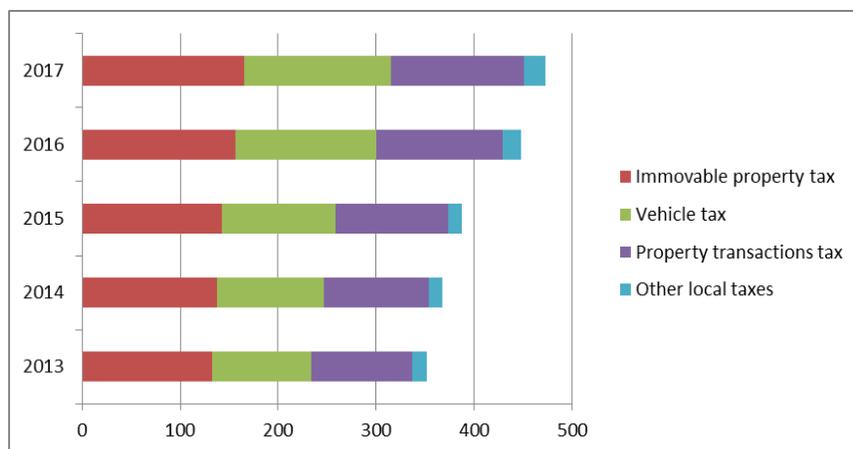
Local tax revenues are traditional sources for financing local investment expenditures. Significant tax revenues testify to good fiscal autonomy and a high level of fiscal decentralization.

Bulgaria

The local taxes of fiscal importance in Bulgaria are as follows: immovable property tax, Vehicle tax, Property transactions tax. Local taxes are also the tourist tax, donation tax, tax on

taxi transportation of passengers and patent tax. Revenue from other local taxes accounts for only 5% of local tax revenue.

Graph 5. Structure of the tax revenue for the period 2013-2017 (in million euro)



Source: Ministry of Finance, Annual Reports on State Budget Execution (2013-2017); own calculations

The immovable property tax ensures steady receipts which continue to grow over the years and has a leading share in municipal tax revenue having a share of 38% of the local tax revenue. The property transactions tax revenue is on the opposite, it's highly sensitive to changes in the economic environment. The vehicle tax is another local tax that brings significant yields for municipal budgets - 32% of the local tax revenue. Due to the efforts of municipal tax administrations to increase revenue collection rate, increases in rates and fewer exemptions, the receipts from this tax have been steadily rising over the years.

The employees of the municipal administration were given the powers of public enforcement agents in connection with liabilities under the Local Taxes and Fees Act. So, the collection rate of proceeds from fines, penalties and default interest improved which increased the tax revenue. Nevertheless, the share of this own-source revenue in the overall increase of the total municipal revenue is insignificant.

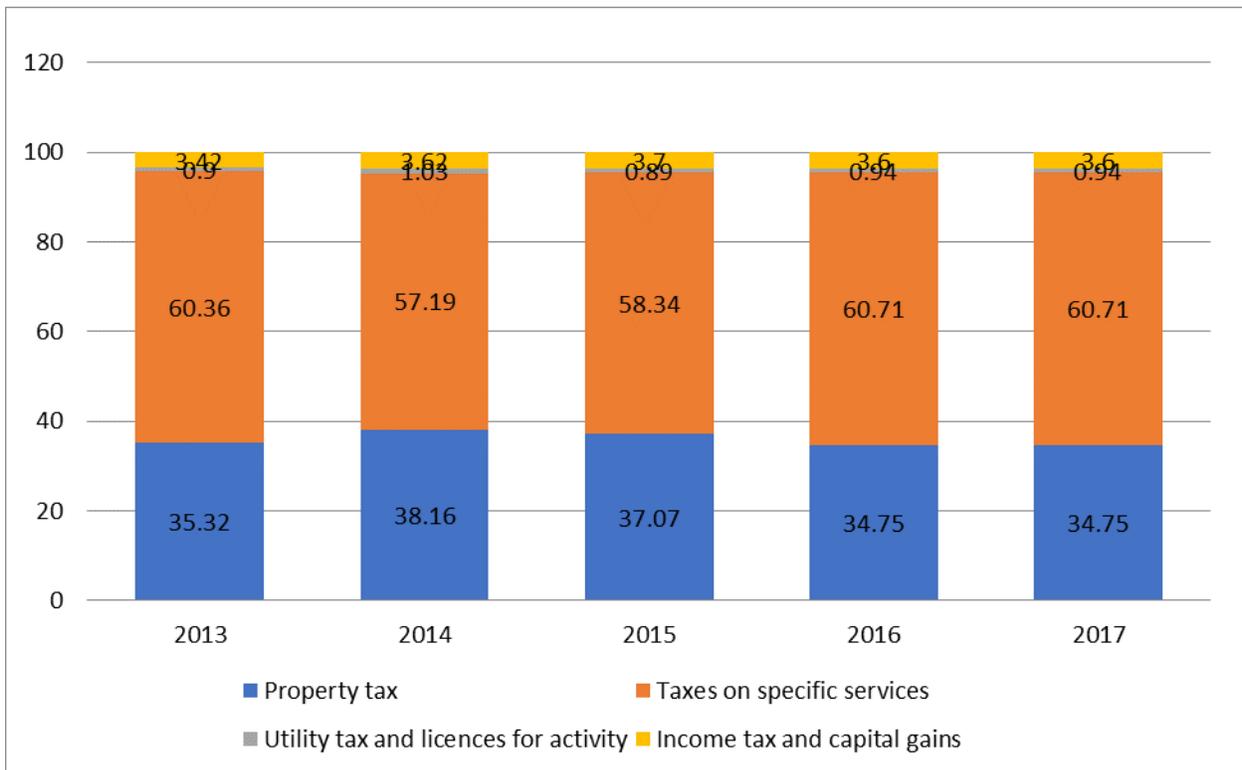
North Macedonia

The local taxes with fiscal importance in Macedonia are as follow: income tax, property tax, tax on specific services, utility tax, licenses for activity. Total tax revenues are increased by 21.80%. There are increase in the income tax and profits and capital gains by 28.32%, property

taxes are increased by 19.83%, however taxes on specific services are decreased by 22.50%. When analyzing the structure of the local tax revenues, taxes on specific services make up 59.94% of total tax revenues, property taxes are 35.28%, income tax on profit and capital gains consists 3.96%, while income from user fees or licenses for performing activities is 0.82% of total tax revenues.

Taxes of specific services encompass communal taxes and fees, as well as fees for arranging construction land and utility bills. It ought to be noted the decreases of the tax of specific services atests that this tax does not have stable revenue yild . At the same time, increase of the revenues in the property tax exemplifies that the local authorities have improved tax collection capacity.

Graph 6. Structure of the tax revenue for the period 2013-2017 (in million euro)



Source: Ministry of Finance: Author's calculations

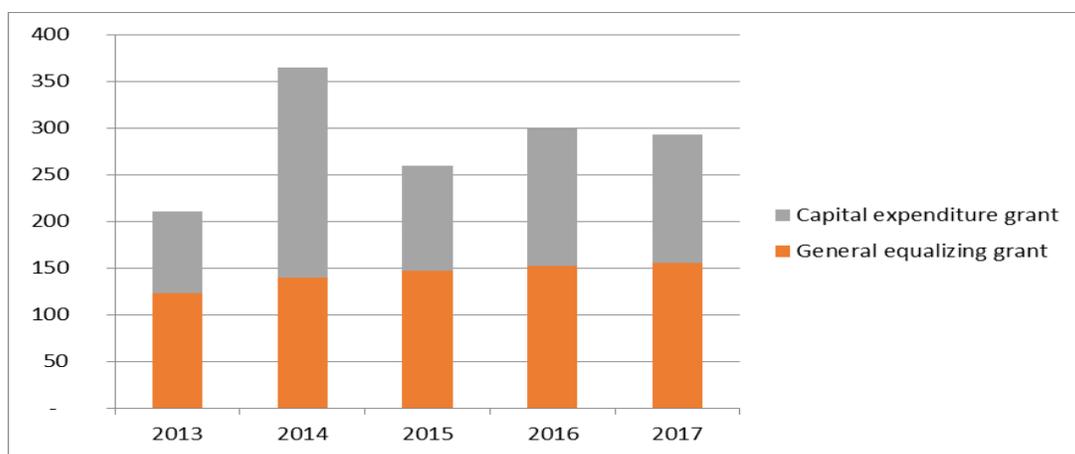
Revenue from tax property reach are in the range 35-38%. Their change is determined by the fiscal capacity of the local authorities to create data base of the properties in the municipality and more aggressive approach to collect this tax. Income tax and and capital gains represents 3,7% of local taxes.

Transfers – general equalizing grant and capital expenditure grant

Bulgaria

The general equalising grant affects local capital spending insofar as its growth, all other things being equal, has a positive effect on municipal current budget balance and results in an increase in DIC. The aim of this transfer is stipulated by law – to ensure that each municipality achieves a ‘minimum level’ of local services provision and local governments have full discretion as to the manner in which the transferred resources are spent for delivering local public services. Since the equalising grant is formula based, and its minimum amount cannot be lower than 10 % of the figure shown in the report on own revenue of all municipalities for the previous year, local governments are protected to some extent from an unexpected decline in the amount of the transferred funds.

Graph 7. Revenue equalizing grant and capital expenditure grant for the period 2013-2017 (in million euro)



Source: Ministry of Finance, Annual Reports on State Budget Execution(2013-2017); own calculations

In comparison to other types of central government transfers, capital transfers, which affect directly local capital spending and which are earmarked, are the most volatile element. In 2014

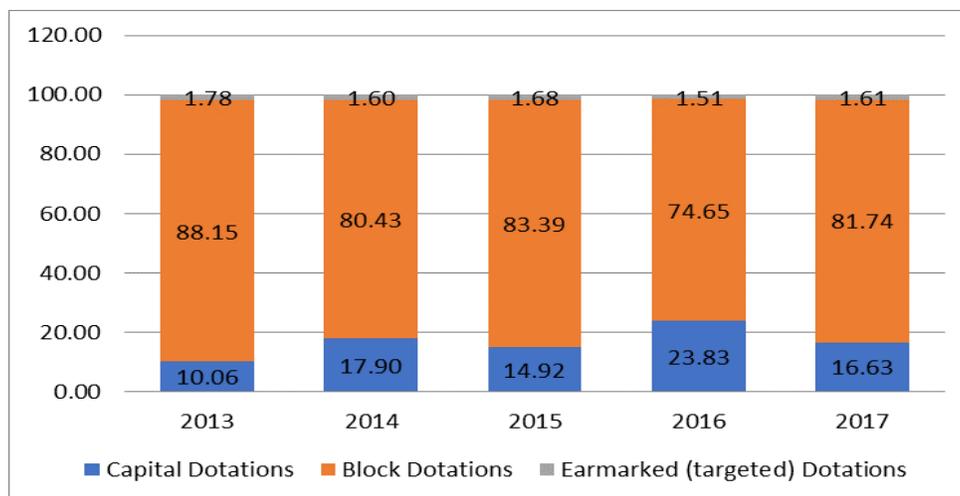
revenue from the capital expenditure grant considerably increased due to the additional funds provided for overcoming the natural disasters of the previous year and those received under the government investment programme “Growth and Sustainable Development of the Regions”. Even though the capital expenditure grant increased by about 30 % in 2016, it remained below the 2014 levels. In 2017 the capital expenditure grant remained at levels close to the levels of the previous year. Often, according to a decision made on an ad-hoc, discretionary basis, local governments in Bulgaria increase their opportunities to invest due to the additional funds received through capital transfers. So they are able to cover urgent infrastructure needs such as road rehabilitation. But the sustainability of the capital programmes, the forecasting and planning are disrupted since the ad-hoc capital transfers cannot be incorporated into the municipal budget plans for the current year.

So, state transfers need to be approached with some reservations although they are intended to cover capital expenditure needs and contribute significantly to the increased investment capacity of local governments. On one hand, the state can finance large investment projects of local importance and support the infrastructure development in a local community, but, on the other hand, transferred resources can undermine local initiative and limit the ability to meet specific local investment needs of which the central government is not aware.

North Macedonia

The share of capital transfers in Macedonia is on a range from 10,06% (2013) and 23,86% (2016), this exemplifies that municipalities are heavily dependent on the central government in the area of capital investments. In terms of dotations, it ought to be noted that two types of dotations Macedonian systems envisages: block dotations that imply financing a competence such as education (primary and secondary) child and social protection (kindergartens and elderly homes) and culture. In the other hand, earmarked transfers encompass financial support for specific activities in the area of fire protection and education in the municipalities which are in phase one of the fiscal decentralization.

Graph 8. Revenue equalizing grant and capital expenditure grant for the period 2013-2017 (%)



Source: Ministry of Finance: Author's calculations

The bulk of the block donations are in the area of primary education (60,26%) and secondary education (28,54%) and only 9.29% of donations are in the area of child and social protection (kindergartens).

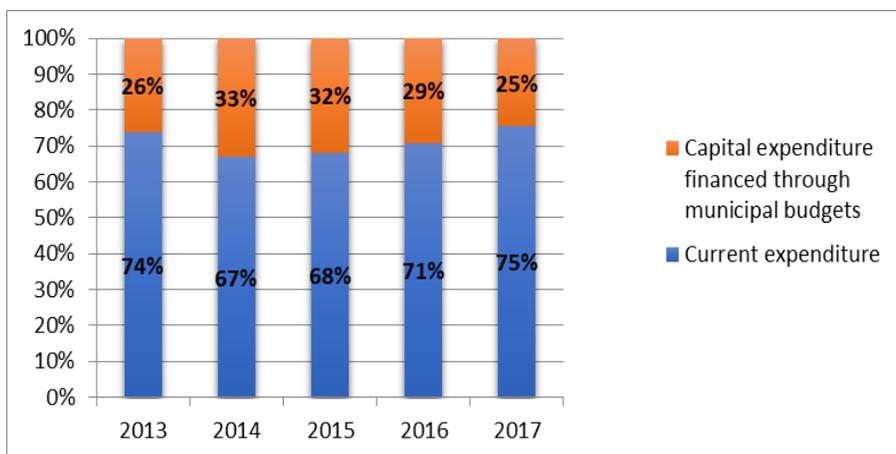
Local Expenditure

The structure of local expenditures has a significant impact on the local investment capacity. Assuming that municipalities have to make urgent current expenditures, such as wage refinancing or emergency costs for repairs, they will not have sufficient resources for investment costs.

Bulgaria

In Bulgaria, capital expenditures account for between 26% and 33% of local spending. The largest share of investment costs is observed in 2014-2015. The main reason for this is the end of the implementation period of EU projects and the municipalities' compulsory in the projects. Local taxes and fees provide the funds for municipalities' own contribution to the EU projects which affects the structure of local spending. This effect is clearly visualized in the graph.

Graph 9. Local government expenditure for the period 2013-2017 (% of local expenditure)



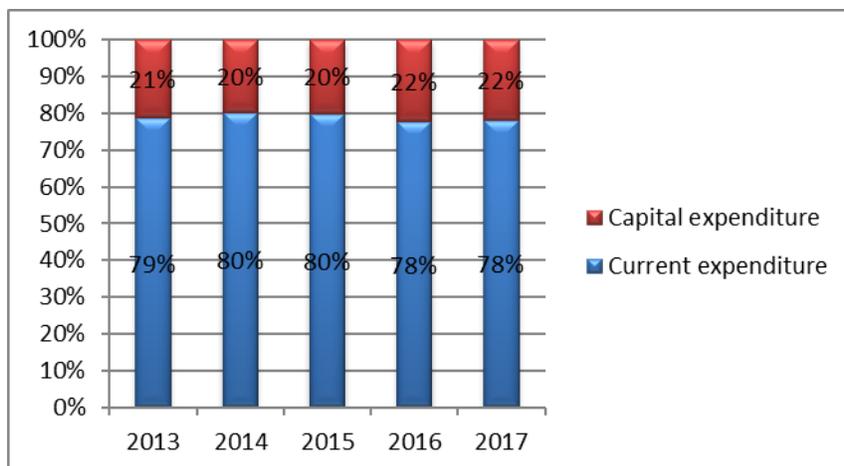
Source: Ministry of Finance, Annual Reports on State Budget Execution (2003-2017);NAMRB Internet platform; own calculations.

Current costs predominate in the local spending, reaching 75% in 2017. The reason for this is the lack of funds for the mandatory investment costs EU projects, increased current maintenance costs and operating costs for ongoing repairs.

North Macedonia

The share of capital expenditure in the local expenditures is between 20-22%. Excluding the peak values of the indicator for Bulgaria, the share of investment expenditures relative to local expenditures is relatively close to the values reported for Bulgaria. Higher capital expenditure in Bulgaria is explained by higher capital transfers, higher financial capacities of wealthier municipalities, and the relatively greater tax autonomy. One of the reasons for higher investment expenditures of the municipalities in Bulgaria is the possibility to implement a number of EU projects .

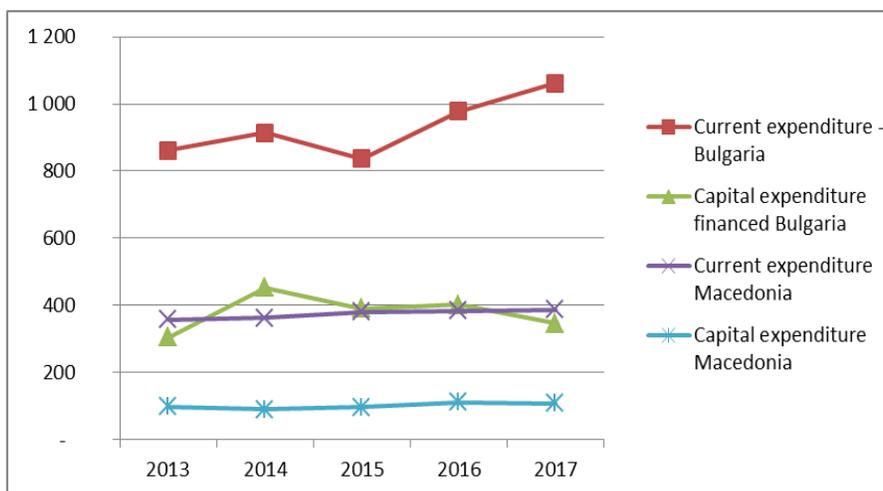
Graph 10. Local government expenditure for the period 2013-2017 (% of local expenditure)



Source: Ministry of Finance: Author's calculations

Additional funding for investment purposes must be secured in order to increase the share of capital expenditures in the municipal expenditures. Given the nature of current expenses and the impossibility of avoiding or significantly reducing them, the investment costs can hardly increase their share in municipal expenditures. This can happen, for example, if the state intervenes and provides additional investment-oriented resources.

Graph 11. Trends in local expenditures (in million euro)



Source: Ministry of Finance, Annual Reports on State Budget Execution (2013-2017);NAMRB Internet platform; own calculations.

As can be seen from the data presented in the graph, operational costs are of high priority in both countries. The capital expenditures of local authorities in North Macedonia are lower than those in Bulgaria. The main reasons for this are enormous operating costs of the municipalities for salaries and compensation. For, illustration, in Macedonia 48% of the total expenditures of municipalities are expenditures for salaries and compensation, which is significantly higher than SEE countries (32%) and EU (33%). However, in both cases, Bulgaria and North Macedonia have seen a significant prioritization of operating costs at the expense of investment over the entire period analyzed.

Possibilities and solutions for growth of the investment capacity of Bulgarian and North Macedonian Municipalities.

The opportunities for increasing of tax revenues of the municipalities in Bulgaria and North Macedonia are: the introduction of tax surcharge on the income tax on employment relationships of individuals or the sharing / assignment of part of the revenues from the PIT (not only those from the craftsmen in case of North Macedonia), refinement and optimization of the real estate tax revenues, introduction of new taxes, such as agricultural land tax.

PIT tax surcharge

One of the possibilities for increasing tax revenues of the municipalities is the introduction of additional rates on the PIT – tax surcharge. Given the tax system in Bulgaria and the concentration of jobs in large municipalities (a practice of maintaining a permanent address in smaller municipalities is observed), it is appropriate to impose them on the basis of the place of employment. EU countries where local authorities are allowed to impose additional tax rates are

Belgium, Croatia Italy, Denmark, Norway, Sweden, Finland, Iceland³. Additional local tax rates may be levied by local and regional authorities in Italy and the Scandinavian countries.⁴

Shared tax revenue

Sharing of revenues from the PIT is an opportunity to raise the level of tax revenue in the budgets of the Bulgarian municipalities. This approach will not increase the tax burden on the local population, but the state will be deprived of part of its revenue. The percentage of sharing depends on the state policy and national priorities. Such practices are observed in almost all SEE countries.

Local and regional authorities in twenty EU countries also receive shared tax revenues. They account for 43% of local and regional tax revenue and 20% of total local and regional revenues⁵. Fifteen EU countries share income tax revenue, VAT revenue is shared in six countries, corporate tax revenue is shared in nine countries⁶. Unlike North Macedonia, tax revenues are not shared in Bulgaria. In the case of Bulgaria, the introduction of shared taxes would be a good opportunity to increase resources for investment costs. . In the case of North Macedonia, VAT represents a dotation for financing the competences of the LSGU in the Republic of Macedonia. VAT revenue is part of the total subsidy, which is allocated by formula (4.5% of VAT) according to certain benchmarks and criteria. In the analyzed period, the share of tax revenues in municipal revenues increased to 18%. The main reasons for this are related with the increase of the base of VAT (from 3% at 2005, in 2018 municipalities receive 4,5% of VAT) increased capacity of the central government for collecting VAT, increased capacity of municipal authorities for collecting local taxes.

Optimizing the real estate tax revenue

Property taxes are typical local taxes because the tax base is not mobile, which makes it impossible to export the tax burden. In addition, property owners are, as a rule, users of public goods produced at regional level, the tax is in line with the principle of consumption according to the benefits received. However, these types of taxes are visible and any increase leads to a

³ EUROSTAT, Taxation and customs Union, "Taxation trends in the European Union, 2014

⁴ For more information: European Commission, Report on Public Finances in EMU 2012: Chapter IV Fiscal decentralization in the EU - main characteristics and implications for fiscal outcomes, 2012

⁵ Central government shares tax revenue with local and regional authorities in Austria, Lithuania, Latvia, Estonia, Romania, Czech Republic, Greece, Hungary, Poland, etc.

⁶ Dexia, Sub-national Governments in the European Union - Organizations, responsibilities and finance, July 2008, p.6

negative attitude of the local population towards the local government. Property tax revenue can be increased by: changes in the tax base, incl. updating of the property tax assessment and bringing it closer to the market value of the property in Bulgaria. In North Macedonia, when paying a property acquisition tax, the tax base should be its market value, it is essential to increase a capacity for registration of the properties in the municipalities and fiscal capacity of administration for control and monitoring of debtors and in other hand having in mind that existing legislation allows municipalities to decide upon the tax base in the range of 0,10% to 0,20% and encourage the municipalities to increase the tax base to the max 0,20% of the value of the property.

Introducing new local taxes

An example of introducing a new local tax is the land tax. The implementation of this tax in Poland⁷ shows good results, and substantial tax revenues were generated for the local budgets due to this tax. The tax base is determined by the central authority and the tax is paid by the owners of agricultural land, whether they possess the land or rent it. In order to be subject to taxation, the property should be larger than one hectare. When determining the rate, criteria such as soil quality, water bodies, adjacent buildings and location are taken into account.

The fiscal function of the land tax is unlikely to be of great importance to Bulgarian municipalities, but the tax serves to encourage the productive use of the land. The fiscal positions of the regions can be equalized by implementing this tax because major part of the revenues will go to the budgets of the poorer agricultural municipalities. The rates can be determined individually by the municipal councils within the minimum and maximum limits set by law. According to NAMRB estimates, after introducing such a type of levy the revenues amount to BGN 30 million.

Other proposal for North Macedonia

In the North Macedonia, fiscal mechanisms ought to address the disparities between municipalities, increase the potency for effective delivery of services to the citizens. There is need for one solidary fund for the municipalities and one for the central government. The municipal solidary fund would be created by allocating 100% of PIT to municipalities, but the urban and the other well-off municipalities to transfer 70% of these resources in the equalization

⁷ Shah, A., Local Governance in Developing Countries: Local Government Organization and Finance: Poland, p.313

fund which would then be allocated to the municipalities which need it based on criterion. The central government ought allocate additional 2% of the VAT for horizontal and vertical equalization between municipalities.

With regard to capital grants and investment programs, the existing investment programs should be transformed into capital grants based on an objective distribution formula; one of the criteria would be the average municipal capacity for local revenue collection (average tax base) and the municipalities with below-average capacity (weaker tax base – smaller population and less economic activity, which nonetheless make fiscal efforts for obtaining more resources of investment should have priority to municipalities with above-average capacity for own revenue collection (stronger tax base). This would imply transforming capital investments into unconditional capital grants with an equalization factor for the ULSG, so that each ULSG has at disposal resources for reconstruction or upgrading of the existing facilities in the respective areas, or for construction of new facilities in accordance with their specific and priority needs.

In North Macedonia, revenue model have provided municipalities with varying levels of revenue bases. Some municipalities generate high levels of revenue while others can hardly pay their essential administrative costs from their own revenue. In 2018, the debt of the municipalities has reached more €250 million. In October, 2018 the Parliament adopted a Law for financial support of LSGU, providing the way for payment of 51% of old debts of the municipalities. The current general-purpose grant (VAT) does not address differences in own-source revenue capacity. Due to these factors, differences in level of services and available resources at the municipal level abide. Significant number of municipalities are endowed with low revenue capacity creating a lasting dependence on central transfers for local service provision and this investment capacity is distant proposition. Even in the city Skopje which has unparallel economic potential compared with other LSGU, own source revenues are not sufficient to cover their total expenditures.

Moreover, the bulk of the local revenue derived from an unstable source- tax on specific services (property construction permits and the property transfer tax). Sustainable local revenue source should be linked to the benefits of local government services and have a stable revenue yield. This can be done by introducing tax surcharge or shared tax revenue (for North Macedonia expanding the types of shared revenue). An additional fiscal space can open through

improvement of tax revenue collection and updating the tax bases of property, introducing new local taxes or expanding the access to international programs and funds.

Improvement of the access to international funds - Interreg IPA CBC Bulgaria North Macedonia - Evaluation of cooperation of Bulgarian and North Macedonian municipalities

Bulgaria and North Macedonia are Interreg program beneficiaries IPA CBC Bulgaria-North Macedonia.

The Bulgarian and North Macedonian local authorities jointly implement projects under the Bulgaria – North Macedonia Cross-Border Cooperation Program 2014-2020. The total budget of the program is 19 461 690 euros (38 063 757 BGN). INTERREG-IPP Cross-border Program Bulgaria-North Macedonia was adopted on August 5, 2015 by the European Commission by Decision C (2015) 5653 and focuses on measures to mitigate the effects of climate change and address issues of the conservation of nature and biodiversity, sustainable use of natural resources, environmental protection and risk management at cross-border level. The main focus of the program is also on protecting the natural and cultural heritage in the region. In addition, funding will help increase the competitiveness of small and medium-sized enterprises and ease their access to new markets. The INTERREG-IPA cross-border program covers 2 border regions in Bulgaria and 3 regions in the Republic of North Macedonia.

There is a strong interest in the program, and by the end of 2016 more than 200 projects have been submitted for funding. The funds under the program are used for municipal investments, incl. in the fields of environmental protection and green infrastructure, flood and fire protection, investment in tourism infrastructure and cultural heritage protection. At the end of 2018 there are 52 contracts concluded to a total amount of BGN 38 million. This, of course, further enhances the investment capacity of the local authorities in both countries and creates conditions for the implementation of the European cohesion policy. An initiative to set up such co-operative international programs under the European Union, EIB or World Bank auspices would also contribute to increasing the investment capacity of municipalities in both countries.

Conclusion:

On the basis of the analyzes and assessments, it is found that the investment capacity of the local authorities in Bulgaria and North Macedonia is low and the growing investment needs can not be covered by the current municipal revenues. By relying solely on their own budget resources, municipalities can not cover the growing investment gaps. The local revenue and expenditure survey did not show any significant changes or improvements in the local finance system during the survey period. It can be concluded that the process of fiscal decentralization in both countries is frozen. This also automatically affects capital expenditures that are suppressed as a result of rising current costs and can hardly be prioritized. In order to increase the investment capacity of the municipalities in these countries, the process of fiscal decentralization should be restored and the revenue base expanded.

The improvement of tax revenue collection and updating of the property tax bases, introducing new local taxes or expanding the access to international programs and funds can open up new financial opportunities for the municipalities in Bulgaria and North Macedonia.

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