# LOCAL TAXES ON ECONOMIC ACTIVITIES AS A REWARD FOR MUNICIPALITIES – THE CASE OF BULGARIA

**Desislava Kalcheva, PhD**
Associate Professor
Faculty of Economics and Business Administration
Sofia University "St. Kliment Ohridski", Bulgaria

Author's e-mail *d.kalcheva@feb.uni-sofia.bg*
Author's ORCID 0000-0002-4361-8981

**ABSTRACT: The article examines mechanisms for transferring revenues from taxes related to local economic activity to municipal budgets as a tool for stimulating economic development and improving local government management. It analyzes different types of taxes, models for revenue distribution, and criteria for rewarding municipalities with higher levels of economic activity. The study combines comparative analysis of international practices with a survey questionnaire distributed to nine Bulgarian municipalities, including three large, three medium-sized, and three small municipalities classified according to population size. The survey aims to explore local governments' perceptions regarding the possibility of strengthening the link between local revenues and economic activity, including preferred policy approaches, expected benefits, potential risks, and the need for equalization or compensatory mechanisms. Particular attention is paid to the advantages of such a system, such as stimulating local business, attracting investment, creating jobs, and increasing municipal competitiveness, as well as to key challenges, including uneven resource distribution and administrative complexity. The study provides practical recommendations for optimizing the revenue-linking mechanism in order to support sustainable local growth, strengthen municipal financial autonomy, and improve the management of local budgets.**

Purpose: The article examines whether local taxes on economic activity and shared tax revenues can function as fiscal incentive mechanisms for municipalities. Focusing on the Bulgarian case, it analyses the extent to which the current local revenue system encourages municipalities to support investment, employment, entrepreneurship and local economic development. The study further explores reform options for strengthening the link between locally generated economic activity and municipal budget revenues, with particular attention to shared revenues from personal income tax and corporate income tax.

Design/Methodology/Approach: The study applies a qualitative research approach combining theoretical, comparative, legal-institutional and exploratory empirical analysis. It draws on fiscal federalism and incentive-based approaches to decentralisation, reviews selected European models of local business taxation and tax-sharing, and analyses the historical and current Bulgarian framework. The empirical component is based on a targeted survey of nine

Bulgarian municipalities selected to reflect different administrative, territorial and economic profiles.

Findings: The analysis shows that Bulgaria's current local revenue system is weakly connected to municipal economic activity. Local tax revenues are dominated by property acquisition tax, immovable property tax and vehicle tax, while business-related local taxes have narrow bases and limited fiscal significance. Historically, municipalities had a stronger link to direct tax revenues, especially in 2000–2002, but this link was gradually weakened after 2003 and removed after 2007. The survey confirms that municipalities see the current system as insufficiently incentive-based, support stronger links between economic activity and local revenues, prefer sharing existing national taxes over introducing a new local business tax, and stress the need for equalisation or compensation mechanisms.

Practical Implications: The findings suggest that Bulgaria should consider a predictable, formula-based mechanism for sharing national tax revenues linked to economic activity. Such a model could strengthen municipal incentives to invest in infrastructure, administrative capacity, investor services and the local business environment. To be effective, however, the reform should be gradual, transparent, data-based and combined with equalisation safeguards for municipalities with weaker economic bases.

Originality/Value: The study contributes to the debate on fiscal decentralisation by treating local taxes and shared revenues not only as revenue instruments, but also as incentive mechanisms for local economic development. Its originality lies in applying the concept of "award-compatible" revenues to the Bulgarian case and combining theoretical analysis, European comparison, historical review and survey evidence from Bulgarian municipalities.

Keywords Local taxes, Fiscal Decentralization, Local authorities, reward, economic growth, Public Policy, Bulgaria

JEL H71, H77, R58, H25

## 1 INTRODUCTION

Municipalities play a key role in creating the conditions for local economic development. They provide and maintain infrastructure, deliver public services, manage administrative processes and shape the local business environment through activities related to planning, permitting regimes, investment support and interaction with local businesses. However, the fiscal benefits generated by higher local economic activity do not always remain at the local level. This creates a potential mismatch between the responsibilities of local authorities and the financial incentives available to them.

The theoretical basis of this problem is linked to the classical theory of fiscal federalism, according to which the allocation of functions and revenues across different levels of government should take into account both the efficiency of public service provision and the link between local benefits and local financing (Musgrave, 1959; Oates, 1972, 1999). In this logic, local revenues are not merely a technical instrument for financing municipal activities, but part of a broader system of incentives that influences the behaviour of local authorities.

Tiebout's classical model (1956) emphasises competition between local jurisdictions and the possibility for citizens and businesses to choose between different combinations of local services and taxation. Although the model is based on a number of assumptions and restrictive conditions, it remains an important starting point for understanding the relationship between local public services, taxes and economic behaviour. Later studies on fiscal decentralisation further develop this logic by focusing on the incentives faced by local authorities. Qian and Weingast (1997) and Weingast (2009) emphasise that when local authorities have real responsibility and are able

to benefit from the results of local development, decentralisation can create incentives for a more favourable economic environment, investment and growth.

At the same time, the literature underlines that decentralisation does not automatically lead to better outcomes. Rodden, Eskeland and Litvack (2003) stress the importance of hard budget constraints and warn that excessive dependence on transfers may create distorted incentives for local authorities. Shah (2006) also emphasises that the design of intergovernmental transfers matters not only for fiscal equalisation, but also for the behaviour of public institutions. Therefore, the question is not only whether municipalities should receive more revenues, but what type of revenues, under what rules and with what incentives.

In this context, Herrmann's report (2022) raises the specific question of whether municipalities in the European Union Member States are fiscally "rewarded" for promoting local economic development through revenues from taxes on economic activity. The analysis shows that there is significant diversity across the EU in the models used to channel revenues generated by economic activity to local budgets, with the share of such revenues varying considerably between countries. This diversity demonstrates that the design of local tax systems matters not only for the size of municipal revenues, but also for the incentives faced by local authorities (Herrmann, 2022).

The more recent report *Local Taxes and Economic Growth* expand the debate by examining the relationship between local taxes, fiscal autonomy and economic growth. It emphasizes that local tax systems can be viewed not only as instruments for financing local public services, but also as part of the broader institutional framework for promoting local development. A particularly important question is whether municipalities have sufficient financial motivation to support investment, employment, entrepreneurship and improvements in the business environment when a significant share of the fiscal benefits from this activity accumulates outside municipal budgets (Preyer et al., 2026).

For this reason, the idea of more closely linking local revenues to local economic activity becomes particularly important in the context of fiscal decentralisation, municipal financial autonomy and sustainable local development. Taxes related to economic activity can function as a mechanism for "rewarding" municipalities that implement policies promoting investment, entrepreneurship, job creation and productivity growth.

When municipalities retain part of the fiscal revenues generated by economic activity on their territory, they may have stronger incentives to support local business development, improve administrative efficiency, invest in infrastructure and increase the competitiveness of the local economy. At the same time, such mechanisms raise important political and institutional questions. On the one hand, they can strengthen municipal financial autonomy and improve the link between local policy, economic development and budgetary outcomes. On the other hand, there is a risk of deepening territorial disparities, as municipalities with a stronger economic base may generate significantly higher revenues than less developed municipalities. Therefore, any model for linking local revenues to economic activity should be considered together with appropriate equalization or compensation mechanisms.

The case of Bulgaria is particularly important in this context, as municipalities have significant responsibilities in relation to local development, infrastructure, services and administrative provision, while at the same time having limited own-revenue potential. This raises the question of whether the current local revenue system creates sufficient incentives for municipalities to actively support economic activity, or whether a better-structured mechanism is needed to link local revenues to economic development.

The present study examines the potential of local taxes on economic activity as a mechanism for "rewarding" municipalities. The analysis considers possible models for the distribution and transfer of revenues generated by economic activity, the criteria for rewarding municipalities and the expected effects on investment, employment, competitiveness and financial autonomy.

For the purposes of the study, a survey questionnaire was also used. The empirical scope includes a survey among nine Bulgarian municipalities, selected through purposive sampling according to their size, administrative status, economic profile and territorial characteristics. Large, medium-sized and small municipalities are included, with the aim of covering different models of local development and different capacities for generating revenues from economic activity. The purpose of the survey was to examine the attitudes of local authorities regarding the need for reform, preferred models for linking revenues to economic activity, expected benefits, potential risks and the need for equalization mechanisms.

In this way, the study contributes to the broader debate on fiscal decentralisation by considering local revenues not only as a financial instrument, but also as a mechanism for stimulating local development. The main argument is that, if properly designed, local taxes on economic activity can contribute to a better alignment between the responsibilities of local authorities, local development efforts and the fiscal benefits accruing to municipalities.

The aim of the study is to analyse the possibilities for linking local revenues to economic activity on the territory of municipalities in Bulgaria through mechanisms for transferring or sharing revenues from taxes related to local economic activity, as an instrument for stimulating local economic development, increasing financial autonomy and improving the management of municipal budgets.

The research tasks are (1) to analyse European practices and models for directing revenues from taxes on economic activity to municipal budgets; (2) to examine the historical and current application of local business taxes in

Bulgaria; (3) to explore the attitudes of selected Bulgarian municipalities regarding the opportunities, benefits, risks and conditions for applying a mechanism that links local revenues to economic activity; and (4) to formulate practical recommendations for optimising such a mechanism, including the need for equalisation or compensation instruments.

The report also presents a good example of interaction between municipal authorities and business in the Plovdiv region, as well as the results that can be achieved through municipal efforts in the context of regional economic development. The example demonstrates the important role of local authorities in creating and maintaining a favourable business environment and attracting foreign investors.

The study covers theoretical, comparative and empirical aspects of the relationship between local revenues and economic activity. From a comparative perspective, it examines European practices for directing or sharing revenues from taxes related to economic activity with local budgets.

The main hypothesis of the study is that a closer link between local revenues and economic activity on the territory of municipalities can create stronger fiscal incentives for local authorities to support investment, entrepreneurship, employment and improvements in the business environment, while also increasing the financial autonomy and efficiency of local government. This hypothesis, however, assumes that such a mechanism must be combined with appropriate equalisation or compensation instruments in order to limit the risk of deepening disparities between economically stronger and weaker municipalities.

The analysis is based on data and information from Eurostat, the National Statistical Institute, the Ministry of Finance, and other publicly accessible institutional, legal and statistical sources.

# 2 LOCAL BUSINESS TAXES AS CATALYSTS FOR LOCAL ECONOMIC DEVELOPMENT

## 1. Theoretical foundations: fiscal decentralisation and local incentives.

The theoretical foundation of the link between local revenues and local economic development can be traced to the classical theory of fiscal federalism. Musgrave distinguishes between the allocation, redistribution and stabilisation functions of public finance, arguing that while macroeconomic stabilisation and redistribution are generally more appropriate for the central level, the allocation of certain public goods and services may be more efficiently performed locally when needs and preferences differ across territories (Musgrave, 1959). Oates further develops this argument by emphasising the potential welfare gains from decentralisation when public services are better aligned with local preferences and conditions (Oates, 1972, 1999).

This logic is complemented by Tiebout's model of interjurisdictional choice, according to which households and businesses may respond to different combinations of local taxes, services and institutional quality across jurisdictions (Tiebout, 1956). Although the assumptions of the model are restrictive, it remains relevant because it highlights the competitive dimension of local governance. In real-world conditions, this competition operates not through perfect mobility, but through decisions about residence, investment location, labour allocation and business expansion.

More recent literature shifts the focus from the normative allocation of functions to the incentives created by fiscal institutions. Qian and Weingast (1997) and Weingast (2009) argue that decentralisation can support market-preserving governance when local authorities have both responsibility and incentives to promote economic activity. From this perspective, the tax system and the transfer system are not neutral. They shape the behaviour of local governments and influence the extent to which municipalities have incentives to support growth, productivity and the expansion of the local tax base.

This point is also central to the work of Shah and Rodden. Shah (2006) emphasises that intergovernmental transfers do not merely finance public services; they also create incentives and accountability mechanisms that affect efficiency, equity and public-sector performance. Rodden, Eskeland and Litvack (2003), in turn, warn that decentralisation without hard budget constraints may generate soft budget constraints, expectations of bailouts and distorted incentives. Therefore, local business taxes or shared tax revenues can act as catalysts for development only when embedded in a system with clear rules, predictable equalisation and limited moral hazard.

In this sense, local business taxes should not be understood solely as revenue instruments. They may also function as institutional mechanisms linking local responsibility with fiscal reward. Local authorities are closer to local information, businesses and development constraints, but they are more likely to act as active facilitators of growth when part of the fiscal result of local economic activity remains within the municipal budget.

### 1.1. Local revenues as incentive mechanisms for municipalities

Local authorities influence economic activity through several channels. They provide and maintain infrastructure, regulate land use, manage permitting procedures, deliver public services, support investors and coordinate interaction between businesses, educational institutions and local communities. The local level is therefore not only an implementer of national policy; it is the level at which the business environment becomes predictable or uncertain, efficient or burdensome, attractive or discouraging for investors.

Municipalities can support economic activity through spatial planning, zoning, administrative simplification, investor servicing, electronic registers and transparent procedures. Instruments such as one-stop shops for investors, digital services and clear administrative processes reduce indirect costs for businesses and improve the predictability of local governance. Local authorities also contribute to human capital formation by facilitating cooperation between employers, schools, training institutions and public administration. Local economic development is therefore not limited to roads and industrial zones; it also includes skills, trust, partnerships and the capacity to retain and attract talent.

Digitalisation and the green transition further increase the role of municipalities. Digital public services can reduce administrative burdens, improve transparency and support more efficient interaction with citizens and businesses. At the same time, climate and environmental policies are increasingly implemented at the local and regional level, which places additional pressure on municipal capacity and local public finances.

The key implication is that local revenues are not only an accounting issue. They are an incentive variable. If municipalities bear the costs of infrastructure, coordination, digitalisation, administrative capacity and local development, but do not receive a visible fiscal return from the economic activity they help generate, the incentive to pursue active development policies is weakened. Conversely, if part of the revenues generated by local economic activity remains in the municipal budget, investment in better local governance becomes fiscally rational.

This is particularly relevant for Bulgaria, where municipalities are the main subnational level with real fiscal responsibilities, but their dependence on transfers remains significant. In such a context, the absence of an origin-based revenue component weakens the fiscal reward for municipal efforts to support local economic development.

### 1.2. Local business taxes, investment and competitiveness

For analytical purposes, local business taxes should be understood in a broader sense. They include not only formally local taxes imposed on business activity but also shared or locally retained tax revenues that increase when the local economy expands. These may include shares of corporate income tax, personal income tax, local business taxes and other tax flows linked to economic activity.

Herrmann (2022) conceptualises such revenues as “award-compatible” revenues, meaning revenues that fiscally reward municipalities for local economic performance. According to the JRC analysis, the average share of such revenues in municipal budgets in the EU is around 23%, but the variation across Member States is substantial, ranging from 0% to over 60%. The same analysis finds that Member States with a share at or above the EU average recorded higher average GDP growth in 2015–2019 than those below the average, although this is presented as an initial indication rather than causal evidence.

Preyer et al. (2026) further develop this argument by introducing indicators for comparing local revenue retention across countries, presenting cases in which the sharing of direct taxes appears to support local growth, and emphasising the behavioural effects of locally visible tax revenues. When taxpayers can observe a clearer link between tax payments and local services, there may be stronger incentives for voluntary tax compliance. This shifts the discussion from taxes as a pure cost to taxes as part of a local fiscal and social contract between businesses, citizens and municipalities.

The mechanism through which such taxes may influence investment and employment is not automatic. Local business taxes do not create investment by themselves. Rather, they may change municipal behaviour. If local governments know that part of the fiscal benefit from new firms, more jobs or higher productivity will be reflected in their own budgets, they have stronger incentives to reduce administrative delays, maintain industrial and logistical infrastructure, improve access and spatial planning, manage local externalities and cooperate with educational and training institutions.

In this sense, local business taxes or shared tax revenues operate as intermediary instruments. They partially internalise the external fiscal benefits of growth for the municipality. Their effect is strongest when combined with good local governance, administrative capacity and transparent public management. The academic literature supports this interpretation: better local government quality and efficiency are associated with stronger local economic outcomes, while decentralisation produces better results only when accompanied by capable institutions and low fragmentation (Balaguer-Coll et al., 2022; Jong et al., 2021).

Competitiveness at municipal level is therefore not only a function of low costs or low tax rates. It depends on infrastructure, skills, institutional predictability, digital services, trust and problem-solving capacity. Local business taxation can support competitiveness if it encourages municipalities to invest in these fundamentals rather than rely on short-term or selective incentives for individual investors.

### 1.3. Benefits, risks and design requirements

Linking local revenues to economic activity may generate important incentive effects. Such a mechanism can reduce the gap between municipal efforts to support local development and the fiscal returns that accrue to municipal budgets. It may encourage local authorities to invest in better administration, infrastructure, digitalisation, investor servicing, skills partnerships and support for local businesses. In broader terms, it can strengthen employment, productivity, competitiveness and fiscal legitimacy, especially when taxpayers perceive a clearer connection between their contribution and local public outcomes.

At the same time, these benefits depend strongly on institutional design. Revenue mechanisms linked to economic activity may also create risks, including wider territorial disparities, tax competition, soft budget constraints, administrative complexity and insufficient attention to social or environmental externalities. These risks are particularly relevant when economic activity is unevenly distributed across municipalities or when revenue-sharing rules are not transparent and predictable.
For this reason, local business taxes or shared tax revenues should be assessed not only as revenue instruments, but also as incentive mechanisms. Their effectiveness depends on whether they combine local fiscal reward with equalisation, fiscal discipline, administrative capacity and clear accountability rules. The main potential benefits, risks and design requirements are summarised in the table below.

Table 1. Potential benefits, main risks and requirements

| Potential benefits | Main risks | Required design elements |
|---|---|---|
| Stronger incentives for municipalities to support investment, employment and productivity | Wider disparities between richer and poorer municipalities | Formula-based equalisation that does not weaken the local incentive |
| Better administrative efficiency, digitisation and investor servicing | Tax competition over mobile tax bases | Limits on rates/bases and coordination between levels of government |
| Higher-quality infrastructure and services for businesses | Underestimation of social and environmental externalities | Integration with spatial planning and environmental standards |
| Stronger local accountability and potentially better tax compliance | Soft budget constraints and reliance on ad hoc compensation | Hard budget rules and predictable transfers |
| Greater fiscal autonomy and more active local governance | Administrative complexity and unequal capacity | Phased reform, standardisation and technical support |

Source: Author's synthesis based on Oates (1972, 1999), Qian and Weingast (1997), Rodden, Eskeland and Litvack (2003), Shah (2006), Weingast (2009), Herrmann (2022) and Preyer et al. (2026).

The table 1. summarizes the general conclusion from the literature: local revenue links to economic activity can act as catalysts for development, but only under careful institutional design. The relevant policy issue is not simply whether to introduce a new local tax, but how to create a predictable mechanism that preserves local incentives while maintaining territorial fairness and budgetary discipline.
For Bulgaria, this distinction is important. A reform aimed at strengthening the link between local revenues and economic activity does not necessarily require the creation of an entirely new tax or an increase in tax rates. A more pragmatic approach may involve retaining existing tax bases and rates while allocating a limited, predictable share of selected tax revenues to the municipality where the economic activity is generated. Such a model could change municipal incentives without radically transforming the tax system. In the Bulgarian context, however, it should be combined with clear equalization rules, a formula-based transfer system and public accountability regarding the local use of these revenues.

**2 Application of Local Business Taxes in the European Union and in Bulgaria**
Based on a review of the scientific literature and European practices, four main categories of "award-compatible" local revenues can be identified - that is, revenues that grow as the local economy expands. These are corporate income tax (CIT), local business tax (LBT), personal income tax (PIT), and local commercial property and land tax (LCPT). What matters is not only the type of tax, but whether the revenue remains where the economic activity occurs or is redistributed according to a formula that weakens the local incentive (Herrmann, 2022).
Local business taxes: Countries that actively implement local business taxes include Germany, Austria, Hungary, and Luxembourg. In Germany, municipalities have the right to impose a local trade tax on profits (Gewerbesteuer), under which the local council sets a multiplier on a base rate; together, these two sources accounted for about 33% of all local revenue in 2019. In Austria, the Kommunalsteuer is a nationally standardized tax on wages generated by local businesses, which accounts for about 12% of all local revenue. In Hungary, the local business tax accounts for 24% of municipal revenue, but its incentive effect is partially offset by a "solidarity contribution" to the central budget.
**Origin-based sharing of PIT and/or CIT**. This type of sharing is characteristic of the Nordic countries, Germany, Romania, Latvia, Poland, Portugal, and Croatia. In Denmark, local PIT accounts for 55% of all local revenue,

while municipalities' share of CIT is an additional 6.6%. In Sweden, local PIT accounts for 67% of municipal revenue. In Latvia, 80% of PIT remains with the municipalities and accounts for 53% of local revenue. In Romania, municipalities receive 65% of the PIT generated by workers in their territory, which is a particularly strong incentive mechanism because it is closer to a production-based rather than a residence-based logic. In Poland, municipalities receive 38% of PIT and 6.7% of CIT collected within their jurisdiction (Herrmann, 2022; Preyer et al., 2026).

**Commercial property and land tax**. are significant revenue source in Ireland, Poland, Romania, the Netherlands, Italy, and Finland. In Ireland, so-called commercial rates account for an average of 32% of all local revenue. In Poland, commercial properties can be taxed up to ten times higher than non-commercial ones, with revenue from this source reaching about 8% of local budgets. In Romania, revenue from commercial property tax accounts for about 6% of the local budget. This model is more stable and predictable, but the feedback loop between growth and revenue is slower, as it depends on property valuation and cadastral-administrative capacity.

**Local licenses and utility fees**, which are not always "pure" business taxes but can partially reward economic activity. Examples include the Greek cleaning and lighting tax, the Croatian communal fee, and various local licensing schemes. Their advantage is that they are often linked to specific services and infrastructure, but the disadvantage is that they incentivize more narrowly defined activities and rarely create a broad systemic incentive for general local development. Several comparative examples are illustrative. In Lithuania, PIT generates local revenue, but the formula takes into account the municipality's previous relative contribution, which partially preserves the incentive. In Slovakia and Slovenia, PIT is redistributed according to fixed formulas that do not depend on local economic performance; therefore, the link between local effort and local revenue is weak. In Luxembourg, at least 65% of the local business tax is pooled and redistributed according to a formula, which reduces the direct incentive despite the high nominal tax rate. In the Netherlands, the higher value of the local tax base can be partially offset by lower general grants, which also weakens the motivation to generate own-source revenue (Herrmann, 2022).

From a public policy perspective, this means that equalization is necessary, but its design is critical. The OECD emphasizes that fiscal equalization typically aims to reduce disparities in fiscal capacity and expenditure needs, but excessive or non-transparent redistribution can weaken discipline, intensify political conflict, and undermine incentives for own-revenue mobilization. Good practice involves transparent, formula-based mechanisms that combine criteria for population, expenditure needs, fiscal capacity, and—in some cases—social or environmental indicators (OECD, 2025; Shah, 2006).

The JRC's main empirical finding is that the share of "award-compatible" revenues in municipal budgets is on average around 23% for the EU, but varies across a very wide range—from 0% to 66%. This in itself shows that member states choose radically different balancing points between incentives and equalization. In Bulgaria and Spain, the role of this type of revenue is very low, while in Denmark, Finland, Sweden, Germany, and Romania, local authorities' share of the tax effects of economic activity is noticeably higher (Herrmann, 2022; Preyer et al., 2026).

Herrmann (2022) also establishes a preliminary macroeconomic link: Member States in which the share of this revenue is at least equal to the EU average had higher average GDP growth in 2015–2019—3.75% versus 2.34%. The report itself explicitly warns that this is not definitive proof of causality, but rather an initial indication. The report by Preyer et al. (2026) goes further, identifying three types of effects: a stronger incentive for local authorities to pursue growth, potential positive effects in weaker regions, and an increase in voluntary tax compliance when revenues remain locally visible (Herrmann, 2022; Preyer et al., 2026).

On a more practical level, local tax incentives work through the quality of local governance. The OECD emphasizes that cities and municipalities are on the "front lines" when it comes to identifying infrastructure needs, land-use planning, and engaging with investors; good planning reduces investment costs and improves the investment climate. The World Bank shows that a combination of simplified administrative procedures, electronic registries, "one-stop shops" for investors, and local economic councils can lead to measurable growth in investment and employment (OECD, 2023; World Bank, 2021). This is an important clarification: local business taxes do not automatically generate growth, but rather work by changing the behavior and priorities of local authorities.

Table 2 summarises the main revenue models linked to economic activity that are applied in European countries.

**Table 2. Application of Local Business Taxes in the European union**

| Model | Examples | Main feature |
|---|---|---|
| Local business taxes | Germany, Austria, Hungary, Luxembourg | Direct link with business activity, profits, payroll or turnover |

| | | |
|---|---|---|
| Origin-based PIT/CIT sharing | Denmark, Sweden, Romania, Latvia, Poland, Croatia | Municipalities receive part of national direct taxes generated locally |
| Commercial property and land taxes | Ireland, Poland, Romania, Netherlands, Italy, Finland | Stable source linked to business property, but slower response to growth |
| Licences and communal fees | Greece, Croatia, local licence schemes | Linked to services/infrastructure, but narrower incentive effect |

**Source:**1) (Herrmann, 2022); (Preyer et al., 2026). [14]2) (Herrmann, 2022); (Preyer et al., 2026). [15]3) (Herrmann, 2022); (OECD, 2023). [16]4) (Herrmann, 2022); (OECD, 2025). [17]5) (Herrmann, 2022); (World Bank, 2021). [18]

**The Application of Local Business Taxes in Bulgaria: Historical Development and Current Status.**

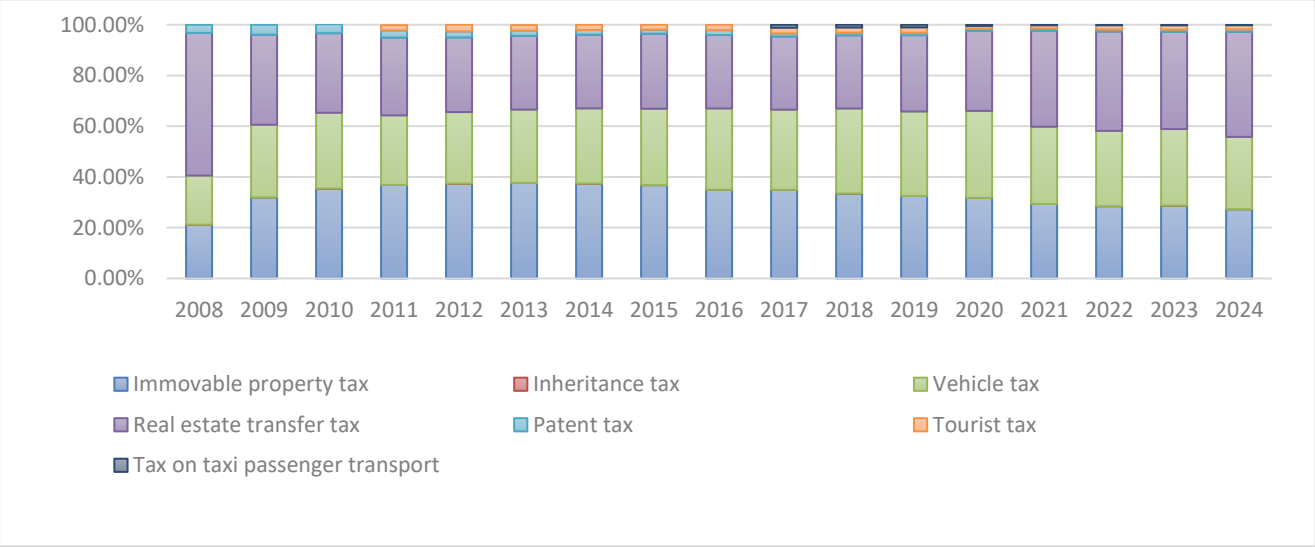
Bulgaria is a unitary state with a single primary level of local self-government—the municipality. There are 265 municipalities in the country, each with its own budget and constitutionally recognized autonomy in addressing issues of local importance. This autonomy, however, is relative, especially with regard to the revenue base and tax powers. Bulgaria has been a member of the European Union since 2007 and of the Eurozone since 2026. The country's population is approximately 6.5 million, with a steady trend of demographic decline observed in recent decades.

With the constitutional amendments of 2007–2008, Bulgarian municipalities gained the right to set local tax rates under conditions, in accordance with procedures, and within limits established by law. This expands the formal tax autonomy of local authorities but does not grant them full tax autonomy. Municipalities do not have the authority to introduce new local taxes or to determine the tax base independently. These matters remain subject to national legislation.

Currently, local tax revenues in Bulgarian municipalities consist of property tax, vehicle tax, tax on the acquisition of property for consideration, gift tax, inheritance tax, business license tax, and tax on taxi passenger transport. This structure indicates that the local tax system has a relatively limited scope and is weakly linked to current economic activity within the municipalities. As of today, municipalities do not receive shared revenues.

Figure 1. presents the change in the relative share of individual types of local tax revenue in the total volume of local tax revenue for the period 2008–2024. The period was chosen to cover the development of the local tax system following the constitutional amendments that granted municipalities the authority to set local tax rates within the limits established by law. The starting year, 2008, marks the first stage of implementation of this model of limited tax autonomy, while 2024 is the last year for which data is available at the time of this analysis

Figure 1. Share of individual local tax revenues in total municipal tax revenues




*Source: Ministry of Finance, State Budget Implementation Reports for the period 2008-2024*

As can be seen from the information presented, municipal tax revenues consist primarily of three taxes: property acquisition tax, real estate tax, and vehicle tax. The only taxes in the current municipal tax system in Bulgaria that are linked to economic development within a municipality's territory are the business license tax, the tourist tax, and the tax on taxi passenger transport. Property tax, including business real estate, can be defined as a tax that is

partially linked to economic activity at the local level and, to some extent, provides revenue for municipalities as an incentive for their efforts to achieve a better economic environment. The taxi fare tax and the tourist tax can be defined as a type of sectoral tax, which places them outside the scope of taxes that fall into the "municipal awards" category.

To some extent, the property tax can be viewed as a local tax that creates a specific link between the development of the local economic base and municipal revenues. This is particularly true for real estate used for commercial purposes—industrial buildings, warehouses, retail premises, offices, hotels, and other commercial properties. When new industrial or commercial facilities are built within a municipality, this expands the property tax base and can lead to an increase in property tax revenue.

In this sense, property tax is one of the few existing local taxes through which a municipality can derive some fiscal return from investment activity within its territory. If local authorities improve infrastructure, urban planning, administrative services, and the overall business environment, this can attract new investments in buildings and commercial properties, which in turn can increase revenue from this tax.

However, this link remains limited. The property tax does not tax current economic activity, turnover, profit, employment, or the value added generated by business. It is primarily linked to the value and existence of real estate, rather than to the actual scale of the economic activity carried out on it. Furthermore, the tax base is determined by statutory rules, and municipalities can primarily influence the rate within legally established limits, but not the method of determining the tax assessment.

Therefore, the property tax can be defined as a partial and indirect incentive for municipalities to encourage investment and improve the business environment, but not as a fully-fledged mechanism for linking local revenues to economic activity. It primarily captures tangible investments in real estate assets but does not sufficiently reflect the dynamics of the local economy, business development, income growth, employment, or productivity.

Consequently, the property tax is closer to the logic of "fiscal returns on investment in the territory" than to the logic of a local business tax that directly rewards municipalities for higher economic activity.

In Bulgaria, the property tax rate is not generally differentiated based on the legal status of the owner—whether an individual or a legal entity. The municipal council determines the tax amount within legally established limits. The distinction between residential properties owned by citizens and properties used by businesses is primarily reflected in the determination of the tax base and the applicable exemptions. Therefore, the tax on commercial real estate may provide some revenue link between investments in tangible assets and the municipal budget, but this link remains limited and indirect. It should be noted that although, as a rule, the tax rate does not differ for legal entities and individuals, different rates can still be observed in some municipalities.

It should be noted that several new business taxes were introduced during the study period. These are the patent tax (2008), the tourist tax (2011), and the tax on taxi passenger transport (2017). However, the new taxes make an insignificant fiscal contribution and account for barely 3% of total local tax revenue.

The patent tax is a specific local tax with a limited scope of application. It is payable by individuals, including sole proprietors, who engage in so-called patent activities specified in the Local Taxes and Fees Act. These are primarily small-scale economic, craft, commercial, and service activities carried out on a small scale. The tax applies when certain legal conditions are met, including a turnover limit for the previous year and the absence of registration under the Value Added Tax Act, subject to the exceptions provided by law.

As a local tax, the patent tax was introduced into the local taxation system on January 1, 2008, in connection with the amendments to the Local Taxes and Fees Act, published in State Gazette No. 110 of 2007. Prior to that, the business license tax existed as a form of taxation on certain activities, but since 2008, the revenue from it has been directed to municipal budgets, and it has become part of the local tax system. This coincides with the broader process of expanding the limited tax autonomy of municipalities following constitutional changes, under which municipal councils were granted the right to set local tax rates within legally established limits.

The amount of the patent tax is not determined as a percentage of profit or turnover, but as a fixed annual amount. The municipal council sets the specific tax rate by ordinance, within the minimum and maximum limits provided by law for the relevant type of activity. When determining the amount, the type of activity, the location of the facility, and the category of the settlement or zone within the municipality may be taken into account. Thus, municipalities have some freedom to adapt the tax to local conditions, but this freedom is limited by legal boundaries and by the exhaustively listed patent activities.

The low revenue yield of the patent tax is mainly due to its narrow tax base and limited scope. It applies only to selected activities carried out by individuals and sole proprietors, while most contemporary economic activity is conducted through commercial companies and remains outside this regime. The tax is also fixed in amount and does not increase automatically with turnover, income or profit, which makes it relatively easy to administer but limits its fiscal potential.

The patent tax is primarily targeted at small-scale services, crafts and local commercial activities, which generally have limited revenue capacity. When a business expands significantly or becomes subject to value added tax registration, it usually exits the patent tax regime. In addition, some activities covered by the regime have declining

importance in the modern economy or operate in highly competitive, low-margin sectors. In smaller and demographically shrinking municipalities, the number of taxpayers subject to this tax is also limited.

Thus, the patent tax is formally linked to economic activity, but it has limited capacity to connect actual local economic dynamics with municipal budget revenues. It does not capture larger investments, industrial activity, employment or corporate profits. This limits its role as an instrument for stimulating local economic development and supports the broader conclusion that Bulgaria's local revenue system remains weakly connected to current economic activity at municipal level.

We focus solely on the patent tax because the tax on taxi services and the tourist tax can be classified as sectoral taxes. Sectoral local taxes are not excluded from the analysis as part of the local tax system, but they cannot be viewed as a primary mechanism for fiscal stimulation of municipalities, as they do not reflect overall economic activity at the local level.

To discuss the future and opportunities for the development of local tax revenues, we must look to the past and examine whether other local taxes linked to overall economic activity at the local level were included in the budgets of Bulgarian municipalities. According to the Municipal Budgets Act and the State Budget Act, during the 2000–2002 period, municipalities in Bulgaria received 50% of personal income tax revenues. In 2003, municipalities received 100% of the revenue collected. During the period 2004–2007, municipalities received a fixed absolute amount of personal income tax revenue in the form of a state transfer to municipal budgets to finance activities delegated by the state. The annual amount transferred to municipalities from the tax is determined based on a mechanism for determining state transfers and formulas containing predefined criteria, including expenditure standards and revenue indicators.

Each municipality's share of personal income tax revenue is calculated based on the state's forecast for personal income tax (PIT) and the maximum amount required (as determined by the central government) to manage the delegated task. Thus, PIT revenues were pooled, and the share used for transfers to municipalities was then determined from this pool.

It should be noted that in 2003, PIT revenues were recorded under the category of own municipal revenues (even though they are shared), and then the revenues were provided in the form of a state transfer to the municipalities and were earmarked for specific expenditures. This reduces the possibility of revenues being distributed based on the location of collection, and municipalities have minimal incentives to generate this type of revenue.

Regarding local business taxes, until 2002 there were two main taxes whose revenues were shared with the municipalities—50% of the personal income tax and the so-called municipal tax (10% of the taxable profit of legal entities registered under the Commercial Act). During the period 1991–2002, municipalities also received 50% of the collected revenues from the profit tax of enterprises with more than 50% municipal ownership. In 2003, a uniform corporate profit tax rate of 23.5% was introduced as revenue for the national budget, and the municipal tax was abolished. However, regarding this tax, it should be noted that a large share of companies in Bulgaria are registered in Sofia, especially in the early 2000s.

Overall, the information indicates that this tax (municipal profit tax) was the predecessor of the corporate tax in Bulgaria. It was levied on the profits generated by legal entities, and the declaration and payment of the tax were carried out based on the legal entity's place of registration. The National Revenue Agency in Bulgaria was established in 2006, and prior to that, territorial tax offices operated. These were the institutions responsible for recording, declaring, and processing this information.

Historically, Bulgaria had a period during which municipalities participated in receiving revenue from direct taxes, including personal income tax and corporate tax. This link was most pronounced during the 2000–2002 period, when municipalities received 50% of personal income tax revenue, allocated according to the taxpayer's place of work, and 10% of corporate tax revenue, allocated according to the employment generated by firms in the respective municipality. This model created a certain fiscal incentive for local authorities to support economic activity, employment, and business development within their territory.

After 2003, this link gradually weakened. The municipalities' share of corporate tax was eliminated, and between 2004 and 2007, their share of personal income tax was replaced with formula-based transfers, limited by projected revenues and the value of delegated activities. After 2007, the link between municipal budgets and personal income tax was completely eliminated. Thus, Bulgarian municipalities were left with no share in direct tax revenues and, consequently, without a direct fiscal mechanism to reward them for their efforts to improve the local economic environment.

From the perspective of criteria for a local business tax or a revenue-stimulating local tax, corporate income tax was closer to this logic, as it was linked to the activities of firms and to employment within the municipality's territory. Personal income tax also had a stimulating effect, especially when distributed according to place of work, because it created a link between jobs, income, and municipal revenue. Following the abolition of these mechanisms, however, the Bulgarian local revenue system remains weakly linked to current economic activity.

To examine the attitudes of Bulgarian local authorities toward changing the system and introducing mechanisms for shared corporate tax and personal income tax revenues, a survey was developed and distributed.

## 3 RESULTS

The survey questionnaire was developed as part of the empirical component of the study and aims to identify municipalities' attitudes toward the possibilities for linking local revenues more closely to economic activity within their territories. It builds upon the analysis conducted to date of the historical development and current state of local business taxes in Bulgaria, as well as the examples examined of active municipal policies supporting investment, local business, and employment.

The questions posed relate to the study's central thesis that the current local revenue system does not create a sufficiently strong fiscal link between municipalities' efforts to promote economic development and the revenues flowing into municipal budgets. In this sense, the survey aims to assess the extent to which municipalities themselves agree on the need for such a link, how they evaluate the potential benefits and risks, and what model they would identify as most suitable for Bulgarian conditions.

The survey questionnaire is structured in three parts. The first part collects basic identifying information about the size and economic profile of the municipality, which allows the responses to be analysed in light of different demographic and economic contexts. The second part includes statements rated on a five-point scale, which examine municipalities' perceptions regarding incentives in the current revenue system, the need to strengthen the link between economic activity and local revenues, the expected effect on financial autonomy, and the potential risk of widening disparities among municipalities. The third part focuses on the preferred reform model, expected benefits, potential risks, and the conditions under which such a mechanism could be implemented.

The questionnaire combines closed-ended questions, Likert-scale statements and open-ended responses. This structure allows the analysis to capture both the general direction of municipal attitudes and the more nuanced arguments provided by respondents regarding the design, feasibility and risks of a possible reform.

In this way, the survey not only gathers opinions on specific fiscal instruments but also contributes to a broader assessment of whether and under what conditions linking local revenues to economic activity can be used as a tool to strengthen financial autonomy, managerial accountability, and incentives for local economic development.

The survey is exploratory in nature and aims to identify the attitudes of Bulgarian municipalities regarding the possibilities for more closely linking local revenues to economic activity within their territory. The selection of municipalities was purposeful, including regional centres, a coastal municipality, municipalities with an industrial and investment profile, as well as municipalities outside major urban and industrial centres. In this way, the sample allows for the coverage of different models of local development and varying potential for generating own-source revenue.

The survey is based on nine municipal responses. Given the limited and purposive nature of the sample, the results should not be interpreted as statistically representative of all Bulgarian municipalities. Their value lies in identifying expert municipal perceptions, recurring concerns and preferred reform directions regarding the possible linkage between local revenues and economic activity.

Although the number of respondents does not allow for representative statistical generalisations for all Bulgarian municipalities, the results outline important trends in the thinking of local authorities. They show that municipalities recognise the limitations of the current revenue system, support a stronger link between economic activity and local budgets, but at the same time are clearly aware of the risks of widening the gap between economically stronger and weaker municipalities.

Despite the limited sample size, the responses reveal a coherent pattern: municipalities recognise the weak incentive structure of the current revenue system, support a stronger fiscal link with local economic activity, but condition such reform on predictable rules, administrative feasibility and equalisation safeguards.

1. Statement 1: The existing local revenue system in Bulgaria provides sufficient incentive for municipalities to promote economic activity.

Responses to the first statement indicate that the majority of municipalities surveyed do not perceive the current local revenue system as a sufficiently strong incentive to promote economic activity. More than half of the respondents disagree with the statement that the current system creates sufficient incentives for municipalities to support local economic development. Some respondents are unable to assess this, which also indicates a lack of a clearly recognisable link between local economic dynamics and municipal budget revenues.

This result confirms one of the main arguments in the study: the existing revenue system in Bulgaria does not provide municipalities with a sufficient direct fiscal incentive to develop active policies for attracting investment, supporting business, and creating jobs. Municipalities have functions related to infrastructure, administrative services, urban planning, and maintenance of the local environment, but the positive fiscal effects of increased economic activity are realised to a significant extent at the national rather than the local budget level.

2. Statement 2: It is necessary to strengthen the link between economic activity within the municipality and revenues in the municipal budget.

The results show clear support for the idea of strengthening the link between economic activity within the municipality and municipal budget revenues. Five of the respondents fully support such a link, while three

somewhat agree. Only one respondent disagrees. This indicates a relatively strong consensus among the surveyed municipalities that such a change would make sense from the perspective of local development.

3. Statement 3: Municipalities should receive a larger share of the revenue generated by economic activity within their territory.

Even more emphatic are the responses to the statement that municipalities should receive a larger share of the revenue generated by economic activity within their territory. Six of the respondents strongly agree, and one somewhat agrees. This indicates that the idea of a fairer sharing of the fiscal benefits of local economic development has significant support among the surveyed municipalities.

This result is particularly important for the report's main thesis. It shows that at the local level, there is an understanding of the need for a more direct link between municipalities' efforts to develop the economic base and the financial resources at their disposal. In other words, municipalities do not frame the issue solely as a demand for more transfers, but as a need for better alignment between local responsibilities, local policies, and local revenues.

4. Statement 4: Such a reform would increase the financial autonomy of municipalities.

The responses to the question of whether such a reform would increase the financial autonomy of municipalities are among the most unequivocal. Five of the respondents strongly agree, three somewhat agree, and only one is undecided. This allows us to conclude that the surveyed municipalities view the linking of local revenues to economic activity as a potential tool for strengthening local financial autonomy.

This conclusion is directly related to the broader analysis of fiscal decentralisation in Bulgaria. When the bulk of revenue linked to income, profits, and economic activity flows into the central budget, municipalities remain dependent on transfers, subsidies, and project funding. This limits their ability to independently plan long-term investments in local infrastructure, the public environment, and business services. Such a mechanism could create a more sustainable link between local economic development and local public resources.

5. Statement 5: Bulgaria has the institutional and administrative foundation to introduce a mechanism linking local revenues to economic activity.

A different picture emerges regarding the question of whether Bulgaria has the institutional and administrative foundation to introduce such a mechanism. Four respondents are unable to assess this, one strongly disagrees, two somewhat disagree, and only two somewhat agree.

This is one of the most important findings of the survey. It shows that while municipalities support the principle of a stronger link between the local economy and local revenues, they are not convinced that the current institutional and administrative environment is sufficiently prepared for the introduction of such a mechanism. This uncertainty may be linked to several factors: the complexity of tax administration, the need for a clear definition of the tax base, the risk of uneven revenue distribution, as well as the need for reliable coordination between central and local authorities.

Consequently, any reform in this direction could not be reduced solely to a change in revenue distribution. It would require a clear regulatory framework, administrative capacity, reliable data, a predictable distribution mechanism, and a well-developed system for compensating municipalities with a weaker economic base.

6. Statement 6: Such a reform would create a risk of widening the disparities between economically stronger and weaker municipalities.

The survey shows that municipalities clearly recognize the risk of increasing disparities between economically stronger and weaker areas. Two respondents strongly agree, and four somewhat agree, that such a reform could deepen inequalities between municipalities. Only two somewhat disagree.

This result is entirely expected in the context of the Bulgarian municipal system, which is characterised by significant differences in demographic structure, economic base, investment potential, the labour market, and access to infrastructure. If a portion of the revenues linked to economic activity remains at the local level without a corrective mechanism, economically stronger municipalities could increase their revenue base significantly faster than weaker ones. This could exacerbate existing territorial imbalances.

At the same time, this risk does not lead to a rejection of the idea. On the contrary, the responses indicate that municipalities tend to support such a reform, but on the condition that it is accompanied by equalisation or compensation mechanisms.

7. Statement 7: In the event of the possible introduction of such a mechanism, it is necessary to provide for an equalisation/compensation mechanism for municipalities with a lower economic base.

One of the strongest findings in the survey is the nearly unanimous support for providing an equalisation or compensation mechanism for municipalities with a weaker economic base. Seven of the respondents strongly agree, one somewhat agrees, and only one somewhat disagrees. This confirms that any potential linking of local revenues to economic activity should be designed not as a mechanical retention of revenues where they are generated, but as a balanced system that combines incentives for development with guarantees of territorial equity. Such a system could include both an element of retaining a portion of revenues at the local level and an equalisation

formula that takes into account the economic base, population, expenditure needs, infrastructure deficits, and opportunities for generating own-source revenue.

This finding is particularly important for formulating recommendations. It shows that local authorities are not seeking solely fiscal autonomy, but rather balanced decentralisation, in which municipalities with active economic policies are incentivised, without this leading to the neglect of weaker territories.

Taken together, the Likert-scale statements show a consistent pattern: municipalities support the principle of a stronger fiscal link between local economic activity and municipal revenues, but they also emphasise the need for institutional readiness, predictable rules and safeguards against territorial disparities.

8. Benefits identified by municipalities: What would be the most important benefits of such a mechanism? Selection of up to three answers.

Since respondents could select up to three answers, the number of selected benefits exceeds the number of surveyed municipalities. The results should therefore be interpreted as a ranking of perceived benefits rather than as mutually exclusive choices.

Among the most important benefits of such a mechanism, the greatest support is for a better link between local policy and local development. This answer was selected by seven respondents. This is followed by greater financial autonomy and a stronger incentive to attract investment, each cited by six respondents. Four respondents cited greater accountability of local authorities, and two cited a fairer distribution of resources.

These results show that municipalities perceive such a reform not only as a revenue-generating tool but as an opportunity to change the logic of local governance. The highest level of support for the response "better connection between local policy and local development" is particularly telling. It points to the understanding that local authorities need a clearer mechanism through which the results of their policies — such as improvements in administrative services, infrastructure, the business environment, and investment attractiveness — are reflected in their budgetary capacity.

From this perspective, the potential mechanism can be viewed as a tool for strengthening governance accountability. If a portion of the revenue generated by economic activity remains at the local level, municipalities will have a stronger incentive to pursue consistent policies to attract investment, develop industrial zones, support local businesses, and improve employment conditions.

9. Risks identified by municipalities: What would be the most significant risks? Selection of up to three answers.

As with the question on benefits, multiple answers were allowed. The responses therefore indicate the relative salience of different perceived risks rather than a single dominant concern for each municipality.

Respondents identify the increase in inequalities between municipalities as the most significant risk. This risk was cited by six respondents. Three each cited administrative complexity, revenue instability, and the difficulty in determining an appropriate tax base. Two cited an excessive burden on businesses, and two saw no significant risks.

This pattern of responses is important because it shows that the municipalities' main concerns are not so much directed at the very idea of linking revenues to economic activity as at the manner of its practical implementation. The risk of inequality is the primary concern, but technical challenges also stand out — how to determine the appropriate tax base, how to avoid revenue instability, how to administer the mechanism, and how to avoid creating an additional burden on businesses.

This means that any future reform must be carefully designed. It is necessary to avoid a model in which municipalities begin to compete through tax breaks or create different administrative regimes that could hinder business. A more appropriate model would be to share a portion of existing national taxes or to distribute revenues according to a formula, rather than necessarily introducing a new local tax that would increase the tax burden.

10. Preferred model for linking local revenues to economic activity: Which of the following approaches do you think is most suitable for Bulgaria?

The responses to the question show a clear preference for a model in which a larger share of national taxes remains with the municipalities. This response was selected by 8 out of 9 surveyed municipalities, making it the most strongly supported approach in the survey.

Although the question was designed to identify the most suitable approach, some municipalities indicated more than one option. The results should therefore be read as evidence of preferred reform directions rather than as strictly mutually exclusive choices.

Second, the expansion of municipalities' powers regarding existing local taxes stands out, cited by 3 respondents. However, this response does not supplant the primary preference for sharing national taxes, but rather complements it. This indicates that some municipalities view the reform not only as a matter of new transfers or shared revenues, but also as an opportunity for broader tax autonomy within the existing local tax system.

Only one respondent cited targeted incentives or transfers based on economic performance as the most appropriate approach. There was no reported support for introducing a new local tax or a new tax element linked to economic activity, nor for the response "I do not support such a change."

This result is particularly important for the study because it shows that the surveyed municipalities do not perceive the reform primarily as the introduction of a new tax burden on businesses. On the contrary, the preferred model involves the redistribution or sharing of existing national taxes, so that part of the fiscal impact of economic activity remains at the local level.

Consequently, the survey results support the argument that a potential reform in Bulgaria should focus on a partial, predictable, and formula-based sharing of revenue from national taxes, particularly those related to income, employment, and economic activity. Such a model could create a more direct link between local economic development and municipal budgets, without necessarily imposing a new tax burden on businesses.

This finding is consistent with the historical analysis presented earlier in the study, which showed that Bulgarian municipalities previously had a stronger link to revenues from personal income tax and corporate profit tax. The preferred model expressed by respondents therefore points not to an entirely new policy logic, but to the possible restoration and redesign of a fiscal link that existed in earlier stages of Bulgaria's municipal finance system.

Conclusions from the open-ended responses

The open-ended responses confirm and deepen the quantitative findings of the survey. They show that municipalities do not primarily seek the introduction of a new local business tax, but rather a mechanism for sharing existing national tax revenues linked to economic activity, especially personal income tax and corporate income tax. Several respondents suggest that a fixed share of these revenues should remain in municipal budgets. This approach appears more politically and economically feasible, as it would not necessarily increase the tax burden on businesses, but would change the distribution of already existing revenues.

The responses also indicate that such a reform should not be treated only as a technical tax measure. Some municipalities emphasise the need for a targeted local investment resource to be reinvested in the local economy. Others underline the importance of a bottom-up approach, where local needs are identified according to the specific characteristics of each municipality. At the same time, respondents point to the need for national and regional coordination in order to avoid duplication of similar economic activities in neighbouring municipalities and to encourage complementarity between territories.

Overall, the survey confirms that municipalities recognise the limitations of the current revenue system and support a stronger link between local economic activity and municipal budgets. They associate such a reform with greater financial autonomy, stronger incentives to attract investment and a better connection between local policy and local development. However, they also stress important risks, especially the possibility of widening disparities between economically stronger and weaker municipalities, administrative complexity, revenue instability and the difficulty of defining an appropriate tax base.

The main conclusion is that the preferred direction of reform is not unlimited tax autonomy or a new tax burden on business, but a carefully designed revenue-sharing mechanism. Such a model should combine three elements: a local incentive, a national guarantee and regional coordination. The local incentive would allow part of the revenue generated by economic activity to remain in the municipality. The national guarantee would operate through equalisation or compensation mechanisms for municipalities with weaker economic bases. Regional coordination would reduce the risk of fragmentation and inefficient competition.

Therefore, a possible reform in Bulgaria should be gradual, transparent and formula-based. It could start with a clearly defined share of selected national tax revenues, combined with safeguards for weaker municipalities and reliable data for monitoring the effects. In this sense, the survey supports the main thesis of the study: linking local revenues to economic activity can strengthen local development incentives, but only if it is balanced by fiscal fairness, administrative predictability and protection for municipalities with lower economic potential.

## 4 DISCUSSION

The case of the Trakia Economic Zone provides a useful empirical illustration of the broader argument developed in this study. It shows that municipalities can play an active role in creating the conditions for investment, employment and local economic development, even when the existing local revenue system provides only limited fiscal rewards for these efforts.

Trakia Economic Zone has become one of the most important industrial and investment clusters in Bulgaria and South-Eastern Europe. It brings together several industrial zones in the Plovdiv region and is based on cooperation between municipalities, businesses and partner organisations. The role of Plovdiv Municipality is particularly relevant, as it goes beyond the passive provision of land or infrastructure. The municipality supports investors through administrative, informational and coordination services, assistance in identifying suitable land and premises, guidance through investment certification procedures, investment promotion, e-services and cooperation with educational and labour-market institutions.

This example is important because it demonstrates that local authorities are not merely recipients of economic development, but active facilitators of it. Municipalities invest administrative capacity, infrastructure, coordination efforts and institutional support in order to attract business and create employment. However, under the current

Bulgarian revenue system, a significant part of the fiscal effects of this economic activity is realised at national rather than municipal level. This creates a mismatch between local efforts and local fiscal returns.

The results of the survey confirm that this mismatch is recognised by municipalities themselves. The surveyed municipalities generally do not perceive the current local revenue system as sufficiently incentive-based. They support a stronger link between economic activity on their territory and revenues in municipal budgets, and associate such reform with greater financial autonomy, stronger incentives to attract investment and a better connection between local policy and local development. In this sense, the Trakia Economic Zone is not an isolated example, but an illustration of a more general problem identified by the survey: municipalities contribute to local economic growth, but do not receive a sufficiently direct fiscal reward for doing so.

At the same time, the survey results also show that municipalities are aware of the risks. They recognise that a stronger link between economic activity and local revenues could deepen disparities between economically stronger and weaker municipalities. This is why the broad support for an equalisation or compensation mechanism is particularly important. The reform should not simply leave all revenues where they are generated, as this could strengthen already existing territorial imbalances. Instead, it should combine a visible local incentive with safeguards for municipalities with a weaker economic base.

The survey also clarifies the preferred direction of reform. Municipalities do not primarily support the introduction of a new local business tax or an additional tax burden on businesses. Rather, they favour the sharing of existing national tax revenues, especially revenues linked to personal income tax and corporate income tax. This is consistent with the historical analysis of Bulgaria, which shows that in the early 2000s municipalities had a stronger link to direct tax revenues, while this link was gradually weakened and removed after 2007.

Therefore, the discussion should not be framed only as a question of whether Bulgaria needs a new local business tax. The more important issue is how to create a more direct, predictable and balanced connection between local economic activity and municipal revenues. The Trakia Economic Zone shows why such a link matters in practice, while the survey results show that municipalities themselves support this direction, provided that it is accompanied by clear rules, equalisation safeguards and institutional predictability.

In this sense, the most appropriate reform direction for Bulgaria appears to be a carefully designed revenue-sharing mechanism rather than a new local tax. Such a mechanism should allow municipalities that actively support investment, employment and business development to retain a visible part of the fiscal benefits generated by this activity. At the same time, it should include formula-based equalisation or compensation instruments to protect municipalities with weaker economic potential.

The broader conclusion is that local business taxation and shared tax revenues should be understood not only as fiscal instruments, but also as mechanisms for aligning local responsibilities, local development efforts and local financial outcomes. A well-designed model could strengthen municipal incentives, improve financial autonomy and support more active local economic governance, while preserving territorial fairness.

# 5 CONCLUSION

In conclusion, the study proves its main hypothesis by combining theoretical, comparative, historical and empirical evidence. The theoretical review shows that local revenues are not only instruments for financing municipal activities, but can also function as fiscal incentives that shape the behaviour of local authorities. When part of the fiscal result generated by economic activity remains at the local level, municipalities have a stronger interest in investing in infrastructure, administrative efficiency, investor servicing, human capital and a better business environment.

The comparative analysis confirms that several European countries use different models to link municipal revenues with economic activity, including local business taxes, shared personal income tax, shared corporate income tax, and taxes on commercial property and land. These models show that local revenue systems can support local development, but only when they are designed to combine local incentives, predictable rules and equalisation mechanisms.

The Bulgarian historical experience also supports the hypothesis. In the period 2000–2002, municipalities had a more direct link to revenues from personal income tax and corporate income tax, which created a fiscal incentive to support employment, investment and local economic activity. This link was gradually weakened after 2003 and removed after 2007, leaving municipalities without a direct revenue mechanism that rewards their efforts to improve the local economic environment.

The current structure of local taxes in Bulgaria further confirms the problem. The fiscally significant local taxes are mainly related to property, property acquisition and vehicles, while taxes formally linked to business activity — such as the patent tax, the tourist tax and the tax on taxi passenger transport — have a narrow scope and low revenue yield. The immovable property tax provides only a partial and indirect link to investment in the territory, but does not reflect turnover, profit, employment, productivity or value added.

The empirical survey confirms the practical relevance of the hypothesis. The surveyed municipalities perceive the current system as insufficiently incentive-based, support a stronger link between economic activity and local revenues, and associate such reform with greater financial autonomy, stronger incentives to attract investment and a better connection between local policy and local development. At the same time, they clearly recognise the risk of deepening disparities between economically stronger and weaker municipalities and strongly support the need for equalisation or compensation mechanisms.

The example of Trakia Economic Zone illustrates this mechanism in practice. It shows that municipalities can actively contribute to investment, employment and economic development through infrastructure, administrative coordination, investor servicing, electronic services and partnerships with businesses and educational institutions. However, a significant part of the fiscal effects of such activity is realised at the national rather than the local level. This confirms the need for better alignment between local development efforts and municipal financial outcomes. Therefore, the hypothesis of the study is proven: a closer link between local revenues and economic activity can create stronger fiscal incentives for municipalities to support investment, entrepreneurship, employment and improvements in the business environment, while also increasing the financial autonomy and effectiveness of local government. At the same time, the study proves the conditional nature of this hypothesis: such a mechanism would be sustainable and fair only if it combines local fiscal reward with clear equalisation and compensation instruments for municipalities with weaker economic bases.

The key issue is design. If additional revenues are fully neutralised through the transfer system, the incentive for local economic development will remain weak. If revenues remain entirely where they are generated, without a corrective mechanism, wealthier municipalities may pull further ahead. For this reason, reform must strike a balance between incentives and solidarity.

The analysis therefore suggests that Bulgaria does not necessarily need a new traditional local business tax. A more appropriate approach would be to restore the fiscal link between local economic activity and municipal revenues through partial, transparent and predictable sharing of national tax revenues. Such a mechanism should be formula-based, data-driven and introduced gradually, possibly through simulations or pilot application before national implementation.

In this sense, the debate on local business taxation in Bulgaria should be broadened. It should not be reduced to the question of whether to introduce a new tax on business, but should focus on how to place municipalities in a better position to share in the fiscal benefits of the economic development they help generate. This is the essence of fiscal decentralisation as an incentive mechanism: not simply more revenue for municipalities, but better alignment between local responsibilities, local efforts and local financial outcomes.

## 6 REFERENCES [FONT TIMES NEW ROMAN, SIZE 12, BOLD][1]


**Books**

**Musgrave, R. A. (1959). *The theory of public finance: A study in public economy*. New York: McGraw-Hill.**

**Oates, W. E. (1972). *Fiscal federalism*. New York: Harcourt Brace Jovanovich.**

**Rodden, J. A., Eskeland, G. S. and Litvack, J. (eds.) (2003). *Fiscal decentralization and the challenge of hard budget constraints*. Cambridge, MA: MIT Press.**

**Print Journal articles**

**Balaguer-Coll, M. T., Narbón-Perpiñá, I., Peiró-Palomino, J. and Tortosa-Ausina, E. (2022). Quality of government and economic growth at the municipal level: Evidence from Spain. *Journal of Regional Science*, 62(1), pp. 96–124.**

**Oates, W. E. (1999). An essay on fiscal federalism. *Journal of Economic Literature*, 37(3), pp. 1120–1149. https://doi.org/10.1257/jel.37.3.1120.**

**Qian, Y. and Weingast, B. R. (1997). Federalism as a commitment to preserving market incentives. *Journal of Economic Perspectives*, 11(4), pp. 83–92. https://doi.org/10.1257/jep.11.4.83.**

**Tiebout, C. M. (1956). A pure theory of local expenditures. *Journal of Political Economy*, 64(5), pp. 416–424. https://doi.org/10.1086/257839.**


[1] Sources must be numbered and listed in alphabetical order by the author surnames or by the publication title in the case of anonymous authors. Units of referenced sources **must not be grouped/divided** by specific resource types. In the present template the sources are grouped by type to facilitate the preparation of your bibliography).

**Weingast, B. R. (2009). Second generation fiscal federalism: The implications of fiscal incentives. *Journal of Urban Economics*, 65(3), pp. 279–293. https://doi.org/10.1016/j.jue.2008.12.005.**
**Wilson, J. D. (1986). A theory of interregional tax competition. *Journal of Urban Economics*, 19(3), pp. 296–315.**
**Zodrow, G. R. and Mieszkowski, P. (1986). Pigou, Tiebout, property taxation, and the underprovision of local public goods. *Journal of Urban Economics*, 19(3), pp. 356–370.**

**Documents of international organizations**
**Blöchliger, H. (2011). *Tax competition between sub-central governments*. Paris: OECD Publishing.**
**CEMR. (2022). *Principles for a digital transition in European local and regional governments*. Brussels: Council of European Municipalities and Regions. At https://ccre-cemr.org/wp-content/uploads/2024/04/CEMR_position_paper_Digital_services_for_all_EN_annex.pdf , accessed 7 June 2026.**
**Committee of the Regions. (2025). *The State of Regions and Cities in the European Union*. Brussels: European Committee of the Regions. At https://www.cor.europa.eu/en/plenaries-events/state-regions-and-cities-european-union-2025, accessed 7 June 2026.**
**Committee of the Regions. (n.d.). *Bulgaria – Fiscal Powers*. Brussels: European Committee of the Regions. At https://portal.cor.europa.eu/divisionpowers/Pages/Bulgaria-Fiscal-Powers.aspx, accessed 7 June 2026.**
**Herrmann, B. (2022). *Local taxes on economic activity in municipalities in EU Member States* (JRC129095). Luxembourg: Publications Office of the European Union, Joint Research Centre. At https://publications.jrc.ec.europa.eu/repository/handle/JRC129095, accessed 7 June 2026.**
**Jong, D. et al. (2021). *A comprehensive approach to understanding urban productivity effects of local governments: Local autonomy, government quality and fragmentation*. OECD Regional Development Papers, No. 11. Paris: OECD Publishing.**
**OECD. (2015). *The innovation imperative in the public sector: Setting an agenda for action*. Paris: OECD Publishing.**
**OECD. (2017). *Systems approaches to public sector challenges: Working with change*. Paris: OECD Publishing.**
**OECD. (2017). *Schools at the crossroads of innovation in cities and regions*. Paris: OECD Publishing.**
**OECD. (2021). *Decentralisation and regionalisation in Bulgaria: Towards balanced regional development*. Paris: OECD Publishing.**
**OECD. (2021). *Funding and financing of local government public investment: A framework and application to five OECD countries*. OECD Working Papers on Fiscal Federalism. At https://www.oecd.org/content/dam/oecd/en/publications/reports/2021/03/funding-and-financing-of-local-government-public-investment_f19213ba/162d8285-en.pdf, accessed 7 June 2026.**
**OECD. (2022). *2022 synthesis report: World Observatory on Subnational Government Finance and Investment*. Paris: OECD Publishing.**

**OECD. (2023).** ***Financing cities of tomorrow*****. Paris: OECD Publishing. At https://www.oecd.org/en/publications/financing-cities-of-tomorrow_51bd124a-en.html, accessed 7 June 2026.**
**OECD. (2025).** ***Intergovernmental fiscal transfers and fiscal equalisation in a time of consolidation*****. Paris: OECD Publishing. At https://www.oecd.org/en/publications/intergovernmental-fiscal-transfers-and-fiscal-equalisation-in-a-time-of-consolidation_4853a4d0-en.html, accessed 7 June 2026.**
**OECD. (n.d.).** ***Local employment and economic development*****. Paris: OECD. At https://www.oecd.org/en/topics/policy-issues/local-employment-and-economic-development.html, accessed 7 June 2026.**
**Preyer, E., Kalcheva, D., Curtale, R., Tucci, M., Kučas, A., Bel, G., Damian, A. C., Łukomska, J., Šķiltere, S., Chtioui, M., Hesse, M., Starke, T., Lyytikäinen, T., Loiacono, L., Secomandi, R., Gastaldi, F., Ferreira, J., Sirvydis, V., Kálmán, J., Käärmann-Liive, K., Runtic, D., Petrovici, N., Houlberg, K., Ramberg, U., Turley, G., Herrmann, B., Agundez Garcia, A., von Ehrlich, M. and Sedmihradská, L. (2026).** ***Local taxes and economic growth*** **(JRC145286). Luxembourg: Publications Office of the European Union, Joint Research Centre. https://doi.org/10.2760/1826247. At https://publications.jrc.ec.europa.eu/repository/handle/JRC145286, accessed 7 June 2026.**
**Shah, A. (2006).** ***A practitioner's guide to intergovernmental fiscal transfers*****. World Bank Policy Research Working Paper No. 4039. Washington, DC: World Bank. At https://openknowledge.worldbank.org/entities/publication/a6fcf378-81ae-5fdb-82b5-52e7ea504dd0, accessed 7 June 2026.**
**World Bank. (2021).** ***Local economic development: Fueling private sector investments and growth*****. Washington, DC: World Bank Group. At https://documents1.worldbank.org/curated/en/947611624606675453/pdf/Local-Economic-Development-Fueling-Private-Sector-Investments-and-Growth.pdf, accessed 7 June 2026.**

**Other Documents**

**Industrial Zones in Bulgaria. (n.d.).** ***Industrial and commercial zones in Bulgaria*****. At https://www.industrial-zones.com/, accessed 7 June 2026.**
**Invest Plovdiv. (n.d.).** ***Why Plovdiv? Investment opportunities in Europe*****. Municipality of Plovdiv. At https://invest.plovdiv.bg/, accessed 7 June 2026.**
**Ministry of Finance of the Republic of Bulgaria. (n.d.).** ***Reports on the execution of the Consolidated Fiscal Programme*****. Sofia: Ministry of Finance. At https://www.minfin.bg/, accessed 7 June 2026.**
**National Statistical Institute. (n.d.).** ***Population, demographic and regional statistics*****. Sofia: National Statistical Institute. At https://www.nsi.bg/en, accessed 7 June 2026.**
**Eurostat. (n.d.).** ***Government revenue, expenditure and main aggregates*****. Luxembourg: Eurostat. At https://ec.europa.eu/eurostat/databrowser/, accessed 7 June 2026.**
**Eurostat. (n.d.).** ***Taxation statistics*****. Luxembourg: Eurostat. At https://ec.europa.eu/eurostat/databrowser/, accessed 7 June 2026.**
**Author's survey of Bulgarian municipalities. (2026).** ***Survey on the views of municipalities regarding the possibilities for linking local revenues with economic activity*****. Unpublished empirical material.**

**National Official Documents**

**Constitution of the Republic of Bulgaria. Promulgated, State Gazette No. 56 of 13 July 1991, as amended.**
**Local Self-Government and Local Administration Act. Promulgated, State Gazette No. 77 of 17 September 1991, as amended.**
**Local Taxes and Fees Act. Promulgated, State Gazette No. 117 of 10 December 1997, as amended.**
**Municipal Budgets Act. Promulgated, State Gazette No. 33 of 24 March 1998, repealed.**
**State Budget Acts of the Republic of Bulgaria. Various years, 2000–2007. Sofia: National Assembly of the Republic of Bulgaria.**

**The use of AI model OpenAI. (2026). ChatGPT, GPT-5.5 Thinking [Large language model]. https://chat.openai.com/ The AI model was used for language editing, translation, text structuring and assistance in preparing summaries and references. The author remains responsible for the content, analysis and final conclusions.**