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FINANCIAL DECENTRALISATION, PREREQUISITE FOR EFFECTIVE LOCAL GOVERNMENT IN THE CONTEXT OF "EUROPE 2020"

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ABSTRACT
The new strategic document Europe 2020 considered priorities in the development of the EU: the growth of knowledge, sustainable growth, inclusion (social inclusion), innovation, mobile youth, digital society,industrial policy for green growth, European antipoverty platform.
Achieving these ambitious goals should be achieved through the widespread inclusion of multiple active entities including: national, regional and local authorities. This European strategy document will lead to a significant change in the balance between central and local governments. Increasing socio-economic role of municipalities, districts and regions will continue to go on the lines of decentralization and regional development. Decentralization process, which provides liability for carrying out the functions of local and regional authority, must be performed by general standards and legal guarantees of equality between different communities and regions. On this basis, can actually be implemented decentralization and measuring the success or failure of the entire process. Fiscal decentralization does not achieve results on the reduced powers of municipalities to plan and manage costs for delegated services and transfers from the sector ministries. Own revenues are often replaced by compensatory subsidies. On the other hand, municipalities have a separate budget with a gradually increasing share of own revenue (in local taxes), which is linked to their respective powers to partially determine the amount of local taxes and fees in the legally regulated limits. **The main objective** of the study is to examine the importance of fiscal decentralization for effective local government. Approaches and methods: a systematic approach, the axiomatic method (hypothetical-deductive), monographic and legal methods, SWOT analysis. Expectations of the study are related to identification and systematization of the main problems and prospects for effective development of the municipalities under the current parameters of fiscal decentralization in Bulgaria.

Keywords: Strategy Europe 2020, fiscal decentralization, local government, regional development

INTRODUCTION

„Europe 2020" is the programme that the EU and its member-states have agreed upon in order to "help Europe recover from the crisis and come out of it stronger both internally and on an international level" (1). Europe's exodus from the crisis requires coordination and a complete programme of reforms, which include fiscal consolidation, a return to stable macroeconomic conditions and fostering growth through suitable measures.

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In order to measure the progress in achieving the goals of Strategy Europe 2020, five EU priorities have been set, which **have become national objectives** for every member-state. Efforts are directly primarily towards:

1. Employment;
2. Scientific research and development activity;
3. Climate change and energy;
4. Education;
5. Poverty and social exclusion.

In order to achieve the set goals and priorities, coordinated and concentrated efforts by the EU are necessary, on the part of national governments and the organs of local government, as an expression of "subsidiarity." (2)

The main obstacle to achieving the Strategy's goals would be the uneven social and economical development within the Union and within the individual states. Regional differences and disproportions can cause major problems for the present and the future of the EU. The pessimistic attitudes shared by both old and new member-states, combined with the negative consequences of the global economic crisis have led to numerous concerns regarding the general vision for the development of the "old continent."

EU's regional policy for the programme period 2007-2013 has been aimed at convergence, increased competitiveness of the regions, employment and intensive territorial cooperation. Towards the end of the programme period, the achieved results can certainly not be evaluated as satisfactory, with regard to the latest member-states. Local self-governance has a decisive role in the process of implementing national and over-national policies for regional development. Yet its goals cannot be accomplished without development of the so-called decentralisation processes, as a collective of legislative, administrative, political and financial actions aimed at the transfer of authority and resources for exercising authority from the higher to the lower levels of public governance.

The main objective of this study is to examine the significance of financial decentralisation for effective local self-governance. **The approaches and methods of the study include**: systemic approach, axiomatic method (hypothetical-deductive), monographic and normative methods.

RESULTS AND DISCUSSION

The concept of decentralisation originated in the middle of the last century. It is an objective result of ongoing social processes and phenomena. Based on the causes (also known as forces) (3) that cause them, they can be systematised into four groups:

1. Aiming for regional political freedom, participation, and conflict resolution. In this situation decentralisation occurs as political reaction to the failures of over-centralised political systems. This type of decentralization was at least in the first place not driven by economic efficiency goals but by demand for regional independence and freedom from central government influence;
2. Pressure of global competition – here, decentralisation is as merely a parallel trend of globalisation. Decentralisation, curiously enough, is not just a parallel trend of globalisation, but is very much driven by it. Therefore, governments have to take into account the ongoing global processes before formulating their internal policy;
3. Demand for Stabilisation – the increasing number of "opening" states makes them vulnerable to an external shock. A response from the regional and local level is to gain power over protective and stabilization related policy instruments. Thus decentralization for regional "shock absorption" may be a paradoxical result of opening up;
4. Aiming for justice and efficiency of local public services – Noted inefficiencies in the management and delivery of local public services, often provided earlier through central government without a proper notion of local needs and demands, has raised the demand for decentralization to improve level, quality and efficiency in delivering public services.

There are various arguments for or against decentralisation in theory and practice:

Table 1. *Arguments "FOR" and arguments "AGAINST" decentralisation*

Arguments "FOR"	**Arguments "AGAINST"**
„Diversification hypothesis" - Equal levels of accessibility of public goods and services in all territories leads to inefficiency. To determine these levels, it is necessary to consider the local communities' preferences.	There is a possibility of increasing the inequality between regions, as the relative more prosperous regions, which can reach a high level of production of public goods, would attract people with relatively higher incomes, while the "poor" region can only offer lower levels of public goods and thus the local communities within them would be unequal.
Local governments are more open to innovation, which would lead to an increase in quality and a reduction of expenses when providing public goods and services.	On the local level, it is possible for the pressure of separate groups on local authorities to be greater than on the central government. There is also the supposition that staff on the local level is better qualified.
„Leviathan hypothesis (4)" – Centralisation in the provision of public goods and services leads to a monopoly of the central government on tax administration, and an urge towards maximising of income from taxes. Horizontal and vertical competition between the different levels of government could prevent that.	The high level of decentralisation could limit the urge of the central government to maintain macroeconomic stability.

One of the most important arguments for decentralisation is the so-called "Diversification hypothesis." In 1972, Wallace Oates, one of the most distinguished scientists in the field of decentralisation, formulated the so- called **Decentralisation Theorem**, which presents graphically where the optimal levels of providing public goods and services lie (5). Oates claimed that welfare is increased by better resource allocation throughout the public sector. He noted that local governments are much closer to the people and are also better acquainted with the local preferences and tastes than central structures. It is difficult for the central government to provide higher levels of services in some jurisdictions (6) than in others. Usually, there are political limitations, which could allow for various types of fiscal differentiation to be introduced, leading to optimization in the public sector. Therefore, increasing the welfare cannot be achieved through a centralised provision of public goods. In order to explain his theory, Oates made the clarification that there would be no transfers of benefits or losses between the territories that he examines. After all these explanations, he presented graphically the various levels of searching in the two examined jurisdictions, making one more clarification that in order to provide a certain good or service, the same expenses per unit are made, i.e. the expenses will remain constant regardless of how much demand increases.

The decentralisation process can be viewed in three dimensions:

1. **Administrative decentralisation** – transferring of rights and responsibilities related to determining the type, quality and range of providing public services, as well as the management of activities related to these services;
2. **Financial decentralisation** – provision of resources, transfer of resource sources, rights of determining their sizes, etc.;
3. **Political decentralisation** – giving authority for decision-making to a larger circle of institutions or such that closer to the citizens and the consumers of services.

In literature, there are other concepts for the types of decentralisation:

- **"Structural" decentralisation (7)**. When formulating this type of decentralisation, the governance formula, and more precisely the number of governance levels, is taken into consideration. Here, Treisman gave Singapore as an example, where there is no local government, which is relatively independent from the central government of China, where there are 4 sub-national levels of governance – provinces, prefectures, districts and cities on a regional level.
- **Decentralisation of "decisions," (7)** i.e. the ability of sub-national structures to take decisions independently (or relatively independently) without being dependent on the central government.
- **"Resource" decentralisation,** i.e. the way resources are distributed among the different levels of governance.
- **"Election" decentralisation,** i.e. the right of the respective community to elect their own governing organs. It is important to know if these organs are elected or appointed.
- **"Institutional" decentralisation,** which is expressed as the right of local communities and the organs elected by them to take part in decision-making on the central level, including the right to impose "veto" on decision taken centrally.

Decentralisation is directly dependent on:

1. The form of state structuring and administrative-territorial division of the different countries;
2. Political regime.

The form of state structuring shows the way a state has organised its territory (8). From this point we can differentiate a unitary state (consists of non-autonomous administrative-territorial units), federation (union state with common central organs and unified internal and external policy) and confederacy (a union of state on a contractual basis). **The administrative-territorial division** can be determined as a collective of administrative-territorial units different in extent and type, which are in mutual dependency, are connected with each other and form a cohesive system (8). Through the administrative-territorial structure the territorial boundaries of competence of the local organs of executive power and self-governance are drawn.

The political regime is a composite element of the state form. It comprises a collective of methods and means of exercising state power. The different types of political regime (democratic or undemocratic) are determined by: the state's nature, presence or lack of power division, character of legislation, condition of political pluralism, factual authority of state organs, etc.

The need for clarifying these concepts is important as decentralisation (in all of its types) is a direct function of the form of state structuring and administrative-territorial division, as well as the political regime.

A significant problem in our country is the decentralisation of resources, with which public goods and services can be realised. There is a fairly suitable grounding about which financial inflows should be decentralised. The criteria that a tax should meet could be systematised into several groups (9):

- **Local political responsibility –** every local tax should be visible to the local voters and be high enough to generate noticeable tax burden. The more burdens endure the "pain" of financing municipal expenses, the more likely they are to hold their electable leaders responsible for the quality of provided services;
- **Immobility of the tax base –** the tax base has to be relatively immobile so that it can allow local authorities a degree of flexibility with different rates, without losing much of their tax base. Thus, despite other problems related to them, local taxes on real estate can still be effective generators of revenue for numerous municipalities throughout the world;
- **Matching the income –** tax incomes should be matching to the local expense responsibilities. Incomes should be "alive" enough so that they can grow at the pace, with which local expense responsibilities increase (considering inflation). The participation of municipalities in sharing the revenues from national income taxes is very common phenomenon in countries in transition of Central and Eastern Europe. In spite of this, sharing the revenues from national income taxes could jeopardize the municipalities' access to revenues. The bigger the share of municipalities in a certain tax, the lesser the fiscal significance of that tax to the government. Its lower significance to the centre could lower the political interest of the government in this tax and the efforts of its collection. Thus, with a change in favour of indirect taxes, as is the situation in Bulgaria nowadays, even if municipalities receive a greater share of the national income tax, that could possibly fail to compensate for the decrease in the rates of income taxes. If we want the shared taxes approach to remain an element of municipal finance in the future, all income sources on the central level could be a better basis for tax sharing than income taxes alone;
- **Stability, predictability and sustainability of revenues** – tax revenues should be predictable, especially if municipalities are expected to participate in the financing of basic services such as education and healthcare. Relationship with shared income taxes, despite their vitality, could decrease municipal revenues during an economic low. Moreover, municipal tax sources should not be decreased without adequate replacement financing;
- **Avoiding the "export" of taxes towards persons who are not local inhabitants** – municipalities should not try to transfer the burden of locally-imposed taxes on persons who are not their citizens and have no "say" in local decisions on taxes and expenses. Otherwise, such a lack of accountability could encourage the tax-imposing municipality to make excessively big expenses, the local citizens would not relate the tax burdens to the benefits of the expenses, and local people in charge would be less responsible to their voters about the way they used up all actually collected tax funds;
- **Visibility of the tax base** – just as with the "export" of taxes, the visibility of the tax base ensures responsibility for it. In fact, the fiscal decentralisation could make taxes more visible if it transfers the tax burden from the indirect tax on the value-added to the direct local property taxes or other genuinely local sources of income;
- **Fairness of a certain tax** – local taxpayers should perceive a tax as fair. Otherwise, its payment would be problematic – certain taxpayers would evade paying it, and organised groups may even openly refuse to pay it. Thus, for example, can happen with inappropriately justified local business taxes;
- **Easy administration** – local taxes should be easily and economically administered. Central administration of some local taxes on behalf of municipalities could be more effective than their local administration. Tax collecting agencies would rarely pursue the collection of these taxes with the same insistence, with which the more directly dependent local organs would do. Simplification of the local taxes and fees, especially taxes on business collected in accordance to a certain schedule, could reduce administrative expenses without harming the collection of revenue.

In Bulgaria, the distributive and redistributive approaches are often used in supporting local authorities with the necessary resources, which would finance the deficit in providing public goods and services of a local character. Financial flows are redirected from the Republican budget to municipalities via the so-called subsidies or transfers. Through the so-called system of "transfers," the central government can redistribute resources to autonomous budgets, measuring 13.8% of GDP for the year 2009. Approximately 80% of all transfers to autonomous budgets were directed towards social security funds (SSO and NHCF) and municipalities.

It is necessary to specify and define the indications, with which we would measure the level of decentralisation. *Decentralisation is a process of transferring of authority and resources for exercising them from a higher to lower level of public governance.* Based on this definition, it is possible to measure the level of decentralisation:

1. With regard to authority, which is related to what activities are performed and managed by the sub-national levels of governance. The primary indication here should point out what portion of public expenses are done by the sub-national public levels of governance. It is determined by the equation:

(1.1)

$$\textbf{D. exp .=} \quad \frac{\text{Local expenses}}{\text{Total public expenditure expenses}} \quad \textbf{x 100 (in \%)}$$

or

(1.2)

$$\textbf{D. exp. =} \quad \frac{\text{Local expenses}}{\text{Gross domestic product}} \quad \textbf{x 100 (in \%)}$$

The second indicator (1.2) shows not only the dynamics of expenses, but also the dynamics of the GDP. It is the primary indicator of the state's economic development.

Table 2 orders some European countries in accordance with their level of decentralization.

It is clearly evident that the first five countries have decentralised a significant part of their public expenses in favour of local governments. This group includes Denmark, Sweden, Finland, the Netherlands, Italy and Norway. In the second "group" (share of local expenses between 10% and 15% of GDP) fall two types of countries. The first type is countries with numerous populations, such as the United Kingdom and France, which are distinguished by their well-developed market and social-political systems. This group also includes the countries of Central Europe and the Baltic republics, which were granted full membership into the Union in 2004, and for which it is considered that they have reformed their social-political systems to a great extent. The third "group" includes the countries, whose local expenses are between 5% and 10% of the GDP. The group includes five countries that have a triple-stage form of governance, with middle levels apart from the central and local governments, i.e. they have a federal structure. Thus, for example, Germany has 16 federal states, Austria has 9 provinces, Spain is a constitutional monarchy and consists of 17 autonomous districts, Belgium is a federal state with 3 districts, and Switzerland is composed of 26 districts called cantons. There is a particularly interesting phenomenon observed in three of these countries (Switzerland, Germany and Spain) – summing up the expenses of the two sub-national levels would produce a value greater than that of the central government, i.e. these are actual cases of true decentralisation of resource in the direction "from above to below." This third "group" also includes Bulgaria and Romania, which have been EU member-states for a very short time and do not yet have traditions in decentralisation. Changes in this direction are usually done under pressure and without a clear vision of the process's development. The last, fourth "group" includes the countries with the lowest levels of decentralisation of expenses, less than 5% of the GDP. They are Greece, Cyprus and Malta.

Table 2. *Order of some European countries in accordance with their level of decentralisation in public expenses – 2009.*

№	Country	Population	Place in order (per population)	Public expenses				Extent of expense decentralisation
				Total	Central government	Middle level	Local level	
1	Denmark	5511451	18	58.5	41.8	-	37.4	Over 15 % of GDP.
2	Sweden	9256347	14	54.9	30.8	-	26.3	
3	Finland	5326314	20	56.0	28.3	-	22.7	
4	Netherlands	16485787	8	51.4	30.6	-	17.6	
5	Italy	60045068	4	51.9	30.2	-	16.6	
6	Norway	4799252	21	45.8	36.5	-	15.0	
7	Poland	38135876	6	44.4	24.8	-	14.7	between 10% & 15% of GDP
8	United Kingdom	61595091	3	51.6	47.3	-	14.4	
9	Iceland	319368	30	50.9	38.1	-	13.6	
10	Latvia	2261294	24	43.9	24.7	-	12.8	
11	Czech Republic	10467542	12	45.9	31.5	-	12.4	
12	France	64366962	2	56.0	22.9	-	12.0	
13	Hungary	10030975	13	50.5	33.4	-	12.0	
14	Estonia	1340415	26	45.2	32.7	-	11.4	
15	Lithuania	3349872	23	43.6	25.4	-	10.6	
16	Romania	21498616	7	41.0	29.4	-	10.1	
17	Slovenia	2032362	25	49.0	30.7	-	10.1	
18	Austria	8355260	15	52.3	26.6	9.9	8.2	Between 5% and 10% of GDP
19	Bulgaria	7606551	17	40.6	30.2	-	8.2	
20	Germany	82002356	1	47.5	15.2	12.9	7.8	
21	Ireland	4450030	22	48.9	39.2	-	7.8	
22	Switzerland	7701856	16	33.7	10.4	13.6	7.4	
23	Belgium	10750000	10	54.2	30.0	15.3	7.3	
24	Spain	45828172	5	45.8	19.9	17.3	7.2	
25	Slovakia	5412254	19	41.5	23.7	-	7.2	
26	Portugal	10627250	11	48.2	35.4	-	7.1	
27	Luxemburg	493500	28	42.2	30.2	-	5.3	
28	Greece	11260402	9	53.2	40.9	-	3.1	Less than 5% of GDP
29	Cyprus	796875	27	45.8	38.8	-	2.1	
30	Malta	413609	29	43.9	43.8	-	0.6	
	EU 27	499700231	1	50.8	27.7	4.8	12.3	

Regarding the resources to exercise authority, which is related to the incomes administering the sub-national public levels of governance, the following principles apply:

(1.3)

$$\textbf{D income} = \frac{\text{Local incomes}}{\text{Total public expenditure incomes}} \textbf{ x 100 (in \%)}$$

or

(1.4)

$$\textbf{D income} = \frac{\text{Local incomes}}{\text{Gross domestic product}} \textbf{ x 100 (in \%)}$$

The second indicator shows not only the dynamics of incomes, but also the dynamics of the GDP. It is the primary indicator of the state's economic development. **Table 3** orders countries in accordance with the extent of incomes decentralisation in Europe:

Table 3. *Order of some European countries in accordance with their level of decentralisation in public incomes – 2009.*

№	Country	Population	Place in order (per population)	Public income				Extent of decentralisation in incomes
				Total	Central government	Middle level	Local level	
1	Denmark	5511451	18	55.7	39.8		36.60	over 15 % of GDP
2	Sweden	9256347	14	53.7	29.8		26.00	
3	Finland	5326314	20	53.3	23.4		22.30	
4	Netherlands	16485787	8	46.0	27.3		17.00	
5	Italy	60045068	4	46.6	25.4		16.30	
6	United Kingdom	61595091	3	40.4	36.4		14.10	Between 10% and 15% of GDP
7	Norway	4799252	21	55.5	47.2		14.10	
8	Poland	38135876	6	37.2	19.6		13.60	
9	Iceland	319368	30	40.9	29.8		12.6	
10	Czech Republic	10467542	12	40.2	26.6		11.80	
11	France	64366962	2	48.4	16.9		11.70	
12	Hungary	10030975	13	46.1	29.8		11.60	
13	Latvia	2261294	24	33.7	18.8		11.00	
14	Estonia	1340415	26	43.4	32.1		10.90	
15	Lithuania	3349872	23	34.5	19.7		10.40	
16	Slovenia	2032362	25	43.2	25.9		9.50	Between 5% and 10% of GDP
17	Romania	21498616	7	32.4	22.6		9.40	
18	Austria	8355260	15	48.8	23.9	9.3	7.90	
19	Switzerland	7701856	16	34.9	11.7	13.5	7.80	
20	Ireland	4450030	22	34.5	26.6		7.70	
21	Germany	82002356	1	44.5	13.5	12.2	7.60	
22	Bulgaria	7606551	17	35.9	26.2		7.20	
23	Belgium	10750000	10	48.1	25.7	14.5	7.10	
24	Spain	45828172	5	34.7	10.6	15.3	6.60	
25	Slovakia	5412254	19	33.6	17.0		6.50	
26	Portugal	10627250	11	38.8	26.5		6.40	
27	Luxemburg	493500	28	41.5	27.5		5.30	
28	Greece	11260402	9	37.8	25.8		3.10	Less than 5% of GDP
29	Cyprus	796875	27	39.8	30.1		2.10	
30	Malta	413609	29	40.1	40.0		0.70	
	EC 27	499700231		44.00	22.00	4.50	12.00	

It is clearly evident again that the first five countries have decentralised a major part of their public expenses and incomes in favour of local governments. This group includes Denmark, Sweden, Finland, the Netherlands and Italy.

The second "group" includes countries with a share of local incomes between 10% and 15% of the GDP, and the third "group" consists of the countries, whose local incomes are between 5% and 10% of the GDP. There is a particularly interesting phenomenon observed in three of these countries (Switzerland, Germany and Spain) – summing up the incomes of the two sub-national levels would produce a value greater than that of the central government. The last, fourth group includes the countries with the lowest extents of income decentralisation, under 5% of the GDP. They are Greece, Cyprus and Malta.

In order to establish the total level of public expenses, we use the data from the Consolidated Fiscal Programme / Consolidated state budget or National Budget. Unlike Table 3, where there is no distribution of own local incomes and transfers from the central government to municipalities within the mass of local incomes, the following Table 4 will make a detailed distinguishing, in order to determine the structure of the local incomes, after which the deterioration of the so-called autonomy ratio can be analysed (1.5).

Table 4. *Share of local incomes and expenses of the consolidated fiscal programme and the GDP, as well as the autonomy ratio for the period 1999 – 2009.*

	Share of local expenses of expenses per CFP - % (1.1)	Share of local expenses of GDP - % (1.2)	Share of local incomes of incomes per CFP - % (1.3)	Share of local incomes of GDP - % (1.4)	Share of transfers towards local governance of GDP -	Autonomy ratio (1.5)
1999	19.34	7.67	11.24	4.47	3.03	0.58
2000	17.85	7.32	10.14	4.10	3.04	0.57
2001	16.56	6.57	11.53	4.50	2.12	0.70
2002	18.78	7.21	11.89	4.49	2.62	0.63
2003	15.95	6.27	10.11	3.97	2.11	0.63
2004	15.67	5.98	5.19	2.07	3.99	0.33
2005	16.44	6.02	5.20	2.06	3.66	0.32
2006	18.24	6.44	6.14	2.37	4.22	0.34
2007	18.77	6.89	6.93	2.77	4.05	0.37
2008	19.96	7.29	6.55	2.58	4.40	0.33
2009	19.65	7.36	6.08	2.22	4.57	0.31

Two tendencies are evident in **Table 4**:
1. Decreasing the share of own municipal incomes;
2. Preservation of the relatively high level of municipal expenses.

Figure 1 presets the differences in the structures of municipal incomes in 1999 and 2009.

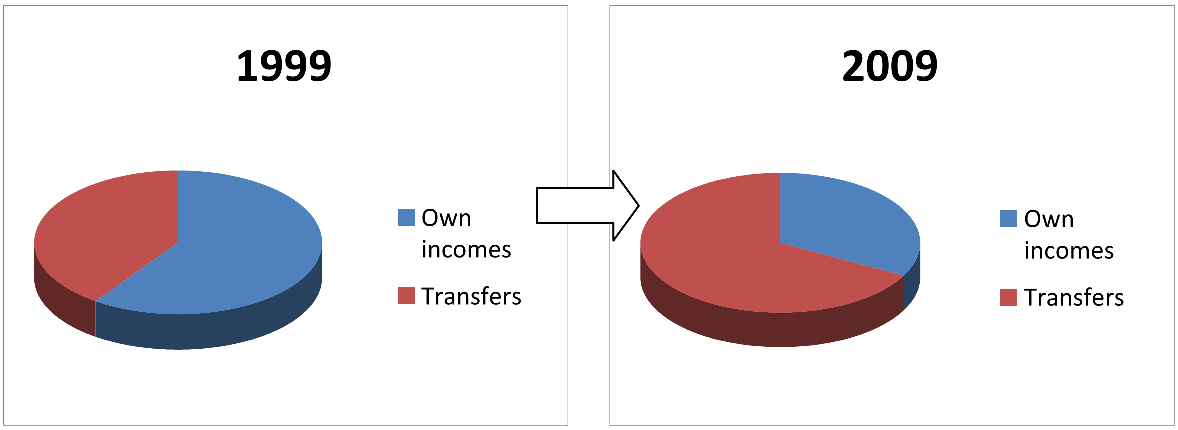

Figure 1. Structure of the local incomes in Bulgaria in 1999 and 2009.

There clearly is an increasing function of transfers from the central government and a decreasing share of own incomes. As a result of this, the autonomy ratio of Bulgarian municipalities has decreased.

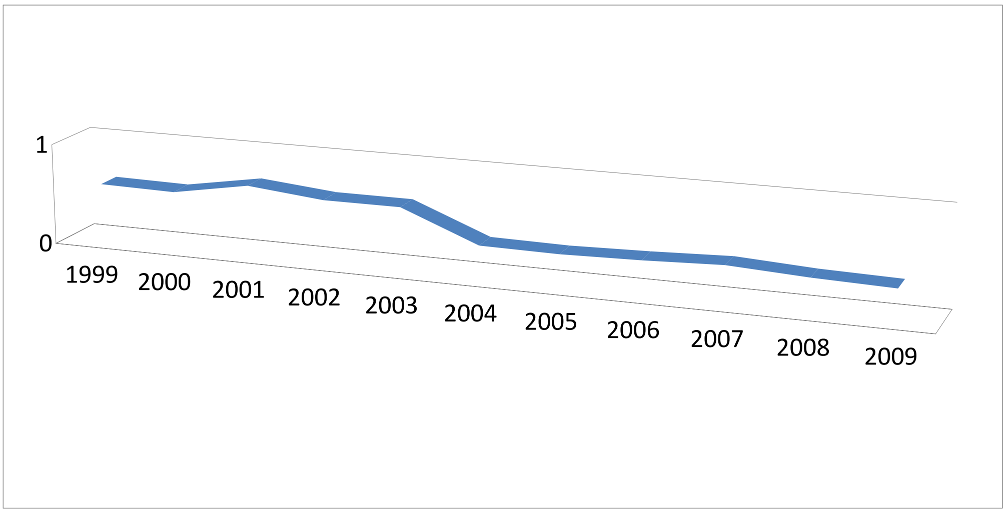

Figure 2. Changes in the autonomy ratio for the period 1999 – 2009.

The tendency in the ratio for the reviewed period is presented in **Figure 2.** The tendency is towards decreasing the share of own incomes, which puts municipalities in even greater dependence on the central government.

MEASURES AND RECOMMENDATIONS:

- During a period of economic crisis, an alarming tendency towards the centralisation of public resources can be observed;
- There is a need for increasing the extent of financial decentralisation in Bulgaria;
- An accelerated rate of increasing "goal-oriented subsidies" and a more moderate growth of "general subsidies" are visible, and these cannot lead to actual decentralisation;
- Greater transparency in budget relations between the different levels of public governance;
- Decentralised public resources are concentrated into municipal centres, while there is a lack or insufficiency of resources in the populated areas within their jurisdiction.

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