

## Financial Sustainability in Rural Areas in Bulgaria

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### Summary

One of the main functions of municipalities, as defined by national legislation, is the function associated with the implementation of the state policy for economic development locally. In this regard, the establishment and maintenance of technical infrastructure and other relevant commitments of the municipalities should be included in their investment activity. Identification and inclusion of investment intentions in key planning and operational documents, however, should comply with the financial capacity and capabilities of each municipality. Limited financial resources of EU Structural Investment Funds put rural areas municipalities in the complex situation to tailor their investment activity to the limitations of their municipal budgets. At the same time, the financial status of municipalities in rural areas is characterized by significant indebtedness, decapitalisation processes, poor financial performance indicators and weak financial discipline.

The main objective of the survey is to identify the main features of municipal finances in rural areas, which are key for the development of the rural areas. For this purpose, the calculated financial and fiscal sustainability indicators are compared with average value for the country and non-rural municipalities. The comparison is used benchmarking techniques and the descriptive statistical tools.

The main results show a serious lack of financial and fiscal discipline which suggests that the financial problems of municipalities in rural areas are results of the general economic and financial conjuncture in the country and of the shortage of management capacity of the municipal budgets.

**Key words:** financial stability, fiscal sustainability, municipal finance, rural areas

## Финансова устойчивост в селските райони на България

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### Резюме

Националното законодателство определя основните функции на общините, една от които е изпълнението на държавната политика за икономическо развитие на местно равнище. В тази връзка създаването и поддръжката на техническата инфраструктура и други съответни ангажименти на общините трябва да бъдат включени в инвестиционната им дейност. Определянето и включването на инвестиционните намерения в ключови планови и оперативни документи обаче трябва да съответства на финансовите възможности на всяка община. Ограничените финансови ресурси на структурните и инвестиционни фондове поставят общините в селските райони в сложната ситуация да приспособят инвестиционната си дейност към ограниченията на общинските си бюджети. Същевременно финансовото състояние на общините в селските райони се характеризира със значителна задлъжнялост, декапитализация, лоши показатели за финансовите резултати и слаба финансова дисциплина.

Основната цел на проучването е да се идентифицират основните характеристики на общинските финанси в селските райони, които са от ключово значение за развитието на селските райони. За тази цел изчислените показатели за финансова и фискална устойчивост се сравняват със средната стойност за страната и за урбанизираните общини. В сравнението се използва бенчмарк и статистически инструменти.

Основните резултати показват сериозна липса на финансова и фискална дисциплина, което доказва, че финансовите проблеми на общините в селските райони са резултат от общата икономиче-

ска и финансова конюнктура в страната и от липсата на капацитет в управлението на общинските бюджети.

**Ключови думи:** финансова стабилност, фискална устойчивост, общински финанси, селски райони

## **Introduction**

Bulgarian national legislation assigns basic economy development functions to local authorities i.e. municipalities. Individual municipalities implement the common policy on one hand according to the specific characteristics of the region in which they are located, the capacity and needs of local population and on the other – according to financial capabilities and resources available. This means that if financial resources are available, municipalities should provide the necessary technical infrastructure for the development of normal business relations. Such infrastructure encompasses roads, streets, water supply and sewerage, means for communication, administrative services with particular characteristics, etc. At the same time, the existing infrastructure should be maintained. This is a minimum requirement for the facilitation of local economy and for attracting investors.

Alongside their commitment to developing local economies, municipalities perform other functions related to social services, education, provisioning of administrative services, etc. Since funding is organized on budgetary principle, projected revenues are spent anteriorly to cover expenses related to matters of higher social significance, or such directly entrusted by the state (related to education, for example). Only after these are attended to, municipalities consider the existing viable options to invest in technical and business infrastructure.

Financial capacities of municipalities located in rural areas are limited. This is a result of the significantly lower level of urbanization and industrial development, and reduces their ability to generate revenues (from local taxes). Hence, the logical question is whether and to what extent the available municipal finances are sufficient for the rural municipalities to effectively perform their

functions in regard to the implementation of local economy development policies.

The aim of this study is to assess the current financial status of municipalities in rural areas, from the viewpoint of their capacity for adequate and full implementation of policies for local economy development through municipal investment activity.

## **1. Assessment of the financial capability of the rural municipalities**

### ***1.1 Methods for assessment the financial status***

The method used is statistical processing of financial data and physical indicators of rural municipalities in Bulgaria, according to Ministry of Finance official data.

The indicators used for methodical purposes in the study are the ones used for assessing the financial status and fiscal discipline of municipalities under the Law on public finances. These indicators are selected and used in accordance with the relevant requirements under Article 130a, paragraph 1 of the Law on public finances (criteria for financial sustainability) and Art. 32, paragraphs 1 and 2 of the Law on public finances (fiscal rules<sup>1</sup>). This set of indicators includes<sup>2</sup>:

<sup>1</sup> Art. 32. (1) The annual amount of payments on municipal debt for each municipality in each year may not exceed 15 percent of the average amount of own revenues and the general equalization subsidy for the last three years, calculated based on data from the annual reports for the implementation of the municipality budget. (2) The nominal value of the municipal guarantees issued during the current budget year may not exceed 5 percent of total revenue and equalization subsidy considering the last annual report on the implementation of the municipal budget.

<sup>2</sup> For analysis purposes “Municipal revenues” are in accordance with Art. 45, para. 1 pt. 1 of the Public Finance Law (excluding §46, §47 and §48), and “Municipal expenses” pursuant to Art. 45, para. 1, p. 2 of the Public Finance Law (excluding §19).

- Share of the income from general revenue;
- Costs of local activities covered by revenue;
- Debt as a percentage of projected revenues and equalization subsidy;
- Arrears as a percentage of projected revenues and equalization subsidy;
- Number of people (local population) per municipal officer;
- Share of the cost for salaries and benefits from the total cost;
- Share of capital expenditure from the total expenditure (investment activity);
- Budget balance;
- Property tax collectability (%);
- Vehicle tax collectability (%);
- Average collectability of both tax (%).

The study uses public available data for the period 2012–2016<sup>3</sup>.

The study is focus on the rural municipalities according to national definition for rural areas in Bulgaria.

### 1.2. Financial and fiscal indicators

A key indicator of the financial stability of each municipality is its ability to generate own income and use it to cover relevant costs. This ability is highly determined by the characteris-

<sup>3</sup> The information sources used represent databases with values for the revenue, expenses and indicators of Municipalities in Bulgaria: “Financial data for municipalities Art. 130 g para. 2 Law on Public Finances Q2 2016”, “Financial data for municipalities Art. 130 g para. 2 Law on Public Finances - 2015-Q1 2016”, “Criteria under Art. 130a, paragraph 1”, “Methodical instructions on the application of Art. 130a, paragraph 1 of the Law on Public Finances “published on the website of the Ministry of Finance at <http://www.minfin.bg/bg/page/810>

tics of local economic development, business activity and the level of income per capita. Since a substantial part of the costs is associated with the implementation of devoluted activities, these are financially covered by the state budget.

The share of own revenue from the general revenue in the rural municipality budget in 2015 is on average 28.61%. This value indicates that the municipality not only is unable to provide own revenue needed to finance devoluted activities, but is also unable to cover the direct costs associated with the municipal administration sustentation. The success rate in covering the costs of local activities with own revenue is estimated at 62.84%, while in municipalities outside the rural areas this rate is around 85%.

The spending of municipalities are covered by the subsidies from the central budget which ensure the implementation of their policies and ac-

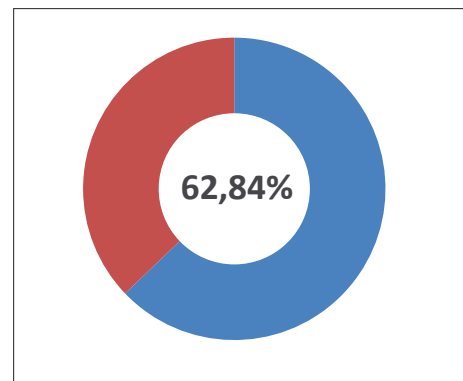


Fig. 1. Covering the costs of local activities with revenue

Source: The calculations made by the author are based on data from the Ministry of Finance.

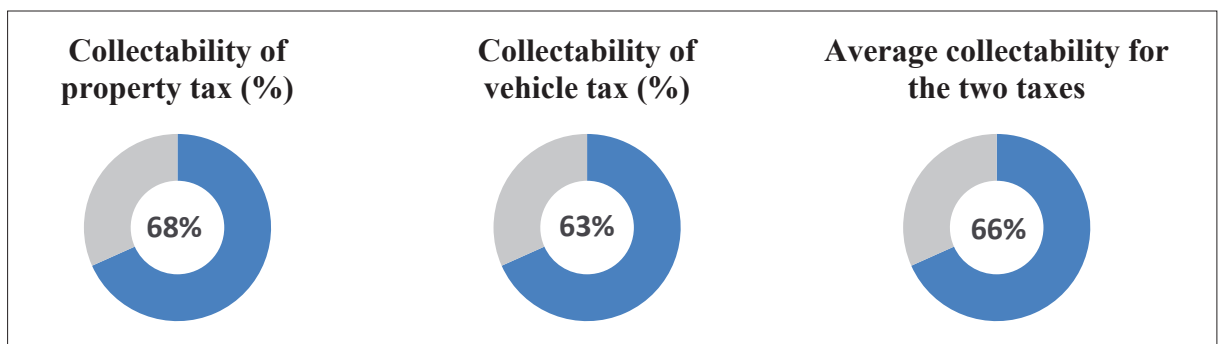


Fig. 2.

Source: The calculations made by the author are based on data from the Ministry of Finance.

tivities. The ability of rural municipalities to generate their own income significantly lags behind that of other municipalities.

The main source of revenue for municipalities in rural areas is revenue from local taxes. Unfortunately, statistics and financial data indicate that such municipalities cannot reach the limit of 2/3 tax collectability considering the above values of covering costs with own revenues.

Statistics outlines that other sources of own revenues of municipalities in rural areas, such as rental income, asset sales, municipal enterprises, concessions, etc. are practically episodic in nature and have negligible contribution to the revenue side of the budget. In this sense, the collectability of the tax is low, it is an evidence for poor willingness to make efforts to enforce fiscal discipline at the local level.

It should be noted that in case of permanent arrear at levels of about 50-60% of planned tax revenues, the application of restrictive measures for tax collection requires particularly political and management decisions. The administrative disinterest and lack of fiscal discipline additionally deepens the municipal debt.

A key indicator for financial sustainability of the municipalities in rural areas is a negative budget balance at the end of the financial year. The logic of budgetary financing is the negative budget balance should be an exception rather than a usual practice. In Bulgaria nearly 58% of rural municipalities reported a fiscal deficit in 2015.

The indicator for the share debt of as a percentage of revenue and public subsidies is 11.54% for the rural municipalities. The debt to a certain extent can be seen as a consequence of the budget deficits, the local authorities usually cover the deficits by the state subsidy. The value of the indicator could be reach 5% according to the Law on public finances<sup>4</sup>. In rural areas the value of the

<sup>4</sup> Art. 130a, Paragraph 2. Existing due payments related to municipal budget costs at the end of the year exceeded 15 percent of the average annual amount of expenses reported for the last four years.

Art. 130a, par. 3. Costs at the end of the year exceeded 50 percent of the average amount of expenses as reported for the last four years.

Art. 130a, par 4. The existing overdue payments related to municipal budget exceed 5 percent of the reported municipal expenses for the last year.

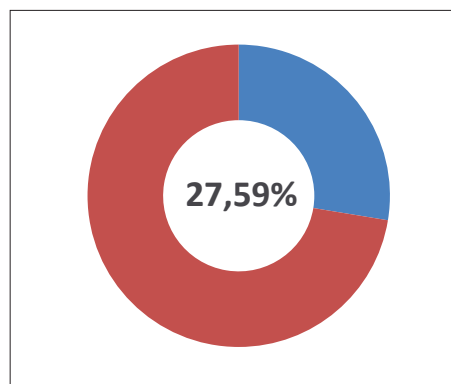


Fig. 3. Debt as a percentage of projected revenue and equalization subsidy

Source: The calculations made by the author are based on data from the Ministry of Finance.

indicator is more than two times higher than acceptable level.

The average amount of debt as a percentage of projected revenue and equalization subsidy for municipalities in rural areas is 27.59%. Since the indicator takes into account only principal payments during the financial year, the real debt exposure is not so great. On the other hand, some rural municipalities are unable to make debt payments for the year using own revenue. The severe budget constraints and accumulated debt limit the capability of the municipalities to use investment loans.

Municipal debt is generated mainly as a consequence of bridge financing of projects, which is opportunity to execute the project funded by the EU funds. The financial situation is worsen after the financial corrections for the projects imposed by the Management authorities, respectively the bridge loans was transformed into long-term debt exposure.

The main performance indicators are aimed to express the quality of the administrative services and labour force value. The productivity of the local administration show the capability to fulfill the obligations and decentralized activities.

The value of the indicator is on average 172 residents per municipal officer. This valued declined for the period 2011–2015, which can be explained with the negative demographic tendency in rural areas, than the administration efficiency.



Fig. 4. Number of residents per one municipal official

Source: The calculations made by the author are based on data from the Ministry of Finance.

The effectiveness of officials in rural areas is much lower than of officials in the urban areas. The difference is almost 3 times.

The efficiency indicator with greater financial significance is related to the share of expenditure on salaries and benefits from the total amount of expenses of the municipality (for local activities). This indicator in rural areas is 49.38%.

The value of the indicator shows that nearly half of the municipal budget is spent on employees' salaries.

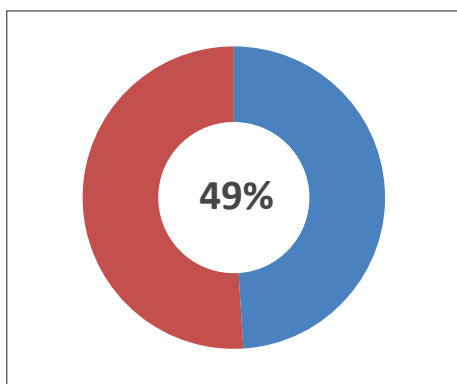


Fig. 5. Share of the cost of salaries and benefits from the total cost

Source: The calculations made by the author are based on data from the Ministry of Finance.

Nearly half of the budget of the rural municipalities is spent on salaries and benefits of the administrative staff. The investment activities are

substantially limited and the need of capital expenditures is significant.

## 2. Investment activity of the municipalities in rural areas

The investment activity of municipalities is measured by the share of capital expenditure as percentage of the total expenses. When calculating this indicator the expenditures co-financed with EU grants is not included. This explains to some extent the relatively low investment activity of 16.54%.

The investment activity within the annual budget of the rural municipalities is represented mainly by the maintenance of already constructed and operating assets. At the same time, municipalities often need to perform maintenance of unused infrastructure facilities since the municipality is committed to stewardship of these facilities.

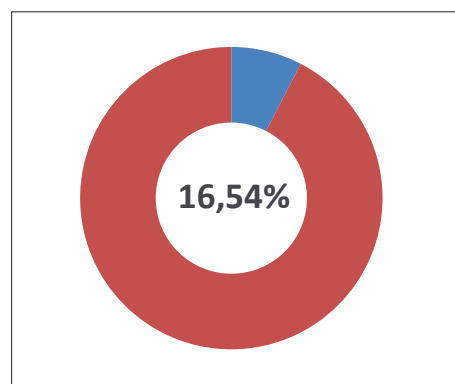


Fig. 6. Share of capital expenditure from total expenditure

Source: The calculations made by the author are based on data from the Ministry of Finance.

This index is considered essential in assessing the investment activity of municipalities, as it does not include grants for capital expenditure outside the target subsidy budget. The expense accounts for planned and current repairs of existing infrastructure. Within that percentage, in rural areas the practice is to carry out primarily urgent and emergency repairs of municipal buildings, roads and streets.

The investments of the rural municipalities are scarce and most of them rely on EU funds and grants from the state budget.



## **Findings and Conclusions**

The results from the assessment of the financial capability of the municipalities in rural areas could be summarized as follows:

- The financial sustainability is instable and investment activity is poor;

- The capability of rural municipalities of carrying out investment activities for improvement of the technical infrastructure, which is a prerequisite for the further investments, is very limited. Practically, the EU Structural Funds funding is main source for infrastructure project;

- Municipalities in rural areas have low credit ratings or have none at all, which is a logical consequence of deteriorating financial and fiscal indicators. This leads to the inability to attract bond or other forms of loans for investment purposes, except for bridge financing of EU funded projects, where the guarantee represents a registered pledge of future receivables of the investment projects;

- Financial performance of rural municipalities is a problem of the ability of the administration to adequately fulfill their commitments to conduct policies for local economy development.

The main conclusion of the analysis is the inability of municipalities in rural areas to carry

out efficiently the delegated statutory functions to develop local economies. Practices for continuous additional targeted funding and covering municipal budgets by the state budget raise the questions the effectiveness of the local administration to encourage the economic and social development. However there is a need to review and to update the documents refer to financial decentralization.

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