Case Study on Municipal Infrastructure Finance Reform in Bulgaria

Submitted to

Municipal Finance Task Force

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Infrastructure Finance Reform in Bulgaria

The following case study describes the comprehensive infrastructure finance reform in Bulgaria that was implemented in the period 2001–2005. The first section gives an overview of the case study. The second section provides background context for pre-reform local government finance conditions in Bulgaria, as well as an overview of the prerequisites that facilitated the infrastructure finance reform. Next, the third section discusses the infrastructure finance reform in detail. The final section presents lessons learned from the Bulgaria reform experience that could be applied to other local and national governments.

The research was drawn from several technical reports written for USAID's Local Government Initiative (LGI) project in Bulgaria. A complete list of sources can be found at the end of the report.

1. Overview

In the late 1990s, the Bulgarian local government finance system was poorly structured, leading to accumulating deficits in municipal budgets and disinvestment in infrastructure. Municipalities were not able to make infrastructure investments because of chronic operating deficits caused by systemic mismatches between available resources and service responsibilities, particularly for services mandated by the central government. Local governments had no taxing authority and revenues were derived primarily through transfers from the central government. The central government placed a low ceiling on capital investments. As comparative research shows, Bulgaria lagged far behind other Eastern European countries on a number of local investment indicators.

USAID-Led Assistance for Comprehensive Fiscal Decentralization Reform

Recognizing the critical nature of the problem, in 2001 USAID technical assistance organized a dialogue between the municipal sector leadership and the key central ministry officials that helped facilitate the initial reform steps. From this dialogue—and supporting technical studies—emerged a comprehensive fiscal decentralization program. Indeed, the dialogue itself was institutionalized in a high level Fiscal Decentralization Working Group created by decree of the Council of Ministers and which has been responsible for crafting the fiscal decentralization program and shepherding it into law.

The core of the reform program is a complete redesign of intergovernmental transfers so that funding is more in line with service requirements and mechanisms are considerably more transparent and predictable. In addition, local governments have been given authority to set service fees resulting in a doubling of this revenue source over the first three years of the program.. Further transfers of revenue sources and a constitutional amendment granting local taxing powers are under discussion. The Municipal Debt Act (MDA), which became effective on June 1, 2005, provides a well-structured environment for long-term borrowing, including prudent debt limits and transparent borrowing procedures.

Comprehensive Nature of the Infrastructure Finance Reform

One of the key components of the overall fiscal decentralization program is the set of reforms to strengthen the financing of investment in municipal infrastructure. The effort has targeted four

major areas of reform, including developing a legislative framework, improving intergovernmental relations, improving municipal capacity, and raising awareness in the investor community. A brief overview of the project's work on these four themes is provided below. The four aspects of the reform are also described in detail later in this study.

- Developing a legislative framework – All of the laws dealing with local government finance have been amended to institute the reforms of the Fiscal Decentralization Working Group. Given that there were so many gaps in the existing legislation dealing with municipal borrowing, a complete new law, the Municipal Debt Act (MDA), was created to provide a comprehensive legal framework for municipal borrowing.

- Improving intergovernmental fiscal relations – The overall reform agenda has tackled intergovernmental finance in two stages. The first stage, completed in 2002, has redesigned the way that municipal operating budgets are financed by adopting a new system of intergovernmental transfers that is straightforward, transparent, and linked directly to expenditure needs of assigned services. It clearly divides service responsibility between municipal services that are "mandated" by the central government (such as education, health, and culture) and those that are "local option"—i.e., provided at the discretion of the local government. The second stage deals with redesign of central government support for capital investment and is still under development. The reforms will rationalize the system of subsidies for capital investment, providing a safety net for poor municipalities, stimulate debt financing in richer municipalities and ensure that all municipalities have adequate resources to take advantage of the infrastructure grant funds being made available by the European Union.

- Improving municipal capacity –Since Bulgarian municipalities have had almost no experience with long term debt financing, LGI has developed and implemented a technical assistance package that focused on activities under the control of the local government in order to improve access to credit markets, covering capital investment planning, asset management, and financial packaging.

Raising awareness in the investor community – this effort has included working with both lenders and local governments to develop the "standard operating procedures" that will be followed in actually implementing the debt financing of municipal infrastructure projects.

2. Context

Overview of Local Government Finance during the Pre-Reform Period

In the late 1990s, the Bulgarian local government finance system was poorly structured, leading to rapidly rising operating deficits in municipal budgets and disinvestment in infrastructure. There was strong evidence that Bulgarian municipalities systematically underfunded their capital infrastructure. A review of municipal budget data shows that municipal own-source revenues devoted to capital investment declined steadily from 1998 through 2001 and began to rebound only in 2002. However, research suggests that all of the growth in local own-source revenues in 2001–2002 went into meeting the operating costs of "local option" and "mandated" services. This means that the operating cost requirements of municipal services grew faster than revenues overall, in effect decreasing the amount available for new capital investment.

Before reform began, there was ample evidence that a sizeable backlog of investment needs had accumulated. The World Bank had completed a study to estimate the financing requirements necessary for Bulgaria to meet the environmental standards of European Union (EU) accession, covering both capital and operating costs at the municipal and national levels. The study produced a range of estimates from low to high. The low estimate for the municipalities to upgrade environmental infrastructure to EU standards amounted to just over BGN 1,000 million per year in capital costs—an amount almost equivalent to the total operating costs of all mandated municipal services in 2003. The high estimate was approximately BGN 1,850 million in capital costs per year—close to the forecasted total of all municipal budgets in 2003. This was a staggering amount, given that total municipal capital investment in 2002 was not quite BGN 200 million—about one fifth of the World Bank's low estimate.

A look at the percentage of municipal budgets devoted to capital investment shows that Bulgaria lagged considerably by international standards and by comparison to other eastern European countries. Generally, 15-20 percent of total municipal budgets are devoted to capital investment on average; in Bulgaria, however, the level was a little over 10 percent in 2002, which was an increase from 6.5 percent from the previous year.

Financial resources for funding additional capital investment at the municipal level were quite limited at the time. The central government was not able to fully fund the agreed-upon mandated service costs in the State Budget Act for 2003.

Increased funding from the central government was most likely going to be devoted first to fully funding the operating costs of mandated services and the Equalization Subsidy for the poor municipalities. McCullough et al make an argument that the costs of mandated services should include capital costs as well as operating costs. If the 15 percent rule of thumb was applied in estimating the annual capital costs that attend the mandated services costs of approximately BGN 1,124 million in 2003, then the transfers would have to be increased by about BGN 195 million to incorporate capital costs. This alone would almost double the capital investment levels in the municipalities. However, given the shortfalls in funding the lower, agreed-upon levels of mandated service costs in 2003, such increased funding is probably not likely to be forthcoming.

Fiscal Decentralization Policy Reform

The fiscal decentralization policy reform was a prerequisite for the infrastructure finance reform. The former started with the Local Government Forum in 2001. The forum was a major effort to set up a mechanism that brought together various stakeholders in local government to build consensus on the key issues confronting local government and, from that, to build a consolidated and unified agenda for strengthening the policy framework. The forum included key national, regional, and local institutions, including The National Association of Municipalities in the Republic of Bulgaria (NAMRB), the Ministry of Finance, the Ministry of Regional Development and Public Works, parliamentary committees, regional associations of municipalities, associations of municipal professionals, and elected officials.

At the forum, the scope of the reform was outlined and included the following aspects:

- Delineating clearly the expenditure responsibilities of central and local government and ensuring an adequate revenue base for the municipalities;

- Increasing the fiscal autonomy of the Bulgarian municipalities;

- Increasing the capacity of the municipalities to finance infrastructure projects;
- Improving the budget environment at the central and local levels;
- Reforming the system of intergovernmental fiscal relations to support the above areas of change;
- Treating fiscal interrelations as an integral system in the reform implementation process, instead of as a sum total of separate components;
- Defining of short, medium and long-term objectives of the reforms;
- Achieving a durable commitment of stakeholders to the overall reform effort;
- Defining the most appropriate way to institutionalize the reforms and the process.

Fiscal Decentralization Working Group

In early 2002, the Ministry of Finance indicated its intention to establish a formal fiscal decentralization working group by a Council of Ministers decision. In February of the same year, USAID's LGI project assisted the Ministry of Finance in drafting the text of the Council of Ministers decision and recommended stakeholders for official designation. In March 2002, a Fiscal Decentralization Working Group (FDWG) was established with Resolution 138/11 of the Council of Ministers. The FDWG included broad local government representation as well as officials from central ministries and prominent local nongovernmental organizations (NGOs). It was mandated by the decision to propose a fiscal decentralization concept and program to the Council of Ministers, and to identify detailed implementation requirements of the program. This was the first time a stakeholder group of this type had been created by the government to work on local government reform issues. Chaired by the Vice Prime Minister/Minister of Regional Development and Public Works and with high-level representation, FDWG proved to be critical in providing leadership for meaningful reform. From its beginning, FDWG formally requested LGI's participation and technical support.

The Fiscal Decentralization Concept and Program

FDWG's first major task was to prepare the Concept for Fiscal Decentralization. The document covered the objective for decentralization in Bulgaria, basic reform principles, and areas for change in the definition of expenditure responsibilities, funding for state responsibilities assigned to municipalities, funding for municipal expenditure responsibilities, and improvements to the legal framework for budget execution.

The starting point of the Concept and the accompanying Fiscal Decentralization Program (see below) was to clarify the assignment of expenditure responsibility at the municipal level. In order to establish a sound basis for the new system of intergovernmental finances, the government accepted the concept that all municipal expenditures are defined as either (a) mandated by the national government or (b) provided at the discretion of the municipal government (i.e., the "local option"). In addition, virtually all municipal services have both annual operating costs and capital investment costs in their provision.

The Concept was adopted in June 2002. It contained the following objectives and principles of decentralization in four areas of change: (1) Identifying and delimiting the expenditure responsibilities of the state and the municipalities; (2) Financing of state expenditure responsibilities delegated to the municipalities; (3) Financing of the municipal expenditure responsibilities; and (4) Improving the legal environment for development and implementation of the municipal budgets.

A Program for Fiscal Decentralization for 2002–2005 was adopted along with the Concept. It built on the Concept by identifying specific policy orientations for the following three years and legislative targets for enactment in the current year. Specific steps, tasks, deadlines, and responsible implementing institutions were identified.

Initial Legislative Successes

Following the Council of Ministers' adoption of the Fiscal Decentralization Concept and Program, the FDWG organized itself into three task groups to work on specific legislative changes for application in 2003. The fiscal decentralization team of LGI was heavily involved in both policy and technical aspects of FDWG's work. The results of these efforts proposed reforms to several laws related to local government finance. The proposed changes were accepted by FDWG and forwarded to the Council of Ministers. Highlights of the reforms that were approved by the FDWG include the following:

Local Taxes and Fees Act, enacted December 2002. It introduced essential changes to the concept of local fees that aimed at (1) establishing general rules for setting service fees and charges; (2) granting maximum discretionary power to the municipalities, and creating opportunities for development of local policies; (3) establishing rate levels; and (4) determining modes of service delivery.

State Budget Act for 2003 – Many of the key provisions for implementing the Program for Fiscal Decentralization as official policy were later incorporated into the State Budget Act for 2003. These included minimum expenditure standards as the basis for financing mandated state services (education, health, and culture), the allocation of the Personal Income Tax to finance the state portion of the mandated services, and the creation of an equity-driven equalizing subsidy that recognized resource-poor municipalities, based on the potential for local resource generation.

Corporate Income Tax Act and Natural Persons Income Tax Act, enacted in 2002. FDWG approved changes that aimed at better predictability, regularity, and even distribution. The corporate income tax was eliminated as a municipal revenue source and was replaced with the full amount of proceeds from the Personal Income Tax.

Municipal Budgets Act – it delineated expenditure responsibilities of the state and the municipalities (mandated services versus local option services). It also set minimum expenditure standards financed by transfers for mandated services; established an equalizing transfer for resource-poor municipalities; and distinguished between current and capital expenditures. Finally, it established a separate budgetary section for debt; eliminated Ministry of Finance review of draft budgets; required public hearings on the draft budget and on budget execution; and prohibited debt to balance current budgets.

Municipal Property Act – it aimed at disencumbering the procedures of municipal property management; placing priority on transferring nonessential state property to municipalities; and extending term of long-term leases.

Municipal Debt Act – approved by Parliament in April 2005. The act set forth a comprehensive legal framework for municipal borrowing. This is described in detail later in the study.

3. Infrastructure Finance Reform

Nature of Problem

It has been well documented that the level of capital investment in Bulgaria's municipalities has been low by international standards and was in a downward trend for most of the decade prior to reform. Not surprisingly, by the time the FDWG was formed, there was a substantial backlog of unmet investment needs.

Assignment of all capital expenditures in Bulgaria was the responsibility of the central government, regardless of the level of government responsible for the provision of the services associated with the capital infrastructure. This assignment was guided by either the capacity to finance large projects or by the belief that only central government officials were qualified to make capital investment decisions. The central government had committed to increasing capital investment at all levels and the EU accession was expected to place a significant burden on Bulgarian municipalities to upgrade municipal infrastructure. Even with planned support from the EU pre-accession grants, municipalities had to increase their own levels of investment considerably. A large part of this increased investment would have needed to come from local own-source revenues, both to pay for increased current outlays and to support borrowing for capital projects.

Prior to the reform efforts, capital investment had not been a high priority topic in the policy debate on local government finance. Instead, the discussion over fiscal decentralization in Bulgaria had focused largely on the issues of expenditure assignment (mandated versus local option costs) and overall levels of funding while largely ignoring the question of operating versus capital costs. In fact, debates and negotiations often centered on determining what the annual operating costs of mandated municipal services should be as a basis for setting the level of central-local transfers. Implicit in these negotiations was that the capital costs of all municipal services (both mandated and local option) will be funded by local own-source revenues supplemented by some level of capital grants.

Analysis of Need

Estimates of the need for municipal investment in infrastructure varied. The World Bank estimated that meeting EU environmental standards alone would require between BGN 1,000 million and 1,800 million annually, a cost that will be largely borne by local governments. Following the conventional benchmark of 15 percent annual spending on capital investments, local government annual capital expenditures should be near BGN 340 million. The NAMRB estimated local investment needs to be at about €300 million (BGN 600 million) per year in the period 2004–2006. Only part of this was financed either from own sources or from credit, resulting in a cumulative and growing investment deficit.

DeAngelis et al discussed various factors inherent in Bulgaria's financial system that indicated the timeliness of the infrastructure finance reform:

- Over the past decade, significant service provision responsibilities had been assigned to municipalities. However, there was not a comparable effort to match responsibilities with available resources. Municipalities were under an increasing burden to undertake required capital investments and thus to provide local services at appropriate standards.

- The central government had limited resources available for capital investments. The central government's need to maintain macroeconomic stability was on track to further diminish any such central government transfers and grants.

- Accession to the EU required a massive investment in environmental repair and improvement, much of it in landfills, incinerators, water treatment plants, and other facilities at the local level. As in other countries aspiring to join to EU, the Bulgarian public sector had to contribute significantly to these investments and to meet the 25 percent country match required to obtain EU pre-accession grants. Developing the ability to leverage local investment resources through access to private debt financing was a precondition for municipalities to contribute their share to this massive undertaking.

- A small number of municipalities had issued debt to finance local investments in the form of bonds and bank loans. This demonstrated the willingness of municipalities and lenders to risk short- and medium-term loan commitments and to explore less familiar forms of loan structures explicitly tailored to the characteristics that distinguish municipalities from private borrowers.

Key Constraints on Local Financing of Municipal Services and Infrastructure

a. Lenders' Perception of Municipalities

Bankers expressed concern that many of the projects that the municipalities present for financing, although technically well-prepared, were not presented and packaged in a manner conducive to credit analysis—such as prioritization of projects, feasibility and cash flow projections, budget impact analysis, etc. Poorly prepared presentations not only reflected badly on the proposed project but also raised credit concerns about the quality of municipal management.

Some banks were wary of making longer-term loans that extend beyond the tenure of the existing mayor and council. In the event of a change in the political composition of the local government's leadership, there was concern as to whether the incumbents would honor the debt obligations taken on by their predecessors in office. Such an assessment of political risk could inhibit the utilization of debt with longer maturities.

Additionally, the scarcity of municipal loans reflected lender inexperience in identifying bankable municipal projects and underwriting local governments. For example, few banks seemed to have considered alternatives to physical collateral for securing repayment. Also, there was a clear preference among bankers to finance revenue-generating projects rather than non-revenue-generating infrastructure projects.

b. Lack of Municipal Capacity

Bulgarian municipalities were perceived by the financing community as not being creditworthy. There were two main reasons for this conclusion: (1) financial weakness of the municipalities, and (2) lack of financial knowledge of municipal officials.

The financial weakness of local budgets was a direct result of the centralized approach to budgeting. While own-source revenues increased significantly due to the amendments to the Local Taxes and Fees Act, local authorities still were perceived as having low levels of own income; therefore, the volume of predictable income that could be used as a reliable source for repayment of debt was limited. Budgets are relied heavily on state transfers as a source for investment. The mandated expenses side of the local budgets was more balanced and predictable due to provisions in the Municipal Budgets Act, and own-source revenues have increased. However, municipal budgets are running deficits primarily in local activities, and therefore are not able to cover potential debt.

Unpredictability of future regulations governing municipal revenues further impeded medium-term financial forecasting. The level of local taxes was set by the central government and the flexibility in identifying new income sources is limited. As a direct result of low resources and high expenses, local budgets ran chronic deficits.

Another issue was the availability of appropriate collateral. As described previously, banks were inclined to require physical property to be used as collateral to secure municipal debt. This became an issue as successful privatizations reduced the asset base of municipalities that could be used as physical collateral. Additionally, banks had not yet accepted municipal revenues as a source of collateral due to a lack of familiarity with revenues as collateral and certain legal uncertainties relating to perfecting a pledge of revenues. The Municipal Debt Act provides for perfecting a pledge of such revenues. It is important that the lending community become familiar with these provisions.

Municipalities were seeking to finance investment projects and loans that were too large for the current size of local budgets. There was a widespread belief among municipalities that the bigger the project, the more likely it was to be financed. Banks commented that projects presented to them are often too large for the municipality to carry—that is, they lack capacity to repay the debt.

The second determinant of low municipal capacity to issue debt was “lack of financial knowledge.” Even when good technical skills in project preparation were evident, frequently they were not complemented by financial skills. Municipal officials often did not have the knowledge necessary for issuing bonds or accessing bank credits. There was a tendency to apply to the financial community with the same approach that had been used with state agencies, i.e., to offer a wide range of projects so that a choice could be made about which ones could qualify for financing, and to support investment projects with subjective arguments instead of financial projections for documenting repayment ability.

This lack of financial knowledge was apparent to the banks, and they perceived it as a poor reflection on the quality of municipal management. In other words, although projects may have been perceived to be prepared well from a technical and engineering perspective, they were rejected by banks due to creditworthiness concerns.

Role of Technical Assistance

In view of weak municipal financial capacity, inappropriate legal framework, and lack of investor experience with the municipal sector, there was an urgent need to demonstrate new approaches to infrastructure finance to spur critical physical development and attract private investment. The goal of USAID's LGI project was to support all facets of the infrastructure finance reform. These included working with FDWG for the preparation of reforms to several laws related to local government finance; working with the Municipal Borrowing Working Group (described below) in drafting of the MDA; using pilot demonstrations for building municipal understanding and raising local governments' capacity to uncover, maximize, and manage all locally available resources; and increasing municipal creditworthiness for gaining confidence of investors and financing institutions.

Municipal Borrowing Working Group

Recognizing the importance of credit in financing infrastructure, LGI provided technical support to the Bulgarian Ministry of Finance in connection with the establishment of the Municipal Borrowing Working Group (MBWG). The primary objective was to develop a municipal borrowing system, including developing and putting in place the appropriate legal and regulatory basis for municipal borrowing as well as equipping local governments with management standards and instruments that would help them attract long-term capital for municipal development programs.

In 2002, the government moved forward on creating a formal structure to oversee the legal reform. An ordinance of the Prime Minister naming specific members of the working group was prepared and accepted by the Council of Ministers.

MBWG was responsible for preparing a draft of the MDA to be submitted to the government. Throughout the MDA drafting process, LGI staff worked closely with the MBWG and various stakeholders and provided intensive technical support that included expert opinions, presentations on relevant topics, and facilitation of numerous working meetings. These covered a wide range of relevant topics, including (1) procedures for authorization of municipal debt; (2) purposes of long- and short-term debt and guarantees to other borrowers; (3) limitations on long- and short-term debt and lender remedies in case of default; and (4) collateral for municipal debt, joint municipal associations, and definitions, etc.

MBWG developed a final draft of the MDA which was submitted to the Ministry of Finance in early 2004. In 2005, the draft became a law.

Study Tours

Study tours were an important aspect of the effort because they created an opportunity to learn other countries' successful approaches to infrastructure financing. In addition, the study tours were intended for a core group of stakeholders in order to provide an opportunity for them to focus on critical issues outside of their working environment, as well as to develop professional relationships among each other.

This aspect of the technical assistance included preparation of international study tours for major stakeholders who were interested in the development of a municipal credit market in Bulgaria. LGI, with the assistance of World Learning, organized several study tours in the period 2003 – 2005; they are described below.

A municipal borrowing study tour to South Africa was conducted in 2003. The scope included presentation of South African experience in development of a municipal credit market, borrowing legislation and the adopted regulatory system, and practical experiences. The participants included representatives from the Ministry of Finance, Members of Parliament, legal advisors, mayors, NAMRB members, representatives of the banking sector, and investors' intermediaries. The participants had a chance to discuss pertinent issues with the regional administration of Pretoria, as well as representatives of a municipal credit rating agency. They also learned about Cape Town's experience in acquiring loans in the municipal lending market, and visited several smaller surrounding municipalities to learn about concepts of community project development and finance.

A study tour on municipal credit enhancement mechanisms to the Netherlands and Poland was conducted in late 2004. The participants included representatives from the Ministry of Finance, local banks and pension funds, the Commission for Financial Supervision, municipalities, and NAMRB. The scope included presentation of both countries' experience in development of credit enhancement tools, such as: recent reforms in the local finance system that aim to increase the borrowing power of local governments; guarantee facilities for the municipal sector; banks that specialize in underwriting and lending for environmental and infrastructure municipal projects; and associations of local governments for carrying out joint debt-financed infrastructure investments, etc.

Another study tour on the municipal bond market in Romania was organized in May 2005. The participants included representatives from the Ministry of Finance, local governments, financial intermediaries and banks. The goal was to show specific examples of successful municipal bond issues for financing municipal infrastructure projects, as well as the challenges faced during the issuance process in an environment that is similar to that in Bulgaria.

Developing a Legislative Framework – The Municipal Debt Act (MDA)

The idea of a municipal debt law was first proposed in 1999 and was given renewed direction with the formation of the MBWG in 2002. The use of study tours and periodic analytical reports built both awareness and support among the key legislators over the subsequent years. The draft MDA was approved on April 5, 2005 by the Parliament to become effective on June 1, 2005, with no opposing votes.

The act sets forth a comprehensive legal framework for municipal borrowing. According to its provisions, local governments can incur debt upon a decision of the municipal council and this debt is a sole obligation of the respective local government.

MDA sets the following specific limits:

1. The annual amount of payments on debt for any fiscal year may not exceed 25 percent of the amount of own revenues and the general equalizing grant as reported in the budget execution report for the previous year.

2. The nominal value of issued municipal guarantees may not exceed 5 percent of the total amount of own revenues and the general equalizing grant as reported in the budget execution report for the previous year. A municipality may guarantee borrowings of companies in which it has a greater than 50 percent share, provided the investment is for a public purpose.

3. Municipalities have to go through a specific procedure in order to describe the proposed project to the general community.

The law does not contain limits on the size of the outstanding debt. Local governments incur debt and issue bonds without national government approval except where a state guarantee has been issued. However, they must notify the Ministry of Finance of their intention to borrow.

According to MDA, local governments have the authority to secure debt obligations by a mortgage and pledge of municipal private property and to register a pledge on their future revenues. The municipality may not collateralize municipal debt through pledge or mortgage of property that is a public municipal property. Previously, local governments could not pledge state revenues or intergovernmental transfers to lenders.

MDA allows payment of municipal debts out of own revenues, state general equalizing subsidy and state transfers for mandated activities in cases when there are no unpaid bills for these activities.

Finally, MDA lays out the procedure for competitive solicitation for the selection of financial institutions or financial intermediaries as part of debt issuance.

Improving Intergovernmental Relations: Reform of Capital Investment Subsidies

The final piece of the fiscal decentralization reform agenda is the system of subsidies to local governments for capital investment. This has been the last issue to be taken up by the central government because the other components were deemed more pressing, especially resolving the mechanism for funding municipality operating budgets and putting debt legislation in place. Furthermore, it was recognized that once the operating budgets and own-source revenues were stabilized, then the need for capital investment subsidies could be better understood.

In mid-2005, the FDWG is just taking up the question of what needs to be done with the capital subsidy system. The current system is fairly simple. Municipalities receive two types of capital subsidies from the state budget. The Targeted Capital Subsidy is set in the annual budget act and allocated by a formula jointly negotiated between the Ministry of Finance and the NAMRB. The formula is weighted heavily by population. In addition, local governments receive a number of other capital transfers that are determined on an ad hoc basis every year and are channeled through different line ministries and central agencies. In 2004, these included earmarked subsidies for such investments as environmental projects, school construction, and roads. Typically, the ad hoc subsidies channeled through the central ministries amount to more, in the aggregate, than the Target Capital Subsidy allocated by formula.

In 2004, which is considered by most informed observers as the best year for the overall financial condition of the local governments, municipal investments reached BGN 269 million (highest level ever, an increase from BGN 240 million in 2003). This represents about 11.5 percent of total municipal budgets—a solid improvement over the recent past, but well short of a level that is needed to make up for past under-investment and to maintain municipal capital infrastructure at a sustainable level.

Furthermore, there is great disparity across municipalities in their ability to fund investment. In 2004, only 30 municipalities (less than 12% of the total number) accounted for 60 percent of

total municipal investment. The poorest half of all municipalities[1] account for just 17.3 percent of total municipal capital investment. This group spends on average just 7.8 percent of its local budgets on capital investment and is highly dependent on state transfers for those investment funds. In sum, the improved financial condition of the municipalities in general has still left the poorer municipalities with inadequate funding for capital investment. The wealthier municipalities have been able to channel at least some of the increased local revenues to greater capital investment, and to increasingly tap the debt markets. However, the poorer municipalities are being left behind.

Coupled with the need to assist poorer municipalities with their investment requirements are two additional issues impacting capital subsidies to municipalities:

- First is the new, and very large, requirement for local matching funds to absorb EU grant funds for regional development investments starting in 2007; and

- Second is an unresolved question of the state's responsibility to fund the capital costs of the mandated services assigned by law to municipalities, especially education, health, and social welfare services.

The matching requirements of the EU grant funds for regional development plans have been estimated to be at least BGN 500 million per year for the period 2007-2009[2]. A large percentage of these projects will be the municipalities' responsibility. While it is difficult to say precisely what the municipal matching requirements will be given the multi-jurisdictional nature of the investment plans, it has been estimated that about BGN 300 million of "new money" will be required at the municipal level to leverage the EU grants.

The question regarding state responsibility for funding capital costs of mandated services is part of the unresolved debate over what portion of these costs should be covered by state-local transfers. Up to this point, the central government has agreed to fund the operating costs and has agreed to the mechanism for setting operating cost parameters annually. This mechanism has been principally responsible for stabilizing the municipal budgets and enforcing budget discipline on the municipalities. However, questions remain about whether capital costs of the mandated services should be included in the funding formula and whether there is growing support for such action.

The FDWG is now reviewing alternatives and proposals for reform to the capital transfer system. The most comprehensive proposal replaces the current system with a new structure that has four main components:

- A subsidy targeted to poor municipalities that would give them a "floor" per capita level of capital investment funding;

- An increase in the transfer formula for the costs of mandated services that includes an allowance for capital costs (set as a simple percentage of the operating costs.);

[1] Defined as the 132 municipalities with less than the median level of local own revenues per capita (BGN 71.9 million in 2004) which includes all own source revenues plus the equalizing subsidy.
[2] Minis, H. Presentation at a roundtable for a Constitutional amendment to grant local taxing powers to municipalities.

- A targeted subsidy for matching EU investment project grants that has a sliding scale based on the economic condition of the municipality and the nature of the project; and

- A targeted subsidy for environmental projects of national concern (essentially a continuation of the current program run by the Ministry of Environment).

The total funding requirements of the new system have not been developed yet, but given the EU matching fund requirements alone, the total level of transfers should rise substantially. The first two components (target subsidy for poor municipalities and capital costs of mandated services) are proposed to cost about BGN 150 million—slightly less than the total capital subsidies now being furnished to municipal governments from all sources (excluding the environmental project subsidy.) It is proposed that the EU matching fund will require approximately BGN 150 million annually from the state budget with an equal amount coming from municipal resources, including borrowing and own-source revenues.

The proposed EU matching fund will have a sliding scale that provides a higher level of state subsidy to projects that are not revenue-producing and to those municipalities that have a lower tax base per capita. Municipalities that are creditworthy are encouraged to use a mixture of long-term debt and own revenues to meet the EU matching requirements with a reduced level of central government subsidy. To ensure that state subsidies are being effectively used in the EU matching fund, municipalities will be required to submit project financing plans that detail all sources and applications of funds needed to complete the project.

Improving Municipal Capacity

Technical Assistance Package

LGI developed and implemented a technical assistance package that focused on activities under the control of the local government in order to improve access to credit markets. The aspects of technical assistance to the local governments included the following:

1. Capital Investment and Planning

Long-term capital investment planning (CIP) is an important public management tool for making financial decisions, assessing capital needs, planning, prioritizing, budgeting, and maintaining a four- to seven-year rolling capital investment program. Under this activity, LGI developed, tested, and disseminated a methodology that enabled municipalities to analyze and improve their capital investment planning procedures and to put in place their first long-term capital improvement program.

For the implementation of this activity, in spring of 2004 four pilot municipalities were selected based on consultations with NAMRB. Working meetings and planning workshops were then organized with management and operational staff of the selected sites. The purpose of these events was (1) to define the scope of the capital improvement program and the time horizon; (2) to identify capital investment projects and acquisitions to be included in the plan; (3) to define criteria for project evaluation and appoint corresponding weights; and (4) to prepare forms for project applications.

A methodology for project evaluation and prioritization was developed in collaboration with the pilot cities. In addition, each pilot city identified capital projects subject to evaluation and ranking, designed its capital investment planning calendar, prepared a set of evaluation criteria,

and assigned weights. In addition, LGI assisted the pilot cities in developing their multiyear capital improvement plan and submitting it to the municipal councils for approval, in developing a manual for implementing the CIP methodology, and in developing a dissemination plan to provide information and training to a larger number of municipalities on how to develop long-term municipal capital investment plans.

2. Municipal Investment Project Packaging

It is vital for local governments to have the capacity to prepare proposals for funding investment projects that will win the interest of funding institutions. The limited lending to municipalities in Bulgaria had not established standard procedures, documentation, or financing structures. As a result, LGI produced a model for municipal investment project packaging for external funding through borrowing to assist both borrowers and investors for whom municipal finance represents a new product, with different types of risk.

As part of the reform, LGI prepared a model prospectus for issuing municipal bonds. The prospectus aimed to enhance the transparency of the procurement processes for investment-intermediary services and bond issuing. In addition, a tender document for selection of an investment intermediary was prepared; it includes a scoring methodology for selection. A roundtable to get investor and municipal feedback on the document was also held.

In addition, LGI developed a number of model documents that would facilitate municipal access to the investor community. These include the following:

- A model solicitation letter;
- A sample timeline for the issuance of municipal bonds;
- Guidelines for contracting municipal debt (municipal bonds and loans); and
- A model loan agreement for municipal financing.

Other model documents that were developed to facilitate debt financing include guidelines for (self) assessment of municipal creditworthiness, model service and guarantee agreements, and a model tender document for selection of banking institutions.
In addition, LGI, in consultation with NAMRB, has selected two pilot cities for preparing a package of investment projects for funding through municipal bonds. Work with these municipalities will include identification of the projects to be financed through municipal bonds and preparation of the proposal to the municipal council for undertaking municipal debt.

3. Municipal Budgeting

The changing environment as a result of the implementation of the fiscal decentralization reform required considerable changes to municipal budgeting. In 2004, LGI started work on the redesign of a new Budget Preparation Manual. The purpose of the manual is to put capital budgeting in the context of the overall municipal budgeting process. In addition, it aims at linking the policy objectives of the council with the way the budget process works by introducing service-based/program budgeting and performance measures. The outline includes topics like: essence of the new budget approach (service-based budgeting, calendar, investment planning as a process); the operational budget (assessment of revenues and expenditures, balancing, budget requests);

the capital budget (forecasting, financial planning, project appraisal, impact on the operational budget); and analysis and evaluation of the budget performance.

Raising Awareness in the Investor Community

In order to facilitate the access of municipalities to the credit market, LGI realized the need for increasing awareness among lenders and recognized their integral part in the stakeholder community. The purpose of this effort was for lenders and local governments to settle on a common agenda of steps to follow to improve municipal access to the credit market. Awareness was raised at a roundtable in the second half of 2004. It touched on the following areas: (1) familiarity with the characteristics specific to local governments and to local finance and budgeting; (2) municipal credit analysis; (3) underwriting and management of municipal credit; (4) risks and rewards of municipal credit; and (5) familiarity with the provisions of MDA. The key objectives were to improve investor perception and understanding of the local government market and to facilitate loan/debt structuring.

4. Lessons Learned

Bulgaria's success with its municipal finance reforms provides a number of key lessons as summarized in the following paragraphs.

The reform scope was comprehensive in nature and guided by a plan. The reforms covered assignment of services to local government, matching of funding sources to service assignment, expansion of revenue authority to local governments, regularizing the central-local transfers system and putting in place a carefully crafted municipal debt law. The process was guided by a "road map" of reform targets, time schedule and designation of responsibility at the outset. While the time schedule was not strictly followed, the road map kept the process largely on target and always served as a point of reference for the participants.

The pivotal reform was the agreement on service assignment and design of the funding mechanism for centrally mandated services. The key piece of the reform strategy was getting agreement between the central government and municipalities on the assignment of service responsibilities to municipalities and agreement on the formulas that would govern how the State would fund the operating costs of these mandated services. This agreement reduced the problem of unfunded mandates to local government, erased the "structural deficits" in municipal budgets and also put limits on the local governments' ability to seek bailouts for their own financial mismanagement.

The reform program and the implementing decisions along the way was the work of a high level working group that drew members from the municipal leadership and from the key central ministries. The Fiscal Decentralization Working Group was appointed by the Council of Ministers and drew on the most knowledgeable people in municipal finance from the different stakeholder organizations in Bulgaria. The FDWG included leaders from the municipal association as well as the key ministries of finance, regional development, education, health and social welfare. The FDWG was also able to draw on technical expertise of several NGOs and the support of the USAID Local Government Initiative for analytical assistance. This model was also followed in the formation of the Municipal Borrowing Working Group to prepare the Municipal Debt Act and shepherd it through Parliament.

The groundwork of the fiscal decentralization reforms was laid in the several years preceding the formation of the FDWG. Although the formal reform program began with the formation of the FDWG in 2001, a considerable amount of work had preceded that with the work of the LGI and two key NGOs—the Foundation for Local Government Reform (FLGR) and Club Economika 2000. These organizations conducted a series of studies and workshops on the financial conditions of the local governments from 1998 onward. This work created a good understanding of the financial conditions across the Bulgarian municipalities, comparisons with the situation in other central and western European countries and potential solutions to the growing crisis in Bulgaria. By the time a new government took office in 2001, there was a solid base of knowledge among the key players at the municipal and national levels.

The FDWG and MBWG have had access to reliable and up to date data on municipal finance conditions. A key role played by the LGI and the NGOs has been the provision of timely data and analysis of municipal finance conditions. This has given the key working groups the ability to assess current financial trends in the municipalities and to simulate the impact of policy options. This has enabled the working groups not only to do their own work well but has enabled the working group members to explain the ramifications to the legislators and elected officials.

Keeping fiscal decentralization on track requires constant monitoring and adjustment. The FDWG is still working after four years and its job is not yet done. Indeed, the dynamic nature of local government finance means that adjustments will always be needed and the reform program must accommodate this continuing need. The Council of Ministers has built into the charge to the FDWG an ongoing monitoring function whereby the FDWG now tracks and reports on set of key indicators covering both the legislative targets as well as financial conditions of the municipalities.

Continuity of leadership has accompanied the reform process. While it is difficult to judge the true impact of this variable, it must be noted that there has been a remarkable degree of continuity among the key players in the reform process—on the municipal side, within the key ministries and in the supporting NGOs. This has undoubtedly helped keep the reform agenda on track and largely free from sudden shifts in policy direction.

The Local Government Initiative (LGI) has been able to maintain a neutral position as a provider of sound analysis and advice to both sides of the central-local debate on fiscal decentralization. LGI has played a key role in the design of the fiscal decentralization reforms and its effectiveness has been heightened by its acceptance by both the central government and the municipal as an even-handed advisor. While LGI was mandated to assist in the overall decentralization movement, it has managed to do it in a way that has kept it from being captured by either side as a partisan advocate.

5. Sources

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