Chapter 27

Eastern and Central Europe
Bulgaria

With the exception of Sophia, weak local finances, uncertain transfers, and a fragile banking system stall local government borrowing.

Peter D. Ellis and Kremena Ionkova

Lessons

Decentralization in Bulgaria during the 1990s was slow and painful, occurring amid political instability and stressful economic conditions. A unitary state with a tradition of highly centralized control, Bulgaria has been reluctant to adopt new policies and implement reforms. The ad hoc design of intergovernmental relations has greatly limited the autonomy of local governments, which face many fiscal guidelines imposed by the central government. Local governments rely heavily on transfers from the center (shared taxes and grants), which have been subject to uncertainty and lack of transparency. As macroeconomic conditions have improved, the intergovernmental fiscal system has recently stabilized, but tight central government control continues to constrain local authorities in developing and implementing their budgets.

The economic upheavals and fiscal pressures of the early 1990s led to widespread deferral and cancellation of capital projects, and infrastructure in all cities in Bulgaria—including its capital, Sofia—has deteriorated. The limited fiscal flexibility of local governments will make it difficult for them to meet investment needs in infrastructure.

Despite large capital investment needs and growing contributions to the nation's revenue equalization system, Sofia has managed its budget prudently since the late 1990s. Relatively debt free, it has successfully entered the international bond markets. As the capital city it has unique advantages. Elsewhere in the country municipal borrowing has been virtually absent—hampered by weak local finances, a fragile banking system, and an unsettled and untested legal and regulatory framework.

What Bulgaria and especially Sofia need is an intergovernmental system providing local governments with greater fiscal autonomy and predictability. Central government rules and regulations, once reduced in scope and detail, should be made less arbitrary and enforced more strictly. The emergence of significant borrowing activity will probably depend on the development of own sources of revenue and healthier financial markets. However, as Sofia's experience shows, good management and improving economic conditions are also key.

Among the formerly communist countries of Central Europe, Bulgaria came late to political decentralization and the shift to a market-based economy, earning the label of an "uncertain decentralizer" (World Bank 2001c, p. 55).[1] With a heavily centralized economy tied into an industrial trade system based on the old communist trading bloc, this relatively small country of 8 million found privatization and market liberalization difficult hurdles to surmount while it struggled to protect old industries and employment. After a rocky start down the path of reform and a period of high inflation and negative real economic growth in the early to mid-1990s, the country began to make significant progress by the end of that decade.

Like the rest of Bulgaria, Sofia has undergone major structural transformations in its economy along with rapid changes in its administrative and fiscal responsibilities. These changes were linked early on with the transition to a market economy and more recently with preparation for accession to the European Union (EU). Despite the uncertainties associated with reform, especially with respect to local government regulations and finance, Sofia has managed to capitalize on the opportunities offered by reform, producing economic growth and maintaining sound fiscal balances. Its success in tapping the international bond markets has been both a part and a product of this positive management.

Like all municipalities in Bulgaria, Sofia faces strict central government guidelines on its budget process, though it also receives many exemptions from central government regulations. Tight budgetary controls combined with changing regulatory constraints have led to uncertainty in planning and executing annual budgets. Even so, Sofia successfully floated and repaid a eurobond of 50 million euros (EUR). During the lifetime of the bond, however, the city benefited from a highly stable macroeconomic environment free of adverse shocks.

Transition from a Planned to a Market Economy

During the first half of the 1990s structural reforms in Bulgaria proceeded slowly in the face of economic stress and political turbulence. Economic contraction had led to large deficits and rampant inflation.[2] The socialist party, which remained in power except for a brief interlude, was generally reluctant to follow through on ambitious reforms, espoused by forces that tended to be centered in the larger cities. After the severe banking and foreign exchange crisis that erupted in 1996–97, the government began to pursue sound economic policies and a comprehensive structural reform program.

Along with the stresses and shocks of the transition to a market economy, Bulgaria also faces the challenge of preparing for EU accession. As part of both these efforts, the country needs to undertake substantial public investment to upgrade its capital and infrastructure stock while also strengthening central administration, local governments, and the judicial system. Bulgaria's large national public debt poses a challenge for sound debt management and implies that the country must accept either a slow pace of investment in fixed assets or a slow pace of national debt reduction.

As Bulgaria began the transition from a planned to a market economy, it redefined the role of its national government to facilitate economic liberalization, a goal that it hoped to achieve while maintaining economic and social stability and ensuring distributional equity. Increasing local autonomy and citizen participation was seen as an integral part of the transformation. Fiscal and administrative decentralization has led to fundamental changes in the way the economy and local governments function. Perhaps the most significant change, especially for Sofia and other large cities, has been the increasing responsibility assumed by local authorities for providing public services.

Recent national and subnational reforms have raised Bulgaria's ranking among the transitioning economies in democracy, financial development, economic liberalization, and private sector share of GDP. However, much remains to be done in achieving meaningful fiscal devolution.

Local Governments

Bulgaria initiated local government reforms in 1991, at the beginning of the transition period. These reforms led to direct elections of mayors and the emergence of municipal councils as the locally elected legislative bodies. Administrative and territorial reform followed in 1995 with the adoption of the Administrative and Territorial Structure Act, which redefined the new regional units in the country. In 1999 a new administrative division increased the number of regions from 9 to 28. The 28 regions were then aggregated into 6 planning regions (oblasts) to facilitate the use of EU structural funds within the context of the country's negotiations for EU accession.[3] Municipal self-determination led to further divisions at the local government level, including the establishment of districts (rayons) in larger municipalities such as Sofia, Varna, and Plovdiv.

The Regional Development Act of 1999 defines the new planning regions as spatial units created for the purpose of regional development of infrastructure, the creation of enabling environments for investment at subnational levels, and the utilization of local, national, and foreign resources. Local authorities and nongovernmental organizations are expected to participate in defining regional priorities. In practice, however, municipalities feel excluded from this process, and most regional plans that have been developed have been driven by a top-down approach.

The 28 regions carry out the regional policy of the national government. As branches of the central administration, they do not have revenue raising powers. Each region is administered by a governor (appointed by the prime minister), whose main functions are to ensure that all decisions made by the municipal council are legal and do not exceed its authority and to bear responsibility for all state property in the municipality.

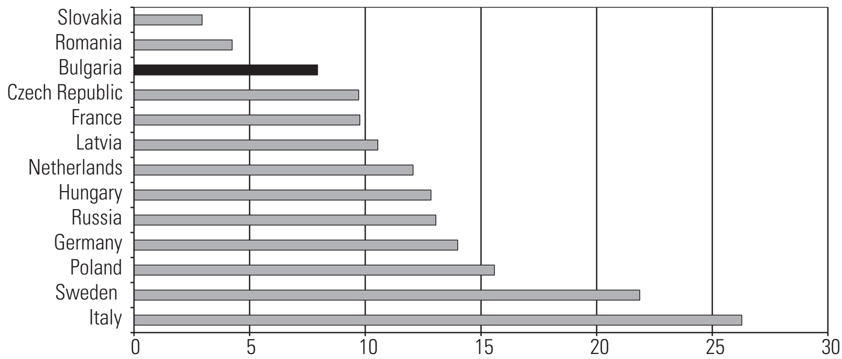
Local governments are the main institutions responsible for urban planning and management and have statutory responsibility for providing and maintaining infrastructure and some urban social services. Most municipalities have acquired ownership of the fixed assets of public housing, public transport, and water and sewerage companies.

Local Government Finances

The preparation of both the state (central government) budget and municipal budgets in Bulgaria involves significant limitations. The state budget is planned and implemented annually, discouraging long-term investment programs. Fiscal discipline has been lax. Local governments are allowed to plan a deficit of 10 percent of expenditures in their budget, regardless of whether the deficit results from operating or investment outlays. Local governments use cash accounting, leaving open the possibility of unfunded and unaccounted-for liabilities. Revenue sources and expenditure assignments at the local level are often mismatched, in part because of the budgeting process but also because of weak management capacity, poor accountability, and inadequate financial control. In 2000 the central government provided additional revenue (beyond the budgeted amounts) to municipalities equal to roughly 1 percent of GDP. These end-of-year payments to localities are opaque and have been criticized as leading to soft budget constraints and political manipulation (Bogetic 1997).

Local budgets are drawn up on the assumption that the municipality will receive the full amount of the state subsidy stated in the annual budget law. However, in practice the municipality may receive less than expected, since only 90 percent of state subsidies are allocated according to the budget law. The other 10 percent are distributed at the end of the year on an ad hoc basis, and the procedure used in these allocations is unclear. Moreover, with year-to-year budgeting there is no guarantee that targeted investment subsidies for a two-year project will be included in the second year's budget law. Local government expenditures account for about 8 percent of GDP, in line with the share in other transitioning economies, and for 20 percent of the nation's consolidated public expenditures (figure 27.1).

Central control over local budgets is pervasive. As a result, local governments lack the flexibility to respond efficiently to local demands and priorities. Their expenditure assignments are limited to payment for services



Source: Authors' calculations based on data from IMF 2002a and 2002b.

Figure 27.1 Local Government Expenditure as a Share of GDP, Selected Countries, Various Years, 1998–2002
(percent)

identified at the national level, and their spending resources are also centrally determined. Central authorities cite two reasons for limiting local autonomy: the need to limit accumulated arrears incurred by municipal governments and the insufficient local management and technical capacity.

As in many countries in Central and Eastern Europe, the intergovernmental finance system in Bulgaria continues to evolve, leading to continual change in revenue sources and funding responsibilities for municipalities. The intergovernmental finance system is based on an equalization mechanism, an explicit attempt by the central government to redistribute wealth to poorer municipalities through a formula incorporating need-based factors. This formula, however, which is subject to ad hoc changes from year to year, does not provide predictability in transfers.

Municipalities all generally have the same set of responsibilities: education (not beyond secondary), social welfare, cultural institutions (such as museums and libraries), public utilities, transport, and sports and leisure. Transfers from the central government to subnational authorities take the form of grants, with targeted capital and social assistance transfers exceeding general grants. Shared service mandates create additional problems. Important consequences are the difficulties in matching expenditure assignments and revenue responsibilities.

In principle, the decentralization of expenditure responsibilities should involve either greater local authority to raise revenues or sufficient and stable intergovernmental transfers. However, municipalities in Bulgaria have very limited authority to raise local revenues, and the central transfers leave substantial unfunded mandates. As a result, the intergovernmental system results in a mismatch between assigned functions and their financing.

The state budget law provides the amount of central government transfers annually, including shared taxes—the personal income tax and the corporate income tax. As the nation's capital, Sofia has a large share of national employment and thus a large share of the personal income tax revenue. Bulgarian municipalities depend excessively on central government transfers, absorbing about a fifth of consolidated public revenues in the form of shared taxes and grants. National transfers and shared taxes account for about 90 percent of total local government revenues, while own-source revenues make up only about 10 percent (World Bank 2001c). Local revenues consist of shared taxes (personal and corporate income taxes), local taxes, local fees, other revenues (property sales, fines, and the like), and state transfers. All local taxes are controlled by national limits on rates and bases.

Since the municipalities have limited revenue and expenditure authority, it is difficult for them to accumulate net savings. Nonetheless, Sofia's capital expenditures account for almost a fifth of its total spending, which is 10 percentage points higher than the average for all municipalities in Bulgaria and in line with the level of local investment in other transitioning economies.

The state budget limits the amount that local governments can devote to capital investments. In 1999 the limit was 10 percent of own revenues, which, according to the Ministry of Finance, includes shared taxes. This limit was reduced to 5 percent in 2000. (Sofia was the only municipality exempted from this rule in 2000, so that it could spend the remaining 60 million Bulgarian leva [BGN] from its eurobond issue.) The restriction on capital investments is aimed at preventing irresponsible local governance and maintaining macroeconomic stability. However, it limits the ability of all local governments, including those in good financial health, to effectively invest in and develop local infrastructure and services, an effect compounded by the unpredictability of the capital investment ceiling.

While local governments have the power to borrow, they may do so only for capital purposes and when there are "insufficiencies" in the local budget (World Bank 2001c, p. 41). Until recently local governments carried out little or no borrowing from banks, borrowing only from the central government. High interest rates, a weak banking sector, unstable transfer systems, and problems in defining assets that can be pledged as security on debt have all conspired against the creation of a domestic credit market for subnational borrowers (Bogetic 1997).

Sofia and the Transition

As the capital of Bulgaria, Sofia serves as its economic, financial, and cultural center. Favorably located at the intersection of three main road transport corridors, Sofia is Bulgaria's largest metropolis, with a population of roughly 1.2 million. According to the 2001 census, the city's population had contracted by 0.2 percent since 1991, less than the national decline of 0.8 percent.

Structure of the City Government

According to the Local Self-Government and Local Government Act, the Sofia municipality (the city) is an administrative and territorial unit with the status of a region (oblast), comprising 4 towns and 34 human settlements. Sofia's local government consists of elected representatives (the municipal council) and the mayor, who performs executive functions with the support of appointed officials and the municipal administration. A lower tier of local government includes districts, a municipal administration, and mayoralties. The Sofia municipality is a legal entity with its own property and is responsible for managing its own budget.

The *municipal council* approves strategic and development plans, the annual budget, the fees charged on services, the acquisition and disposal of municipal property, service contracts and concessions, indebtedness, and the management of municipal companies. It also passes subacts—such as ordinances, decisions, and instructions—and elects standing and ad hoc committees.

The *mayor,* elected directly by the citizens of Sofia, performs the executive functions. The mayor's primary responsibilities relate to maintaining public order, implementing the municipal budget, managing long-term programs, and the like. The municipal council has elected six deputy mayors, nominated by the mayor, who are responsible for finance and business affairs; transportation and infrastructure; education and culture; investment and construction; ecology, environment, and land reform; and public health care and social assistance.

Sofia is divided into 24 *districts* (rayons), each of which has a district mayor nominated by the mayor of Sofia and approved by the municipal council. The districts implement municipal policies and administer the budget. In addition, district mayors assist Sofia's mayor in the provision of services to the district population. Some of the larger districts have a significant administrative apparatus.

The *mayoralties* (kmetstvos) extend direct self-government to the level of human settlements, especially those too small to be a distinct municipality. The scope and type of responsibilities of the 34 mayoralties in the Sofia oblast vary considerably. Their mayors, directly elected by a majority of registered voters, may attend municipal council meetings but have no vote. Their activities are coordinated by the mayor of Sofia.

The *municipal administration* drafts and implements policies on health, education, social assistance, municipal development, environmental protection, management of municipal property, enterprises and finances, and public works and utilities. The municipal administration and the 24 district administrations together constitute one of the largest employers in Sofia, with roughly 1,700 employees.

All this conveys a sense of fragmentation in Sofia's governance structure. The 34 mayoralties are only marginally represented in the decisionmaking process. Most district governments are too small to operate basic services independently or to implement local policies. Instead, they can be seen as a mechanism to foster coordination with the region and economies of scale in management. Some of the districts (such as Lozenetz, Sredetz, and Krasna Poljana) have the population, economic activities, and diversity of land uses to justify a relatively independent tier of local government. Others (such as Kremikovtzi and Studentska) tend to have uniform land uses—being predominantly industrial or residential, for example—and do not function as self-sufficient entities. Moreover, the administrative boundaries of the districts do not conform to the urban development patterns or natural landscape of Sofia and are perceived as superimposed divisions that preclude efficient urban planning and management.

Economic Development

Sofia serves as the main engine of economic growth for the national economy, contributing an estimated one-fifth of Bulgaria's GDP. The city's economy benefited from the national economic recovery toward the end of the 1990s and from the country's increasing macroeconomic stability. Although no official time-series data exist on Sofia's gross regional product, experts estimate the city's real growth rate to be about double the national growth rate. Estimates by Sofia's regional statistical office put the city's gross regional product per capita in 1999 at BGN 4,917, compared with the national GDP per capita of BGN 2,841. Thanks to the city's more rapid growth, its unemployment rate in 2001 (4.5 percent) was much lower than that in the rest of the country (17.8 percent). Similarly, the city's poverty rate in 2001 (5.0 percent) was less than half the national rate (12.8 percent).

In earlier decades Sofia pursued an intensive strategy of industrial development, and its rapid industrialization in the 1960s and 1970s led to brisk in-migration from rural areas. This strategy resulted in an economy dependent on manufacturing and heavy industries but also created an administrative and intellectual hub. The city's strong ties to export markets in the former Soviet Union made the transformation from a highly centralized command economy to an open, market-driven one difficult. Once these captive markets were lost, Sofia and the rest of the country had to struggle to find new customers in a competitive market. While painful, the shift in Bulgaria's foreign trade was nonetheless relatively rapid, and by 1997 more than 60 percent of its exports were going to markets of the Organisation for Economic Co-operation and Development (OECD).

With Bulgaria slow to embrace privatization, less than half the manufacturing in Sofia has been privatized. Still, about half of Sofia's employment was in the private sector by 1998. Sofia generally receives a large share of the foreign investment flowing into Bulgaria. In 1992–2000 the city attracted about half of the country's foreign direct investment, though it accounts for only 15 percent of the nation's population (Standard & Poor's 2002). Of the total investment of $1.1 billion in Bulgaria in 2000, Sofia attracted $693 million. About a third of the foreign direct investment in the city has gone to the financial sector as foreign banks enter the market, followed by trade, tourism, and light industry—all potential growth sectors for the city's economy.

Sofia's shift to a service-based economy has been slow, and its economy still has a large share of manufacturing employment, concentrated in a few large state-owned enterprises. Trade and transport are the most developed sectors, accounting for almost a third of employment. Construction is growing and employs about 7 percent of the city's workforce, compared with about 5.4 percent for Bulgaria as a whole. Industry, with 19 percent of employment, is largely concentrated in a single, loss-making steel company, Kremikovtzi. The city needs to further improve the competitiveness of its economy by developing a more sophisticated service sector and industries with greater value added.

Financial Situation

Like all local governments in Bulgaria, Sofia has seen its financial responsibilities increase significantly since the beginning of the reforms, encompassing a wide range of social and infrastructure tasks.[4] Moreover, the functions assigned to the municipality are not always well defined, and laws and regulations guiding the division of functional mandates are sometimes conflicting. The unfunded mandates are undesired and should be eliminated in full. A related problem is the lack of clarity about which level of local government is responsible for delivering a service, a situation that tends to reduce accountability. Assigning clear responsibility to a unit of government for a specific service is important to enable constituencies to hold that unit accountable.

In 1998 grants from the central government accounted for 23 percent of Sofia's revenue. By 2000, however, such grants accounted for only 3 percent of the city's revenue as the newly created equalization mechanism began to redistribute resources from cities like Sofia to poorer regions. In 2001 Sofia received no grants, becoming a net contributor to the central budget. Of the 262 local governments in Bulgaria, only 19 do not receive grants. Sofia is expected to remain a contributor to the central budget, since the equalization mechanism is likely to stay in place for the foreseeable future.

Taxes (including shared taxes) contributed more than four-fifths of the city's revenue of BGN 398 million in 2001. The city's tax revenues have been increasing faster than the inflation rate, growing by more than 15 percent a year, and their share in total revenue increased from 70 percent in 1995 to more than 80 percent in 2001. Driving the growth in tax revenues are higher collection rates, an expanding economy, and the corresponding rise in income. The city's income tax base supports revenue stability. In 1999–2001 personal income tax revenues rose by 27 percent, from BGN 150 million to BGN 190 million, or about 15 percent in real terms. Total tax revenues grew by 13 percent in real terms during the same period.

Although the city has a good tax base, it has limited revenue and expenditure flexibility. All local and shared taxes are determined by national legislation that specifies their base and a range for the rate. The central government exerts tight control over the allocation of local revenues and expenditures. In addition, Sofia faces liquidity constraints resulting from seasonal fluctuations in its tax revenues, low cash balances, and a limited ability to borrow from local financial institutions to cover short-term financing gaps.

Capital revenues, like current revenues, have been unpredictable and not necessarily linked to the level of economic activity in the city. Local capital receipts, which come mainly from property sales and are accounted for in the extrabudgetary privatization fund, dropped from BGN 12 million to BGN 5 million between 1999 and 2001. These receipts are likely to continue to decline until 2012, when privatization sales are expected to be completed. Another source of capital revenue is the state capital expenditure grant, a transfer from the central government. This revenue has varied from BGN 29 million in 1999 to BGN 16 million in 2000. With no set rules for allocating this grant among local authorities, the distribution appears to be the outcome of annual negotiations between the municipalities and the Ministry of Finance.

Despite the constricting expenditure requirements by the state, Sofia has been capable of prudent fiscal management. In 2000 the city had an operating surplus of 4.3 percent and a deficit after capital expenditure of 13.5 percent (table 27.1). The deficit after capital expenditure in 2000 was attributable to the city's investment program, largely financed by its eurobond sale. In 2001 and the first part of 2002 the city curtailed its investment program to accumulate funds for repayment of its eurobond. Sofia should therefore show surpluses after capital expenditures for 2001 and 2002.

Debt Management

Sofia is among the few municipalities in Bulgaria that have successfully borrowed funds independent of the central government. The municipality has received three loans—two loans from local banks in 1994 and a syndicated loan from local banks in 1998—and issued one bond—the only municipal eurobond issued in Bulgaria so far. The 1998 syndicated loan, from Lead Bank and Bulbank, was for cash management purposes (road rehabilitation and repair) and used two forms of collateral. Two public facilities (a hospital and a kindergarten) were pledged as half the collateral, and shares in municipal companies were pledged as the other half. The eurobond of

Table 27.1. Financial Performance Indicators for Sofia, 1996–2001 (percent)

Indicator	1996	1997	1998	1999	2000	2001[a]
Ratio of operating surplus to operating revenue	3.6	3.7	8.6	7.2	4.3	31.0
Ratio of surplus after capital expenditure to total revenue	2.2	4.3	0.7	10.5	–13.5	24.6
Ratio of overall balance to total revenue	0.1	2.6	–5.6	–11.9	–13.7	24.6

a. Data refer to the first three quarters only.
Sources: Regional Statistical Office of Sofia; Standard & Poor's Ratings Direct.

BGN 100 million was an important source of capital funds for the city between 1999 and 2001.

Neither the 1998 loan nor the later eurobond sale was guaranteed by the national government. However, since Bulgaria has no legislation definitively prohibiting central government bailouts, national and international lenders may be more willing to lend to municipalities than they would be if the country had such legislation. In any case there has been no need for central government bailouts of Sofia.

In contrast to the national government, which has a high level of public debt, Sofia has a small debt burden by international standards. Sofia's conservative debt position is reflected in its credit rating relative to those of other cities (table 27.2). The only debt the city had outstanding at the end of 2001was the EUR 50 million note at 9.75 percent interest, which was issued in May 1999 and matured in June 2002. The eurobond, issued to help fund the city's capital investment program, financed mostly small transport-related infrastructure projects. With the eurobond outstanding, the city's debt burden, as measured by the ratio of debt to operating revenue, stood at 26 percent in 2001. In that year the city repaid BGN 10 million from the budget, and in 2002 it repaid BGN 40 million from the budget and other revenue sources, such as its extrabudgetary privatization fund. The lifetime of the eurobond coincided with a period of macroeconomic stability during which the city enjoyed steady growth. These conditions made it easier for the city to save and accumulate funds to repay the bond.

In early 2002 Sofia signed two new loans. The first is a EUR 35 million loan from the European Bank for Reconstruction and Development to finance an extension of the subway and the purchase of new buses. This

Table 27.2. Credit Ratings of Selected Local Governments, 2001

	Date	Local currency rating	Foreign currency rating
Sofia	7 November	BB/Stable/—	BB–/Stable/—
Moscow	19 December	—	B+/Stable/—
St. Petersburg	19 December	B+/Stable/—	B+/Stable/—
Samara Oblast (Russian Federation)	13 November	—	B/Positive/—
Istanbul	14 December	B–/Stable/—	B–/Stable/—
Rio de Janeiro	9 August	BB+/Negative/—	BB–/Negative/—

Note: Table shows local governments with non-investment-grade ratings only.
Source: Standard & Poor's Ratings Direct.

loan, to be disbursed over the period 2002–04, has an estimated 7 percent interest rate, a 10-year payback period, and a 3-year grace period for the principal. The second is a loan for 12.9 billion yen (roughly BGN 210 million) from the Japan Bank for International Cooperation, to be disbursed in 2002–06. It is estimated to carry a 1.5 percent interest rate over 30 years, with 10 years' grace. Even with zero real growth over the next 30 years, the debt service for these two new loans, which have highly favorable terms, will be less than 6 percent of total revenue. These loans probably will serve as a catalyst for new lending from multilateral institutions in the immediate future—just as has happened in many other transitioning economies—although Sofia may increasingly tap private credit as its financial conditions warrant.

What Local Governments Need

Political decentralization in Bulgaria has proceeded with no comprehensive policy framework and in the midst of political instability and tough economic conditions. The impromptu design of intergovernmental relations that has emerged is defective, causing administrative and fiscal bottlenecks that limit the effectiveness of local governments and thereby constrain the economic development of cities. The central government imposes many fiscal guidelines on municipalities, including Sofia, but also grants exemptions from its rules, making it difficult for local authorities to develop an appropriate set of internal rules to alleviate these bottlenecks. In Sofia an additional problem is the hierarchical structure of decisionmaking, with almost no devolution of authority within the municipality.

Sofia, like the rest of Bulgaria, has a deteriorated stock of infrastructure. The economic upheavals and fiscal pressures of the early 1990s led to widespread deferrals and cancellations of capital investment projects (Bogetic 1997). To upgrade its infrastructure stock, Sofia needs to undertake major investments, but the limited fiscal flexibility allowed by the central government will make it difficult for the city to make the expenditures needed. Dealing with the backlog of investment needs also will limit the city's ability to meet other expenditure needs. Despite its large capital investment needs and its increasing contribution to the revenue equalization system, Sofia has managed its budget prudently over the past five years. The city's financial performance has benefited greatly from the improving macroeconomic environment and from the greater stability and flexibility of the intergovernmental system since 1998.

While the intergovernmental finance system has become fairly stable recently, with little change since 1998, Bulgaria's municipalities had to cope with significant change earlier in the 1990s. Tight control by the central government continues to constrain local authorities in developing their budgets. At the same time the lack of enforcement of central government regulations and the selective exemptions from rules have created uncertainty in revenue and expenditure flows for local governments. What Bulgaria and especially Sofia need is a system where local governments enjoy greater fiscal autonomy but where the remaining central government rules and regulations are more strictly enforced, with fewer arbitrary exemptions.

Notes

The analysis refers to the situation in Sofia as it existed until the end of 2001. The chapter draws on World Bank reports; the recently produced city strategy for Sofia, which was prepared with the assistance of the Cities Alliance (as well as the World Bank and the United Nations Human Settlements Programme); Urban Institute studies commissioned by the U.S. Agency for International Development; statistical reports of the city of Sofia; and reports of the credit rating agency Standard & Poor's.

1. "Uncertain decentralizers" are defined as countries that need substantial changes in intergovernmental finances and face major macroeconomic challenges that may take precedence over granting more local autonomy (World Bank 2001c).

2. In part because of the loss of trade with the Russian Federation, which also was in decline, Bulgaria saw its GDP shrink by 40 percent in 1990–93. Government revenues fell by even more, and the government's deficit ballooned to 14 percent of GDP in 1991.

3. The structural funds work toward the goal of achieving economic and social cohesion in the EU. Resources are targeted to actions that help bridge the gaps between the more developed regions and the less developed ones and promote equal employment opportunities for different social groups.

4. Much of the earlier decentralization policy essentially consisted of pushing the central government's deficit down to the local level as service responsibilities and norms were assigned (or, in the case of such norms as wages, dictated) without corresponding increases in transfers.