BULGARIAN MUNICIPALITIES' CAPACITY TO INVEST AND FACTORS AFFECTING LOCAL GOVERNMENT CAPITAL SPENDING FOR THE PERIOD 2003-2017

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Introduction

Capital expenditure assignment between levels of government is a complex issue that is individually resolved in each country. A number of research studies bring significant arguments in support of public infrastructure decentralisation (Bahl, 2013; Frank and Martinez-Vazquez, 2014; Estache, 1995). The majority of these arguments are related to the possibility of achieving allocative and technical efficiency, increasing the welfare of the local population, better meeting local needs, improving accountability and control over capital spending.

The construction, maintenance and expansion of municipal infrastructure are a key prerequisite not only for an adequate delivery of essential public service but also for enhancing local economic growth in the long run. According to Fisher and Sullivan: "the issue of public infrastructure remains of keen interest to both public officials and the general public" mainly because of the positive spillover effects and the benefits local government capital spending entails for a region's economy. (Fisher and Sullivan, 2016, p. 3). The academic literature widely recognizes these benefits – economic and social, as well as the returns of well-designed and functioning public infrastructure. (Hulten, Bennathan and Srinivasan, 2003; McKibbin and Henckel, 2010; Bivens, 2012).

As a result of the decentralisation processes launched in Bulgaria in 2003 and the reforms over the years in the field of local finance, Bulgarian local government opportunities to invest has changed significantly. The serious lagging behind in the maintenance and construction of municipal infrastructure in the pre-2003 period has been somewhat overcome, and the necessary revenues intended for investment have gradually increased over the years. Nevertheless, the level of municipal investment and the role of Bulgarian local authorities in financing public investment differ significantly from the EU model. Whilst on average local public sector investment in Bulgaria stands at about one-third of the total

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public sector capital expenditure for the period 2003–2017, in EU Member State local and regional authorities are responsible for approximately one half of total public investment (European Commission, 2017). It was only in the last few years that the level of local public investment in Bulgaria started approaching the EU average, primarily as a result of resources coming from European funds. This trend can be considered unfavourable because the support from the European funds should be complementary rather than almost entirely substitute national and municipal investment in basic public infrastructure.

The main objective of this article is to overview municipal investment activity during the years 2003 through 2017 and to assess direct investment capacity of local authorities in Bulgaria. The study focuses on several questions: How has capital spending been changing over time? What has been the impact of the crisis? Why has municipal capital expenditure been relatively low if spending financed through European funds was excluded? In addition, key factors affecting the levels and dynamics of Bulgarian local government capital spending are being examined. Factors that also influence capital spending at local level, such as administrative or technical capacity or debt issued are outside the scope of the paper.

The role of Bulgarian sub-national sector in public investment process

At the beginning of the period under review Bulgarian municipalities spent 297 million BGN on capital investment, an amount which represents about 22 % of overall public sector capital spending (Fig. 1). Relatively low levels of municipal investment could be explained with the fact that before the start of the public sector decentralisation in Bulgaria there were a number of statutory restrictions on the amount of municipal investment, mandatory spending priorities, etc. On the other hand, insufficient budget revenue did not allow for the majority of Bulgarian municipalities to cover even their state-allowed investment with own and borrowed funds. The resources invested by municipalities in capital expenditure stood at a maximum of about 80 % of their respective authorised limits. (Yankova at all., 2010, p. 130).

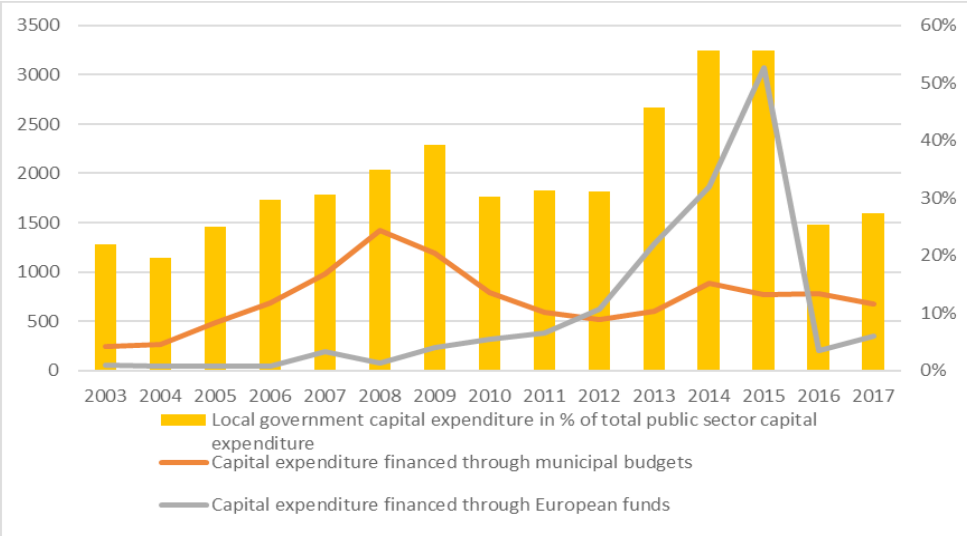

Fig. 1. Trends in Local Public Investment in Bulgaria (2003-2017), Source: Ministry of Finance data on consolidated fiscal program (2003-2017), Annual Reports on State Budget Execution; own calculations

Annual local government spending on capital goods has increased substantially over the 2004–2009 period and the share of local investment in total public sector investment reached 39 % in 2009. This is indicative of the growing role that local authorities have in building and maintaining public infrastructure. It is important to notice that the large dissimilarities in different years between the contribution to the public capital spending process of investment financed through municipal budgets and investment financed through European funds remains hidden if one observes only general trends in changing shares of local investment in total public sector. Until 2007 financing with European resources (through pre-accession financial instruments) was insignificant, while the total amount of funding from municipal budgets was gradually increasing.

During the 2008 fiscal year, the total amount of local government investment reached its highest value – 1,420 million BGN. The observed increase in local capital spending ceased as a result of the consequences of the financial and economic crisis. Capital expenditure made with budget funds shrunk substantially and reached a total of only 518 million BGN in 2012; this is more than 2.5 times lower than the volumes realised in 2008. By the end of the period under review, capital expenditure remained at levels significantly below the reported maximum.

The drop in investment financed with budget funds also affects the values of the local to total public investment indicator which fell to about 33 % on average after 2009. The increased values of this indicator to 46 % in 2013 and 56% in 2014–2015 — levels close to the EU average — resulted from the implementation of a number of European projects. Capital expenditure made with budget funds during this period was many times lower than that financed through European funds. In 2016 a decline in the share of public investment at local level is observed. On the one hand, capital expenditure funded through municipal budgets did not register an increase; on the other hand, after the end of the first programming period there were the so-called ‘zero years’ in which there were no significant utilisations of funds under European projects. The latter affected the local to public investment indicator and its value decreased more than twice, reaching the level of 25 %. In 2017 local investment increased in absolute terms, but again thanks to the capital expenditure made with European funds [1]. At the same time investment made with budget funds decreased. The local to public investment indicator slightly increased and reached 27 %, but still remained far below the EU average of about 50 %.

Thus, in recent years, the Bulgarian municipalities’ opportunities to invest have increased mainly due to the financing from the European Funds, while at the same time the municipalities’ participation in public investment process with their own resources remained low. To examine the capacity of Bulgarian municipalities to participate in the construction and maintenance of public infrastructure we use the Direct Investment Capacity (DIC) indicator. The indicator aims at measuring the amount of budget funds immediately available to finance public investment, without new borrowing or changes in revenue or expenditure structure (Hulbert and Vammalle, 2014).

The direct investment capacity indicator is the sum total of the current surplus at the end of the year (calculated as the difference between current municipal revenue and current municipal expenditure) and the capital expenditure grant, which local governments receive from the central government. Current municipal revenue includes local tax revenue, income from municipal fees, concessions, fines, sanctions and penalty interest, sale of LTAs and the total amount of funds from the general equalising grant. The latter is intended to provide unconditional financial aid to municipalities for delivering local public services and to equalise to a certain extent their fiscal capacity. Current expenditure includes the expenditure under the control of local government, i.e. spending on local activities. Current spending on state delegated activities covered by centrally provided financing in the form of grant and out of local governments’ control is not included in the DIC calculation. The total amount of that grant is determined annually on the basis of accepted standards for state delegated activities with natural and value indicators. Local authorities can influence the determining of the amount of that grant to a very low extent and can submit proposals for changes through the National Association of Municipalities in Bulgaria during the discussions on the draft budget for the respective year. The funds from the general grant for state delegated activities can be spent in a strictly targeted manner and cover costs, with a major share of spending concentrated on education, as well as on salaries and social security and health insurance contributions (NALAS, 2017).

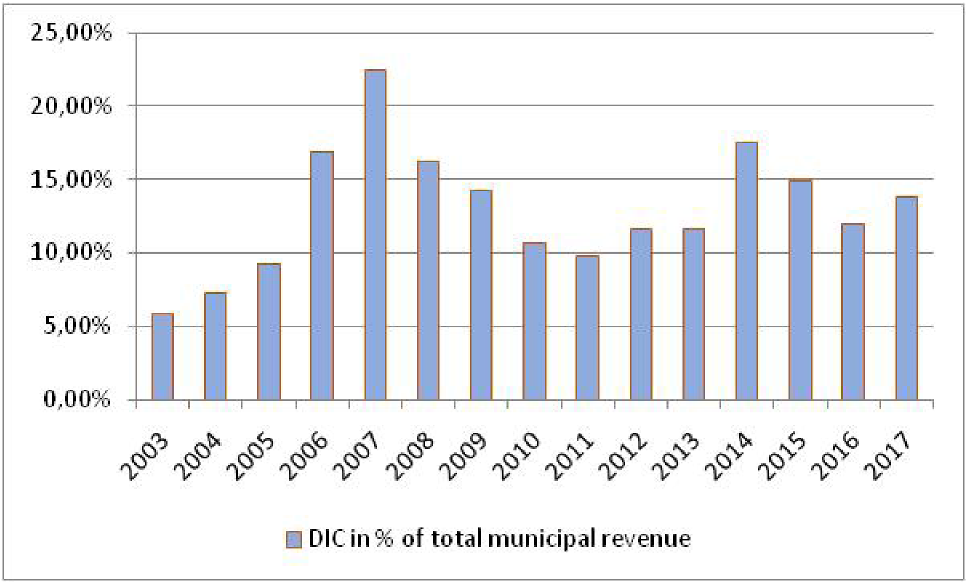

Fig. 2. Evolution of Local Government DIC, Source: Ministry of Finance data on consolidated fiscal program (2003-2017), Annual Reports on State Budget Execution; own calculations

Between 2003 and 2007 a trend towards an increase of DIC as a share of total municipal revenue became clearly visible (Fig. 2). At the beginning of the period under review, Bulgarian municipalities had a relatively low direct investment capacity. Local government DIC started rising from 2004 onwards, and reached its peak in 2007. However, the global financial crisis reversed this trend and DIC as a share of total municipal revenue has declined significantly since 2008. After 2013 there was again a positive change in the share of DIC.

The patterns shown in Figure1 and Figure 2 suggest that the level of public investment implemented by Bulgarian municipalities is positively correlated with the levels of DIC – as a result of the deterioration of the DIC share in total municipal revenue, investment financed through municipal budget declined in the period after 2008 and increased moderately in the period after 2013 as a consequence of the positive change in DIC share. There are several factors to consider when interpreting the evolution of DIC and all of them concerns the ability of local governments to generate more free resources directed to funding capital expenditure.

Direct investment capacity – revenue side

All revenue components of DIC — own revenue, general equalising grant and capital expenditure grant — affected capital spending at local level in Bulgaria in the period under review. Changes in total municipal revenue (Fig. 3) clearly demonstrate the expanding role and importance of municipalities in the economy and the public sector in the pre-crisis years, and, respectively, their declining capabilities to generate surpluses that can be used to finance investment afterwards.

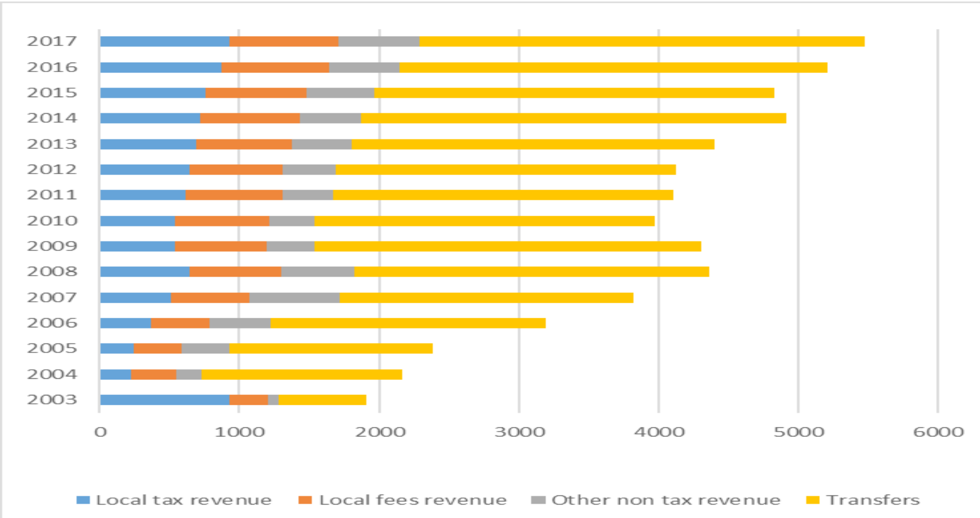

Fig. 3. Structure of municipal revenue for the period 2003-2017 (in million BGN), Source: Ministry of Finance data on consolidated fiscal program (2003-2017), Annual Reports on State Budget Execution; own calculations

A key factor affecting Bulgarian municipalities' capacity to invest is the structure of municipal revenue — the central government transfers is the main component in municipal income with a share of approximately 60% of total revenue over the years, followed by non-tax revenue and income from local taxes, with the lowest share. Naturally, such a structure of municipal revenue placed local governments in a position of strong dependence on the capability (and willingness) of the central government to provide the necessary funding as the experience gained during the period 2010-2013 shows.

The main reason for the dominant share of central government transfers is the tax base centralisation as a result of which municipal tax revenue stands at a mere

3.1 % of consolidated tax revenue. By way of comparison, the tax revenue (both own-source and shared tax revenue) accruing to sub-national government budgets in EU on average reach 16.1 % of the total public sector tax revenue. In a large number of EU countries, local authorities, in addition to receipts of local taxes, also receive substantial revenue in the form of shared taxes – local and regional authorities receive a fraction of the national tax revenue, which is determined on the base of redistribution or equalisation criteria (CEMR-Dexia 2012, p.15). The range of shared tax revenue usually includes receipts from personal income tax, corporate taxation and in rare cases VAT. For example, in Estonia revenue attributed of national tax receipts to local authorities provides about 90% of local budgets tax revenue, and in Poland this share reaches about 59 %. In the Southeast European countries, on average, 22 % of the municipal budgets benefits from the allocation of national tax revenue to local authorities (NALAS, 2017, p. 24). At present, local governments in Bulgaria do not receive shared tax revenue and this has a negative impact on the volume of tax revenue entering in the municipal budgets. Significant quantitative effects on tax revenue could be realised through changes in tax legislation concerning the determination of the tax bases of local taxes, a more active use by municipalities of the possibilities for setting tax rates that are close to the maximum permissible under the law, or introduction of new taxes, including assignment of part of the revenue from national taxes.

Own revenue

Maybe, among the different components, municipal own-sources revenue was especially significant for the continual increase in the budget funds potentially available for investment during the fiscal years 2003–2009. A number of steps that have been taken to increase local revenue base, as well as to broaden revenue decision-making power of local governments in Bulgaria created conditions for an accelerated increase in own revenue which reached a nominal peak in 2008 (Fig. 3). Income from user fees is the largest own-source revenue for local governments in Bulgaria. Together with other non-tax revenue they account for more than 60% of own revenue receipts. In fact, the onset of revenue decentralisation was marked by granting local authorities full discretion over municipal fees in 2003, followed by delegating tax collecting responsibility to newly-created municipal tax revenue offices and increasing tax autonomy (since 2008 local governments are granted the power to set rates of local taxes within the range limits postulated by the law). The growth in own revenue and its positive impact on DIC was a result not only of the greater local government financial autonomy but also of the expansion of the real estate market. A major increase was reported in income from sales of non-financial assets, fees for administrative and technical services, income from property transactions tax and tax on immovable property. One of the most dynamic own-sources revenue for municipalities is the income from sale and management of municipal property, fines, penalty charges and other non-tax revenue. The property sale is a very attractive option as a source of revenue, albeit, one-off income. Indeed, over the years local authorities in Bulgaria have largely relied on this type of income in order to balance their cash flows, which is the reason underlying the significant increase of municipal revenue from property sales. However, the accelerated sales resulted in a decrease in yields from municipal property, which in addition was hardly hit by the crisis.

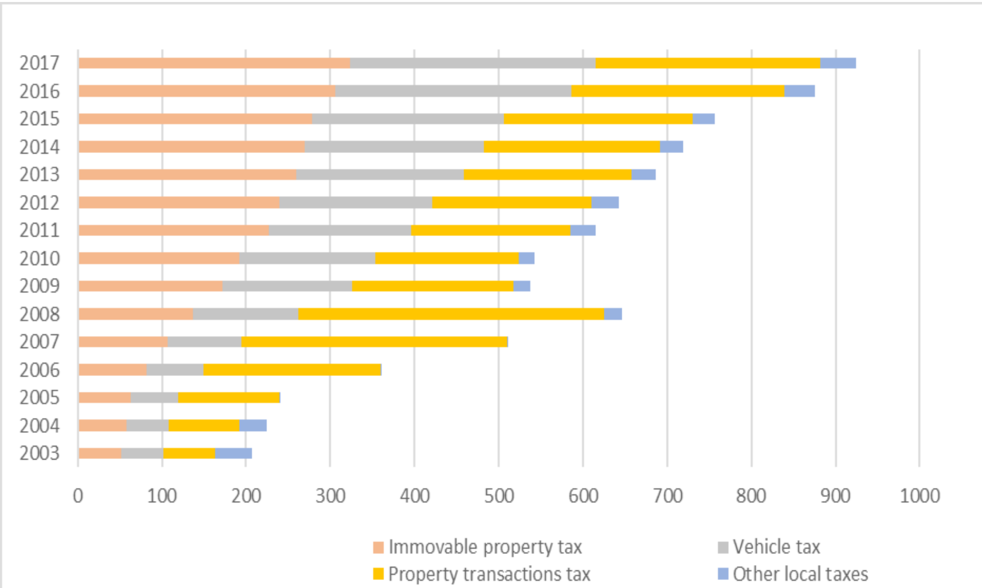

Fig 4. Structure of the tax revenue for the period 2003-2017 (in million BGN), Source: Ministry of Finance, Annual Reports on State Budget Execution (2003-2017); own calculations

Revenue from tax on immovable property has a leading share in municipal tax revenue (Fig. 4). The tax ensures stable receipts which steadily continue to grow over the years, as opposed to the property transactions tax the revenue from which is highly volatile and sensitive to changes in the economic environment. The high volumes of sales of property in the territory of different Bulgarian municipalities resulted in a growth in the revenue from the transactions tax after 2005, but in 2009 its receipts was almost twice lower than in 2008.

Another local tax that brings significant yields for municipal budgets is the vehicle tax. Over the years, the vehicle tax receipts have been steadily rising, due both to increases in rates and narrowing the scope of exemptions, and to the efforts of municipal tax administrations to increase revenue collection rate. Revenue from other local taxes account for only 5 % of the local tax revenue, and the main reason for this is their limited tax base.

The possible positive effects of the broadened revenue decision-making power of Bulgarian local governments and its importance for the expansion of DIC cannot fully manifest themselves due to the unfavourable consequences of the crisis. The decrease in municipal own-sources revenue, notably property transactions tax and income from the sale of municipal assets, coupled with the dramatic cut in the capital expenditure grant by almost 65 % in 2010 (Fig. 6), had a strongly negative effect on the volume of own funds available for investing in the period after 2009. It was only in 2012 that an increase, albeit marginal, was observed in the volume of total municipal revenue in absolute terms. This increase was due to the improvement of the collection rate of proceeds from fines, penalties and default interest as a result of the fact that the employees of the municipal administration were given the powers of public enforcement agents in connection with liabilities under the Local Taxes and Fees Act. The low share of this own-sources revenue, however, makes an insignificant contribution to the overall increase in total municipal revenue. In fact, own revenue is the proceeds whose sustained, albeit low growth (mainly due to improved collection) sets the beginning of the recovery of municipal budgets, and in 2014 own municipal revenue managed to exceed the pre-crisis level of 2008 by almost 7 % (Fig. 3).

Current and capital transfers

The general equalising grant affects local capital spending insofar as its growth, all other things being equal, has a positive effect on municipal current budget balance and results in an increase in DIC. The aim of this transfer is stipulated by law – to ensure that each municipality achieves a 'minimum level' of local services provision and local governments have full discretion as to the manner in which the transferred resources are spent for delivering local public services. Since the equalising grant is formula based and its minimum amount cannot be lower than 10 % of the figure shown in the report on own revenue of all municipalities for the previous year, local governments are protected to some extent from an unexpected decline in the amount of the transferred funds. Notwithstanding this, as shown in Figure 5, in 2010 the total amount of the grant was reduced by about 10 % compared to the previous year, and its size remained unchanged during the period 2011–2013. This freezing of the equalising grant and thus reducing local authorities' self-financing capacities affected directly their DIC. The freeze of the equalizing grant, together with the decrease in own revenues, severely limited the opportunities of municipalities to have more resources, some of which can be directed to capital improvements.

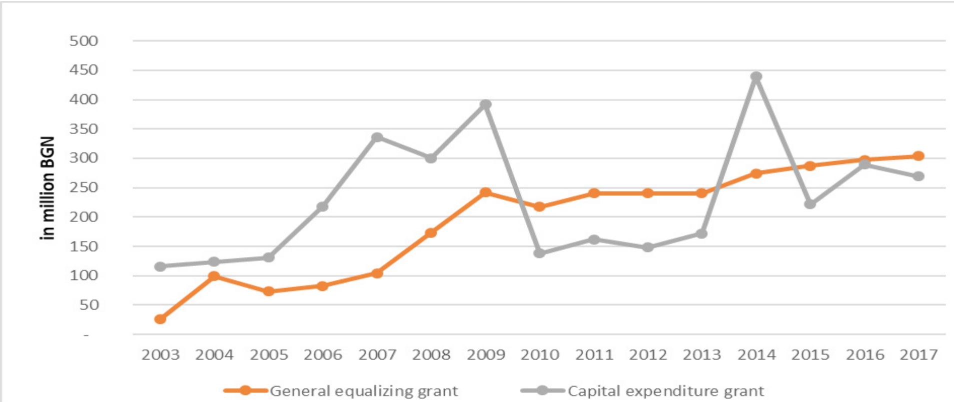

Fig. 5. Revenue equalizing grant and capital expenditure grant for the period 2003-2017, Source: Ministry of Finance, Annual Reports on State Budget Execution(2003-2017); own calculations

Capital transfers, which affect directly local capital spending and which are earmarked, are the most volatile element in comparison with other types of central government transfers. While during the period 2003–2009 revenue from capital expenditure grant registered a considerable growth, in 2010 a sharp drop to 138 million BGN was observed. The updating of the state budget and the decrease in the total sum of state transfers to local governments by about 138 million BGN also contributed to the reduction in the amount of capital expenditure grant in 2010. By the end of 2013, its amounts could not register values close to those in 2009. In 2014 a considerable increase in the revenue from capital grant was reported. The reason was the additional funds delivered for overcoming the disasters of the previous year and those received under the government investment programme "Growth and Sustainable Development of the Regions". In 2016 the total amount of capital expenditure grant increased by about 30 %, but remained below the 2014 levels. In 2017 the grant for capital expenditure financing remained at levels close to that of the previous year. It should be emphasised that frequently local governments in Bulgaria increase their opportunities to invest because of the additional funds received through capital transfers decided on an ad-hoc, discretionary basis and thanks to them they are able to cover urgent infrastructure needs such as road rehabilitation. The negative side here is that ad-hoc capital transfers cannot be incorporated in municipal budget plans for the year in question, and thus the sustainability of capital programmes, forecasting and planning is disrupted.

Although state transfers intended to cover capital expenditure needs contribute significantly to increased investment capacity of local governments, they need to be approached with some reservations. On the one hand, the state can finance large investment projects of local importance and support infrastructure development in a local community, but, on the other hand, transferred resources can reduce local initiative and limit the satisfying of specific local investment needs of which the central government is not aware.

Direct investment capacity – expenditure side

For the most part, the two largest current spending items on local activities comprises personnel costs, and intermediate consumption on goods and services. The DIC of local governments is directly affected by their current spending. Growth in personnel costs or intermediate consumption of goods and services often results in a reduction in capital spending when the possibilities for accumulating additional local revenue are limited and there is no option to avoid or permanently reduce current payments.

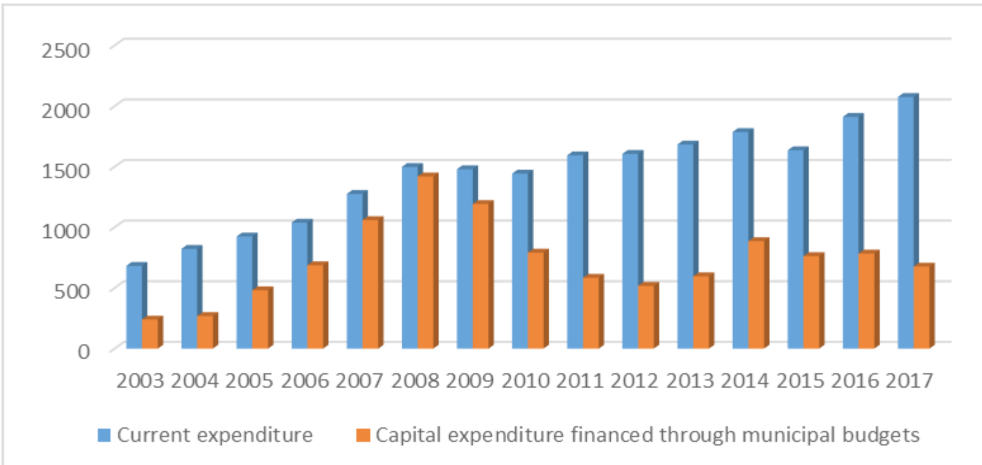

Fig. 6. Local government expenditure for the period 2003-2017 (in million BGN), Source: Ministry of Finance, Annual Reports on State Budget Execution (2003-2017);NAMRB, Internet platform, own calculations

The data presented in Fig. 6 clearly demonstrate that the trend observed in municipal expenditure follows the changes in municipal revenue; it registered an increase till 2008 and a decline during the consequent years until 2012. The overall drop in municipal expenditure after 2008 combined a slowing of current spending (which also has the prevailing share in the structure of municipal expenditure and exceeds the capital expenditure several times) with sharply lower capital spending. The shrinking of municipal budgets had a negative impact mainly on the volume of municipal investment which absorbed almost the entire decrease in municipal expenditure in the period after 2008, with most of municipal funds shifting to current expenditure. Normally capital expenditure is first to downsize in a situation of a fiscal squeeze. Thus part of the overall decline in capital spending financed through municipal budgets in this period was due not only to the serious decrease in own revenue and the amount of capital expenditure grant but also to the growth, albeit slight of noncapital components of local government budget.

Conclusion

After 2003 and as a result of the reforms in the field of local finances, Bulgarian municipalities' opportunities to invest have changed significantly. Direct investment capacity and receipts with investment focus increased gradually over the years till 2009. Regardless of this, the contribution of Bulgarian municipalities to public sector investment is quite lower than the average contribution of local governments in EU. It was only in the last few years that the level of local public investment in Bulgaria approached the EU average, primarily as a result of resources coming from European funds. At the same time, direct investment capacity remained relatively low. In other words, municipalities cannot satisfy the growing investment needs by relying only on budget funds.

Capital spending by local governments financed through budget funds declined significantly both in absolute and relative terms after 2009 and its low levels do not seem to be explained by any single factor. Current expenditure was generally a greater component of local government budgets and recorded a continual, although slow increase during the years. At the same time own municipal sources of funding are continually under stress. Moreover, local governments have not taken any concerted action to enhance attention to public capital and there is no evidence of a reallocation of central and local resources toward an expansion of investment. Since municipal capital spending is crucial for local economic and social development, opportunities should be sought for expanding the investment capacity of Bulgarian municipalities, such as increasing tax revenue, including sharing part of national tax receipts, or alternative funding options such as pooled financing.

Notes:

[1] The second programming period in Bulgaria covers the 2014–2020 timeframe. In the first years of the period projects were approved and public procurement procedures for selecting contractors are conducted. In 2017 the first payments under the projects were made, and this affected the total amount of capital expenditure.

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BULGARIAN MUNICIPALITIES' CAPACITY TO INVEST AND FACTORS AFFECTING LOCAL GOVERNMENT CAPITAL SPENDING FOR THE PERIOD 2003-2017

Abstract

Since 2003, the level of local government investment in Bulgaria has increased substantially. On average for the period 2003-2017 local public sector accounted for about one-thirds of total public sector capital spending. However, the contribution of Bulgarian municipalities to the public sector investment shows significant differences as compared to the prevailing EU pattern. It was only in the last few years that the level of local public investment in Bulgaria started approaching the EU average, primarily as a result of resources coming from European funds. The main objective of this article is to overview municipal investment activity during the years 2003 through 2017 and to assess direct investment capacity of local governments in Bulgaria. In addition, key factors affecting the levels and dynamics of local government capital spending are also being examined.

Keywords: municipal investment, direct investment capacity, local governments, fiscal decentralization, local revenue, local expenditure

JEL: H77, R51, O18