

# Enhancing Financial Capacity and Democratic Accountability of the Local Government: The Romanian Case

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## Introduction

### **The world is changing.**

Dramatic reform is taking place worldwide and, as important components of the political reform process, the decentralisation and the introduction of local self-government are present too.

Decentralisation has become a worldwide phenomenon in the last decades, and, in particular, for the countries of Eastern Europe, it has represented an important component of the reorganisation of the state in the transition from planned to market economy.

Decentralisation, defined as the transfer of authority and responsibility for public functions from the central government to intermediate and local governments or quasi-independent government organisations and/or the private sector, is a complex concept. Different types of decentralisation should be distinguished: political, administrative, fiscal.

Among these, financial responsibility is a core component of decentralisation. If local governments and private organizations are to carry out decentralised functions effectively, they must have an adequate level of revenues –either raised locally or transferred from the central government– as well as the authority to make decisions about expenditures.

Countries find themselves at different starting points in the process of decentralisation and, as a result, can be grouped into four categories<sup>3</sup>: “keen decentralisers”, “uncertain decentralisers”, “non-decentralisers” and “decentralisers by necessity”.

Romania can be described as an “uncertain decentraliser”. It tries to improve its system of intergovernmental finance, but do not always has a consensus on where it is going. Additionally, the country has not yet fully come to a macrostabilisation and

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<sup>3</sup> The World Bank – “Decentralization in the transition economies. Challenges and the road ahead”, 2001

therefore efforts at decentralisation must be careful not to cause further deterioration on the macro front.

In these circumstances, Romania's new government (since 2000) has identified central and local public administration reform as a central objective. The government's strategy<sup>4</sup> calls for an acceleration of public administration reforms and decentralisation and for further allocation of responsibilities for the delivery and financing of public services to local governments.

## **1. Local Government at a Glance**

### **Structure Of The Local Public Government**

Romania has a tradition of strong local governments. Romania's pre-communist system, modeled on the French system, included financially autonomous and democratically elected districts and municipalities.

However, following the communist takeover power was centralised and local governments became only prolongations of the central government.

In 1991, after four decades of centralisation, the country adopted a constitution mandating that responsibility for local affairs management be transferred to local governments. Shortly afterwards, the first law on local public administration<sup>5</sup> defined the institutional framework for local governments.

The basic structure of the local public government in Romania is defined by the Constitution, which says that local public government is based on the principle of local autonomy and decentralisation of public services. These provisions, together with those of the Law on Local Public Administration 215/2001 allow the organisation of the local public administration in the following administrative units: counties, cities, towns and communes. Nowadays in Romania there are 41 counties, 260 cities and towns and 2688 communes.

There are two levels of local government in Romania: first level consists of the 41 county councils and the second level of the 2948 local councils. There is no official hierarchical relationship between the two levels.

At local level there is also the prefect, in charge of the decentralised services of ministries and other central agencies within local administrative units). The relationship between these government representatives and local authorities is laid down in the Local Government Act. The prefect reviews only the legality of administrative decisions

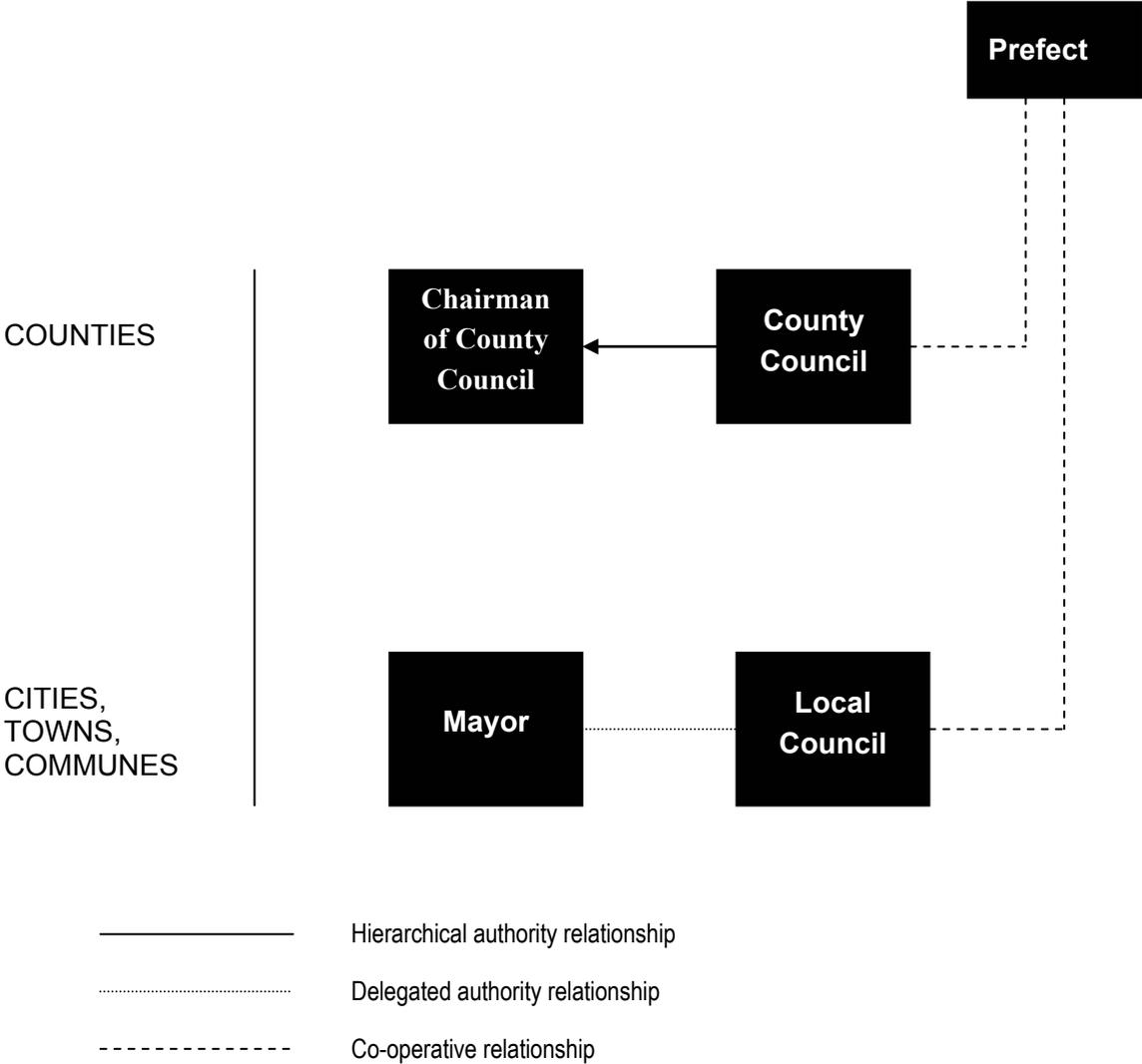
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<sup>4</sup> "Strategy on the advance of reform in public government", approved by the Government Decision 1006/2001

<sup>5</sup> Law on Local Public Administration no 69/1991

by local and regional authorities (local councils, mayors and county councils). There is no hierarchical subordination between the prefects on the one hand and local councils, county councils and mayors on the other (fig. 1).

**FIG.1 The structure of local government in Romania**



**Legal framework**

As part of the local public administration reform, the financial decentralisation relies on four main legislative packages:

- The Law on Local Public Administration no. 215/2001 – the provisions are general, by enumerating a long list of attributions and making very few distinctions between the two level of local government;

- The Law on Local Taxes and Fees no. 522/2002 - establish the notion of own taxes, controlled and levied by the local government (though the control has never been total);
- The Law on Local Public Finance no.189/1998 (likely to be replaced in 2003) - increase the autonomy of local governments by addressing the following basic principles of fiscal decentralisation: the alignment of expenditure responsibilities between the various levels of government, taxation responsibilities (setting, collection, administration) of local governments, transfers from the central government to local governments and the borrowing power of local governments.
- The Annual State Budget Law- governs one budgetary cycle (January-December) and provides the total amount of funds that is transferred from the central budget to local governments.

The legislation in this field is extremely dynamic. Each year, many pieces of legislation affecting local budgets are enacted, thus making the Romanian regulatory framework unpredictable, unstable and complicated.

## **2. Local Government Finance: An Overview**

### **Developments in Local Finance**

Financial decentralisation in Romania has progressed for some reasons, including the overall shift from centralised planning, and the commensurate transfer of increasing political and economic responsibility to lower levels of government. At the same time, it has been influenced by the severe fiscal crisis associated with transition.

The most common measures of decentralisation -- local government expenditure as a share of GDP and local expenditures as a share of total general government expenditure – have varied considerably between 1995 and 2001 (table 1).

Although local government fiscal responsibilities have increased, between 1996 and 1999 local expenditures and revenues have fallen as a share of GDP. This trend stabilized in 1999, when total local government expenditures rose to 4.1 percent of GDP from 3.6 percent in 1998, and then in 2001 (almost 2% higher than those in 1996). Local expenditures also increased as a share of state budget expenditures, from 20,6% in 1996 to 38,3% in 2001 expenditures. As it regards the local government revenues, these followed the same trend as the expenditures.

**TABLE 1: Selected Fiscal Indicators**

Indicators	1995	1996	1997	1998	1999	2000	2001
<b>in billions of lei; at current prices</b>							
GDP	72,136	108,920	252,926	373,798	545,730	800,308	1154,126
State budget expenditures	15,858	23,732	52,896	77,616	106,886	149,167	184,012
State budget revenues	12,888	18,372	43,834	67,216	93,239	120,342	148,203
Local budgets expenditures	3,265	4,955	10,370	13,381	21,599	33,216	70,522
Local budget revenues	3,336	4,998	10,468	13,454	22,246	33,445	70,675
<b>% GDP</b>							
State budget expenditures	21,98	21,79	20,91	20,76	19,59	18,64	15,94
State budget revenues	17,87	16,87	17,33	17,98	17,09	15,04	12,84
Local budgets expenditures	4,53	4,55	4,10	3,58	3,96	4,15	6,11
Local budget revenues	4,62	4,59	4,14	3,60	4,08	4,18	6,12
<b>% State budget expenditures</b>							
Local budgets expenditures	20,59	20,88	19,60	17,24	20,21	22,27	38,32
Local budget revenues	21,04	21,06	19,79	17,33	20,81	22,42	38,41

Sources: Romanian National Institute for Statistics, IMF

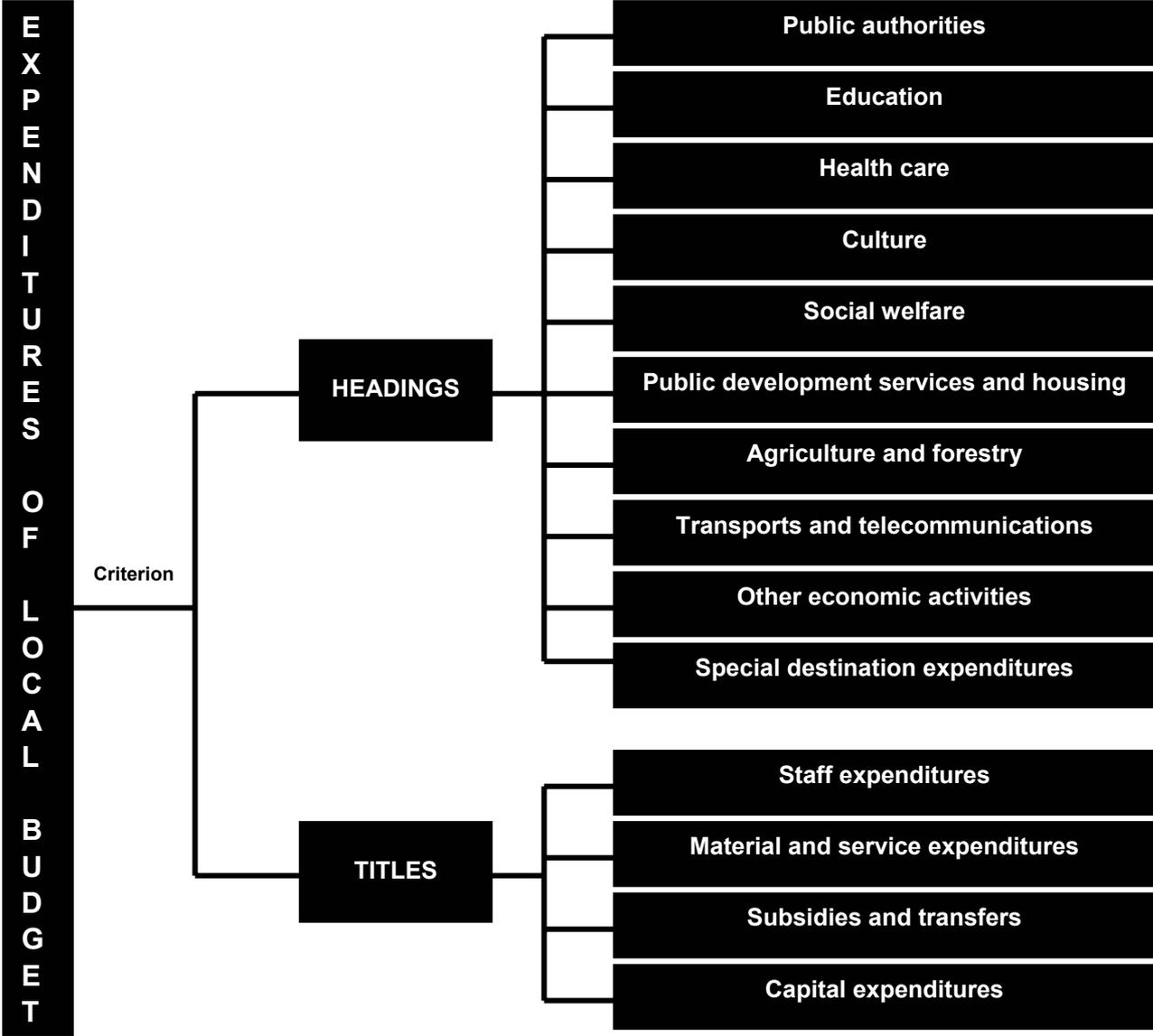
### Structure Of The Local Budget

The Law on Local Public Finance, passed in 1998, brought important changes in the structure of local budgets. It put local finances and the local budget process on an equal legislative basis with those of the central government and introduced tax sharing.

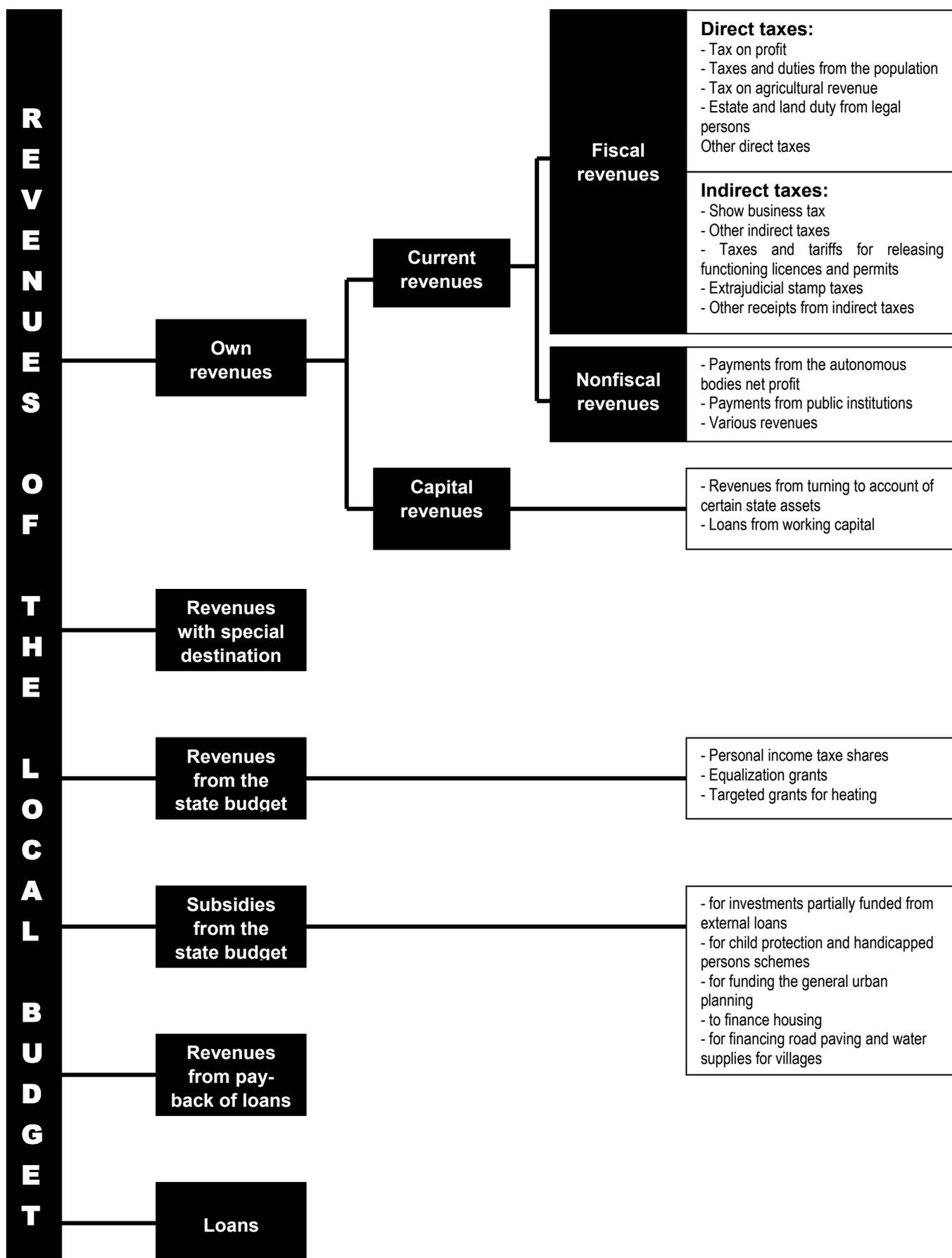
The Law on Local Taxes and Fees, authorized in 2002, expanded the local government control over its own revenues and authorized local councils to administer their own taxes.

As a result of the legislative reforms, a change in the structure of the local budgets occurred. The basic structure of the local budget is presented in fig.2 & 3.

**FIG.2 The structure of expenditures of the local budget**



**FIG.3 The structure of revenues of the local budget**



## Changes in local government revenues

A major problem regarding the local government revenues is represented by the *own revenues*, the most important of which are the local taxes and fees regulated by the Law on Local Taxes and Fees no.522/2002. We can distinguish two moments in the usage of local taxes and fees:

- 1994-2003 – the legal framework is represented by the Law on Local Taxes and Fees no.27/1994; the period is characterised by discretion in setting the tax rate, within a range specified by the law for the local *property taxes* (land, buildings, vehicles) and other *user fees* (licenses, permits, etc);

- after January 2003 – the new law will be in force and it will set fixed rates .

Another important problem regarding the revenues of local government is the improvement of the system of intergovernmental transfers, composed by:

- personal income tax shares
- equalization grants
- operational and capital subsidies established by the state budget law.

The *income tax shares*<sup>6</sup> have been established for the first time in 1998 by the Law on Local Public Finance: 50% to the state budget, 40% to local budgets, and 10% for the county council. But the percentages were modified when the global income tax was introduced, in 1999, to 35 % and set up the budget equalization fund available to the county council, with a share of 15% of the income tax. Additionally, the state budget law modifies each year the shares and for 2003, the law no 631/2002 states that 36% goes to the local budget of communes, towns and cities, 10% to the own county council budget and 17% to the county councils for the equalization grants targeted to communes, towns and cities.

The *equalization grants* are established by the annual budget law: the amounts are earmarked from some revenues of the state and the allocation criteria for each administrative unit are designed to support the poorer communities to compensate for the diminished fiscal capacity.

Although the Law on Local Public Finance introduced in 1998 the equalization grants, their budget classification, “shared amounts”, has existed for several years. Shared amounts were transfers in the form of general subsidies, as opposed to other subventions which were mostly earmarked for specific investment projects. Each year, the Annual State Budget Law publishes the pool of funds for “shared amounts”, and the criteria and corresponding weights for distribution. The most important difference between “shared amounts” and equalization grants is that equalization grants follow a

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<sup>6</sup> Sometimes, the personal income tax shares are considered to be “own revenues” for a certain purpose, e.g. the purpose of municipal borrowing

similar criteria with the “shared amounts”, except for the addition of an indicator for fiscal capacity.

The only two sources of funds for equalization are personal income tax and VAT. The personal income tax (PIT) amounts are defined discretionary by the central government in the Annual State Budget Law and there is no legal requirement as to how large this pool of funds taken from the central government’s share of income tax should be. However, it doesn’t exceed 25% of the total amount.

The second source of funds for equalization is the VAT. Since VAT is a purely national tax, the central government allocates conditional grants in relation with a set of attributions that were transferred to local government since 2000. The sums by destinations and counties are specified in the annex to the Annual State Budget Law. The total pool of funds to be transferred is not defined in any law, because the system is relatively new, but in the 3 years when it was used about 30% of the revenues collected were transferred to local governments. The actual split of VAT revenues by destination in the 2003 budget is the following: the total amount of VAT allocated to local government is 34.348,4 billions ROL: 99% - public primary and secondary education; 0,55% - nurseries; 0,45% - county/local agro consulting offices.

Because the total amount to be distributed from the state budget is not known, while both the income tax percentages and the equalization grants formula, published in the state budget, have been changed from one year to another, the transparency and predictability of the system are limited.

*The operational and capital subsidies* are sized in the Annual State Budget Law, in relation to the macroeconomic policies of the Government. The distribution is not regulated based on fixed criteria and leaves room for discretion.

The structure and the volume of local government revenues over the past three years are the following (table 2).

For 2003 consolidated revenues for all local governments, including counties, is estimated to be 117,749 billions ROL. Local government revenues have been growing. The most recent executed budgetary data (2002) show that financial autonomy degree, showing the percentage of own revenues and personal income tax in total revenues is at a high level and it is expected to remain unchanged; it also show a balanced repartition between central and local government. But if the data is thoroughly analysed it can be observed a drop in the financial autonomy degree, due to a slight increase in the income tax shares. And also it can be seen an increase by more than 100% in the subsidies from the state budget (2,056 billions ROL in 2001 to 5,083 billions ROL in 2003).

The main source of local revenues (about 75%) is given by the revenues from the state budget, while the second is represented by the own revenues.

**TABLE 2: Local government revenues (2001-2003\*)**

Indicators	2001	2002	2003*
<b>in millions of lei; at current prices</b>			
<b>TOTAL REVENUES</b>	70.675,4	90.490,3	117.749,6
Own revenues	15.273,1	17.253,5	21.140,1
Revenues from the state budget	50.870,0	71.080,4	90.900,6
- VAT share	21.810,8	31.218,7	34.348,4
- Personal income tax shares and funds	29.059,2	39.861,7	56.552,2
PIT shares	21.946,3	27.414,4	37.267,0
PIT funds	4.453,5	9.811,0	15.699,3
PIT funds for residential heating subsidisation	2.659,4	2.636,3	3.585,9
Subsidies from the state budget	4.345,4	2.056,4	5.083,9
Subsidies from other budgets	177,9	100,0	625,1
<b>%</b>			
Financial autonomy degree (Own revenues/ Total revenues)	21,6	19,1	18,0
Financial autonomy degree (Own revenues + PIT shares/ Total revenues)	52,7	49,4	49,6

Sources: Romanian National Institute for Statistics, 2003 State Budget Law

\* - projection

### **Changes in local government expenditures**

The expenditure responsibilities for local and county councils are outlined in the Annual State Budget Law. Mainly, the local councils provide public services for a specific community, while the county councils are responsible for services concerning a group of communities.

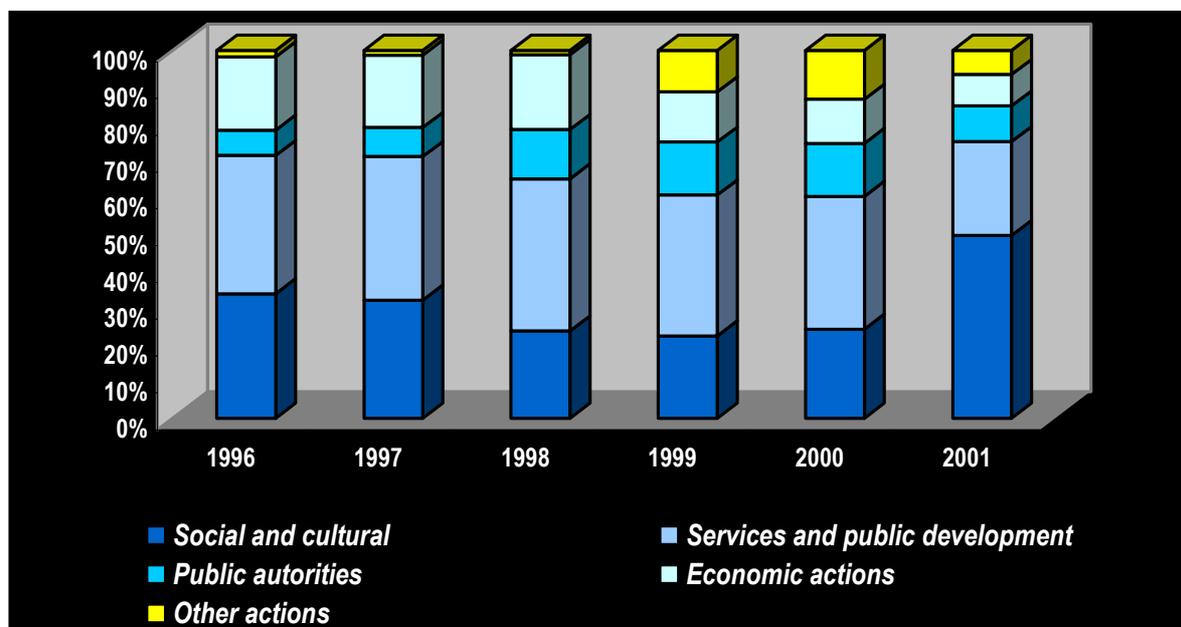
Central government has the tendency of maintaining control over the level of expenditures in local governments for several reasons. One of them is the macroeconomic reason. Secondly the local governments are, as described, partially funded from the state budget.

Controlling the level of expenditures means a very restricted local autonomy. And, in these circumstances, local authorities are only used as agents in executing

national policies (such as education) or play the part of revenue distributors to public services.

The structure of the local government expenditures and the way it has changed between 1996 and 2001 are shown in figure 4.

**FIG.4: Local government expenditures (1996-2001)**



The data presented in the chart above needs some comments.

① Social and cultural expenditures refer to those local government expenditures in the fields of education, health, culture, religion, sport and youth activity actions, social assistance, allowances, pensions aids and indemnities.

Funding of primary and secondary state education are provided from the local budgets by using the shared amounts of VAT to local budgets with this destination and own sources of the local budget. Since 2001, when the wages were finally transferred to local governments, education has become one of the most important expenditures for the local budgets.

Funding of health is small compared with the overall budget and is done from a targeted subsidy from the nationally-collected VAT and own sources of local budgets.

Funding of culture (decentralised culture institutions transferred gradually in time) is done from local budgets. Staff wages are still regulated at central level.

Starting with 2002 salaries for the non-clergy personnel of the religions recognized by the Romanian state are paid from the local budgets.

Finally the social welfare expenditures will all their components (services/care for people with disabilities; child protection; minimum income support policy; residential district heating; vouchers for heating) can be considered partly or fully funded.

② Public authority expenditures are also supported from the local budget, but the amount of funds for this budget item is available to the local government with a number of strings attached that limits to the local decision, such as: the maximum number of staff, the wages, etc.

③ Services and public development comprises maintenance and repairs of streets, street lighting, sanitation, maintenance of parks, entertainment, sports grounds, water supply, sewerage, district heating and power plants that are fully regulated at local level; then maintenance/building of national and county roads that is financed from national special funds through dedicated transfers to local budgets, and finally roads and water supply in rural areas, also funded from a special fund.

④ Economic actions have as a core component the local transport and communication whose quantity and quality are fully controlled by the local governments. Until 2001 these services were partially funded by state subsidies. Starting with 2002, local authorities can choose to subsidize the public transportation in their area of competence, but if they do so they must provide the subsidy from their own revenues.

Analyzing the structure of local governments expenditures, several conclusions can be drawn:

- the number and size of services increased steadily over time;
- the most important attributions, and therefore expenditures, are those transferred recently, such as education and welfare support;
- in most of the cases discussed above, the decision is shared between the central and local authorities;

Although the central government intervenes sometimes with spending limits or targeted subsidies, the first are hard to enforce in practice and the second are not mandatory. Therefore the local governments enjoy a fair degree of local autonomy.

For the future the central government announced its intention to complete the reassignment of functions to local authorities; the functions concerned are:

- Police (criminal, traffic) .should be demilitarized and transferred to local councils
- Citizens' ID and passport service .should be demilitarized and transferred to local councils
- E-government – Local governments must organize the collection of local taxes by Internet (cities by Feb 2003; other towns by the end of 2003)<sup>7</sup>.

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<sup>7</sup> Law no. 291/2002

### 3. Local Public Borrowing

One of the most revolutionary provision of the Local Public Finance Law is the possibility for local authorities to obtain credit in their own name from the domestic and foreign capital market.

Faced with competing demands for scarce resources, local and county councils are turning progressively to borrowing as a way of financing priority investment projects. Financing provided on commercial terms is becoming the main complement to more traditional funding from State and local budgets.

There are two forms of credit that can serve the same purpose of intermediate-term investment financing for a municipality: bank lending and municipal bonds.

Although based on experience in other developing markets it may have been expected that initially bank lending would predominate over the issuance of bonds, in Romania the second debt instrument prevailed, quite if the publicly sold municipal bonds requires more publicly disclosed financial and other information than does a loan made by a bank.

In the past two years, ten issues of municipal bonds have been successfully publicly offered and approved by the Securities Commission (table 3).

**TABLE 3: Issues of municipal bonds approved by the Securities Commission**

Issuer	Date	Maturity	Amount (ROL)
Predeal I	08.10.2001	18 months	5.000.000.000
Mangalia	12.10.2001	24 months	10.000.000.000
Zalău	30.05.2002	24 months	10.000.000.000
Alba Iulia	18.07.2002	24 months	16.000.000.000
Cluj-Napoca	15.08.2002	12 months	25.000.000.000
Breaza	19.08.2002	24 months	3.000.000.000
Predeal II	21.10.2002	42 months	7.500.000.000
Bacău	27.11.2002	30 months	35.000.000.000
Sebeş	02.12.2002	24 months	10.000.000.000
Târgu-Mureş	10.12.2002	30 months	20.000.000.000

The legal framework for local government credit provides broad authority and discretion to local and judet councils to decide whether and when to borrow, but it also stipulates some limitations:

- The amount of interest and principle you pay on all outstanding loans of your local or judet council must be 20 percent or less of your current revenues;

- In order to borrow in the international markets you must obtain prior approval from a special commission created by the Law on Local Public Finances;
- Approval of a loan requires a two-thirds vote by the municipal or judet council; the requirement of a “majority” enhances the status of the commitment to the obligation to repay the debt.

The Law stipulates that long and medium-term loans may be authorized to finance public investments of local interest and to refinance local public debt. This provision limits municipal debt to infrastructure projects that are in the “public domain” and sets an advisable “public purpose” standard for municipal credit. Additionally, municipalities may incur loans from their Treasury accounts for cash flow financing, but such loans shall not be greater than the amount that the municipality can pay in the current fiscal year.

The Law on Local Public Finance provides that municipalities may not maintain accounts with commercial banks. As a result, funds of municipalities are held in non-interest bearing accounts at the Treasury and the municipalities are not presently perceived by banks as “potential customers”. And the result is the lack of development of bank-client relationships.

One of the most important problems concerning local public borrowing is represented by the central government role in local debt issuance and guarantee.

Even in a decentralised public finance system, the central government has to keep an interest in the integrity of municipal budgeting and financial management. It has two major concerns:

- to limit the consolidated public deficit (that includes the deficits of local governments);
- to protect the integrity of the overall public finance system against imprudent local public borrowing.

But this is not implying the authorisation of the Ministry of Finance to exercise prior restraint of municipal debt issuance. The Law on Local Public Finance takes a prudent course by not requiring the approval of local debt by the Ministry of Finance unless it is in the form of external debt.

In a developing capital market we must confide in the self-interest of banks and other financial institutions to assess the ability of borrowers to repay their debts.

As it regards the central government role in local debt guarantee the law states that there is not any implied guaranty of the central government of municipal debt and additionally requires that such an effect to be expressly stated in an instrument of municipal debt in order for such instrument to be a valid obligation.

## Conclusion

Within the process of public administration reform, fiscal decentralisation and strengthening local self-government is certain to remain one of the main areas of activity.

The last few years have brought important progress in the decentralisation of Romanian local public finances, but it is still place for improvement. In practice, the financial relationship between central and local levels of government remains unclear despite of the new legal framework promoted starting 1998.

Even though the aim of the legislation on local public administration was to strengthen local fiscal autonomy by clarifying and expanding local control over revenues, expenditures and the budget process, the effect was, at the local level, more in the sense of administrative local autonomy than financial autonomy.

This came from the fact that the segment of fiscal decentralisation was less approached, and real local autonomy cannot be done only by delegating decision to the local level, if there is no transfer of mandates over financial resources enough to cover for the administrative decision. In addition to insufficient financial resources, because of constraints regarding the number of staff, local authorities are also facing the lack of organizational capacity to implement the new responsibilities.

Another important issue, directly related, is the legislative instability. Starting with 1998, political and economic responsibilities needed to be transferred to the local level also because of the financial pressure associated with the transition process, and the growing number of legislative acts determined increased expenditures for the new mandates, without adequate funding. The basic legislation was amended by a multitude of ordinances issued mostly during the fiscal year, after the budget law was enacted, thus catching local authorities by surprise.

Transparency and predictability of the transfer system are another major problems. These two necessary conditions are still limited because the total amount to be distributed from the state budget is not known, while both the values of tax shares and the equalization grants formula, published in the state budget, may be changed from one year to another.

If it is to analyze the five conditions<sup>8</sup> for a local government to have financial autonomy: ❶ create new local taxes and fees; ❷ determine the tax base; ❸ establish the tax rates for local taxes; ❹ ensure tax collection; ❺ obtain revenues directly; only in the last two of them: competence to collect the local revenues and the ability to obtain revenues directly without approval by the central government, the local government has authority. Therefore a conclusion can be drawn: there is a long way until a real financial autonomy of the local public administration can be reached.

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<sup>8</sup> C. Romanik, P. Coman, D. Dăianu, H. Garzon – “Romania. Winners and losers: the impact of reform of intergovernmental transfers”, 1999

In these circumstances, with the purpose to accelerate fiscal decentralisation some important measures need to be taken, such as: establishment of local budget principles; amendments to the existing laws by introducing clear criteria for transparency; definition of government's objectives and public institutions attributions.

Legislative measures should introduce requirements for using modern management methods and techniques (such as program budgeting or budgets oriented on performance, quality analysis, introducing performance indicators).

There is also a need for improving the legislation for local credit. Both the local public administrations and the public service operators need to have access to loans – an instrument that imposes efficiency and involves financial discipline and this needs a sum of measures.

The municipalities have to be granted the permission to maintain commercial bank accounts. The present restriction requiring municipalities to deposit their funds in non-interest bearing account at the Treasury. Quite if a Government Ordinance 146/2002 states the possibility for municipalities to hold escrow accounts in banks authorized by the National Bank of Romania, there are no methodological norms and therefore the GO is not applicable.

Banks and municipalities need to have a better understanding of municipal finance structure and the legal framework governing such financing. Since the investment credit analysis norms of the Romanian banks refer only to business companies, as banks begin to consider municipalities as potential customers they must develop their lending “norms” to adjust to a municipal legal framework for lending.

And above all these, there must be coherence.

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