Fiscal Decentralization in Romania: Assessment of Recent Developments

By
Razvan Manta

Submitted to Central European University
Department of Political Science

In partial fulfillment of the requirements for the degree of Master of Arts

Supervisor: Professor Attila Folsz

Budapest, Hungary
2007

Abstract

The aim of this paper is to present the state of fiscal decentralization in Romania as resulted from recent legislative changes. I employ as method an in depth case study with qualitative and quantitative measurements of data. The aspects that are touched include the structuring of fiscal responsibilities between levels of government and local fiscal autonomy. The latter is assessed using the legal framework on subnational borrowing, the intergovernmental transfer system and empirical data from selected county budgets. The new legislation has brought improvements into the area of fiscal decentralization, but some developments come against local fiscal autonomy. The identified shortcomings are the starting point of policy recommendations.

Table of contents

Introduction

For some time now part of the literature of political-economy has dealt with the issue of fiscal decentralization. The topic has been researched at both individual levels (case-studies), as well as cross country studies. As will be detailed in the theoretical chapter, the debate goes on and one can point to both positive and negative aspects. But one thing clearly derives from the multitude and diversity of opinions expressed by the academia. The topic is a centre focus for research and there are no definite strategies that can determine a successful process of decentralization in any particular context.

To this ever-enlarging body of academic statements I would also like to bring my own contribution. This will be realized through a carefully detailed and informed in depth assessment of Romania's fiscal decentralization at present. What I set out to achieve is a comprehensive analysis of the state of affairs in the structuring of intergovernmental fiscal relationships. The focus will be on the degree of fiscal autonomy enjoyed by local governments, with special focus for the empirical part on the tier of the county, between the national and literally local (localities) level. The puzzle instigating the research relates to the mismatches between general statements of policies and secondary legal framework or even particular articles within the same law.

Fiscal decentralization is a phenomenon that needs to be investigated in the course of political and economic developments. It is not an end phase of democratization or good governance. It also can not be brought about in a quick and decisive fashion. It has both time-related development problems and the continuous influencing forces of context specificity. Some authors have established phases and sequences to be undertaken.[1] Others have

[1] Falleti, Tulia G. 2005. "A Sequential Theory of Decentralization: Latin American Cases in Comparative Perspective", *American Political Science Review* 99, no. 3: 327-346.

underlined the need to develop "tailor made" designs of fiscal relationships between various levels of government.[2] At any point in time fiscal decentralization can show its strengths and possible shortcomings, leading to suggestions for improvements, in the form of policy conclusions.

Concerning particular circumstances having an impact on fiscal decentralization arrangements, the local context as such can prove to favor the decentralization process or hinder/ oppose it. If one does not take into consideration specific aspects of a country, one will not be able to formulate adequate responses to problems and deficient practices. Local consideration scan include previous history with such policies, structure and characteristics of territory and population. Moreover all the context specificity could lead to the conclusion that there are no uniform answers for structuring and/ or reforming the existing patterns of intergovernmental fiscal transfers. If this should be accepted, one will be left with pure descriptive possibilities of research, with no value beyond their limited cases. I believe this is not totally correct. Sure one must not ignore local circumstances and also not blindly validate superimposed, imported recipes of success. But the scheme for effective fiscal decentralization should lie somewhere in between and take past failures and incorrect foreign implementations as lessons and starting points; adapt them to the constraints and particularities of the given environment in order to generate the best possible outcomes. The legal framework in any case should be subject to review and reassignments of "responsibilities with changing economic and political realities".[3]

It is in this perspective, of stage in time development and context specific circumstances that I wish to focus my research. The case of Romania has not been investigated separately and thoroughly in the literature and thus I believe it deserves my

[2] Bird, Richard and Vaillancourt, Francois. 1998. "Fiscal Decentralization in Developing Countries: An Overview" in *Fiscal Decentralization in Developing Countries,* ed. Bird, Richard and Vaillancourt, Francois, Cambridge: University Press; 1-49. 35
[3] Shah, Anwar. 20004. *Fiscal Decentralization in Developing and Transition Economies.* Policy Research Working Papers 3282. World Bank. 37

attention and effort in order to fill this gap. The studies that exist do not include major legislative changes that have occurred in 2006, the year before Romania's accession to the European Union. Although innovative the new legal framework presents some weaknesses and shortcomings. It is precisely these new changes that I wish to research. The results of the analysis can yield both policy proposals in the case of Romania, or serve as an agenda for further research, or even enable cross country comparisons and appraisals.

The puzzle before mentioned could formally be translated into one simple *working hypothesis*: although in Romania there is a framework for fiscal decentralization, it is not able to generate sufficient autonomy of spending and/ or revenue generation on the part local governments. Even if there are higher level legal stipulations concerning fiscal decentralization, it is inappropriately met by second (lower) level regulations and restrictions that reduce substantially local fiscal decentralization. There are also some articles in the legislation that do not come in support of the general principles. The level of local fiscal autonomy (as a dependent variable) is thus influenced not only by legal stipulations on fiscal decentralization (independent variable), but also by the mechanisms inserted in the law, secondary regulations and procedures (independent variable). The principles need to be translated into means and here I believe the shortcomings are generated in the legal framework. Besides secondary regulations one has to consider also existing operations and practices that happen when the fiscal system is performing. In this respect I will present some findings from budget analysis on subnational government level.

When offering motivations for the topic of the current research I would like to draw attention to two types of arguments that come forth. The first one is related to the democratization process, while the second one concerns a more recent development, namely globalization. In the democratic perspective, one can also find some of the arguments that speak in favor of the decentralization process. Ideas in favor of and against decentralization will be the focus of the second part of the paper, so they will be mentioned here only in brief. In a timeline perspective the first category, democratic related considerations, has been investigated for a longer period. Still, due to the impact of the globalization phenomena that leads to the integration of more and more countries in a global economy, one must see the link between globalization and decentralization.

Coming to the first type of importance concerns, the way in which the relationships between different tiers of the state government are formulated can influence the evolution of democratic practices and lead to economic success. The issue of local democracy should be understood in the larger picture encompassing democratic practices and democratic consolidation in any given country. In order to function, local democracy requires some form of decentralization practices. These can come in the form of political and administrative decentralization, but these lose their significance if not backed up by effective fiscal regulations. By awarding local governments the capacities to collect and spend accordingly to locally set criteria and priorities, the central state institutions can improve their responsiveness to local pressures and legitimate demands. This does not come against the need to have some form of general, minimum standards of public goods provision. These, along with more cost-demanding public goods (such as national defense for example) and a supervision function, should still rest with the central government.

When structuring the relationships of local and central governments, problems arise regarding functions and responsibilities. Who is to accomplish what objectives (public goods) and under what procedures (tax collection and expenditure)? This is one important aspect fiscal decentralization must address and will be investigated in this paper. There has been an increase in the debate concerning the nature of taxes that different forms of government should levy. It can be attached to the problem of what goods can or must be provided by which structures. Aspects of the sort will be the focus of the theoretical as well as the empirical part of the paper. Problems as such are more serious in the case of transition countries such as was the case of Romania, not to long ago. Having had a history of communist experience, it is thus more difficult for the public sector to reform and function according to new standards. Figuring out the causes that have generated the present situation or the evolution in time of the legal framework and practices will not constitute the focus of this research. I will only evaluate the current level of fiscal autonomy for sub-national governments and point to the existing deficiencies of the system.

However we understand the reform process, its functioning and outcomes, one has to bear in mind that in order to evaluate results a certain period of time needs to pass. Romania has been experiencing decentralization since the early 1990s, but the progress has been slow.[4] Intergovernmental relations, although they might appear very formal and straightforward when reading legal texts, are subject to ever evolving practices. Even if central governments embark on the path towards fiscal decentralization they require, alongside will and resources to develop some form of strategy to support the effort.[5]

The process of decentralization could manifest backward trends. This could happen when the practices of local governments would induce macro-economic stability that could only be handled by central governments. In this situation central authorities would be forced to impose restrictions on the autonomy enjoyed by lower lever authorities. This might turn out to be a process of recentralization; tasks are being taken away from local actors as they appear to be yet unfit for the nature of the obligations. Recentralization tendencies, occurring when the systems experiences financial instability, should not be overlooked. Sometimes conflicts of such nature can be viewed as debates over certain values to be achieved by the system as a whole. It is clear that values will not be the same at all levels of government, regardless of

[4] Leonardo Gabriel, Martinez-Vazquez Jorges, Miller Benjamin and Sepulveda Cristian. 2006. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* International Studies Program Working Papers 06-19. Andrew Young School of Policy Studies. 2
[5] Bird. "Fiscal Decentralization in Developing Countries: An Overview"; 36

homogeneity of population or similarity in economic means. Macro-economic stability can be pinned against freedom of financial decisions by subnational governments. Sub-national divisions can vary in one or more respects and it brings about potential conflicting objectives, values. This adds more difficulty to the assessment and understanding of fiscal decentralization that needs investigations.

In the larger group of state agencies one has to single out the importance of local, sub-national governments and the beneficial effects they could achieve. At all levels of government state agencies are faced nowadays with increasing demands coming from their respective citizens. There is also the pressing need for balanced budgets and reduced deficits, which have been addressed by cuts in public spending. Taking this into consideration, as well as the need to secure an efficient provision of classical public goods, the state has the ability to delegate some of these functions to lower level of government. This requires the state to decentralize, to pass on authority, means and outcomes, to lower territorial levels. This can be considered as a solution to the many problems that exist in modern societies. I will not assess the appropriateness of such a model, but will only focus in the research part of the paper on the existing practices of fiscal decentralization in the case of Romania.

Regarding the two of the most salient topics in international politics and economics, decentralization and globalization are powerful driving forces of mobilization. Both phenomena seem to affect the workings of today's democracies. International institution, especially the World Bank or the International Monetary Fund (IMF), have repeatedly emphasized the stringency of the 'localization' phenomena. The World Development Reports note that "along with globalization (…), localization- the desire for self-determination and the devolution of power- is the main force 'shaping the world in which development will be defined and implemented' in the first decade of this century."[6] In this context localization refers to all forms of decentralization, political, administrative and fiscal.

The effects of globalization have an enhancing effect upon the fiscal decentralization process. As all forms of capital become ever increasing mobile and information technology more advanced, classical centralized state structures become "too small to tackle large things and too large to address small things."[7] Again decentralization politics are seen as a way out of this.

Fiscal decentralization characterizes the relationships that manifest itself between different levels of government. In this respect sub-national (local) governments should be understood as important economic players.[8] With their growing local demands for autonomy and decentralized decision making, sub-national governments need to understand the need to bear responsibilities. Moreover they need to be aware of the implications that such a system generates. There will no more central bailouts when financial difficulties occur. At the same time local governments must develop capacities of making use of the scarce resources they can mobilize to respond to local demands. One particular aspect of fiscal decentralization actually considers the revenue capacities of local governments. Underlining both expenditure capabilities and revenue generating mechanisms is part and parcel of the same decentralization process, as will be developed in the empirical part.

The paper will be structured in the following manner: the first chapter will present a general theoretical perspective on fiscal decentralization. It will be followed by a smaller chapter which includes the methodology, data, variables and their measurement. The third and forth chapter consist of the actual analysis of the Romanian case. One concern the legal

[6] Ebel, Robert and Yilmaz, Serdar. 2002. "On the Measurement and Impact of Fiscal Decentralization" in *Public Finance in Developing and Transition Countries: Essays in Honour of Richard Bird*, ed. Martinez-Vazquez, Jorge and Alm James, Northampton: Edward Elgar; 101-126.102
[7] Shah, Anwar. 2004. *Fiscal Decentralization in Developing and Transition Economies*, 2
[8] Bahl, Roy and Wallace, Sally. 2003. "Fiscal Decentralization: the Local-Provincial Dimension" in Vazquez, Jorge-Martinez and Alm, James (eds.). *Public Finance in Developing and Transitional Countries*, 5-34

framework of decentralization and the other presents some empirical findings on budget structures. The paper will end with a section on conclusions and policy recommendations.

Chapter 1 Theoretical Perspectives

The concept of decentralization is complex and manifold, as it can have several interpretations, and many authors work with it without proper delimitation and clarification. Decentralization can be seen as both a ‘process’ (giving powers to subnational governments) and a ‘state’ (the degree of decentralization at one point in time).[9] In the analysis carried on in the next chapters the questions relate to the actual degree of fiscal decentralization in intergovernmental relations. Fiscal decentralization will be viewed as a state and less as a process in this research. First of all, it must be said that the understanding used and analyzed in this research will deal with the decentralization of state power in a particular, delimited form, namely *fiscal decentralization*. There are other interrelated forms such as political and administrative (bureaucratic).[10]

1.1. The concept of fiscal decentralization

Fiscal decentralization is one aspect of decentralization policies. I will here relate it to the other forms of decentralization and provide a definition of the concept. The main point in decentralization policies is that the state central government takes steps to give up responsibilities, functions and authority to lower levels of government. In short, decentralization is the transfer of power, resources and responsibilities to lower levels of government by the central government.[11] This is done regardless of the structure of the state, unitary or federal. Subnational governments are political entities that appear at regional, county/district or federal state levels. In this sense decentralization encompasses all three

[9] Prud'homme, Remy. 1994. *On the Dangers of Fiscal Decentralization.* Policy Research Working Paper 1252. Washington D. C.: World Bank. 2

[10] Falleti. "A Sequential Theory of Decentralization: Latin American Cases in Comparative Perspective": 329

[11] Oxhorn, Philip. 2004. "Unraveling the Puzzle of Decentralization" in *Decentralization, Democratic Governance and Civil Society in Comparative Perspective*, ed. Oxhorn, Philip, Washington D. C.: Woodrow Wilson Center Press; 3-33. 7

possible methods to transfer effective powers (uninfluenced decision making) in the area of local politics, local administration and fiscal autonomy.

The decentralization process comes in a variety of forms and they all should help manifest the autonomy of the local governmental structures. These types of decentralization include[12]: political decentralization, administrative decentralization and *fiscal decentralization*.

The three aspects of decentralization are intertwined and must be understood together as a "multidimensional process"[13]. A consideration of all aspects of decentralization in a case study would constitute a too broad topic. Despite the understanding and consideration of this perspective the current research will not deal with problems of mutual influence. Although I realize the effects one form of decentralization can cast upon the other I will focus on the *fiscal decentralization* process only. Moreover the process of decentralization must be regarded as ongoing and dynamic. There is a degree of fiscal decentralization that characterizes a country at one point. It is in this light that I want to analyze the concept in the case of Romania.

Political decentralization permits the existence of secondary, subnational governments. These are elected in territorial subdivisions of the state. This type of decentralization process is relatively easy to implement, as it allows the election of local representatives responsible to their jurisdictions, a much praised democratic value. Closely related, administrative decentralization sets the framework for duties to be carried out by the subnational governments. The theory that will be presented in the next sections advises administrative duties and decisions to be taken at the closest possible locus to the problem.

---

[12] Schneider, Aaron. 2003. "Decentralization: Conceptualization and Measurement", *Studies in Comparative International Development* 38, no. 3: 32-56. 33
[13] Montero, Alfred and Samuels, David. 2004. "The Political Determinants of Decentralization in Latin America" in *Decentralization and Democracy in Latin America*, ed. Samuels, Alfred Montero and David, Notre Dame, Indiana: University of Notre Dame Press; 3-32. 5

For the working definition of the concept of fiscal decentralization I will base it on Luiz de Mello's consideration on the subject. Fiscal decentralization will be understood as the reform or/and character of fiscal relation within a state by which expenditure function and revenue sources are reassigned to subnational governments.[14] This includes financial resources that constitute the budgets of subnational authorities, as well as the nature in origin of these funds. The money can be either locally generated (e.g. local taxes or shares from national taxes, local borrowing) or received through intergovernmental transfers from central authorities. The concept includes both the expenditure and the revenue raising side of subnational/ local budgets.

I will now look at the arguments in favor and against fiscal decentralization.

1.2 Debating Fiscal Decentralization

Even though it has been a topic of great importance in the academia and policy implementation worldwide, there are few considerations everyone agrees upon. Fiscal decentralization is still fervidly debated and empirical studies show mixed or even contradicting results.

I will present the arguments favoring the process, as well as the counterarguments and pitfalls. First of all I will focus on the general arguments and than turn to the perspective of decentralization in transition. I support this by the need to regard general trends as well as more problematic conditions. As Romania was a transition country and just recently joined the European Union, the decentralization efforts have and still are influenced by both developments. The lack of clear theoretical perspectives can be seen in the number of for and against arguments. All positions have their respective counter-arguments. This is why I will present the general issues followed by arguments on both sides.

[14] De Mello, Luiz R. 2000. "Fiscal decentralization and Intergovernmental Fiscal Transfers: A Cross-Country Analysis", *World Development* 28, no. 2: 365-380. 365

The literature on fiscal decentralization is abundant, marking the concern for the topic. The major part of the literature analyzed tries to offer the positive case for fiscal decentralization. Still most of the authors are aware of the lack of clear set criteria and models in the theory. Pieces published by international structures (World Bank and International Monetary Fond) have more of a prescriptive character. Another aspect worth considering is that no author attempts to envision fiscal decentralization as an inherent negative phenomenon, but rather draws attention to some of the weaknesses and possible ill turns it might take. These are interesting finding as they can point to fiscal decentralization as a normative object, with internal defining value, which is subject to different paths of realization. Some authors underline taking into account local circumstances of the country where fiscal decentralization is implemented. They point to "institutional differences of countries" that might make a "universal model (…) difficult to develop".[15]

Without putting aside the above statements, some aspects of fiscal decentralization are agreed upon by the vast majority of writers on the topic. These include the structuring of the tax system and the separation of tax management between levels of government. I will return later to this aspect. In the next sections I will review the literature on the topic, emphasizing points in favor and against, followed by an analysis of fiscal decentralization in transition.

First of all, it must be stated that the trend towards decentralization and the furthering of local autonomy is a general one in today's state politics, "regardless of (…) political system, geographical location, history, level of economic development and cultural traditions".[16] It has been so because of the growing complexity of modern states, requiring the delegation of some functions to local governments.

---

[15] Thiessen, Ulrich. 2005. *Fiscal Federalism: Normative Criteria for Evaluations, Developments in Selected OECD Countries, and Empirical Evidence from Russia.* Discussion Paper 518. Berlin: German Economic Institute for Economic Research.
[16] Oxhorn. "Unraveling the Puzzle of Decentralization"; 3

The discussion on fiscal decentralization has its origins in federalist constitutional arrangements. In countries with federal systems (USA, Canada) the issue of decentralization was first perceived from an economic point of view. That is why most theoretical arguments come from the economics field of research. Others hinge on the border between political science and economy, in the area of political economy. I believe this one of the most suitable frameworks to analyze fiscal decentralization, because the economic benefits of fiscal decentralization are mixed with enhanced local political participation and accountability of officials. As such fiscal decentralization arguments stem from either a classical public finance view of fiscal federalism, or from the political economy field of public choice. When presenting the general debate, the arguments can be grouped as mentioned.

1.2.1 Political and Public Choice Arguments

First of all decentralization is linked to democratic systems and *democratization* processes. In the current process of democratization that is and has been going on worldwide, decentralization in all its aspects plays a fundamental role. As the number of democracies increased throughout the years, the decentralization problem has been brought to the forefront of politics everywhere. Theoretical perceptions as well as empirical studies have pointed to the link between democracy and fiscal decentralization. Garret and Rodden have found high correlations between the two phenomena in one of their studies.[17] As people feel less attached to national politics they can find a substitute in the arena of local democracy, where many believe that their interests are better articulated.[18] Decentralization, in its many forms (administrative, fiscal, and political) appears one of the best solutions at hand to preserve traditional democratic practices and to offer new patterns of state relations for developing democracies.

---

[17] Garret, Geoffrey and Rodden, Jonathan, "Globalization and Decentralization," in *Annual Meeting of the Midwest Political Science Association* (Chicago: 2000). 3

[18] Pratchett, Lawrence. 2004. "Local Autonomy, Local Democracy and the New Localism", *Political Studies* 52: 358-375. 359-361

Decentralization as a solution to many of the problems faced by modern states has been equated with "greater democratization due to its commonsense association with more citizen participation, accountability, and transparency in governmental decision making".[19] In the political dimension of decentralization the first step that central authorities take is to allow for the election of local representatives. To these they delegate powers and responsibilities previously held by national/ central government. The electorate is capable and sometimes very much willing to elect local officials to whom they feel more attached or with whom they relate better. After delegation of responsibilities and duties to the new political authorities, central governments need to take steps to ensure the financial means of fulfilling those assigned roles. Here the stage is set for the process of fiscal decentralization that regulates the financing of subnational budgets.

One of the normative effects of fiscal decentralization should be *improved governance* at local levels. This strain of theory is based on the public choice approach, including elections and public goods' selection. Improved governance includes better accountability of local public officials. By their choice of vote, individuals in a jurisdiction point to financial management skills of officials closest to them. In the same manner fiscal decentralization is suppose to reduce the levels of corruption, one of the indicators for good governance.

In an international study, Fisman and Gatti have found that fiscal decentralization is "consistently associated with lower measured corruption across countries".[20] Their argument starts from a setting of decentralized system with competition among jurisdictions. This perception of heterogeneity and competition among subunits leads to a competition for investors and residents, as in a market situation. Assuming local elites want to attract investments they will offer advantages and also charge lower entry costs for new business (e.g. bribes), if any at all. Because they are better visible to their constituents, local officials

[19] Oxhorn. "Unraveling the Puzzle of Decentralization"; 13
[20] Fisman, Raymond and Gatti, Roberta. 2002. "Decentralization and Corruption: Evidence from across Countries", *Journal of Public Economics*, no. 8: 325-345. 326

will be reluctant to engage in corrupt practices.[21] Moreover if we consider that a decentralized system represents a power sharing arrangement, then local officials will have only influence on local affairs. If corruption occurs here, its magnitude and repercussions will be much smaller than had it been on central level. This is due to the reduced resources and capital markets accessible to local representatives.[22]

The political argument of accountability can be diminished if we conceive that in fact local governments are in charge with limited decisions. The type of decisions that are effectively in the hands of local governments are regulating very few of the areas of general interest for the population. Most of the activities relate to administrative actions at subnational level which do not have the power to seriously influence the economic or welfare conditions. In other words there are limited aspects for which local representatives can be held accountable.

The idea of increased accountability of local elites is formulated by having more or less real assumptions as background. First of all, the elites in a given polity are supposed to be accountable for their actions by electoral mechanism. How different are elites with respect to their territorial localization? If, for example, one is unable to obtain responsiveness via accountability mechanism for the national elites, perhaps the same logic will apply to locally elected officials. We suppose the electorate is the same in reasoning attitudes at both stages of selection, local and national, that the competitors have the same incentives to get elected and that the process is characterized by the same parameters (the same voting procedures).

Linking fiscal decentralization to governance, and particularly to corruption, there are also some negative trends. From an income perspective, on average, governmental offices at local level are paid less comparative to central appointees. The lower wages will generate

[21] Martinez-Vazquez, Jorge and McNab, Robert. 2001. *Fiscal Decentralization and Economic Growth.* Working Papers 01-1. Atlanta: Andrew Young School of Policy Studies.
[22] Ibid.25

lower qualifications for local officials, as “national office is more prestigious and powerful”.[23] Less qualification and smaller incomes can be seen as a factor contributing to increased corruption. Local elites, in my opinion, see the exercise of public elected posts on local level just as the step to qualify for national officialdoms. Moreover due to a dispersion of powers and responsibilities officials will be faced with less communication among jurisdictions and levels of government. This lack of communication as well as dispersion of powers can lead to “lack of coordination when extracting bribes”.[24] In other words, “decentralization can increase rather than decrease waste, inefficiency, rent-seeking and corruption”.[25]

One other argument favoring fiscal decentralization is *political stability* within divided societies. Fiscal decentralization is associated with “country size and ethno-linguistic heterogeneity”.[26] The pressures to decentralize (in all aspects) could stem from certain segments of the population, for example a minority of any kind (linguistic, religious, or ethnic). To maintain the unity and general stability of the system this group could be integrated in new state institutions at grass-root levels.[27] Allowing subnational governments to exist and granting them fiscal capacities could reduce tensions. Of course the argument could be put the other way around: as states are faced with regional tensions they could decide to centralize decision making.[28] By such a move they might try to take away resources of local communities and restrict their options. Also, in an economic perspective of fiscal decentralization, equalizing and redistributive policies carried out by central authorities could reduce inter-district disparities. By uniform economic benefits, divided societies could be appeased.

---

[23] Fisman. "Decentralization and Corruption: Evidence from across Countries": 328
[24] Ibid.: 329
[25] Oxhorn. "Unraveling the Puzzle of Decentralization"; 14
[26]Garret, "Globalization and Decentralization.", 5
[27] Smith, B. C. 1985. *Decentralization - The Territorial Dimension of the State* London: G. Allen and Urwin. 23
[28]Garret, "Globalization and Decentralization.", 10

While it is often asserted that local and regional authorities “provide mechanism to deal with ethnic conflicts (…) and contribute towards stable national political developments”[29], there are sometimes fears of secession after decentralization, as actors gain some kind of autonomy. It is argued that decentralization does not reduce ethnic conflict but intensifies it by “reinforcing regionally based ethnic identities, (…), supplying groups at the regional level with the resources to engage in ethnic conflict and secessionism”[30].

In a recent study of the relationship between decentralization and ethnic conflict, Brancati manages to demonstrate using statistical relevant analysis that decentralization in fact helps to reduce both ethnic conflict and secessionism. The study also points to an intervening variable, namely regional parties, which “undermines the effect of decentralization on ethnic conflict”[31] and suggest the regulation of these parties through institutional mechanisms.

1.2.2 Public Finance and Fiscal Federalism: the Economic Arguments

Most pertinent arguments on fiscal decentralization derive from economics and public finance. The traditional and most important argument is increased efficiency due to *better allocation of public goods* at local levels. The argument comes from the writings of among many others, Richard Musgrave and latter on William Oates on *fiscal federalism*. There are public goods whose production can not be sustained at subnational levels, such as defense for example. Other will have characteristics and demands that are different from locality to locality. In order to deal with such differences fiscal federalist literature tries to determine “roles of the different levels of government and the ways they relate to one another through

[29] Kirchner, Emil and Christiansen, Thomas. 1999. "The Importance of Local and Regional Reform" in *Decentralization and Transition in the Visegrad*, ed. Kirchner, Emil, Macmillan Press; 1-18. 2
[30] Down, Brancati. 2006. "Decentralization: Fueling the Fire or Dampening the Flames of Ethnic Conflict and Secessionism?" *International Organization*, no. 60: 651-685.
[31] Ibid.: 681

such instruments as intergovernmental grants."[32] Decentralized local governments can "adapt outputs of public services to preferences and particular circumstances of their constituents".[33]

Richard Musgrave, in his book "The Theory of Public Finance" (1959) points to efficiency gains of fiscal decentralization. The local goods and services are presumed to be delimited to a certain area, with no spillover effects. This means that individuals in one jurisdiction will not be able to consume (free-ride on) the goods from neighboring jurisdictions. Gains in efficiency will occur only if the public goods are "paid for by those who benefit"[34] from its consumption. As rational choice theory point out, individuals have different needs and preferences. If individuals are not satisfied with the provision of goods in one community they will move to another one where their package of goods is better achieved. Consumer mobility will thus generate "formation of groups of individuals with similar demands for public services" and "increased centralization of the public sector with more homogeneous levels of services is likely to involve loses in welfare".[35] Thus, there will be more efficiency in the provision of public goods in a more decentralized setting.

According to de Mello, efficiency gains will also be achieved due to *reduced information and transaction costs* local representatives employ. Local governments are better able to extract and fine-tune the preferences of the communities they are close to.[36] In the same manner as corruption might go down so could the level of taxes. If local governments find themselves in a quasi competitive market for investment they will try to provide fiscal

[32] Oates, Wallace E. 1999. "An Essay on Fiscal Federalism", *Journal of Economic Literature* 37: 1120-1149. 1120
[33] Oates, Wallace E. 2006. *On the Theory and Practice of Fiscal Decentralization.* IFIR Working Papers 2006-05. Institute for Federalism and Intergovernmental Relations. 2
[34] Musgrave, Richard A. 2000. "Fiscal Federalism" in *Public Finance and Public Choice- Two Contrasting Visions of the State*, ed. Buchanan, James and Musgrave, Richard Cambridge: MIT Press; 155-176. 156
[35] Oates, Wallace E. 1991. "The Challenging Structure of Intergovernmental Fiscal Relations" in *Studies in Fiscal Federalism*, ed. Oates, Wallace E., Aldershot, England: Edward Elgar; 39-48. 41
[36] De Mello. "Fiscal decentralization and Intergovernmental Fiscal Transfers: A Cross-Country Analysis": 365

environments that appear more attractive. This competition for capital could lead to lower taxation and rents in that jurisdiction.[37]

Another less desirable outcome of fiscal decentralization is due to the very essence of the competition between governments. As mentioned above, local authorities will try to offer benefits for investors. By doing so they will reduce the amount of taxes taken in, leading to fewer revenues to local budgets. This means "suboptimal output of public services" and a "'race to the bottom'"[38] between jurisdictions from which individual tax-payers suffer.

Although fiscal decentralization will benefit from lower costs at local level, goods provided will not benefit from economies of scale. With a limited level of provision to a small group of individuals there is "limited exploitation of economies of scale in decentralized provision of goods and services".[39]

Even if we go or not by the assumption that individuals have some possibility to relocate themselves between jurisdictions, there are adverse economic effects. These are enhanced by the possibility to set differentiated tax rates and provide different bundles of goods and services. We can witness a segregation process in which differences between localities in terms of income and welfare will be very high[40]. This could generate a lack of uniformity in the distribution and provision of public goods as people will flock to those jurisdictions that provide better services or hurt less financially.[41] In the above mentioned regards, the public choice of suitable jurisdictions for residents and business shows its adverse effects.

[37]Garret, "Globalization and Decentralization.", 9
[38] Oates. "An Essay on Fiscal Federalism": 1134
[39] De Mello, Luiz R. and Barenstein Matias. 2001. *Fiscal Decentralization and Governance: A Cross Country Analysis.* Working Papers 01/07. International Monetary Fund. 15
[40]Martinez-Vazquez. *Fiscal Decentralization and Economic Growth.*, 21
[41] Oates, Wallace E. 1991. "An Economist's perspective on Fiscal Federalism" in *Studies in Fiscal Federalism*, ed. Oates, Wallace E., Aldershot: Edward Elgar; 21-38.24-26

A fiscal decentralization setting includes, aside from local revenues and expenditures, intergovernmental transfers. These are usually employed by the central government to assure uniform provision of certain public goods (e.g. education, health, social benefits). At the same time it means a system of risk sharing between jurisdictions and protection against macroeconomic instabilities. But the very existence of such risk sharing procedures can also generate moral hazard issues on both individual and lower governmental level. The fiscal transfers mean that jurisdictions are ensured against adverse effects by transfers from other individuals. So they will do less to protect themselves against such ill-turns, hence moral hazard dilemma.[42]

One other way to synthesize the argument of moral hazard is that local governments will undertax and overspend, if faced with a system of transfers that tries to equalize incomes (a "benevolent government").[43] To this "lack of commitment" to fiscal effort one can add informational asymmetries that further burden the task of establishing good redistributive policies. Redistribution can be followed by the central government through its transfer system. But the rules (formulae) that govern the policy will not benefit from full information. Local government has more information about its tax base and fiscal capacity then the central government. But it is the central government who needs to employ the redistributive policies and "not all available information can be incorporated in the transfer rules".[44]

If there are inequalities between different constituencies and an intergovernmental system of transfers is in place it can further those inequalities. For example the poor regions will be more dependent on the transfers and will undermine efforts for further decentralization. Also they will not concede to increase their tax efforts, knowing their deficits will be taken care of by transfers. In fact they could even demand more centralized

[42] Persson, Torsten and Tabellini, Guido. 1992. *Federal Fiscal Constitutions: Risk Sharing and Moral Hazard.* Discussion Paper 72. Minneapolis: Institute for Empirical Macroeconomics
[43] Bordignon Massimo, Manasse Paolo and Tabellini Guido. 2001. "Optimal Regional Redistribution under Asymmetric Information", *The American Economic Review* 91, no. 3: 709-723. 710
[44] Ibid.: 711

actions when faced with economic hardships.[45] The rules taken into account when performing transfers must be designed well to take into account both the fiscal need and the fiscal capacity of subnational governments.[46] Transfers are most of the time done taking into account criteria as: "population size, economic need, and capacity for local resource mobilization (…) exacerbating existing disparities among wealthier and poorer regions and localities within countries".[47]

While assuring the preferences of local individuals, subnational governments are less likely to handle stabilization policies. In times of economic recession for example they will not have the means to cope with it. This is due to the reduced scope of their assignments. It is national (central) governments that have both the capacities and means (monetary policy) to overcome economic cycles. Macro-policy is "an essentially central function."[48] Martinez-Vazquez and McNab have undertaken a cross-country study to see the links between fiscal decentralization, macrostability and growth. Their conclusions clearly state that "fiscal decentralization per se does not create conditions that undermine efforts to achieve price stability."[49]

Another negative side of decentralization could be the generation of fiscal instability through budget deficits. If there are no stipulations of balanced budgets and legally regulated borrowing procedures for subnational governments, deficits could occur, due to overspending or inappropriate borrowing. Recent studies, however, have uncovered the fact that fiscal decentralization leads to improved fiscal performance. Without posing threats to economic

[45]Garret, "Globalization and Decentralization.", 9
[46] Oates. "An Essay on Fiscal Federalism": 1127
[47] Oxhorn. "Unraveling the Puzzle of Decentralization"; 307
[48] Musgrave. "Fiscal Federalism"; 163
[49] Martinez-Vazquez, Jorge and McNab, Robert. 2005. *Fiscal Decentralization, Macrostability and Growth.* Working Papers 05-06. Atlanta: Andrew Young School of Policy Studies. 17

stability, in fact “fiscal decentralization is associated with improved fiscal performance and better functioning of internal common market”.[50]

1.2.3 Task Assignment and Taxation

In this subsection I will review the theoretical considerations for different task to be assigned to central and local governments. I will also present the separation of taxation methods resulting from the task division. Through this I will try to resolve some of the conflicting arguments presented in the previous two parts. Also this theoretical background, concerning taxation, will serve as a basis for the assessment of the degree of fiscal decentralization in the analytical chapters to follow.

When confronted with the difficult task of public service provision the central government can employ fiscal decentralization mechanisms. By doing so it empowers local (subnational) governments with responsibilities and means to achieve public objectives. Still not all governmental tasks are suited for lower level governments. The theory of public finances as envisioned by Richard Musgrave distinguishes “three ‘branches’ of government: the stabilization, distribution and allocative branches”.[51] According to the author, stabilization and (re)distribution policies are best suited for the central government (federal government in a federation), while the allocation function is best achieved by subnational governments (state governments in a federation).[52] If one employs such a framework of *task assignment* then some of the shortcomings of fiscal decentralization can be dealt with.

There have been authors that have underlined the challenges posed by fiscal decentralization. Among those shortcomings macro-economic stability was enumerated. The stabilization of the economy can not be handled by lower level governments as they have only limited tools (mainly fiscal ones) to serve this purpose. The central authorities can reduce the

[50] Shah, Anwar. 2005. *Fiscal Decentralization and Fiscal Performance.* Policy Research Working Papers 3786. World Bank.
[51] Rubinfield, Daniel L. 1987. "The Economics of the Local Public Sector" in *Handbook of Public Economics*, ed. Martin, Auebach Alan J. and Feldstein, Amsterdam: Elsevier Science; 571-648. 626
[52] Ibid.; 626-631

risks of instabilities by nation-wide effective policies (including monetary ones). In order to avoid subnational governments running deficits, central authorities can employ a system of "hard budget constraints with respect to the devolved functions".[53] To avoid fiscal imbalances due to excessive borrowing, a sound legal framework is required. This should include limits to the amount of money to be contracted and the possibility of bankruptcy of local governments when unable to repay.[54]

The redistribution of wealth is also theoretically better suited as a task for the central government[55]. Another less desirable solution could also be to provide subnational governments with transfers specifically aimed at welfare policies (redistribution) and general standards designed by central governments. Maintaining redistribution at the center level is based on the existence of income inequalities between regions that would make the capabilities to redistribute unequal. This would lead to differentiated treatment of citizens in the same socio-economic situation but geographically located differently. Also the system of redistribution is aimed at maintaining "a certain level of public goods provision and thus certain minimum social standards".[56] In this manner one can avoid discrepancies in service provision which have been identified as arguments against fiscal decentralization. If there are different arrangements for redistribution in a multi-jurisdictional system then we would witness a migration to those regions that redistribute more.[57] For the redistribution function central authorities can diminish inequalities between jurisdictions through the fiscal transfer system (different types of grants).

The last function, allocation, is best suited for local governments. These are "better equipped to extract information on local preferences and needs more effectively than the

[53] Bird. "Fiscal Decentralization in Developing Countries: An Overview";
[54] Shah, Anwar and Thomson, Theresa. 2004. *Implementing Decentralized Local Governance - Treacherous Road with Potholes, Detours and Road Closures.* Policy Research Working Papers 3353. World Bank.
[55] Thiessen. *Fiscal Federalism: Normative Criteria for Evaluations, Developments in Selected OECD Countries, and Empirical Evidence from Russia.* 4
[56] Ibid. 4
[57] Rubinfield. "The Economics of the Local Public Sector"; 628

central government and to be more accountable to local residents".[58] As such they will aggregate local preferences with reduced costs and will be able to provide different bundles of public goods determined by local demand.

A closely related issue to that of *task separation* is that of *tax assignment*. Similar considerations as the ones above mentioned play an important role in deciding which level of government taxes what. As such central government are considered more efficient in collecting most taxes in comparison to local governments.[59] Secondly the tax bases that local governments can reach are different. Inequalities in local endowments (natural resources, financial differences) could generate different levels of collection, leaving some jurisdiction worse off. This is why central governments should tax "those resources that are more likely to be important and unequally distributed".[60] Be doing so, central government will be able to redistribute and reduce inequalities.

Taking the above into account central level should have powers of taxation of "mobile factors and tradable goods"[61], that is personal income taxes (PIT) and corporate taxes, as well as value-added taxes (VAT). For the local level the literature assumes as appropriate taxes on immobile factors (property taxes) and for the consumption of locally delimited public goods (user charges).[62] As the later have smaller tax bases, revenues of subnational governments will not be enough to cover expenditures and hence the need for a transfer system. "In all multi government economies, lower levels of government finance some of their expenditures responsibilities by transfers from the higher level".[63]

The transfer system is set up out for several reasons. One of them is to bridge the fiscal gaps that occur in local budgets. Others include redistributive objectives of central

[58] De Mello, Luiz. *Fiscal Decentralization and Subnational Expenditure Policy.* World Bank. 1
[59] Bird. "Fiscal Decentralization in Developing Countries: An Overview"; 11
[60] Boadway Robin, Roberts Sandra and Shah Anwar. *The Reform of Fiscal Systems in Developing and Emerging Market Economies.* Policy Research Working Papers 1259. Washington D.C.: World Bank. 16
[61] Shah. *Fiscal Decentralization in Developing and Transition Economies.* 17
[62] Boadway Robin. *The Reform of Fiscal Systems in Developing and Emerging Market Economies.* 16
[63] Ibid. 2

government or the encouragement of local expenditures.[64] Whatever the motivation concerned, the design of the transfers should be transparent. This means it should be based on rules (such as formulas, or proportions of given revenues) “rather than on discretion and political bargaining”.[65] The fiscal transfers should also be based on actual (not potential) revenue capacity of local governments, to avoid “disincentives to fiscal effort”.[66]

1.3. Fiscal Decentralization in Transition

In the difficult process of transition from a command to a market economy a lot of hope is placed with decentralization policies. Considering the liberalization of prices and the opening of the economy, state authorities relinquish their tight control in favor of market mechanisms. Still the state is the main vector in this newly emerging and rapidly changing environment. This is why the main effort needs to stem from sound economic reforms employed by the central governments. Everyone wants the state to confer more channels and opportunities to the market forces, but still retain some of the benefits of former communist (socialist) regime (such as full employment, stable prices, powerful currency). This is one of the major dilemmas facing reforming actors. To this one has to add the changing political realities that constitute the dual reform. All in all decentralization in all its aspects is one of the first topics touched by newly elected elites as it relates to both economic and political reforms.

Fiscal decentralization in a transition setting should not neglect the legacies of the communist rule. These are both at the behavior level of central as well as local agents. Local governments in communist times had very limited real powers. This also applies to the fiscal relations. Subnational governments were merely agents, “administrative units with little

[64] Smoke, Paul. 2001. *Fiscal Decentralization in Developing Countries: A Review of Current Concepts and Practices.* Democracy, Governance and Human Rights 2. United Nations Research Institute for Social Development. 25
[65] Thiessen. *Fiscal Federalism: Normative Criteria for Evaluations, Developments in Selected OECD Countries, and Empirical Evidence from Russia.* 4-5
[66] Bird. "Fiscal Decentralization in Developing Countries: An Overview"; 32

independent fiscal responsibility”.[67] Whatever fiscal transfers existed, they were subject to bargaining with central authorities and other informal mechanism.

Central authorities find it at first difficult to concede powers to local organisms. Or even if they relinquish authority they do this because of either pressure coming from local politicians or rational thinking. The former is linked to the strategic choices made by central authorities. They will give in to bottom up demands only if they will be “compatible with the incentives of central government”.[68] Pressure to decentralize will come from outside too. Almost all former communist countries in Central and Eastern Europe have had in the early 1990s the wish to join the EU. Accession was conditioned by a program of reforms which included decentralization measures and reform of intergovernmental fiscal relations.[69] Beside regional actors as the EU, other international institutions (IMF, World Bank) will also endorse the reform of the public finances and fiscal decentralization with it.

The process of fiscal decentralization is performed in a general weak economic context. This environment is subject to legislative changes, which occurs frequently. This will lead to uncertainty on behalf of the actors involved and their behavior will be constrained.

Fiscal decentralization in transition is linked with macro-economic stability, income redistribution (“provision of social safety net”) and privatization.[70]

Due to the fact that budget deficits are one of the most common phenomena in transition, central authorities try to reduce costs by “shift[ing] down the deficit”.[71] This means making local governments responsible for tasks that were previously not theirs (increasing the expenditure side of their budgets). Usually this is not accompanied by raising revenue

[67] Norris, Era-Dabla and Wade Paul. 2002. *The Challenges of Fiscal Decentralization in Transition Countries.* Policy Research Working Papers 103. World Bank. 10
[68] Garret, "Globalization and Decentralization." 8
[69] Dunn, Jonathan and Wetzel, Deborah. 2000. *Fiscal Decentralization in Former Socialist Economies - Progress and Prospects* World Bank. 5
[70] Bird Richard, Ebel Robert and Wallich Christine. 1995. "Fiscal Decentralization: From Command to Market" in *Decentralization of the Socialist State- Intergovernmental Finance in Transition,* ed. Bird, Richard et al., Washington D. C.: World Bank; 1-68. 2
[71] Ibid.; 69

capacities or providing transfers to local entities, as this would mean strains for the state budget. In all this reform process central government must uphold uniformity of service provision and ensure the basic services and public goods for the entire population, regardless of location. Moreover the reform process itself presupposes uniformity in changes that occur. If central governments were to decentralize too many responsibilities and capacities to local governments future reform would be harder to conceive.

In order to achieve macro-economic stability, central governments will try to reduce the activity of the public sector. During the communist regime, full employment was valued more than efficient distribution of the work-force. Because of this, not only industrial complexes were over-employed, but also the public sector. The very essence of the control economy and societal supervision required a massive administrative apparatus. The reduction in personnel in public administration is a difficult task due to the lack of evaluation criteria of public employees. Another way to reduce the public spending can be the cutting down of funds. Reduced earnings in the public service will determine the most skilled public servants to search for an alternative work place in other economic fields. Thus the public service could be deprived of valuable human assets. Reducing employment and all sorts of costs is done in a period when there is also the need to build new staff and new institutions capabilities. In this process decentralized practices will be harder to initiate.

Macroeconomic stability will be followed by limiting the debt-generating practices of local governments. This can be achieved by restricting or forbidding borrowing or central bailouts in case of impossibility of repayment. Keeping second level governments away from the credit market can also be linked to the incipient nature of such markets. As the private credit market develops and the trust in financial capacities of governments increases, the possibility of borrowing will be regulated.

In the area of redistribution policies we also witness the shifting down of responsibilities to local governments.[72] This transfer implies that local governments should be in charge for those services that are "best delivered locally" and whose benefits accrue to residents of that jurisdiction only.[73] Central authorities should maintain the provision of those services whose benefits are not limited to one single jurisdiction. Subnational governments taking responsibilities formerly pertaining to central authorities should not mean a deterioration of service quality. Central and local governments should understand that service provision of public goods need not be equivalent to service production.[74] Local governments should take benefit of the new emerging private market and contract the service production to private operators.

The privatization process brings the formerly state owned assets in the ownership of local governments. This transfer could generate problems as the new local administrators will find it hard to close down local enterprises or to give up a source of revenue (risks of ownership). They could also embark on entrepreneurial paths with the newly acquired assets. In this latter case decentralization can prove to be a barrier for reforms, "a bottleneck to true decentralization".[75] The essence of privatization is giving up ownership of state (local or central authorities) owned assets and not the perpetuation of inefficient state management. In this way local governments can help private sector development.

To sum up, the prospects of facing a transition can be regarded as an impulse to fiscal decentralization. One must not overlook all the interaction between the other facets of the reform process. Pressures to decentralize must be met with fiscal caution so as to avoid the possible side-effects of ill-conceived systems. Due to a highly changing environment (legally, economically, socially) the effects of decentralization could be overlooked at first sight. They

[72] Bird Richard and Wallich, Christine. 1993. *Fiscal Decentralization and Intergovernmental Relations in Transition Economies.* Working Papers 1122. World Bank. 37
[73] Ibid. 39-40
[74] Ibid. 38
[75] Ibid. 63

could also come against the effort of reform, as they must answer to an ever changing environment and fight past legacies. This is why the prospect of reform of local finances should always be of major concern for the authorities.

1.4 Summing up the arguments

The theoretical arguments and empirical findings on fiscal decentralization are mixed and sometimes conflicting. An informed assessment is thus not easy to come at. Because fiscal decentralization is linked to political decentralization, economic and political objectives collide. In this setting weighting the arguments for and against is problematic. The political considerations are thought to be methods of achieving more local autonomy and improving governance. In face of such value oriented statements sometimes the economic facts will be of secondary importance. But economic consideration can not be rejected, especially in transition or developing countries where democracy and economic prosperity are regarded as an indivisible nexus. Also economic and political tradeoffs can not be quantified and compared.[76]

A secondary issue is that fiscal decentralization has been "motivated in many cases by theoretical, rather than empirical considerations".[77] Though we have comparative studies showing the positive effects of decentralization politics, others relate the exact opposite findings. Empirical evidence for both camps is limited and the data analyzed, the time spans or country selections induce various results. Even when working with the same data authors did reproduce different results. For the purpose of the current research I will only make use of the theoretical framework that is the least disputed. Here I include the separation of taxation powers and the structuring of the fiscal transfers. I will also employ measuring tools that are less dependent on international data-sets and focus on up-to date empirical data from the country of study.

[76] Oates. "An Essay on Fiscal Federalism": 1138
[77] De Mello. *Fiscal Decentralization and Subnational Expenditure Policy.* 25

To conclude with, the overall debate on fiscal decentralization points to an array of potential benefits, both economic and political. It also underlines the possible errant practices and limits of the process. Fiscal decentralization is not a matter of reaching an end-stage, a level of ultimate decentralization. It is a continuous process, with changing objectives and practices forced by circumstances. There are various degrees of decentralization, ranging from country to country and thus assessment can be made through careful analysis of given practices in one place at one point in time. Moreover "there is no unique optimum degree of fiscal decentralization".[78] In the following parts of the paper I will measure the level of fiscal decentralization in the case of Romania.

[78] Norris. *The Challenges of Fiscal Decentralization in Transition Countries.*

Chapter 2 Methodology, data and measurement

This section will present the general method of investigation used in the current research. I will employ a case study research method, the case selected being Romania. It will also show the measuring of the variables that constitute the empirical puzzle and working hypothesis. For the assessment of the actual degree of fiscal decentralization I will use qualitative and quantitative measurements. The later include revenue autonomy[79] and expenditure autonomy[80] of subnational governments that have been employed before in some studies. The former refer mainly to qualitative investigations into the institutional framework (legal stipulations and actual practices).

2.1. The method

I have chosen as method of investigation the case study due to considerations of the research. I want to investigate the present institutional framework that governs the intergovernmental fiscal relations. For such a delimited time-frame, the case study is best suited as it "is preferable in examining contemporary events".[81] In the classification of Robert Yin the current paper will constitute a descriptive case study in which I present the state of affairs on the topic of fiscal decentralization in Romania.

The choice of Romania as the case selected was due to several considerations. First of all, Romania has been a country to follow a gradual reform process since the early 1990. Due perhaps to tightened central planning before 1990, incomparable to other communist countries, the reform has moved in a slower rhythm. Economic reforms have emerged slowly and such was also the case of decentralization. Secondly there were many legislative acts to regulate fiscal decentralization during time. The legislation has been changed a lot in the past

[79] Meloche, Jean-Philippe, Vaillancourt Francois and Yilmaz Serdan. *Decentralization or Fiscal Autonomy? What Does Really Matter?* World Bank Policy Research Papers 3254. World Bank.
[80] Shah. *Implementing Decentralized Local Governance - Treacherous Road with Potholes, Detours and Road Closures.*
[81] Yin, Robert K. 1994. *Case Study: Research Design and Methods* London: Sage. 8

17 years with the last change occurring in 2006 with modifications to several laws on local government. Altering the laws on decentralization in substantive fashion can be the sign of inbuilt difficulties that were tried to be overbridged.

Last but not least the integration in the European Union has generated much action in the sense of improving fiscal decentralization. This has happened just before Romania's accession on the 1st of January 2007. In the year prior to accession a great deal of legislative reformation in the area has occurred. Considerations of the new legislative framework imply the need for research into the effects it had on current practices. In my opinion this is an invitation to assess the new institutional setting to see if it matches to its promises of effective fiscal decentralization. Because of the short time span, the assessment of fiscal decentralization can not fully be accomplished. For the laws to have effect on the behavior of state agents some time needs to pass, while all adjust to the new setting.

To my knowledge none of the previous research has focused only on Romania. Some of the comparative studies have included Romania, but all were conducted before the legislative changes of 2006. What I will present is but a limited characterization of the potentials of the present legislation.

2.2. Variables and their measures

As pointed out in the introduction, the main puzzle driving the research is the investigation of the actual degree of fiscal decentralization enjoyed by subnational governments.

Although there is a legal framework that guarantees fiscal decentralization, there are also some stipulations that reduce the actual degree of decentralization. Making an assessment concerning the right degree of decentralization could prove difficult. But there are ways to qualify the state of fiscal decentralization. I start from the assumption that the level of fiscal decentralization is both a result of legal framework as well as practices. In this statement the level of fiscal decentralization can be regarded as a dependent variable, while the legal framework on financial matters and the practices are independent ones. For the assessment of the legal framework I will employ content analysis. This will be used on the legal data collected, main laws of local public administration, decentralization laws and fiscal regulations. In order to grasp the essence of the secondary independent variable I will analyze the way the budgets of subnational governments are structured.

Fiscal decentralization can be considered to be 'real' if the subnational governments are in control over their financial resources. As such local fiscal autonomy will be considered as the channel to measure fiscal decentralization. Here I will include autonomy of revenues and of expenditure. Revenue autonomy is defined as "the ratio of subnational governments own source revenue over its total revenue".[82] As for expenditure autonomy the definition is similar, percentage (or ratio to total) of own expenditure under effective control of subnational governments.[83] I will apply these measurements to county level budgets for the year 2006.

The comparative studies to date have made use of data coming from international institutions such as the World Bank or the IMF. The cross-country data most widely encountered, due to its availability, is the IMF collection of Government Finance Statistics (GFS). The particular data system provides national statistics of the shares of expenditure or revenues of subnational governments from the total state budgets. Some authors[84] have pointed to the shortcoming that the aggregated data presents which generate an overestimation of fiscal decentralization. This is due first of all because the data does not indicate the degree of subnational autonomy, including centrally mandated expenditures that appear as

---

[82] Meloche. *Decentralization or Fiscal Autonomy? What Does Really Matter?*, 12

[83] Shah. *Implementing Decentralized Local Governance - Treacherous Road with Potholes, Detours and Road Closures.* 14

[84] Ebel. "On the Measurement and Impact of Fiscal Decentralization";

subnational expenditure.[85] Secondly the data set does not distinguish between the types of revenues that are tax, non-tax, grants, and other transfers.[86] Out of such consideration the current paper will employ the before mentioned measurements of fiscal decentralization, revenue and expenditure autonomy of local governments.

In order to provide a more detailed analysis, the qualitative measures (legal framework analysis) will include the following points of analysis[87]. I will look into the ability of local governments to freely set tax rates and decide over their tax base (revenue assignment and tax collection). A second issue will involve the control over local services. Here I will see if the legislation has clear stipulations that the services in jurisdictions are subject to the control and financing of local governments. Also I will investigate if there is a clear separation of responsibilities between levels of government and how are the shared tasks solved and financed. Thirdly I will offer inside on the legal basis for subnational borrowing and local governments' bankruptcy. Last I will investigate the fiscal transfer system.

The data that I included in the research includes legislative pieces and also effective budgets of given subnational governments. Both legislation and budget situations are public information and can be accessed. The entire budgetary process for local governments is considered public information and all interested can acquire it upon request. The county councils are also obliged to post annual budgets at the institution or online. Every county has an official internet site, but not all of them have posted the budget there. I have gathered budgets from a number of 17 counties (out of a total of 41) using the official websites of county administrations. Understanding that the criterion of selection was not a valid one I admit the shortcomings of the results and their limited generalization potential.

[85] Ibid.; 105
[86] Ibid.; 105
[87] The measurements have been part of the comparative study of Ebel and Yilmaz, mentioned above

Chapter 3 Fiscal Decentralization in Romania as Resulting from Legal Framework

This part of the paper starts the analysis into fiscal decentralization in Romania. It provides insides into the general legal framework that governs local public administration. As a general remark, the decentralization process in Romania's transition implied both political and fiscal arrangements. The political democratic changes did occur first due to great popular expectations and less negative side-effects. Economic changes were to follow slowly and did impose costs on all the society. In transition, political decentralization is closely linked to local autonomy and fiscal decentralization. Achieving the second part of the reform process of subnational governments required far more time in the case of Romania. The country did not experience any kind of reforms during the past years of communist rule which was overall marked by a high level of centralization. This meant all important decisions, economic or political, national or local in scope, were taken by the central party leadership.

3.1. Structuring levels of government

The constitutional design in Romania ensures the existence of two levels of government. There are the central government and authorities, and local governments at the level of administrative units. These include communes (composed of several villages), cities (some of them with the rank of municipalities[88]) and counties. There are 41 counties (judet in Romanian) plus the municipality of Bucharest (with distinct administrative status). The counties can be considered as an intermediate, second level of organization, as their task are of coordination and service provision on county level. They coordinate the activities of the communes and cities.[89] There are no legal hierarchical relationships between the various levels of government, but prefects in the territory can attack decisions of local governments if

[88] Municipalities are usually the county capitals and can also include other urbanized, economically important cities; I will refer to communes and cities as localities in general;
[89] Constitution of Romania, article 122, paragraph (1)

they deem them to be unlawful, thus suspending them *de jure*.[90] As localities are considered to be the communes and cities, their institutions are referred to as local governments. The county level is treated separately as level between central and local authorities. I will use the term local governments and subnational governments interchangeably to refer to all governmental levels other than the center.

The counties, cities and communes elect councils (as legislative, deliberative bodies) and mayors (composing the executive branch). There is also the function of prefect, inspired by the French tradition. After recent legislative reforms, the prefect is a high public official, representing the central government and overseeing all deconcentrated service at county level.[91] The prefect is named by the Government, but has to pass an exam for the office. His office has no fixed duration, in contrast to the other offices of subnational governments who organize elections at least every 4 years. Until 2004 this function was intensely politicized as the prefect was a political figure appointed by the Government and usually changed as electoral shifts occurred in the territory. The current law forbids any political affiliation. The changes in the area of structuring of institutional relations are just one step in the process of decentralization.

The institution of the prefect, although with reduced political weight after recent legislative changes, still maintains some forms of influence over local authorities. Even though he can not be the representative of any party the prefect can wield influence, as an agent of the Government in the territorial-administrative units. His responsibilities include legislative supervision, ensuring that all laws passed by local governments are in agreement with the Constitution and all other laws and governmental dispositions. Bringing such an act of local government before the administrative courts makes it void until a final judicial

[90] Constitution of Romania, article 123, paragraph (5)
[91] Law 340/ 2004, published in the Official Gazette of Romania no. 658, July 2004

decision has been reached[92]. Acts of local governments also include the local budget laws. Hence, in theory, the prefect can block local governments' legislative decision making even in fiscal matters. Other less important duties of the prefect include emergency situations due to calamities, preventing social tensions and enabling the fulfillment of national governmental programs.[93]

Each unit (county, city, and commune) has a secretary, appointed by the prefect, after having passed an examination[94]. The secretaries can not be politically affiliated. They have the role of legislative oversight in their jurisdiction, similar to the role of the prefect at county level. Each decision of mayors, presidents of county council, county/local councils need to be notified by the secretary. Although named by the prefect they can not be dismissed by him. Instead a two thirds majority of local/county council is required.[95] The legislative supervision and the possibility for judicial attack and suspension of local governments' acts bring reduced local autonomy. As in other aspects to be detailed, in this regard local authorities are seen as unequal players in the political game.

Local authorities are being supervised extensively by the prefect and his appointed secretaries to all local governments, as well as the deconcentrated institutions of central government. This is legislative supervision. Other forms of supervision include financial matters. Braches of the Ministry of Finance (MEF- Ministry of Economy and Finances), named directorates for finance, work in the territory, at county level. Through these directorates the MEF gets information on county finances and also shares national statistical data. It is these directorates that assist local deliberative bodies in the budget process. They provide the macro-economic indicators and other considerations to be followed when constructing the budget.

---

[92] Law 340/ 2004, article 26
[93] Law 340/ 2004, article 24
[94] Law 340/ 2004, article 28
[95] Law 340/ 2004, article 29

Financial control on levels of government in Romania is also performed by the Court of Accounts[96]. This is an independent institution, with own budget and no higher authority reporting to. Its audits can affect both central and local authorities, the main concern of the Court being the proper administration of funds. Due to its function and regulation, the Court can not be used in any way by third parties to infringe on local financial autonomy.

The existing framework allows for associative structures of local public administrations, and there exist now and Federation of Local Authorities, comprised of Associations of Communes, Cities and Municipalities. They play a role in the consultation with the central authorities on various technical matters or designs of further reform.

After 17 years of reforms there is now a modern and thorough legal framework that defines fiscal decentralization. The process did have an early start but concrete measures to effective fiscal decentralization have been just recently implemented. In 1991 there were already a new Constitution in place, a law on local elections and a law of local public administration. The Constitution clearly stipulated from those early years of transition the general principles under which the subnational authorities would function. These included: "decentralization, local autonomy and deconcentration of public services".[97] After a delay of several years, effective measures of decentralization were introduced by the law on local taxes and fees (1994). Allowing subnational governments to raise taxes was one of the first steps of guaranteeing fiscal decentralization.

3.2 General principles

In 2006, the year before Romania's entry in the EU, the Parliament adopted bulk of laws on decentralization that brought modifications to all existent texts. The main law in that package was the framework-Law of Decentralization.[98] This law includes all principles upon

[96] Law 94/ 1992, republished and amended; the Official Gazette of Romania no. 116, March 2000
[97] Constitution of Romania, article 120, paragraph (1)
[98] Law 195/ 2006, published in the Official Gazette of Romania no. 453 , May 2006

which fiscal decentralization should be designed, and all subsequent legislation should follow its principles. Other laws that concern fiscal matters include: the Law of Public Finances[99], the Law of Local Public Administration[100] and Fiscal Code.[101] They bring clarifications to the more general law on decentralization. I will consider the latter mentioned laws, together with other governmental degree, as 'secondary' legislation for fiscal decentralization. 'Secondary' is in the sense that they come to explain the exact mechanisms to achieve the principles of the decentralization law. The methods to achieve fiscal decentralization include among others: sharing tasks between levels of government, supervision, fiscal decision making, and redistribution of money through transfers. Even if some laws have the general principles for fiscal decentralization as a starting point (first articles), the subsequent unfolding of the law reveals methods and results inconsistent with fiscal autonomy.

Even though the legal framework includes general principles of fiscal decentralization, there are minor departures from the theoretical perspectives that could call for improvements. I will follow the order of issues mentioned in the methodological part, starting with taxes, governmental responsibilities, borrowing and finishing with fiscal transfers.

First of law, there are some general principles mentioned in the law of decentralization[102], besides the one already included in the Constitution. The general principles are followed by criteria and means of achieving fiscal decentralization. The principle of subsidiarity comes first, competence being assigned and performed by the authority closest to the citizens. This is followed by the assurance of fiscal means for all responsibilities transferred to local governments. Next are a stability and autonomy principles. The decentralization process is designed as stable, predictable and should not constrain the activities of local administrations nor limit local financial autonomy. Resulting from the

[99] Law 273/2006, published in the Official Gazette of Romania no. 618, July 2006
[100] Law 215/2001, republished and completed by Law 286/2006, published in the Official Gazette of Romania no. 621, July 2006
[101] There is at present no separate law on local taxes and, but for a title (no. IX) in the Fiscal Code
[102] Law 195/ 2006, article 3

analysis, one will be able to deduce that there is no full commitment to these principles by all legal acts.

First the law on decentralization touches upon all major concerns of fiscal decentralization as pointed in the literature. One of the criteria in the law, the principle of "geographic area of beneficiaries", implies that the provision of the public decentralized services should correspond as best as possible with the local area of beneficiaries.[103] The law also mentions criteria such as economies of scale; the public provision of services is to be done at the level of public administration that can best acquire economies of scale.[104]

Another mention concerns horizontal and vertical balancing of budgets that are to be achieved by transfers from the state budget.[105] Horizontal balancing of local budgets refers to transfers of financial resources from the state budget to local governments to rectify for differences in financial capacities between jurisdictions (counties, localities). Vertical balancing of budgets refers to transfer of funds in order to cover decentralized public services. Local governments are entitled to assurance of financial resources in the case of transfer of task to lower levels (article 6, paragraphs 1 and 2). As a novelty the law establishes cost and quality standards for the supply of public services (article 9). These are set by the central government structures unilaterally, while the updating of these indicators is made in collaboration with associative forms of local public administration (article 9).

3.3 Taxation

Fiscal decentralization theory presupposes that subnational governments have access to an own tax base. Ebel and Yilmaz have underlined it as an essential part of fiscal decentralization: "sub-national (local) govt. must be given the authority to exercise 'own-source' taxation".[106] In this respect Romania does follow general theoretical prescriptions of

[103] Law 195/2006, article 2, paragraph (h)
[104] Law 195/2006, article 2, paragraph (i)
[105] Law 195/2006, article 2, paragraphs (m) and (n)
[106] Ebel. "On the Measurement and Impact of Fiscal Decentralization"; 103

tax levy. The central government, through its deconcentrated agencies, gathers most of the important taxes, the value added tax (VAT), the personal income tax (PIT), the tax on profits and excise taxes.

For the local governments the most valuable taxes they are assigned include the taxes on property (buildings and land), taxes on means of transport and other several smaller taxes. These include taxes on issuing certificates and permits, advertising taxes, and hotel fees.[107] Also local authorities can establish special taxes. The law on public finances states that the special taxes will be paid by the persons who use the public services for which the special tax was set up.[108] Again the principle of geographic area is being respected. Although the PIT is collected at local level (the locality where the employer is situated) it is shared with the subnational level according to specified share (quota) mentioned in the law of local public finances. This particular issue will be covered in the subsection on fiscal transfers.

The separation of taxation functions is in accordance to theoretical prescriptions.[109] The taxes on mobile factors and tradable goods (VAT and PIT) are collected by the central government. Taxes on immobile property (buildings and land) are assigned to local governments. A schematic synthesis of tax assignment is presented in Appendix 1.

Even though they can collect local taxes, the local authorities must follow rates predefined by central authorities. The Fiscal Code has specific regulations on the methods of structuring local taxes, possible exemptions, penalties and time lines when taxes are due. For example, the tax on buildings has set amounts per square meter to be levied. These are indexed according to the type of locality, location within the community of the immobile in question and the year of construction.[110] The second tax as importance, the land tax is set

[107] Fiscal Code, Title IX, article 248
[108] Law 273/2006, article 30, paragraph (6)
[109] Thiessen. *Fiscal Federalism: Normative Criteria for Evaluations, Developments in Selected OECD Countries, and Empirical Evidence from Russia.* 8-9
[110] Fiscal Code, article 251, paragraph 3-7

according to the type of locality and the current usage of the land property[111]. There are different regulations for individuals and legal entities.

Awarding these taxes to local governments is in accordance with tax separation in a multi-tier system. The individuals pay in order to benefit from public services consumed in their area of residence, so the geographical principle functions. Perhaps in order to increase the revenues locally generated, subnational governments should be awarded more leverage when setting local tax rates. This is currently done following the prescriptions of the fiscal laws. Most of the taxes have fixed rates, while few are allowed to vary between two limits or up to certain ceilings (this is the case of issuance taxes, advertising and hotel fees). According to Thiessen Ulrich, local authorities "should have significant own revenues determined within limits by themselves."[112] It points to a tax system with limits to the rates that can be charged by local governments.

There is one stipulation in the Fiscal Code allowing for an increase of local taxes, for the entire fiscal year with up to 20%, through decisions by deliberative local bodies.[113] Governments at second level have also limited influence over their tax base. Local authorities can define for example the areas within their jurisdiction according to which property taxes are calculated. But the type of locality is decided by central authorities through the Ministry of Administration and Interior. As such subnational governments can not take advantage of characteristics of their jurisdictions in order to follow efficiency in tax collection.

3.4 Responsibilities of local governments

The law of decentralization differentiates between three types of responsibilities in the sphere of public administration. There are exclusive competences, shared competences and

---

[111] Fiscal Code, article 258

[112] Thiessen. *Fiscal Federalism: Normative Criteria for Evaluations, Developments in Selected OECD Countries, and Empirical Evidence from Russia.*9

[113] Fiscal Code, article 287; applies to all local taxes and fees minus the tax on transport means over 12 tones and judicial taxes

delegated competences.[114] In case of the shared competences, responsibilities are divided between central government and county government, between the latter and cities/ commune level and between central government and communes and cities. Delegated responsibilities to local level governments include payments of social assistance for children and adults with disabilities. The shared and exclusive competences are summarized in Appendix 2.

For these competences to be effectively divided, the law needs to mention which level of government does what. That is who is regulating the activities, who is financing them and who is in charge of implementation.[115] The legal framework is still vague, or lacks the above mentioned attributes for shared responsibilities. In this sense the law on decentralization is deficient as it only stipulates that delegated mandates will be financed by adequate amounts through the intergovernmental transfer system (totally by central government).[116] From the introduction of the quality standards we can assume that central government is responsible for the regulating of task assigned to various levels. As for the implementation of decentralized responsibilities this is solely the effort of local governments.[117]

Besides the above mentioned competences there are other task assignments between central, county and local (cities, communes), as shown Appendix 3.

According to the decentralization literature the responsibilities of redistribution are best suited for central level governments.[118] The central government in Romania is in charge for the unemployment benefits directly through deconcentrated institutions at local level. For other social assistance programs it employs a delegative mechanism. In this sense the local governments are in charge of implementing the programs and they receive specific grants through the state budget. This is first of all the case of child protection institutions, social and

[114] Law 195/ 2006, article 19
[115] Leonardo Gabriel. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* 30
[116] Law 195/ 2006, article 6, paragraph (2)
[117] Law 195/ 2006, article 9, paragraph (4)
[118] Thiessen. *Fiscal Federalism: Normative Criteria for Evaluations, Developments in Selected OECD Countries, and Empirical Evidence from Russia.* 4

medical assistance for the disabled and persons in need. This applies also to the salaries of teachers from schools and high schools. To the amount of these transfers the local governments do not have any formal direct influence.

Concerning both health care institutions and education facilities problems might arise due to the current practice. Local governments (county, cities and communes) are not the owners of these facilities. They exert only care-taker functions, maintenance and current operation. This separation of ownership and operations could induce “serious moral hazard issues.”[119] Local officials will be less inclined to internalize the costs of maintenance, leading to deterioration of assets and reductions in the “quantity and quality of services provided to citizens.”[120]

Another wrong assignment relates to fire protection. Such a service provides benefits that are geographically determined and as such should accrue to local governments. It is local governments who assure the fixed costs to these institutions by the local budgets. The funds for salaries and capital investments are being transferred from the Ministry of Administration and Interior (MAI). The fire brigades are subordinated to this Ministry and not to local governments.

3.5 Borrowing of subnational governments

In order to finance capital investments local governments in decentralized systems can access credit markets. This is one alternative to central government allocation of funds for investment purposes. This way, subnational authorities can better determine their investment priorities and need not be at the mercy the national government’s priorities. Still central governments need to regard macro-economic factors. Because of this they can not allow soft-

[119] Leonardo Gabriel. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* 28
[120] Ibid. 28

budgets constraints when subnational governments borrow. Thus the need arises for clear legal regulations and monitoring efforts on behalf of the central government[121].

The legal framework for local borrowing can be found in the law of public finances.[122] It includes both general principles of debt generation, debt monitoring and financial crisis/insolvency of administrative units. A general assessment would qualify this as serving both the interests of local governments (who have multiple possibilities to gain finances) and those of central government (macro-economic stability, prudential borrowing).

The main instruments for gaining credit are bond issuing and loans from commercial banks. This is done on the private credit marked, local or international (for the latter the state needs to be contractor or guarantor of the loan[123]). The local government can borrow from the state, trough the State Treasury under certain conditions but the amount is limited to 5% of total annual revenues[124].

There are ceilings on all types of borrowing procedures in place, as well as a monitoring mechanism. The latter allows central authorities to keep track of all subnational debt. The ceiling for borrowing on the credit market is set at 30% of own annual revenues of local government.[125] It is only through own revenues that borrowing can be guaranteed. Moreover in order to access such a credit, there has to be an application submitted to the commission in charge with local loans authorization (from here on commission). The credit can not be obtained unless the local government receives a certificate from the commission. The composition of the commission is set by the Government and is permanent body of high ranking officials, most of them centrally appointed.[126] All loans need to be documented at the MEF and monthly reports sent. There is no bailout policy from the central government: "the

[121] Ibid. 71
[122] Law 273/2006, published in the Official Gazette of Romania no. 618, July 2006
[123] Law 273/2006, article 61, paragraph (5)
[124] Law 273/2006, article 65
[125] Law 273/2006, article 63, paragraph (4)
[126] the composition of the commission: 4 appointees from the Ministry of Finance, 2 from the Ministry of Administration and 3 from the associative organizations of local governments; this is included in the Governmental Degree 158/ 2005

service of local public debt does not represent any obligation or responsibility for the Government" (article 62, paragraph 10).

The concerns of the central government for macro-economics stability and thus no occurrence of debts at any public level are justified. But in my opinion the establishment of the commission, with appointees of central authorities (majority of 6 out of 9 members, coming from MAI and MEF) can turn into a barrier for borrowing by local governments. This is a step in the way of more centralized decision making, slowing down the decentralization effort and inhibiting investments.

Another issue regards the ceiling placed on borrowing. This is currently at 30% of own revenues. Own revenues at the local level do not constitute a major share in the budgets. Considering the EU programs developing after accession the limit appears prohibitive for small governmental units (cities and communes). The monitoring system designed by the law could serve the purpose of constant assessment of public indebtness and can reduce the risks of insolvencies. The law stipulates for every loan or emission of bonds the constitution of a risk fund, apart from the local budget.[127] This is an efficient way of preventing any financial crisis situations that might occur in the repayment of the debts.

In case negative financial situations do occur the law on local public finances has stipulation to address these situations. They are constituted in two different cases: financial crisis and insolvency. The difference consist in the time period for which the administrative-territorial unit has been unable to serves its financial obligations and the amount of debt[128]. As the law is newly enacted, to the knowledge of this author, there were no cases of local governments declaring insolvency or experiencing financial crisis.

[127]Law 273/2006, article 64; the funds are kept with the State Treasury

[128] Law 273/2006, articles 74 and 75; for financial crisis 90 days of inability to pay amount larger than 15% of annual budget, or more than 90 days of overdue salaries; for insolvency the limit is 120 days of no payments that account for more than 50% of total annual budget, or more than 120 days of not having paid due salaries

To redress the financial situation a plan will be developed by the local authorities under strict control form the territorial branches of the Court of Accounts. The introduction of regulations regarding the bankruptcy of local governments can be seen as an improvement in the legislation of decentralization. Through this, local governments can develop a sense of independence in local financial matters, with no possibility of bailouts from higher level authorities. It also can induce more accountability in planning investments, knowing the money will be locally paid for. This could imply more caution in making fiscal decisions on investments.

3.6 Intergovernmental transfers

Local governments, through their deliberative branches, prepare and vote on a budget every year. The law on public finances sets out the way the budget is structured (chapters, points etc.) in both revenue and expenditure sides. As there are mandated task from the central government and shared taxes, there are mechanisms to distribute them along jurisdictions. The methods of distribution and the sums included form the intergovernmental transfers. The amounts transferred to local budgets from different state revenues fall into two categories: amounts for balancing local budgets and amounts with special destination.[129] The latter include mandated task such as education and social assistance programs. The system of transfers is slightly complicated by different level divisions and share settings for amounts to be allocated.

The transfers are included in the revenue part of local budgets. Local revenues are composed of: 1) own revenues per se: a) local taxes and fees; b) shares from PIT; 2) amount distributed from some state budget revenues (for balancing and mandated tasks); 3) state subventions; 4) donations.[130]

[129] Law 195/ 2006, article 2, paragraph (r)
[130] Law 273/2006, articles 5, paragraph (1)

As mentioned in a previous section the PIT is considered a shared tax between levels of government. As such the law on public finances states the exact share of the tax received by different authorities[131]. A part of the PIT revenues remain at the place of collection. Others are being transferred between levels of government either by county councils (a smaller part) or by county finance directorates. The latter employs a formula of financial capacity when distributing shares of PIT in two stages.

The financial capacity criterion is actually represented by a formula. This is applied to both the amounts above mentioned (who have as source the PIT) and the other transfers that are made at county level for the balancing of local budgets. The amounts of these transfers are given to county governments on criteria of financial capacity (70%) and area of the county (30%). The financial capacity is a formula that is based on the average PIT levied in the precedent year in the specific county and in all counties, as well as population size.

A more schematic of the transfer system can be seen in Appendix 4. The following appendix also contains the detailed financial capacity formula (Appendix 5).

The indicators included in the formula are computed by the directorate for finances at county level and the institution is the actor who actually makes the distribution. When making the distribution there are two stages. The directorate distinguishes those administrative units whose average PIT is smaller than the county average. They are the beneficiaries of the first stage of transfers, according to population (ratio to total population for first stage) in proportion of 75%, and land area (ratio to total land area of units included in this phase) in proportion of 25%. The amounts that remain after this first stage will then go to all units in one county, regardless of average PIT size. For this second stage the institution uses the same formula as the Government when distributing to counties, only that now localities are the units.[132]

[131] Law 273/2006, articles 32 and 33
[132] Law 273/2006, article 33, paragraph (4)

The transparency of the transfers system is lost due to the many regulation, tiers and institutions involved. One positive aspect is that there exists a formal criterion (formula) for sums allocated at county level and within counties. As such there can be limited manipulation from central or local authorities when allocating monies. It induces predictability in the budget process and local governments are more secure on prospective revenues. Yet, the system is complicated by the stages of distribution of the amounts.

The introduction of the two stages for balancing budgets can serve equalization principles. The money goes first of all to the jurisdictions worst off within every county. At the same time this could prove to be a disincentive for tax efforts and lead to moral hazard. As local actors witness that they are excluded from the first equalization and that they will be included anyway in the second, they might decide to undertax. By keeping low revenues from PIT they could be included in both phases of distribution.

The formula for financial capacity includes only one tax collected at local level, the PIT. Capacity for revenue generation should not be limited to the one tax, as second tier governments have access to other taxes and fees.[133] The formula used also employs “lagged revenues”[134], collected PIT levels for the past year. Using past measures does not fully catch the potential for revenue generation and could be a source of disincentives.[135]

If we are to compare the current system with previous ones, there are improvements. Concerning the financial capacity formula, it had been previously designed only with respect to own county/locality past revenues. Introducing a ratio of own revenues to total revenues of local governments (PIT levels only) could help reduce the inequalities between jurisdictions and also reduce negative incentives. By this I mean incentives to reach lower levels of revenues and benefit from more transfers. If the formula includes the revenues (average PIT)

[133] Leonardo Gabriel. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* 61
[134] Boex, Jamie and Martinez-Vazquez, Jorge. 2003. *Designing Intergovernmental Equalization Transfers with Imperfect Data: Concepts, Practices and Lessons.* 24
[135] Leonardo Gabriel. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* 61

for other jurisdictions negative incentives might be reduced by the relative measurement (ratio).[136]

Another difference in comparison to previous legislation includes the mandating of balancing funds to local directorates of finance. This is not fully done by them, but majority of balancing funds is transferred in this way. County council still maintains some money they have to redistribute, for investment projects and external development projects that require local financial effort. If mandating the branches of the MEF to redistribute is an improvement or not is debatable. Past experiences have pointed to political distribution of funds by county councils. Moving the responsibilities away to an agent of the central government, with the same procedure to follow, was seen as needed. Only as more time passes could such changes be evaluated.

Apart from equalization using PIT, local governments are faced with conditional funds. These include the amounts received from central government for education (teachers' salaries), health and social assistance. For these decentralized tasks there is no special source mentioned in the law. It just mentioned they will be funded entirely from central budget, from "some revenues".[137] If the local governments are expected to provide decentralized services, but they do not the source of the funds they receive, problems of accountability and financial efficiency might arise. The money received via transfers can come from locally generated non-shared revenues like the VAT (after 2006) or from money raised elsewhere. This comes against the principle of "correspondence", according to which taxes levied in one jurisdiction should be spend in the same geographical area.[138]

From an overall perspective, the legislative framework seems to cover almost all matters of fiscal decentralization. It is very detailed and exact in most respects. Still the laws

---

[136] Boex. *Designing Intergovernmental Equalization Transfers with Imperfect Data: Concepts, Practices and Lessons.* 24
[137] Law 273/2006, article 5
[138] Leonardo Gabriel. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* 49

do not mention the financing and fulfillment of shared tasks between levels of government. The framework also lack any mention of designing the quality standards for local public utilities.

In other areas the legal framework is far to complicated. This includes the design of intergovernmental transfers, where several actors at different levels have responsibilities. The sharing of PIT, the only tax that is shared with the local governments, is done in sequential steps that do not always follow sound fiscal rules.

In the area of subnational borrowing there are restrictive policies, regarding both the amounts to be loan, their source and their authorization by central appointed bodies. Last, concerning the separation of responsibilities and taxation there seem to be no major concerns. The only shortcomings include wrong assignment of responsibilities, coming against the principle of geographic correspondence, in the case of fire prevention. One source of possible neglect could concern the health and education systems were responsibilities aim only at maintenance costs, without any other possibilities to influence policy in the area. This can be argument due to the lack of financial capacity of local governments, or the need to secure uniform services across jurisdictions.

Chapter 4 Empirical Evidence from Local Budget Practices

To support the hypothesis of the research, that fiscal decentralization although promoted is held back by secondary legislation and ill-conceived practices, I will in this chapter turn to local budgets. I will show that fiscal decentralization is found to a lesser degree, using limited aggregate and individual. This will constitute the endeavor to grasp the second independent variable in my study: the practices of local governments.

4.1 The budgeting process

The structure of individual local budgets in Romania is not quantified in the national budget. The state budget includes just an annex with the funds to be transferred to local governments for decentralized responsibilities. These are lump-sums allocated per county. They do not say much about the contribution they bring to local budgets, nor the way they have been determined. The state budget sets forth all the revenue and expenditure classifications to be use by second level governments when drafting their budgets. The norms thus set are binding on local governments who can not depart from them. These earmarked, specific grants go to child protection, the elderly, special educational institutions, social assistance of persons with disabilities or in need.

Having a uniform measure of budget structure can prove beneficial in ensuring a nation wide identical fiscal practice. It can ease centralization of data for the Ministry of Finance and enable comparative and aggregate assessments. But it also implies that all governments are treated as having the same patterns of fiscal needs. Following the norms of the sate budget laws in preparation and execution of local budgets can "reduce subnational budgetary autonomy".[139]

[139] Ibid. 78

Every local government, at county level, cities and communes, votes on the structure of the budget for the coming year. This process is initiated by the MEF, who sends out notifications to all deconcentrated directorates of finance. From this institution, the information is passed on to local officials who have to take into account when drafting their own budget. The letter will include the macro-economic context for the coming year as well as the amounts (limits) of transfers and the sums to be received from the state budget on county level[140]. The drafts for the local budgets are sent via the MEF territorial institutions to the center. After the national budget law has been approved by Parliament the local governments are told the exact sums to aspect and they finalize the budget project. During the fiscal year there can be revisions to the state budget that imply the possibility of further funds for local level governments.

4.2 Aggregate results

In the measurement of budgetary practices I have included two forms of autonomy, for revenues and expenditures. These I intend to apply to a number of county budgets approved during the year 2006. Aggregated data for recent years is not available at national level. Because of this aspect I was forced to make my own inquiry into county budgets. I only analyzed a sample of county level budgets.

In order to compensate for the number of cases, I will briefly engage in an aggregated attempt to measures the two variables at national level for some past years. This would be beneficial for pointing to some trends that have manifested themselves in the structure of local budgets. For this I will use data from the years 2002-2004 comprised by the National Institute for Statistics[141]. The data provided by the Institute is not as detailed as one would like but it serves a general overview purpose of past practices. On the expense side it does not qualify titles according to source of income, but according to destination. Moreover for the years

[140] Law 273/2006, article 37
[141] Romanian National Institute for Statistics; http://www.insse.ro/cms/files/pdf/ro/cap21.pdf

analyzed there was shifting legislation which does not permit me to make general remarks considering expenditure chapters as education, social assistance and so on. Because of this lack of differentiation I will not be able to compute, for this data the expenditure autonomy index.

The statistics refer to aggregated data on the execution of local budgets, in the form of both revenues and expenditure assignments. Starting from the given structure of the budget I decided to include as local own revenues all contributions that are not passed down from higher levels of government through transfers. The choice is backed by the idea that the central government is able to set the shares and conditions for transfers and subsidies. I will include only those revenues/expenditures over which central government can not directly regulate. Of course in a more general approach the central government is also the one who decides on the rates of local taxes (if not exactly than using intervals). Leaving this general assessment aside, and for the purpose of the index, I have divided the revenues as follows. Fiscal revenues, non-fiscal revenues and capital revenues will form the category of own revenues. 'Samplings from state budget' (shared taxes, quotas) and subsidies are counted as transferred revenues. Own revenues mostly include local taxes on property, land, various fees. Revenue autonomy will be measured as the ratio of own revenues from total revenues.

Table 1 National level data on composition of local budgets

Year	**2002**	**2003**	**2004**
Total revenues	93228	130781	159558
Fiscal revenues	11842	18259	21772
Non-fiscal revenues	3773	4600	5700
Capital revenues	592	1239	3288
Samplings from state budgets	70960	93743	119098
Subsidies	1174	7349	9202

Source: Romanian National Institute for Statistics

Table 2 Percentages, by type of revenue, in local budgets

Year	**2002**	**2003**	**2004**
Own revenues (percentage)	17	18	19
Transferred amounts from central government (subsidies and samplings)	76	71	74

Source: computed using data provided by the Romanian National Institute for Statistics

As can be seen from the above results the degree of revenue autonomy is rather low[142]. The index is situated at around 18% of total revenues. Still the trend appears to be ascending for the three years analyzed. It points to the major importance that transfers have in Romania’s financial intergovernmental relations.

The problem is that there is no clear standard for some transfers. The PIT sharing has well defined patterns, with an equalization formula for within and across county distribution. But the VAT does not have such a clear pattern of distribution. Until the reforms of 2006 the mandated responsibilities of education and social assistance where said to derive from VAT collected at county level, without specification of an actual share.[143] The present legislation stipulates that mandated tasks will be paid from sums coming from the central budget. The VAT tax is not any more mentioned in any of the current laws as a shared tax, although it is assumed that the transfers are based on it.

4.3 County level results

In order to compute the indexes of local revenue/expenditure autonomy I will now discuss the legal framework and the selections of amounts. The budgets are those for the year 2006. Considering the titles and subtitles in the structure of the budget year for 2006, I have decided to group as local, own revenues: personal income tax, taxes on local profits, fees

[142] similar results have been obtained in Leonardo Gabriel. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* 42; the difference is that my results do show growing own source revenues compared to those of Leonardo et al.
[143] Ibid. 40

and other local taxes. The remaining part of the revenue side consists of shares from VAT and subsidies.

The expenditures are divided in the local budgets both by type of activities founded (salaries, investments, costs) and by domain (education, health, social insurance etc.). For computing the ratio of own expenditures I have decided to take the mandated tasks of education and social assistance[144] as sectors over which local governments do not have too much influence. The amounts to be paid and the services are set up by central authorities. For this type of activities local governments act as agents of the central government, with little maneuvering possibility. The other part of the expenditures include health (maintenance duties only), with very small percentage from total revenues, and other spending like transportation, culture and local public services. This will constitute the 'own expenditures'.

The indexes will be ratios of own revenues/expenditures out of total revenues/expenditures at county level. For the entire population of cases (counties) I have computed an average of both revenue and expenditure autonomy. The list of respective counties is included in Appendix 6.

Table 3 Index of local revenue autonomy for the counties analyzed (2006)

Index (percentages)	**34**
Minimal value	18
Maximum value	56
Standard deviation	10

[144] Ionita, Sorin. 2003. "Halfway There: Assessing Intergovernmental Fiscal Equalization in Romania" in *Dilemmas and Compromises: Fiscal equalization in Transition Countries*, ed. Slukhai, Sergii, Budapest: Local Government and Public Service Reform Initiative - Open Society Institute; 35-63. 49

Table 4 Index on local expenditure autonomy for counties analyzed (2006)

Index (percentages)	**48**
Minimal value	40
Maximum value	61
Standard deviation	7

There are no widely accepted standards for assessing the results of such indexes. There is no set standard to define an adequate level of fiscal autonomy. Still, as can be seen from the above results, local governments in the counties selected, have limited financial powers when it comes to their own budgets. This applies to both revenue generating as well as definition of expenditures. In part this is due to the way central governments have delegated responsibilities to lower levels of government. These are being financed extensively through direct purpose specific grants. This is reflected in the shares from VAT that are assigned for meeting decentralized activities and in other types of subsidies. Using a classification[145] the transfers for education and social assistance, in the case of Romania, are earmarked grants. If the structure of the local budgets is at this length dependent on transfers and sharing (PIT), local governments risk "becoming just a spending agent for the center".[146]

A recent comparative study by Blochliger and King concerning fiscal autonomy of OECD countries, showed that to the major part of local budgets (60% of total revenues) consisted of own revenues[147]. If one compares Romania to those results there is a wide gap. Whether we look at the aggregate data for the entire country in the years 2002-2004, or just to the results of the current analysis, the ratio of own revenues remains limited. The trend of increased mandated expenditures has also been acknowledged by Ionita Sorin, in his research

[145] Blochliger, Hansjorg and King, David. 2005. *Fiscal Autonomy of Subnational Governments.* OECD Network on Fiscal Relations across Levels of Government: OECD. 23
[146] Leonardo Gabriel. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* 44
[147] Blochliger. *Fiscal Autonomy of Subnational Governments.* 4

into the fiscal equalization system of Romania.[148] The results of the present research show that the ascending trend has been followed up until 2006 at least. The legislative reform of 2006 might bring about changes in this but the prospects do not seem high. Even though some of the transfers have been regulated wiser through the new system (for example the PIT sharing), other have still been left to the annual decision of the state budget. This includes the sums for financing decentralized public services (such as education, social assistance) that are to be mentioned in the annex to the state budget as separate special purpose grants.[149]

If in the index of fiscal revenue autonomy I was to set aside as local revenues the shared PIT amounts, the values would be much lower. It would situate the index at around 8.5% of own revenues per se, at county level, in 2006, for the cases analyzed.

Using another comparative study, this time done on 10 transition countries in Central and Eastern Europe, recent developments in Romania still remain marginal in effect. The study by Meloche, Vaillancourt and Yilmaz[150] points to the index of local autonomy for the year 1999. The mean to other reached was at 37%. In this study Romania was tagged with 21% of own revenues relative to total revenues. In time the index appears to have risen, but it is still lower than the average for 1999 on transition countries.

When analyzing the expenditure side of the local budget for the cases selected one can see that most money at county level go to social assistance (an average of 38% in the sample), followed by transport (17% average) and education and culture (13% each). This again comes to show that the expenditure priorities are not fully decided by local governments. The mandated tasks seem to include the majority of local governments' spending agenda.

After they deal with the mandated task of social assistance and education there are limited financial possibilities to deal with other tasks. In the budgets of the counties analyzed chapter as environmental protection, housing or development had no, or very limited

[148] Ionita. "Halfway There: Assessing Intergovernmental Fiscal Equalization in Romania"; 59
[149] Law 273/2006, article 6
[150] Meloche. *Decentralization or Fiscal Autonomy? What Does Really Matter?* 12

allowances, fact that lead me to leave them out of my computations. Of course the tasks passed down to subnational governments for financing can be considered to be of local importance.

Conclusions and Policy Recommendations

The legal framework in the area of fiscal decentralization includes both the principal laws with direct reference to the process as well as secondary legislation. The latter is aimed at clarifying the general principles stipulated by the former. The breaking down into actual procedures of the principal laws by the secondary legislation does not always come in favor of effective fiscal decentralization. Considering general theoretical principals of fiscal decentralization I will now try to present possible improvements in the current legislation.

In a general light, the effort of all governmental agencies in Romania comes to support fiscal decentralization. In my opinion this is a valuable development, which still needs to be strengthened by clear legislation. The major principles of fiscal decentralization appear in the laws, but the way the fiscal system is designed comes sometimes against them. Also the practices point to slow movements toward local autonomy in fiscal matters, as shown in the computed indexes on local autonomy.

The qualitative assessments of the legal framework come to support my hypothesis. I have underlined some shortcomings in the area of task assignment, in restrictive borrowing procedures, in restrictive an inefficient tax setting, in too much legislative control over local governments. These problems are all situated as secondary regulations or as articles following the general principles, not necessary concerning fiscal decentralization.

The quantitative measurements, including indexes of local expenditure and revenue autonomy have shown reduced ratios. Most of the budget revenues are transfer in nature, while most of the expenditures are mandated. This comes to support the idea that local fiscal autonomy is reduced, seen both in legal perspective and empirical results.

Due to effects of time (the legal framework being still new) the analysis could be made more interesting if evaluated at different point in time. As a starting point of future research the material covered here can serve as an analytical kit. For enlarging the research the inclusion of more (preferably all) administrative units would be beneficial and could bring more insights. This could be done in using some time period analysis. This in order to show how exactly changes in legislation affect the practices, as this was not fully covered by the current research.

Further research could investigate more clearly if the links between various local factors (income, region, economic development) and the structuring of local finances. This paper was more descriptive and general in nature. The legal framework can point to general trends, while an analysis of all administrative units (not just a reduced number) can give insights into the causes of such results and practices.

Making appraisals on the right balance between decentralization and centralization is not easy. Some functions always need to rest with the central government, while other are better suited for the local level. Even the theoretical basis for this is not very clear, as there are pitfalls however the system is designed. The balance that appears to be forming in Romania results from a complicated and sometimes incomplete legal framework. In my opinion there are still areas where local autonomy can be increased without the fear of macro-economic instability or unequal public service distribution. These include taxation, borrowing, task assignments and the transfer system.

Concerning taxation, the division of task is mostly adequate. There is one particular aspect that could be improved. This relates to the collection of the PIT tax at the administrative level where the individual works. Taking into account that the place of residence does not always coincide with the locality of the workplace, it could have negative effects. The process of commuting from the suburbs (e.g. communes) to cities, where economical activities are mostly situated, implies more revenues for already well-off governments[151]. Thus the separation of place of residence and location of the workplace could benefit those units with already more jobs, which could increase economic differences. Another argument in favor of such change could be that the tax payer actually consumes more public utilities at his place of residence, than at his place of work. So the taxes he gets deducted should flow to the locality where he resides.

Another source of reduced autonomy for local governments can be considered the restrictive stipulations of the fiscal code concerning rates and calculation methods. Local authorities can not exercise full discretion in setting the tax rate. Most taxes are either fix at particular level, or there intervals in which they could vary. The possibility of tax increase with up to 20% from the prescribed levels could help local could be helpful for governments. They could take advantage of differences in economic characteristics and income structure of jurisdictions. In this respect the Romanian Fiscal Code is still too restrictive in my opinion.

As the PIT and the property taxes form most of local revenues, to secure local government autonomy it is in this area reforms should occur. It would be advisable to allow for the property taxes (land and buildings) to vary not according to location within communities and year of construction. A more desirable approach would be to design a "modern real estate property tax".[152] The current system calculates value according to the positioning of the building within the locality perimeter. Other criteria include the building material and utilities connected to, the age of the building, the total area. For the land tax, the only criterion is current usage, possible agricultural purposes. The assessment of the tax is done not according to real market value, in neither case.

Increasing local revenues can also be achieved by the introduction of "personal income tax piggybacking"[153] system the local authorities can use. This would mean a decision by local authorities to add surtax to PIT, resulting revenues being kept locally. The surtax

---

[151] Ionita. "Halfway There: Assessing Intergovernmental Fiscal Equalization in Romania"; 51
[152] Leonardo Gabriel. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform.* 50
[153] Ibid.51

varies according to income and would correlate with increase demand for public services. Perhaps as the transfer sums from central authorities would be reduced, local governments will learn to tap in the revenue raising possibilities they have.

If we review the task assignments between levels of government points calling for betterment include a division that fully follows geographical area benefits. This refers to the practices of maintaining the fire fighting forces as financially subordinated to the central authorities. Some of the costs of the service are locally internalized but all the activity should be circumscribed to local governments. If so then the benefits of the service and the financial contribution could be geographically identical.

The borrowing opportunities introduced in the new legislative package are intended to allow private financing of local governments, while at the same time prevent any macro-economic imbalances. Making trade-offs between macro-economic stability and investment capacities derived from borrowing is hard. The regulation in this area can be considered restrictive in the sense of the introduced ceiling of 20% of own revenues. Some localities might have problems accessing loans. The small localities have reduced own revenues (transfers for balancing budgets and mandated task are not included). The larger units do have more own revenues, but also their needs for investment are greater. Perhaps changes in the amount of borrowing allowed would allow more flexible actions. Another way would be to change the source, from 'own incomes' to total revenues, leaving the rate unchanged.

Another concern for borrowing possibility is affected by the establishment of the commission for authorization of loans. It is again another example of how secondary legislation can have effects on general stipulation of decentralization and fiscal autonomy. The institution set up at central level could employ discriminative and restrictive practices of authorizing borrowing. By establishing such an institution, the central government shows its concern for the capabilities of subnational authorities to follow the legal prescriptions of the law. Introducing such a ‘gatekeeper’ does not coincide with treating local governments as partners in the decentralization effort. A recommended solution could be the establishment of commissions on local levels with more decision powers for local agents who are the actual bearers of the costs of borrowing. The existence of a centralized system of debt monitoring could be enough to guarantee that local governments do not overburden themselves with borrowing. As a complementary measure, the local public authorities can always be subject to extraordinary verifications from the Court of Accounts.[154] This could again diminish the possibility of non-service of fiscal obligations.

Concerning the current transfer system used, one could conceive reducing its complexity. The shares from PIT are divided too many times between different actors. This does not help to confer transparency to the process. The introduction of clear formula criteria for the sums to be transferred is a welcomed improvement of the system. Using only criteria that are politically neutral (population, area size, revenues) is also an improvement to previous legislation that did allow a certain percentage to be distributed on locally decided criteria (political at some times). Introducing deconcentrated institutions (the county directorate for finances) into the process can serve to improve efficiency and guarantee that equal measures are used all over the country.

The factors used in the formula of financial capacity (population and past incomes) could be used together with other measures of fiscal needs for example. Having measures of fiscal capacity for only one tax (PIT) might not take into account other incomes derived from local taxes. Making use of last years fiscal measures is a simple procedure but does not take into account potential revenues.

The second stage of the distribution by finance directorates might imply negative incentives as the jurisdictions with below average incomes get distribution funds first. This

[154] Law 273/2006, article 66

does speak in favor of equalization, helping the worst offs, but can potentially turn into a disincentive for fiscal effort. Introducing an index of revenue collection[155] at the distribution stages could mitigate possible side-effects. Redistribute to the less off first, but only to those whose tax effort is higher, although low in aggregated results.

The way the local budgets included in this analysis is structures points to another characteristic of the system. This is the overall reliance on transfers for financing expenditure. If this is reasonable to expect for mandated responsibilities, it should not be so for all expenditures. As from 2007 subsidies as such will not be part of the transfer system and local authorities will need to cope with the situation. This could be a step to improve the collection of local revenues, or the designation of new taxes to benefit local communities. The best suited way to structure the fiscal system I believe is to allow local governments as much autonomy as possible within certain limits. This ought to be done in a context of central government supervision, which should not be prohibitive or over-reaching.

Overall, the effort to introduce effective measures for fiscal decentralization appears in most of the general legal framework. Still there are some shortcomings that have been underlined by this paper. They do not concern all areas of fiscal decentralization. In particular areas, like the definition of task between levels of government, or the fiscal capacities of subnational actors, problems are present. Both the analysis of the legal framework and the evidence from the cases studied did point to low level of financial autonomy, a basic measure of fiscal decentralization. I have also offered some recommendations of how the situation can be improved, as discerned from the theoretical and empirical literature on the topic.

[155] Boex. *Designing Intergovernmental Equalization Transfers with Imperfect Data: Concepts, Practices and Lessons.* 14

Appendix

Appendix 1 Division of taxes by level of government

Level of government	**Central government**	**Local governments**
Type of taxes	Personal income tax (shared) Tax on enterprise profit Value added tax Excises on tobacco, alcohol and gas Custom taxes	Property taxes (buildings and land) Tax on means of transportation Tax for issuance of public documents Tax on advertising and publicity Hotel tax Tax on shows Special taxes (set up by deliberative local authorities)

Appendix 2 Task assignment between levels of government
(Source: adapted from Leonardo Gabriel et al. *Intergovernmental Fiscal relations in Romania* Table 6, page 32; also using Law 195/ 2006, articles 21-27)

Level of Government	**Central Government** (Shared competences)	**County level** (Shared competences)	**Communes and Cities** (Exclusive competences)
Communes and cities	▪ Provision of thermo energy produced in centralized system ▪ Construction of social houses and houses for the youth ▪ Pre-university education ▪ Public order ▪ Assistance to persons in need ▪ Preventions and combat of emergency situations ▪ Health services for social persons in need ▪ Health services for disabled persons ▪ Population statistics ▪ Local roads	▪ Supply of public utilities by regional operators	▪ Administration of the public domain ▪ Local roads ▪ Cultural institutions of local interest ▪ Health institutions of local interest ▪ Water, sewerage and waste disposal ▪ Primary social assistance (child protection, elders, victims of domestic violence) ▪ Local transportation
County	(Shared competences) ▪ Roads of county interest ▪ Special education system ▪ Health services for persons with social problems ▪ Social assistance for child protection and disabled persons ▪ Population statistics	(Exclusive competences) ▪ Local airports ▪ Administration of county public domain ▪ Cultural institutions of county interest ▪ Health institutions of county interest ▪ Primary social assistance (domestic violence victims and elders)	

Appendix 3 Task assignments between levels of government according to area
(Source: adapted from Leonardo Gabriel et al. *Intergovernmental Fiscal relations in Romania* Table 2, pages 20-21)

Level of Government	**Central**	**County**	**Localities**
Education	Building schools; all affairs of Universities	Special education institutions	Maintenance of buildings (schools and high schools); paying salaries (funds through transfers)
Health	Emergency institutions, hospitals (deconcentrated directorates for health at county levels)	Maintenance of county health units	Maintenance of local health units
Culture	National museums, theaters	Cultural institution (museums, libraries, theaters, concert halls) of county importance	Cultural institution at local level
Social assistance	Unemployment benefits	Social assistance to the elderly, the disabled, child protection	Social assistance to the elderly, the disabled, child protection
Civil Protection	Fire brigades and civil protection		Local civil protection

Appendix 4 System of intergovernmental transfers in Romania
(Source: adapted from Leonardo Gabriel et al. *Intergovernmental Fiscal relations in Romania*; Figure 2, page 55, and the Law of Local Public Finances 2006, articles 32 and 33)

<table>
<tr><td rowspan="3">Fixed share of income tax</td><td>47% local budgets (cities and communes)</td><td colspan="2" rowspan="2"></td></tr>
<tr><td>13% county budget</td></tr>
<tr><td>22% special account for balancing budgets</td><td>•</td><td>27% county budget</td></tr>
<tr><td></td><td></td><td></td><td rowspan="2">58.4% by formula to localities</td></tr>
<tr><td rowspan="2">Sums for decentralized activities</td><td>70% according to financial capacity</td><td>•</td></tr>
<tr><td>30% county area</td><td>•</td><td>14.6% for development projects, by decision of County Council to localities</td></tr>
</table>

The figure shows how two forms of local revenues are distributed: their origin and shares shared between levels of local government (county and localities).

The PIT is levied at the level of administrative units and 82% of it remains, in one form or another at local level (county or locality). This percent is further divided as follows: 47% to the exact administrative units where the taxpayers operates; 13% to the budget of the county and 22% in a separate account at the State Treasury which will be used to balance local budgets. To these 22% the central governments adds other funds for balancing local budgets. The resulting amount is divided according to the following criteria: 27% goes to the budget of the county and the difference is further divided- 80% goes to administrative units, by order of the head of the general finance office using as criteria population size, land area and financial capacity; the rest of 20% is to be distributed by the county government for programs of local development or infrastructure.

Appendix 5 Financial capacity formula

The formula is used in the two stage distribution of funds when balancing local budgets

(Source: adapted from Law 273/2006, articles 33, paragraph (2), letter (a); I used personal abbreviations)

Ac= ((AvPITtc/AvPITc)*(Popc/Poptc))/ (Σ [(AvPITtc/AvPITc) * (Popc/Poptc)]) *Atc

Where: Ac- amount to be distributed for specific county

Atc- total amount to be distributed to all counties

AvPITtc- average PIT collected last year counting all counties

AvPITc- average PIT collected last year in specific county

Popc- population size of the county and Poptc- total population of all counties

Appendix 6 List of counties whose budgets are included in the analysis

For computing the revenue autonomy index

County	Total revenues county level	Own revenues (percentage of total)	Transferred revenues (percentage of total)
Bacau	83466	29913	53.293
BistritaNasaud	59943	11669	35551
Braila	54630	14144	40176
Cluj	178014	74141	103872
Constanta	167979	86460	81517
Covasna	40547	12311	28268
Dambovita	81146	27495	53651
Giurgiu	59276	20042	38.732
Harghita	70975	39864	40.926
Hunedoara	92289	34683	51.504
Ialomita	48.024	11.453	36.570
Maramures	106947	29459	77.488
Mures	121042	41465	79.577
Neamt	102193	18302	83.875
Olt	80170	17080	63085
Timis	132735	58482	74.168
Vrancea	66584	29106	51072

For computing the local expenditure autonomy index

County	Total expenditures	Transferred expenditures	Own expenditures (in percentages)
Bistrita Nasaud	59943	35465	40,83546
Braila	54630	30600	43,98682
Cluj	178014	68305	61,62942
Constanta	167979	66790	60,23908
Covasna	40547	19469	51,98412
Dambovita	81146	46374	42,85116
Giurgiu	59276	27985	52,78865
Hunedoara	92289	36260	60,71038
Ialomita	44109	24629	44,16332
Maramures	106947	56216	47,43565
Mures	97238	55385	43,04181
Neamt	102193	57880	43,36207
Olt	80170	46357	42,17662
Prahova	139412	64645	53,63025
Timis	132735	76332	42,49294
Vrancea	66584	36345	45,41481

Bibliography

Bird, Richard and Vaillancourt, Francois. 1998. "Fiscal Decentralization in Developing Countries: An Overview" In *Fiscal Decentralization in Developing Countries*, ed. Bird, Richard and Vaillancourt, Francois, 1-49. Cambridge: University Press.

Bird Richard and Wallich, Christine. 1993. *Fiscal Decentralization and Intergovernmental Relations in Transition Economies*. Working Papers 1122. World Bank. http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/1993/03/01/000009265_3961004094828/Rendered/PDF/multi0page.pdf (13.05.2007)

Bird Richard, Ebel Robert and Wallich Christine. 1995. "Fiscal Decentralization: From Command to Market" In *Decentralization of the Socialist State- Intergovernmental Finance in Transition*, ed. Bird, Richard et al., 1-68. Washington D. C.: World Bank.

Blochliger, Hansjorg and King, David. 2005. *Fiscal Autonomy of Subnational Governments*. OECD Network on Fiscal Relations across Levels of Government: OECD. http://www.oecd.org/dataoecd/10/47/2765013.pdf (20.04.2007)

Boadway Robin, Roberts Sandra and Shah Anwar. *The Reform of Fiscal Systems in Developing and Emerging Market Economies*. Policy Research Working Papers 1259. Washington D.C.: World Bank. http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/1994/02/01/000009265_3961006021533/Rendered/PDF/multi0page.pdf (18.03.2007)

Boex, Jamie and Martinez-Vazquez, Jorge. 2003. *Designing Intergovernmental Equalization Transfers with Imperfect Data: Concepts, Practices and Lessons*. http://isp-aysps.gsu.edu/academics/conferences/conf2004b/Presentation9.pdf (10.05.2007)

Bordignon Massimo, Manasse Paolo and Tabellini Guido. 2001. "Optimal Regional Redistribution under Asymmetric Information." *The American Economic Review* 91, no. 3: 709-723.

De Mello, Luiz. *Fiscal Decentralization and Subnational Expenditure Policy*. World Bank. http://www1.worldbank.org (07.05.2007)

De Mello, Luiz R. 2000. "Fiscal decentralization and Intergovernmental Fiscal Transfers: A Cross-Country Analysis." *World Development* 28, no. 2: 365-380.

De Mello, Luiz R. and Barenstein Matias. 2001. *Fiscal Decentralization and Governance: A Cross Country Analysis*. Working Papers 01/07. International Monetary Fund. http://ssrn.com/abstract=879574 (28.04.2007)

Down, Brancati. 2006. "Decentralization: Fueling the Fire or Dampening the Flames of Ethnic Conflict and Secessionism?" *International Organization*, no. 60: 651-685.

Dunn, Jonathan and Wetzel, Deborah. 2000. *Fiscal Decentralization in Former Socialist Economies - Progress and Prospects* World Bank.

http://www1.worldbank.org/wbiep/decentralization/Courses/Budapest%204.10.00/wetzelECAwico.pdf (03.04.2007)

Ebel, Robert and Yilmaz, Serdar. 2002. "On the Measurement and Impact of Fiscal Decentralization" In *Public Finance in Developing and Transition Countries: Essays in Honour of Richard Bird*, ed. Martinez-Vazquez, Jorge and Alm James, 101-126. Northampton: Edward Elgar.

Falleti, Tulia G. 2005. "A Sequential Theory of Decentralization: Latin American Cases in Comparative Perspective." *American Political Science Review* 99, no. 3: 327-346.

Fisman, Raymond and Gatti, Roberta. 2002. "Decentralization and Corruption: Evidence from across Countries." *Journal of Public Economics*, no. 8: 325-345.

Garret, Geoffrey and Rodden, Jonathan. "Globalization and Decentralization." In *Annual Meeting of the Midwest Political Science Association*. Chicago, 2000.

Ionita, Sorin. 2003. "Halfway There: Assessing Intergovernmental Fiscal Equalization in Romania" In *Dilemmas and Compromises: Fiscal equalization in Transition Countries*, ed. Slukhai, Sergii, 35-63. Budapest: Local Government and Public Service Reform Initiative - Open Society Institute.

Kirchner, Emil and Christiansen, Thomas. 1999. "The Importance of Local and Regional Reform" In *Decentralization and Transition in the Visegrad*, ed. Kirchner, Emil, 1-18: Macmillan Press.

Leonardo Gabriel, Martinez-Vazquez Jorges, Miller Benjamin and Sepulveda Cristian. 2006. *Intergovernmental Fiscal Relations in Romania: Challenges and Options for Reform*. International Studies Program Working Papers 06-19. Andrew Young School of Policy Studies. http://isp-aysps.gsu.edu/papers/ispwp0619.pdf (12.05.2007)

Martinez-Vazquez, Jorge and McNab, Robert. 2001. *Fiscal Decentralization and Economic Growth*. Working Papers 01-1. Atlanta: Andrew Young School of Policy Studies. http://isp-aysps.gsu.edu/papers/ispwp0101.pdf (05.05.2007)

________. 2005. *Fiscal Decentralization, Macrostability and Growth*. Working Papers 05-06. Atlanta: Andrew Young School of Policy Studies. http://isp-aysps.gsu.edu/papers/ispwp0506.pdf (10.04.2007)

Meloche, Jean-Philippe, Vaillancourt Francois and Yilmaz Serdan. *Decentralization or Fiscal Autonomy? What Does Really Matter?* World Bank Policy Research Papers 3254. World Bank. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=524903 (07.05.2007)

Montero, Alfred and Samuels, David. 2004. "The Political Determinants of Decentralization in Latin America" In *Decentralization and Democracy in Latin America*, ed. Samuels, Alfred Montero and David, 3-32. Notre Dame, Indiana: University of Notre Dame Press.

Musgrave, Richard A. 2000. "Fiscal Federalism" In *Public Finance and Public Choice- Two Contrasting Visions of the State,* ed. Buchanan, James and Musgrave, Richard 155-176. Cambridge: MIT Press.

Norris, Era-Dabla and Wade Paul. 2002. *The Challenges of Fiscal Decentralization in Transition Countries*. Policy Research Working Papers 103. World Bank. http://www.imf.org/external/pubs/ft/wp/2002/wp02103.pdf (29.04.2007)

Oates, Wallace E. 1991. "The Challenging Structure of Intergovernmental Fiscal Relations" In *Studies in Fiscal Federalism*, ed. Oates, Wallace E., 39-48. Aldershot, England: Edward Elgar.

________. 1991. "An Economist's perspective on Fiscal Federalism" In *Studies in Fiscal Federalism*, ed. Oates, Wallace E., 21-38. Aldershot: Edward Elgar.

________. 1999. "An Essay on Fiscal Federalism." *Journal of Economic Literature* 37: 1120-1149.

________. 2006. *On the Theory and Practice of Fiscal Decentralization*. IFIR Working Papers 2006- 05. Institute for Federalism and Intergovernmental Relations. http://www.ifigr.org/publication/ifir_working_papers/IFIR-WP-2006-05.pdf (15.05.2007)

Oxhorn, Philip. 2004. "Unraveling the Puzzle of Decentralization" In *Decentralization, Democratic Governance and Civil Society in Comparative Perspective*, ed. Oxhorn, Philip, 3-33. Washington D. C.: Woodrow Wilson Center Press.

Persson, Torsten and Tabellini, Guido. 1992. *Federal Fiscal Constitutions: Risk Sharing and Moral Hazard*. Discussion Paper 72. Minneapolis: Institute for Empirical Macroeconomics http://www.minneapolisfed.org/research/DP/DP72.pdf (15.04.2007)

Pratchett, Lawrence. 2004. "Local Autonomy, Local Democracy and the New Localism." *Political Studies* 52: 358-375.

Prud'homme, Remy. 1994. *On the Dangers of Fiscal Decentralization*. Policy Research Working Paper 1252. Washington D. C.: World Bank.

Rubinfield, Daniel L. 1987. "The Economics of the Local Public Sector" In *Handbook of Public Economics,* ed. Martin, Auebach Alan J. and Feldstein, 2, 571-648. Amsterdam: Elsevier Science.

Schneider, Aaron. 2003. "Decentralization: Conceptualization and Measurement." *Studies in Comparative International Development* 38, no. 3: 32-56.

Shah, Anwar. 2005. *Fiscal Decentralization and Fiscal Performance*. Policy Research Working Papers 3786. World Bank. http://info.worldbank.org/etools/docs/library/206744/Fiscal%20Decentralization%20and%20Fiscal%20Performance.pdf (20.02.2007)

________. 20004. *Fiscal Decentralization in Developing and Transition Economies*. Policy Research Working Papers 3282. World Bank. http://siteresources.worldbank.org/PAKISTANEXTN/Resources/pdf-Files-in-Events/IRISD/FiscalDecentral02.pdf (20.03.2007)

Shah, Anwar and Thomson, Theresa. 2004. *Implementing Decentralized Local Governance - Treacherous Road with Potholes, Detours and Road Closures*. Policy Research Working Papers 3353. World Bank. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=610397 (19.04.2007)

Smith, B. C. 1985. *Decentralization - The Territorial Dimension of the State*. London: G. Allen and Urwin.

Smoke, Paul. 2001. *Fiscal Decentralization in Developing Countries: A Review of Current Concepts and Practices*. Democracy, Governance and Human Rights 2. United Nations Research Institute for Social Development. http://lorc.ryukoku.ac.jp/docs/smoke.pdf (20.03.2007)

Thiessen, Ulrich. 2005. *Fiscal Federalism: Normative Criteria for Evaluations, Developments in Selected OECD Countries, and Empirical Evidence from Russia*. Discussion Paper 518. Berlin: German Economic Institute for Economic Research. http://www.diw.de/deutsch/produkte/publikationen/diskussionspapiere/docs/papers/dp518.pdf (29.03.2007)

Yin, Robert K. 1994. *Case Study: Research Design and Methods*. London: Sage.

Legislative References:

Constitution of Romania, available in English at [http://www.cdep.ro/pls/dic/site.page?id=339&idl=2] (last accessed 30.05.2007);
Law 340/ 2004, published in the Official Gazette of Romania no. 658, July 2004;
Law 94/ 1992, republished and amended; the Official Gazette of Romania no. 116, March 2000;

Law 195/ 2006, published in the Official Gazette of Romania no. 453, May 2006;

Law 273/2006, published in the Official Gazette of Romania no. 618, July 2006;

Governmental Degree 158/ 2005;
Fiscal Code of Romania, Law number 571/ 2003 republished and with subsequent modifications;
Romanian National Institute for Statistics; [http://www.insse.ro/cms/files/pdf/ro/cap21.pdf] (last accessed 25.05.2007)

Web links:

http://www.csjbacau.ro/2006actualizari/bugetfinante/bugetdetaliat/bugetdetaliat.htm
http://www.cjbn.ro/popup/buget/2006/
http://www.portal-braila.ro/index.php?meniuId=43&viewCat=1016
http://www.cjcluj.ro/buget-venituri-1/

http://www.cjc.ro/
http://www.covasna.info.ro/Buget/bugetcjc.pdf
http://www.cchr.ro/index.php?option=content&task=view&id=281&Itemid=77
http://www.cicnet.ro/Buget_2007/anexa_cont_exec_2006.pdf
http://www.cicnet.ro/Transparenta/RAPORT_2006_.pdf
http://www.cjmures.ro/Hotariri/Hot2006/hot150_2006.htm
http://www.cjneamt.ro/download/Anexa%20ven%20HCJ%20a.pdf
http://www.cjph.ro/index.php?_init=consiliu.hotarari_list&
http://www.cjtimis.ro/buletininfo/H03_2006.pdf
http://www.cjvrancea.ro/htmluri/info.html
http://www.cjneamt.ro/download/Anexa%20chelt%20HCJ%20b.pdf
http://www.cjneamt.ro/download/Anexa%20ven%20HCJ%20a.pdf
http://www.cjhunedoara.ro/index.php?meniuId=7&viewCat=1144
http://www.cjgiurgiu.ro/?action=buget