HALFWAY THERE
Assessing the intergovernmental fiscal equalization in Romania[*]

ABSTRACT

Immediately after the fall of the Communist regime, Romania made some timid steps towards decentralization. The process has accelerated in 1997-98, with the passing of a new Law on Local Public Finance, but there are still many flaws in the functioning of intergovernmental finance. This paper focuses on a particular category of transfers − the equalization grants − and highlights the achievements and the shortcomings identifiable so far. The analysis is based on budget execution data from all local governments of Romania: 41 counties and 2,950 localities (safe for the capital, Bucharest, which has a special status and does not receive equalization funds). While many conclusions and recommendations are country-specific, some are more general and may apply to other transition countries too.

First, states with weak administration and poor financial discipline should not attempt to implement complex redistribution rules or rely on data that are difficult to develop or unreliable. Many times second-best solutions should be adopted if they minimize the implementation costs and increase transparency and predictability, preventing narrow interest groups from taking advantage of intricacies and abuse the system. Simplicity and the daylight are the best disinfectant for public funds.

Second, the battle lines in the process of decentralization are not always clear-cut, with the good guys on one side (local governments) and the bad ones on the other (central government, presumably opposing decentralization). Instead, local decision-makers may cherish those aspects of decentralization that bring them more resources, but not those that require painful decisions, and hence incur political costs. They may prefer a situation when funds keep coming from the center, instead of having to raise own resources from the community and pay a political price for it. This is important, because many times the analysts assume that local politicians do want more local autonomy − which may not be the case.

Third, local governments are not a monolithic group: different tiers or types of localities may have diverging interests when it comes to financial decentralization, and the central government ends up as a mediator rather than a player in the process. For example, in Romania's case, too much discretion for county councils in the allocation of funds affects the financial autonomy of localities. A careful balance should be found between the legitimate interests of all tiers of government, so that the resources match responsibilities and moral hazard or rent seeking situations are avoided.

Finally, the new democracies should learn that good governance means not only passing legislation, but also implementing it, collecting feed back on a steady basis and adjusting the policies whenever necessary. Had the Romanian decision-makers done so in the case of intergovernmental equalization, they would have noted that the main goal of the whole exercise − i.e. equalization − is often not met. Because of its loopholes, the system works erratically and even, in some instances, transfer resources from poor communities to rich ones. This paper concludes with a set of recommendations aimed at making the Romanian equalization system simpler, more transparent and, as a result, fairer.

1. Introduction

Like all the other ex-Communist countries Romania started, in early nineties, the transition towards democracy and the market economy in a global intellectual environment where decentralization and the public sector reform were the words of the day. There were many motives why most of the developed and developing nations have engaged in decentralization in the last decades: stimulate economic growth, reduce urban-rural disparities, deepen democracy and encourage the civil society at the local level. All were objectives only partially fulfilled through the previous top-down policies pursued by the centralized states (Manor, 1999). In other cases, central governments wanted simply to get rid of part of the development burden at a time when the public sector was facing tighter budgetary constraints, by placing it on the shoulder of locally elected politicians. In a way or another, decentralization was seen as the right solution to many types of problems.

However, it was soon discovered that, as it always happen in real life, any policy has its own downside. More local autonomy and less central intervention in resource allocations lead to increasing disparities among communities. The tolerance towards inequality is not very high in the region, given the expectations built into the public in the decades of Communism, and the previous centralist tradition of the pre-Communist states. Inefficiency and corruption can also be decentralized, so that there is no guarantee that by simply transferring more attributions and resources to local governments the state will function better. On the contrary, the overall public spending may increase, creating additional problems for the national macro equilibria. Moreover, when designing and promoting decentralization the central government officials and experts assume that local decision makers prefer more autonomy and self-reliance, rather than less. However, this is not always the case: often local officials avoid making use of their full decision-making power, especially when it comes to the raising local taxes, if they have the more convenient alternative of getting funds from the center without any political costs attached.

These considerations converge into a more general vision that underpins all the proposals outlined in the final part of this paper: in spite of the apparent complexity of the equalization system, its design and monitorization cannot be left entirely to technical experts. The role of technical expertise in the process of policy making must be better understood. Too often, we live in Central and Eastern Europe with the impression that each public problem has one right solution, and all we have to do is find the best experts in the field – and occasionally, appoint them in positions of power – to sort things out. This is naïve and unworkable. Experts, whether they are in public institutions or independent, can help by framing the discussion properly, identifying and analyzing alternative courses of action, pointing out inconsistencies in existing policies, and clarifying options. But ultimately, like in other public policy areas, the basic design of the intergovernmental fiscal relations embodies fundamental choices that must be made deliberately, by the broader community as much as possible in an informed and rational manner. In our case, for example, there are trade-offs where a decision is needed, such as: how much money should be eventually transferred (i.e. how much equality do we want to achieve); or what is the right balance between economic efficiency, which may require larger local governments, and a higher degree of autonomy in smaller, traditional local units that may be sub-optimal from the economic point of view. Another trade-off exists between the flexibility of fiscal arrangements, allowing adjustments or bailouts by higher-level

governments of local communities in need, and the safeguards against discretionary political interference or rent-seeking behavior.

All these considerations must be taken into account when designing the intergovernmental financial relations. The equalization grant systems must strike the right balance between local autonomy and national solidarity, administrative tradition and the new public sector reform requirements, self-interest and external control. Unfortunately, it is a rare case when such decisions are taken in a coherent and deliberate way. Most often, the system of relations between the tiers of government in a country evolve at least in part by default, its structuring being the by-product of economic and fiscal decisions that do not follow a deliberate decentralization strategy, or the result of institutional struggles among local interest groups. Romania is no exception, though some rationality has been instilled into the system with the 1998-99 reforms.

This paper analyzes the functioning of the equalization grants in Romania a few budgetary cycles after they were introduced. The basic questions are: have they actually fulfilled their goal so far – i.e. provide extra resources to the poorest communities? And can something be done to improve their effectiveness? The next two sections present and discuss the structure and legal framework of local governments in Romania, focusing on those elements that influence the equalization transfers. Section four analyzes the functions and revenues of local governments, and the influence of their assignment on local disparities. Section five evaluates the grants system, with its two conceptual components – vertical and horizontal equalization – and outlines its current shortcomings. The final section concludes with a blueprint for reforms aimed at improving the equalization system, phased over two stages: short term and medium term.

ABBREVIATIONS
ASBL – the annual state budget law
CEE – Central and Eastern Europe
LG – local government
LLPF – Law of Local Public Finance
LLT – Law of Local Taxes
MoF – Ministry of Finance
PIT – personal income tax
VAT – value added tax

2. The Structure of Local Governments in Romania

The local administration in Romania is organized on two tiers: localities and counties (Fig. 2.1). There is no hierarchical administrative subordination between localities, counties and the central government, each constituting a component of the public sector with full political legitimacy. The ruling bodies of the localities and counties are the councils, elected directly every four years. Since both convene only periodically, usually not more than 2-3 times per month, they need executive structures to oversee the daily operations of local governments. In practice, the counties are led on a daily basis by a Standing Delegation elected by the councilors from their own ranks, headed by the county president, also elected by the councilors. The county presidents exert very much power, formally and informally, since they

control the budgets, the appropriations process and human resource policies of the executive bodies of the county government, plus, under the current system, a good part of the equalization funds distributed to the localities in the respective county.

The councils of cities, towns and communes elect council chairmen too, but they have far less power than the county presidents − actually, they are not part of the executive of the local governments proper. Instead, the head of the executive is the mayor, elected directly through uninominal vote[1] for a term of four years in the same local elections, and hence possessing his/her own political legitimacy.

The only exception from the uniform pattern outlined above is Bucharest, with a special − and, in some respects, unclear − status). The capital city does not belong to the Ilfov county − which for the purpose of this paper makes little difference, since Bucharest does not get equalization funds anyway − and so indirectly enjoys county status. On the other hand, it is divided into of six 'sectors' with their own elected councils and mayors. Each sector has approximately the population of an average county, and most of the attributions that are common for large cities.

Fig. 2.1. Central and local governments (2 tiers) in Romania

→ Directly elected; political legitimacy
⇒ Appointed; political control

Government

Parliament

County Councils
(41 counties)

Prefects
(41 counties)

Local Councils
(2,951 localities)

MAYORS
(2,951 localities)

VOTERS

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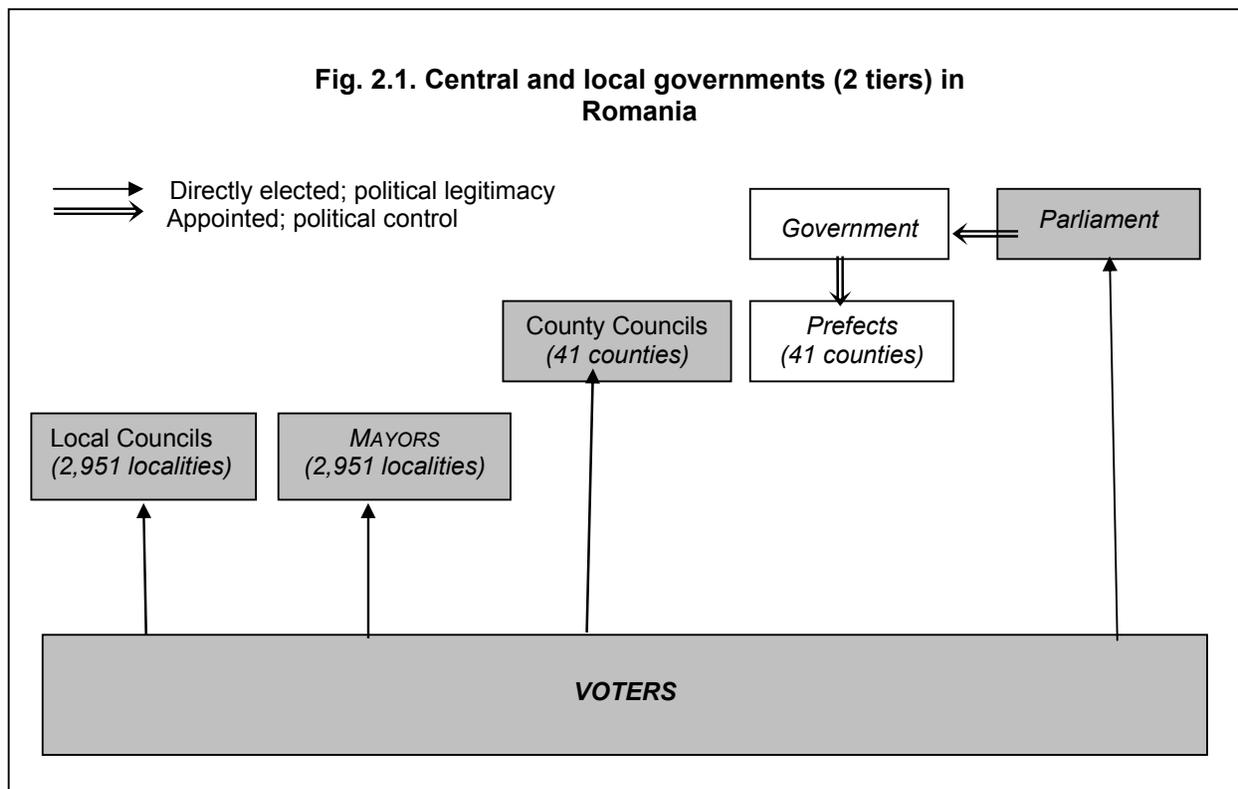
[1] As a result, there are three ballots in Romanian local elections: party lists for county councils, party lists for locality councils, and uninominal ballots for the office of mayor.

In brief, counties have monolithic government, while localities have dual government with the power split between the legislative and executive. In theory each of them is independent from the higher-order authorities and accountable only to the citizens. In practice the real distribution of powers between tiers of government, or executives and legislatures vary a lot, being influenced by the party affiliation of mayors and council majorities, their relationship with the prefect, and, last but not least, by the personality of mayors and county presidents. Sometimes, especially in the case of cities, mayors can be powerful characters who manage to act almost independently from their councils, very much in the way a strong British prime minister controls its parliament. On the other hand, the real independence of action in local government can be constrained by the lack of administrative capability, opaque budgetary allocations or interference from the part of the central government. This is usually the case in poor rural communes, where mayors and local councils try to build good informal relationships with the president of the county council, the prefect or the deconcentrated offices of the ministries, especially the Ministry of Finance, in order to make their ends meet.

Paralleling this structure, there is also a number of offices that are not local government proper, but nevertheless influence the local policies in general, and the equalization process in particular. *The prefects* are the representatives of the central government in territory, acting as coordinators of the ministry branches at the county level and heads of the territorial emergency services. They also perform the "legality supervision" of the decisions taken by local governments, both at county and locality level, which means they can sue LGs in administrative courts whenever they consider an act or action undertaken by councils or mayors in their jurisdiction exceeds the limits of the Constitution or national laws. In such cases the local decision or action is suspended until the court issues a final ruling. Since they are not elected but appointed, prefects are not part of the system of local government proper, being an impartial instrument of central government's check over locally elected officials. However, since the local elections are held every four years just a few months before the general ones, and so the ruling party is likely to have majorities in many county councils too, the prefects tend to have close party links with the county councils and presidents. As a result, prefects are perceived as officials with a pro-county bias. They are more likely to take tougher action against local councils or mayors, especially the ones affiliated with an opposition party.

Some ministries such as Finance, Transportation and Public Works, Agriculture, Environment or Home Affairs have offices in territory, typically in county capital cities. While all of them have legal attributions in aggregating sectoral policies, some are important for the activity of all local governments. The Romanian public institutions must keep all their funds in the State Treasury[2], which is a unit of the Ministry of Finance. The Treasury offices collect and disburse all the funds in / from the LGs' accounts. Moreover, the County Directorates of MoF assist LGs in the process of preparing their own budgets, aggregate financial data for reporting purposes, collect and allocate the shared national taxes (PIT and VAT). The frequent interactions of these MoF branches with the LGs make them important instruments into the hand of the central government for exerting informal control over local affairs.

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[2] Romania has adopted the National Treasury system of unified cash management.

3. Sub-national government framework

By tradition, the modern Romanian state born in the second half of the 19th century copied the centralized, uniform structure of the French republic. Most of the time since its inception the local governments were organized on two tiers (though there were several attempts to create a third tier). But if the details of the administrative structure changed several times in the last century and a half, the institutional culture in the local government has remained more or less the same: central government's intervention in the local affairs is tacitly accepted, or at least tolerated, especially when it comes from the office of the Prefect. Local autonomy has never been as strong as in the Central Europe, which was exposed more to the German influence. Moreover, since nation- and state-building were top priorities in the 19th century, all the other political goals had to be subordinated to the urge to create a modern and functional national body politic and bureaucracy. The local needs and agendas were seen as secondary and accepted only as long as they did not threaten the interests of the broader, national community.

Therefore, a uniform pattern of the local units was created which, though not totally independent of the regional traditions, was meant to serve first of all the functional imperatives of the young state. Grassroots democracy has been traditionally weak, and all the attributions of the local governments, irrespective of the formal constitutional setting, were perceived as mandates or liberties delegated or created by the nation state.

The Communist regime that took over in 1948 operated many changes in the local government framework, but found the old arrangements fundamentally convenient for its own purposes. Since the local communities were generally accustomed to being patronized − and sometime abused − by the central government, they did not represent a real obstacle for the new authorities. As a result, when decentralization was embarked upon immediately after 1989, being regarded as a mandatory stage on the 'road towards Europe', the historical experience of local self-government was neither rich, not very useful in the new context. Creating a functional network of local governments turned out to be both a challenge, because of the difficulties, and an opportunity, since a new system could be build up from scratch in a coherent manner.

As it happens in real life, a complex system such as this could not be organized entirely rationally. Many decisions that affected the process of decentralization were taken by default rather than deliberately, and the final result is sub-optimal. Many characteristics that support this conclusion will be discussed further in this material − and a good deal of them have to do with the allocation of transfers and the equalization grants. But eventually a system did emerge. As far as the intergovernmental fiscal relations are concerned, it relies on four main streams of legislation:

- The Law on Local Public Administration (LLPA), adopted in 1991 and amended many times afterwards, until it was replaced by a new LLPA in 2001. This piece of legislation defines the structure and attributions of the local governments in Romania, at both the local and county level. It actually formalizes the return to the Romanian sub-national administrative structure from the interwar years[3]. The language is rather general as far as the functions are concerned, enumerating a

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[3] With slightly larger counties: 41 now instead of 60 before World War II within the current borders of Romania (or 74 including the ceded territories).

long list of attributions and making very few distinctions between the two levels of local government.

- The Law on Local Taxes (LLT), adopted in 1993, and modified in 2002. This act established in law the notion of own taxes, controlled and levied by the local governments (though the control has never been total). Thus, the property tax became the main source of own revenues for the sub-national government in Romania.

- The Law on Local Public Finance (LLPF), adopted in 1998. This act governs the system of transfers among tiers of government, the shared taxes, the equalization grants and the municipal borrowing issues. In its current form it represents an attempt to codify and make more transparent and rule-based the revenue-sharing system in Romania. The Annex of the law contains the chart of accounts that must be used by local governments in managing their own revenues and expenditures.

- The Annual State Budget Laws (ASBL), which governs one budgetary cycle (Jan-Dec) and must be passed by the Parliament before the end of the previous year. ASBLs specify the total amount of funds transferred from the central budget to local governments in the form of equalization money or conditional grants. It also sets the criteria to be used by the Ministry of Finance and counties in the process of equalization.

While in the early '90s the ASBL was the focus of local government policy, reflecting a high degree of centralization in decision-making and high uncertainty at the local level, the situation has gradually changed in time. LLPA and LLT extended substantially the local administrative autonomy and created own sources of revenue for the local governments. However, many fiscal issues had not been sorted out and the predictability of the allocation process remained low.

Changes in the Local Taxes norms passed in 1997-98 increased LGs' control over their own revenues and authorized local councils to administer their own taxes. First, monitorization and collection of local taxes were entirely transferred to LGs. Second, an automatic formula of sharing the personal income tax (PIT) among the three tiers of government was introduced, which improved the predictability of the intergovernmental finance. A system of equalization grants was introduced, thus reducing central government's discretion in earmarking sums for LGs.

There are still shortcomings left, however, some of which became apparent only subsequently in practice. The rate of the shared taxes has been altered each year through ASBLs, though lately it has stabilized around the values specified in the LLPF. Special funds dedicated to investments continued to exist, and they are allocated to LGs in a way that is neither transparent nor very accountable. Some matching grants for investments are included in the state budget with a known destination. But some of them are simply given to the relevant line ministries, who are responsible for administering them (most often Public Works or Industries, since the typical investments are in roads, social housing, water systems, and gas pipes).

Another problem is the substantial interaction taking place, through both formal and informal channels, between county and locality officials in the process of drafting the budgets and allocating the transfer funds. As counties have to wait for the passing of the ASBL in order to see how much money they will eventually get, so the localities have to wait in turn for the county councils to finalize the equalization process. This

process creates many points of entry for political lobbying and the rent-seeking behavior.

4. Intergovernmental Fiscal Relations

In the last decade we have witnessed a steady process of reassignment of both functions and revenues to sub-national levels of government in Romania. The language of the LLPA drafted in 1991 was loose enough so as to accommodate without problems the subsequent reassignments. As a result, until 1997-98 a slow process of decentralization by 'creeping' took place. Two kinds of motivations at the central level may explain this process:

- Successive governments faced mounting external pressure to implement reforms packages, whether from the international financial institutions, bilateral aid agencies of the European Union. Decentralization has a crucial component in all these packages.

- The central government wanted to get rid of some spending and administrative burdens, and hence transferred responsibilities to the lower levels.

On the other hand, there were constraints that sometimes made the decentralization process look half-hearted, such as:

- The genuine concerns in central government regarding LGs' poor managerial capability, possibilities of fraud or municipal bankruptcy, overall public debt, rising inequality, etc.

- The well-entrenched paternalistic attitude towards LGs, who are not regarded as equals of the government by top officials and the public, no matter what the law says.

Fig. 2.2. Size of LG expenditure
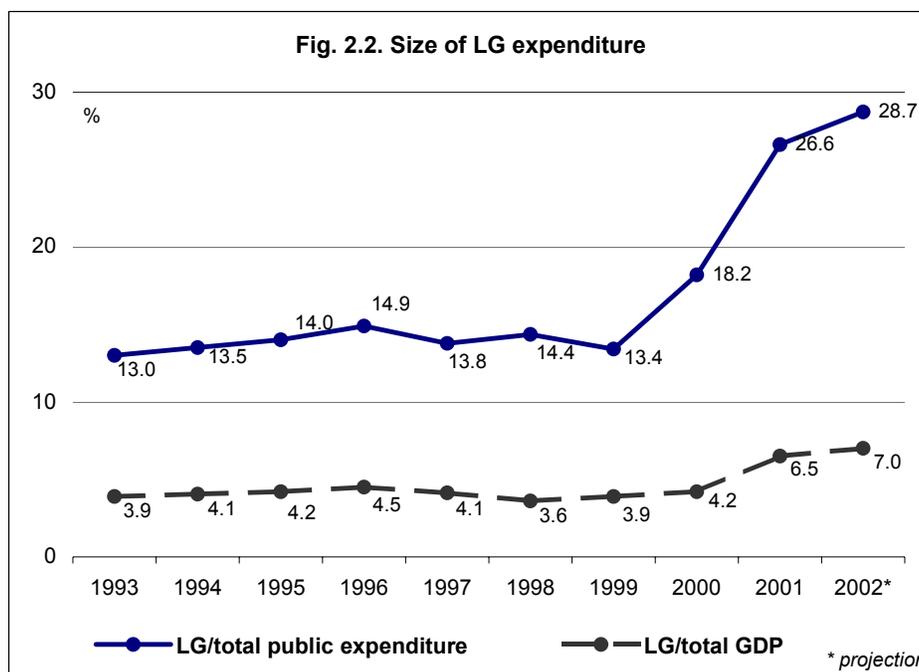
Nevertheless, the decentralization continued and actually gained speed on both dimensions − attributions and revenues − after the big push initiated in 1998 and continued in 2001. Fig.2.2 displays the evolution in time of the size of local governments expenditure. While the trend may be judged as positive, we should also bear in mind the warning of Vito Tanzi (2001): in modern and democratic societies, decentralization in spending correlates with a larger public sector. *In other words, some European countries may be more decentralized just because they have more state and less private sector in their societies.* Many times when assets or services are privatized, these are more likely to come from the portfolio of local governments. Which is to say that privatization may be an even better alternative than decentralization.

4.1. Functions of local governments

Central authorities have a tendency of maintaining control over the level of expenditures in LGs from macroeconomic reasons on the one hand, and because they are partially funded form the state budget on the other hand. Local autonomy is strongly restricted when central authorities micro-manage expenditures at the local level. In fact, in this situation, local authorities are only used as agents in executing national policies (such as education) or play the part of revenue distributors (up to an amount set at the central level) to public services that, by their nature, need to be provided at the local level (utilities). At the other extreme, in case of strong local autonomy, the central authority only plays the part of control in the consolidated level of local governments, leaving them the whole decision-making power on the amount of expenditures and their allocation.

Fig. 2.3. LG expenditure, USD
(average yearly exchange rate)

* projected
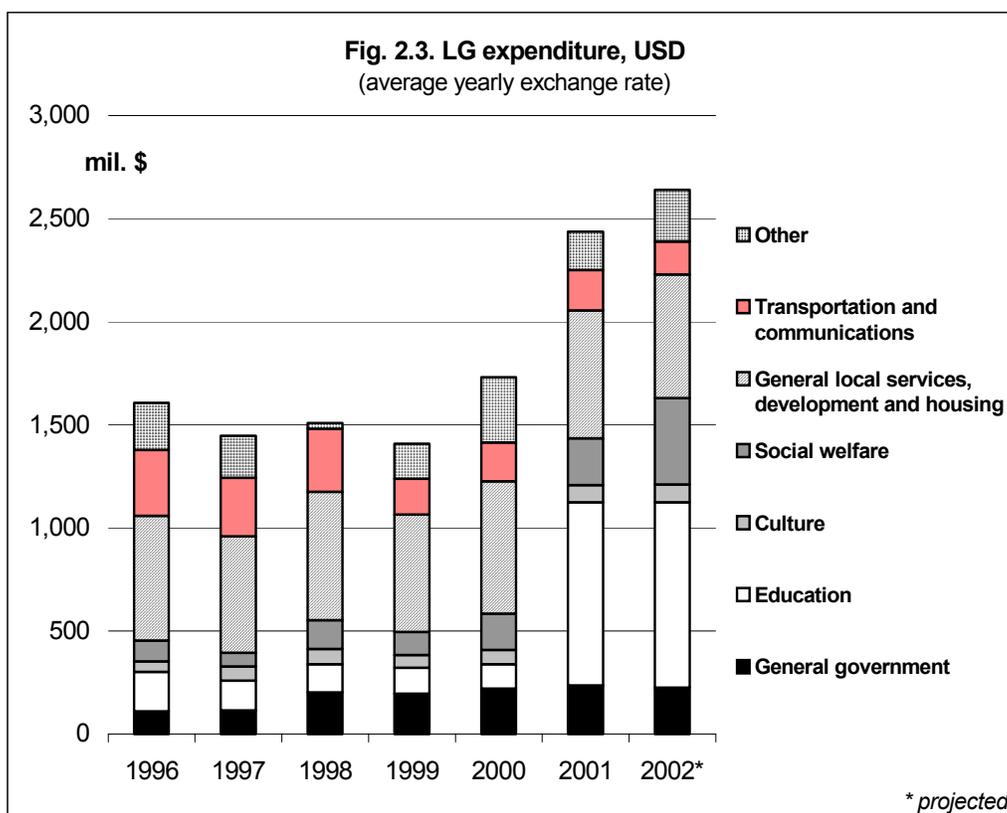
The ex-communist countries, Romania included, are somewhere in-between these two extreme cases. Their place on the continuum is defined by the combination of own and mandated functions imposed on them by the central government. The analysis below distinguishes between mandatory and optional tasks of LGs, taking into account they way a particular service is financed, provided and regulated, as well as the degree of limitation of local decision-making power each of them implies. Fig.2.3 gives an idea of the functional structure of expenditures at the local level in 2002, which is the most expanded the Romanian LGs have seen so far.

Several observations can be made about the attributions of LGs in Romania, in connection with their degree of autonomy. First, the scope and size of services increased steadily over time, as the central government transferred additional functions to lower levels. Currently The most important mandates, both in terms of visibility and share in the local budgets, are the ones that were transferred (or redefined) more recently: *education* and *welfare support*. Second, some mandates were terminated, such as the obligation to subsidize the local public transportation. And third, many substantial attributions are currently in process of being decentralized, such as police, emergency services or the specialized health sector. All these generate important effects for the equalization system. The new functions and mandates will probably reinforce the current trend of increasing the share of LG expenditure in the total public expenditure through earmarked sums allocated by the central government, both by functional destination and geographical area. In practical terms, this will reduce both the share of own revenues in LGs' budgets and their autonomy to make spending decisions.

On the other hand, the government argues that the decentralization agenda will not be expanded forever, and this will be the last wave of substantial reassignments of functions. When these are completed, in one or two years, the situation will stabilize and we shall have a clearer picture of the costs of each service – and of the true vertical and horizontal imbalance in the Romanian intergovernmental fiscal relations. Then, the central government committed themselves to relax some of the mandates now imposed on the local governments, and transform some of the dedicated transfers associated with them into own revenues, or at least general purpose tax shares. Until then, the pure quantitative analysis of trends in both expenditures and revenues is a bit misleading if it is not supplemented with an institutional assessment, as well as a description of the general direction of evolution.

Nevertheless, the overall impression one gains from the unfolding of the decentralization of functions in Romania is that a uniform template was used so that the attributions do not differ by region or type of local unit. The central government was in charge and the whole process is very much centrally driven. The principle of correspondence was followed most of the time in decentralizing the functions. However, there are marginal variations from this principle which could be attributed to 'subsidiarity by default': for example, when service provision is maintained at sub-optimal levels, either because of sheer institutional inertia or local opposition to the transfer of the service to the next upper level. A good case in point is education in small rural communities, provided in school that continue to function with very few pupils.

4.2. Revenues of local governments

According to the OECD classification (OECD, 1999), the fiscal discretion in local government should be judged with two criteria: freedom to determine the *taxable base* and the *tax rate*. Starting from a situation of complete local autonomy, when the LG can determine both the rate and the base of a tax, the freedom of movement is reduced in subnational units as the central government can intervene and set the base or the rate of a local tax − or both. In addition, various tax-sharing arrangements may range from those controlled by the LGs to those completely controlled by the central government. Judged on these terms, the situation of the Romanian LG own revenues is the following:

i) *Own revenues proper*, the most important of which are the local taxes and fees regulated by the LLT:

- Since 1997-98 until Jan 2003: there was some discretion in setting the tax rate, within a range specified by the law for the local *property taxes* (land, buildings, vehicles) and other *user fees* (licenses, permits, etc); all qualify for (b), but just

- After Jan 2003, when the new LLT will be enacted: all of the above are governed by the new Local Taxes Law, which narrows the range of local options for the property tax rate − so everything moves to (e)

- The special purpose taxes, that can be introduced by LGs at their own will, and other own revenues that are not affected by the new LLT remain in the category (a)

ii) *Personal Income Tax shares* (considered to be own revenues for the purpose of municipal borrowing, for example), qualify for the category **(d4)**: both the base and the rate are set by the central government, but the revenue is split automatically, on a monthly basis, according to a formula specified in the LLPF that can be modified by the Annual Budget (Tab 2.1). The PIT shares serve both for horizontal and vertical equalization, as it is shown in the next section.

iii) *VAT share grants*, allocated yearly through the Annual State budget. They were introduced for the first time in 2001, the amount of the transfers is set discretionary by the central government and the money is earmarked.

iv) Other transfers and subsidies from special funds, also defined in the ASBL.

Tab 2.1. The PIT shares assigned to LGs by LLPF and the Annual Budget Laws

	LLPF	1999	2000	2001	2002	2003
Municipalities	40%	35%	35%	36.5%	36.5%	36%
Counties, own	10%	15%	10%	10%	10%	10%
Counties, for equalization				15%	15%	16%	17%

The evolution in time of the proportion of each type of revenue is shown in Fig.2.4. LGs are allowed to introduce *new local taxes* (and then the revenue is usually earmarked for a specific purpose) for which they will determine freely the taxable base and the rate. Many have done so, but their total contribution to the budgets is hard to evaluate since they are not usually shown separately in the aggregated reports.

The percentage is likely to be small, though it may make a difference for the provision of that particular service.

Though in theory the government encourages LGs to become more self-reliant, this doesn't always happen in practice. There were instances when county prefects sued local councils in administrative courts when they try to introduce new local taxes (it happened in Bucharest in 2000). Some ministers reprimanded several times local councils that levied "unreasonable taxes on the already-impoverished population" (on pets, garbage collection, vehicles pulled by animals, park entrance fees, etc). The media, more often than not, is also ready to pour scorn on any such local initiative.

Fig. 2.4. LG revenues, USD
(annual average exchange rate)

* projected
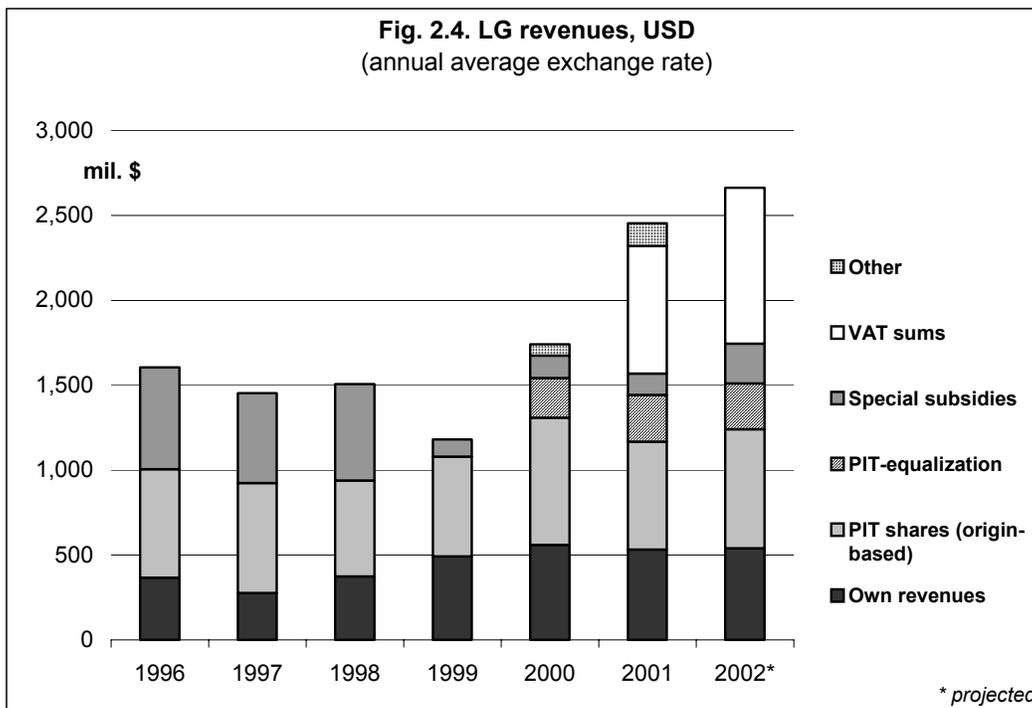
On the other hand, as mentioned above, the same government removed recently from the new Local Taxes Law the possibility of the LGs to go the other way and lower the taxes − the minister argued that, because of "populist reasons", irresponsible mayors were threatening the local own revenues base. The examples given were several large cities, but no hard data were produced to back the allegations. Moreover, there seems to be indeed a race to the bottom taking place in small towns or rural municipalities: the mayors underestimate their own revenues in the draft budgets in order to get more equalization funds. This is a typical case of substitution effect induced by the equalization system, was confirmed by local CFOs and it becomes apparent when one analyzes the difference between the projected budgets and the execution one year later: the projected own revenues have systematically been lower that what was actually collected realized.

The mayors and CFOs do not seem to be affected very much by the newly introduced limitations (the shift from b to e tax categories). They estimate that the new law, because of the zoning policy and other provisions, will increase their revenues by at least 20-25%.

5. The Equalization System

The equalization system is an important component of the intergovernmental fiscal relations, in both federal and unitary states. Even loose confederations like the European Union have set up systems to transfer funds between their components units − national states − in order to compensate for disparities in the level of development (structural funds) or cross-unit externalities (environmental or agricultural subsidies). In theory, LGs may provide public goods that not only benefit their own residents, but residents of other localities as well. Because of these externalities, the central government is assumed to set up programs of intergovernmental transfers that function as Pigovian corrective subsidies (Wildasin, 1997). If we consider, by stretching a bit the meaning of the concept, that a certain amount of equality among regions and localities is also a public good, than the moral ground for the fiscal equalization is established: by redistributing a portion of the local income, the government maximizes the general welfare of the society.

However, the basic premise of the theory is that public-sector decision-making proceeds sequentially, in two steps. First, the central government's program of corrective intervention sets normative budgetary limitations for localities. Then, in turn, LGs choose their level of local taxes and expenditures according to the local autonomy principles. But the circle does not close here. After observing the local fiscal decisions, higher-level authorities can intervene in the third step with extra subsidies or bailouts, transparent or hidden under various disguises, in those places where resources do not match the "needs". Knowing this, the LGs can anticipate the moves of the central government and act in such a way so that they become net receivers of financial help − either by overspending or by not exploiting fully the local revenue generating power. This is a typical *moral hazard* situation, and all those who design equalization systems try to build safeguards against it.

Nevertheless, no matter how carefully these safeguards are projected, the basic fact remains that the equalization grants are subsidies for poor LGs − and like in the case any other good, poverty is something the more you pay for, the more of it you will get. In time the agents in cause will adjust their behavior creatively to the subsidy system rules, and the claims against the equalization system will multiply. In order to minimize these perverse effects, the analysis and recommendations below concerning the equalization system in Romania start from a few simple principles:

- The simpler, the better. Transparency discourages rent-seeking and makes rule-bending more difficult.

- Enforcing hard budget constraints (Kornai, 1986) is a prerequisite for any sustainable intergovernmental fiscal arrangements. The local budgets should be "hard" in the sense that the third step of intergovernmental policy mentioned above does not occur − or is exceptional enough so that it does not represent an easy exit for local officials. Moral hazard should thus be prevented, whether it is related to municipal borrowing proper, or overspending and accumulation of arrears.

- Whenever a change in rules needs to be made, it should lead to as little fiscal shocks as possible on the short run. In other words, new rules may be introduced as long as they determine a gradual departure from the status quo. Otherwise, it is unlikely that the fiscal reforms will be accepted by the majority of the stakeholders (Molle, 1997).

5.1. Sources of funds

There are two main sources of funds used for horizontal and vertical equalization in Romania: the Personal Income Tax (PIT) and Value Added Tax (VAT). Until 1999 the first was actually a simple salary tax and the central government used to allocate discretionary amounts to local governments through the Annual Budget Law from the total yield of the tax. It was only the LLPF that introduced in 1998 the notion of sharing the **PIT revenues** according to predefined quotas among the three tiers of government. The sums are collected by stoppage at origin (the location of the workplace) and transferred to localities, counties and the state budget on a monthly basis. Therefore the system works more or less automatically and is fairly predictable − which sometimes make people argue that the PIT shares can be assimilated to LG own revenues. However, the local governments cannot control the base, the rate or the collection system, and hence this is actually a typical shared tax. The total of sums allocated as shared PIT has increased in time from 50% of the total yield indicated in the text of the LLPF to 62.5% in 2002 (see Tab 2.1)[4], which reflects a higher degree of financial autonomy at the local level.

Of the PIT shares they receive, the counties must allocate some funds for the purpose of horizontal equalization. This amount was not defined as a specific share at the beginning, and hence the counties have tended to abuse the system by confiscating most of the funds. Starting with 2000 the State Budget Laws have split the county shares into two parts: own, and earmarked for equalization (Tab 2.1).

The rest of the PIT revenues (37.5% in 2002) goes to the state budget − but part of it returns to LGs as conditional grants attached to some mandates (hence serving the purpose of vertical equalization) or block grants for horizontal equalization. Eventually, the state budget is left with little more than 10% of the total PIT revenues. The actual split of PIT revenues by destination in the 2002 budget is detailed in Fig.2.5.

(Fig.2.5 and 2.6 about here, 2 pg. landscape – see at the end)

As mentioned before, the PIT sharing system combines the horizontal and vertical equalization. Moreover, the conditionality and destination of sums should be analyzed in connection with the assignment of functions discussed in the previous section. Certain aspects that influence the process of fiscal equalization should be outlined here. First, the PIT revenues transferred to LGs are split into two main categories:

- PIT shares ('*cote*'), defined according to the percentages specified in LLPF and Annual State Budget Laws (box S in Fig.2.5). Even though the ASBL can alter these percentages, they tended to remain stable in time, with a slight upward tendency that benefits LGs (Tab 2.1). Part of the shares that go to counties is earmarked for horizontal equalization (box 8). The percentages that define the PIT sharing are fixed for one budgetary cycle (and fairly stable since they have been first introduced) and apply to all local government units. No county or locality is allowed to change the rates or apply surcharges.

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[4] The LLPF was passed in 1998 and the article that specifies the shares was meant to serve just as guidance – an ideal target to be met in time – since the actual shares can be modified by Annual Budget Law. In the first year when the new system was implemented, 1999, the actual percentages were indeed lower than those provided by in LLPF (Tab 2.1).

- PIT 'amounts' ('sume'), defined discretionary by the central government in the Annual State budget Law (box A in Fig.2.5). There is no legal requirement as to how large this pool of funds taken from the central government's share of PIT should be. However, it has always revolved around 25% of the total collection.

Fig.2.7 represents in simplified form the flow of funds for equalization, with their two main components, E and S, and the two-step transfer for the component E.

**Fig. 2.7. The basic design of the equalization system in Romania
     (E = boxes 3 and 4; S = box 8 in Fig.2.5)**
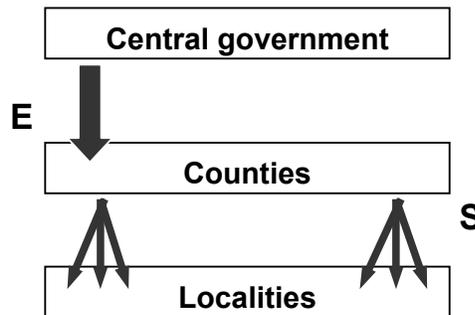
The PIT 'amounts' (box A) serve both for vertical and horizontal equalization:

- Welfare support, introduced for the first time by the 2002 budget (box 1): general welfare support distributed by LGs and based on means testing; residential heating supplementary subsidy (heating vouchers), also based on means testing

- General price subsidy paid to the utilities through the local budgets (box 5)

- Horizontal equalization grant allocated to counties; they can withhold up to 25% of it for their own use (box 3), and distribute the rest to localities from their jurisdiction (box 4).

The grants depicted in boxes no.1, 2, 4, 5 and 8 (Fig.2.5) are those where County Councils can intervene in their allocation by localities, because the money is transferred first to them and they distribute it further. The language of the law is not clear − typically it refers to 'consultations' among county councils, mayors and the relevant deconcentrated ministry offices. The issue is important especially for the process of horizontal equalization (boxes 3, 4 and 8) and creates problems in the allocation of funds. We will come back to this in the next section.

The second source of funds for equalization is the **VAT yield**. Since VAT is a purely national tax, the central government allocates conditional grants in relation with a set of attributions that were transferred to LGs starting with 2000. The sums by destinations and counties are specified in the annex to the State Budget Law. The total pool of money to be transferred is not defined in any law, since VAT sharing was only introduced in 2001 and the need for flexibility prevailed at a time when major reassignments of functions are still under way. Nevertheless, the total VAT share transferred to LGs did not vary too much in the two years when it was used:

about 31% of the revenues collected in 2001 and 33% in 2002. The actual split of VAT revenues by destination in the 2002 budget is displayed in Fig.2.7.

The counties get the sums from the state budget, following the list annexed to the State Budget Law. In turn, the counties transfer the funds further to localities, where applicable (boxes 2, 3, 4 and 6), according to the local needs that were originally incorporated into the draft local budgets. There is still not much experience with this process, and no firm criteria to be followed. As a result, the process is not very transparent yet. In practice, the county councils decide how much to give and to whom following the need estimates that fundamented the local draft budgets sent to the MoF in the first stage of the budgetary cycle. If the MoF allocated less money than the LGs requested at the aggregate level, then the shares of each locality are reduced proportionately. The whole process is based on consultations among county council presidents and mayors, with expert advice from the part of the county offices of the relevant ministries (Finance, Education, Welfare, etc.).

5.2. Vertical equalization

Vertical disparities in Romania have fluctuated widely in the last decade. In the early '90s, when the LGs were still not consolidated and lacked a reliable base of own revenues, most of the spending was controlled and financed from the center. As a consequence the disparities were high and many functions were matched by conditional transfers. By the mid-nineties, after the adoption of the Law of Local Taxes, the LGs were able to secure their own basis of revenues − the most important of which has been the property tax − and their fiscal independence increased. In 1996-98 the proportion of own revenues in total expenditure increased slowly to 25-30%[5].

The situation improved even more in 1999 and 2000, with the introduction of the PIT sharing system: if we include the automatic shares of the PIT allocated to LGs, the rate of coverage surpassed 50%. In these two years the total transfers from the state budget aimed at financing mandated functions were roughly one third of the LGs expenditure (the rest includes various subsidies and funds earmarked for non-mandated functions).

But the substantial reassignment of functions that begun in 2001 reversed the trend. Section 4.1. in this chapter explains why this happened: many new functions that were transferred to LGs created in fact mandates for the sub-national government (Tab 2.2). The typical cases are salaries in education and the national welfare policy, in which the central government maintains many points of intervention. In parallel with the task to execute these mandates, earmarked grants were created − supplementary PIT 'amounts' and VAT shares − to finance their provision. As a result, the total LG expenditure increased by almost 40% in absolute volume, the share of own revenues declined proportionately and the portion of transfers aimed at making up for vertical imbalances surged.

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[5] However, the real ($) values for 1999 are the least reliable due to a surge in the inflation rate that occurred in the spring of that year and which reduces the significance of the yearly average exchange rate.

Tab 2.2. Categories of expenditure in the LG budgets

		Before 2000	2001-2002
Not mandated	General local services	40%	25%
	Public transportation	20%	8-9%
Mandated	Education	10-12%	35%
	Welfare policy	5-6%	15%

This long term trend is reflected in the evolution of the Hunter coefficient − the ratio of own revenues to total revenues in LGs − over the last years (Fig.2.8). Since 1998, when the sharing of PIT was inaugurated and the shares proper have become quasi-own revenues (boxes 6 and 7 in Fig.2.5), the Hunter coefficient can be calculated in two ways:

- conservatively, by taking into account the own revenues only (the solid line);
- more broadly, by including among own revenues the PIT shares (the dotted line)

Fig. 2.8. Vertical imbalance: the Hunter coefficient (own revenues of LGs/total)
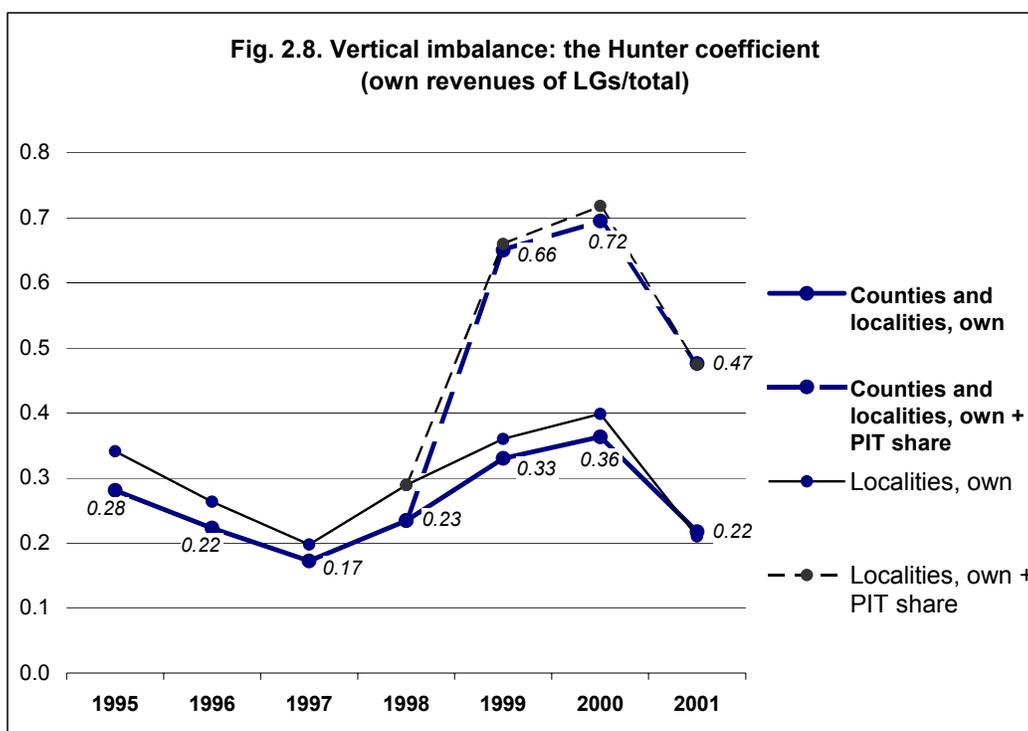
In both cases, the value is slightly higher if we separate the two tiers of local government and refer to the first one only (localities). In other words, localities have a little more control over their own revenues than counties do. However, the numbers may underestimate the important role the counties play in allocating the equalization amounts (box 8 in Fig.2.5), especially since they can decide how much of these funds they can withhold.

For both counties and localities, the trend is clear: the proportion of sums spent for covering the cost of mandates has risen, at the expense of the non-mandated functions. The situation is unlikely to change much in the near future. The government has set an ambitious agenda for the next one or two years − more attributions will be reassigned to LGs. The list includes police, disaster relief, emergency services, local power plants. The exact impact on the local budgets is hard to estimate, but the direction of change will be the same: more mandatory spending, and probably more dedicated transfers paid from the VAT revenues collected at the national level.

In the long run, the government will be probably able to transform some of the earmarked sums and subsidies into own sources of revenue (or at least general purpose transfers with stable allocation formulas, such as shared taxes) and the local budgetary process will become more stable. Until then, the attempts to do fine-tuning in revenue allocation are probably useless, and the attention should focus on the few big issues that can make a difference irrespective of how the final assignment of functions look like.

The process of transfer is complex and unpredictable and sometimes even the central government cannot control it fully. For example, some services that will be transferred to LGs must be first demilitarized (police, firefighters). This is a sensitive and visible issue. Most probably, it will be fiercely opposed by the stakeholders involved, who will not like to see their special military status abolished and become local civil servants instead of employees of a central ministry. This creates uncertainty and political risks until the reassignment is completed. Moreover, it is difficult to make an estimate of the real costs of these services as long as they are part on central ministries, because many auxiliary operations and overheads are shared with other departments. The only realistic option in this respect is learning by doing − and hence the central government has one more reason to continue for some time to use earmarked sums and preserve its rooms of maneuver.

5. 3. Horizontal equalization

The capacity of LGs to raise their own revenues varies substantially from one unit to the other. For example, the county revenues per inhabitant in the 2001 budgetary cycle range more than 1:3 from the poorest to the most well-off county (Tab 2.3). The range of variation is larger than that of the PIB per capita or any other measure of development, because it reflects not only the absolute level of poverty in a particular area, but also the incapacity of the government, central or local, to develop a tax base and collect revenues in that constituency. The value of property varies more than the average salary from one region to the other; moreover, the informal economic sector is much larger in some areas that in others − for example in predominantly rural regions with strip farming and household consumption of the production. Without valuable property to tax and official jobs that generate PIT in the constituency, the local governments cannot realize own revenues. If anything, the disparities are even more pronounced within than among counties. The power to generate own revenues in the lower tier of local government, the localities, varies from 1 to 600 (Tab 2.3).

The formula of PIT sharing introduced in 1999 is simple and straightforward (Tab 2.1), but it has a downside: it functions as a generator of horizontal imbalances, especially at the lowest level of LGs. Since the tax is collected at the point of origin

and then split among national, county and locality budgets, it benefits those municipalities (usually large cities or towns) which have many official jobs on their territory. When residents of rural settlements commute to work in the nearby town, the latter collects all the corresponding share of the PIT. Thus, the differences in revenue raising capacity are magnified, both at the local and county levels. Richer counties also benefit, because at the same level of personal income you are more likely to have a formal job here than in a poor county, where a larger part of the real income tends to remain hidden.

Tab 2.3. Variations in resources per capita in LGs: own revenues plus PIT shares, 2001

	$/cap	**Counties**	**Localities**
Average		8.6	33
Max		25.6	705
Min		2.9	1.2
Standard deviation / average		0.48	0.9

Therefore, the need arises to mitigate the effects of these discrepancies. There are many reasons to do this: it would be politically unacceptable to decrease the provision level under a certain threshold even in the poorest communities. Even if, strictly speaking, not all the local government functions are national mandates, certain general government and local services have to be offered to every citizen. Moreover, in the ex-communist states almost all local communities have inherited a network of local services, more or less extended, and a strong expectation that they will continue to function. Terminating this tacit social contract is difficult even in the direst financial situations. Many local governments are now confronted with the issue of over-extended services and shrinking finances − especially small towns, where the urban services cannot benefit from economies of scale.

Before the adoption of the Law of Local Public Finance in 1998, it was hard to distinguish in Romania between the vertical and horizontal equalization. Both kinds of imbalances were addressed through the distribution of conditional transfers. The criteria for the distribution were numerous and kept changing from one year to the other, while vertical negotiations at all levels were playing an important role. The basic idea was to develop a comprehensive set of normative criteria that could approximate as closely as possible 'the real need of the community'. Many things were factored in at one moment or another − such as the area, number of inhabitants, length of roads, size of the running water and sewerage systems, number of children in school, hospital beds, persons assisted in special institutions, but they were not specified in a text of law. The problem with this system was that the rules were cumbersome, negotiable and thus unpredictable. They created perverse incentives: the LGs had strong motives to oppose any kind of reform or rationalization in the social services, since the transfers were not linked with performance, but with the physical extension of the service.

Horizontal equalization was not so much a goal as such, but rather a by-product of the distribution based on normatives. Moreover, the pattern of allocation ran against it:

the richer and better endowed with local services a local community was, the more money was likely to receive. Corrections were applied to this distribution, but in a non-systematic manner.

The decentralization reform package initiated in 1998 separated the objectives and instruments for vertical and horizontal equalization. It also introduced the notion of fiscal capacity as a benchmark to be used in the process of equalization across LGs. At the beginning, the fiscal capacity was weighted only 30% in the process of equalization. The rest of 70% depended on a combination of normatives used as a proxy for the community 'need'. Gradually all the other criteria were removed one by one, so that in 2002 the fiscal capacity represents the only element used for horizontal equalization.

The gradual removal of needs as a factor in horizontal equalization, shown in Tab 2.4, is the result of a long debate that could not be settled in 1998. The 'fast reformers' (Ministry of Local Administration, foreign advisers) tended to favor a simpler solution based predominantly on the fiscal capacity principle. They also argued for the inclusion in the text of the precise notion of 'equalization formula'. On the other hand, the 'conservatives' (Ministry of Finance) wanted to preserve their room of maneuver by continuing with the looser concept of 'equalization criteria'. Even though the latter prevailed at first, the formula-based equalization gained ground and eventually won. Currently a formula is included in the ASBL that uses the collection of PIT in each local government area − a variable beyond the control of LGs − as a proxy for local fiscal capacity.

The fiscal capacity formula

$$E_L = \frac{(OR_C/P_C)/(OR_L/P_L) \times P_L/P_C}{\sum_{L=1} ((OR_C/P_C)/(OR_L/P_L) \times P_L/P_C)} \times E_C$$

E_L = equalization grant per locality
E_C = equalization grant per county
OR_L = own revenues (including PIT shares) per capita – locality
OR_C = own revenues (including PIT shares) per capita – county
P_L = population of locality
P_C = population of county

Tab 2.4. Criteria for horizontal equalization, in time

	Need		Fiscal capacity
1999	Population, length of streets, no. houses, water and sewerage network, children in school, children in orphanages, disabled persons	70%	30%
2000	Population, length of streets, no. houses, water and sewerage network, children in school, children in orphanages	70%	30%
2001	Area of LG, children in school, children in orphanages, disabled persons	30%	70%
2002			100%

The system of horizontal equalization works in two steps:

- First the MoF allocates by county the total pool of funds defined as PIT 'amounts' (box A in Fig.2.5, corresponding to the 2002 budget). The fiscal capacity formula is then applied and the resulted distribution of funds is published as an annex to the State budget Law.

- In the second step, the counties withhold their share of the equalization funds (up to 25% of the sum received) and distribute the rest to localities. This stage of equalization is much more problematic, since not all the counties use the fiscal equalization formula. Actually, few of them do so − and only as a base for starting negotiations with the mayors of localities. Most counties interpret the provisions in the ASBL as mere 'guidelines' and argue that following strictly the formula's results is not workable in practice. MoF has been unable so far to enforce a uniform and transparent equalization mechanism at the sub-county level.

By design, the fiscal capacity formula aims at compensating the counties and localities for both the relative poverty of a region and the adverse effect of the PIT shares stopped at origin. The departures from this policy goal at the county level are only marginal, and due to the differences occurring between the budget projection and execution.

The problem is, the inclusion of own revenues as a fiscal capacity indicator creates disincentives to maximize them at the LG level − the typical substitution effect of own revenues with equalization money. The phenomenon was not apparent in the first years of application of the new mechanism, but as people become more accustomed to it, especially in rural communes, the practice is spreading fast. Since the data introduced in the fiscal capacity formula are the projected own revenues for the following year, the LGs can underestimate them in order to get more equalization funds at the expense of their neighbors. In time, this triggers a 'race to the bottom' among the localities in the same county that only skews the pattern of distribution, while the total pool of funds stays the same. A quick solution is needed here in order to remove the vicious incentives from the system.

Apart from the above, counties get additional equalization funds on a monthly basis, as a direct share of the PIT yield (box 8 in Fig.2.5, defined as 15% of the PIT in 2001 and 16% in 2002). They distribute this money to "communes, towns, cities, and their own budget, after getting expert advice from the territorial MoF offices". This second pool of money is more reliable and predictable than the first, since it depends on the level of PIT collection, not on the central government's wishes. However, the legislator ignored a small detail: to impose a cap on the share that can be withheld by the counties. As a result, predictability only applies to counties; the localities are completely at the mercy of the county councils and presidents, who in some cases have decided to give nothing to localities. Fig.2.9 below reproduces the basic logic of the equalization system in Romania displayed in Fig.2.7 and shows the most important sources of problems in the process of fiscal equalization − in the form of loopholes or 'points of entry' for discretionary decisions.
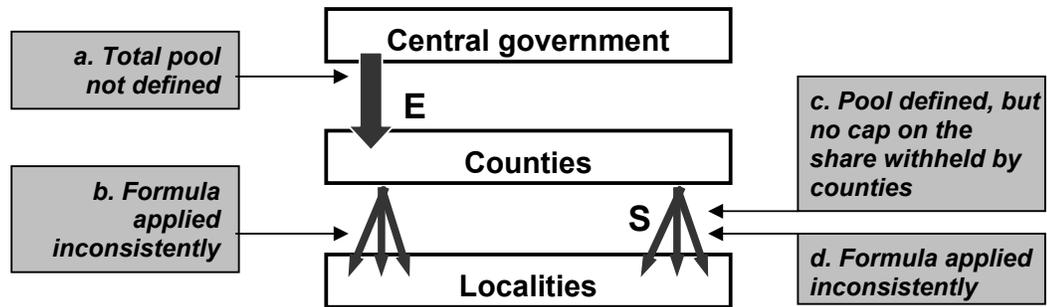
Fig. 2.9. Main sources of problems in the Romanian equalization system

Fig.2.10 below illustrates the wide range of variation in allocating the second PIT share (S) by localities − i.e. the effects of the loopholes described in boxes (c) and (d) on Fig.2.9. The discretion exerted by counties is total: in some cases the localities are given next to nothing (ex. Vrancea county); in others, large cities get a disproportionate share. Rural communes, who are generally most in need, are the most likely to suffer from this erratic distribution. What is more, there is no obvious correlation between the general poverty of counties and a specific pattern of allocation. Which suggest that it is entirely up to the county councils to decide how to distribute.

The current practices governing the relations between counties and localities generate problems for both tiers of local government. Lacking appropriate instruments to pursue their legitimate goals − investments with inter-locality spillover or economies of scale effects, regional development, etc − the counties resort to informal pressures, conditioning of investments allocations, or distorting the equalization mechamisms. The sums are sometimes used to reward political associates, and sometimes as a lever to force localities into thinking broadly and cooperate more with each other. The first goal is illegitimate, the second is legitimate − but in both cases the instrument for pursuing it should not be the equalization grants system.

Rural communes are the most affected by these interventions, since in most cases their financial autonomy is weaker. But all the localities suffer, more or less. Professional multi-annual budgeting becomes impossible when they cannot estimate in advance the size of the equalization grants. Ideally the grants should only depend on the overall size of the equalization pool in one year. The allocation formula is only meant to provide a ranking of localities according to their fiscal capacity. If the evaluation is correct, there will be relatively little changes in this ranking from one year to the other, and so the local officials will know in advance with a high degree of probability where they stand and what will be the level of resources they can rely on. Their incentives will thus be to focus not on permanent lobbying for larger sums, but on prioritizing the spending items.

More specifically, several systemic flaws can be identified as far as the equalization grants rules are concerned.

Fig. 2.10. The way counties have distributed the PIT share for
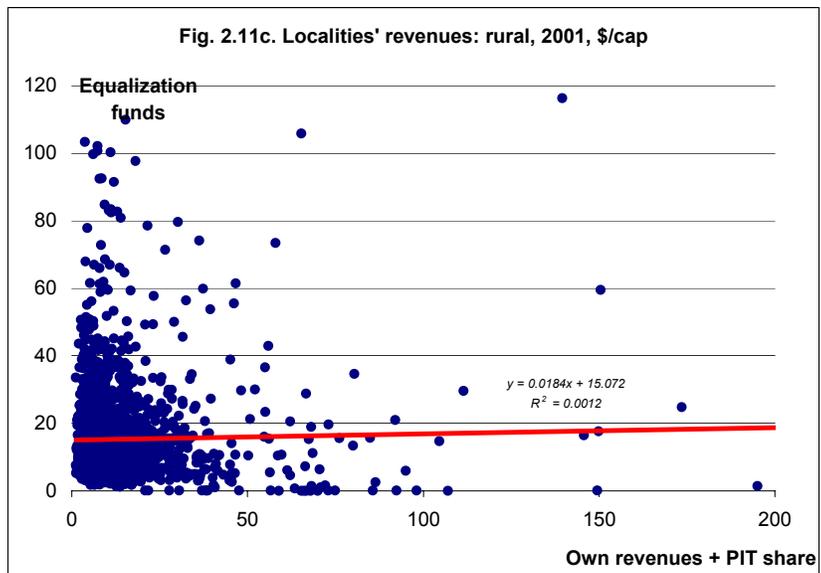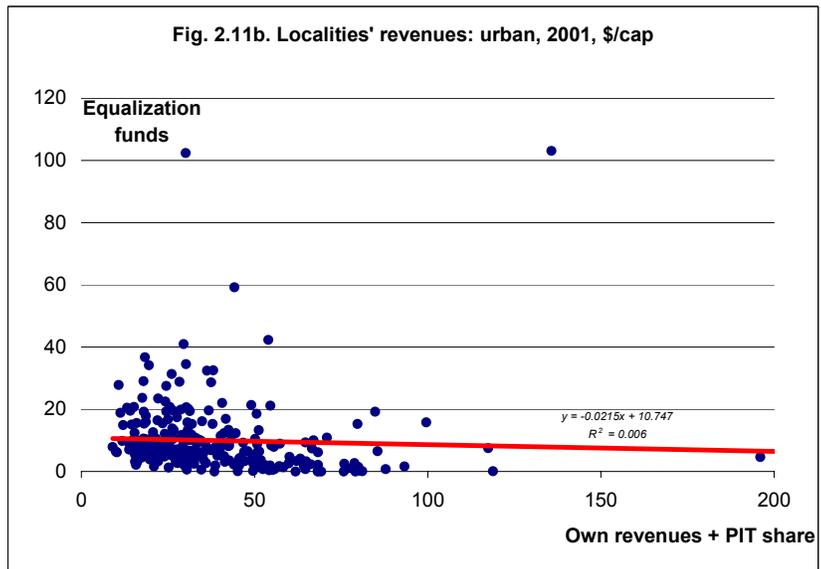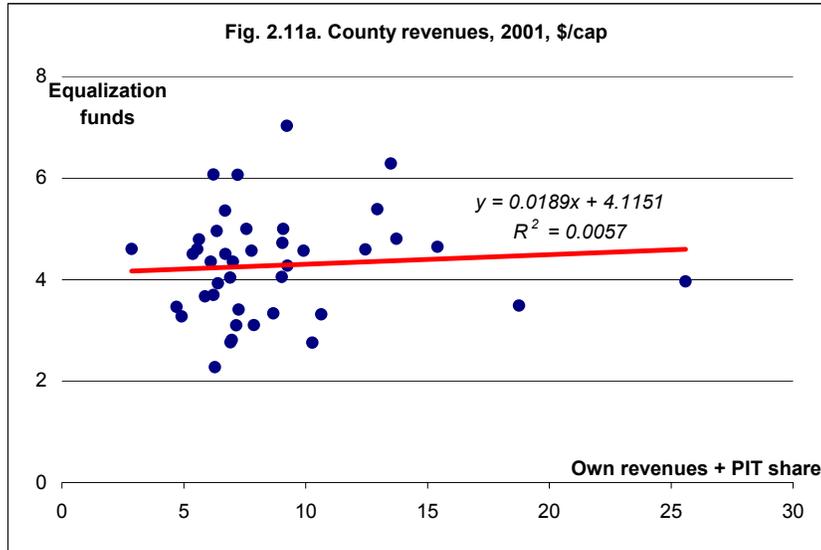equalization, 2000 -- 15% (box 8 in Fig. 5)
- the absolute sums also show the relative wealth of counties -
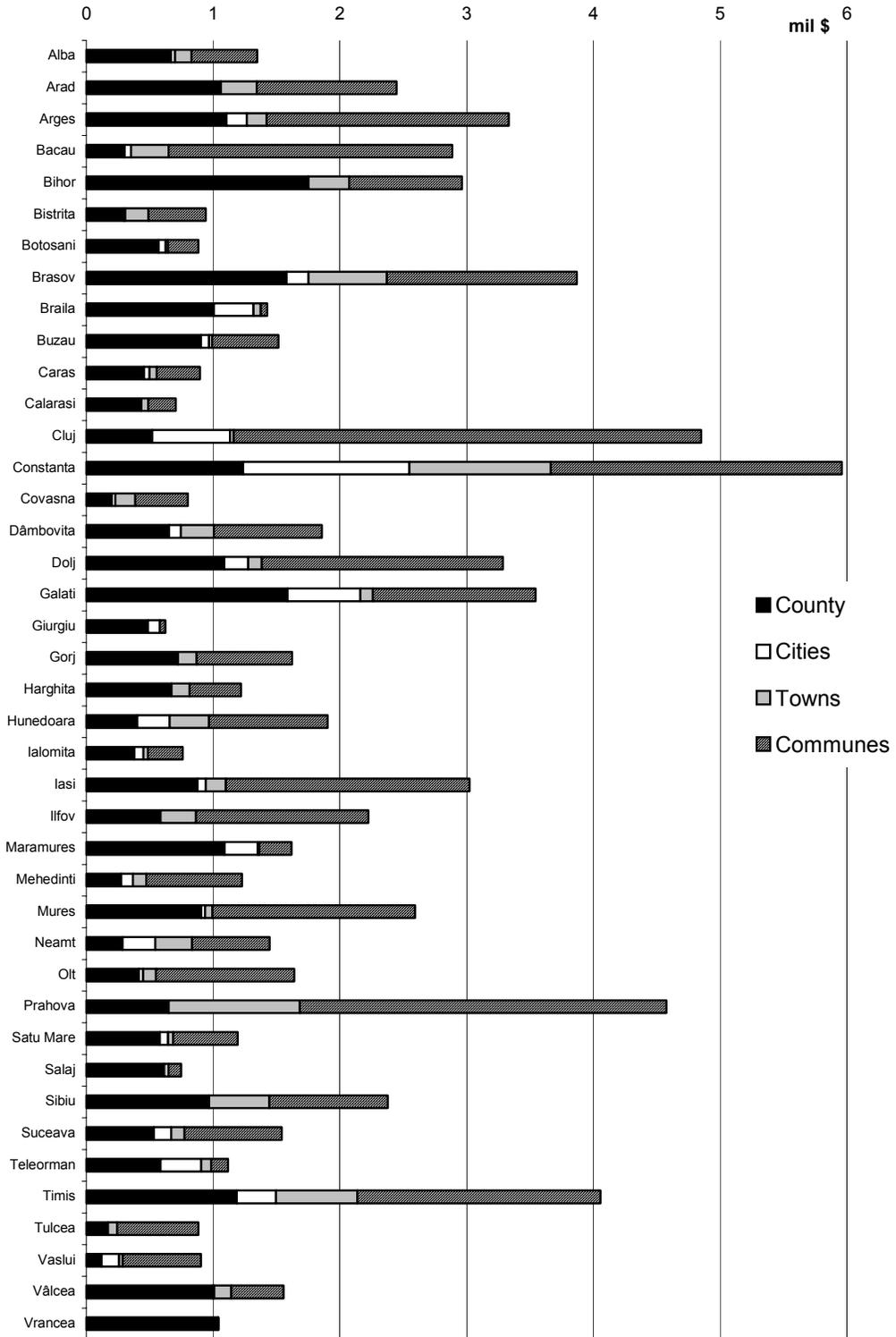
Unfairness. The equalization funds are distributed more or less randomly, both at the locality and county level, as Fig.2.11a-c show. Though in theory these sums should compensate LGs with low capacity to generate own revenues, and hence there should be a clear inverse correlation between fiscal power and grants funds, the legal loopholes allow counties to intervene and bend the rules. First, since there is no limit on the portion of the 16% PIT share the counties can withhold for their own budget (box 8 in Fig.2.5), a wide variation appears in the pattern of distributing these funds (Fig.2.10). Some counties take much more than others, at the expense of the localities in their geographical area − and thus shift funds from the horizontal to the vertical equalization component. The process is not controlled or coordinated, and hence the distribution resulted has nothing to do with equalization: in Fig.2.11a-c there is no relationship between the fiscal power of counties and the per-capita sums received / or withheld / as equalization funds. This creates a serious problem for rural communes, left at the mercy of cash-hungry counties.

Second, the counties do not follow the fiscal capacity formula when distributing equalization funds at the sub-county level. Though the reason usually put forward by county officials is that the formula is too rigid and does not provide enough resources too the poorest localities, Fig.2.11 shows that the current "flexible" practices do not actually improve fairness. The 2,951 Romanian localities are plotted on the charts according to the level of own revenues (proper + PIT share) and the equalization funds per capita they receive. There is very little correlation between the 'need' of localities and what they actually get from the equalization system. The counties' discretion in defining the total pool of equalization funds going to localities, and the rules of allocation by locality, create the combined effect displayed in Fig.2.11a and b: cities and towns get funds almost randomly; while in the rural communities several dozens of them get disproportionately large funds, while many poor LGs do not have money either from own sources or transfers.

These findings are not surprising, nor are they specific to the case of Romania. It has been noted before that there is a systematic asymmetry in the way hard budget constraints are enforced in intergovernmental fiscal relations: larger LGs tend to face "softer" constraints (Wildasin, 1997). This tendency is manifest both at the level of localities and regions. Cities (especially county capitals) often get more than their fair share of the equalization funds (Fig.2.10), sometimes as a result of overspending in the previous years. Counties definitely face softer budgetary constraints, as it was explained above, since they can interfere in the equalization process and adjust at will the portion withheld for their own budget. A good system should counteract this trend that puts smaller and poorer LGs at disadvantage.

Fig. 2.11a. County revenues, 2001, $/cap

Equalization funds

$y = 0.0189x + 4.1151$
$R^2 = 0.0057$

Own revenues + PIT share

Fig. 2.11b. Localities' revenues: urban, 2001, $/cap

Equalization funds

$y = -0.0215x + 10.747$
$R^2 = 0.006$

Own revenues + PIT share

Fig. 2.11c. Localities' revenues: rural, 2001, $/cap

Equalization funds

$y = 0.0184x + 15.072$
$R^2 = 0.0012$

Own revenues + PIT share

Lack of clarity of purpose. This refers to many things: policy objectives of the equalization system; procedures for aggregating financial data; the allocation of investment funds. In theory, LLPF and ASBL define, indirectly, two streams of funds that are meant to (1) alleviate disparities among the three tiers of government (central, county, local), and (2) perform some redistribution among local government units within the same tier of administration. In the words used above, the first objective is vertical equalization; the second is horizontal equalization. In practice, the discretionary power of each county in defining how much of the PIT equalization share (box 8 in Fig.2.5) goes actually to horizontal equalization, and how much is kept in the county budget, muddles the process on both components. The total pools for vertical and horizontal equalization thus become uncontrolled and unpredictable. Together with the inconsistent use of equalization formula mentioned before, this generates an uncertain environment for localities, especially small rural ones, which makes long-term budgetary planning difficult.

The current reporting procedures of financial data is also a problem, because they are not designed so as to allow modern public management in the LGs, and policy analysis at the macro level. A lot of relevant information is lost in the process of aggregating data as they are passed up from LGs to the Ministry of Finance. The accounting system is still cash-based, so that many assets, liabilities and debts are not recorded. There is additional pressure on them not to do so, since the law does not allow LGs to close the budgetary cycle with deficits. More generally, there is no tradition in the Romanian public sector to analyze and report financial data to external users (banks, firms, independent analysts, ultimately the citizens) in the appropriate format and with due diligence. This lack of transparency in the use of funds, even when there is no need to cover something up, turns eventually against the institutions: for example, it would be easier for localities to demonstrate that they are abused by counties if they analyzed and presented the situation of equalization funds like in Fig.2.11.

The way in which LGs and the MoF classify revenues can also hide useful information and skew the redistribution rules: the "Other" category is too large and unspecified, and it may be that both localities and counties divert funds towards it from "Own revenues" line in order to get more equalization funds. The special transfers − price subsidies for heating, special funds for roads, housing, etc − also contains money that are unevenly and opaquely distributed, functioning in fact as a counter-equalizer (Polishchuk, 2001).

6. Conclusions and recommendations

In spite of the shortcomings mentioned in the previous section, the current equalization grants system introduced in 1998-99 represents an improvement when compared with the situation that existed before. The notions of vertical and horizontal equalization were operationalized separately and it is now possible to estimate how much financial effort goes into each of them, and to follow trends in time. A simple and clear allocation formula was eventually reached which is applied consistently in the first step of the equalization process: the distribution of funds from the central government, by county. Even if the formula is not consistently applied in the second

step − from counties to localities − it remains a benchmark against which the process of horizontal equalization can be assessed.

In this context, it is now possible to outline an agenda for improvement. It must fix the flaws in the system that have become apparent so far − but on the other hand take into account the need for flexibility and uncertainties that will continue for a while. The reassignment of functions to LGs is not yet completed and substantial transfers are on the agenda for the next one or two years. The calendar − or indeed costs − of these new transfers of functions are difficult to foresee. Therefore, any attempt to fine-tune and write in stone the intergovernmental fiscal rules are premature. It is likely that any new major reallocation of attributions by the central government will be matched with a slice of funds taken from the national general budget − most likely, from the state's residual share of the PIT or the VAT revenues. Only after several budgetary cycles would have passed with the new arrangements can the policy be stabilized and more automatic transfers set up that will minimize the vertical imbalances and stabilize in the long run the horizontal equalization mechanisms.

The agenda for reform has thus to be organized on several steps and put into the broader policy context.

In the short run, several quick improvements are possible that will address some of the problems identified in the previous section.

a) The total amount of funds distributed as equalization grants should be stabilized, by tying it more clearly to the total PIT yield. Right now only one component is defined in this way: the 16% PIT share (box 8 in Fig.2.5). The other component (PIT "sums" − boxes 3 and 4 in Fig.2.5) is not, though in practice it has been remarkably stable in the last years, at about 10% of the PIT revenues. Since counties can be removed from the process of allocation altogether (c. below), the two parts should be merged into *one single equalization fund, defined as 26% of the PIT*. Thus, no additional financial burden on the state budget will be created, but one fundamental condition will be met for increasing the predictability of the intergovernmental fiscal relations.

b) Vertical and horizontal equalization have to be recognized as legitimate and distinct policy objectives, and hence two pools of funds dedicated to each of them must be created, out of the 26% of the PIT defined above. (This would be equivalent, under the current system, with a cap imposed on the percentage withheld by counties for their own budget from the second source of equalization funds − box 8 in Fig.2.5). The total equalization funds should be split from the beginning of the budgetary cycle into two components: *funds for counties, and funds for localities*. No transfer of money would be allowed between them. This way the vertical equalization will be implemented much more coherently and no tier of government would siphon off funds for its own vertical compensation at the expense of the horizontal equalization in other tiers. Currently the counties keep about ¼ of the PIT "sums" (boxes 3 and 4) and $^2/_5$ of the 16% share (box 8). In order to preserve the stability of expectations and the current degree of vertical balance, the total fund should be split into two according to the average ratio of $^1/_3$: of the 26% of the PIT earmarked for equalization, *8-9% would go to counties and 17-18% to localities*.

c) *Counties can be excluded from the process of allocating equalization funds to localities*. Their role can be very well taken over by an automatic mechanism

under the supervision of the central government. Right now, the counties only make the system unpredictable and permeable to political lobby. They have their own specific functions, such as coordinating regional development or supplying services with economies of scale larger than a local community. But none of these must interfere with the equalization system, which should not become an instrument for forcing localities into compliance with countywide objectives.

d) After the two pools of funds are separated (a. above), the allocation by counties and localities of the two should be done by *following strictly the fiscal capacity formula*, so that all LGs can estimate in advance how much money they get and plan accordingly. Two adjustments need to be done to the fiscal capacity formula currently in use (see section 5.3. above):

- *Own revenues should be excluded from the calculation of fiscal power*, in order to prevent LGs from reducing their revenue-raising effort and get more equalization money in return. Moral hazard will thus be eliminated. As a result, the only proxy for fiscal capacity of LGs remains the automatic share of PIT collected locally (box 6 for localities and 7 for counties), by capita. The exclusion of own revenues would not influence much the ranking of LGs by fiscal capacity, since PIT share by capita and own revenues by capita are two variables closely correlated. But it would remove the possibility of substitution: LGs do not collect the PIT themselves, and thus cannot adjust their behavior so as to maximize the equalization grants received.

- *A cap may be imposed on the per capita equalization sum*, so that the outlayers do not receive disproportionately high amounts. The calculations below are done for a cap of 45 USD/capita, which is about 3 times the average per capita equalization grant in rural LGs.

The logic of this impoved system of equalization is summarized in Fig.2.12, which should be compared with Fig.2.7 and 2.9 above. Its distributional effects are presented in Tab 2.5 below.

Fig.2.12. Proposed system (I), separating vertical and horizontal equalization
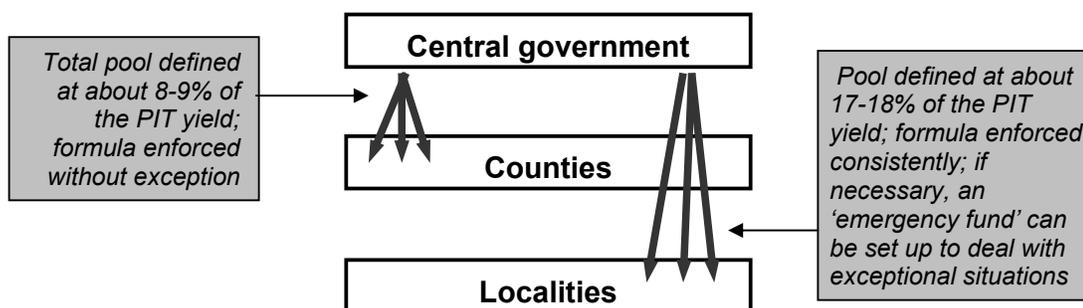
Contrary to the often-expressed opinion that a more automatic, formula-based allocation cannot take care of particular local needs, the analysis shows that the equalization system proposed here (I in Tab 2.5) is both simpler and fairer, at the county and locality levels. Simplicity is crucial, because it reduces the administrative costs of implementation, which is important especially when they are not immediately apparent but spread across many central and local public institutions. It also increases stakeholders' confidence in the system, since everybody can understand how the system works and has little incentives to engage in rent-seeking. On the contrary, if rules are complicated and depend on data that are either unavailable − which is often the case in CEE − or easy to manipulate, the system will be perceived as unfair and unreliable.

Tab 2.5 compares its results with those of the current practices, and with those of an alternative system (II) based on allocating the equalization pool, defined as the same PIT share, not on fiscal capacity but on "need" − measured by the number of population[6]. The proposal I put forward here reduces substantially the variations in allocation, and especially across rural LGs, where the problem is the most serious.

Tab 2.5. Results of applying different equalization systems: total revenues of LGs, USD/cap, 2001

County level		Current	Proposed (I)	Alternative (II)
	Average	17.7	17.7	17.7
	Max	32.5	29.8	32.8
	Min	11.6	13.1	11.6
	Standard deviation / average	0.3	0.22	0.28
Locality level		**Current**	**Proposed (I)**	**Alternative (II)**
Total	*Average*	81.3	81.3	81.3
	Max	782.9	741.7	785
	Min	11.8	24.7	14.6
	Standard deviation / av.	0.44	0.37	0.42
Urban	*Average*	109.3	107	
	Standard deviation / av.	0.43	0.42	
Rural	*Average*	53.2	55.5	
	Standard deviation / av.	0.61	0.47	

More important, the proposed system produce results that are fairer than the current ones, by targeting better the equalizations funds towards LGs that really need them. This is true in the case of counties, towns and municipia and rural communes: in the Annex we present the allocative effects of the current system (Fig.2.13-15a) alongside

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[6] One of the options currently considered in the discussions for amending the Law of Local Public Finances. Its main attraction is simplicity.

those of the proposed system (Fig.2.13-15b). It also increases exponentially the sum per capita transferred as the total revenues per capita before equalization decrease, especially in rural LGs, thus reflecting the economies of scale in providing most local services − general government included.

On the medium and long term, depending on the pace of policy reform in attributions reassignment, there are some elements the government would be well advised to take into consideration.

- It is important that the government resist the temptation to complicate the horizontal equalization system by factoring in various 'normatives' meant to function as a proxy for local needs. Once they start to go down on this road, the proliferation of 'needs' will be unstoppable and the system will become unmanageable (Hungary is sometimes cited as a bad example in this respect). It was noted above that there is a trade-off here between simplicity and transparency on the one hand, and technical refinement on the other. From the experience available so far with the current Romanian system, which is fairly simple and easy to understand, *the biggest problem turns out to be not design, but consistent implementation.* As long as rules are not enforced at the lower levels so that they create stable expectations and the right incentives, the design is practically irrelevant.

- The central government should plan carefully so as to allow some degree of flexibility, without compromising the stability of the predictability of the equalization system. The intergovernmental fiscal relations in Romania concern about 3,000 local units; it is not possible to build it according to a predefined plan down to the last detail. Feedbacks from implementation should be collected and analyzed in order to operate corrections when the need arises. The best way to do this is by creating a joint ***grants commission*** with the participation of central government officials and Parliament staff, for reviewing periodically the equalization policy. When changes are proposed, all the stakeholders should be consulted − primarily the LGs' associations − and sufficient time should be allowed for the local governments to understand them and adjust their behavior. As a rule of thumb, all changes should be decided at least one budgetary cycle before they become effective. The setting up of a grants commission can be useful on the long term, as more services will be reassigned to LGs. The commission would evaluate periodically the best way to finance locally services like education and health care, where reforms are not likely to be finalized soon; study the cases of inter-constituency spillovers from locally provided public services; develop benchmarks; and advise the decision-making bodies on what intergovernmental instruments − capitation, matching or general purpose grants − are most appropriate for a particular type of service.

- As reporting procedures and databases improve, a ***more accurate indicator of true fiscal capacity of LGs*** can be developed to replace the current PIT/capita collected. However, this should remain simple and based on elements that are outside the control of local government officials. All the indicators should be easily measurable and the data put in the public domain.

- In the long run, when all the reassignments are completed, the situation stabilized and LGs accumulate enough experience in managing the new functions, the local autonomy can be formally increased by transforming most of the additional conditional grants (such as PIT shares for welfare support, price subsidies, etc) into **general purpose transfers**, preferably in the form of predefined tax shares. The Hunter coefficient would thus increase (Fig.2.8) and the need for vertical equalization will be reduced accordingly. Their allocation by LGs should not be based on complex normatives, but on simple and available data: for example, funds can be distributed on a per capita basis.

- In a few cases transfers that are currently earmarked would be best kept tied to a specific service. They could be stabilized in the form of a **capitation grants system**, where the money is made conditional on a specific level of performance that must be achieved by local providers. Taking into account the administrative tradition in the region, education (and health care, if it is reassigned to LGs) is a sector where earmarking of funds is likely to continue.

- Competitive grant-giving funds should replace the current discretionary financing of investments (roads, housing, etc) and here counties may play a role in administering some of them with the purpose of promoting countywide policies. More specifically, a matching grant system can be established to encourage investments in those particular projects that generate positive spillovers across jurisdictions. Again, the grants would act as Pigovian subsidies and contribute to the increasing of efficiency in production (Bird, 2000).

- Professional financial reporting and data analysis should be introduced, starting with the relevant MoF units that interact with local governments. Under the current procedures, there is a lot of uncertainty regarding the true financial position of LGs, and as a result the equalization rules can be exploited by those who engage in "creative bookkeeping". Elements of accrual accounting should be introduced and more refined reporting standards imposed, so that budgetary categories like "Other revenues" are reduced in size.

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Fig. 2.5. The sharing of the Personal Income Tax (PIT, shared tax) revenues among tiers of government, 2002

Equalization system: sums (3 + 4) and share (8).
Counties decide the allocation of horizontal equalization funds (boxes 4 and 8); in theory they should use the same formula as the government in allocating PIT by county. Shaded boxes are those where counties can intervene in vertical and horizontal allocation.
The rest of 11.5% of the PIT collected and not allocated to LGs goes to the central government's budget.

```
                        PIT collected centrally
                       100% ($1,290 bn in 2002)
                    _____|_____
                   |                                 |
       (A) PIT amounts ("sume")            (S) PIT shares ("cote")
    transferred on quarterly basis;            monthly transfers
   total pool set by the govnt. in Nat. Budget      62.5%
      (26% in 2002 = $336.1mil)              ($806.3 mil in 2002)
          ____|____                  _____|_____
         |         |                |             |             |
(E) 'Equalization'  5. Producer   6. Localities  7. Counties'  8. Counties, to be
("echilibrare")     subsidy for     36.5%          own        allocated for
total amount        residential                    10%        equalization
specified in        heating                                     16%
Nat Budget          govnt. decides
(21.1% in 2002)     total sum
                    (4.9% in 2002)
  ___|_____
 |      |        |        |
1. Welfare  2. Culture,  3. Own,     4. Equalization
support     religion     counties    proper, to localities
(10% in     (1.35% in   max 25% of E (7.3% in 2002)
2002)       2002)       (2.5% in 2002)
```

Fig. 2.6. The sharing of the VAT (national tax) in the 2002 budget
All sums are earmarked
Total VAT revenues (100%) = $2,746.5 mil

```
                        VAT sums allocated to LGs
                     no formula, amount in Nat Budget
                       ($918.2 mil in 2002 = 33.4%)
    _____|_____
   |            |            |            |            |
Public primary  3. Nurseries 4. County/local 5. Child     6. Protection system
+ secondary     (localities)  agro consultancy protection  persons with handicap
education         0.2%        offices        authority       2%
(29.3%)                       0.15%          (county)
  ___|___                                    1.8%
 |       |                                     |
1. County  2. Locality                    ...of wich - kids
(special    28%                            with handicap
needs)                                       1.5%
1.3%
```

Fig.2.13a. Counties' revenues, current system, 2001, $

$R^2 = 0,0726$

Fig.2.13b. Counties' revenues, proposed system, 2001, $

$y = -0.2548x + 7.7246$
$R^2 = 0.5569$

Fig.2.14a. Localities' revenues: urban, current system, 2001, $

$R^2 = 0,0035$

Total / cap before equalization

Fig.2.14b. Localities' revenues: urban, proposed, $

$R^2 = 0,5546$

Total / cap before equalization

Fig.2.15a. Localities' revenues: rural, current system, 2001, $

Equalization funds / cap

$R^2 = 0,0168$

Total / cap before equalization

Fig.2.15b. Localities' revenues: rural, proposed, $

Equalization funds / cap

$R^2 = 0,3597$

Total / cap before equalization