FISCAL EQUALIZATION SYSTEM IN ROMANIA

Grigore Gheorghe

Universitatea „Constantin Brancoveanu", Facultatea de Finante si Contabilitate, Calea Bascovului nr 2A, Grigore_gh@yahoo.com, Tel. +40(0)721 27 65 93

After 1990s, the countries in transition have been in a process of finding their own path for public sector democratization and construction of a sound public finance management system. This paper aims to provide an overview of the system of fiscal equalization transfers in Romania starting from the first major step of decentralization taken after the fall of the communist period and the subsequent modifications for adapting to the new environmental conditions imposed especially by the European Union perspective. Therefore, in the first section of the paper I will provide a conceptual framework addressing fiscal equalization, in the second part I will approach the intergovernmental transfers and the design of the equalization transfer process while in the third section, I will present an overview of the system and its evolution in the post-communist period and the last section will provide the concluding remarks on fiscal equalization.

Cuvinte cheie : decentralisation, fiscal equalization, intergovernmental transfers

Conceptual framework

After 1990s, the countries in transition have been in a process of finding their own path for public sector democratization and construction of a sound public finance management system and fiscal decentralization is one of major importance in the current context of public policies.

Fiscal equalization is a transfer of fiscal resources across jurisdictions with the aim of offsetting differences in revenue raising capacity or public service cost. Its principal objective is to allow sub-central governments to provide their citizens with similar sets of public services at a similar tax burden. Fiscal equalization can be seen as the natural companion to fiscal decentralization as it aims at correcting potential imbalances resulting from sub-central autonomy. (OECD 2007)

Fiscal equalization is shaped by the wider institutional framework such as size, number and geographical distribution of sub-central governments, the responsibilities and fiscal resources allocated to each jurisdiction, or the mechanics of power sharing between the central and the sub-central level. Those arrangements often form the constitutional backbone of a country and will, if ever, be difficult to change.

The main rationale for fiscal equalization is the presence of unequal economic circumstances, which produce disparities in the capacity of different regions to generate wealth and thus fiscal resources. Policies to reduce these disparities are justified by equity concerns. Specifically, it is assumed that citizens of the same country should have approximately the same access to public services independent of the place where they live.

The central government generally keeps for itself most of the revenue-raising authority and at the same time, it is typical of decentralized systems that sub-national governments are responsible for more expenditures responsibilities than they can finance. The result is that the local governments rarely have, on average, the means to finance a standard basket of local public goods and services by themselves. Equivalently, central government typically has relatively more resources than those needed to provide the public goods and services for which they are responsible.

In this context, it is clear that local governments normally depend, at least to some extent, on centrally raised revenues to balance their budgets; and additionally, it is also clear that different local governments will end up with unequal abilities to cover their expenditure responsibilities. The concept of fiscal disparities provides a useful framework to define and analyze the budget imbalances generated in a decentralized system of government. Fiscal disparity can be defined, for every level of government, as the excess of expenditure needs over fiscal capacity. Moreover, expenditure needs consist in the funding necessary to cover all expenditure responsibilities assigned to the government at a standard level of service provision; and fiscal capacity can be broadly defined as the ability of a government to rise revenues from its own sources, exerting a standard level of fiscal effort, in order to finance a standardized basket of public

goods and services. In general, whenever the fiscal disparity of a unit of government is positive, then it might be said that it has no enough per capita revenues to cover its per capita needs.

The differences in per capita fiscal disparities among units of governments are called fiscal imbalances, and represent the asymmetric conditions under which the government units are financing their respective expenditure responsibilities. There are two types of fiscal imbalances. First, vertical fiscal imbalances refer to the difference in fiscal disparities between the central government and all sub-national governments. Second, horizontal fiscal imbalances refer to the differences in fiscal disparities among governments at the same level. As it can be easily seen, the existence of fiscal imbalances so defined do not arise as a result of the behavior of government units, but rather depend on the mismatch between the assigned expenditure responsibilities and revenue-raising ability of the government units. Moreover, such a mismatch will likely exist even under optimal conditions, and thus a proper measure to reduce it becomes essential to virtually all decentralized system of government.

Of course, it will always be possible to reduce fiscal disparities at the sub-national level by increasing the revenue-raising power of local governments or by decreasing their expenditure responsibilities, but these options could potentially be either inefficient or contrary to the spirit of a decentralized organization of the public sector. In order to address the problem of fiscal imbalances, it is important to recognize that their solution does not require a correction of local government incentives by changing the relative price of public goods and services, nor the imposition of any condition beyond the simple presence of a positive fiscal disparity.

Intergovernmental transfers

Intergovernmental transfers represent the basis for sub-national government financing in most developing and countries in transition. In the process of design and implementation of equalization transfers one has to consider several issues and one has to make sure that the proper equalization is used for a country depending on its specific objectives. All the elements (sub-national expenditures, revenues, transfers) are part of a whole system that should not be disregarded. Even if our main concern refers to equalization grants, it is important to notice that all types of transfers are just a part of the fiscally decentralized system, together with expenditure assignment, revenue assignment and borrowing. Intergovernmental fiscal transfers finance about 60% of sub-national expenditures in developing and transition economies and about a third of such expenditures in OECD countries (Shah : 2006, page 3).

The central government has several types of transfers available, from which a proper combination can be chosen in order to design the transfer program that better suit the objectives of policymakers. For example, intergovernmental transfers can be *conditional* or *unconditional*, depending on whether the purpose of the grant is defined/controlled by the grantor or not. Unconditional or "general purpose" grants are openly defined, and thus the recipient government can use its own discretion to decide how to use the funds. In contrast, when grants are conditional the grantor specifies the destination for which the funds must be used, and so the recipient government has less discretion over the final use of the funds(Grigore:2006, p 147).

Intergovernmental transfers can also be categorized as *lump-sum* versus *matching* grants. Lump-sum transfers are fixed in amount, and can be either conditional or for general purposes. In contrast, the amount of funds received in the form of matching grants varies proportionally with the recipient's expenditures in certain project or function: for any given funds provided by the grantor, the recipient must contribute with certain sum of money to finance the same project or function. Therefore, due to their basic structure, matching grants are essentially conditional. Additionally, matching grants can be *closed-ended* or *open-ended*, depending whether they are limited to a maximum amount or not. Clearly, lump-sum transfers are closed-ended by definition (Velasquez: 2007, pg 14).

The design of a system of equalization grants is a complex and demanding task which requires having clear objectives, transparent procedures and good data. The design of equalization transfers needs to be framed with the rest of the components of the fiscal decentralization.

The design of fiscal transfers is critical to ensuring the efficiency and equity of the local service provision and the fiscal health of sub-national governments. Shah suggests the following guidelines in designing fiscal transfers (Shah: 2006, pg 15):

- *Autonomy*–sub-national governments should have independence, flexibility in setting priorities

- *Revenue adequacy* – sub-national governments should have adequate revenues to discharge designated responsibilities.

- *Responsiveness* - the grant program should be flexible enough to accommodate unforeseen changes in the fiscal situation of the recipients

- *Equity/fairness* - allocated funds should vary directly with fiscal need factors and inversely with the tax capacity of each jurisdiction

- *Predictability* - the grant mechanism should ensure predictability of sub-national governments' shares and the grant formula to have ceilings and floors for yearly fluctuations

- *Transparency* - both the formula and the allocations should be disseminated widely, in order to achieve as broad a consensus as possible on the objectives and operation of the program

- *Efficiency* -the grant design should be neutral with respect to sub-national governments' choices of resource allocation to different sectors or types of activity

- *Simplicity* -grant allocation should be based on objective factors over which individual units have little control. The formula should be easy to understand *Incentive* - the design should provide incentives for sound fiscal management and discourage inefficient practices. Sub-national government deficits should not be covered by transfers

- *Reach* - all grant-financed programs create winners and losers. Consideration must be given to identifying beneficiaries and those who will be adversely affected to determine the overall usefulness and sustainability of the program

Equalization transfers in Romania – an overview

In order to understand the developments in fiscal equalization one has to consider the different political and economic factors which represent the backdrop of ongoing changes in fiscal relations and affect the intensity of reform performance (Slukhai: 2003, pg 14). There have been many negative developments and steps backward and the reforms are far from being completed. The mechanism of equalization are rather unstable – sudden changes take place due to shifting balance of political power between the center and sub-national entities. All post socialist countries use equalization schemes and this is due to the inherited unequal territorial allocation of industries and weak fiscal basis for local government (Slukhai 2003, pg 17)

Briefly looking into the structure of the local governments (LGs) in Romania one can notice that the local administration is organized on two tiers: counties and localities. However, there is no hierarchical relation between localities, counties and central government, each of them being politically legitimate. When decentralization was adopted immediately after 1989, being regarded as a mandatory stage on the "road towards Europe," the historical experience of local self-government was neither rich, nor very useful in the new context. Creating a functional network of local governments turned out to be both a challenge, because of the difficulties since a new system could be built up from scratch in a coherent manner (Slukhai: 2003, pg 18). Therefore, many decisions regarding the process of decentralization were taken by default rather than consciously and the results were below the expectations. However, a change is still in progress. In terms of intergovernmental fiscal relations there are a few streams of legislation that I am going to briefly mention:

- *The Law on Local Public Administration (LLPA)* adopted in 1991 and amended several times until its replacement with the new LLPA in 2001. It defines mainly the structure and attributions of the local governments at the two levels.

- *The Law on Local Public Finance (LLPF)* adopted in 1998 which is the cornerstone of the system of transfers among tiers of government, the shared taxes, the equalization grants and the municipal borrowing issues. In the same time, local governments control over their own revenues increased and the local councils were allowed to administer their own taxes. Moreover, a formula of sharing the PIT among the three tiers of government was introduced which improved the predictability of the intergovernmental finance. A system of grants equalization was introduced reducing in this way the central government's discretion in assigning sums for LGs.

- *The Emergency Ordinance 45/2003* approved by Law 108/2004 on Public Finance provided the basis for the system of intergovernmental transfers, improving the LLPF of 1998, the law that has incorporated for the first time provisions on intergovernmental transfers.
- *The Law 273/2006 on Local Public Finance*, defined the "principles, broad framework and procedures for local public finance generation, administration, commitment and use, as well as the responsibilities of local government authorities and public institutions involved in local public financing" (Article 1). The new law came into effect in 2007 and with it, a substantially revised system of inter-governmental equalization transfers (Articles 32-33 of the new law).

Until the reform from 1997-98, Romania faced a slow process of decentralization. Nations in transition engage in decentralization activities in order to increase the efficiency of the public sector being in line with Oates' theorem of decentralization (Oates 1972), to diminish the costs of public administration, to reduce horizontal disparities. Potential motivations behind this low performance could be: governments faced external pressure for reform implementation from international organizations or EU agencies providing aid – and here comes the proof for the argument made earlier that decisions were made by default, being pushed by external factors; the central government sought to dispose of some spending and therefore transferred responsibilities to lower levels; one should also consider the possible constraints that made the process go slowly: lack of managerial capabilities, fraud opportunities.

The system of fiscal equalization in 1999-2003

However, the major starting point was represented by the law adopted in 1997-98. The Law 189/14.10.1998 brought major changes in the process of decentralization. It established the transfer of responsibilities from the central government to lower tiers and defined the tasks and responsibilities of the local governments: drafting and approving the local budgets in due time, setting, and cashing in and watching the flow of the local taxes, administer efficiently the public goods, efficiently manage the financial resources, setting priorities in public expenditures (Art. 5 of the Law 189). The main revenues come from the local taxes and quotas and sums allocated from the state budget or local budgets having a specific destination. The salary tax remains the main source of revenue – the paying firm has to pay 50% towards the state budget, 40% to the local budget-local territorial administrative institution to which it belongs, and 10% goes to the county's budget. Article 10 of the law refers to fiscal equalization transfers. Different sums are allocated from the state budget towards the lower tiers. Out of the amounts allocated, 25% go to the county's budget and the rest is allocated by the county council to the municipalities, towns and communes according to some criteria pre-established in consultation with the councils from lower levels.

The system of equalization in 2003-2007

The system of intergovernmental transfers in Romania comprises a system of equalization grants (within and across counties) and a system of conditional grants. The main sources of equalization comprise a lump sum amount determined annually at the central level subject to the discretion of the central authorities and a percentage share of the revenues collected from PIT (personal income tax). The pool of funds is determined according to a rule based on pre-established (in the law) revenue sharing rates in the central government personal income tax. For instance, in 2005, the share of PIT revenues retained at the county level for equalization purposes was 22 percent.

The equalization funds determined under the discretion of central authorities are distributed to counties according to a formula with two factors:
- *county fiscal capacity*, which is measured by the inverse of per capita personal income tax collections in the jurisdiction, and given a relative weight of 0.7 in the distribution formula
- *county land area* of the local jurisdiction, has a relative weight of 0.3 in the formula

Of the total amount of funds received for equalization at the county level 25 percent is retained by the county council. The law required the county councils to distribute the other 75 percent of these funds applying a formula with the following components:
- *local fiscal capacity*, which is measured by the inverse of per capita personal income tax collections in the jurisdiction, given a relative weight of 0.3

- *land area* of the local jurisdiction, given a relative weight of 0.3
- *population* of the jurisdiction, given a relative weight of 0.25
- "*other factors*" as determined by the county council, given a weight of 0.15

The current system of equalization transfers

The last Law on Local Public Finance (L 273 / 06), came into force in January 2007, and involved substantial modifications not only to the institutional arrangements in place for the disbursements of equalization transfers, but also to the formula employed in order to distribute the funds across counties and communes.

Article 32 of the Law states that 22 percent of all revenues collected from the income tax will be deposited in "a distinct account opened on behalf of the county general directorates for public finance…for equalization of local budgets." The county general directorates for public finance, the de-concentrated arm of the Ministry of Finance, thus replaces the county councils in the task of implementing the equalization amounts corresponding to every level of government (Velasquez: 2007).

The law's definition in Article 32 of a 22 percent share of PIT revenues for equalization purposes effectively sanctions the increase in transfers conducted in 2005 (from 17 to 22 percent) to offset the expected lower tax revenues from the introduction of a flat rate income tax schedule. The previous distribution formula is maintained at the county level. The funds determined annually in the national budget, are distributed by county on the basis of financial capacity (70 percent) and county surface area (30 percent).

Concluding remarks

The systems of fiscal equalization starting from 1999 onwards are characterized by an increasing complexity, instead of simplifying it more elements and steps are added which undermines the transparency and objectivity of the process. A major concern remains the formula which seems to be far from its ideal shape now being even more complex, a four variable formula. An important issue encountered refers to the interaction between county and locality officials in the process of drafting and allocating the transfer funds. Counties have to wait for the annual state budget law to be passed in order to find out the funds allocated to them and the localities in turn will have to wait for the county councils to conclude the equalization process.

Despite all the shortcomings, the reforms had also some achievements that are worth mentioning. For instance, the formula has improved in the sense that it avoids negative incentives in terms of collecting revenues. Moreover, a cap was imposed in terms of the funds withheld by the county as own budget out of the funds received for equalization purposes. However, the process is far from being complete but the important thing is that a change has emerged. In order to improve the process, I would suggest some considerable changes in terms of formula, allocation of resources, management and control of the financial statements and reporting:

- The formula needs to be simplified – the fiscal capacity should be avoided to be double used
- The flow of funds should be easier in the sense that passing through so many tiers it takes time; probably, a good option would be a direct allocation from the center to the lower tiers
- The lump sums are still established by the central government; probably, a better option would be to increase the share of PIT and make less the lump sums
- In terms of data availability, a software should be acquired in order to gather data from all levels of local governments; this would make easier the process of forecasting and would increase predictability and improve the system on the overall

However, all the changes have to consider the whole environment, including the social, economic and political conditions.

Bibliography

1. Hansjörg Blöchliger, Olaf Merk , Claire Charbit, Lee Mizell - Fiscal equalization in OECD countries -*OECD Network on Fiscal Relations Across Levels of Government* WP(2007)4

2. Ionita S (2003), Halfway there: assessing intergovernmental fiscal equalization in Romania, LGI Studies

3. Shah A - *A Practitioner's Guide to Intergovernmental Fiscal Transfers,* World Bank Policy Research Working Paper 4039, October 2006

4. Slukhai S (2003) Dillemmas and compromises: Fiscal equalization in transition countries, LGI Studies

5. Local Budgets Equalisation policy in Romania, Institute for Public Policy, Bucharest

6. Law 273/2006 and Law 189/2003, Ministry of Economy and Finance of Romania

7. Grigore Gh (2006) *Finante Publice – sinteze*, Ed Paralela 45, Pitesti